Assessing Uzbekistan's Transition

Country Economic Memorandum

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Full Report

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Overview

A. Introduction

Uzbekistan's transition from planning to market started almost 30 years ago following its independence from the Soviet Union. For most of this period, economic modernization and transformation were stalled, with little change in institutions and policies from those prevailing at the time of the planned economy. In late 2016, Uzbekistan surprised by launching reforms with a breadth and speed that at times exceeded the pace of those observed in some of the earlier reformers at a similar stage of the process.

The Uzbek authorities started by focusing on the main vulnerabilities of the economic paradigm that guided development until recently. The state planned and led the distribution of resources and outputs among state-owned enterprises through the government budget, overbearing regulation, and state diktat. Apart from exports of commodities that connected the country with global markets, the economy was closed and inward looking, with no competition, and with minimum dynamism. The government provided rationed basic services to all, without linking budget outlays to results, paying little heed to efficiency, accountability, and productivity. The past development model was dominated by heavy industry, abundant use of natural resources and physical capital, and a neglectful attitude towards the employment and development of human capital. Jobs were scarce. Abundant resources were misallocated. Labor mobility was restricted. In other words, the government was too present in some areas, too little involved in others, but its role throughout the economy lacked adequate effectiveness, efficiency, and support for inclusive and sustained growth.

In late 2016, newly-elected President Mirziyoyev embarked upon an ambitious economic modernization program to reinvigorate economic growth. The government announced a broad market-oriented reform program (Uzbekistan's Development Strategy 2017-2021) which was adopted by a Presidential decree in February 2017 following public consultations. The strategy includes five priority policy areas: (i) improving state and public institutions; (ii) securing the rule of law and reform of the judicial system; (iii) promoting economic development and liberalization; (iv) creating jobs and fostering social development; and (v) ensuring personal and public security through inter-ethnic and religious tolerance and constructive foreign policy. The program also restated the authorities' commitment to macroeconomic stability and to improving the business climate.

In November 2018, building on the results from more than a year of economic reforms, the government announced the agenda for the next phase of its bold and ambitious economic transformation. The Reform Roadmap outlined the government's economic reform priorities for 2019-2021. The roadmap contains five major pillars: (i) maintain macroeconomic stability; (ii) accelerate the market transition; (iii) strengthen social protection and citizen services; (iv) align the government's role with the needs of a market economy; and (v) preserve environmental sustainability. The reform priorities within each pillar draw on lessons learned from the market transitions of other countries but are also firmly based in Uzbekistan's unique context.

Where is Uzbekistan today in its transition from plan to market? In brief, the sequencing of reforms has been very similar to the first reformers in Eastern Europe and East Asia. The authorities proceeded most resolutely with liberalizing prices, providing enterprises with access to

foreign currency, liberalizing external trade, and unifying the exchange rate. They have taken more time with reorganizing the structure of government finances and the revamping the government's role in the economy. Progress with enterprise restructuring, privatization, and introducing a supportive investment framework for new private firms has been substantially slower. Similarly, the restructuring of the financial sector and bank privatization, and the expansion of social protection have also taken much longer. And the shift to a more effective and efficient delivery of education, health, and other social services to help build human capital has progressed least rapidly.

This outcome – its sequencing rather than its pace – is not surprising. Countries in both Eastern Europe and East Asia have had similar experiences. Areas that require more fundamental restructuring and deeper rethinking of the role of the government take longer. What may be different in Uzbekistan is that the speed and breadth of reforms have sometimes been emphasized more than their depth, the clear link to results, and their careful implementation.

In terms of the pace of transition, Uzbekistan's record has been mixed – but appropriate, given that reforms are dependent on experience with markets and prices, initial conditions, and institutional strength. In several comparators such as Estonia, Poland, and Russia, the first year of transition was dedicated to market liberalization, small privatization, the building of essential market institutions (including for financial sector development), and controls on medium/large SOEs to forestall asset stripping. During years 2-3, the authorities further developed market institutions and started medium/large privatization. During year 4, large/medium privatization continued, and best practices of corporate governance were introduced for the remaining SOEs. Based on this timeline, it is clear that Uzbekistan's transition proceeded in line with comparators in terms of market and trade liberalization, small privatization, and the building of essential market institutions. Large/medium privatization of both SOEs and the state-owned commercial banks has barely begun 4 years after the transition and so has the introduction of best practices of corporate governance.

Before the COVID-19 pandemic started, the reform momentum was supported by comfortable external and fiscal buffers and a robust global economy. The buffers are still sizable, even with doubling of public debt since 2017, and a sign of strength but the pull from the global economy has been substantially diminished. The rest of the introduction reviews progress in the key areas of economic transformation.

B. Prices, the Exchange Rate, and Trade

First-generation reforms have been well-advanced. The authorities launched their ambitious economic agenda by liberalizing the exchange rate, the foreign trade regime, a substantial number of domestic prices, and revamping taxation.

Price Liberalization

Liberalizing prices is key for creating markets, reducing budget subsidies, and reinvigorating private sector growth. Prior to the reforms, the authorities applied price controls to most goods and services in the economy. Moreover, a significant number of inputs were acquired by SOEs through non-market, government allocation mechanisms.

In 2017, the authorities adjusted prices for many good and services and subsequently deregulated many others. In this context, the authorities removed regulatory price controls for a list of key products, in particular production inputs and raw materials, such as cotton. They also adopted requirements for a set of products to be transacted through the commodity exchange to develop markets and liberalize prices. Along with the exchange rate liberalization that began in September 2017, this resulted in adjustments in relative prices across the board. Inflation also rose.

In late 2018, the authorities started implementing increases – towards fuller cost recovery – for prices for electricity, natural gas, water and heating. Even with the two major increases so far – in 2018 and 2019 - tariffs for natural gas and electricity tariffs are not yet at the full cost-recovery levels. Domestic gas prices are about 60 percent of cost and about half of the international export price. The average electricity retail tariff similarly does not cover the full cost of service; it is equivalent to about 92 percent of cost-recovery. In 2020, the Government also decided to liberalize the prices of petroleum products through shifting their trade to commodity exchanges, while removing the associated direct government subsidies.

As part of the broader energy sector reform, the Cabinet of Ministers issued a resolution in April 2019 that adopted a new electricity tariff methodology. The resolution also established a separate tariff commission under the Cabinet of Ministers and set out a path for tariffs to be adjusted to full cost recovery levels. Due to the COVID-19 impact on the country's economy and people, the government put its tariff adjustment plans on hold in 2020-2021.

With first-generation reforms to liberalize prices and create markets well-advanced, the emphasis is shifting to creating and strengthening markets for labor, land, and capital. This will require complementary reforms of the business environment, privatization of SOEs and state-owned commercial banks (SOCBs), and ensuring that the principle of competitive neutrality is consistently and fairly implemented.

The Exchange Rate Regime

Exchange rate unification and liberalization was one of the first most important reform steps. On September 5, 2017, the authorities abolished all foreign exchange surrender requirements by companies, eased access to foreign exchange for individuals, devalued the official rate by 50 percent, and unified it with the black market rate. After these initial reforms, the central bank still limited daily som fluctuations to 5 percent. Individuals could only legally buy foreign currency for business or travel. The black market was reduced but it continued to exist.

In August 2019, the authorities lifted all restrictions on individual purchases of foreign currencies and abolished the limits to the som's daily fluctuations. Currently, the authorities operate a managed float arrangement. They are committed to allowing the exchange rate to moving in line with fundamentals and have been limiting their foreign exchange transactions only to offsetting purchases of domestically produced gold and for smoothing exchange market fluctuations.

Trade Liberalization and WTO Accession Negotiations

Uzbekistan's progress in opening up its economy has been remarkable. The government announced unilateral trade liberalization measures through tariff reductions in 2017-2018, reducing average effective tariff rates from 15.3 percent in September 2017 to about 7.5 percent in 2020. These measures lowered most peak tariffs, changed most mixed and compound tariffs to more transparent ad-valorem tariffs, and eliminated most instances of discriminatory excise taxes on certain imports. These measures significantly strengthened trade competitiveness. Simultaneously, the government has enacted other trade liberalization and facilitation measures, including removing export permit requirements for most goods, improving the efficiency of customs procedures, and reducing customs clearance times. The government has also prepared a Comprehensive Legislative Action Plan (LAP) to assess the WTO conformity of domestic trade-related legislation and practices. The LAP serves as a full inventory of WTO-related legislation enacted in Uzbekistan and serves as a roadmap for WTO-related domestic legislative reform.

Substantial progress has been achieved on non-tariff barriers. The main reforms include the unification of the exchange rate the elimination of foreign exchange surrender and advance pre-payment requirements, and the removal of most export inspection processes.

WTO membership negotiations resumed in mid-2020, 15 years after the last formal meeting of the working party on the country's accession. Since mid-2018, when the authorities informed the WTO of their intentions to resume negotiations, the government has prepared a roadmap for WTO accession, revised its negotiation inputs, and initiated multilateral negotiations for WTO accession; the World Bank and other partners helped in the process. In 2019, the government submitted an updated Memorandum on the Foreign Trade Regime (MFTR), a comprehensive description of Uzbekistan's foreign trade regime that is a necessary step to resume accession negotiations. The submission of a revised MFTR enabled discussions to resume between Uzbekistan and the WTO Working Party on accession.

Applying WTO principles, particularly those of the WTO Trade Facilitation Agreement (TFA), will significantly reduce the self-imposed costs, time, and uncertainties in the current trading regulatory framework. In addition to the WTO accession, the accession *process* itself entails rigorous policy and legislative reforms and has emerged as one of the most effective tools for structural transformation and integration into the global economy. For Uzbekistan, it is an opportunity to restructure the economy in accordance with international rules and best practices.

C. Public Finance

Public finance has been the mirror of the state of Uzbekistan's economy. Between independence and the start of the reforms in late 2016, the government's fiscal strategy focused exclusively on maintaining the state-directed, self-sufficient, and externally isolated economy. Since 2017, the fiscal strategy changed – and along with it, the composition and efficiency of spending. The level of spending has increased, as the authorities have brought on budget and onto the Treasury single account substantial parts of the oversized off-budget and quasi-fiscal spending, which are now more transparent and easier to monitor. Outlays have also increased with the COVID-19 pandemic. The tax system has been drastically simplified through reforms that secured revenue neutrality. The consolidation into the budget of the previously extrabudgetary Uzbekistan

Fund for Reconstruction and Development (UFRD) has been the latest reform effort, changing profoundly the way the government is thinking of its support to SOEs.

While progress since 2017 has been substantial, the slow reforms of SOEs and the state-owned commercial banks (SOCBs) have delayed a more fundamental restructuring of fiscal policies and institutions. This is to be contrasted with Poland, for example, where within five years from the start of transition, the authorities advanced rapid transformation of SOEs and the state-owned banks, and broke the problematic connection between the two. In addition to these reforms, several opportunities exist in Uzbekistan to improve tax administration and accounting rules, to reduce high marginal effective tax rates on investment and capital spending by firms, increase the fairness of the system for private sector investors, and further increase fiscal transparency and public accountability. Measures to strengthen debt discipline are welcome but are likely to require stronger measures to harden SOE budget constraints.

Tax Reform

The government has significantly overhauled tax policy since 2017 and has committed to a medium-term improvement framework to strengthen tax administration. The thrust of the reform in 2018-2019 was 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; rationalizing the VAT payments; reducing the number of direct taxes and mandatory payments, and improving tax administration procedures. Despite the lower tax rates, the tax reform significantly improved compliance – as expected – and increased revenues.

In late 2019, additional measures were enacted to further improve the tax system. The authorities ended many tax and customs preferences for companies, which cost about 4-6 percent of GDP a year. Measures were also enacted to expand the VAT to include the agriculture sector, a significant part of the economy that had been previously left out of the VAT changes introduced in 2018.

A new tax code came into force from January 2020. The new code is a significant improvement over the previously burdensome, complex, and regulatorily invasive code that was inherited from the Soviet era. The most important objective of the new code is to modernize and simplify tax policy and processes. The new code also introduces new measures to expand the VAT to include digital services, modernize the transfer pricing, thin capitalization, and controlled foreign company (CFC) regimes.

A major program of tax administrative reform is under way and will be supported by the World Bank and IMF. In addition to institutional reforms, the program includes an overhaul of systems and technological upgrades, the appeals processes, and the audit regime. Several opportunities also exist to further rebalance the tax system to reduce high marginal effective tax rates on investment spending by firms, increase the fairness of the system for private investors, and to further increase fiscal transparency and public accountability.

Government Spending

Uzbekistan's public spending is substantially higher than that of most of its peers. Consolidated government spending amounted to about 35.2 percent of GDP in 2020; it is about seven percentage points of GDP higher than the average for lower middle-income countries.[1] This high level of spending reflects Uzbekistan's state-led economic model.

Spending has increased by about 6 percent of GDP since the start of the reforms – or about a fifth in real terms – mostly during 2017-2019. The increase reflects largely stepped-up capital expenditure on infrastructure, a large expansion of safety nets, and higher health and education sector wages. The COVID-19 crisis led to a large reprioritization of resources in 2020, with a sharp increase in health and social assistance spending largely offset by reduced investment spending.

Significant progress has been made towards consolidating the government's spending footprint. Since 2018, several reforms have been enacted to strengthen fiscal transparency and accountability. Excluding quasi-fiscal activities, the share of budget spending subject to government budgetary regulations and laws is estimated to have increased from 56 percent of total estimated spending in 2016 to 90 percent in 2020.[2] The most important consolidation measures were enacted from the 2020 budget and include the full inclusion of UFRD operations into the consolidated government budget. In 2021, coverage was again expanded to include programs financed with external borrowing. Only two spending areas remain outside the budget: special authorized extrabudgetary funds operated by line ministries that are not connected to the Treasury Single Account; and spending from an estimated 20-30,000 off-budget accounts. Collectively, spending from these two categories amounts to about 3-4 percent of GDP. Quasi-fiscal deficits of the SOEs are also likely to be substantial and are likely to have amounted to 6-7 percent of GDP in 2019.

Structural reforms to reduce the state's economic footprint are likely to restore fiscal balance. Since 2017, the emergence of a structural deficit has largely been due to the increase in public spending from reforms that have had large fiscal costs, such as increased spending on public services and infrastructure, higher wages, and the expansions of safety nets. Accelerating structural reforms that could potentially generate fiscal savings—notably the privatization and reform of state enterprises, and to some extent the reform of agricultural financing—are likely to create additional fiscal space that could be used to reduce the deficit or to finance further public enabling investments to support the economic transformation.

Fiscal Transparency and Public Finance Management

The authorities have made important progress on fiscal transparency. In 2018, the authorities began publishing for the first time detailed quarterly GFS financial reports, information on external debt and guarantees, and the audit conclusion of the previous year budget. All of this information was included on a new "open portal." In 2019, the authorities published the first citizens' budget.

Before the reforms began, Uzbekistan's public sector consisted of at least 2,400 separate units of various legal forms and the central budget included about half of overall public revenues

[1] World Bank Public Expenditure Review (2019)

[2] Prior to 2020, this was expenditure subject to the regulations of the Budget Code and annual Presidential Resolutions relating to the annual budget. From 2020, this is expenditure subject to the revised Budget Code and annual Budget Laws approved by Parliament.

and spending. Over the last several years, there has been substantial progress in simplifying the structure of the public sector and consolidating into the central budget most extra-budgetary funds (EBFs) and off-budget accounts. In 2020, the Uzbekistan Fund for Reconstruction and Development (UFRD) – the most important EBF – was consolidated into the budget.

Uzbekistan's fiscal framework and the process of budget preparation have undergone substantial change. The draft budget ("budget message") was published for the first time in 2018; in earlier years, scant details were made public. Starting with the 2019 budget, the authorities introduced a medium-term budget framework (MTBF) with aggregate fiscal forecasts for a three-year period and discussed fiscal risks. The 2020 budget was the first one adopted as a law by Parliament rather than via a government decree.

Public Investment Management

The public investment management framework has shifted from an annual to a multi-year perspective from 2020 and updated its procedures for project selection. Public investment spending decisions remain highly fragmented. For example, UFRD's investment lending (which is decided outside the budget investment process) accounted for about one-third of total spending on economic activities between 2017 and 2020. Limited regulations and guidance for economic appraisals also allow for most projects to be selected based on non-economic judgements. These decisions and responsibilities for public investments are largely delinked from the regular budget process which oversees current expenditures, and recurrent asset maintenance and replacement costs are not required when costing investment projects.

D. Enterprises, Markets, and Banks

Competition

Recently, the government adopted reforms to support the development of a comprehensive competition policy framework, key to leveling the playing field for all enterprises and encouraging smooth market functioning. Having a strong and independent competition authority is one of the essential factors for implementing this framework. In January 2019, the authorities reorganized the State Committee for Assistance to Privatized Enterprises and Development of Competition into three separate state bodies; one of them was the Anti-Monopoly Committee and the others were the State Assets Management Agency (SAMA) and the Agency for Development of Capital Markets.[3]

Subsequently, in July 2020, a Presidential decree introduced a comprehensive strategy to promote competition. The decree establishes basic competition principles, detailed measures to encourage competition, and specific timelines, while assigning specific authorities (AMC, alone or in coordination with other relevant authorities) to be responsible for implementing a comprehensive competition policy strategy for Uzbekistan. The decree is broad in scope and

[3] Presidential Decree #UP-5630, January 14, 2019 "On Measures for Cardinal Improvement of State Assets, Antimonopoly Regulation, and Capital Markets Management System.

touches on the key constraints affecting the development of competition in Uzbekistan. It also gives special attention to the potential lack of competition in public procurement. Such effort is essential to gradually replacing the government as the leading player of Uzbek markets, introducing competition, and promoting private sector development.

While the first steps in promoting pro-competition policies have been taken, effective competition depends on contestable markets in which enterprises face a level playing field. As a result, effective competition can exist only after the substantial number of SOEs has been reduced and those enterprises that remain in state ownership face similar rules as the private enterprises. The agenda the authorities face is substantial.

State-Owned Enterprises

The presence of SOEs in the economy remains pervasive, as little progress has been achieved in divesting the 2,800 SOEs directly owned by the central government. Uzbekistan's progress on SOE corporatization and privatization has been slow, much slower than at a similar stage of reforms among the advanced reformers in Eastern Europe. Reforms of the state-owned enterprises are key for reducing the huge misallocation of resources, reinvigorating growth, creating jobs, and improving living standards.

In January 2019, a presidential decree set up the State Asset Management Agency, the central government's focal point for SOE ownership, oversight, and privatization. The Agency (SAMA) is now responsible for the portfolio of centrally owned SOEs, and over time it is expected to take over the oversight of sub-nationally owned SOEs.

The state dominance of the Uzbek economy across most sectors creates misallocations of labor and capital, burdens the state budget, limits competition, and constrains private sector development. The 2,800 SOEs owned directly by the central government account for about 18 percent of employment, 20 percent of exports, and their output is equivalent to about 50 percent of GDP. The financial performance of these large enterprises remains mixed. In 2020, four the largest SOEs were among the ten most profitable state enterprises and three of the largest SOEs were among the top ten loss-making ones. In 2020, the President approved an SOE reform action plan that intends to keep 71 strategic enterprises in state ownership, privatize promptly about 600 others, and restructure a further 500 SOEs for subsequent privatization. The remaining SOEs will be merged, transformed into public institutions, or liquidated. The privatization of these 1,100 SOEs is a priority for the government over the next several years. Improving the governance of those enterprises that remain in state ownership is another important priority.

In March 2021, the government approved the SOE Ownership Strategy, and a detailed roadmap for its implementation for 2021-2022. The strategy outlines the government's objectives for SOE reforms and states the agreement to undertake the steps necessary to implement the complex reforms, including: (1) provide a rationale for SOE ownership; (2) establish types and categories of state ownership; (3) segregate regulatory and ownership functions; (4) set out major corporate governance policies; and (5) develop SOE financial accountability mechanisms, as well as transition policies to market-based mechanisms. The SOE Ownership Strategy is a strong foundation for ongoing SOE reforms and will secure the momentum of coordinated implementation by all stakeholders.

The government is committed to reducing the state's share in the economy while keeping a limited number of large SOEs in state ownership. This process needs to be structured with care, strategically implementing the recent mapping of the SOE portfolio to fulfill the government's intent to keep certain entities state-owned for strategic or other reasons; privatize; restructure – including by mergers and consolidations; or close nonviable entities. This analysis and the adoption of the SOE Ownership Strategy are the foundation for "rightsizing" the SOE sector and bringing in private capital. SOEs that will remain in state ownership must be held to the same requirements as private entities, and gradually transitioned to cost recovery and financial sustainability.

Privatization needs to be implemented in a transparent and accountable way. In order to do so, a comprehensive framework is needed. This includes a clear and predictable regulatory framework, institutional mandates that ensure accountability, and measures that will ensure a social safety net for the employees of the SOEs who might be affected by privatization.

In addition to the broad thinking about the SOEs, the authorities have been reforming the network sectors of the country. We take one example, the energy sector.

Energy Sector

Uzbekistan is one of the most energy-intensive countries in the world. With strong economic growth, demand for electricity is expected to continue growing steadily. Renewable energy is a promising source of energy to diversify the energy mix away from its dependency on natural gas, but it is not yet exploited on a large scale, except for hydropower.

The government has initiated ambitious energy sector reforms. These envisage introducing market-based principles in sector management and operations with the support of IFIs, including the World Bank.

Sector oversight functions have been consolidated under the Ministry of Energy (MoE) established in February 2019. Before the MoE's establishment, energy sector entities, such as Uzbekneftegaz (UNG) and Uzbekenergo (UE), reported to multiple deputy prime ministers and ministries and agencies; there was no regulator to oversee gas and electricity operations; and there was no clear delineation of policymaking, regulatory, and operational roles. After its establishment, the MoE has assumed consolidated responsibilities for policy-making and regulatory functions in relation to gas, coal, nuclear power, and electricity, while day-to-day operations are delegated to the sector entities such as UE and UNG.

In March 2019, the government decided to unbundle the vertically integrated electricity company UzbekEnergo into separate functions: generation, transmission, and distribution. The same approach was adopted with the unbundling in June 2019 of Uzbekneftegaz, the vertically integrated natural gas company. These reforms have contributed to the improved allocation of roles and responsibilities in the sector and to the progress of operationalization of newly established entities.

With an explicit focus on increasing private investment in renewable energy generation, a new Renewable Energy Law was adopted in May 2019. It addresses a fundamental institutional gap for renewable energy development in Uzbekistan, enabling greater private sector participation in renewable energy and creating opportunities for climate change mitigation and adaptation. The

Renewable Energy Law also sets out key rights for private renewable energy producers, including guaranteed access to the power grid and dispatch of generated renewable energy. The first 100 MW Solar Photovoltaic (PV) of the Navoi Solar Independent Power Producer has been developed under the World Bank Group Scaling Solar Program and yielded a power purchase agreement tariff of US¢2.67/kWh. Building on this success, the government has entered into agreements with the World Bank Group and other international organizations to support the preparation of additional 1900 MW solar PV, 1,300 MW efficient gas-fired IPPs, and 1,000 MW wind IPPs.

Following the adoption of 2020–30 generation expansion plan in April 2020, the government is currently initiating the transmission and distribution network rehabilitation and expansion plans to 2030. This aims at reducing the high system losses and facilitating grid integration of large-scale renewable energy (solar and wind) and efficient gas fired IPPs.

Energy reform remains one of the highest reform priorities for the government of Uzbekistan. Addressing the inadequate operational and financial performance of the energy SOEs, removing infrastructure bottlenecks, and improving the institutional and market structure—these are some of the key areas of reforms that remain, building on the efforts thus far. In addition, the authorities need to revamp the policy and regulatory framework of the energy sector. Energy reform would address some of the most binding constraints to economic activity and private sector growth. It would also tackle one of the most pressing service delivery complaints of citizens. Financially viable, operationally efficient, and commercially-run energy SOEs would also help the energy sector attract private investment.

The Financial Sector

Historically, the state has been the dominant owner, lender, and borrower in Uzbekistan. The state-owned commercial banks (SOCBs)—13 out of the total 32 commercial banks—still account for almost 90 percent of outstanding credit. Until recently, the principal activity of SOCBs was to lend to SOEs in priority sectors of the economy at heavily discounted rates. Directed lending was a main pillar of the system: largely from the UFRD to SOCBs, which in turn lent to SOEs. Corporate governance and risk management in the banking sector has been weak. Boards of state banks are dominated by public officials who do not have operational independence and have limited banking sector expertise. Improving corporate governance has rightly been prioritized by the government as a first critical step toward improving the stability and operational effectiveness of the banking system.

The authorities began the reform process by modernizing the institutional and legal frameworks for banking and gradually strengthening prudential supervision. In November 2019, Parliament approved new banking and central bank laws to provide a robust legal basis for developing a modern bank regulatory and supervisory framework and strengthen CBU's mandate and autonomy. The authorities also adopted a law on payment systems and FX controls. Since then, the authorities have focused on implementing requirements to operationalize the new laws, including further improvements to the CBU's regulatory and supervisory framework, strengthening the government's ownership and shareholder oversight of state banks, as well as reducing market-distorting policy lending.

The government has begun correcting market distortions in the banking sector. In November 2019, the government introduced measures to limit all state-directed lending below the central

bank's reference rate starting on January 1, 2020. The resolution also fully liberalized lending rates starting from January 1, 2021 and restricted government interventions using explicit, on-budget interest-rate subsidies. All directed lending programs for low income households, small producers, and supporting entrepreneurship have been concentrated in three SOBs intended to remain in the public domain in the foreseeable future.

The government also made a key policy decision to clean up the SOCBs' balance sheet ahead of their transformation and privatization. In December 2019, the government transferred from the SOCBs to the balance sheet of the UFRD almost all UFRD-funded loans to large SOEs, and prohibited future directed on-lending by SOCBs to SOEs using UFRD funds. This action has significantly improved the capital positions of SOCBs, decreased exposure to foreign currency risk, and will help advance the banking sector reform and eventual privatization of most SOCBs.

In May 2020, the government adopted a financial sector reform strategy. The goal, among other things, is to significantly reduce the number of state banks through a transparent and competitive privatization process and to modernize corporate governance and transparency of banks in state ownership. The strategy outlines an implementation roadmap to prepare at least 6 out of 13 state banks for privatization between 2021-2025.

The authorities are currently preparing national financial inclusion strategy (NFIS) and revising the law on non-bank credit organizations. The NFIS will set the stage for taking structured and prioritized actions in the next five years to achieve better access to finance and quality of financial services for all individuals and MSMEs.

Uzbekistan has embarked on vital reforms of its banking sector, the dominant part of its financial system. International experience indicates that Uzbekistan needs to continue strengthening its institutions to help mitigate the systemic vulnerabilities generated by the rapid deepening of credit markets since economic liberalization started several years ago. Weak corporate governance and capacity gaps faced by the banking supervisor are the key areas for reforms. As reforms advance, the banking sector can soon become an important driver of private sector investment, productivity, and inclusive growth. Without these reforms, the country could see systemic risk accumulation reaching the point when a banking crisis becomes unavoidable.

Agriculture

Despite favorable resource endowments, Uzbekistan's agriculture is characterized by significant distortions that lead to low productivity. Agriculture is the largest economic sector, accounting for about a third of GDP, a quarter of the workforce, and the largest share of new jobs until 2016. Since the early 1990s, farmers have operated under a centrally planned state production system that sets out targets for cotton and wheat. More than 70 percent of arable land was administratively allocated for state-controlled production of cotton and wheat, commodities that generate lower profits, labor intensity, and labor productivity than most horticulture products suitable for production in Uzbekistan. Cotton and wheat consume 90 percent of water in agriculture and 75 percent of water used in the entire country.

Starting with incremental reductions in cotton and wheat growing areas, a big wave of reforms in 2018 removed almost all export restrictions on horticulture products and liberalized bread prices. Further reductions in cotton and wheat growing areas were enacted,

along with the slow easing of land restrictions, and almost all areas assigned for cotton production were linked to private textile companies that facilitate raw cotton production and process cotton into higher value products such as yarn and textiles. In 2019, wheat and cotton farm-gate prices, set by the state, converged with market prices, and Uzbekistan is close to its target of ending exports of raw cotton in favor of processed exports.

In March 2020, the government abrogated the state cotton order system. This system previously required all cotton produced in the country to be surrendered to the state, and for all cotton growing areas to meet (stringent) annual production targets. With historically severe penalties (including the loss of land ownership) levied against farmers who missed the target, the policy was widely viewed by observers as a binding constraint to ending forced and child labor in the cotton sector. The targets were also viewed as contributing significantly agricultural practices that were environmentally suboptimal and discouraged adaptation to climate risks. With the end of mandatory state procurement, farmers will have increased freedoms to determine, based on market conditions and availability of technologies, how and how much cotton to grow. They will also have increased post-harvest freedoms in determining cost-optimal harvest strategies, the most common of which being the non-harvesting of residual cotton after the main harvest.

Uzbekistan's agricultural reforms carried out since 2017 have been impressive. Many reforms have changed Uzbekistan's agri-food sector. Yet, this is only the beginning of the transformation, as Uzbekistan is catching up with long-overdue reforms to transition from a planned to a market economy. The initial reforms have shown good results, including the increase in agricultural growth and agri-food exports. But compared with, for example, Vietnam, Uzbekistan has just begun its export-oriented journey. A hectare of cropland in Vietnam generates $3,650 of exports, while in Uzbekistan it is only $760.[4] The list of the needed reforms is still long, due to inaction in the past, while some reforms initiated during 2017–20 still need to be effectively implemented to deliver results and avoid policy reversals. Prioritization is informed by Uzbekistan's Strategy for Agricultural Development 2020–2030. The COVID-19 pandemic has added urgency to the need to modernize agriculture and ensure more resilient, inclusive, and sustainable growth.

E. Delivery of Public Services

Protecting the Vulnerable

Strengthening social protection (SP) has been at the core of the reforms in Uzbekistan since the beginning of the transition. Progress since 2017 has included improvements in social assistance, labor market programs, social insurance, and social care services. In 2020, Uzbekistan started developing the National Social Protection Strategy to bring cohesion to the fragmented social protection sector, with an adoption expected by December 2021. Nonetheless, up to one-third of the poor are not included in any social protection scheme. An additional test of the system will occur when the authorities begin restructuring and privatizing the SOEs and SOCBs.

To improve the efficiency and effectiveness of social safety nets for low-income families, the government has started implementing a Single Registry of Social Protection. The registry was piloted in July 2019 and the nationwide rollout started in September 2020. Currently,

[4] World Bank staff estimates based on World Development Indicators data.

all the applications of the three low-income family allowances are being processed through the registry. Improving targeting will allow the government to increase the number of poor and vulnerable households supported by social benefits, thereby generating potential adaptation co-benefits, while reducing the number of non-poor families receiving benefits. As a result, the registry is expected to increase both the absolute number and share of poor households assisted by family allowances and the proportion of cash allowances received by the poorest 40 percent of the population.

The implementation of the single social registry is a critical, but first, step in the process of modernizing Uzbekistan's social safety nets. Ongoing engagement with the World Bank, other development partners, and the government is intended to complement the establishment of the registry by implementing improved targeting, increasing the equity and efficiency of family allowances by consolidating benefits into a single means-tested benefit; and expanding the scope and functionalities of the registry to include other social and employment benefits.

As the state withdraws from the economy and as resource reallocations create adjustment cost, the emphasis of policy is shifting. The authorities are working on strengthening the employment insurance system, addressing weak policies/incentives in social care system, and expanding maternity care. In addition, they are working to reduce the fragmentation of labor market policies (LMP), strengthening the links between LMP and social allowance systems, and addressing data and measurement issues.

Health

Health reforms are at an initial stage and progress has been much slower than in the advanced Eastern European reformers at a similar stage of transition. This is understandable, as health care reforms require substantial planning, additional resources, and a thorough restructuring of existing institutions and policies. As a result, a more deliberate approach is justified.

As Uzbekistan strives to transition its health system towards universal access and high-quality, patient-centered care at a reasonable cost, a few critical factors will shape the outcomes of the reform efforts and their impact on the population's health outcomes. A 2018 Presidential Decree set the vision for the national health reform agenda and identified several key reform areas - health financing, integrated care, and quality of care. On health financing, the government committed to broadly doubling health spending as a share of overall government expenditures to 15 percent by 2025. Such increases, however, need to be tied to the achievement of specific results.

On integrated care, the government has preserved and strengthened its vast network of health facilities; no restructuring has been initiated yet. In terms of improving the quality of care, the government efforts have been directed at improving the capacity of the Ministry of Health and strengthening the quality of the health workforce. In the coming years, the government aims to further expand reform initiatives nationwide by scaling reform pilots in health financing and integrated care to the entire country.

Education

Uzbekistan's economic growth has not translated into job creation. According to Uzbekistan's Human Capital Index, a child born in the country today will be only 62 percent as productive when she grows up as she could be if she enjoyed complete education and full health. As a result of revamped education policies, learning outcomes were improving somewhat before the pandemic. Significant learning loss has occurred because of the COVID-19, requiring serious efforts not just to improve the quality of education during the process of transition, but also to recover from the hit of the pandemic.

Education reforms are ongoing at all levels of education. The most relevant reforms are in preschool and higher education. In the former, the government has announced an ambitious plan to expand services provision with the aim of achieving 100 percent enrollment for children ages 6-7 by 2022. With this goal, the government established the Ministry of Preschool Education in September 2017 to lead the expansion of preschool education in the country. Since then, enrollment increased from 30 percent to more 40 percent. In the latter, the reforms aim at increasing the very low enrolment rate of 10 percent. The highest returns to education are observed in this level.

In general secondary education, the main reform is the expansion of schooling from 9 to 11 years starting with the 2018/19 academic year. Students in grades 10 and 11 are receiving dedicated vocational training to ensure that they gain exposure to practical training and skills. However, students can still choose to attend academic lyceums instead of GSE schools for grades 10 and 11, with the caveat that the study program for academic lyceums has been condensed to two years. Starting with the 2019/20 academic year, graduates of grade 11 can choose to continue their studies in vocational colleges or apply to a university.

F. The Path Forward: Summary of Recommendations

The authorities embarked on an ambitious reform agenda in 2016, transforming the economy, society, and the government. The extensive reforms have delivered results while raising expectations for further progress. Impressively, the reform momentum has not slowed during the times of the COVID-19 pandemic, even as the authorities implemented a sizable package to support lives and livelihoods. The next stage of market and institutional reforms the authorities are advancing aims to allow for more efficient resource allocation - of labor, capital, land, and other natural resources. The reform agenda is grounded in credible macroeconomic policies that built cushions against domestic and external shocks and support vulnerable households during the economic transformation.

The lessons from the other transition countries suggest that a substantial, broad reform agenda remains on the path to a market economy. Some of the key elements of the path forward are summarized below; for details, consult the individual chapters and spotlights.

Fiscal Policy and Public Financial Management

1. Improve the efficiency of public expenditures by strengthening the public investment management framework and establishing a unified pipeline of public investment projects

subject to common assessment, selection, and implementation criteria based on good economic principles, alignment to government policy priorities, and value for money criteria.

2. Continue to consolidate off-budget and quasi-fiscal activities into a single budget framework. Unify budget, financial, statistical, performance reporting in a single chart of accounts in line with the international standards.
3. Consider reducing or even eliminating trade taxes to accelerate Uzbekistan's outward economic orientation and conformity with global trade agreements.
4. Review the business tax regime to reduce high marginal effective tax rates that are likely constraining domestic and foreign direct private sector investment.
5. Implement new debt legislation and expand fiscal risk management to cover contingent liabilities.
6. Develop and implement a medium-term budget framework.
7. Introduce a system of recording and effective management of financial assets and liabilities. Adopt country public sector accounting standards based on IPSAS.
8. Improve the public debt management system.
9. Strengthen the parliamentary and public oversight of the budgetary process, including SOE debt.
10. Carry out a functional and business process review of the MOF to improve its efficiency, analytical capacity, and business processes.
11. Strengthen financial discipline by implementing an effective internal control and internal audit framework in the public sector in line with international standards and good practices.
12. Bring the Chamber of Accounts in alignment with international standards (ISSAI).

Private Sector Development, Competition, And State-Owned Enterprises

13. Advance privatization in a transparent and an accountable way on the basis of a modernized institutional and legal framework. Be explicit and transparent about the privatization program and its implementation.
14. Assess the social impact of privatization and put in place the needed social safety nets.
15. Disclose the quasi-fiscal activities of SOEs in the budget and in SOE financial statements.
16. Harden SOE budget constraints. Replace quasi-fiscal budgetary support with explicit subsidies and plan for their reduction and ultimate elimination.
17. Gradually reduce directed lending to SOEs.
18. Boost competition to put both SOEs and private companies on a level playing field.
19. Strengthen the corporate governance of all SOEs that will remain in government ownership. Gradually reduce the number of civil servants on SOE boards and bring on board independent members.

20. Follow up on current plans for SOEs to adopt the IFRS. Ensure that SOEs are audited under the ISA.
21. Ensure regular (at least annual) and timely reporting by SOEs. Ensure that SAMA effectively undertakes the function of conducting centralized monitoring, analysis, and oversight over SOE performance. Streamline regulations that may push firms to remain small.
22. Creating conditions that help firms formalize is important, but not at the cost of thwarting private sector activity; it is better to have informal private firms than no private firms.

The Energy Sector

23. Sequence and prioritize energy reforms in the following priority areas: (i) advancing energy sector decarbonization; (ii) energy market development; (iii) private sector participation; (iv) subsidy reform and sector financial sustainability; (v) sector operational efficiency; (vi) developing the energy efficiency market; and (vi) institutional and capacity development.
24. Prepare and adopt an Energy Sector Decarbonization Strategy and Implementation Plan.
25. Advance energy sector cost recovery while protecting the poor.
26. Implement a program on loss reduction and improving the sector operational efficiency.
27. Enact the Electricity Law. Begin the transition to a competitive wholesale electricity market.
28. Improve the policy, regulatory, and legal framework to upscale energy efficiency, including through establishing and operationalizing sustainable financing mechanisms.

The Financial Sector

29. Advancing with pro-competition reforms in the banking sector is crucial for streamlining access to finance, a key driver of private sector development.
30. The SOCB state-owned commercial banks must be freed from political interference in their lending. All other directed lending needs to be properly registered under the "directed lending portfolio" and reported in the SOCBs financial statements.
31. The MoF must clearly define the developmental mandates of the SOCBs that will remain in public ownership, and establish transparency and accountability mechanisms for the provision of "public services" by SOCBs and the associated fiscal costs.
32. The CBU needs to improve its oversight of the commercial banks by conducting thematic reviews of credit quality, and facilitate banks strengthening their corporate governance, internal controls, risk management, and underwriting standards.
33. Several products could be developed, with the help of authorities, to strengthen the resilience of credit intermediation. For example, the framework for loan syndication, including with foreign bank participation, could be improved. Developing the hedging market could help mitigate exposures to foreign currency risk.

Social Protection

34. Ensure there is an adequate institutional arrangement for the SP system by developing the national SP strategy, setting up a unified management structure with a clear and codified accountability and coordination, and set up an effective monitoring and evaluation system
35. Ensure that all extreme poor are covered with effective social assistance.
36. Develop an adaptive SP system to ensure it is responsive to new shocks and is forward-looking. This can be accomplished by developing and linking the Social Protection Strategy, the Employment Strategy, and the Poverty Reduction strategy.
37. Implement the Single Registry and improving the service delivery capacity in SP. Link the single registry and the labor market information.

Health

38. A shift toward an integrated, holistic healthcare delivery system should be expedited. A service delivery redesign that drives integration among and within the levels of care, prioritizes cost-effective care, and strives toward patient-centeredness is at the core of the national reform vision.
39. In quality of care, the government should prioritize the implementation of critical pillars of a national quality improvement system. Over the short and medium term, Uzbekistan should prioritize establishing a continuous quality care data collection and reporting system, strengthening local expertise in quality care analysis and governance, and reforming medical education and CPD.
40. In health financing, increased health spending may be justified provided there is the necessary fiscal space and that higher spending delivers better outcomes more efficiently.

Education

41. Improve the qualifications of teachers and ensuring alignment between the different levels of education in teacher preparation and professional development.
42. Improve the school management and modernize the learning environment and orienting the education processes toward strategic skills and outcomes.
43. Improve the governance and financing of education, including by proper autonomy to schools, vocational education providers, and higher education institutions within an accountability framework to improve cost-effectiveness and labor market relevance.
44. Expand the potential of the education system through better links with the private sector and innovations using public-private; (ii) improving the credibility and recognition of selected national education institutions as hubs for excellence and incubators for ideas and discovery; (iii) strengthening the role of education in support of the national vision on; and (iv) strengthening partnerships between national and international well-recognized institutions to exchange ideas and students, conduct joint research, and open the national programs to the world.

Chapter 1. Prices and Markets

Uzbekistan's transformation from a planned economy has been remarkable. Before 2017, few prices were left to the market; at present, few are left to the government to determine. Markets were largely absent, and prices did not provide signals to producers, consumers, and the government. Several years later, many markets have emerged and, along with rapidly progressing integration with the regional and global economy, are helping reduce the substantial misallocations of resources in Uzbekistan. As the post-COVID-19 recovery picks up, promoting the efficient functioning of new markets should be a priority and it needs to remain at the center of the government's agenda to allow for a more efficient and competitive economy to take hold.

Much like in Central Europe in the early 1990s, Uzbekistan's transition began with a reform of the exchange rate and the liberalization of regulated prices. The authorities devalued the Som in late 2017, liberalizing the exchange rate and unifying the official and unofficial rates. Price liberalization of goods and services was also initiated in late 2017 and, at least until the onset of the COVID-19 pandemic, advanced at a sustained pace with important results being achieved across the economy, and notably in agriculture and energy. The process was nonetheless slower than observed in countries like Estonia and Poland where near complete price liberalization was achieved within three years from the start of the transition process. In particular, the price of a number of transportation services and intermediate goods in the agri-food sectors remain regulated. Responding to rising inflation pressure, in 2017 the authorities started a reform of the CBU's mandate. The new mandate was centered around aggregate price stability, initiating a gradual move towards an inflation targeting regime.

Factor markets retain substantial frictions and reforms in this area have been slow. The credit market remains highly segmented with a high (but decreasing) difference between market and preferential rates. First steps to create a market for non-agricultural land have been taken in recent months, but the country still lacks a market for agricultural land. High frictions remain in the labor market, with restrictions on labor movement reduced but very much still a factor in labor movement across the country. These distortions have major consequences on the allocative efficiency of productive factors and underscore the need for additional reforms in these areas.

A. Liberalizing Prices and Creating Markets

In 2017, the authorities launched an ambitious reform program aimed at radically changing the Uzbek economy, with a focus on liberalizing prices and creating new markets. The first measures targeting regulated prices and administered tariffs were adopted in 2017 to gradually ease income constrains for farmers and reduce losses in the provision of public utilities. On March 30, 2018, the government announced a list of 21 socially significant and strategic goods and services that would, at least initially, remain under a regime of price regulation and two additional goods were added to the list in December 2018. The prices of several of these items have since been liberalized. Deeper reforms followed in the subsequent months, aimed at freeing up space for private enterprises and create new markets that could be efficiently served by private firms. More interventions are underway and plans for additional major reforms are currently being drafted.

Since 2017 and until the onset of the current pandemic, the process of price liberalization in Uzbekistan was sustained but was slower than what was observed in the early 1990s in countries like Estonia and Poland. Starting from a situation of nearly total price control, three years into its transition, Estonia had liberalized nearly all regulated prices. Similarly, as of end 1991, two years after its transition began, Poland maintained some form of price control only in the transport and energy sector. The speed of the reforms adopted in these countries is in part explained by their initial conditions, which left no alternative but to reform their economies quickly and radically. Uzbekistan's price liberalization agenda has so far been relatively more gradual and in this sense closer to the one of Vietnam.

The magnitude of the ongoing price liberalization program represents an opportunity for the country and a challenge for the government. The authorities will need to ensure that the right conditions are in place for this liberalization effort to result in a sustained and inclusive development process. To achieve this goal, the liberalization agenda is part of a broader strategy that supports low income households in their transition to the new system.

Consumer Goods and Services

As part of its liberalization plan, the government relaxed price regulations and adjusted administered tariffs on several consumer goods and services, but more measures are required to achieve an efficient determination of prices for many of these items. The prices of some agricultural goods were among the first to be deregulated. Oil and petroleum products were also liberalized in 2020, but the price of coal remains regulated. Since 2017, the authorities implemented important adjustments to the tariffs for public utilities and are now planning a major reform of energy markets, but current prices remain below full cost recovery. The prices of several other services remain regulated and competition limited or inexistent, especially in the provision of transportation and delivery services.

As part of a broader effort to reform the agricultural and food sector and improve farmers living conditions, the retail prices of several food and agricultural items have been liberalized over the last years. In one of the first measures that the government took at the onset of the liberalization program, the price of social bread was liberalized. Aware of the regressive risk associated to this action, the authorities accompanied this measure with a series of targeted subsidies aimed at offsetting its negative effect on poor households. Similar measures were implemented for the prices of high grade (September 2018) and first grade flour (October 2019) and for the price of cotton oil (March 2019).

The distribution and transmission of electricity and natural gas in Uzbekistan have long been managed by two SOEs, Uzbekenergo and Uzbekneftegaz. Until recently, the strictly regulated tariffs for electricity and gas were too low to recover the costs of operation, resulting in chronic operational losses for the two state companies and a high level of subsidization form the state budget. As recently as 2019, the magnitude of energy subsidies in Uzbekistan was imposing. IEA data shows that total energy subsidies (implicit and explicit) amounted to 7.4 percent of GDP, with an average subsidization rate of 54 percent. While this policy kept prices for final consumers low, the implicit subsidy resulting from this system was not targeted to low income households, disproportionately favoring those with higher income and higher energy consumption.

In 2017, the government launched a reform of these sectors, starting with an increase in tariffs and a reorganization of its direct presence in the transmission and distribution services. After a first increase in July 2017 in both electricity and natural gas tariffs, between April 2018 and August 2019 the authorities implemented a series of tariffs adjustments that lead to a 44 percent increase in the residential price of electricity and a 54 percent increase in the price of gas (Table 2.1). These increases resulted in a reduction of operational losses for the two state-owned utility companies with the level of cost-recovery in the distribution of electricity going from 70 percent in April 2018 to an estimated 92 percent in August 2019. Nonetheless, implicit energy subsidies remain high. The authorities are currently preparing additional measures to reduce losses in energy production and transmission (for more detail, see the spotlight on Energy).

The government increased tariff for cold water delivery services, a sector that has historically suffered from chronical distribution losses and financial fragility. After a series of tariffs increases implemented over the recent years, in April 2019 Resolution #310 from Cabinet of Ministers adopted a new tariff framework based on a close link between cost of delivery and level of services on the one end and tariffs on the other. A simultaneous increase in tariffs was implemented to reduce the gap to full cost-recovery, with an increase of 23.5 percent and 16.3 percent for households with centralized and non-centralized supply, respectively.

The provision of transport and delivery services remains a highly regulated sector with limited competition. The authorities have adopted a first set of measures to stimulate competition and more are being considered. In the aviation sector, the national carrier NAK has been reorganized into three companies managing the airline, airports, and air navigation services separately. Similar reforms have been adopted in non-air transport sectors and restructuring of the state-owned rail monopoly, Uzbekistan Temir Yullari, is expected after the end of the COVID-19 crisis. Plans are also being drafted to foster competition in the airline industry by attracting more carriers. Tariffs for postal and courier services have seen recent increases of 44 percent in July 2019 and 18 percent in February 2020 and are being considered for deregulation. Finally, tariffs for urban and rail passenger transport continue to be regulated with a revision of the latter expected to take place after the end of the Covid-19 pandemic.

Of the remaining consumer goods and services listed in Declaration #310 of the Cabinet of Ministers, several remain under state regulation. These items range from broadcasting services to solid waste removals. For some of these, such as international data transfers, deregulation is being consider or is underway.

While price liberalization is essential to create markets and promote business development, they an have major distributional implications. This is notably the case when they involve basic goods and services that represent a high share of poor and low-income households' consumption. It is therefore critical that the government adopt the necessary measures to ensure that the gains from its reform program are shared with the poorest and most exposed households. The authorities have so far recognized this concern. It is important that they maintain this approach, devising measures to protect the most vulnerable as the reform agenda is further developed and ensure that its positive effects are shared among the population.

Industrial Goods and Services

Since 2017, the government has taken important measures to liberalize the prices of intermediate inputs and reform energy markets. In 2018 the authorities initiated a liberalization of the intermediate market for agricultural goods, which is expected to continue in the coming years. The intermediate oil market was reformed in 2020 and since 2017 tariffs for gas and electricity have been gradually raised, with a major reform of intermediate energy markets currently being drafted. Non-residential energy tariffs remain nonetheless below full cost recovery and the prices of several business-to-business services are still regulated.

In recent years the government has launched a reform of the food industry, which has historically operated under a strict regime of centrally determined prices and direct state intervention. This system imposed clear restrictions in the market for agricultural inputs. The reform was initiate in 2018 with a liberalization of the prices for some agricultural inputs. The authorities first implemented measures to improve farmers' income and living conditions. In 2018 they adopted a 60 percent increase in the procurement price of wheat. They also increased the administered price of cotton from 1700 to 3200 Soms per kilo and the wholesale price of 1st grade flour from 650 to 1400 Soms per kilo. This represented the first increase in the wholesale price of 1st grade flour since September 2014. In March 2019 the authorities abrogated the state cotton system removing mandatory production targets and mandatory state procurement.

These early interventions on administered prices were followed by broader liberalization. Between March and October 2019 the authorities removed the state price regulation of cottonseed oil, husks and meal of cotton seeds and by the deregulation of the price of grains and wholesale 1st grade flour.[1] Full liberalization of farm-gate wheat prices and the end of the state wheat order is happening, and a deregulation of the prices of mineral fertilizers used in agriculture is under way.

As part of the undergoing reform in the oil sector, measures were adopted to reform the market for refined petroleum. Starting from May 1, 2020, petroleum refineries have been able to sell refined oil directly on the commodity exchange at market prices. Effective from the same date, the regulated intra-industry price for oil condensate, a by-product of natural gas extraction used in the production of heavy oil, is required to be benchmarked to the global commodity exchange price of Brent oil.

In line with the changes operated in the residential market, the government adjusted non-residential energy tariffs and launched a liberalization of the electricity and gas sectors. Electricity tariffs for non-residential consumers were first increased by 12 percent in April 2018, followed by a 45 percent increase in November 2018 and by an additional 36 percent in August 2019 (for more details, please see the Spotlight on Energy).

In 2019, the authorities took further measures that paved the way to the creation of an intermediate electricity and a gas market. In March the state-owned electricity company Uzbekenergo was unbundled into three entities, separately managing the generation, transmission, and distribution of electricity. Similar measures were implemented in July in the gas sector, resulting in the unbundling of the state-owned gas company Uzbekneftegaz. In October 2020, the

[1] The measure kept a 1,300,000 Soms per ton cap on the price of wheat sold to flour producers.

government detailed its plans to move by 2024 from the current single buyer model to a competitive electricity market under independent oversight. The authorities are also working on a similar transition in the gas sector with the objective of developing a competitive intermediate gas market. The authorities expect to complete the transition in 2024. Under the new systems the supply from producers and the demand from distributors would meet in newly created energy hubs, and distributors would compete in the retail gas and electricity markets under an independent oversight.

The price of some business-to-business services remain regulated. The fees for the delivery of two strictly business-to-business services defined as "socially significant or strategic" in the Resolution 249 of the Cabinet of Ministers remain regulated, with no current plan for liberalization. These are defined as "Exchange services (transactions, bidding, and so on) of the JSC Uzbek Commodity and Raw Materials Exchange" and "Cash collection services, their transportation and other valuables between banks".

Developing efficient intermediate and business-to-business markets is an important step to provide businesses with a timely access to production inputs and promote an efficient allocation of resources in the economy. As prices and administered tariffs for intermediate inputs adjusts, changes in production costs are likely to be passed through to consumer prices, requiring once again a careful assessment of the distributional consequences of these reforms and of possible redistributive measures to offset their unintended effects.

Markets and Competition

The goal of the government's market reform agenda is to ensure an efficient determination of prices and an efficient allocation of resource in the economy. In this sense, while liberalizing prices is an important step in this direction, it needs to be accompanied by creating a competitive environment. Liberalizing prices in a market that is dominated by a monopolistic firm would do little to improve the allocative efficiency in the economy and would most likely result in a transfer from the consumers to the monopolist renters.[2]

Achieving an efficient allocation of resources calls for the design of measures guaranteeing effective market competition and preventing the formation of monopolies. Such policies, which should include adequate anti-monopoly regulations and supervision, should ideally be in place when price liberalizations and privatizations of SOEs are implemented. Firms in dominant market positions are still widespread. Government data indicate that 101 firms occupy a dominant position in product and financial markets and 137 firms are identified as natural monopolists (for more details, please see Chapter 4).

In implementing its privatization plans, the government should pay close attention to the competitive environment that such privatizations would generate. The authorities should consider breaking up SOEs before selling them to separate private owners and ensure that effective competition regulations and supervision is in place. Tight budget rules for SOEs and the elimination of targeted subsidies to SOEs competing with private firms would also prevent them

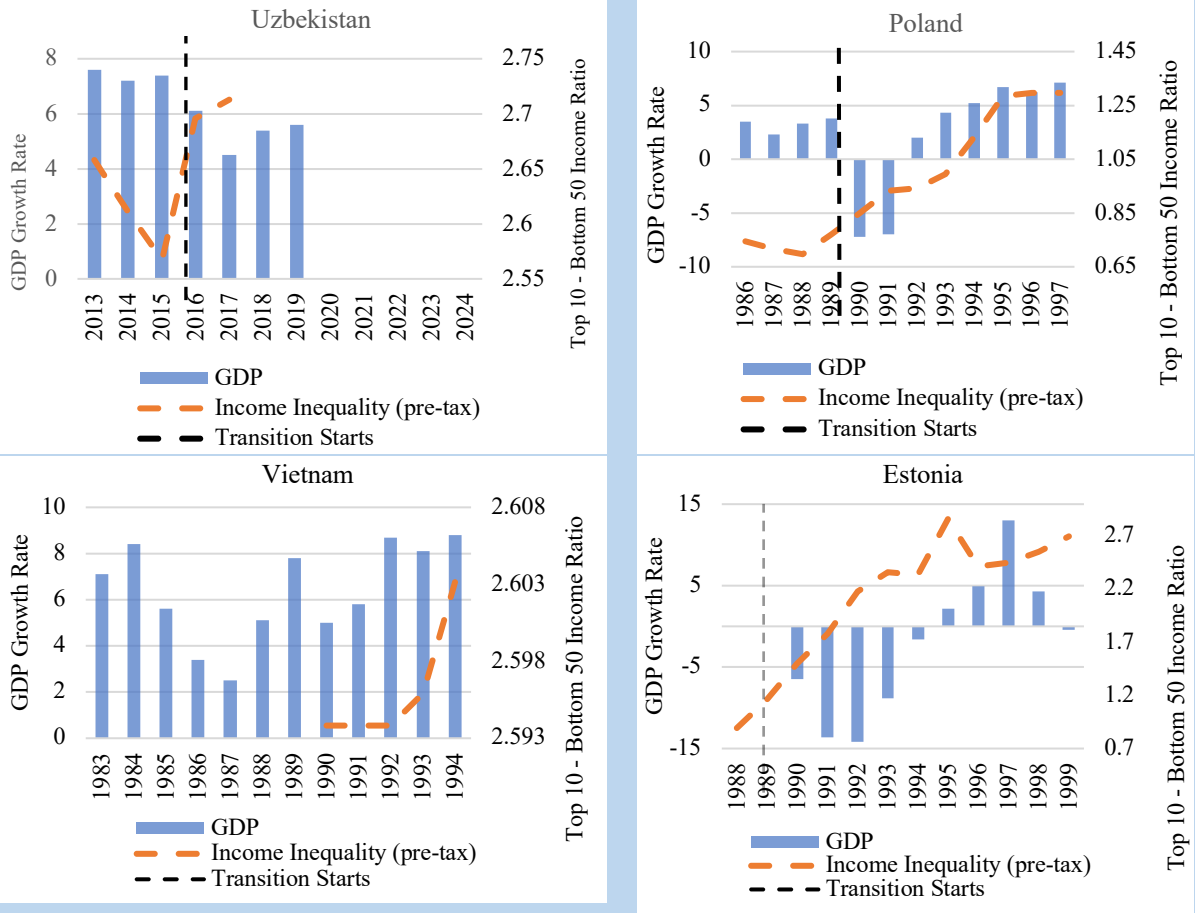
[2] The same is true for input markets dominated by monopsonistic firms.

from driving other firms out of the market and (re)gain a dominant position (for more details, please see Chapter 7).

Box 1.1: Comparisons: Early Transition, Price Liberalization and Privatization

The **experience of other transition economies shows that the early transition process can entail substantial adjustment costs, which tend to strongly affect the most vulnerable part of the population.** At the onset of the Covid-19 pandemic Uzbekistan was in a favorable position to pursue a comprehensive reform agenda, while containing its social costs. The current crisis represents a challenge for this transition and calls for appropriate measures to mitigate its damage and ensure the inclusiveness of the ongoing reform program.

At **the onset of their transition process most formerly centralized countries experienced a sharp slowdown in economic growth** as value chains were disrupted, SOEs were dismantled, and new private firms were slow to emerge. The initial disruption in economic activity was accompanied by an increase in fiscal deficit as former revenue sources were cut and the new tax system was slowly established. In the early years of transition several countries financed their fiscal deficit by printing money, fueling an inflationary pressure on aggregate prices (IMF (2014)).



Sources: IMF, WID. Vertical lines are commonly assumed starting dates for the country's transition.

Not all countries recovered quickly from these initial shocks. Some, like Yugoslavia, Russia and Moldova experienced only moderate recoveries as their transition process was slowed down by political turmoil and was captured by vested interests. Most countries that took a drastic and sustained approach, like Poland and the Baltic countries, payed high initial costs but experienced a quick recovery. Countries like Vietnam, where initial conditions favored a more gradual approach experienced early slowdowns but were able to contain the magnitude of the initial shock.

This early disruption in the economy came at high social costs. In most counties, unemployment rose sharply as guaranteed employment and jobs in SOEs were lost and private job creation lagged. Low-income

households were usually hit the hardest and the initial benefits from privatization and liberalization tended to be concentrated among a small share of the population (World Bank, 2002). As a result, poverty rates increased and so did inequality. Income inequality kept rising in the years following the transition while poverty rates slowly decreased as growth gained momentum and social safety nets were developed.

While **the transition processes in former centrally planned economies have common characteristics, countries facing different initial conditions often followed alternative approaches.** With the dissolution of the soviet system the economies of Central European countries started to collapse, making a China-style gradual transition either unfeasible or undesirable and pushing them to adopt more drastic approaches. These countries usually implemented ambitious liberalization and privatization plans early in their transition. Other countries, like Vietnam, adopted a more gradual approach to transition.

Poland

Poland swiftly enacted a comprehensive price liberalization in the first two years of its reform process. A contemporaneous privatization program was implemented. As of 1989, the prices of goods and services that accounted for around 80 percent of the Polish GDP were under some form of price controls. By 1991, price control was removed on nearly all items leaving controls only on transport and energy. Small firms in the retail and service sector were quickly privatized, mostly by transferring ownership of the commercial real estate to existing employees, a practice that allowed for a rapid privatization process but at the same time limited its competitiveness. By 1992 the vast majority of small SOEs were privatized. The privatization of bigger firms in the manufacturing, extractive and banking sectors on the other hand was slower than anticipated and the privatization program began to slow-down in the mid-90s (Kozarzewski, 2006). By the end of 1996, 58 percent of the 8441 medium and large SOEs that were active at the end of 1990 had been privatized.

Vietnam

Vietnam followed a more gradual approach, with a transition spanning over a longer period. The late 1980s was nonetheless a time of intense reforms in the Vietnamize economy. The process was kickstarted in the late 1986 and a first wave of reforms took place in 1987-88, which included the introduction of a new investment law and some partial liberalization of prices and wages. The centralized system of price and output control was then dismantled between 1988 and 1989 and as of 1992 no pervasive system of subsidies and price control was in place (Dodsworth et al. (1996)). In the following years the government continued its effort to gradually open and reform the economy with a focus on attracting FDI, but SOEs continued to have an important role in the economy.

Uzbekistan

At the onset of the Covid-19 pandemic, Uzbekistan was in a favorable position compared to where these countries stood at a similar stage in their transition. As the fall of the Soviet Union unfolded Estonia and Poland had to a large extent no choice but to drastically reform their already collapsing economies and three years into their transition they were only beginning to recover from this initial shock. Vietnam recovered more quickly from a milder initial slowdown, but three years into its transition the country still lacked a comprehensive transition plan in many areas of its economy. Relative to Estonia and Poland, Uzbekistan experienced a milder initial decline in growth. These more favorable conditions leave Uzbekistan with the option to adopt a more gradual, albeit sustained, approach to transition, focusing on the efficiency and inclusiveness of its reform program. With many major reforms still lying ahead, a preemptive study of their synergies and a careful selection of their timing can thus lead to substantial benefits in both the short and long term.

The ongoing Covid-19 pandemic poses an additional challenge to the transition process in Uzbekistan. Faced with the social cost of the current crisis, the government might consider postponing those planned reforms that are likely to entail substantial short-term costs. The current situation should not however undermine the commitment to the overall reform agenda or risk exposing the transition to the influence of vested interests.

The government should take stock of the lessons learnt from countries that were least successful in their transition process. Their experience in fact highlights the concrete risk that the first beneficiaries of the liberalization program might exert their power to derail the reform process, opposing redistributive and pro-competitive measures. The authorities should act swiftly to set up the necessary institutional framework to contain this risk.

B. THE EXCHANGE RATE

Since 2017, the authorities have undertaken major reforms aimed at liberalizing the exchange rate and easing currency controls. In September 2017 they sharply devalued the som, reunifying the official and black-market exchange rate, and have since reduced their foreign exchange (FX) market interventions to allow for a more flexible and market-based determination of the exchange rate. These have been important steps to ensure that Uzbekistan benefits from the shock absorbing role of a flexible exchange rate and to guarantee a favorable environment for the development of its exporting sector. The authorities should implement additional reforms to improve the efficiency of the FX market and enhance the responsiveness of the exchange rate to changes in the economy's fundamentals.

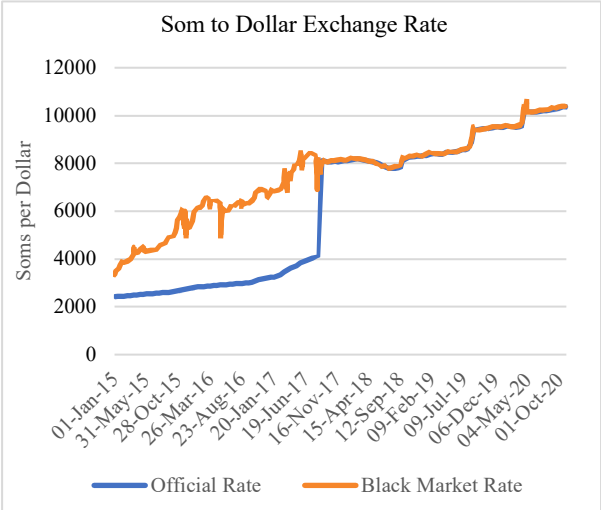
Prior to September 2017, the Central Bank of Uzbekistan (CBU) administratively set the official exchange rate with foreign currencies. Foreign currency transactions were also tightly regulated. The system resulted in a dual exchange rate regime where the official rate coexisted with the widely used unofficial black-market rate. Differences between the official and unofficial rates were high, alimenting distortions in the economy, with an official rate substantially overappreciated, and a large black market for foreign currencies.

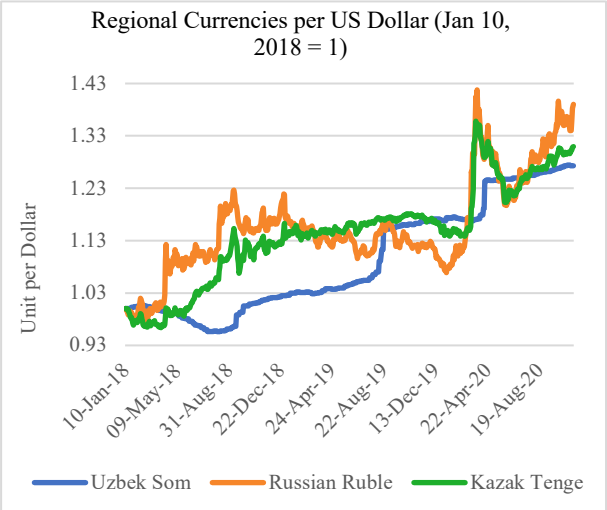
A presidential decree issued on September 2, 2017 opened the way to the liberalization of the official exchange rate and the end of the dual system. On September 5, the authorities devaluated the nominal exchange rate by nearly 50 percent and unified it with the black-market rate (left panel in Figure 1.1). The CBU let the exchange rate to be *de jure* determined by market forces, officially intervening to offset daily fluctuations exceeding a 5 percent limit.

With a parallel effort, and in contrast to an initial tightening of currency controls adopted in July 2016, the authorities started to relax the restrictions on foreign currency transactions. Foreign exchange surrender requirements, mandating that exporters sell any foreign currency obtained in exchange for their exports, were lifted on September 5, 2017 and access to foreign exchange for individuals was eased. Following these regulatory changes, legal entities, individual entrepreneurs, and farmers could purchase unlimited foreign currency for use in their activities.

As part of a gradual move in CBU's mandate from exchange rate control to inflation targeting, in August 2019 the authorities took further measures to liberalize the exchange rate. The 5 percent daily limit to the som's fluctuations that triggered a CBU intervention was abolished and the CBU has since committed to abstain from influencing the fundamental trend of the exchange rate. Its foreign exchange interventions are now limited to the sole purpose of offsetting purchases of domestic gold and smooth excessive exchange market fluctuations.

Figure 1.1: The exchange rate

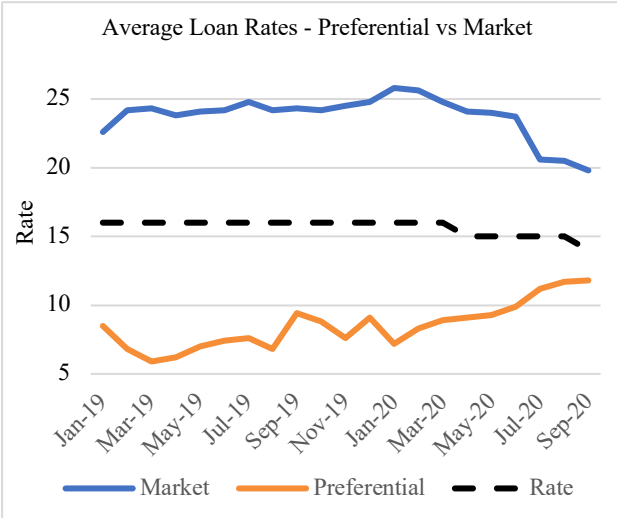


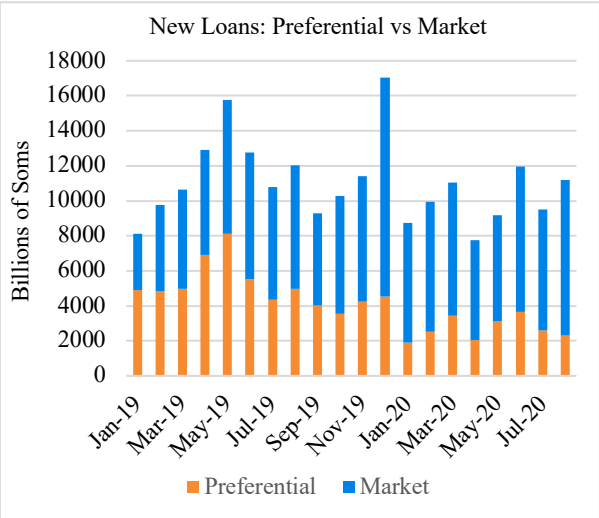


Sources: Country authorities.

Figure 1.2: Lending rates, 2019-2020

(In percent)





Sources: CBU.

While the authorities have made remarkable progress in liberalizing the exchange rate, there remains ample room for improving the efficiency of the FX market. Since September 2017, the exchange rate of the som to the US dollar rate has remained stable except for three sharp jumps in September 2018, August 2019, and April 2020 (left panel in Figure 1.1). Second, FX data show limited weekly volatility in the som to US dollar exchange rate relative to that of other currencies in the region (right panel in Figure 1.1). Since January 2018, the dispersion in the weekly percent increase in the Som to dollar exchange rate has been 62 percent and 49 percent lower than the equivalent statistics computed on the Russian Ruble and Kazak Tenge to US dollar exchange rate, respectively.

The limited volatility in the exchange rate could be the symptom of underlying rigidities in the FX market. These rigidities may limit the shock absorbing role of the *de facto* floating exchange regime, something that the authorities should take into consideration. On January 9, 2021 the Board of the CBU took a first step to enhance the fluidity of the internal FX market, partially reforming its procedure for intervening in the domestic FX market and increasing the frequency at which it publishes the official exchange rate from weekly to daily. In order to further improve FX market fluidity, the authorities should make sure that CBU interventions are transparent and publicly announced and, in line with IMF recent guidelines, they should ensure that CBU interventions to sterilize liquidity from purchases of gold are more regular and predictable.[3]

C. Factor Markets

Since 2016, factor markets have benefited from some reforms, but high levels of frictions remain, with potentially large consequences on the allocative efficiency of productive factors. The credit market remains highly segmented with a high (but decreasing) difference between market and preferential rates. First steps to create a market for non-agricultural land have been taken in recent months, but the market for agricultural land remains inexistent. High frictions remain in the labor market, alimenting labor misallocation and slowing down job creation.

Credit and Interest Rate

The credit market in Uzbekistan has historically been very segmented and market rate loans have coexisted with a large share of credits granted at preferential terms. At the end of 2018 the average interest rate on preferential loans, which represented about half of newly granted loans in the years before 2019, was as low as one third of the market rate. Differences in the terms of market and preferential credits, which are mostly used to finance SOEs, persists and more remains to be done to develop a competitive banking sector.

The government has adopted a series of measures to rein in the spread of new preferential loans. In November 2019 the authorities moved all preferential policy lending duties from state-owned banks to the Fund for Reconstruction and Development (FRD), a state administered investment fund, and restricted government intervention to the use of explicit on budget interest rates subsidies. In January 2020 the government increased the lower bound for preferential interest rates to the CBU refinancing rate, a measure that has contributed to the recent increase in the average interest rate on outstanding preferential loans in the economy (left panel in Figure 1.2). As a result, the total share of outstanding loans granted at preferential terms decreased from 77 percent at the end of 2018 to 52 percent at the end of August 2020 (right panel in Figure 1.2).

While the government has been working to reduce credit market segmentation, more remain to be done to develop a competitive banking sector. Recognizing this need, in May 2020 the authorities adopted an ambitious reform plan for the 2020-25 period, which includes a reduction in state-ownership in the banking sector and the adoption of international reporting standards. The

[3] See IMF (2020).

plan will also require new preferential loans to be issued at rates at least equal to the market rate starting from January 1, 2021.

Land Prices and Rents

Until recently, there existed no private ownership of land, and therefore no market for land, in Uzbekistan. On Aug 13, 2019 the government approved a legal framework for the privatization of non-agricultural land (Law No. ZRU-522), which represented a first step towards the creation of a land market. Under the new law, citizens and legal entities that reside in Uzbekistan are given the right to privatize non-agricultural land either via direct buyout from individuals and entities owning permanent use rights or via auction from the state. The law entered into force on March 1, 2020 after a preliminary legal experiment was carried out in the Syrdarya region. All agricultural land remains under state ownership and can be exploited only under a lease or if in possession of a land use right. There is therefore no agricultural land market, and thus no agricultural land price, and there is no rental market.

In recent years, the government has adopted measures to improve the country's real property and cadaster system. Ensuring the existence of an efficient cadaster is an important step for the development of a real property market that to these days remains very limited. A reorganization of the Cadaster Agency and the current COVID-19 pandemic have slowed down the adoption of the new system, which remains to be completed.

Wages and Labor Market

The authorities have in recent years taken some measures to mitigate some of the most critical issues affecting the labor market, but a lot remain to be done to ensure its proper functioning. While additional reforms are currently being discussed, the labor market remains subject to strong frictions that are likely to limit its ability to efficiently match jobs and workers, decreasing labor productivity and slowing down the creation of new jobs. More efforts are also needed to improve the working conditions of the Uzbek working population, especially in the agricultural sector.

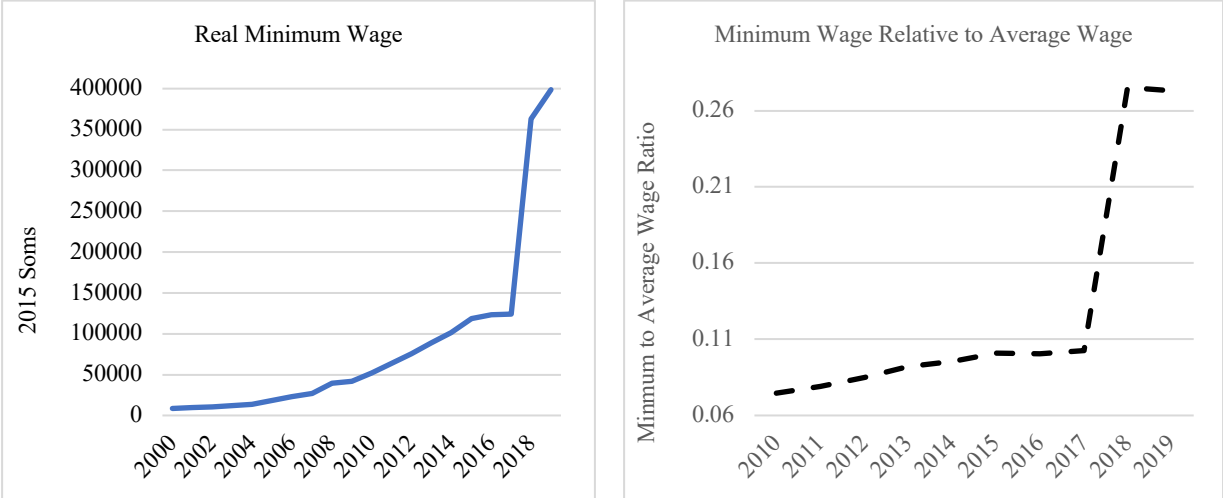
Insufficient job creation and low supply of high skilled workers are chronic features of the Uzbek labor market. These problems are compounded by high spatial frictions, aggravated until recently by the residence and migration permit system (propiska) that limited the spatial mobility of labor, strengthening employers' monopsony power. Mobility costs to regions with the highest growth potential are exacerbated by high urban housing costs, with a housing problem that is particularly acute in Tashkent City. Women participation in economic activity remain low and significant work is needed to lift the many legal, social, and cultural constraints to their full participation in the labor market.

Starting in 2017, the authorities have implemented measures to ease its restrictions and incentivize labor mobility. As a first step the quotas and limitations on the issuance of permits outside Tashkent City and its region were removed, as were the requirements to have a *propiska* permit to access basic health and education services. In mid-2018 the government removed restrictions limiting employers from hiring workers without *propiska*. In March 2020, new measures were adopted resulting in the breakup of most of the old *propiska* scheme, which was

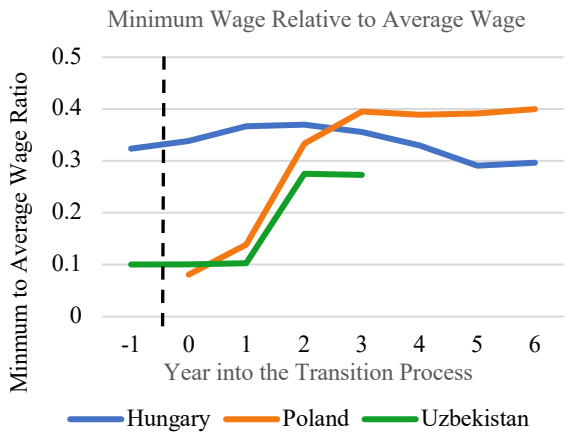
replaced by a new online registration system. The measures further eased internal mobility restrictions and limitations to the access of public services without a *propiska* permit. Restrictions remain in place in the highly dynamic Tashkent region, although the requirements for a temporary registration have been substantially eased; in the first half of 2019, for example, more than 160,000 people received a temporary registration for the first time.[4]

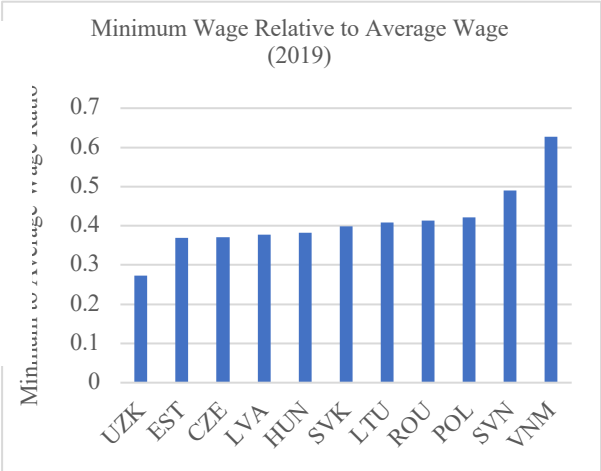
The government has gradually increased the nominal minimum wage over the last decades, with a sharp increase in 2018, but it remains low relative to the average wage. This increase has outpaced the growth in aggregate prices resulting in an increase in the real minimum wage (top-left panel in Figure 1.3). The increase in the minimum wage have also outpaced the growth in the average wage. As a result, the ratio between the minimum and average wage has almost quadrupled in the last 10 years, going from 7.5 percent in 2010 to 29.2 percent in 2019 (top-right panel of Figure 1.3). The sharp increase implemented in 2018 mimicked the pattern seen in Poland at the onset of its transition and seems a response to a very low initial minimum wage (bottom-left panel in Figure 1.3). The ratio between the minimum and average wage in Uzbekistan remains nonetheless low relative to that of other (former) transitioning countries (bottom-left panel in Figure 1.3). This discussion about the minimum wage has to be taken with a grain of salt, as only 40 percent of workers are formal; for the informal workers, the minimum wage is of little consequence.

Figure 1.3: Wages in Uzbekistan and selected comparators



[4] Muradova, Sevilya and W. Seitz. 2019. *Compulsory Registration in Uzbekistan.*





Sources: country authorities, ILO, OECD, and World Bank staff calculations. Transition years are 1989 for Hungary and Poland and 2016 for Uzbekistan.

In recent years, the government stepped up its effort to fight child and forced labor in the cotton sector achieving important results in this area. These practices were until recently commonly used during the cotton harvest season and their use was alimented by the rigid system of mandatory production quota imposed on farmers. ILO inspections fund that as of 2019 child labor is no longer systematically used in cotton picking, but isolated cases still occurred. The number of cotton pickers working under some form of forced labor declined by 40 percent in 2019 and a further 33 percent in 2020. About 4 percent of cotton pickers still faced some form of coercion in 2020 (ILO, 2021). The ILO notes that child labor is no longer used in the cotton harvest in Uzbekistan.

D. Inflation and Monetary Policy

Since 2017, the authorities have initiated a reform of the monetary policy framework, gradually moving towards more exchange rate flexibility and inflation targeting. While effectively implementing an inflation targeting regime will require some time, there are good examples to follow. Among the transition economies, an example to consider is that of Poland, a country that between 1991 and 1997 managed to contain hyperinflation and stabilize prices before introducing a full-fledged inflation targeting in 1998.

The liberalization of prices and the exchange rate, increased openness to imports, and the adjustment of relative prices have generated substantial inflation since 2017. Twelve-month inflation reached 20 percent in January 2018 before starting to trend down. Nonetheless, it still remains in the low double digits. The pass-through from exchange rate depreciation and directed lending, which accelerated during the transition, has also contributed to inflation pressures.

The authorities consider reducing inflation a priority and have taken measures to stabilize aggregate prices and reform CBU's monetary policy guidelines. Before the liberalization of the exchange rate, CBU's interventions were mainly aimed at maintaining the exchange rate at its target level. The authorities have since reformed their monetary policy objectives and have started a gradual move from exchange rate targeting to inflation targeting. In January 2018, the mandate

of the CBU was redefined by presidential decree, setting price stability, stability and development of the banking system, and stability and development of the payment systems as its main goals.

Further steps towards price stabilization were taken on January 1, 2020, when inflation targeting was formally introduced in the mandate of the CBU. The goal is for inflation to be reduced to 10 percent in 2021 and to 5 percent in 2023. A parallel effort was undertaken to provide the CBU with the tools to effectively fulfill its new mandate, including the development of proper macroeconomic analysis and forecasting units, and an improved system of communications, but more efforts are required in this area.

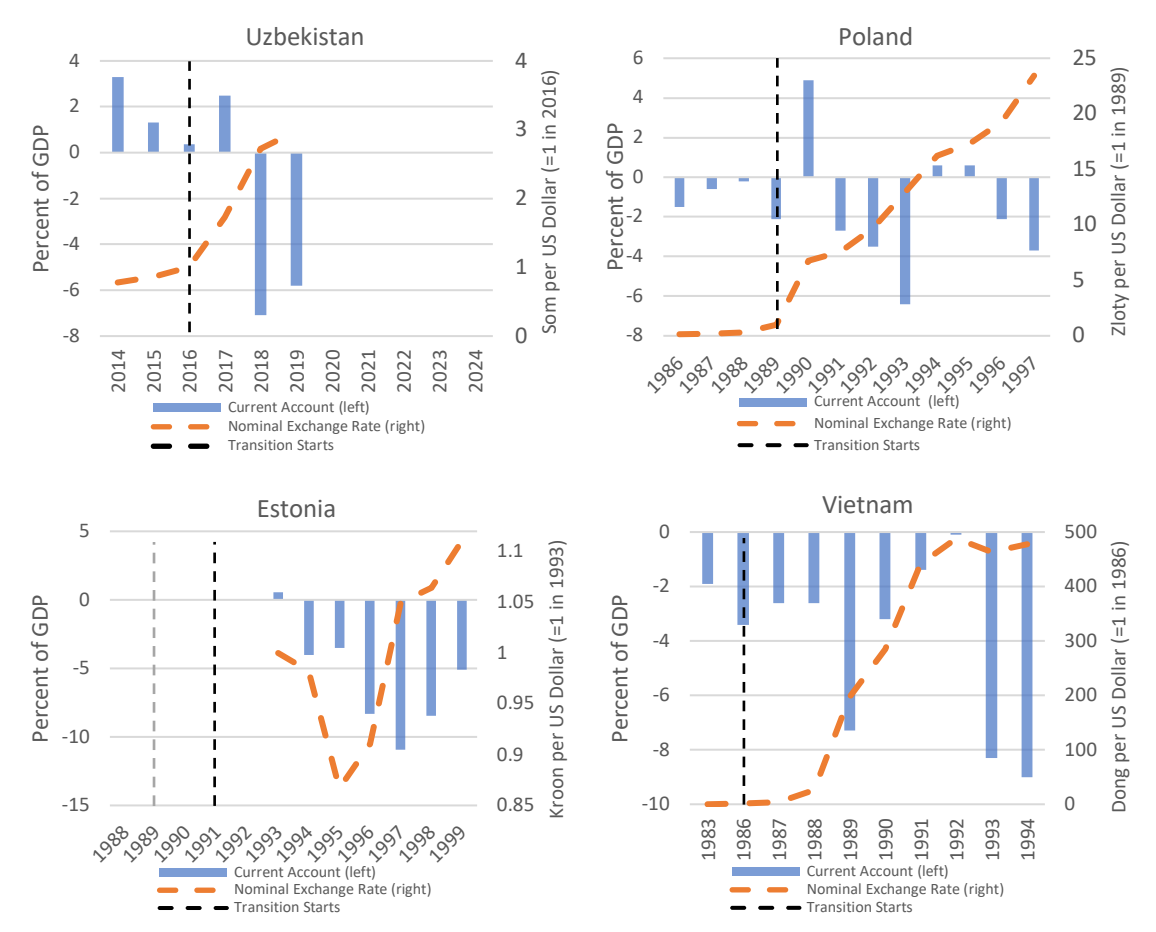
In line with its new focus on price stability, the CBU has started to actively adjust its policy rate to reduce the inflationary pressure in the economy. The interest rate was first raised from 9 to 14 percent in June 2017 and further increased to 16 percent in September 2018. This tighter monetary stance was relaxed in recent months to respond to the ongoing Covid-19 crisis, with the policy rate being reduced to 15 percent in April 2020 and to 14 percent in September 2020.

The effectiveness of the CBU's efforts to guide inflation and stimulate the economy remains nonetheless constrained by the fragmentation in its credit market. In this regard, the government has taken steps to scale-back policy-based lending but plans for a reform of the credit market and banking sector had until recently been outpaced by those seen in other sectors. Recognizing this, in May 2020 the government developed an ambitious plan to reform the banking sector in the next five years, reducing its fragmentation and promoting (for more information, please see Chapter 6).

Box 1.2: Monetary Policy, Inflation, and the Exchange Rate in Transition

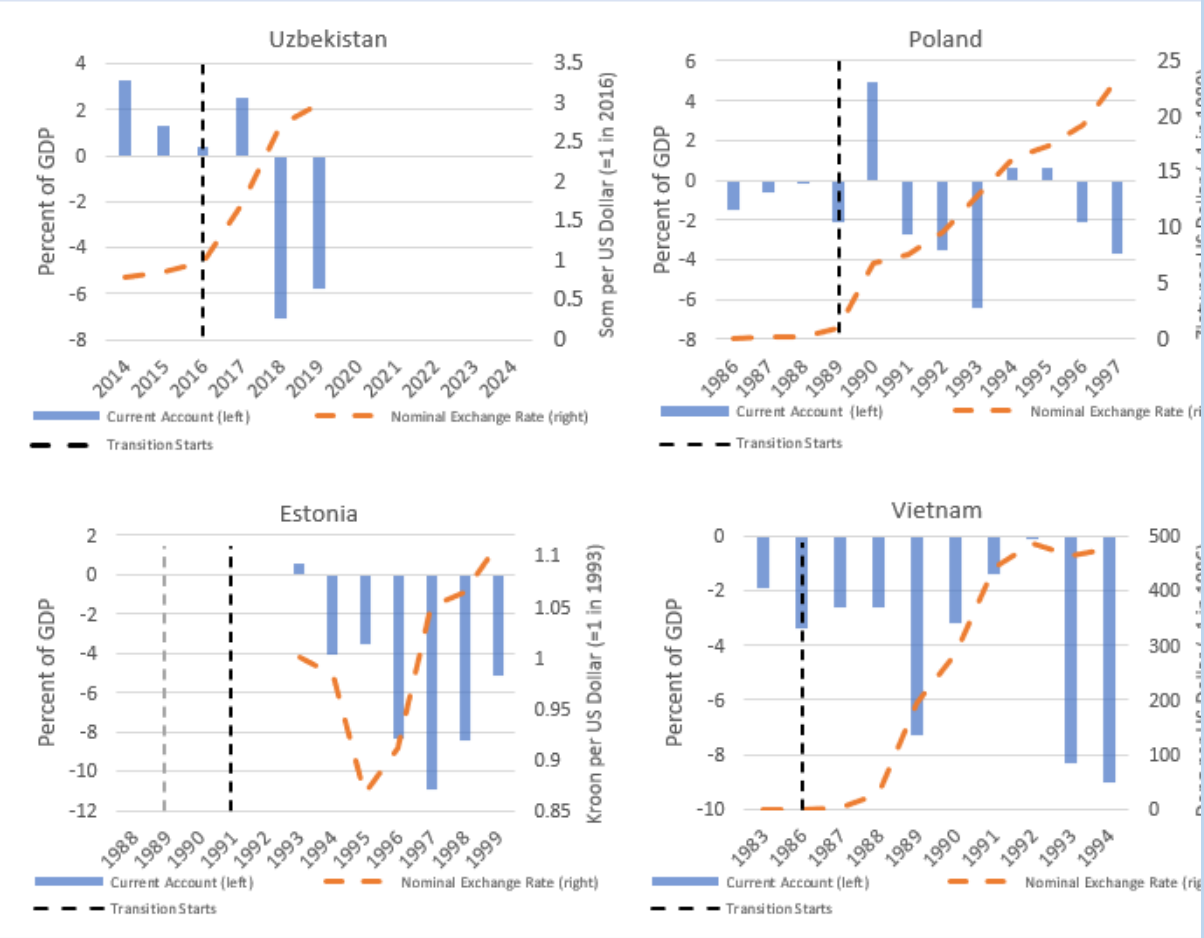
As early liberalization reforms were being implemented, price stabilization became a central issue in transition economies and forced governments to rethink their approach to monetary policy. Sharp currency depreciations and repressed inflationary forces pushed inflation to extraordinary levels, which were met with drastic stabilization measures. Since 2016 Uzbekistan has seen both a depreciation in its currency and an increase in inflation, but the magnitude of these changes remains limited compared to those observed in most transition economies, leaving Uzbekistan in a comparatively favorable position. Containing inflation should nonetheless remain a priority as the ongoing liberalization and privatization reforms are likely to exert additional upward pressure on prices,

When planned economies first embarked in their transition, the radical transformation in their economy released repressed inflationary forces and lead to rampant inflation. The increase in the prices of artificially underpriced goods, the release of existing monetary overhangs and the sluggish adjustments in productive capacity all contributed to the spike in inflation. In most transition countries the inflationary pressure was sustained by a sharp depreciation in the local currency and in some the monetization of a fiscal deficits drove the economy into hyperinflation. The commonly observed depreciation of local currencies was the product of a pre-transition tendency to overvalue currencies and thus came as a response to the underlying fundamentals of these economies. The initial depreciation was generally accompanied by a deterioration in the current account balance as the repressed demand for foreign goods was released, more than offsetting the effect of a depreciating currency. In some, albeit not all, transition economies the initial depreciation was followed by a slow appreciation of the real exchange rate (Halpern, Wyplosz (1996)) and a gradual reduction in current account deficits



Sources: IMF. Vertical lines are commonly assumed starting dates for the country's transition

The initial increase in prices reached dramatic levels in many transitioning economies. As the risk of an inflation spiral become clear, governments adopted restrictive measures to rein in the increase in prices. While the detailed implementation of these adjustments differed among transition economies, they usually centered around a reduction in fiscal deficits and a tight control of money supply. Additional measures that limited credit growth and wage growth to repress the development of price-wage spirals were sometimes part of these adjustment packages. Countries that reacted vigorously were usually successful at containing inflation and for many of them this stabilization effort anticipated a new wave of structural reforms.



Sources: IMF, World Bank. Vertical lines are commonly assumed starting dates for the country's transition.

Poland

As the Soviet Union and the COMECON trade system started to collapse, Poland entered its transition with large fiscal imbalances and emerging hyperinflation. A first adjustment program was aborted in 1989, but fueled expectations of future price increases, which coupled with the introduction of a wage indexation system pushed the economy into a price-wage spiral. The combined effect of these factors and of an excessive expansion of the monetary base in 1989 lead to raising inflation, which was further fueled in 1990 by a wave of price liberalizations and by a sharp depreciation of the zloty. Inflation climbed to 245 percent year-on-year in 1989 and reached an alarming 568 percent in 1990.[5]

Responding to the treat of hyperinflation, in late 1990 the Polish government adopted a major stabilization program. The authorities worked to reduce the fiscal deficit by cutting investments and subsidies, introduced a ceiling on domestic credits and adopted a tax-based income policy to contain the growth of wages. The stabilization plan was implemented together with a radical one-off liberalization of prices in almost all sectors of the economy and the authorities proceeded to devalue the zloty by 31 percent. The currency was initially pegged using the US dollar as a nominal anchor, first adopting a fixed exchange regime, and starting in October 1991 with a pre-announced crawling peg system. These measures were effective at containing the inflationary spiral and inflation fell to 77 percent in 1992. This

[5] See Ebrill et al. (1994) and Ouanes, Thakur (1997) for a detailed discussion of the early transition in Poland.

disinflationary trend continued in the next years, but inflation remained in double digits until the late 90s, pushed primarily by adjustments in relative prices

As its transition process evolved, Poland gradually increased CB independence and moved its monetary policy towards an inflation targeting and floating exchange rate regime. After an intermediate period between 1990 and 1997 when both inflation and the exchange rate were targeted, in 1998 the CB moved to full-fledged inflation targeting. This was accompanied by a gradual shift toward a flexible exchange rate regime. In 1995 the crawling peg system was replaced with a crawling-band, which gradually evolved into a de facto floating regime in 1999.

Estonia

When Estonia regained independence in 1991, its economy was under severe stress. The collapse of the soviet system had caused major disruptions in trade, causing widespread shortages in goods and inputs and a large drop in exports. The government decided to quickly reform prices with a major liberalization program that was implemented between 1990 and 1992. The aggregate price level started to rapidly increase in 1991 and rose into hyperinflation in 1992, when the liberalization of prices in Russia caused a jump in the price of imported goods and commodities, increasing at an annual rate of above 1000 percent.

Confronted with the risk of hyperinflation the authorities anticipated their plans to adopt a new currency and, to rapidly build confidence in the new kroon, introduced a currency board system. The currency board, which required the monetary base to be backed by foreign currency, strongly limited the scope for discretionary monetary policy and served as a clear commitment to inflation reduction. The kroon was initially pegged to the German mark and later to the Euro, which became a natural choice as the country pursued its path to EU and EMU accession. The currency board also put a strict restriction on the state's fiscal deficit. As deficit had to be financed within the possibilities of the private credit market, which at the time were almost inexistent, the regime effectively imposed a hard budget constraint on the government.

Facing dire economic conditions and in line with the new constraints posed by the currency board, in 1992 the government adopted a rapid stabilization program aimed at reducing the fiscal deficit and slow down the increase in prices. The plan was equivalent to around 5 to 6 percent of GDP and included an increase in VAT from 10 percent to 18 percent. The combined effects of this package of measures and of the commitment to price stability underlying the currency board arrangement was successful at containing the rise in prices. Inflation fell sharply in 1993 to 90 percent and kept decreasing in the following years. The increase in the prices of services and the real appreciation due to an initially undervalued exchange rate nonetheless slowed down this disinflationary dynamic and the inflation rate remained in double digits until 1997.[6]

Vietnam

In the mid-80s Vietnam faced difficult economic conditions with a rising inflation that was largely fueled by excessive money creation. To improve the living conditions of the Vietnamize people, in 1986-87 the government launched a reform campaign that gradually opened the Vietnamize economy[7]. As the first part of the reform process unfolded, the inflation rate remained high at above 300 percent, sustained by a major price liberalization plan that was initiated in 1988 and a growing monetary base that was used to cover a persistent fiscal deficit.

After three consecutive years of high inflation, the government implemented a fiscal stabilization program. The package focused mostly on a reduction of the fiscal deficit, eliminating the need for a monetization of the state's deficit that was largely responsible for the increase in prices. The authorities

[6] See Sutt et al. (2002) for a detailed discussion of the Estonian currency board and the early transition in the country.
[7] See Srinivasan et al. (1996) and Baum (2020) for a detailed discussion of the transition process in Vietnam and an analysis of the determinants of inflation over the transition period.

also acted to impose hard budget constraints on SOEs, raised the real interest rate at positive level and allowed the dong to depreciate to values that more closely reflected the economy's fundamentals. The combination of these measures was successful at reducing the inflationary pressure while preserving the competitiveness of the economy. The inflation rate dropped to 96 percent in 1989 and 36 percent in 1990. Inflation temporarily rebounded in 1991-92 driven mostly by shocks to the prices of staple goods like rice, before falling to single-digit levels in 1993.

During the transition period monetary policy in Vietnam remained strongly dependent on the government and the national assembly. The CB was charged with a wide set of goals that transcended price stability and the administration of the exchange rate. This institutional arrangement did not prevent the local authorities from proceeding to a devaluation of the then overvalued Dong and to effectively stabilize inflation, in line with the experience of other successful transitioning countries. The initial depreciation of the Dong was achieved by the temporary adoption of a floating exchange regime between 1989 and 1992. In 1992 the authorities reintroduced a fixed exchange rate, which evolved into a de jure managed floating but de facto pegged regime in 1999.

Uzbekistan

Relative to these countries, prior to the Covd-19 pandemic, Uzbekistan found itself in a more favorable position. The increase in inflation seen after 2016 has been relatively small compared to the one observed in most other transitioning economies. This is in part due to the more advantageous situation that Uzbekistan faced as it entered its transition, with a more limited growth in money supply, a balanced state budget and price adjustments that had been partially undertaken before 2016, and in part to its more gradual approach to price liberalization. This milder increase in prices did not require the adoption of a drastic and potentially painful adjustment program. The authorities were also quick to devaluate the Som and reunite the formal and informal exchange rate and are now moving towards an inflation targeting monetary policy regime.

The government should nonetheless continue in its reform effort, completing its reform of the CB and working to improve the fluidity of the FX and credit markets. The Covid-19 pandemic and the economic downturn it is causing underscores the importance of these measures. A well-functioning and independent CB and a fluid transmission of its monetary policy can in fact play an important stabilization role on the economy and will help make the Uzbek economy more resilient. Inflation control should remain a priority beyond the horizon of the current crisis as future liberalization and privatization reforms are likely to exert additional upward pressure on prices.

E. Conclusion

Ensuring that prices are set efficiently is essential to guaranteeing an efficient allocation of resources in the economy and promoting sustained productivity growth. In a complex economy where markets do not exist, correctly identifying the value of an item can be a daunting task, putting a clear constraint on a government's ability to efficiently administer a large number of prices. In the absence of natural monopolies, delegating this task to an open and competitive market can represent an efficient price setting mechanism and can provide large efficiency gains for the economy. Liberalizing prices and stimulating competition will also create new space for private businesses, stimulating entrepreneurship and business dynamism, with likely positive effects on aggregate productivity.

Since 2016, Uzbekistan has made remarkable progresses in this area, opening its economy, and pursuing an ambitious liberalization program. It has liberalized many initially administered or regulated prices, creating new markets and opening space for private businesses. In a parallel reform effort, the government initiated a major shift towards a more open and

internationally integrated economy, working to reduce tariffs and non-tariffs trade costs and liberalizing the exchange rate. The authorities have also started a broader reform of their monetary policy framework, which has become increasingly centered around aggregate price stability. While these reforms have been remarkable, many challenges still lay ahead. First, price regulations remain in place for several goods and services that can be efficiently provided in a competitive market. Second, many markets remain subject to substantial frictions that are likely to seriously undermine their efficiency and competitiveness.

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Spotlight 1. Lessons from Transition

A. Summary

Since the mid-1980s, many countries have transitioned away from planned socialist economies. Many of those in Europe and Central Asia (ECA) have mostly become free market economies. In Asia, some have transitioned into "socialist market" economies, a hybrid discussed later. This spotlight focuses on four components of economic transition: (1) Liberalization of prices, production land, foreign exchange, and interest rates – which is needed to provide more reliable market-based information for efficient investment decisions; (2) Development of market institutions, including laws and regulations, to replace central planning administration where all economic actors were agents of the state; (3) Financial sector development, including commercial banks that must assess creditworthiness as well as securities markets and non-bank financial institutions; and (4) State-owned enterprise (SOE) reforms, including privatization of small SOEs and medium/large SOEs as well as corporate governance for the latter.

How much economic transition could Uzbekistan achieve by 2025 based on the experience of other transition economies? Section II provides a regional perspective, averaging progress by 26 ECA countries toward economic transition after their first 8 years of reforms; citing some high performers; and discussing correlations among reforms, starting conditions, and renewed growth. Section III summarizes three transition cases – Russia, Poland, and Vietnam[1] – focusing on reforms by each during their first 4 years of economic transition; varying approaches to implementation; and political-economy considerations. All this suggests the following priorities (elaborated in Table S1-1) for the first 4 years of an economic transition from socialism:

- Year 1: market liberalization, small privatization, essential market institutions (including for financial sector development), and controls on medium/large SOEs to forestall asset stripping
- Years 2-3: further development of market institutions, plus preparations and commencement of medium/large privatization
- Year 4: ongoing medium/large privatization transactions and attainment of best practice corporate governance for remaining SOEs.

Liberalization is reasonably straightforward and quick. It may be enough for the government to stop intervening or interfering with markets. The reforms highlighted in Exhibit 1 can be implemented within a few months. Liberalization may result in temporary price rises – which can be severe – and other dislocations.

[1] Poland ranked 2nd in EBRD's 1998 ranking of transition performance, but 1st in 1990 – 2000 real growth. While ranked at about the 70th percentile for its economic reforms, Russia is included because of its influence on other ex-USSR republics and its important lessons. Vietnam is included as an example of a "socialist-market" economy in Asia.

Table S1-1: Recommended Economic Transition Workplan: Years 1-4

Year	Transition Component	Action
1	Market liberalization	• Elimination of all price controls, with safety net subsidies for vulnerable citizens • Elimination of production controls • Elimination of differences between official and black-market FX rates • Elimination of administrative caps/floors on interest rates for loans or deposits • Elimination of import or export controls
	Market institutions	• Legal recognition of private entrepreneurship • Legal recognition and protections for private land ownership and transfers • Civil Code amended to include market-friendly sections on business registration, contracts, and secured lending • New Tax Law to provide consistent tax treatment of SOEs/private firms and replace government revenues from SOEs • Adoption of International Financial Reporting Standards (IFRS) for all enterprises, including banks • Development of regulations and institutions to register private land ownership and transfer

	Financial sector development	• Initiation of a 2-tier banking system, with mono-bank converted into a central bank and its commercial banking assets spun off
		• Central Bank establishment of Bank Supervision Department
		  o Essential staff selected and trained, including through "twinning" support from bilateral/multilateral partners
		  o Development of appropriate "fit and proper" tests for new commercial banks
		  o Development of appropriate rules on loan classification and provisioning

	Small privatization	• Control over retail properties conveyed from SOEs and property ownership perfected by local authorities (e.g., municipalities) • Small privatization transactions begin by end of Year 1
	Medium-large SOEs	• Controls established to prevent asset stripping • Hard budget constraints imposed • Analysis of medium/large SOE portfolio and preliminary decisions on the disposition of individual SOEs – e.g., liquidation, privatization, or retention with appropriate corporate governance
2	Market institutions	• Competition Law • Competition Agency established, duties to include maintenance of "competitive neutrality" between SOEs and private firms • Law on Foreign Investment • Law on Bankruptcy
	Financial sector development	• Initial awards of new banking licenses • Development of capital market strategy
	Small privatization	• Small privatization completed by end of Year 2; all new small firms (and any freehold property interests) registered
	Medium-large SOEs	• Law and Program on the Governance and Privatization of Medium/Large SOEs • Independent external audits for all medium/large SOEs • Design and implementation of safety nets for redundant SOE staff
3	Market institutions	• Development of capacity for bankruptcy practitioners – e.g., training, expat staffing, and twinning arrangements
	Financial sector development	• Law on Securities • Establishment of securities regulation/supervision capacity – with support from development partners • Stock Exchange opens; listing rules implemented

	Medium-large SOEs	• Non-viable SOEs liquidated; severance and health/pension support for staff
		• Initial privatization transactions
		• OECD-style corporate governance rolled out for SOEs to be retained by the State
		  o Establishment of centralized responsible/authoritative State shareholder
		  o Creation of supervisory boards (each with at least 2 independent directors) at each such SOE

4	Medium-large SOEs	• Ongoing privatization transactions • Perfection of corporate governance at retained SOEs

Relatively easy and quick, small privatization offers important benefits. These include more consumer choice, neighborhood uplifts, and employment growth – especially if accompanied by increased opportunities for new green-field small businesses. Small privatization is, as highlighted by Poland's approach, essentially a real estate event. It should be possible to begin small privatization during the first year of a transition and complete it during the second. Existing staff tend to build on their insider advantages, and gain control of most retail privatizations. This contributes to speed, but is somewhat unfair to non-insider citizens, as discussed later.

While market infrastructure – including laws, regulations, and institutions for general business (including ease of market entry and market exit) and for financial sector development – is important, the times needed for full implementation can vary widely. It could be a mistake to unthinkingly adopt "suitcase laws" provided by visiting consultants.[2] That said, many good models (e.g., for contract, property, competition, secured lending, insolvency, securities, and banking law) can be identified and adapted. Full implementation may take longer, however, especially if the legal concepts or procedures are unfamiliar to local judges, lawyers, and supporting professionals. If so, as soon as the underlying new law is reasonably set, it will be important to begin building implementation capacity. Capacity-building can benefit from a combination of in-country and foreign training courses, temporary expat staff hires, and supplemental "twinning" support from bilateral or multilateral development partners with substantial relevant experience.

While not the highest immediate priority, medium/large privatization poses the most complex set of issues and program design choices.

- **Case-by-case sales to a strategic or financial investor are highly desirable**, both for concentrating enterprise control and for maximizing revenues from the government's sale of a "control premium." But the needs for compiling information to support due diligence, valuation, investor search, negotiation, and legal documentation are so labor-intensive that a country could not realistically expect to complete more than 20-30 such privatizations each year. It should be possible to begin completing some case-by-case privatizations in the third year of a transition. But if a country wishes to privatize hundreds of medium/large SOEs, the labor intensity of case-by-case may lead to consideration of faster alternatives, e.g., management-employee buyouts (MEBOs) or voucher privatization, as discussed below.
- **Some public share offerings on the local stock exchange** can facilitate development of a local capital market. But transaction costs will likely be higher (because of the need to comply

[2] For example, the concept of "fiduciary duty," defined by decades (if not centuries) of common law precedents in Anglo-American jurisdictions, does not automatically fit into a legal system based on Roman law or the Napoleonic Code.

with securities regulations and stock exchange listing requirements) while sales proceeds may be lower (if no shares purchaser obtains a controlling interest, for which it pays a control premium). Public shares offerings should be limited to well-known and financially secure SOEs.

- **A management or employee buyout (MEBO)**, while promising speedy closure as a result of insider support, entails two significant disadvantages. First, a MEBO-ed enterprise is less likely to undertake restructuring to raise its competitiveness. Second, by favoring insiders, MEBOs are often criticized by the general public who receive no preferences from the government.
- **For mass privatization, the government distributes some means** (e.g., physical vouchers, dematerialized privatization accounts) that citizens may bid to obtain some ownership interest in designated SOEs. A mass privatization program (MPP) may need to reserve substantial shares for insiders, as happened in Russia, which may then require some offsetting compensation for non-insider citizens. Another consideration is how to reconsolidate share ownership – which may become widely dispersed from mass privatization – to allow effective control over enterprises' strategic direction. Standardized procedures for *share tenders*, whereby the party seeking corporate control ends up paying the same price for shares tendered by insiders and outsiders (e.g., "widows and orphans") could be one way to effect ownership reconsolidation. ECA MPPs, however, looked to newly-developed local capital markets (which *could* benefit from mass privatization) as the vehicle for reconsolidating ownership – in one of two ways:
    - In "retail MPPs" (e.g., Czech Republic, Russia), citizens could either bid directly on SOEs or convey their bidding power to a privately-sponsor investment fund (which might or might not be well-regulated and supervised – usually not) that would then use its shareholders' bidding power to acquire SOE shares. Vouchers and privatized shares could be bought/sold on the local stock market.
    - In "wholesale MPPs" (e.g., Poland), the government organized and sponsored a limited number of investment funds, to be managed by private investment fund managers. Citizens obtained shares only in these funds.

The retail MPP approach imposes extra burdens on security markets and regulators for the sake of a one-time reconsolidation of dispersed share ownership. Spontaneous development of a large number of privately sponsored investment funds may strain the market monitoring and supervision capabilities of a nascent securities regulator.

The wholesale MPP approach could be more promising, although its reputation suffers from Poland's slow and politicized implementation in the 1990s. government-sponsored citizen-owned MPP investment funds would be analogous to government-owned state shareholding funds, which have worked reasonably well in Singapore (Temasek) and Austria (OIAG).

Public tenders could be an efficient way to reconsolidate dispersed MPP-ed shareholdings, similar to public tenders used for corporate M&A transactions. This approach, however, has never been tried in a transition economy.

Other important design questions include the influence of enterprise insiders and public attitudes toward foreign investment.

- Is it more-or-less inevitable that enterprise insiders will dominate privatized firms after privatization? If so, should some offset accrue to the government or citizens – e.g., long-term enterprise bonds held by the MOF, or more MPP bidding power for citizens?
- How much foreign ownership and/or management of important enterprises and banks, or privatization investment funds, is the public willing to accept?

Whatever design choices outside experts might recommend, government design of a privatization program should consider political-economy constraints, including public opinion.

Lastly, a transition government should establish "adequate" governance arrangements for its SOEs. For SOEs intended for privatization, a "lite" version to prevent asset stripping might suffice. For medium/large enterprises that may remain state-owned for years or even indefinitely, more robust corporate governance arrangements are needed to preserve state capital while enabling the SOE to operate in a free market without unfairly disadvantaging private firms. Extensive guidance on this is available, both best practices[3] and how these have been implemented in practice by developing countries.[4]

B. Regional Perspectives

The discussion follows of (a) "average" economic transition reforms among 26 ECA countries during 1991–1998 as well as ECA leaders, and (b) correlations among reforms, starting conditions, and renewed growth.

ECA Early Transition Reform Accomplishments

On average during the 1990s, ECA countries' transitions were the greatest in small privatization and liberalization of trade/foreign exchange, and the least in competition policy and development of securities markets/non-bank financial institutions (Table S1-2).

Table S1-2: ECA Economic Transitions: Average Accomplishments, 1990 – 1998

Market liberalization	• Substantial progress on price liberalization. State procurement at non-market prices largely phased out. • Removal of all or almost all quantitative and administrative import and export restrictions (apart from agriculture) and significant export duties. Less significant or insignificant direct involvement in exports and imports by ministries and state-owned trading companies. Little or no major non-uniformity of customs duties for non-agricultural goods and services. Full or almost full current account convertibility. • Full or almost full interest rate liberalization.
Market institutions	• Enactment and initial enforcement of bankruptcy legislation. • Competition policy legislation and institutions established. Some reduction of entry restrictions or enforcement actions against dominant firms.
Financial sector development	• Establishment of commercial banks. • Limited preferential access to cheap financing.

[3] See OECD, *OECD Guidelines on the Corporate Governance of State-Owned Enterprises*, 2015.
[4] See, for example, OECD (2020).

	• Progress in establishment of bank solvency, and of a framework for prudential supervision and regulation. • Increased lending to private enterprises, and increased presence of private banks. • Formation of securities exchanges, market makers, and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
Small privatization	• Nearly complete or complete privatization of small SOEs. • Progress toward fully tradable ownership rights.
Large SOEs privatization & governance	• Almost 25 percent of large enterprise assets in private hands. • Moderately tight credit and subsidy policy; efforts to harden budget constraints. • Some actions to strengthen corporate governance.

Source: European Bank for Reconstruction and Development (EBRD), *Transition Report 1998*, as adapted in Section II Annex.

Economic transition reforms in ECA were led by East European countries (Table S1-3). Hungary, Poland, and the Czech Republic and Slovak Republic reformed the list. Except for Estonia, ex-USSR republics were not represented in the 1998 transition leadership list.

A government pursuing some particular aspect of economic transition may wish to examine the experiences of these ECA leaders.

Table S1-3: ECA Economic Transition Leaders, 1998

Transition Component	Grade (1 – 4)	Accomplishments	Leading Countries
Price liberalization	3+	Nearly or fully comprehensive price liberalization. Utility pricing beginning to approach economic cost recovery.	Hungary, Poland
Trade & FX liberalization	4+	Standards and performance typical of advanced industrial economies. Removal of quantitative and administrative import and export restrictions. Full current account convertibility. Removal of most tariff barriers. Membership in WTO.	Hungary, Poland, Czech Republic, Slovak Republic, Slovenia
Competition policy	3	Competition policy legislation and agency established. Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates. Substantial reduction of market-entry restrictions.	Hungary, Poland, Czech Republic, Slovak Republic
Commercial banking	4	Full interest rate liberalization. Significant term lending to private enterprises and significant presence of private banks. Significant movement of banking laws and regulations toward BIS standards. Well-functioning banking competition and effective prudential supervision. Substantial private sector deepening.	Hungary
Small privatization	4+	No state ownership of small enterprises. Tradability of ownership rights and land or land-use rights.	Hungary, Poland, Czech Republic, Estonia, Slovak Republic, Slovenia
Large privatization	4	>50 percent of SOE and farm assets in private ownership, and significant progress on corporate governance in these enterprises.	Hungary, Czech Republic, Estonia, Slovak Republic
Governance & enterprise restructuring	3+	Hard budget constraints. Enforcement of bankruptcy legislation. Significant improvement in corporate	Hungary

		governance. Beginnings of an active market for corporate control. New investment by enterprises.	
Securities markets & non-bank financial institutions (NBFIs)	3+	Establishment of independent share registries. Secure clearance and settlement of securities trading. Substantial issuance of securities by private enterprises, with increasing market liquidity and capitalization. Increasing protection of minority shareholders. Some securities laws and regulations approaching IOSCO standards. Emergence of NBFIs (e.g., private investment funds, insurance, pension funds, and leasing companies) and increasingly effective regulation and supervision.	Hungary, Poland

Source: EBRD (1998).

Although Hungary led in reforms, four other countries achieved higher real growth during the first decade of ECA's economic transition (Table S1-4). Second-ranked reformer Poland was by far the fastest grower. Adjusted for inflation, Poland's GDP was 44 percent higher in 2000 compared with 1990.

Table S1-4: ECA Economic Growth & Transition Reforms, 1990s

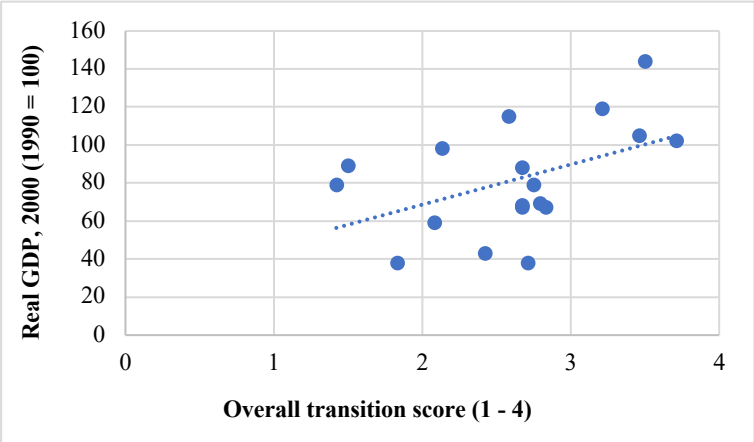
Country	Overall Transition Reforms Score, 1998 (1 – 4)	2000 Real GDP (1990 = 100)
Poland	3.50	144
Slovenia	3.21	119
Albania	2.58	115
Czech Republic	3.46	105
Hungary	3.71	102
Uzbekistan	2.13	98
Belarus	1.50	89
Romania	2.67	88
Bulgaria	2.75	79
Turkmenistan	1.42	79
Kazakhstan	2.79	69
Armenia	2.67	68
Kyrgyzstan	2.83	67
Russian Federation	2.67	67
Azerbaijan	2.08	59
Ukraine	2.42	43
Georgia	2.71	38
Tajikistan	1.83	38

Source: EBRD (1998); and http://data.worldbank.org .

The correlation between transition reforms and output performance among ECA countries in the 1990s is positive – but loose – and there was no downside risk to economic reform (Table S1-5):

- No country with an overall transition score of at least 3 had failed to grow by the end of the decade.
- Relatively high growth by strong reformers Hungary and Czech Republic was about as expected, as was slower growth by weaker reformers Romania and Bulgaria.
- Of 13 countries with an overall transition score of less than 3, only Albania restored GDP to its 1990 level (in real terms) by 2000.
- Countries with growth well above the trend line included a mix of above-average reformers (Poland, Slovenia) and below-average reformers (Uzbekistan, Belarus, Turkmenistan).
- Those with growth well below the trend line were also below-average reformers (Tajikistan, Ukraine, Georgia, Azerbaijan, Armenia, Kyrgyzstan, and the Russian Federation).

Figure S1-1: ECA Economic Growth vs. Transition Reforms, 1990s



Source: WDI and WBRD.

Liberalization policies and initial conditions emerge as most important for explaining these different growth results among ECA countries. "Liberalization policies [had] a stronger positive impact during 1995-1999, while initial conditions [had] a stronger impact on the earlier period. In both cases, the difference is statistically significant."[5]

Significant initial conditions may include structural features in the economy, pre-transition distortions, institutional factors, or external shocks:

Structure:

- *Share of industry in GDP* – If investment in industry is artificially high, some of this may need to be liquidated. On the other hand, repression of services may create opportunities for growth.
- Degree *of* urbanization – More urbanized countries may find it easier to transition and grow.
- Administered *trade* – Greater reliance on administered trade (versus free trade for convertible currency) could have encouraged slippage in export competitiveness.

[5] World Bank (2002), p. 20.

- Natural *resource endowments* – These could enable rapid growth, but might require large investments.
- Income – Pre-transition incomes were generally higher in the western parts of ECA.

Distortions:

- Repressed *inflation* – Relaxation of severe government controls (e.g., wages, consumer prices) spurred high inflation, which might then be exacerbated by government monetization of fiscal deficits
- *Black* market *exchange rates* – While convergence of official and market FX rates put exports and imports on a sustainable footing, rapid devaluations in highly overvalued local currencies hurt near-term growth and impoverished citizens.
- *Terms of trade effects* – The end of administered trade at administered prices within the Council of Mutual Economic Assistance (CMEA) tended disproportionately to hurt small energy importers and help energy exporters.
- *Pre-transition reform history* – Some Central European countries introduced some elements of market-based reforms well before the USSR collapsed.
- *Pre-transition growth rate* – The more mature countries stagnated in the late 1980s, while the poorest countries averaged higher growth.

Institutions:

- *Market memory* – Central European countries were able to draw on their market experience and legacy laws from before the Soviet period.
- *Location* – Countries in Central Europe, especially those bordering the EU, had more extensive *trade* links with market economies, with their enterprises and institutions more exposed to competitive pressures. Individuals had opportunity for travel and exposure to Western ways.
- *New states* – Countries with little or no experience as independent nations may have had more *difficulty* establishing efficient political institutions and political consensus.

Shocks:

- "Collapse of the institutional and technological links of the Soviet centrally planned system disrupted *the* supply of inputs for production and the delivery of outputs," posing challenges that varied among transition countries.
- "The loss of budget transfers from the center and the elimination of subsidized energy imports were severe blows, particularly to some newly independent states" from the former USSR.
- The *external* environment was less favorable in the 1990s, with lower growth rates in other developing countries and various financial crises.

- War and civil strife hurt affected countries and undermined political consensus on reforms needed *for* successful transition.[6]

Relative to ECA countries, Vietnam was an early-transition outlier. Its overall reform score after ten years of transition would probably have been about 2, i.e., at about the 85th percentile if included among EBRD-rated ECA countries. But Vietnam's real GDP doubled during the first ten years of its economic transition. Section III.C assesses whether the "socialist market" variant is a superior approach to economic transition, or whether Vietnam could have done better by moving further away from socialism.

C. Case Studies: Russia, Poland, and Vietnam

Early transition efforts in Russia, Poland, and Vietnam share some similarities, including an immediate emphasis on market liberalization and rapid privatization of small SOEs.[7] Liberalization of prices (e.g., foreign exchange, interest rates, outputs) provided market prices upon which investment decisions could be more reliably based. Openings up to trade and inbound foreign direct investment increased domestic competition and alternative employment opportunities in foreign-invested enterprises. Small privatization – beyond being relatively easy to implement – supported more consumer choice, neighborhood improvements, and employment growth.

Beyond that, these three countries varied widely in their sequencing of medium/large privatization market infrastructure and financial sector development. During their first decade of transition:

- Russia rushed medium/large privatization, while leaving gaps in its market infrastructure and financial sector development.
- Poland was relatively slow at medium/large privatization, but meanwhile filled in most of its market infrastructure and financial sector development needs.
- Vietnam left important gaps in its market infrastructure and financial sector capacity, and also retained thousands of medium/large SOEs. The government's "socialist-market" strategy was to liberalize markets, create market institutions, and encourage competition from private firms (ex-SOEs, greenfield domestic, and foreign-invested), while retaining medium/large SOEs in infrastructure, manufacturing, and financial sectors.

Transition reforms and subsequent real economic growth varied widely:

- Poland was an ECA leader in both reforms and growth. After beginning its transition, Poland's GDP declined for only two years. After ten years of transition, Poland's real GDP was 144 percent of where it had started.

[6] Ibid, pp. 11-12.
[7] For more detailed discussion, see Annex B on Russia, Annex C on Poland, and Annex D on Vietnam.

- Russia: In about the 70th percentile of EBRD reformers, Russia's real GDP declined for seven years after accelerating its economic transition. By 2000, Russia's real GDP was just 67 percent of its 1990 level.
- Vietnam is not strictly comparable to the ECA economies. If rated by EBRD after eight years of transition, Vietnam probably would have been in about the 85th percentile of reformers. Nonetheless, Vietnam did not experience a real decrease in output and within ten years its GDP (in real terms) was 199 percent of where it had been at the start of transition.[8] This paradox warrants a longer timeframe for assessing the accomplishments and possible limitations of Vietnam's socialist-market economy.

The transitions in Russia and Poland probably went about as well as they could have.

- In Russia, rapid liberalization was economically and financially necessary to address massive price distortions and debt overhangs. But awful initial conditions accentuated initial shocks which, together with a continuing lack of political consensus, slowed macroeconomic adjustment. Small privatization was easy enough and provided many benefits but ended up being dominated by insiders. The legal/regulatory framework retained huge gaps for at least a decade, reflecting Russia's left-leaning legislature and bureaucracy. Implementation was even more problematic, due to Russia's near-total lack of "market memory." Desires to end medium/large SOE claims on public finances and fears of a Communist resurgence drove the Yeltsin government to pursue rapid voucher privatization of medium/large SOEs. But insider dominance (inevitable, due to Soviet-era initiatives) and incomplete/ineffective market institutions limited post-privatization incentives for raising the competitiveness of these firms.
- In Poland, medium/large privatization was slowed by worker resistance and public suspicion of FDI. It is not obvious, however, that this relative slowness hurt Poland's transition. Small privatization moved quickly and provided employment, competition, and consumer benefits, but was also dominated by insiders. Poland made notable strides in filling in its market infrastructure and developing its financial sector – aided by a stronger anti-Communist popular consensus, availability of legacy laws, and greater market memory and exposure to the West.

Despite socialist-market Vietnam's post-transition growth leadership, the retention of a huge SOEs portfolio was probably a hindrance rather than a help. Vietnam's SOEs continued to absorb disproportionately large shares of capital, becoming less efficient users of capital during the 2000s as their gains in labor productivity were far outpaced by Vietnam's private domestic and foreign firms.[9] Fragmented and weak SOE corporate governance set the stage for SOE and financial sector distress.[10] Pronounced deterioration in the quality of bank loans during 2007-

[8] http://data.worldbank.org ; author's estimates; and World Bank, *Transition: The First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union*, 2002, p. 5.

[9] By 2010, SOEs provided for 27 percent of Vietnam's output, but still absorbed 39 percent of invested capital. World Bank, *Market Economy for a Middle-Income Vietnam*, December 2011, p. 27.

[10] Issues included "political interference with investment and credit decisions of banks, very weak governance structures and risk management practices, and an opaque and complex shareholding structure that promotes connected lending and reduces accountability." World Bank and IMF, "Vietnam: Financial Sector Assessment Program, Aide Memoire," February 2014, p. 7. Failure of the Vietnam Shipbuilding Industry (Vinashin) Group in 2010 dramatized these issues. See World Bank, *Vietnam Development Report 2012*, p. 38.

2011 resulted in bank recapitalization needs estimated at up to 8 percent of GDP.[11] Even after the government established a Committee for State Capital Management to "manage" nineteen state-owned groups and corporations, SOE corporate governance remains decentralized.[12] In retrospect, Vietnam might have grown even more with fewer (or at least better-governed) SOEs.

Russia

Russia's economic transition proceeded fitfully, due to insufficient consensus on whether and how to transition from Socialism. The Yeltsin government's 2 January 1992 program of price liberalization is often cited as the start of Russia's transition. In fact, efforts to reform SOEs and the financial system began earlier, toward the end of the USSR, as part of the Gorbachev regime's *perestroika* program to raise productivity. Examples included a new Law on Enterprises and Entrepreneurial Activity (December 1990), opening non-prohibited sectors to entrepreneurship and allowing ordinary Western forms of economic association, and 1988-1991 moves to convert the Gosbank "mono-bank" into two tiers: a proper central bank and a second tier of newly established commercial banks. Reactions against Gorbachev policies, particularly the loosening of Union controls on non-Russian republics seeking independence, resulted in the failed coup attempt of August 1991. Emerging from the USSR's dissolution in December 1991, the newly sovereign Russian Federation remained beset by struggles between Yeltsin government reformers and Communists in the Russia's Supreme Soviet (parliament), culminating in a second failed coup attempt by reactionaries in October 1993. Yeltsin government reformers continued to worry about a possible restoration of Communist power.

Newly sovereign Russia was in a perilous economic situation. "The state of the economy at end-1991 could hardly have been worse."[13] Consider:

- Output decreased 9 percent during 1991, mainly because of ministries' inability to enforce supply relationships among Russian SOEs, a breakdown in trade among ex-USSR republics, and the end of barter trade among the Soviet bloc's Council of Mutual Economic Assistance (CMEA) nations. Thus, Russian output was declining even before 1992.
- After non-Russian republics reneged on agreed tax payments, leaving the USSR bankrupt by April 1991, ongoing expenditures (including 60 percent wage increases and 40 percent increases in savings deposit balances to cushion against intended price reforms) left Russia with a huge "monetary overhang" and a fiscal deficit at 31 percent of GDP by end-1991.
- Prices increased by 142 percent for retail and 236 percent for wholesale during 1991.
- Russia's external position was deteriorating. During 1990, Russia's share of foreign exchange reserves decreased by $7.4 billion and foreign commercial banks withdrew $10 billion in short-term credit lines. They cut short-term credit lines by an additional $7 billion during 1991 and called in $4 billion of medium/long-term loans. Meanwhile, official creditor claims increased from $23.2 billion at end-1990 to $36.5 billion at end-1991.[14]

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[11] World Bank and IMF (2014), pp. 7 and 32-33.
[12] "'Super Committee' for State-Run Firms Debuts," *Viet Nam News*, 1 October 2018; and OECD, *Transparency Frameworks for State-Owned Enterprises in Asia*, 2020, p. 12.
[13] World Bank, *Russian Economic Reform: Crossing the Threshold of Structural Change*, September 1992, p. 7.
[14] Ibid, pp. 7-17.

- Russia had a huge number of state enterprises (23,776 medium/large industrial SOEs; 25,600 state or collective farms; 5,000 road transport enterprises; and 170,000 small retail trade enterprises).[15] The state sector accounted for 95 percent of 1990 GDP.[16] Industrial SOEs suffered from numerous problems, including overstaffing; little or no export competitiveness; overinvestment in non-productive projects; no tradition or capacity for financial management marketing; unclear ownership and control rights; and asset stripping facilitated by weak government oversight.[17]
- While the end of central planning made it incumbent upon SOE managers to begin making their own investment decisions, controlled prices meant that they had no reliable basis for such investment decisions.
- Although the Gorbachev regime took preliminary steps in 1988 to establish a two-tier banking system, Russia's financial sector at end-1991 lacked capacities for credit assessment, banking regulation and supervision, or capital market transactions.
- Laws and regulations were overwhelmingly oriented toward the administrative needs of the USSR's planned economy. Laws from Russia's pre-1917 experience with a market economy were long forgotten.

The Yeltsin government initially emphasized spending cuts, tax increases, and liberalization of prices and trade. Through cuts in defense procurement, subsidies, and investment plus increases a new value-added tax (VAT) and new excise taxes, "an extraordinary improvement in the budget balance – a textbook example – was accomplished."[18] As part of an early 1992 program of liberalizing prices and trade, price controls were eliminated for 90 percent of consumer products on 2 January 1992. Inflation remained an issue. Retail prices immediately rose about 250 percent in 1992. Inflation peaked at 1,876 percent for 1992 (Exhibit 6), remained about 100 percent until 1996, and generally receded below 10 percent only after 2009. After the initial spike in early 1992, inflation generally paced increases in the money supply.[19]

Table S1-5: Annual Inflation in Russia

Year	Increase in Consumer Price Index (percent)
1992	1,876
1993	874
1994	308
1995	197
1996	48
1997	15
1998	28
1999	86

Sources: Aslund (1995), p. 184; http://worldbank.data.org

Retail supply, however, quickly began to increase. In February 1992, an index of the availability of 98 basic commodities in 132 cities stood at about 35 percent. Soon, however, "shortages started to diminish, and one long-unseen commodity after another reappeared in shops. Meat and sausages, bananas and kiwifruits, and color televisions suddenly appeared. However, the arrival of new commodities in the shops was slow in comparison with what had happened during price liberalizations in Eastern Europe." Despite the Yeltsin government's decree broadly liberalizing

[15] Anders Aslund, *How Russia Became a Market Economy*, Brookings Institution, 1995, p. 152.
[16] World Bank (2002), p. 6.
[17] Ibid, pp. 33-42 and 81-85.
[18] Aslund, (1995), p. 187.
[19] Ibid, p. 190.

domestic trade, numerous detailed regulations remained a hindrance. Russia's index of commodities availability reached 92 percent, however, by October 1994.[20]

Other market reforms proceeded slowly. A November 1991 Law on Foreign Investment allowed in principle for foreigners to invest via joint venture or wholly-owned subsidiary in any non-proscribed sector. Private ownership of land was not allowed or recognized until late 1993. While Soviet-era civil code's focus on administrative implementation of central planning decisions provided no basis for arms-length market transactions, the introduction of new Civil Code provisions on legal entities, property, securities, and contracts did not begin until December 1994. Its implementation would remain limited by judicial ignorance, administrative obstruction, and public unfamiliarity with market economics and ethos.[21]

Moreover, market reforms sometimes suffered from reversal or bureaucratic strangulation. For example, a late-Soviet elimination of restrictions on private enterprises was increasingly rolled back in favor of local licensing requirements from May 1993. Control over an Anti-Monopoly Commission, established in 1990 to deal with the many artificial monopolies from central planning, was transferred from the Yeltsin government to the Communist-dominated Supreme Soviet in late 1991. A subsequent government program in March 1994 limited competition regulation to natural monopolies. Efforts to implement a bankruptcy system, mainly to resolve thousands of non-competitive and insolvent SOEs, were hampered by insufficient authority for creditors and tools to protect their rights.

In the financial sector, banking activity surged ahead of regulation and supervisory capacity. In 1988, the former Gosbank "mono-bank" was converted into a central bank (with authority over monetary policy, bank supervision, and interbank settlements), while its commercial lending operations and assets were spun off to create new "second tier" banks (e.g., Sberbank, Vneshekonombank, Promstroibank, and Agroprombank), typically as self-supporting joint companies operating independently from the state. Three other types of banks also arose: foreign joint venture (JV) banks, "wildcat banks," and commercial banks. Competition led to Central Bank and government restrictions on foreign JV banks. Meanwhile, with the lack of regulations posing no barrier to entry, wildcat banks established by SOEs, industries, and local governments "proliferated wildly," soon accounting for 80 percent of all commercial banks. Primarily accepting deposits from group members, wildcat banks borrowed on the cheap interbank credit market to fund member activities. Lastly, were several new large domestic banks – concentrated in Moscow/St. Petersburg and focused on private enterprise lending and securities market transactions.[22]

Russia's August 1998 financial crisis resulted from ongoing fiscal deficits. To fund these, the government issued "GKOs" – short-term ruble-denominated, zero-coupon obligations traded on local exchanges. The crisis hurt mainly GKO holders (including local banks) and Russia's currency and foreign exchange reserves.[23] Retail deposits, however, seemed reasonably safe. In

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[20] Ibid, pp. 140-141 and 171.
[21] Lane H. Blumenfeld, "Russia's New Civil Code: The Legal Foundation for Russia's Emerging Market Economy," *The International Lawyer*, Fall 1996, p. 479.
[22] Juliet Ellen Johnson, "The Russian Banking System: Institutional Responses to the Market Transition," *Europe-Asia Studies*, 1994, pp. 977-979.
[23] IMF, "Russian Federation: Recent Economic Developments," September 1999, pp. 56-70.

addition to formal deposit insurance, large state shareholdings provided further assurance for retail depositors in the large "legacy" commercial banks.[24]

Tradable securities preceded a legal/institutional framework for securities trading. The distribution of tradeable privatization vouchers began in 1992, and some tradeable shares in privatized SOEs were available by early 1993. Problems then included a lack of rules on share ownership registries, which were often maintained by enterprises to the disadvantage of outside shareholders. A Russian Federal Securities Commission (RFSC) was established sometime during 1993, but its duties and authority are unclear. After the Russian Trading System was established in 1995, consolidating regional trading floors via one electronic system for trading and settlement, a Securities Law was passed and published in April 1996. In July 1996, the RFSC was restructured and reestablished as the Federal Commission on Securities Market (FCSM), whose duties included the maintenance of independent share registries, resolution of custody disputes, and coordination with other government agencies.[25]

Despite Russian's lack of market institutions, the Yeltsin government moved quickly to begin privatization in 1992. This reflects three considerations. Yeltsin reformers presumably saw little likelihood of getting a complete set of free-market laws passed by the left-leaning Supreme Soviet. Also, reformers saw privatization as a way to end SOE claims on government financing, and thereby promote macroeconomic stability. Lastly, privatization officials saw rapid and extensive privatization as an obstacle to renewed Communist rule.[26]

Russia's privatization program had three components:

1. Small privatization – mainly of small retail SOEs.
2. Voucher privatization – of medium or large SOEs.
3. "Loans for shares" privatization – of large strategic SOEs.

Small privatization finished very quickly. From April 1992 through June 1994, over 87,000 small SOEs were privatized (Table S1-7). During the peak of small privatization in the second half of 1992, privatizations averaged over 6,300 per month.

[24] For example, the Russian Government reportedly now owns 52.3 percent of Sberbank, 60.9 percent of VTB, and 72.4 percent of Agriculture Bank. Gazprombank is 35.5 percent owned by Gazprom, itself owned 50.2 percent by the Government. Wikipedia accessed 14 December 2020.

[25] Greg Lumelsky, "Does Russia Need a Securities Law?" *Northwestern Journal of International Law & Business*, Fall 1997, p. 111.

[26] A member of GKI management said that privatization leadership wanted enough privatization so that "there would be blood in the streets" if a new leftist government tried to restore Communism. Private conversation, February 1993.

Table S1-6: Privatization of Small SOEs in Russia

Time Period	Transactions Per Period	Cumulative Transactions
April-June 1992	7,581	7,581
July-September 1992	13,639	21,220
October-December 1992	24,243	45,463
January-March 1993	11,949	57,412
April-June 1993	10,453	67,865
July-September 1993	7,439	75,304
October-December 1993	4,249	79,553
January-March 1994	3,695	83,248
April-June 1994	3,941	87,189

Source: Aslund (1995) p. 250.

Qualitatively, small privatization did not go quite as intended. Contrary to the intent of Moscow reformers, "auctions and public tenders did not become the dominant methods." By end-April 1993, 13.6 percent of small retail objects had been privatized via auction and 36 percent via public tender, while 40.4 percent had first been leased and then bought out by employees and the remainder had been privatized after transformation into joint stock companies, which usually amounted to employee buyouts. "The impression of a lack of transparency and predominance of insider ownership is reinforced by data on the new owners." Employees bought 69.9 percent of all privatized retail outlets as of end-April 1993. "One reason for the mass acquisition of enterprises by their employees was that they were offered excellent purchasing conditions."[27]

Voucher privatization of medium/large SOEs also proceeded quickly, heavily influenced by Soviet-era laws:

- A 1987 Law on State Enterprises shifted authority from line ministries to SOE managers and workers – including over output, product development, marketing, selling at "market" prices, retaining foreign currency earnings, and obtaining credit from non-traditional sources. This law also allowed more for non-state forms of enterprises, e.g., joint ventures, leases, cooperatives, collectives, and limited firms. Spokespersons claimed the existence of 215,000 cooperatives employing 5.2 million workers in October 1990, plus 12,500 registered leases of SOE assets and many more informal leases. Thus, insiders exercised authority and claimed significant ownership rights in many SOEs.
- A July 1991 Russian Law on Privatization of State and Municipal Enterprises established that the government must submit an annual privatization program (what and how) to the legislature; assigned overlapping responsibilities to several different authorities; and gave enterprise workers' collectives "the power to approve or reject, or at least delay, privatization proposals."
- Another July 1991 Law on Privatization Accounts "vaguely indicated that 'investment certificates' would be distributed to all citizens for use in the privatization process."[28]

Preparations for voucher privatization accelerated during the second half of 1992. This followed President Yeltsin's October 1991 decision to move forward on privatization and April

[27] If a work collective submitted a winning bid in an auction, it received a 30 percent upfront discount on its bid price; made only a 25 percent down payment on this; and could pay the remaining 75 percent over a three-year period, at no interest in a highly inflationary economy. Aslund (1995), p. 251.
[28] Nellis (2008), pp. 105-106.

1992 decisions on design for a mass privatization program. Subsequent preparations included the distribution of privatization vouchers to about 144 million Russian citizens, development of voucher auction procedures and infrastructure, and compilation and publication of information on SOE voucher auction candidates.[29] The first eighteen SOEs were voucher auctioned in December 1992. By mid-1994, almost 14,000 medium/large SOEs had been privatized through voucher auctions (Exhibit 8).

Table S 1-7: Voucher Privatization of Medium/Large SOEs in Russia

Time Period	Transactions Per Period	Cumulative Transactions
December 1992	18	18
January-March 1993	750	768
April-June 1993	2,100	2,868
July-September 1993	2,631	5,499
October-December 1993	2,969	8,468
January-March 1994	2,305	10,773
April-June 1994	3,059	13,832

Source: Anlund (1995), p. 256.

Against the backdrop of Soviet-era laws, such speed required and resulted in heavy insider ownership. The need to obtain their cooperation resulted in SOE managers and workers obtaining "a dominant 2/3 of the shares in about 2/3 of all firms divested."[30]

Officials recognized huge remaining gaps in Russia's market economy. These included the lack of an adequately regulated and supervised security market to reconsolidate dispersed enterprise shareholdings; incentives for enterprise restructuring; and corporate governance protections for outside shareholders. Negligible corporate governance disadvantaged outsider (especially minority) shareholders, who "often complained that their stake was being illegally diluted or eliminated, or that they were being ignored, misled, or actively cheated." [31]

Following a hiatus, major privatization resumed in late 1995 with the "loans-for-shares" program. Under it, the Yeltsin government borrowed funds from Russian commercial banks, offering shares in thirteen high-potential natural resource SOEs as collateral, which the banks took ownership of when the government defaulted on these loans. These loan arrangements were "neither competitive nor lucrative to the selling state." The commercial banks were "all apparently owned by a group of financial 'oligarchs' connected to the presidency. . . . To give some idea of the results, Uneximbank obtained 38 percent of the shares of Norilsk Nickel, a firm that in 1999 (reportedly) made annual profits of $2 billion, on the basis of a U.S. $170 million loan." Perhaps loans-for-shares was necessary to defeat the Communist Party and secure President Yeltsin's reelection in 1996.[32] Citing the lack of transparency, clear conflicts of interest, and collusion, however, other observers conclude that "in two years the Russian privatization program has moved from the outstanding accomplishments of the [Mass Privatization Program] to the point where its

[29] State Committee of the Russian Federation for the Management of State Property, *Annual Report 1992*, p. 5.
[30] Ibid, p. 109-110.
[31] Ibid, pp. 110-112.
[32] Ibid, p. 112.

program is now widely regarding as collusive and corrupt, failing to meet any of its stated objectives."[33]

Table S1-8: Russia's Transition Timeline

Transition Years 1-4 (1/92-12/95)	Transition Years 5-8 (1/96-12/99)
I. Liberalization	
• Price controls eliminated for 80 percent of wholesale prices and 90 percent of consumer prices. Other still-administered prices (e.g., energy, freight) raised three- to fivefold (January 1992) • Liberalization of domestic trade (January 1992) • Liberalization of foreign trade (January 1992) • Virtually all consumer prices liberalized (March 1992) • Solid majority of Congress of People's Deputies votes against private land ownership (April 1992) • Administered wholesale oil price raised 6.3x (May 1992), leaving it at about 15 percent of world price • Foreign exchange essentially unified (except for centralized imports) and ruble made convertible on current account (July 1992), with the Moscow Interbank Currency Exchange as the main platform for currency transactions among banks and enterprises. • Currency exchanges established in five additional cities (from July 1992) • Presidential decree allowing private ownership of land (October 1993) • New Constitution for the Russian Federation (December 1993), recognizing private land ownership	
II. Market Institutions	
• Law on the Fundamental Principles of the Tax System (1991), providing a system of federal, regional, and local taxes • Part I of new Russian Civil Code published (December 1994), addressing definitions of legal entities (e.g., joint stock companies); securities; property ownership rights; contract law (parties, performance rules, obligations); and secured transactions	• Part II of new Russian Civil Code published (January 1996), addressing specific forms of contractual obligations (e.g., sale, leasing, banking, agency, insurance, simple partnership, trust, personal injury)
III. Market Entry/Exit	
• Anti-Monopoly Commission (established 1990) transferred from government to Supreme Soviet (late 1991) • Law on Foreign Investment, followed by liberalization decree (November 1991), allowing foreigners to invest through JVs or wholly owned enterprises, in principle in any business not prohibited	

[33] Ira W. Lieberman and Rogi Veimetra, "The Rush for State Shares in the 'Klondyke' of Wild East Capitalism: Loans-for-Shares Transactions in Russia," *George Washington Journal of International Law and* Economics, 1996, p. 738.

• December 1990 elimination of any restrictions on private enterprise revoked by requirement for local licensing (May 1993) • Law on Bankruptcy of Enterprises passed (November 1992), giving main responsibility for declaring bankruptcy to existing arbitration courts; few cases • State Bankruptcy Agency established and staffed at 1,000 (by December 1994), focused on instructing SOEs; an additional hindrance • Government "Program for De-monopolization of the Economy and the Development of Competition" announced (March 1994), limiting regulation to natural monopolies	
IV. Financial Sector Development	
• Gosbank converted from mono-bank into Central Bank of the Soviet Union (CBSU)(1988), in charge of monetary policy, bank supervision, and interbank settlements • Russian Banking Law (December 1990) • CBSU superseded by Central Bank of Russia (CBR) (December 1991) • Several "second tier" commercial banks established as self-supporting joint stock companies independent from the state (1991) • Former Union Savings Bank replaced by "new" Sberbank, with deposits guaranteed by the Russian government (January 1992) • CBR limits foreign ownership in Russian commercial banks to 12 percent (April 1993) • President Yeltsin bans foreign banks from doing business with Russian customers until 1996 (November 1993) • Presidential ban on foreign banks relaxed (June 1994) • Russian Federal Securities Commission (RFSC) established (1993) • Joint Stock Company Law (December 1995) • Russian Trading System established (1995), consolidating regional trading floors via one trading and settlement system	• Securities Law published (April 1996) • RFSC restructured and reestablished as the Federal Commission on Securities Market (FCSM)(July 1996) • Law on Insolvency of Credit Institutions (February 1999), establishing procedures for insolvency prevention, declaration and liquidation
V. State-Owned Enterprises	
• Law on State Enterprises (1987) • Law on Privatization of State and Municipal Enterprises in the Russian Federation (July 1991) • Law on Personal Privatization Accounts (July 1991) • Government prohibition on insider leasing of SOEs (1992) • 21 shops privatized by auction in Nizhny Novgorod (February 1992) • 45,463 small SOEs privatized (1/1/92-12/31/92) • Voucher privatization program approved by government and submitted to parliament (April 1991)	

• First voucher auction privatizations of 18 medium-sized SOEs (December 1992) • First nationwide voucher auction, for ZiL (April 1993) • 88,090 small SOEs privatized (1/1/93-12/31/93) • Presidential decree "On Measures to Assure the Rights of Shareholders" (October 1993), to provide more protections for outsider shareholders. • Shares in 8,468 medium/large SOEs auctioned for vouchers (1/1/93-12/31/93) • 7,636 small SOEs privatized (1/1/94-6/30/94) • Shares in 5,364 medium/large SOEs auctioned for vouchers (1/1/94-12/31/94) • Loans-for-shares auctions (November-December 1995)	

Sources: Aslund; Lumelsky (1997); Nellis; Blumenfeld (1996).

Poland

Unlike Russia, Poland achieved macroeconomic stability and completed its market infrastructure before privatizing many medium/large SOEs. Even under Communism, about 30 percent of Poland's output was private – mainly private agriculture (about 75 percent of all agricultural land), small industrial and construction firms, and small service enterprises (shops, restaurants).[34]

As reforms began in 1990, production was stagnating while inflation and external debt threatened:

- The 70 percent Socialist economy focused on heavy industry and mining. Industrial production was "heavily concentrated, with enterprises employing over 1000 workers accounting for over two-thirds of industrial employment and output." Only about 12 percent of industrial output was exported. This industrial base was outmoded and in need of restructuring. Material and labor inefficiency in manufacturing were of particular concern. Although price controls, trade barriers, and other socialist distortions made it difficult to evaluate competitiveness, it seemed that most industrial output was not competitive "on the basis of world market prices, even after marked real devaluations in recent years." Excessive energy consumption and reliance on heavily polluting coal were additional concerns.[35] There were about 8,400 medium/large SOEs and 236,600 mall SOEs (see Exhibits 6 and 7)
- Despite private ownership of land, agricultural productivity was low and stagnant, "even with respect to its East European neighbors" as a result of "systemic and institutional difficulties (extension, credit, inputs supply, marketing, pricing." Agro-processing was "a severe bottleneck, with low levels of efficiency and poor quality performance."[36]

[34] World Bank, *Report and Recommendation of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Proposed Structural Adjustment Loan in an Amount Equivalent to US$300 Million to the Government of the Republic of Poland*, 10 July 1990, p. 2.
[35] Ibid.
[36] Ibid, p. 3.

- Poland lacked a good financial intermediation system. Financing decisions "tended to be made in conjunction with other centralized decisions, and enterprise investments and operations were insulated from the consequences of their mistakes and achievements, through major transfers from/to the state budget, price controls, and the monopolistic structure of production. Lending and deposit rates remained substantially negative in real terms for years." Earlier attempts at financial system reform intensified in 1989 with the shift from a mono-bank to a two-tier banking system. The National Bank of Poland (NBP) was established as the central bank and its commercial operations and assets were spun off to nine independent commercial banks. "However, the financial system remained at an early stage of development."[37]
- "Artificially low interest rates and poor planning resulted in numerous inefficient undertakings which survived as they were protected from domestic and foreign competition. There was too much emphasis on inefficient construction and completed projects typically had very low rates of return, while high investment rates absorbed vast quantities of resources."[38]
- An investment drive during the 1970s had left Poland with large external debt of $41 billion at end-1989. Even after several debt rescheduling agreements, Poland was unable to make full payments, so arrears on $37 billion owed to Paris and London Club creditors accrued during 1989. Its external debt stock was about five times Poland's annual convertible currency earnings, "one of the highest such ratios in the world," reflecting "the relatively small share of convertible currency exports in GDP."[39]
- Although real output had been increasing for five years (recently at 4.5 percent per year), "many sectors showed serious signs of overheating as increases in nominal wages far exceeded increases in output." Increases of 10-12 percent in enterprise investment and 3-4 percent in personal consumption exacerbated market imbalances, resulting in "widespread shortages." A nine-fold increase in nominal wages during 1989 further accelerated inflation from 70 percent in 1988 to 252 percent for 1989. "As a result of these and other disruptions in the economy, output began to decrease during the last months of 1989." As in Russia, pay raises were intended to set the stage for raising energy and other prices. The ensuing instability from large price increases and lax financial discipline (including from credit expansion and subsidies) "led to changes of expectations and accelerating inflation." Further contributors were negative interest rates and the monetization of rising fiscal deficits – from 2-3 percent of GDP during 1988 to over 10 percent during the first nine months of 1989.[40]
- Local laws (but not legal practice) were a relative bright spot. Poland began its transition with "a rich legal tradition dating from pre-socialist times. This tradition was suppressed but not eliminated during its 40 years of socialism. . . . The current legal framework in Poland follows closely other continental jurisdictions (particularly the French system) and has a clear and reasonable internal logic." While many of the laws are old (e.g., company law and bankruptcy law from the 1930s), "most are flexible enough to permit a wide range of modern market-oriented activity." Property law was the most problematic, characterized as "a jungle" by one local practitioner. Legal practice, however, was "still very uncertain in all areas. The generality of the laws leaves wide discretion for administrators and courts, and there has not yet been

[37] Ibid.
[38] Ibid.
[39] Ibid, p. 4.
[40] Ibid, p. 5.

time to build up a body of cases and practice to further define the rules of the game." Courts were at least generally honest, and used by the public. But judges were not well paid. All this created "tremendous legal uncertainty that is sure to hamper private sector development." The real need was for judicial training and the compilation and dissemination of information on cases, precedents, and practice.[41]

The government responded with a broad and ambitious program. Named for the minister of finance, the Balcerowicz Plan announced on 6 October 1989 and enacted by 1 January 1990, was "one of the most comprehensive and radical ones ever undertaken." Emphasizing stabilization, it "also introduced significant structural and systemic changes," including "a virtually balanced budget; credit controls; positive real interest rates; price decontrol; a changed foreign trade and exchange regime with a fixed exchange rate after significant devaluation; and a substantial reduction in real wages (to be enforced through a tax-based income policy." E.g.:

- The 1990 fiscal budget reduced the projected deficit to <1 percent of GDP, from about 8 percent for 1989.
- Price controls, previously imposed on goods/services comprising 80 percent of GDP in early 1989, were eliminated – leaving price controls only for public transport, energy, and a few other items.
- Nominal interest rates were raised sharply – from 100 percent per year to monthly rates starting at 36 percent for January 1990 and then reduced in line with declining inflation. Rates were set "with a strong concern for achieving positive real interest rates and making *zloty* savings instruments more desirable than previously, and thus helping to stabilize the exchange rate." Money creation was limited by credit ceilings as well as a prohibition on monetization of any fiscal deficit.
- All current account transactions were liberalized, except for dividends from foreign-invested enterprises (to be phased out) and travel abroad. FX purchases for current account transactions were freely allowed, although all export proceeds had to be surrendered. The official FX rate devalued the *zloty* from 1400/USD to 9500/USD. A parallel FX market would continue to exist for private non-current account transactions. If its FX rate deviated more than 10 percent from the official rate, domestic interest rate changes or other initial measures would adjust the official FX rate toward the market rate.[42]

Structural reforms were codified in ten acts passed by parliament in late 1989:

1. Act on Financial Economy Within State-owned Companies – allowing SOEs to declare bankruptcy and creditors to initiate insolvency proceedings against unprofitable SOEs, and removing guarantees for SOEs regardless of their financial results, which ended "the fiction by which companies were able to exist even if their effectiveness and accountability was close to none"

[41] Cheryl W. Gray, et al, *The Legal Framework for Private Sector Development of a Transitional Economy: The Case of Poland*, World Bank Policy Research Working Paper 800, November 1991, pp. 1-2.
[42] World Bank, *Report and Recommendations of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Proposed Structural Adjustment Loan in an Amount Equivalent to US$300 Million to the Government of the Republic of Poland*, 10 July 1990, pp. 8-9.

2. *Act on Banking Law* – forbidding NBP financing of fiscal deficits or the issuance of a new currency
3. *Act on Credits* – abolishing preferential laws on credits to SOEs and linking interest rates to inflation
4. *Act on Taxation of Excessive Wage Rise*, introducing a tax on excessive wage increases by SOEs
5. *Act on New Rules of Taxation* – introducing common taxation for all companies and abolishing special taxes that could previously have disadvantaged private companies by administrative decision
6. *Act on Economic Activity of Foreign Investors* – allowing foreign companies and individuals to invest in Poland and export their profits abroad, and exempting foreign-invested enterprises from the tax on excess wages
7. *Act on Foreign Currencies* – introducing internal exchangeability of the *złoty* and abolishing the state monopoly in international trade
8. *Act on Customs Law* – creating a uniform customs rate for all companies
9. *Act on Employment* – regulating the duties of unemployment agencies and allowing the existence of unemployment.
10. *Act on Special Circumstances Under Which a Worker Could be Laid Off* – protecting the workers of state firms from being fired in large numbers and guaranteeing unemployment grants and severance pay[43]

Thus, the government quickly imposed hard budget constraints on SOEs. Courtesy of a legacy bankruptcy legislation from the 1930s, mechanisms existed to force the restructuring or liquidation of SOEs for failure to service their debts. After one awful year, inflation dropped sharply and then progressively declined. Annual inflation went from 245 percent in 1989 to 568 percent in 1990 and 77 percent in 1991, then continuing to decline to below 10 percent after 1998 (versus 2009 in Russia).[44] Real GDP growth turned positive in 1992 (versus 1997 for Russia), at 2.5 percent for the year.[45]

Additional reforms built upon Poland's initial endowment of some market institutions:

- The Constitution was amended (December 1989) to eliminate Socialist property classifications and treat all types of property equally in civil, administrative, and criminal proceedings as well as to restrict expropriation.
- A new Law Counteracting Monopoly Practices (March 1990) provided sanctions and remedies for abuse of market dominance as well as independent powers to initiate de-monopolization by targeting multi-plant SOEs for breakup.

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[43] https://en.wikipedia.org/wiki/Balcerowicz_Plan , accessed 16 December 2020. See also Annex C for allocation of Plan initiatives into different economic transition categories.
[44] http://data.worldbank.org . The 245 percent rate for 1989 is reasonably close to the 252 percent rate cited in World Bank (1990).
[45] http://data.worldbank.org .

- An independent Anti-Monopoly Office was established (April 1990), reporting directly to the Council of Ministers.
- An amendment to the Land Use and Expropriation Act (1990) gave state and local governments the right to sell land outright, rather than remaining limited to the sale of land use rights (LURs).
- A new Foreign Investment Law (June 1991) allowed 100 percent foreign ownership, limited government screening/approval to a short pre-defined list of "strategic" activities and allowed unrestricted profit repatriation.
- The Civil Code was amended (July 1991) to restore contract law to its 1933 basis.

The government quickly augmented Poland's financial infrastructure:

- The new NBP established a Department of Bank Supervision in 1989. In August 1990, it promulgated temporary prudential and supervisory regulations, including for loan classification and provisioning, capital adequacy, and required liquidity.
- A new Securities Law (April 1991) provided for a Securities and Exchange Commission, stock exchange, brokers/dealers, and open-end mutual funds and fund managers.
- The Warsaw Stock Exchange re-opened in April 1991, initially trading shares in five privatized firms.
- Accounting standards were revised in 1991.

New banks quickly entered the market. Minimal NBP regulations (e.g., for equity and prior banking experience) encouraged 54 new banks during 1990-1992. These tended to be very small and specialty-oriented (e.g., energy sector, sugar industry); many were established by SOEs or municipalities; and their founders often hoped for easy access to credit. Poor human capacity and some criminality soon posed problems, necessitating intervention/rehabilitation by the NBP and a revision of licensing practices. Despite a strong dislike of foreign investment by some political parties, eleven foreign banks entered the market during 1990-1993. NBP developed more effective supervisory practices in the mid-1990s.[46]

Financial distress among state-owned banks became evident in 1991. By end-1989, Poland had 18 state-owned commercial banks (SOCBs), including nine former local branches of the former state mono-bank. In 1989, these nine were transformed into joint stock companies (owned by the Treasury) to legally prepare them for privatization. The January 1990 reforms and the 1991 collapse of exports to CMEA countries caused "a dramatic worsening" of the financial position of SOE borrowers. Analysis of the nine NBP spinoffs revealed that bad credits had increased from 9-20 percent in individual banks at end-1991 to 24-68 percent in individual banks and to 34.8 percent overall by end-June 1992.[47] Seven SOCB spin-offs were particular problems.

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[46] Ewa Balcerowicz and Andrzej Bratkowski, "Restructuring and Development of the Banking Sector in Poland: Lessons to be Learnt by Less Advanced Transition Countries," Cenrtum Analiz Spoleczno-Economicznych (CASE) Report 44, 2001, pp. 13-14.
[47] Ibid, pp. 8 and 14.

Rejecting foreign recommendations for transfer of bad credits to a new "bad bank," the Ministry of Finance pursued a decentralized approach to SOCB rehabilitation. Seven NBP spinoffs separated loans classified by auditors as non-performing (i.e., doubtful or loss); stopped new credits to these borrowers; and created workout departments to manage the non-performing portfolios. In return for *ex* ante capital injections equivalent to $538 million to enable them to maintain 12 percent capital adequacy after making provisions for non-performing loans, the nine NBP spinoffs were required to restructure these non-performing loans within 12 months, e.g., via debt restructuring, debt sale, court-supervised reorganization or liquidation, or debt-to-equity conversion. Three other specialized state banks received even larger recapitalizations of $1.8 billion, for total recapitalization charges equivalent to $2.3 billion. MOF's approach is credited with restoring the solvency of state-owned banks, ending new bad debts, improving bank culture and containing moral hazard, and making some contribution to enterprise restructuring and privatization.[48]

Bank privatization, through traditional commercial methods, was much more time consuming than originally expected. The MOF's 1991 plan contemplated the privatization of all nine NBP spinoffs during 1993-1996, using the same method to facilitate quick completion. In fact, "the preparation of each privatization was a complicated task and as time was passing, more and more politically sensitive. Frequent changes of the government . . . did not facilitate a smooth continuation. . . . Individual cases of bank sales were hotly debated in public, much and often unfair[ly] criticized by opposition parties, sometimes even opposed within the government and ruling coalition. Debates in the parliament as well as in the media expressed a lot of fears and prejudices against foreign capital." All responsible ministers were accused "of accepting too low prices, choosing a wrong method of privatization or a wrong buyer." All faced parliamentary accusations and censure. The two NPB spinoffs that had not required recapitalization were sold via initial public offering to a strategic investor in late 1993/early 1994, but with the Treasury retaining ownership of 44 percent or 33 percent. By end-1995, of the nine NBP spinoffs, only four had been just partly privatized (see Annex C for more details). Three others were formed into the PEKAO S.A. holding company. Two other NBP spinoffs were partly privatized in 1997, albeit with the Treasury retaining ownership of >50 percent of PBK (sold to foreigners) and 8 percent in Bank Handlowy through a complex transaction resulting in a management takeover.[49]

Privatization proceeded much more quickly for small SOEs than for medium/large SOEs.

For small, Poland achieved the most rapid transformation of retail, catering, and service sectors in all of ECA.[50] Between 1989 and end-1990, the privatization of about 194,000 retail, catering, and service outlets decreased the number of socialized outlets by 82 percent, from 236,000 to 42,000 (Exhibit 10). Meanwhile, private outlets more than tripled in number to 970,000 – representing 96 percent of total outlets.

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[48] Ibid, pp. 15-16.
[49] Ibid, pp. 17-19.
[50] R. Frydman, et al, *East European Experience with Small-Scale Privatization*, World Bank collaborative study with the Central European University Privatization Project, April 1999, p. 29.

Table S1-9: Estimated Retail, Catering, and Service Outlets: Privatized and Privately Owned, 1989-1992

	1989	1992	percent Change
Socialized	236,000	42,000	(82)
Private:	300,000	970,000	223
Privatized	*0*	*194,000*	*nm*
Greenfield	*300,000*	*776,000*	*159*
Total	535,000	1,012,000	89

Source: Frydman, et al, (1999); and author's estimates.

Small privatization in Poland was a real estate event. In fact, the government never established a separate or specific small privatization program. Key to success was the government's realization "that the transformation of retail trade, catering, and consumer services centered not around the privatization of the sub-standard businesses run by the command economy's domestic trade sector, but around a *transfer of the real estate* on which these businesses had operated." Thus, small privatization in Poland "had little to do with a transfer of ownership in businesses as going concerns." Indeed, "the implicit objective . . . was to dissolve the state-run trade network, not to preserve it. Insofar as the retail units themselves were concerned, there was little of value in them beyond the premises." Thus, a first step was restoring genuine property rights to the titular owners (e.g., municipalities) of the real estate, who had loosely leased it to state trading organizations. "Local governments and housing cooperatives, the main beneficiaries of this change, had no interest in preserving the old empires of the state trade organizations." Employees at the state-run outlets, "who had local connections and the sympathy of their neighbors," however, were a potential obstacle. Hence, key to success "was an alliance between local authorities and the insiders from the affected units, who turned against their old employers and went into business for themselves."[51]

Not surprisingly, small privatization was dominated by existing employees and local government insiders. A survey of municipalities (which controlled 51 percent of retail outlets) indicates that open auctions were used in only 27 percent of the cases. Otherwise, auctions were limited to employees (often with a rebate as large as 70 percent on the first year's rent) or – most commonly – transfer to insiders via a negotiated rental or sale at an administratively determined price. This tended to reduce municipal rent collections while driving up rents for competed real estate. Another 46,000 cooperative or socialized units were simply reclassified as "private."[52]

Insider domination of privatization can pose a serious problem. "Insiders are less likely to restructure and invest in the newly privatized business." Indeed, a survey shows that "post-privatization investment levels in Poland are significantly lower than in Hungary or the Czech Republic."[53]

Central government preferences for market procedures and open auctions notwithstanding, "insider domination in part explains the speed with which small privatization was achieved in Poland." A cross-country assessment of small privatization concludes that "unless the government is extremely strong and insiders are incapable of mounting effective resistance (which

[51] Ibid, pp. 29-30.
[52] Ibid, pp. 31 and 32.
[53] Ibid, p. 31.

seems not to be the case in most post-command economy countries), there is a clear trade-off between the speed of small privatization and an open, competitive method of allocation."[54]

Opportunities for new small businesses to enter the market and compete were also important. These often operated in makeshift locations, including kiosks on streets or vacant lots. This "played an important role in creating a genuinely competitive environment in which both the remaining state stores and the newly privatized units had to operate." New small businesses "quickly filled temporary gaps in supply, and also forced other units to modify their behavior, with overall gains for the efficiency of the entire domestic trade sector." Thus, during 1989-1991, when overall unemployment increased to 12 percent of the labor force, retail employment actually grew by 6 percent or more.[55]

The privatization of medium/large enterprises moved more slowly. Poland's privatization was subject to at least six laws, some introduced 3+ years into the program:

- A pre-transition State Enterprise Law (September 1981) allowed for liquidations, bankruptcy, or reconciliation for financially distressed SOEs.
- The Act on the Privatization of State Enterprises (July 1990) provided for two main privatization methods: (i) "Capital privatization" of large SOEs began with their transformation into joint stock companies (corporatization), followed by an offering to private investors through public offering, tender, or negotiation following a public invitation. (ii) Liquidation transferred SOE assets by sale, in-kind contribution to a company, or leasing. In addition, this Act gave substantial privileges to employees and established the basis for a future voucher privatization program.
- An Act on the Financial Restructuring of Enterprises and Banks (February 1993) allowed state-owned banks to initiate debt reduction proceedings for distressed SOEs and convert debt into equity.
- Another act (1993) exempted 155 "strategic" SOEs (from the coal, power, and defense industries) from generally applicable privatization rules in favor of special privatization procedures.
- An Act on National Investment Funds (April 1993) would allow every adult to acquire a portion of national assets for a nominal charge. Although conceived in 1991, this law was delayed by "bitter and divisive arguments over the powers and selection of the foreign managers, exactly which firms should and should not enter the program, and fears of workers that entry into the [mass privatization program] would mean the loss of jobs."[56]
- A new Privatization Law (August 1996) gave SOE employees a more privileged position regarding acquisition of shares. While allowing outsiders to initiate a privatization proposal without insider approval, this Law reduced number of SOEs wherein outsiders might exercise this right.

[54] Ibid, p. 38.
[55] Ibid, p. 32.
[56] Nellis (2008), p. 89

- A new Ministry of the Treasury (October 1996) replaced the Ministry of Privatization and also assumed responsibility for supervising state-owned assets.[57]

During its first six years of transition, Poland privatized less than 3,600 medium/large SOEs (Exhibit 11). Of the 5,722 SOEs definitely designated for some form of privatization, 3,373 (59 percent) were designated for privatization by asset sale or bankruptcy. Privatization by asset sale or bankruptcy was completed by end-1996 for 51 percent of the SOEs so designated. The high (78 percent) completion rate for "other privatizations" reflects the large number of agricultural SOEs easily disposed of by management contract, lease, or sale

Table S1-10: Disposition of Poland's Medium/Large SOEs, December 1990 – December 1996

Designation	Total	Completed	Remaining
Privatization by asset sale or bankruptcy	3,373	1,715	1,658
Other privatizations	2,349	1,837[1]	517[2]
Indeterminate	2,719[3]	--	2,719[3]
	8,441	3,552	4,889

Source: Adapted from Blaszczyk and Woodward (1999), p. 11.
[1] Includes 183 "capital privatizations" and management contract, lease or sale transactions for 1,654 agricultural units.
[2] Transferred to 15 National Investment Funds (NIFs) for restructuring and/or privatization.
[3] Includes 160 "strategic" SOEs, 372 other SOEs transferred to the Treasury, 262 SOEs transferred to local governments, and 1,925 SOEs for which the source provides no information.

The slowness of medium/large privatizations likely reflects, in part, the nature of these transactions. Poland did not jump to privatize most of its medium/large SOEs through voucher auctions which, as Russia showed, could be organized in eight months.

- While an asset sale/liquidation might finish quickly via public auction, a court-supervised reorganization could take months or years.
- The privatization of 183 medium/large SOEs through public offering, tender, or negotiation following a public invitation ("capital privatization") would have been a much more complicated process – involving compilation of information to support due diligence, valuation, investor search, negotiation, and perhaps compliance with securities regulator and stock exchange rules for a public share listing. Indeed, 183 corporate sales through commercial techniques in six years (i.e., 30-31 per year) is a relatively rapid rate by OECD standards.[58]
- While the government included a mass privatization component, its wholesale approach (per an April 1993 law) of sponsoring 15 National Investment Funds was more complicated that the Russian or Czech programs that simply allowed spontaneous private sector creation of voucher funds. Following a government Selection Committee's selection of NIF supervisory boards/managers and selection of NIF management companies and negotiation of their contracts, NIFs began operation in June 1995 – eventually receiving majority shares in 512 SOEs for the NIFs to restructure and privatize. Between November 1995 and November 1996, 25.7 million Poles purchased NIF ownership certificates (each convertible into 1 share in each NIF). Both certificates and shares could be freely traded over-the-counter or on the Warsaw

[57] Barbara Blaszczyk and Richard Woodward, "Privatization and Company Restructuring in Poland," Centrum Analiz Spoleczno-Ekonomicznych (CASE) Report 18, March 1999, pp. 10-11.
[58] Nellis (2008), p. 84.

Stock Exchange. By August 1996, the NIFs had submitted plans for the sale of 76 companies, completing 21 of these within the next year. Unfortunately, the financial position of NIF companies (mostly manufacturing or construction companies with 1000 or fewer staff) showed relative deterioration due to a prolonged implementation period with insufficient attention to these companies and their restructuring needs.[59]

Empowered workers also resisted and slowed privatization. As a result of pre-transition SOE reform efforts, "workers' councils had been created and empowered to negotiate with management and branch ministries on a range of production issues." Similar initiatives in the USSR and Czechoslovakia were more recent and improvisational. "In Poland, this was a much more serious and long-standing effort, partly in response to the decentralization ethos, but also clearly in an effort to placate Solidarity, the powerful and popular workers' movement." Solidarity's leaders "were suspicious of privatization and wanted workers to have some substantial say in how, and to whom, and SOE would be sold." Without worker support for the privatization option, "the firm would simply remain in state hands."[60]

Worker involvement, however, had its advantages. In other jurisdictions, "where workers' councils were weak or non-existent, the result was asset stripping and deterioration of firm quality on a large scale." Poland avoided much of this problem, in part because of "good macroeconomic and financial policies, but also because in the firms the workers' councils were keeping an eye on managers and checking if not totally preventing them from asset-stripping and 'spontaneous' privatization. In Russia, by contrast, workers mostly focused on pay issues, otherwise leaving management to do as it wanted.[61]

Lastly, the government showed farsightedness in giving its new Treasury (in 1996) mandates both to privatize and to supervise state-owned assets. Supervision would normally entail the voting of state (Treasury) shares and the nomination/appointment of a supervisory board at each SOE. Privatization takes time to implement, as seen in the Poland case, and some SOEs may never be privatized. Thus, it is important to designate a responsible State shareholder for remaining SOEs and implement effective corporate governance.

Table S1-11: Poland's Transition Timeline

Transition Years 1-4 (10/89-9/93)	Transition Years 5-8 (10/93-9/97)
I. Liberalization	
• Act on Banking Law (1989), forbidding Central Bank financing of fiscal deficit and the issuance of new currency • Act on Taxation of Excessive Wage Rise (1989), limiting SOE wage increases to limit hyperinflation • Act on Foreign Currencies (1989), to introduce internal exchangeability of the *zloty* and abolish the state monopoly on international trade. Reduction of export restrictions and elimination of export subsidies, complete	

[59] Blaszczyk and Woodward (1999), p. 13.
[60] Nellis (2008), pp. 83 and 86.
[61] Ibid, pp. 92 and 105.

elimination of import licensing, and freedom for anyone to engage in foreign trade. • Act on Customs Laws (1989), creating a uniform customs rate for all companies • Act on Employment (1989), regulating unemployment agencies and allowing the existence of unemployment • Price controls ended for 90 percent of the economy, leaving controls only on public transport, energy, and a few other items. • Interest rates gradually liberalized (1989) • Stabilization through tight fiscal, monetary, and wage policies – including hard budgets for SOEs (January 1990) • Near complete trade liberalization and current account convertibility (January 1990)	
II. Market Institutions	
• Enactment of new Law Counteracting Monopoly Practices (March 1990), providing sanctions and remedies for abuse of dominant position as well as independent powers to initiate de-monopolization by targeting multi-plant SOEs for breakup. • Independent Anti-Monopoly Office established (April 1990), reporting directly to the Council of Ministers	
III. Market Entry/Exit	
• Constitution amended to eliminate socialist property classifications and treat all types of property equally in civil, administrative, and criminal matters, and to restrict expropriation (December 1989) • "Complete liberalization of entry" (January 1989) • Act on New Rules of Taxation (1989), introducing common taxation for all companies and abolishing special taxes that could have been administratively applied to private companies • Amendment to Land Use and Expropriation Act (1990), giving state and local governments the right to sell land outright, rather than being limited to land use rights (LURs) • A new Foreign Investment Law (June 1991), allowing 100 percent foreign ownership, limiting government screening/approval to a short-predefined list of "strategic" activities, and allowing unrestricted profit repatriation • Amendment of Civil Code (July 1991), restoring contract law to circa 1933 status	
IV. Financial Sector	
• National Bank of Poland (NBP) was transformed from a mono-bank into a real central bank, while 9 independent commercial banks were established to take over NBP's commercial loan portfolio (1989)	• Deposit Insurance Fund (DIF) Act (December 1994), regulating DIF operations and setting coverage limits • DIF established (by mid-1995)

• NBP establishes a Department of Bank Supervision (1989) • Temporary prudential and supervisory regulations (August 1990), including for loan classification and provisioning, capital adequacy, and liquidity requirements • Economy-wide revision of accounting standards (January 1991) • A new Securities Law (April 1991), providing for a Securities and Exchange Commission, stock exchange, brokers/dealers, and open-end mutual funds and fund managers • Warsaw Stock Exchange reopened (April 1991), trading shares in 5 privatized firms • Nine commercial bank spinoffs from NBP corporatized and transformed into state-owned joint stock companies (November 1991), of which seven were recapitalized • Wielkopolski Bank Kredytowy privatized: 28.5 percent strategic investor and 27.2 percent via IPO (April 1993)	• Bank Slaski privatized: 25.95 percent strategic investor and 58.05 percent via IPO (early 1994) • Bank Przemyslowo-Handlowy privatized: 15.06 percent strategic and 36.94 percent via IPO • Bank Gdanski privatized: 36.75 percent strategic investor, 25.1 percent to foreign portfolio investors via Global Depository Receipts, and 8.21 percent via domestic IPO (December 1995) • Minority shares in two NBP spinoffs (PBK and BH) sold to foreign and domestic institutional investors.
V. State-Owned Enterprises	
• Amendment to the Law on Bankruptcy (1989), subjecting SOEs to normal commercial bankruptcy procedures and ending the guaranteed existence of all SOEs regardless of productivity and financial results • Act on Credits (1989) abolishing preferential laws on credits for SOEs and linking interest rates to inflation • Act on Special Circumstances Under Which a Worker Could be Laid Off (1989), protecting SOE staff from being fired in large numbers, while guaranteeing unemployment grants and severance pay • Amendment of the Law on State Enterprises (March 1990), giving the state – typically represented by the founding ministry (e.g., Ministry of Industry) – full authority to exercise ownership rights and force a non-performing SOE into restructuring or bankruptcy • Initial steps to break up multi-plant SOEs in several sectors, including meat processing, coal, and transportation (early 1990) • Privatization Law passed (July 1990), stipulating that SOEs would be sold only with approval of managers & workers councils. Insiders encouraged to voluntarily submit their firms for sale to the newly created Ministry for Ownership Change. Option for Ministry on its own to designate SOE for privatization (w/ opportunity for worker appeal to a parliamentary committee) was rarely if ever applied. So, forced to hope on insiders' willingness • Act on the Management of Agricultural Property of the State Treasury (October 1991) • Act on the Financial Restructuring of Enterprises and Banks (February 1993)	• A new Privatization Law (August 1996) • Ministry of Treasury established (October 1996), replacing the Ministry of Privatization and receiving responsibility for supervision of state-owned assets

• Act on National Investment Funds (April 1993) • Act requiring special procedures for the privatization of "strategic" SOEs	

Sources: World Bank (1990); Wikipedia; Nellis (2008); World Bank (1991); E. Balcerowicz (2001); World Bank (1997);

Vietnam

In contrast to desires elsewhere to establish market economies, Vietnam's transition sought to create a "socialist market" economy. Through the liberalization of prices and market entry, some privatization, and establishment of market institutions, new private or privatized firms would compete with remaining SOEs on a more-or-less level playing field. SOEs would continue, however, to dominate the "commanding heights" of the economy.

Vietnam started its transition earlier, in 1986, in response to the inability of its Soviet-style system to adapt to the peacetime development of a recently unified Vietnam.

- To reduce vulnerability to U.S. bombing (ended in 1973), the more heavily industrialized North had decentralized plant locations and emphasized local self-sufficiency by redirecting industrial output to meet agricultural and essential consumer requirements. Industrial growth slowed considerably. The relocation of mostly smaller factories to the countryside hurt productivity because of a lack of trained manpower and a need to use simpler technologies.[62]
- Following reunification in 1976, the government attempted to impose the north's planning system on the south. "In agriculture, however, collectivization in the south never proceeded very far. In industry, medium and large-scale enterprises in the south were nationalized and integrated into the planning mechanism." In both north and south, however, there were "are a large number of collective and family enterprises in small-scale industry and services that have never been subject to planning. This large non-state sector, accounting for roughly one-half of industrial output, is a unique feature of Vietnamese socialism."[63]
- An estimated 12,000 SOEs operated mostly under an "administrative supply" system, whereby SOE managers had little incentive to organize production efficiently or to adjust output to meet actual demand. At the same time, the government directly influenced the real incomes of workers in SOEs, State farms, and public organizations (about one-third of workers) by setting their nominal wages and supplying (through its rationing system) food and consumer essentials at fixed prices to meet up to 65 percent of families' needs. Official prices remained unchanged for decades, which contributed further to management inefficiency.[64]
- "Performance in industry has . . . been disappointing. Investment has been spread over many large industrial projects, without adequate provision for supporting investments to provide transport, energy and materials. Investment funds have also tended to go to new projects. . . . The result is that most capital stock is very rundown, and industry frequently suffered from shortages of materials and spare parts, especially those that need to be imported. The organization of enterprises has provided weak incentives to maintain capital stock and produce

[62] World Bank, "Viet Nam: A Socialist Economy in Transition," 5 March 1980.
[63] World Bank, *Vietnam Stabilization and Structural Reforms*, 30 April 1990, p. 7.
[64] George Abonyi, "Policy Reform in Vietnam and the Asian Development Bank's State-owned Reform and Corporate Governance Program, Asian Development Bank, August 2005, ERD Working Paper #70.

efficiently. Consequently, capacity utilization in industry has generally been very low, well under 50 percent."[65]

- Declining incomes and increasing trade and fiscal deficits prompted a 1978 statute aimed at improving efficiency by allowing each SOE to invest part of its earned profit, improve working conditions, and pay bonuses. But implementation was slow. Additional 1981 reforms included a partial contract system for agricultural production as well as some autonomy for SOEs to sell on the free market and set salaries. Preceding the USSR's 1985-1990 efforts at *perestroika*, Vietnam's experiments roughly coincided with China's efforts to improve SOE efficiency while strengthening Party-Government controls to minimize asset stripping.
- Tax systems were underdeveloped because the Ministry of Finance could rely on receipt of any profits from SOEs. In 1984, transfers from SOEs accounted for 79 percent of all government revenues.[66]
- Virtually all investment was financed by foreign loans and grants from the Soviet bloc or China. National savings were actually negative during1986-88, implying that foreign inflows financed some consumption as well as all investment.
- The banking system followed the Socialist mono-bank model. The State Bank of Vietnam provided domestic banking services to SOEs, complemented by two specialized banks to finance trade transactions and infrastructure investment.[67]
- Vietnam's legal system was a blend of "several important legacies: a centuries-old Vietnamese legal tradition, seventy years under French-influenced codes, and forty years of socialist legislation, with a measure of U.S. common law influences in the pre-1975 period."[68] Such a "blend" seems, however, a possible source of investment uncertainty.

Ultimately, the aforementioned government reform efforts were too little too late. By 1986, Viet Nam was suffering from annual inflation >700 percent; large trade deficits; excessive spending for defense and SOE subsidies; and a lack of foreign direct investment (FDI). This led to internal debate about shortcomings with central planning as the institutional framework for economic management.

This debate was resolved by the Communist Party's end-1986 Doi Moi (renewal) policy of abolishing bureaucratic centralized management based on state subsidies and moving toward a multi-sector market-oriented economy where the private sector could compete with the State in "non-strategic sectors." Far reaching reforms followed: liberalization of markets and new market institutions, financial sector development, and some privatization. Following no clear pattern of sequencing, Vietnam's reforms were largely driven by experimentation.[69]

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[65] World Bank (1990), pp. 7-8.
[66] World Bank, *Vietnam: Stabilization and Structural Reforms*, Economic Report 8249-VN, 30 April 1990.
[67] World Bank, *Transforming a State Owned Financial System: A Financial Sector Study of Vietnam*, 15 April 1991, p. 17
[68] Nathalie G. Lichtenstein, "A Survey of Vietnam's Legal Framework in Transition," World Bank Working Paper, April 1994, p. 3.
[69] Abonyi (2005), p. .

Doi Moi reforms accelerated during late 1988/early 1989, focusing on liberalization and stabilization measures, plus adaptations for a smaller SOE sector:

- *Rural reforms* – Collectives were largely dismantled, and agriculture returned to family farming on the basis of 15+ year land use rights (LURs).
- *Price liberalization* – Virtually all price controls were removed.
- *Foreign exchange* – The Vietnamese Dong was devalued, and official FX rates were brought into line with market rates. An FX trading floor was established to allow the FX rate to be determined largely by market forces.
- *Foreign trade reforms* – Vietnam partially reformed its highly restrictive trade regime, so that both SOEs and private firms have easier access to imports and greater incentives to export.
- *Interest rates* – To curb inflation, interest rates were raised to very high levels. Relaxation then resulting in renewed inflation, further interest rate reforms since 1992 kept real rates positive and reduced annual inflation from 70 percent in 1990-1991 to 17 percent in 1992.
- *Fiscal reforms* – The government reduced its fiscal deficit, from 8.4 percent of GDP in 1989 to 1.7 percent in 1992, by demobilizing >500,000 soldiers, eliminating budgetary subsidies to SOEs (forcing almost 800,000 layoffs), and reforming taxes to increase revenues. Meanwhile, to deal with transitional unemployment caused by its reform program, the government initiated retraining schemes and soft loan support for the small private businesses.[70]
- *Other private sector development support* – This included legal reforms, for both domestic and foreign direct investment, as summarized below.

Vietnam enacted important reform legislation but implementing regulations and judicial interpretation remained issues:

- A new Constitution (April 1992) clearly permitted private ownership of property and enhanced legal protections. It prohibited nationalization of private property and required compensation for any exercise of eminent domain.
- A new Law on Private Business and Law on Companies (December 1990) established the basis for private investment. These allowed for the establishment, operation, and State regulation of three new enterprise forms: private business (sole proprietorship), limited liability company (LLC), or shareholding company. There remained, however, "ample requirements" for government approvals "in the stages of establishment (including limitations on fields of business) and dissolution." Furthermore, any change in operation required registration. But by March 1993, 3,469 sole proprietorships, 1,169 LLCs, and 75 shareholding companies had registered.
- Ordinances on economic contracts (1989) and civil contracts (1991) allowed private entities to agree on mutual rights and obligations, with relatively few constraints. The latter established "a general set of contractual principles (offer and acceptance, effectiveness, remedies for

[70] World Bank, *Vietnam: Transition to the Market*, September 1993, pp. 3-4.

breach) which are necessary for contractual relations to exist on a firm footing." It also provided some specificity on the use of guarantees and collateral.

- A Law on the Bankruptcy of Enterprises (enacted December 1993) offered "for the first time a comprehensive legal framework for the restructuring or liquidation of insolvent enterprises." It applied equally to domestic private firms, SOEs, and FDI firms, albeit with special rules for enterprises involved in national defense, security, or important public services.
- A new Land Law (enacted July 1993) clarified procedures for allocations of land by the State as well as leasing; usage rights; transfer and mortgage; and the leasing of land to foreigners. "To a large extent, the practical value" of the new law, however, would depend on its implementing regulations.
- Similarly, the Law on Foreign Investment (enacted December 1987, as amended through December 1992) was a good start, but dependent on implementing regulations. The Law allows for three types of investment: a non-equity joint venture (JV), an equity joint venture, or a wholly foreign-owned enterprise. Amendments allow JV land use for up to 70 years; establishment of export processing zones; build-operate-transfer (BOT) type public-private partnerships (PPPs); and assurance against regulatory changes that hurt an existing JV. Implementing regulations, however, adopted "a control-oriented approach where the state authorizes and supervises all the foreign investor's activities with the exception of the everyday running of businesses."
- Although the National Assembly established economic courts (December 1993) to handle bankruptcy proceedings and specialized economic matters, "judges and assessors with actual commercial experience will be needed to give the system the credibility and efficacy necessary to enhance reliance on market transactions."[71]

Competition and capital market development remained issues for future legislation and regulation.

From 1988, when Vietnam began developing a two-tier banking system, many new institutions entered the market. The SBV began devolving its commercial banking functions and focusing more on its role as a central bank. SBV ceased direct lending to enterprises in 1991 and to finance the state budget in 1992, but it continued to refinance loans made by state-owned commercial banks (SOCBs) at least until 1995. In addition to the existing specialized trade and infrastructure state banks, two additional SOCBs were created: the Industrial and Commercial Bank (Incombank) and Agribank. Post-1990 legislation extended banking services to allow for shareholding joint stock banks, JV banks, foreign bank branches/offices, and credit cooperatives. Early 1994 regulations allowed savings and loan institutions (called popular credit funds). By end-1994, in in addition to the four SOCBs, Vietnam had 36 joint stock banks, 69 credit cooperatives, 3 JV banks, 9 foreign banks, 153 or so popular credit funds, 2 finance companies, and 1 state insurance companies.

[71] Lichtenstein (1994), pp. 4, 6-8, 13, 34-35, 44, 46-47, and 56.

Despite an inadequate legal framework, credit to the private sector has grown substantially, although SOEs continued to dominate borrowing. The SOE share of bank credit declined, however, from 86 percent during 1991-1992 to 63 percent as of late 1994.

SOCBs continued to dominate commercial banking. In 1994, SOCBs "accounted for 87 percent of commercial bank operations [presumably loans and/or assets]."

The finances of many banks, especially SOCBs, however, were shaky. Vietnam had shifted from direct government financing of loss-making SOEs to their financing by SOCBs. "If non-performing assets were calculated using international accounting standards, they would be much higher than the recorded amount. well over 25 percent of outstanding loans." The greatest proportion of overdue credits (96 percent in 1994) was held by SOCBs, and 63 percent was owed by SOEs. With Vietnam lacking a standardized loan classification system and international accounting standards, it was "not possible to place credence" on reported capital adequacy ratios averaging 7.9 percent of risk-weighted assets. In fact, the World Bank estimated that non-performing loans were double bank capital.

Bank supervision was weak. Within SBV, supervision activities were fragmented, and there was dispersion and some duplication of supervisory functions between SBV departments. SBV either "followed a policy of relatively free entry into the banking system" or the "assessment of applicant financial projections and prospects has not been performed with much rigor." As of end-1994, SBV had never denied any license application. Lacking "essential elements of discipline," such as a requirement "to maintain adequate capital for the risks being borne," it was judged "unlikely that bank supervision can ever be truly effective in ensuring the health and stability of the banking system."[72]

The number of SOEs decreased from about 12,000 in 1990 to about 7,000 by 1994. About 2,000 were closed or liquidated. Whether the other 3,000 were somehow conveyed to workers or outside investors is not known. In general, Vietnam's SOEs were small and loss-making. By one estimate, some 6,700 SOEs accounted for 20 percent of the sector's total contribution to the government budget. The remaining SOEs absorbed a disproportionate share of credit. At end-1993, SOEs accounted for 25 percent of GDP and 9 percent of employment, but more than 63 percent of bank credit.

Governance and control over SOEs were limited. About 2,000 SOEs are centrally managed through line ministries, while other 5,000 were under provincial or municipal authorities. "Since 1987, SOEs have received greater autonomy in production, planning, and business operations, but this has not been accompanied by suitable control and oversight by the state as owner of the assets. Financial performance data do not seem to be systematically monitored and SOEs are not subject to regular audits. The lack of effective monitoring and control for locally controlled SOEs: little is known about the assets of the 2,000 firms that have been closed or liquidated, and the extent to which their banking sector debts have been paid off."[73]

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[72] World Bank, *Vietnam Financial Sector Review: An Agenda for Financial Sector Development*, 1 March 1995, pp. iii-iv, vii, x, and xii.
[73] Ibid, p. xi.

Instead of urging privatization or corporate governance improvements to address these problems, the Communist Party of Vietnam (CPV) focused on merging SOEs and developing SOE group national champions that could compete internationally.

- In 1991, the 7th CPV Congress directed the GVN "to rearrange enterprise groups in a manner consistent with production and business requirements of the new market mechanism to build some big companies and enterprises with sufficient prestige and competitiveness to participate in international economic relations."
- In 1994, Decisions 91 and 94 of the Prime Minister established 18 general corporations (General Corporations 91) and sought to reduce "the power of line agencies to interfere with business management and capture profits and rents of SOEs."
- In 1996, the 8th CPV Congress gave clear direction to concentrate State economic development resources on social and economic infrastructure; banking, insurance, and financial services; important business production and service units; and enterprises in the national defense and security sectors.

Table S 1-12: Vietnam's Transition Timeline

Transition Years 1-4 (12/86-11/90)	Transition Years 5-8 (12/90-11/94)
I. Liberalization	
• Reduction in differences between official prices and free market prices. Ration system abolished for many commodities. Internal trade liberalized (1987) • Farmers given land use rights (LURs) for 15+ years and permission to take initiatives in farming and benefit from surplus production (1988) • Interest rates raised to achieve real positive interest rates (1989) • Devaluation of official FX rate, close to the market rate (1989) • Substantial trade liberalization. Private sector allowed to produce export commodities and trade with foreign partners. Import-export quotas significantly reduced. Export subsidies ended. Foreign exchange restrictions relaxed (1989)	• Establishment of foreign exchange centers, and use of exchange rates established at these centers as the basis for official FX rates (1991) • Land Law, granting LURs and right to construct/use fixtures on land for 20 years to Vietnamese persons. Farmers given flexible LURs on farmland for up to 50 years, depending on use (1993)
II. Market Institutions	
• Enactment of a Foreign Investment Code, plus regulations and a State Committee for Cooperation and Investments (1987)	• New Constitution, introducing property rights and a private right to conduct business in line with Vietnam law (1992) • Law on Disputes Resolution (1993) • Establishment of an interbank foreign exchange market (1994) • Establishment of economic courts to hear commercial and bankruptcy cases (1994) • Labor Code, including for labor contracts, wages, and collective labor agreements (1994) • Law on Promotion of Domestic Investment (1994)

III. Market Entry/Exit	
• Initial banking reforms, including separation of State Bank of Vietnam functions from those of commercial banks (1988) • Law on Private Business & Law on Companies, authorizing the establishment of private businesses (1990)	• Law on Bankruptcy, governing all enterprises (1994)
IV. Financial Sector	
•	•
V. State-Owned Enterprises	
• Increased autonomy for SOEs (1988) • Fiscal reforms, including broader tax base and equal tax rates for all economic sectors (1989) • Initial SOE restructuring, including the merger or dissolution of loss-making SOEs (1990) • Preliminary closure or merger of some small, loss-making or inefficient SOEs (1989-1990)	• Communist Party directive to the government the GVN "to rearrange enterprise groups in a manner consistent with production and business requirements of the new market mechanism . . . to build some big companies and enterprises with sufficient prestige and competitiveness to participate in international economic relations." (1991) • Several decrees on SOE reorganization, including provisions on lease, sale, merger, or liquidation and a policy on surplus labor (1992) • Initial "equitization" (corporatization) of a few SOEs (1992-1994) • Relicensing of SOEs. Effective termination of all forms of subsidized credit to SOEs (1993) • Additional fiscal reforms, including introduction of a land use tax and revised salaries for SOE workers (1993) • Prime Minister decisions to merge many SOEs into 18 general corporations and reduce "the power of line agencies to interfere with business management and capture profits and rents of SOEs" (1994)

Chapter 2. Fiscal Policy

Since Uzbekistan's independence in 1991 until 2016, the government fiscal strategy focused on building strong buffers to support the government's broader objectives of economic self-sufficiency, industrial diversification, and production localization. Since 2017, a shift in economic policy towards greater openness and global market orientation has led to profound changes in the fiscal strategy. The level and composition of public spending has changed through the reorientation of capital spending towards reform priority areas and through a large increase in social sector outlays. The tax system has been simplified and made more neutral through a complete overhaul of tax policy and improved tax administration. The financing strategy has also changed, with a large increase in debt – both foreign and domestic – helping to finance public spending after large declines in debt in the previous decade and a half. Fiscal buffers have declined, first due to the emergence of a structural deficit with the change in strategy and later to help respond to the COVID-19 crisis. The strategy has also modified the role and operation model of the Uzbekistan Fund for Reconstruction and Development (UFRD)—a critical catalyst of government industrial policy prior to 2017 – including through changes to the government's investment and localization planning approaches, and measures to withdraw UFRD from lending to the banking sector.

These changes in fiscal policy have played an important role in supporting the broader reform objectives of the 2017-2021 Development Strategy. Yet slower progress with reforms to streamline SOE operations, increase competition in the economy, and curtail state-directed financing activities has reduced the effectiveness of fiscal policy changes. Several opportunities exist to further improve tax administration to reduce factors driving high marginal effective tax rates on investment spending by firms, increase the fairness of the system for private investors, and enhance fiscal transparency and public accountability. Measures to strengthen debt discipline are welcome but are likely to require strong measures to harden SOE budget constraints. The UFRD remains a valuable fiscal policy instrument to help the government achieve its reform objectives, but its role in supporting the transition process needs to be clarified and strengthened. Public investment spending is fragmented and not always well-aligned with reform priorities. Overhauling the public investment framework is likely to significantly improve the impact of public investment. Harnessing these opportunities would strengthen both fiscal discipline and the impact of fiscal policy in achieving stronger reform outcomes.

A. An Evolving Fiscal Strategy

Prior to 2017, fiscal policy supported self-sufficiency and state-led development. Three policy priorities determined the government's fiscal strategy. These priorities were to ensure the country's financial self-reliance, support industrial diversification, and improve social and road infrastructure.[1] In response to these priorities, spending decisions were largely driven by annual economic investment plans to support industrial diversification and social investment plans to improve local infrastructure. Tax revenue policies were designed to heavily tax larger enterprises (state and private-owned) while also providing generous tax expenditures for enterprises (mostly

[1] Pomfret (2019).

state-owned) that implemented industrial policies. Taxes were especially high on labor income—labor taxes and contributions as a share of commercial profits were as high as 37 percent in 2005 and averaged about 27 percent between 2010 and 2017, compared to about 11 percent in Kazakhstan and around20 percent in low and middle-income countries in Europe and Central Asia.[2] Surplus revenues generated from natural resource rents were invested in the Uzbekistan Fund for Reconstruction and Development (UFRD), a sovereign wealth fund designed to support the government's industrial policy priorities. External loans were signed only on an exceptional basis, and there was no domestic public debt (either issued by the treasury or central bank) in circulation between the mid-2000s and 2018. General government debt fell from a peak of 48 percent of GDP in 2001 to a low of about 7 percent in 2015.[3]

The widespread use of quasi-fiscal activities was an important part of fiscal policy. As part of the government's fiscal strategy under the old economic model, every category of quasi-fiscal activity defined under the IMF Fiscal Transparency Manual was used to support fiscal and economic management (Table 2.1).[4] Until 2017, these generated both quasi-fiscal "profits" to the fiscal balance—in the form of exchange rate and trading restrictions that allowed SOEs to be more profitable at a cost to individuals and the private sector—and quasi-fiscal losses from activities such as below commercial pricing, insufficient capital reinvestments, and opportunity costs on subsidized financing.

Table 2.1: Quasi-Fiscal Activities in Uzbekistan

Type of Quasi-Fiscal Activity	In Use Before 2017	Still in Use	Quasi-Fiscal Loss or Profit
Financial System			
Subsidized lending	**X**	**Yes ↓**	Loss
Under-remunerated reserve requirements	**X**	**No**	Loss
Credit ceilings	**X**	**Yes ↓**	Loss
Exchange and Trading System			
Multiple currency exchange rates	**X**	**No**	Profit
Import deposits	**X**	**No**	Profit
Exchange rate guarantees	**X**	**No**	Profit
Nontariff barriers	**X**	**Yes ↓**	Profit
Commercial Operations of SOEs			
Charging less than commercial prices	**X**	**Yes ↓**	Loss
Provision of non-commercial services	**X**	**Yes ↓**	Loss
Special pricing power	**X**	**Yes ↔**	Profit
Paying above commercial prices	**X**	**Yes ↑**	Loss

Source: World Bank staff calculations.
Note: Arrows indicate if activity is decreasing, same, or increasing in use since 2017

A significant shift in fiscal strategy was announced in the 2017-2021 Development Strategy. Several important fiscal policy changes were announced as part of the government's decision in 2017 to reorient the economy towards a more open and market-oriented model. These included substantial increases in public infrastructure and social assistance spending, a gradual increase in regional fiscal autonomy, a transformation of the tax system, greater collaboration with

[2] World Development Indicators
[3] Official statistics
[4] Classifications based on the IMF Fiscal Transparency Manual (2007) See Guide to Transparency in Public Finances for more information.

international development partners and lending institutions, and a large reduction in the size and inefficiency of the state balance sheet.

To implement this shift in the fiscal strategy, several fiscal policy measures have been enacted. Reforms to liberalize the economy and strengthen public financial management have led to significant changes to the government's fiscal strategy. Increased spending, to support reform implementation and buffer social costs, led to the first budget deficit in 2019 since 2003.[5] An overhaul of tax policies sharply cut labor, income, and trade taxes and widened the indirect tax base. Public debt has increased from 8.6 percent of GDP at end-2016 to nearly 40 percent at end-2020 (Figure 2.1), and domestic debt instruments were reintroduced in 2018—the first time in more than a decade. The integration of UFRD operations into the government consolidated budget implied that the UFRD ceased receiving automatic revenue from natural resource rents in 2020. These fiscal policy changes have simultaneously been accompanied by sustained reforms to strengthen public financial transparency and accountability.

Slow progress on SOE reforms increases fiscal risks and reduces the effectiveness of fiscal policy. As Chapter 7 shows, reforms to privatize SOEs and improve SOE corporate governance have taken longer to implement. As a result, the SOE sector is still a major beneficiary of public spending, tax expenditures, quasi-fiscal activities, and new public debt. Total economic spending by the state (a large share of which is directed to SOEs) more than doubled between 2016 and 2020, outpacing expenditure increases in other areas and was a key driver leading to the emergence of a structural deficit. Although quasi-fiscal losses are difficult to estimate, structural reforms enacted since 2017 to reduce "profitmaking" quasi-fiscal activities—such as distortions in exchange rates and trading restrictions—have likely worsened the overall level of quasi-fiscal losses in recent years. Reforms to unify the foreign exchange market in 2017, while essential to start liberalizing prices, also carried a high fiscal cost—banks and large SOEs exposed to foreign currency risks required substantial fiscal support. Although tax revenues remained buoyant following the tax reforms, there are many opportunities for further competition policy and regulatory reforms to generate revenue-positive outcomes for the state. The government continues to rely largely on SOEs—which remain inefficiently managed and governed—to implement large infrastructure and modernization projects linked to reform priorities. These projects are the main driver of public debt dynamics—especially in the energy and transportation sectors.

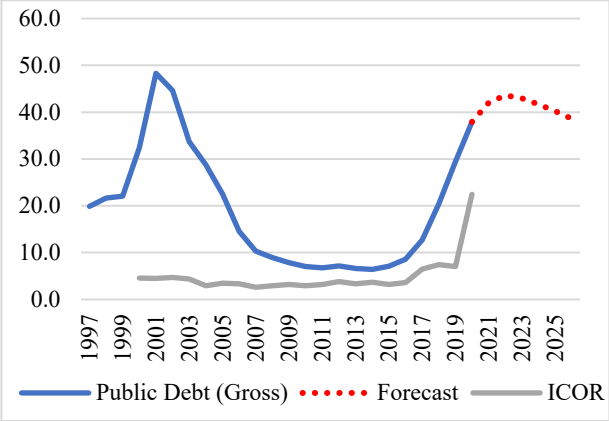
Weaknesses in the public investment framework could be limiting the value for money from investment spending. The focus of public investment has been shifting in line with government policy priorities under the 2017-2021 Development Strategy. Public investment has increased significantly since the start of the reforms, and total spending on economic activities has nearly doubled between 2017 and 2020. A significant portion of these activities has been financed through external debt-financed projects. But this has also been accompanied by a sharp increase in the incremental capital output ratio (ICOR), a metric that assesses the marginal impact of increased investment in generating additional economic growth in the economy. Uzbekistan's ICOR averaged about 3.3 between 2004 and 2016. Between 2017 and 2019, the average ICOR more than doubled to seven (Figure 2.2). Although subject to several data and inference limitations, this higher ICOR may point to the growing inefficiency of capital investments in the economy without

[5] Public Expenditure Review (2019). Refers only to the budget balance and not to the general government balance which includes policy lending.

broader improvements to the investment management framework and other market reforms that increase the economy's ability to absorb these investments—and convert them into higher growth and job creation—more productively.

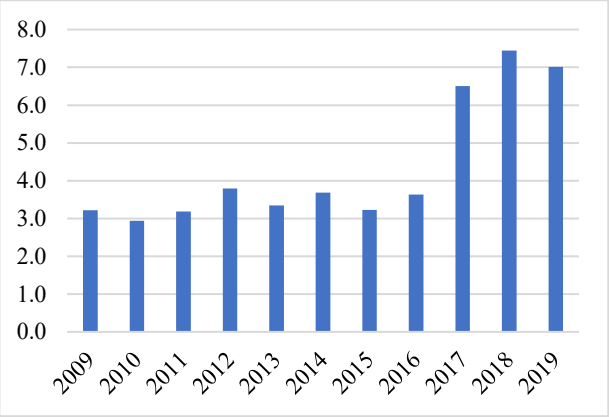
There are many opportunities to further strengthen the effectiveness of fiscal policy in supporting the transition to a market economy. In the area of expenditures, further budget consolidation and measures to overhaul the public investment framework are likely to increase expenditure efficiency, increase the alignment of public spending to policy priorities, and improve value for money. Although tax policy changes have significantly improved the business environment, further measures to improve tax administration and address the drivers of high marginal effective tax rates on private investment could help increase revenue collections and support the effectiveness of other reforms being implemented to increase private sector growth. There are also opportunities to review Uzbekistan's trade and excise tax regime to increase the economy's external trading competitiveness and environmental sustainability. SOE and public investment management reforms will be critical to moderate the rapid acceleration of debt in recent years, while the changing shape of fiscal policy offers a useful opportunity to review and strengthen the role of UFRD in shaping the transition.

Figure 2.1: Government Debt and Investment Efficiency



Source: World Bank/IMF Debt Sustainability Analysis and World Bank staff calculations using official data

Figure 2.2: Incremental Capital Output Ratio, 2009-2019



Source: World Bank staff calculations using official data

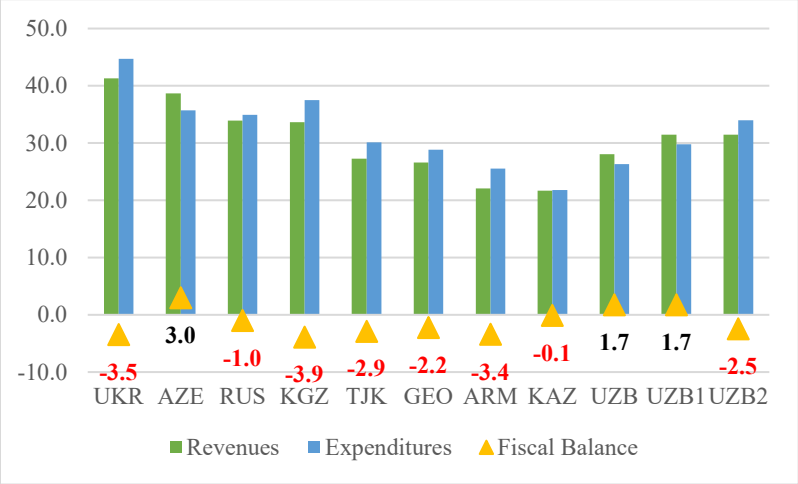
B. Public Spending

Uzbekistan's public spending is higher than most of its peers. Estimates suggest that the public sector contributes to about half of the country's GDP.[6] Total public spending—including on-budget, off-budget, and quasi-fiscal losses—in Uzbekistanis higher than in many of its regional peers (Figure 2.3).[7] It is also about seven percent of GDP higher than the average for lower-middle income countries, and about eight percent of GDP higher than countries with similar per capita

[6] Systematic Country Diagnostic (2016 and 2021 forthcoming)
[7] The World Bank Public Expenditure Review (2019) estimated that quasi-fiscal losses were at least 6 percent of GDP in 2018.

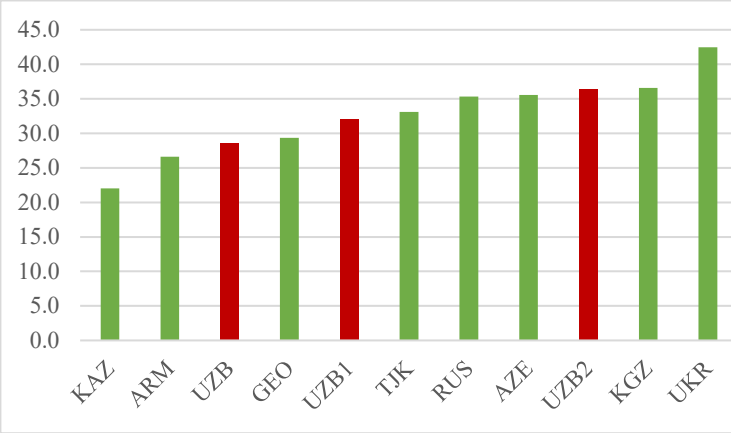
income levels.[8] This high level of spending reflects the legacies of Uzbekistan's state-led economic model.

Figure 2.3: General Government Fiscal Position as a Share of GDP (Average 2010-2020)



Source: World Bank staff calculations using official data.
Note: UZB includes state budget and UFRD operations; UZB1 adds estimated off-budget spending and revenues. UZB2 adds estimated quasi-fiscal losses. Estimates for UZB1 and UZB2 are modeled based on data collected during the preparation of the 2019 PER.

Figure 2.4: Average General Government Spending Between 2016-20 (Share of GDP)



Source: Staff calculations using official data and IMF World Economic Outlook database.
Note: UZB includes all budget and estimated off-budget spending. UZB1 adds estimated additional off-budget spending. UZB2 adds estimated quasi-fiscal losses. Estimates for UZB1 and UZB2 are modeled based on data collected during the preparation of the 2019 PER.

[8] World Bank Public Expenditure Review (2019)

Spending has risen by almost a fifth since the start of the reforms. Total government spending is estimated to have increased by 20 percent since 2016 (Figure 2.5). The largest share of this increase has been to finance economic activities between 2017 and 2019—especially capital expenditure to rehabilitate and renew social, energy, and transportation infrastructure. Social spending has also increased, supporting a large expansion of safety nets and higher health and education sector wages (Figure 2.6). The onset of the COVID-19 crisis led to a large reprioritization of resources in 2020, with a sharp increase in health and social assistance spending, and an almost proportional decrease in economic investment spending due to the slower pace of capital project implementation. Estimates of the public sector wage bill has been declining steadily falling from about 10.5 percent of GDP in 2018 to 8.8 percent in 2020 (Figure 2.7).

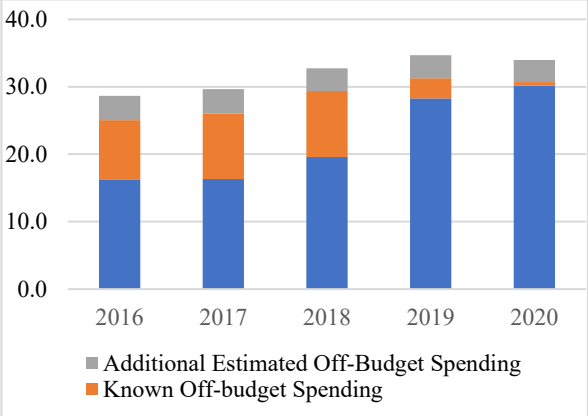
Uzbekistan's capital spending is rising but remains lower than that of peer countries. Capital spending, including UFRD net disbursements, increased in 2018 and 2019 to above 5 percent of GDP, before falling in 2020 to about 4.3 percent due to slower project implementation during the COVID-19 crisis. Relative to its peers, Uzbekistan has a high wage bill and relatively low capital expenditures. For example, wage and capital spending in Central Asian and Caucasus countries is 6.4 percent and 7.7 percent on average.

A weak public investment management framework reduces the effectiveness of Uzbekistan's low capital spending. Public investment spending decisions are highly fragmented in Uzbekistan—for example, net disbursements of UFRD (which are decided on outside the budget investment process) accounted for about one-third of total spending on economic activities between 2017 and 2020. Investment decisions are fragmented and linked to their revenue source, and there is no standard and systematic framework for public investment providing common guidance for project screening and selection. Limited regulations and guidance for economic appraisals also allow for most projects to be selected based on a non-economic basis. These decisions and responsibilities for public investments are largely delinked from the regular budget process which oversees current expenditures, and recurrent asset maintenance and replacement costs are not required when costing investment projects.

Significant progress has been made towards consolidating the government's spending footprint. Since 2018, several reforms have been enacted to strengthen fiscal transparency and accountability. Excluding quasi-fiscal activities, the share of consolidated budget spending subject to government budgetary regulations and laws is estimated to have increased from 56 percent of total estimated spending in 2016 to 90 percent in 2020.[9] The most important consolidation measures were enacted from the 2020 budget, and include the full inclusion of UFRD operations into the consolidated government budget. In 2021, coverage was again expanded to include externally debt-financed programs. Only two spending areas remain outside the purview of the budget accountability system: the special authorized extrabudgetary funds operated by line ministries and by select SOEs that remain outside the Treasury Single Account and the budget; and spending from an estimated several thousand off-budget accounts that are part of the Treasury Single Account but are not included in the budget. Collectively, these two categories amount to about 3.3 percent of GDP.

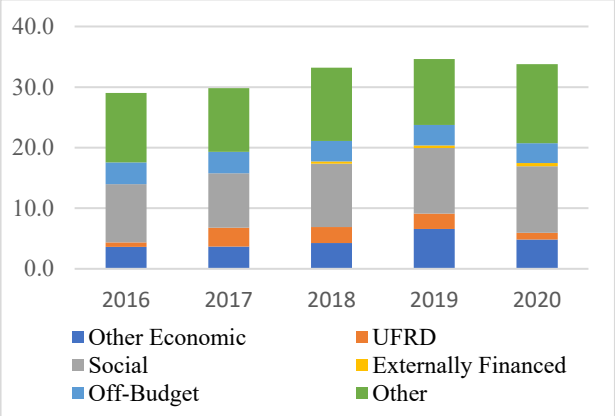
[9] Prior to 2020, this was expenditure subject to the regulations of the Budget Code and annual Presidential Resolutions relating to the annual budget. From 2020, this is expenditure subject to the revised Budget Code and annual Budget Laws approved by Parliament.

Figure 2.5: Government Expenditures
(Share of GDP)



Source: World Bank staff calculations using official data
Note: Notes: Does not include quasi-fiscal losses

Figure 2.6: Composition of Spending
(Share of GDP)



Source: World Bank staff calculations using official data

The progress towards ending the remaining quasi-fiscal activities has been slowed by the COVID-19 crisis. Since 2017, good progress has been made in ending the use of quasi-fiscal activities to support state economic activity. As Chapters 3 and 7 show, there has been sustained progress in liberalizing input and output prices and increasing the cost-recovery prices that utility SOEs can charge. Simultaneously, structural reforms to liberalize domestic and international trade have removed many of the preferential policies that favored SOEs. As Chapter 6 highlights, good progress has also been made in reducing subsidized lending to SOEs. Further progress to support the achievement of full cost-recovery by SOEs (especially public utilities)—the largest remaining source of quasi-fiscal losses—has been constrained since the onset of the COVID-19 pandemic. Utility tariff increases were frozen in early 2020 until the end of 2021 and are expected to again be gradually increased towards full cost recovery over the medium-term.

Structural reforms to reduce the state's economic footprint would help restore fiscal balance. Since 2017, the emergence of a structural deficit has largely been due to the increase in public spending from reforms that have had large fiscal costs, such as increased spending on public services and infrastructure, higher wages, and expansions of safety nets. To a smaller extent, this deficit has been worsened by the (marginally) net negative revenue impact of tax policy changes.[10] Accelerating progress in implementing structural reforms that could potentially generate fiscal savings—notably the privatization and reform of state enterprises, and to some extent the reform of agricultural financing—are likely to create additional fiscal space that could be used to reduce the deficit or to finance further public investments to support the economic transformation.

C. Revenues

Uzbekistan's revenue collection levels are close to regional averages and above averages of its income group. Including estimates of off-budget revenues, Uzbekistan's general government revenues as a share of GDP averaged 31.5 percent between 2010 and 2020 (Figure 2.7). This is

[10] Does not include quasi-fiscal losses.

slightly above the average of regional peers (30.7 percent of GDP), and above the middle-income country average (28 percent of GDP).[11] By revenue category, Uzbekistan was at or above the average of regional peers in collections from sales taxes, social contributions, and other revenues—largely revenues from SOEs or resource rents.

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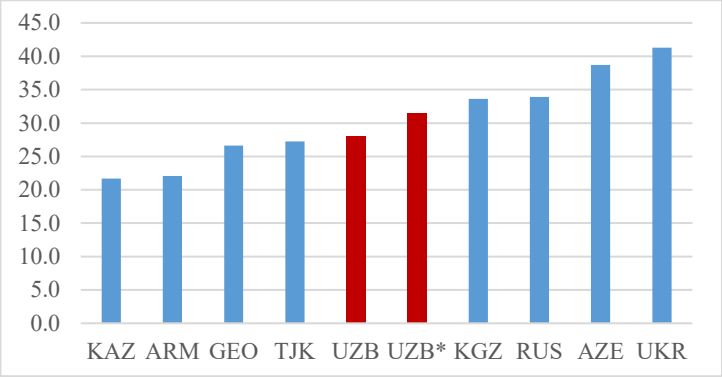
Figure 2.7: Total government Revenues
(Average between 2010-2020)



Source: Staff calculations using IMF GFS data and official statistics.
Note: UZB* includes staff estimates of off-budget revenues.

Prior to 2017, Uzbekistan's tax system was complex, disproportionately burdensome on income, and discouraged firm growth and investment. Although personal income tax rates paid by employees were relatively modest compared to regional and income group peers, Uzbekistan's labor taxation wedge was substantially higher due to mandatory employer contributions. Labor taxes and mandatory contributions in Uzbekistan were among the highest in the world (Figure 2.9). Three separate business tax regimes created significant disincentives for firm growth and encouraged informality and tax arbitrage by splitting businesses. The classification of firm size by employee headcount, location, and residency—rather than turnover—encouraged firms to stay small to avoid paying higher tax rates levied for larger firms. This also reduced the effectiveness of the value-added taxation (VAT) system as small firms were subject to a different sales taxation regime. Estimates of Uzbekistan's VAT productivity in 2018 placed it significantly lower than global, regional, and income-group averages (Table 2.2).

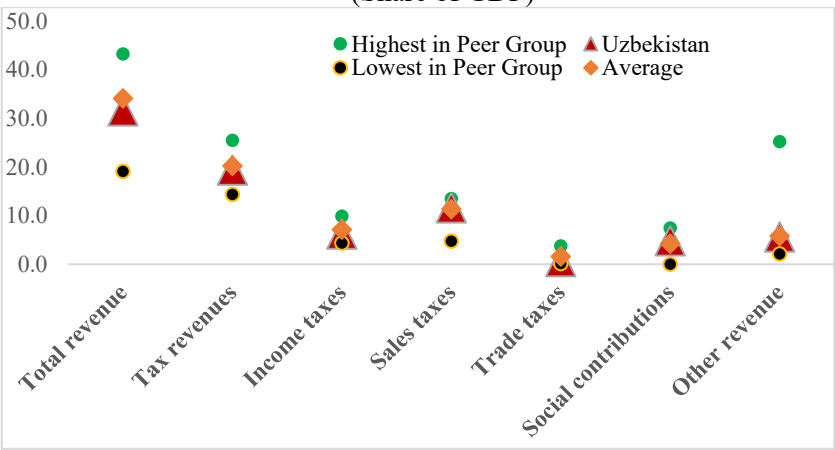
Since 2017, several reforms have been enacted to address weaknesses in the tax system. Following reforms to consolidate and reduce mandatory social contributions in 2018, a major overhaul of the tax system was implemented at the start of 2019. Personal and corporate taxes—for all individuals and firms of all sizes—was unified at a flat rate of 12 percent. Firm size

[11] Source for income comparator averages - World Development Indicators
[12] Source for income comparator averages - World Development Indicators

classifications were moved from employee headcount to turnover, and a new unified tax rate for small firms was set at 4 percent of turnover. Rules were relaxed to allow small businesses to register to pay VAT, allowing them to participate more efficiently in the VAT supply chain to larger firms. The VAT system was also reformed to allow all VAT registered firms to claim VAT refunds on intermediate inputs.[13] Property taxes were reduced from 5 to 2 percent, as were dividend taxes from 10 to 5 percent. The previously excessive employee labor tax regime was largely abolished and unified into a single social payment of 25 percent for state entities and 12 percent for private firms. In late 2019, the VAT rate was reduced from 20 to 15 percent, and at the beginning of 2020, a new tax code was introduced to simplify tax administration and compliance. The new tax code also streamlined rules for transfers of tax losses and introduced a one-time depreciation allowance of ten percent of income to encourage investments in modernization.

Figure 2.8: Revenue Collection, 2019

(Share of GDP)



Source: Staff calculations using IMF GFS data.
Note: The peer group includes Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Russia, and Ukraine.

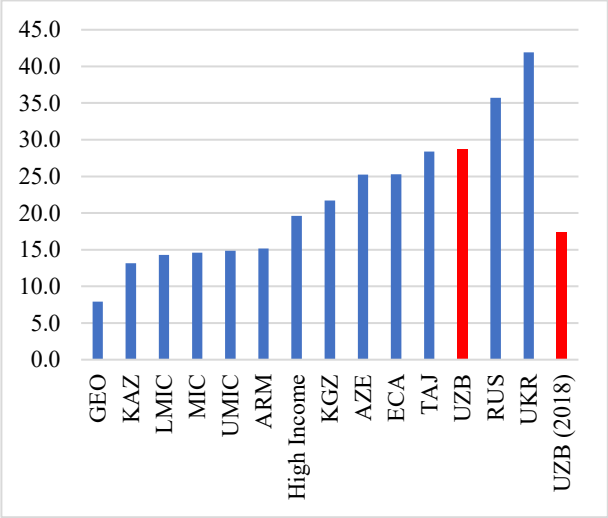
Despite the substantial realignment of tax policy and the large reductions in tax rates, a rapid increase in the tax base and increased employment formalization has supported revenue buoyancy. Offsetting the large reductions in tax rates and mandatory contribution levels, a substantial widening of the tax base led to a modest increase in tax and pension revenues in 2019 as a share of GDP. Reforms to reduce labor taxes on employers likely contributed to a surge in new income taxpayer registrations in 2019, which exceeded half a million within the first six months of the tax reforms.[14] Tax revenues continued to increase in 2020 despite the COVID-19 impact, from 19.2 percent of GDP in 2019 to 19.5 percent in 2020.

Tax reforms have improved the neutrality of the tax system, but weaknesses in tax administration are likely still contributing to Uzbekistan having among the highest marginal effective tax rates in the world. Reforms since 2018 have helped reduce high labor taxes on firms and the complexity of business taxation (Figure 2.9). As a result of these reforms, the share of direct taxes to total revenues has nearly doubled in two years and is equal to the share of indirect taxes (Figure 2.10). Despite these reforms and a substantial reduction in tax rates for businesses,

[13] Previously this was only available to exporters.
[14] Source: State Tax Committee data

marginal effective tax rates on capital and investment remain among the highest in the world and were estimated to have increased since 2017 (Figure 2.11).[15] It suggests that there are still unresolved issues within the tax system beyond the tax rates and policy structure. More likely, it suggests that weaknesses in tax administration, such as the complexity of the tax code, accounting rules and allowances for depreciation—are still contributing to the high effective taxation of investment spending in the economy. These administrative constraints in the tax system may still be deterring greater private sector and foreign direct investments in Uzbekistan. As Chapter 4 notes, tax administration continues to be among the most significant concerns for enterprises in Uzbekistan. Reforming tax administration remains among the highest priorities for the authorities over the medium-term.

Figure 2.9: Labor taxes and contributions as a share of commercial profits (Average 2010-17)



Source: World Development Indicators.

Table 2.2: VAT Productivity in 2018 (Unweighted Averages)

CIS	0.48
Emerging and Developing Europe	0.47
Latin America and the Caribbean	0.44
Advanced Economies	0.39
Global Average	0.39
Emerging and Developing Asia	0.38
Sub-Saharan Africa	0.35
Uzbekistan	0.30
Middle East and North Africa	0.21

Source: Reproduced from IMF Fiscal Affairs Division *Uzbekistan: Review of the Tax System* (2018).

The privatization of SOEs and other structural reforms could reduce revenues in the short-term but generate positive benefits as a more vibrant private sector and more efficient state enterprise system emerge. Significant reforms are being implemented to privatize state owned enterprises and strengthen corporate governance. These are likely to have a small negative revenue impact in the short-term—Uzbekistan's reliance on dividends from non-gold producing state enterprises has declined significantly, falling from 4.2 to 0.6 percent of GDP over the last decade.[16] These declines are likely to be offset by continued progress with the implementation of structural reforms to strengthen the competition environment and to improve market institutions that increase private sector growth. They are also likely to be offset by measures being implemented to improve

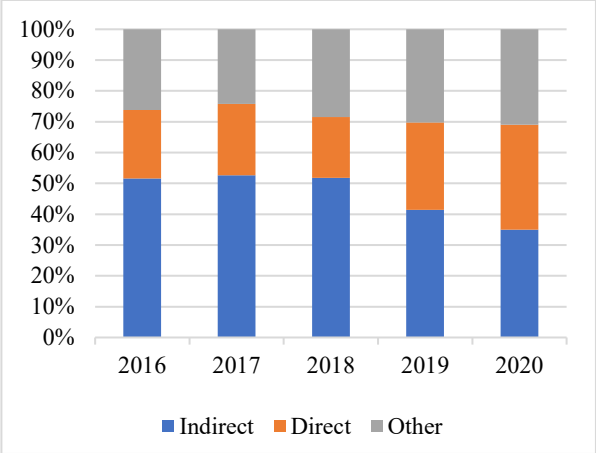
[15] Uzbekistan ranks 93 out of 94 countries in the size of its marginal effective tax rate on investments in machinery and equipment, buildings, inventories, and land. Bazel, Philip and Mintz, Jack, The 2019 Tax Competitiveness Report: Canada's Investment and Growth Challenge (March 12, 2020). The School of Public Policy Publications, 2020, Available at SSRN: https://ssrn.com/abstract=3554103

[16] Uzbekistan's mining SOEs, which contribute the largest share of dividends and rents, will not be privatized during the current phase of SOE privatizations.

the financial performance (and dividend contributions) of SOEs. These measures are expected to increase tax buoyancy over the longer term.

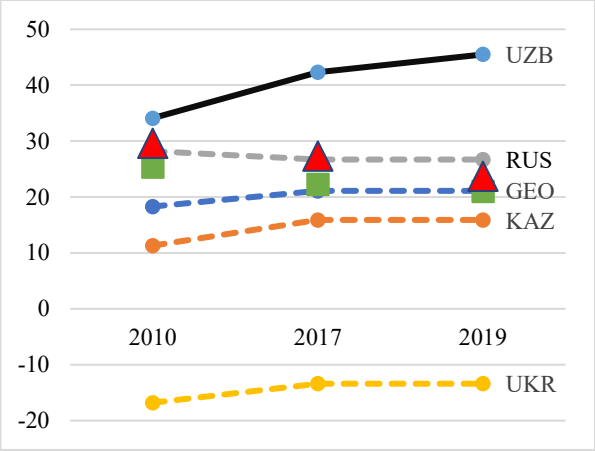
Better tax administration and further consolidation of budget revenues could offset revenue losses. Uzbekistan's VAT gap was estimated to be 40 percent in 2020, suggesting that there is potential to increase indirect tax revenue collections. Uzbekistan's non-tax revenue collections from administrative fees have declined by more than half over the last decade, and these revenues are subject to a fragmented and complex processes guiding their setting and use. A significant part of these revenues is collected in off-budget spending accounts managed by line ministries with limited oversight. Reforms to close all off-budget accounts and review administrative (non-tax) revenues could also increase revenue collections. Collectively, these two reforms could add up to an additional five percent of GDP in revenue collections.

Figure 2.10: Shares of Direct and Indirect Taxation in General government Revenues (2016-20)



Source: Official statistics.

Figure 2.11: Estimated Marginal Effective Tax Rates on Investment in 2010, 2017, and 2019



Source: Bazel and Mintz (2020).

Large tax expenditures also reduce revenue collections. Uzbekistan uses several tax incentives to support local economic activity, SOEs, and private sector investments. These include tax holidays, reduced tax rates, economic zones, and discretionary tools to grant incentives to individual investors. In 2018, foregone revenue from these expenditures was estimated at 6.4 percent of GDP (not including trade tax or VAT exemptions).[17] In 2019, many of these expenditures were cancelled or allowed to lapse, and most sectoral VAT exemptions and individual customs exemptions were removed during the implementation of reforms to reduce the VAT rate from 20 to 15 percent. Further measures to cancel tax expenditures were enacted in 2020 and are planned over the medium-term.

Uzbekistan's trade and excise tax regime offers opportunity to enhance outward economic orientation and increase environmental sustainability. Revenues from trade taxes have fallen as the economy has opened up to international trade, amounting to about 0.5 percent of GDP in recent years. Excise revenues have also fallen as a result of reforms to remove previous excise levies on imported and manufactured goods. Significant customs revenues are also foregone

[17] Official estimates; see Public Expenditure Review (2019) for more details.

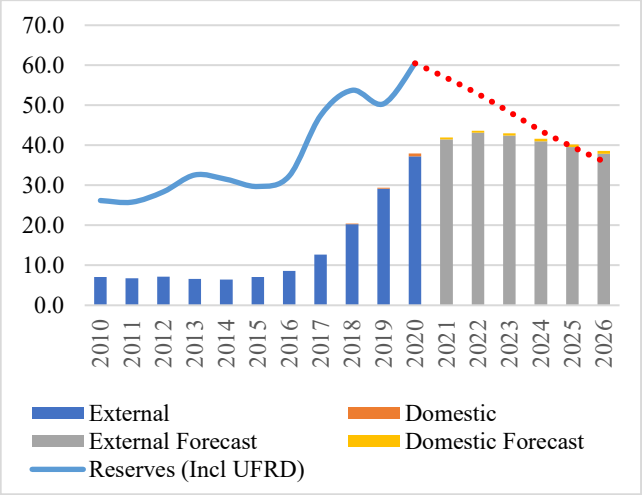
through various exemptions and through corruption at the border.[18] Uzbekistan's strong revenue base and high level of collections, and several other policy opportunities to increase revenues further, provide an opportunity for further reductions in trade taxes, and for the removal of protective excise duties on imported goods to establish advance compliance with potential international global trading obligations.

D. Deficit Financing

Public Debt

Prior to the reform process launched in late 2016, the government fiscal strategy focused on limiting external financing, thereby sharply reducing public debt between 2001 and 2015. Over this period, public debt fell from 48 percent to 7 percent. Prior to the reforms, the government's fiscal financing strategy was highly conservative, supporting the broader government policy objectives of increasing economic self-sufficiency. New external loans were signed on an exceptional basis and usually linked to high priority investment policy needs. During this time, domestic public debt levels were negligible, and the use of all domestic debt instruments was suspended in 2013. Since independence, the government has been the largest net lender to the financial sector.

Figure 2.12: Uzbekistan's Public Debt Stock and International Reserves



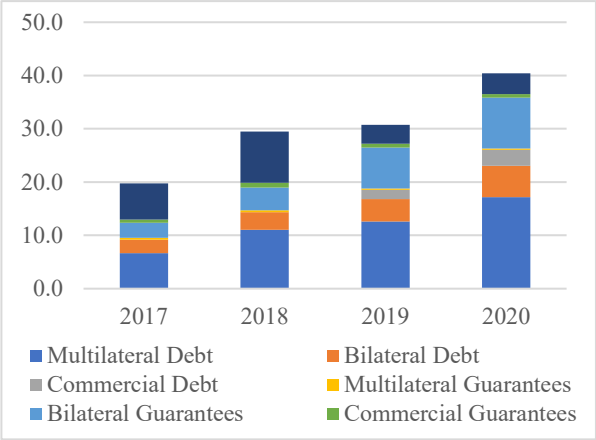
Source: Official data and World Bank/IMF Debt Sustainability Analysis

Constraints to the use of debt financing have been significantly eased since 2017. A shift in government policies towards greater outward orientation and economic openness has cascaded to the fiscal strategy. Public and publicly guaranteed (PPG) external debt has increased threefold

[18] Public Expenditure Review (2019), OECD assessment of Uzbekistan's Commitment to Comply with the Istanbul Anti-Corruption Plan (2019).

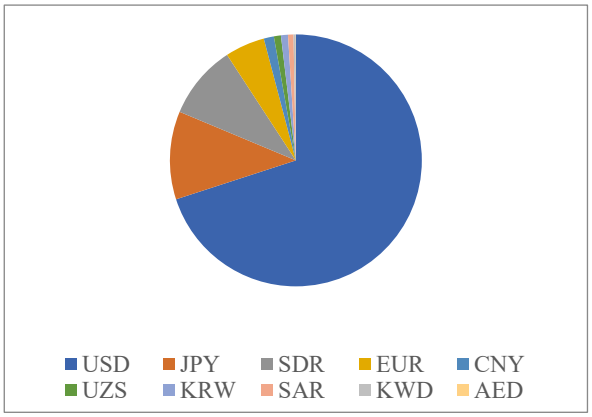
since 2017, from 12.6 percent of GDP to 36.5 percent by the end of 2020 (Figure 2.12).[19] Multilateral debt accounts for nearly two-thirds of the total PPG debt stock. Most external debt is on concessional terms with long maturity profiles. Guarantees are a significant share of external debt, and in 2020 were nearly half of the PPG debt stock (Figure 2.13). Some 70 percent of PPG external debt is denominated in US dollars, and about one percent is denominated in local currency following the successful issuance of a domestic currency Eurobond in 2020 (Figure 2.14). Domestic debt has also reemerged as a financing tool, with a mix of treasury bills and government bonds now being deployed as part of the fiscal financing strategy.

Figure 2.13: Composition of Public Debt



Source: Official Data.

Figure 2.14: Currency Composition of Debt



Source: Official Data.

The use of external debt linked to investment needs. Most external debt is earmarked to investment projects, with about a quarter for budget operations. Just under three quarters of the total PPG debt stock at the end of 2020 was linked to investment projects implemented by International Financial Institutions or SOEs. A quarter of the debt stock, including Uzbekistan's Eurobond issuances was used for budget support.[20] The distribution of sectors in the economy receiving debt financing are also largely aligned with priority focus areas under the 2017-2021 Development Strategy and the government's SDG financing strategy.[21] For example, nearly half of outstanding external debt is linked to projects in the energy, agriculture, housing, and water (urban and irrigation) sectors (Figure 2.15).

Uzbekistan's debt is classified as sustainable in the latest World Bank/IMF Debt Sustainability Analysis. Debt service ratios peak in coincidence with Eurobond repayment dates, but otherwise are at manageable levels and are considerably lower than regional peer group levels (Figure 2.16).[22] Uzbekistan's debt is also backed by strong buffers—under current projections

[19] Source: Ministry of Finance. 2017 valuation is based on adjustments to the exchange rate following the unification of the foreign exchange market in September 2017.

[20] Although budget support is fungible, the government is usually required to soft-tag debt-financed budget spending to specific economic investment projects when seeking approval to withdraw the loan balance from the lender; as part of this process, the government is also usually expected to provide some analysis of benefit cash flows generated by the project that exceed the repayment costs. There are exceptions to this process, but they are applied rarely (e.g. for social projects where such analysis may be more difficult to estimate).

[21] Ministry of Finance Annual Debt Report end-2020

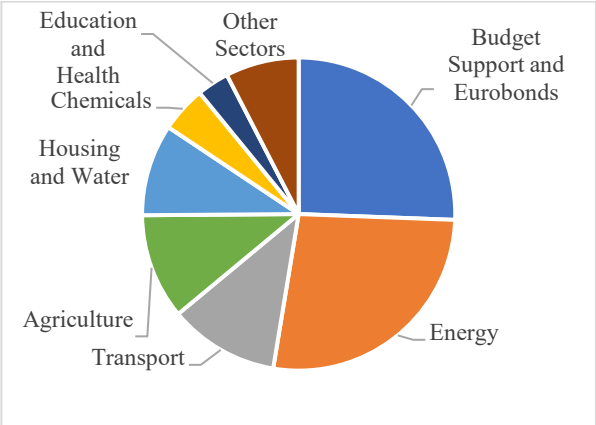
[22] For example, the average debt service to exports ratio for developing ECA countries was 22.4 percent in 2019.

international reserves are likely to be sufficient to cover the entire public debt stock over the medium-term.

Domestic debt levels are low but steadily growing. Since 2018, the government has issued a range of treasury bills and government bonds, including a domestic currency Eurobond in 2020. Almost three quarters of the domestic debt stock has a maturity period of one year or less. The longest maturity of outstanding domestic public debt stock is three years (accounting for 10 percent of the outstanding domestic stock). The share of longer-maturity domestic debt issuances is likely to increase as broader structural reforms are implemented.

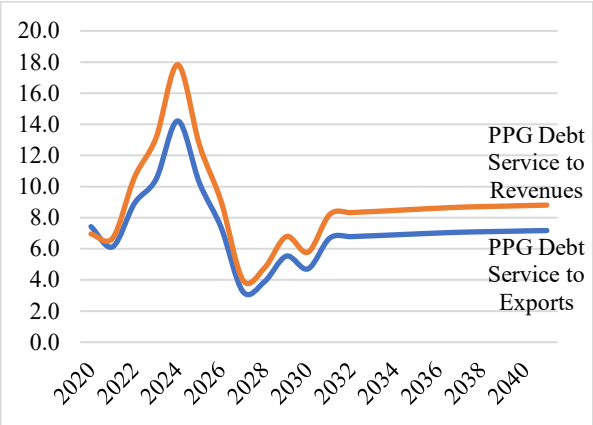
The government is in the process of implementing fiscal rules and debt transparency reforms to strengthen economic management. New debt legislation is being developed to clarify sovereign debt obligations and to establish a debt ceiling of 60 percent of GDP. In 2020, as part of reforms to the budget process, an annual nominal debt ceiling was established, restricting newly signed public external debt and guarantees to not more than $5.5 billion. In 2021, this ceiling was maintained at the same level but also included domestic debt issuances. Measures have been enacted to require all debt financed public spending to be mandatorily audited by the Chamber of Accounts (the supreme audit institution in Uzbekistan). These measures have been effective at restricting new debt financed projects and strengthening the evaluation and selection process for newly financed loans. In 2020 and 2021, significant changes have been made to the debt-financed project pipeline to adhere to the ceilings.

Figure 2.15: Sectoral Allocations of Debt Stock, 2020



Source: Official data.

Figure 2.16: PPG Debt Service Ratios



Source: World Bank/IMF Debt Sustainability Analysis.

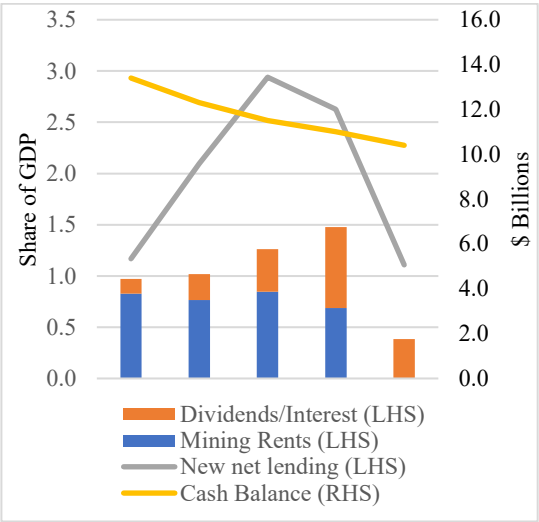
Like expenditure and revenue reforms, the effectiveness of these reforms and the sustainability of Uzbekistan's debt strategy depends on the implementation of broader structural reforms to reshape the state's role in the economy. Weaknesses in public investment management and the corporate governance of SOEs have increased fiscal pressures that have contributed to the structural deficit that is now being financed in part by higher debt levels. The burden of infrastructure modernization costs that have arisen to resolve binding production constraints in the economy have largely fallen on state enterprises that have not yet been privatized. The costs have also arisen at a time when the foreign and domestic private investment response remains tepid. These costs have also significantly contributed to higher debt levels, especially the large increase in guarantees which constitute about half of the outstanding PPG debt stock. The

privatization of SOEs linked to these debts will provide an opportunity for the government to review and restructure its debt stock and increase the role of private financing and risk taking for larger infrastructure projects.

The role of UFRD in the Fiscal Financing Strategy

Fiscal policy operated largely on a cash budget until the creation of the UFRD in 2006, and budget financing remained subject to cash budget constraints until 2018. Between 2001 and 2006, tight financing constraints meant that budgets needed to be balanced by available revenues, with revenue shortfalls leading to expenditure compression. The creation of the UFRD in 2006 established a buffer that allowed for capital and investment expenditures—which were high priority under government economic policies—to be more smoothly executed. Regular budgetary recurrent and capital spending, however, remained constrained by annual revenue collections, although this constraint does not appear to have been binding given the consistent budget surpluses generated between 2003 and 2019.

Figure 2.17: UFRD Revenues, Operations, and Cash Balance



Source: Official data.

During 2006-2016, the UFRD has played an important role in supporting the government's fiscal strategy but has also contributed to many distortions that have limited Uzbekistan's structural transformation. The UFRD was established as a sovereign savings vehicle for revenues from government gold sales and as a sterilization mechanism for other state foreign exchange earnings. The UFRD's mandate was to support high priority industrial policy investments determined by the state's annual investment planning process. Since 2006, the UFRD has played an important role as an equity and debt investor in Uzbekistan's economy and banking system, and as a buffer that has helped augment international reserves. The UFRD operating model also created several distortions in the economy that have had a binding constraint on the efficiency of resource allocation in the economy and on the efficiency of public investment spending. The UFRD's approach of providing directed and subsidized financing to state enterprises through commercial bank on-lending operations contributed significantly to financial market distortions and the ineffectiveness of monetary policy transmission. The UFRD has also played an outsized role in financing public capital investments, accounting for nearly a third of total capital investments in recent years. Although investment decisions were determined through central investment plans, separate systems for budget capital execution and UFRD investment activity reduced fiscal coordination and effectively created two national budgets. As Chapter 6 shows, the impact of this uncoordinated approach was most visible between 2017 and 2019 where budget and monetary policy measures to curtail inflation through tighter credit controls were hindered by expansions in UFRD investment project activities.

The ongoing structural transformation and several fiscal policy changes have had an impact on the UFRD operating model, requiring a reexamination of its role in the government fiscal strategy. A key aspect of the 2017-2021 Development Strategy is to reduce the state's economic footprint and role as an investor in the economy. As structural reforms to achieve this outcome are implemented, the UFRD's conventional role of serving as a financing vehicle for state industrial policies and financing for state enterprises will need to be revisited. The integration of the UFRD into the government budget in 2020 also led to the reallocation of gold revenues to the state budget rather than to UFRD income. UFRD's income in 2020 was limited to dividends and interest on existing assets (Figure 2.17). Although this approach may change as Uzbekistan recovers from the COVID-19 pandemic, resource rent revenues flowing to UFRD will still be discretionary as part of the overall budget accountability framework rather than a guaranteed and reliable income stream. With one of the main strategic objectives of the UFRD becoming less relevant and with less dependable revenue inflows, a reevaluation of the government's sovereign wealth savings objectives could help strengthen the role of UFRD during the transition. Its sizable cash balances—nearly a fifth of GDP—remain a critical fiscal buffer and an investment opportunity to support the government's role in enabling a private sector economy.

E. The Path Forward

The reform agenda in building fiscal policies and institutions is substantial. The following priorities are some of the more immediate ones.

- Strengthen public investment management by establishing a unified pipeline of public investment projects based on common assessment, selection, and implementation criteria that are well aligned to reform priorities and represent strong value for money.
- Continue to consolidate off-budget and quasi-fiscal revenues and expenditures into a single budget framework to allow better planning, execution, and monitoring of fiscal policy.
- Consider eliminating trade tariffs to accelerate Uzbekistan's outward economic orientation and alignment with global trade agreements.
- Review business tax administrative processes and accounting rules to reduce Uzbekistan's high marginal effective tax rates that are likely constraining domestic and foreign direct private sector investment.
- Implement new debt legislation and expand fiscal risk management to cover contingent liabilities.

Chapter 3. Public Financial Management

Many aspects of the Public Finance Management (PFM) system are functioning at a satisfactory level, allowing the government to achieve its fiscal and budgetary objectives. However, there is significant scope for improvement. Areas identified include: the introduction of multiyear budgeting (a medium-term budgetary framework, MTBF, is currently being developed); the implementation of risk analysis and of a revised audit approach (including modern internal control and internal audit frameworks); more information on the performance of service delivery (with performance based budgeting and accrual accounting); capturing and publishing information on all assets bought with public funds; issuing more detailed budget execution reports in line with the Government Finance Statistics Manual (GFSM) 2014 and the whole of government financial statements using International Public Sector Accounting Standards (IPSAS) as a reference; improving the (financial) independence and professionalization of the Chamber of Accounts (the country's supreme audit institution); and enhancing parliamentary scrutiny of budget proposals and execution.

Many of the areas identified for improvement are included in the recently adopted PFM Reform Strategy 2020-24. The government is working to improve fiscal risk management and transparency; implement a medium-term budget; strengthen fiscal rules and accountability, including by introducing a parliamentary appropriation system; and reform intergovernmental relations. Many of the planned reforms reflect good practices earlier followed by Estonia and Poland during the initial phase of their PFM reforms. These include gradual introduction of IPSAS in the public sector, moving toward implementation of modern public financial control, which is based on COSO and global good practices, and the implementation of an effective decentralized internal audit function.

A. Budget Policies and Medium-Term Budgetary Framework

Although the present budget preparation process achieves the minimum desired results, the policy-based fiscal strategy and budgeting are generally weak. The process to allocate budgetary resources is not in accordance with the government's declared strategic objectives. The multi-year focus in fiscal planning was non-existent before the current efforts to implement the MTBF. The budget lacks a forward-looking policy focus—forecasts are presented for the budget year only and are not guided by clear and precise fiscal objectives, while investment planning is only partially incorporated. Budget ceilings are only now being introduced as part of the planning process. Although there are sizeable explicit and implicit sources of fiscal risks to which public finances are exposed, there is limited analysis and disclosure of the main sources of these risks.

The Parliament, in lieu of a Presidential Resolution, authorized spending limits for budget organizations for the first time through a newly enacted budget law for 2020. As local budgets are approved by local legislative councils, it would be problematical for the *Oliy Majlis*, the central and supreme parliament, to appropriate the State Budget.

The current budget preparation process is unconstrained, fragmented, and lacks a proper strategic framework. Budgets for current spending, capital investment, and policy lending follow separate tracks and are not informed by a top down resource envelop. Budgets are largely prepared and managed centrally. Public sector organizations do not 'own' them and often do not receive information on final budgets until the end of the first quarter of the fiscal year. If these issues are not addressed

quickly and decisively, any move toward developing a medium-term strategic budget focused on performance is likely to fall short of expectations.

The government prepares forecasts of key macroeconomic indicators for the budget year and the following two fiscal years, but only forecasts for the following fiscal year are included in the budget documentation submitted to the legislature. This practice provides for standard assumptions to be included in the budget documentation but does not ensure that fiscal forecasts are produced based on policies set out in the national development strategy.

Revenue forecasting is formalized and integrated in the budget process, but its timeframe is too short, only being published for the next budgetary period. The Ministry of Economy makes projections that are provided to the Ministry of Finance, but they are not harmonized with the national strategy. Revenue forecasts are comprehensive, including all revenue sources such as domestic revenue (tax and non-tax revenue) and grants (capital and budget support), and form part of the budget documentation sent to Parliament, with the macroeconomic and fiscal forecasting (but again only for Y+1). Different macroeconomic scenarios are established and the one inserted into the budget documentation is generally the pessimistic scenario.

A budget calendar exists and is respected but it does not define aggregate ceilings for the budget. Ceilings are decided by the Cabinet just before sending the budget to the Parliament.

Recommendation. It is recommended that steps be taken to develop the MTBF for the implementation of a strategic approach to fiscal policy and that a new performance based budgeting system is used in forming and reporting on the annual budget. The framework for public investment management should be enhanced, initially by developing methodologies that should be piloted and then adopted in a regulation.

Budget Coverage

The comprehensiveness and classification of budget documentation are broadly in accordance with international standards. The annual state budget covers all general government budgetary organizations, but excludes significant transactions conducted by them. The state budget covers both central and local government. However, not all revenues and expenditures of state budgetary organizations are presented in the budget or included in the state budget fiscal aggregates.

The Constitution requires that Uzbekistan's central and supreme parliament, the *Oliy Majlis*, approves the State Budget. However, this is problematical as in doing so, the *Oliy Majlis* is appropriating local budget expenditures, which could undermine the autonomy of local governments (Oblasts also have their own parliamentary councils-*Kengash*). It is impractical for two legislatures to appropriate the same expenditures so it would be more logical from an accountability perspective if local budget expenditures were appropriated by local legislatures. But it is unrealistic to expect local legislatures to have the capacity in the near future to implement appropriation systems for local budgets. They are not prepared or expecting to do so. This will only be possible once the appropriation system has been implemented successfully at the Republican level. Until then, detailed appropriations are likely to only be provided by the *Oliy Majlis* and should only be for the Republican budget (including transfers to local governments). Local governments should continue to approve their budgets in general terms, as is currently done.

Recommendation. Once the MBTF is functioning correctly at the Republican level, appropriate systems should be implemented for local budgets. The aim should be for Republican legislatures to approve the Republican budget and local legislatures to approve local government budgets. A separate authorization in the annual budget law to approve the state budget will be required to meet constitutional requirements.

Budget Reliability

Uzbekistan's PFM system produces a credible budget. Total expenditure outturn variation did not exceed 5 percent in the last two years and the composition variance by functional and economic classification was good. The comparison of revenue estimates to actual outturns also scored well. Revenues, especially from tax, regularly meet and exceed targets. This may be because of pessimistic revenue projections (including on VAT collection) or the effectiveness of the revenue authorities. These elements contribute to a credible national budget. In addition, there are no concerns at all around the frequency of monitoring expenditure arrears.

The current budget preparation process lacks a proper strategic phase and does not have a unified view of the budget. As a result, it is an unconstrained and fragmented bottom up process where critical decisions on allocation of resources follow an incremental approach rather than a logical sequence. Different budget timelines apply to current expenditures, public investment projects, and policy lending decisions. Centrally managed budgets mean organizations feel very little responsibility for them.

Recommendation. It is recommended to undertake a functional and business process review of the Ministry of Finance (MoF) to guide improvements to its efficiency, analytical capacity, and business processes.

Debt Management

Annual borrowing is approved as part of the government budget approval process. Primary legislation grants authorization to the MoF to borrow, issue new debt, and issue loan guarantees on behalf of the central government. Documented policies and procedures provide the Ministry of Finance with guidance on these processes and on monitoring debt management transactions. Management of the debt portfolio is based on a sustainable debt strategy, minimizing debt servicing costs. Debt management has improved over time. The recording and reporting of (external) debt and government guarantees are complete and are updated and reconciled on a monthly basis. For internal purposes, comprehensive reports are produced on a quarterly basis. Managing debt will further improve with the implementation of a medium-term debt strategy, planned to be developed in the near future. Publication of external debt data was an important step, however sizeable asset holdings and non-debt liabilities, some of which are reflected in the financial statements compiled by budgetary organizations, are not yet published in consolidated fiscal reports.

Recommendation. It is recommended that the public debt management system is improved to provide better quality data, including on recognition, valuation, and disclosure with linkages to public investments.

Public Investment Management

Public investment management is highly fragmented, with different processes and procedures in place for project development, planning, appraisal, selection, and monitoring depending on the project's source of funding or method of procurement. Capital investment planning is not sufficiently supported by the current public investment management framework nor is it well integrated with the budget process, delinking responsibilities for capital and recurrent budgeting. The system of public investment management does not sufficiently reflect generally accepted good practices. It is further weakened by the lack of fiscal rules (currently being developed) which mean there are no established processes on intersectoral and intrasectoral allocations nor effective public investment management. As established in national guidelines, there are economic analyses of most major investment projects, reviewed by an entity other than the sponsoring entity, but the results are not published and some economic analyses are conducted superficially. While all major investment projects are prioritized by central entities on the basis of published standard criteria for project selection, political considerations and, ultimately, available funding influenced the selection process of some projects. The total cost and physical progress of major investment projects are monitored by the implementing government unit and the Ministry of Economy, with quarterly reports provided to the Cabinet of Ministers, but these are not published.

Recommendation. It is recommended that an effective system of public investment management is developed and implemented, and that greater transparency is introduced through the publication of reports on major investment projects.

Public Assets Management

Uzbekistan's arrangements for the effective management of assets and liabilities are not yet in line with international standards and lack sufficient transparency. Effective management of assets and liabilities ensures that: (i) fiscal risks are adequately identified, monitored, and addressed in a timely and appropriate manner; (ii) public investments respond to infrastructure needs, including maintenance costs, and provide value for money; (iii) financial investments provide appropriate returns, assets are recorded regularly, and rules for asset transfers and disposal are followed; and (iv) the debt portfolio is managed based on a sustainable debt strategy minimizing debt service costs.

Public asset management in Uzbekistan indicates a mixed performance on the accounting and reporting of public assets. The government maintains a record of its holdings in major categories of financial assets, recognized at their book or market (stock exchange) value, and includes the total value of financial assets in its balance sheet. A specific consolidated report on financial performance is not prepared or published. The reporting of asset registers and inventories is not consolidated and is dispersed over various agencies. The government maintains registers of its holdings of different types of nonfinancial assets, with varying details about information on value or usage of the assets. Very little information is published. Procedures and rules for the transfer and disposal of nonfinancial assets are established but only partial information on transfers and disposals is included in internal reports of the Ministry of Finance. The implementation of public sector accounting standards should bring improvements to asset management.

Monitoring of public corporations appears to be reasonable, but a comprehensive picture of the sector and the risks it poses to the country's public finances is lacking. Except for one fully

government-owned commercial bank, public corporations published their audited financial statement within six months of the end of the fiscal year. Unitary enterprises which are not JSC or LLC report to their founder/parent ministry. If budget funds are involved, these are reflected in entity financial reports. Key performance indicators are used to analyze the economic and financial situation of public corporations, but there is no consolidated report on the financial performance of the public corporation sector.

Recommendation. It is recommended that a system to record and effectively manage financial assets and liabilities is introduced and that more information on public asset management is made publicly available.

Treasury Operations

The MOF operates several IT systems/modules which are not sufficiently integrated with each other or with the current Government Financial Management Information Systems (GFMIS). Many key modules still need to be developed and integrated under the new Integrated Financial Management Information System (IFMIS): budgeting, accounting, financial reporting, state assets management, etc.

In parallel, the Treasury system effectively operates the Treasury Single Account (TSA). Introduced in 2012, the TSA is a system of domestic currency bank accounts controlled by the Treasury. All revenues and expenditures are channeled through the TSA and are reported; revenue collection is fully entered into the TSA daily. The TSA is in the central bank and also covers foreign currency accounts. Bank reconciliations for all central government accounts takes place daily at the TSA and at least monthly for central government accounts in commercial banks. Suspense accounts and travel allowances are promptly expensed, and any reconciliation is conducted by the Treasury.

The Treasury has been working hard to identify, and where possible close, all bank accounts used by budget organizations that are outside the TSA. It identified 7,307 accounts of which 1,241 were domestic currency accounts opened by budget organizations for various reasons for regular operations (i.e. not for the purpose of placing term deposits in commercial banks) and were identified for closure. As of July 1, 2019, 80 percent (987) had been closed. The Treasury assessed each account identified for closure to ensure that incorporation in the TSA would not lead to any unsurmountable operational problems. Of the remaining 6,066 accounts, some are foreign currency accounts, and some are for the purpose of placing term deposits in commercial banks. The Treasury has closed the foreign currency bank accounts of budget organizations in Uzbekistan and processes all related foreign currency transactions in Uzbekistan via the TSA system. However, offices abroad, notably embassies, still retain foreign currency accounts in commercial banks for the foreseeable future.

Recommendation. It is recommended that implementation of the IFMIS is advanced by integrating new PFM modules or improving the existing ones and ensuring interoperability of the modules.

B. Financial Reporting, Auditing, and Control

Financial Reporting

The government does not yet produce financial statements following internationally recognized accrual standards, such as the IPSAS, and practices, although the gradual implementation of national accounting standards based on IPSAS is planned. The current annual budget execution report is produced covering all budget organizations (including their own revenue funds), all State Targeted Funds, and other Extra Budgetary Funds. The budget execution report contains revenue and detailed expenditure accounts (on a cash basis) broken down into functional, administrative, and economic classifications. The reports do not include cash balances. The budget execution reports do not produce full information on flows and stocks of assets and liabilities and there is no information provided on loans or debt and guarantees. In addition, no reconciled cashflow statement is produced. Other aspects included in the annual budget execution reports are budget organizations' own revenues and expenditures, balance sheet, staff breakdown, fixed assets report, and accounts receivable and payable report. However, data is presented in a series of separate schedules and there are no inter-entity eliminations as they are not consolidated.

In-year budget execution reporting covers state government and is on a quarterly basis. Reports are broken down by economic and functional classifications. All reports are produced at the payment (and not at the commitment) stage. The annual financial statements cover the State budget, but this does not include all ministries, agencies, and other budget entities. They are prepared according to the cash basis of accounting, which is in accordance with the legal framework. However, this framework does not comply with the accrual-based IPSAS.

Annual regional government financial reporting is part of the consolidated budget execution report that is audited by the Accounts Committee within the same timeframe. The report on the financial position of all subnational governments is consolidated with the report on the financial position of the state budget and state targeted funds. Central government entities and agencies do not quantify significant contingent liabilities in their financial reports.

The budget documentation sent to parliament is sufficiently comprehensive to support effective decision-making and ex-ante parliamentary scrutiny. The budget documents include all the basic elements, and additional supplementary information, required to support a transparent budget process. The budget documentation even includes the presentation of new budget and tax policy decisions and their respective fiscal impact which supports maintaining fiscal discipline and facilitates strategic allocation of resources. The budget documentation could be enriched further by including information on details of debt stock, financial assets, fiscal risks, medium-term fiscal forecasts, and quantification of tax expenditures.

There is substantial expenditures and revenues outside the government financial reports. Expenditure outside government financial reports is more than 10 percent of total budgetary central government (BCG) expenditure while revenue outside government financial reports is slightly less than 5 percent of total BCG revenue. Detailed financial reports of less than 75 percent of extrabudgetary units are submitted to the government annually within nine months of the end of the fiscal year.

There is little performance information on service delivery available at the planning and reporting stage, but steps are taken to promote informed policy decisions and to drive a proper accountability process on the outcome of financial execution through delivery of public services. Most performance information submitted as part of budget requests includes the nature of input or activity information or the number of users but little on outputs (with a few exceptions) or outcomes. The budget documentation does not contain any performance information.

The IT system effectively supports information on front-line service delivery units providing services such as primary schools, primary health care, and other facilities. Tracking of information on all types of resources received is done through UzASBO. Information on resources received by frontline service delivery units is collected and recorded for all ministries and budget institutions, disaggregated by source of funds. Each ministry produces a consolidated report that is sent to the Ministry of Finance.

Public access to fiscal information is not yet sufficient to align with international good practices. All required basic elements, except the annual executive budget proposal, are made available to the public. Uzbekistan has no pre-budget statement yet, there is a lack of information on tax expenditure and macroeconomic forecasts, and external audit reports are not made public other than the audited annual budget execution report. Key budget information is accessible to the public in a summary format. The government is focused on increasing transparency which will elevate the score in the near future, for example the annual budget proposal has now been made available to the public on the Ministry of Finance website. Public disclosure of information is becoming a critical feature of PFM systems in the country, with a series of other initiatives demonstrating the government's willingness to facilitate scrutiny of government policies and programs by citizens.

Recommendation. It is recommended that Uzbekistan adopts public sector accounting standards based on IPSAS, and unifies budget, financial, statistical, and performance reporting in a single chart of accounts that is in line with international standards but adapted to the national context. There should also be strengthening of parliamentary and public oversight of the budgetary process, seeking to improve the active involvement of citizens.

Public Internal Controls

The concept of internal control involves all procurement rules and formalized acts that control the various kinds of risks relevant to an organization. Internal control objectives relate to (i) the execution of operations in an orderly, ethical, economical, efficient, and effective manner; (ii) fulfilment of accountability obligations; (iii) compliance with applicable laws and regulations; and (iv) safeguarding resources against loss, misuse, and damage.

The PFM internal control procedures and practice in Uzbekistan is fairly sound to contribute to the achievement of the four control objectives. The strict observance of regulation and law are a characteristic feature of PFM in the country. There are ex-ante controls exercised by the Treasury and ex-post by various bodies including the Financial Control (inspection) unit of the Ministry of Finance. Controls are related to Treasury operations and accounting procedures and are designed to prevent fraud and identify weaknesses and errors. Basic internal controls are focused on heavy transaction level controls. Strict internal control exists on financial transactions ensuring compliance with payment rules. Comprehensive expenditure commitment controls are in place. These effectively limit

commitments to actual cash availability and approved budget allocations through the GFMIS. Payroll and accounting controls are good, but procurement is too cumbersome for users and not transparent enough. Reform is underway to improve the public procurement system.

Risk Assessment

Specific risks are covered by preliminary control activities and decisions appear to take account of risk factors that are predicted and managed in good time. However, there is no evidence of a general framework nor formalized risk assessment mechanism. The status of risk assessment at different stages of the PFM system are analyzed as follows:

- Pillar 1: Budget reliability: high expenditure and revenue outturn increases the credibility of the budget.
- Pillar 2: Transparency of public finances: part of the revenue and expenditure of the public establishments is not reported even if the funds are transferred to the TSA. The amount of off-budget revenue and expenditure is not disclosed in the annual financial reports. This creates the risk of misuse of funds and poor service delivery to the public.
- Pillar 3: Management of assets and liabilities: The Budget Code does not contain requirements concerning monitoring and reporting of contingent liabilities and other fiscal risks. There is little guarantee of value for money without economic analysis of investment proposals, costing of investment and written procedures for monitoring the performance of public investments. There is a risk of losing or rather not benefiting from the non-financial assets when they are not disclosed to the public.
- Pillar 4: Policy-based fiscal strategy and budgeting: Lack of medium-term perspective in budgeting expenditure and limited visibility of fiscal forecasts and sensitivity analysis in budgeting creates the risk of having budgets that are prone to amendments by various internal and external factors.
- Pillar 5: Predictability and control in budget execution: The revenue administration practice applies risk management for the basic compliance risks but, with the expansion of economic life and the transition to a market economy, the risks will increase and the system must be prepared to predict and mitigate them. A risk assessment and management system is being implemented to accommodate the changes in the legislation of the two main revenue-collecting entities. The risks of incurring expenditure arrears are basically eliminated by the strict control and regulatory environment. The personnel database is linked to the payroll software thus reducing the risk of errors and retroactive adjustment. The recently reformed procurement establishment and practice shows that competitive selection methods are mostly applied, which keeps the risk of favoritism low, but the level of independence of the appeal body is still not convincing enough to eliminate any risk. There is clear segregation of duties between salary and non-salary expenditure. Non-salary expenditure is electronically monitored (being equipped with various authorization levels) and roles are assigned to different functions and operational staff. This keeps the risk of errors and non-compliance low. Also, nearly 100% of transactions are controlled, indicating there is no sampling of risk assessment. This uses many resources (time and staff) and may have an impact on time efficiency. Risk management principles do not seem to be guiding the newly established internal control function. This creates the risk of focus on areas of less significance for the smooth operation of the internal control system.

Control Activities

Control activities in PFM appears to be very well developed and applied. Use of GFMIS with clear control of payment rules for all operations for budget execution enhances transparency and accountability. Internal audit units have been established but are not yet fully developed in line with international good practice, which may open gaps in the internal control system risk management, and operations.

Information and Communication

PFM information such as the approved budgets, the in-year budget execution reports, and the annual budget execution report are available to the public. The Chamber of Accounts' report on the annual execution of revenue and expenditure is not consistently published nor is it easily accessed by the public (although there may be some media reporting on it from parliamentary discussions). Other gaps in information and communication to the public are the hearing on audit findings in the Parliament. An important recent development was the publication of a citizen budget that clearly and interactively describes the purpose of the budget, its composition, and priorities. There is little information on whether public participation forums or events are held in relation to the budget formulation. There is clear and comprehensive information on revenue collection and administration with regard to the right of and obligation of the public. With the launch of the new e-procurement platform in 2018, information on procurement tenders, plans, statistics, and appeals is extensive.

Monitoring

Monitoring in Committee of Sponsoring Organizations (COSO) terms means the process of assessing the quality of internal control performance over time. Performance monitoring of the PFM system is not developed yet. The main tools of PFM monitoring are ensuring that the in-year quarterly reports and the budget execution reports are consistently prepared. There are no specific reports elaborating on consistency of performance-planned outputs and achieved outcomes, nor explanations of any deviations. The internal control framework of the PFM system has in place adequate and reliably applied control activities that can identify key irregularities and errors.

The international concept of internal control, based on the COSO framework, and the related internal audit framework is still being developing in Uzbekistan. Nevertheless, the internal control environment exists, and it is rigorously regulated and complied with by the application of the current control inspections by the Control Revision Unit (CRU). However, the CRU only identifies errors, it does not perform evaluations with recommendations to eliminate future weaknesses or explain the reasons and causes for a particular control not working as designed. CRU and the newly established internal audit functions are responsible to test the effectiveness of the internal controls used and to detect material misstatements.

Recommendation. It is recommended that an enhanced internal control framework is established in the public sector in line with international standards and good practices.

Public Sector Internal Audit

Internal audit was formally introduced in 2017, with internal audit units established in six budget organizations. However, they are mainly involved in financial inspection activities focused

on financial compliance and financial information verification, and do not have the required methodology, knowledge, or tools to implement appropriate internal audit following a risk-based approach. Involvement of different entities in financial inspection (financial compliance) blurs the roles and functions of the public internal and external audit and inspection bodies. No internationally recognized internal audit standards and practices are used. In parallel, payroll audit covering all central government entities are conducted by the CRU once every two years as part of their review of the targeted use of budget funds.

Recommendation. It is recommended that the internal audit framework in the public sector is further developed in line with **international** standards and good practices.

Public Sector Oversight and External Audit

Oversight of the public sector is partially effective. There are improvements in Parliamentary scrutiny of Chamber of Accounts reports. However, the Chamber of Accounts is constrained in the scope and nature of the work it performs on public sector external audit as it lacks financial independence and does not follow internationally accepted standards and practices or receive international

External audit and scrutiny by the legislature are reasonable to hold the government accountable for its fiscal and expenditure policies and their implementation. The Chamber of Accounts reports on its review of budget execution applying national standards but lacks a focus on material issues and control risks. The external audit process will be enhanced in the new Law on the Chamber of Accounts to bring it closer to good international practice. The external audit report represents a specific output produced by the Chamber of Accounts with conclusions on the execution of the State Budget rather than an audit opinion. The legislative scrutiny of the audit report follows the practice established by the Law on Parliamentary Control.

Recommendation. It is recommended that the Chamber of Accounts is brought into alignment with international standards (the International Standards of Supreme Audit Institutions - ISSAI) to become a harmonized and effective assurance body of Parliamentary oversight.

C. THE PATH FORWARD

On the basis of the discussion above, the path forward is multi-faceted, with a large number of priorities. These are summarized in Table 1.

Table 3.1: PFM Priorities	
Action	**Priority**
(i) Development of the medium-term budget framework for the implementation of strategic approach to fiscal policy.	Substantial
(ii) Design and implementation of a new performance based budgeting system to be used in forming and reporting on the annual budget.	Substantial
(iii) Improve the public investment management framework with methodologies developed and piloted and regulation adopted.	High
(iv) Introduction of a system of recording and effective management of financial assets and liabilities.	High

(v)	Adoption of the country public sector accounting standards based on IPSAS, and unification of budget, financial, statistical, performance reporting in a single chart of accounts in line with the international standards adapted to the country context for reliable, comprehensive and relevant information for improved public sector transparency, accountability and performance.	High
(vi)	Improve Public debt management system for better quality of data, recognition, valuation, disclosure with linkage to the public investments.	Substantial
(vii)	Strengthening parliamentary and public oversight of the budgetary process.	High
(viii)	Functional and business process review of the MOF to improve the efficiency, analytical capacity, and business processes of the MOF.	Substantial
(ix)	Strengthening financial discipline, governance and public sector operations by implementing an effective internal control and internal audit framework in the public sector in line with international standards and good practices.	High
(x)	Bringing the Chamber of Accounts into alignment with international standards (ISSAI) and make it a harmonized and effective assurance body of the Parliamentary oversight.	High
(xi)	Implementing Integrated Financial Management Information System by integrating new PFM modules or improving the existing ones and ensuring interoperability of the modules, along with ongoing reforms in public finance management	Moderate
(xii)	Improve the process of participatory budgeting with active involvement of citizens.	Moderate

Chapter 4 Private Sector Development

The Uzbekistan government has undertaken important reforms since 2017 to create markets and strengthen their functioning. Given the starting point, the degree of competition in Uzbekistan's product markets is still perceived as weak compared with key peers. Private enterprises have started to emerge, but private entrepreneurship is still constrained. The entry of new firms remains well below the averages for the Europe and Central Asia (ECA) and lower than predicted by its income per capita. Post-entry firm performance has also been sluggish, with formal private firms staying small as they age. Besides, the formal private sector's labor productivity has been falling in the past ten years, revealing lackluster achievements in other areas, such as insufficient trade exposure, low innovation intensity (in terms of inputs and outputs), and weak firm capabilities.

The private sector's restrained response reflects a distorted operating environment, which impedes resource allocation toward firms with higher productivity and growth potential. This is due not only to the limited level of competition in product markets but also to tax rates, informal sector practices, unreliable energy supply, and insufficient access to finance. These results reinforce the need to develop a comprehensive policy agenda to improve the business environment and boost private sector development in Uzbekistan. Pressing reforms and policies include six main areas:(1) continuing to foster competition in product markets; (2) ensuring the tax regime does not penalize firm growth; (3) tackling practices from the informal sector to guarantee that resources are not diverted from the most efficient users; (4) advancing pro-competition reforms in the banking sector to streamline access to finance; (5) progressing with pro-competition reforms in the electricity sector to update the aging infrastructure and improve the quality of services provided to firms; and (6) introducing active policies to support firm growth.

A. Setting the Stage: Pro-Competition Reforms

Since 2017, the government of Uzbekistan has introduced market reforms and created conditions for private sector development. Some of these measures have had no specific sector focus. Starting in 2017, the authorities have implemented several reforms to boost market functioning. A presidential decree from September 2017 opened the way to the liberalization of the official exchange rate and the end of the dual system.[1] The government lifted foreign exchange surrender requirements, which used to impose exporting firms to sell any foreign currency obtained in their exporting activity, and eased access to foreign exchange for individuals (see Chapter 5 for more detail). Simultaneously, the Uzbek authorities strengthened trade facilitation by introducing in 2018 an electronic application and payment system for multiple import and export certificates and reducing the time needed for issuing permits for trade activities.

Overall, these reforms in Uzbekistan are consistent with other economic transition experiences. Early in their transition process, Poland and Vietnam also introduced measures to liberalize the foreign exchange rate, encourage free trade, and abolish the state monopoly on international trade. For instance, Poland reduced export restrictions, eliminated export subsidies

[1] See Presidential Decree #5177, September 2017 "On Priority Measures to Liberalize Monetary Policy."

and import licensing, and gave everyone the freedom to engage in foreign trade.[2] Likewise, Vietnam relaxed foreign exchange restrictions and partially reformed its highly restrictive trade regime so that both state-owned enterprises (SOEs) and private firms have easier access to imports and greater incentives to export.

Price liberalization has been another key pillar of government reforms. Prices represent one of the most important variables for economic activity because they carry information needed to solve the core economic problem: reallocating scarce resources to meet as many of the unlimited needs of consumers as possible.[3] In this context, price control distorts the information system embedded in price mechanisms and may lead to supply and demand agents' inefficient decisions. The government has been reducing the list of socially significant and strategic types of goods and services subject to price control (see Chapter 1 for more details about the price liberalization process in Uzbekistan).

In addition to these actions, more recently the government adopted reforms to support the development of a comprehensive competition policy framework. Enabling a comprehensive competition policy framework is key to leveling the playing field and encouraging smooth market functioning.[4] Having a strong and independent competition authority is one of the essential underlying factors for implementing this framework. In January 2019, authorities created three separate agencies out of the State Committee for Assistance to Privatized Enterprises and Development of Competition. These were: the Anti-Monopoly Committee (AMC), the Agency for State Asset Management (SAMA), and the Agency for Development of Capital Markets.[5] The primary responsibilities of the newly established AMC include: (1) analyzing the competitive environment across the economy; (2) suppressing abuse of the dominant position, cartel agreements, and unfair competition; (3) tackling anticompetitive regulations and state aid control; (4) ensuring nondiscriminatory access to goods, works, and services, including in the case of market segments with natural monopoly characteristics; and (5) evaluating the impact on competition of legal acts that are adopted by state bodies.[6] The mandate of the AMC includes issuing opinions on the establishment of new SOEs and making proposals to facilitate state divestiture decisions and privatization.[7]

In July 2020, a presidential decree charted a comprehensive strategy and milestones to promote competition. The decree established basic competition principles, detailed measures to encourage competition, and specific timelines and assigns specific authorities responsible for

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[2] The Poland Act on Foreign Currencies (1989) introduced internal exchangeability of the *zloty.*

[3] For a thorough discussion on the economics of price control, see, for instance, Coyne and Coyne (2015).

[4]In practical terms, competition policy involves: (1) the promotion of measures to enable contestability, firm entry, and rivalry; (2) the enforcement of antitrust laws (typically rules against abuse of dominance and anticompetitive agreements, and merger control); and (3) competitive neutrality and state aid control. For further discussion, see World Bank (2019b)."

[5] Presidential Decree #UP-5630, January 14, 2019 "On Measures for Cardinal Improvement of State Assets, Antimonopoly Regulation, and Capital Markets Management System.

[6]Dentons, "Administrative Reform in Full Swing in Uzbekistan," January 17, 2019. https://www.dentons.com/en/insights/alerts/2019/january/18/administrative-reform-in-full-swing-in-uzbekistan.

[7] Additionally, the State Assets Management Authority is responsible for the management of state assets and SOEs and improvements in the overall SOE governance.

implementing a comprehensive competition policy strategy for Uzbekistan.[8] The decree is broad in scope and touches on the key constraints affecting the development of competition in Uzbekistan, such as: (1) burdensome and anticompetitive sector regulation; (2) pervasive price controls; (3) significant and distortive state aid; (4) the significant presence of SOEs in competitive markets and the lack of a level playing field; (5) the widespread presence of legal monopolies; and (6) the anticompetitive behavior of market players. It also gives special attention to the potential lack of competition in public procurement.

B. Perceptions and Firm-Level Surveys

While the government has undertaken significant reforms to strengthen market functioning, the degree of competition in Uzbek markets is still perceived as weak. According to the latest Bertelsmann Transformation Index (BTI), the perception of the state of market competition in Uzbekistan have improved since 2016 but lags those of selected ECA regional peers (Figure 4.1). The same is true for the perception of antimonopoly policy effectiveness (Figure 4.2).

Figure 4.1: Perception of market competition in Uzbekistan and selected ECA countries, 2016 and 2020

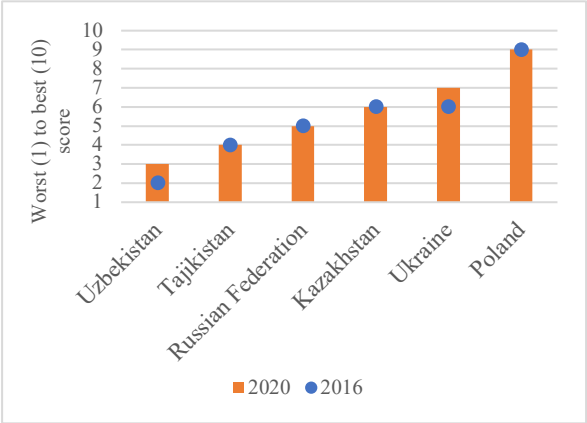
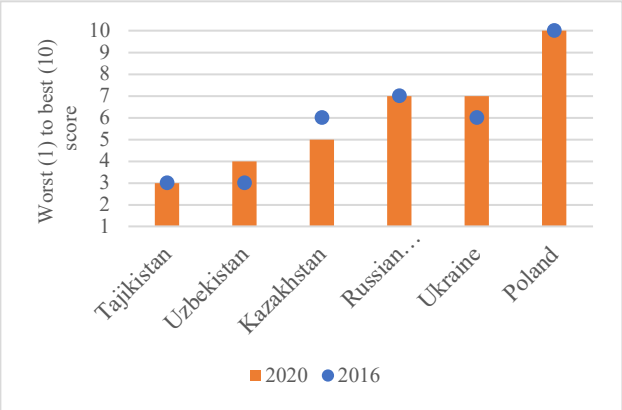


Figure 4.2: Perception of the effectiveness of antimonopoly policy in Uzbekistan and selected ECA countries, 2016 and 2020



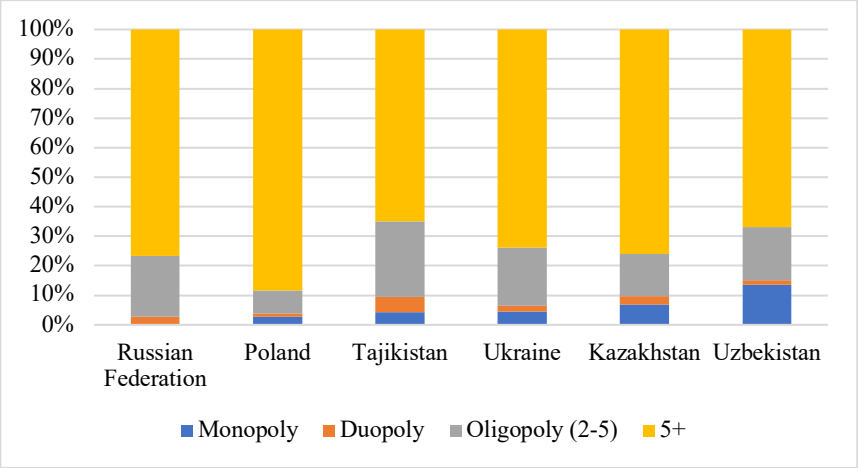
Source: World Bank staff elaboration based on data from the Bertelsmann Transformation Index (BTI) (2020).

Firm-level data corroborate this perception and highlight the concentrated structure of Uzbek manufacturing. The 2019 World Bank Enterprise Survey (WBES)—a representative sample of firms in the nonagricultural, formal, private economy – suggest that monopolistic, duopolistic, and oligopolistic market structures are widespread in the Uzbek manufacturing sector.[9] The proportion of Uzbek formal private manufacturing firms that consider themselves as operating in monopoly, duopoly, or oligopoly markets in 2019 is relatively high (33 percent) compared with key regional peers (Figure 4.3). Only Tajikistan has a more concentrated structure (35 percent). In principle, high levels of concentration should not necessarily be a cause for concern, either because specific markets are prone to higher market concentration given their

[8] See Presidential Decree #6019, "Additional measures to further develop the competitive environment and reduce state participation in the economy," July 2020.
[9] See Annex 1 for further details about the 2019 WBES data in Uzbekistan.

structural characteristics[10] or because high market concentration can reflect a process where successful firms obtain larger market shares through efficiency-enhancing measures.[11] On the other hand, persistently concentrated markets can also offer risks of anticompetitive behavior, especially in the presence of structural and behavioral barriers to entry that protect incumbent players from competition.

Figure 4.3: Market structure of the manufacturing sector in Uzbekistan and selected ECA countries, 2019



Source: World Bank staff elaboration based on data from the WBES (2019).

By the same token, government interventions are still seen as hampering competition, despite the relative improvement over the past few years. According to the latest data from the Economist Intelligence Unit (EIU, Risk Tracker dataset, January 2021), firms in Uzbekistan perceive that their ability to compete might be impaired by government rules that impede competition on merit. Uzbekistan performs at the bottom of its comparator group, particularly on the perception of vested interests that are distorting economic decisions (Figure 4.4). The perception of unfair competitive practices, discrimination against foreign companies, and price controls also appear at the highest level among comparator economies.

A. The Entrepreneurship Landscape

The entry of new firms into the formal sector has improved in the past few years. However, it is still well below the ECA average and is lower than predicted by the country's income per capita. The entry of new firms plays a crucial role in fostering competition and increasing pressure on incumbent firms to become productive. Figure 4.5 displays the evolution of new firms' entry into the higher end of the formal sector in Uzbekistan during 2006–2018; it is measured as the average annual number of new limited liability firms registered per 1,000 working-age people.[12] As shown, the entry density rate has been experiencing an increasing trend, from 0.23 in 2006 to

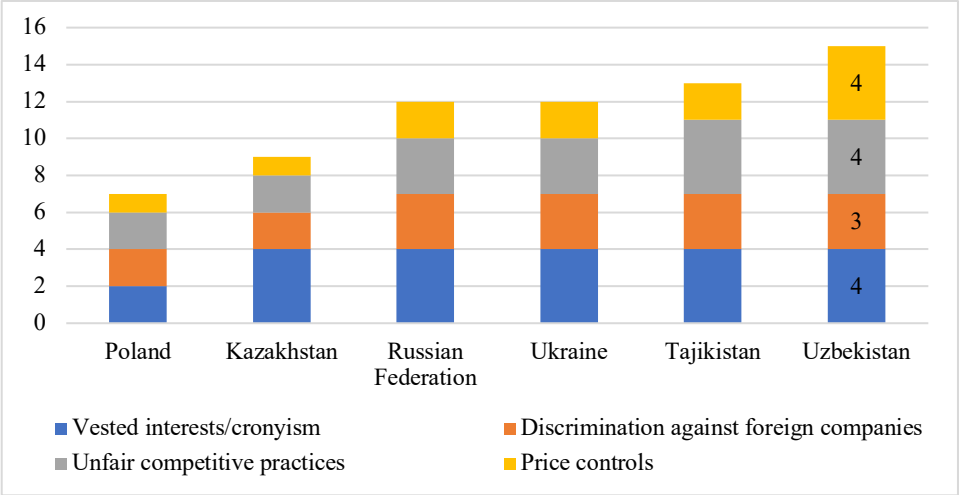
[10] For instance, high fixed costs and sunk investments, economies of scale and scope, and high minimum efficient scale.

[11] For instance, investment in product differentiation.

[12] It is worth acknowledging that these numbers only capture entry through the Limited Liability Company (LLC) modality. They do not include entry of firms as sole traders, corporations, non-profit, etc.

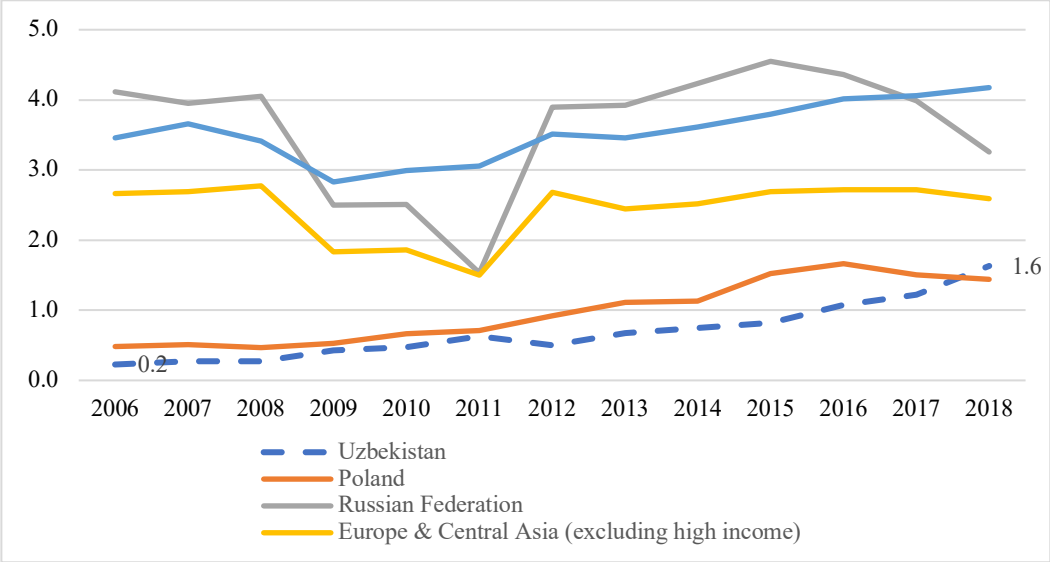
1.63 in 2018. This might reflect the recent government efforts to reduce costs to start a new business. According to Doing Business data, the cost to open a business shrank from 3.2 percent of income per capita in 2016/2017 to 2.2 percent of income per capita in 2019/2020. However, the same entry rates are still much lower than the ECA averages, and within the ECA region, Most important, the average formal entry rate in Uzbekistan for the whole period is below what would be predicted by the country's average income per capita in the same period (Figure 4.6).

Figure 4. 4: Competition-related risks for business in Uzbekistan and selected ECA countries (January 2021)



Source: World Bank staff based on the EIU's Risk Tracker data (January 2021).
Note: The graph shows an aggregation of four indicators, each scored on a scale from 0 (very little risk) to 4 (very high risk).

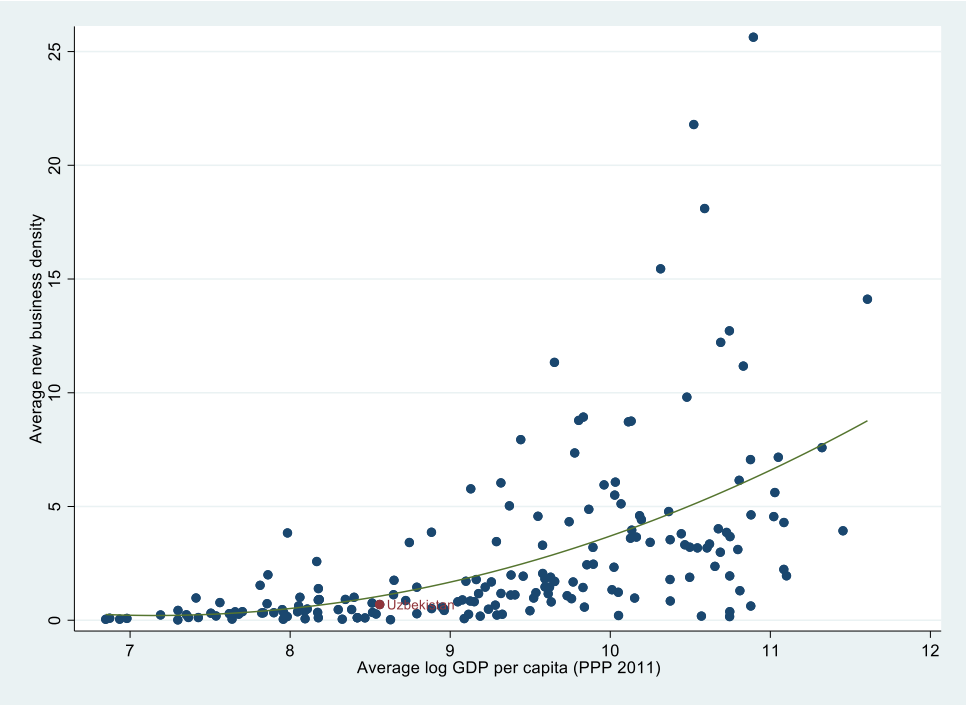
Figure 4. 5: New firm entry density: Uzbekistan vs. ECA region (2006–18)



Source: World Bank staff based on World Bank Entrepreneurship Dataset.
Note: New business entry density is defined as the number of newly registered formal, private limited-liability firms per 1,000 working-age people (ages 15-64).

The poor entry rate performance might suggest that reducing administrative costs to entry alone, without implementing additional and complementary pro-competition reforms, is not enough to boost firm entry. While in specific circumstances, reducing the time and cost for a firm to enter a market or obtain a license can increase competition, this is often not the binding constraint for firm entry. In practice, the entry of new firms—and firm conduct afterward—are more influenced by regulatory barriers that determine the market design, such as monopoly and exclusivity rights, price controls, discriminatory or preferential access to inputs or finance, etc. Several of these practices are still present in Uzbekistan, especially in sectors where SOEs operate. SOEs operate together with the private sector in various subsectors—such as light industry, fruits and vegetables, hospitality services, chemical industry, banking, and insurance—but often enjoy preferential access to land and cheap (domestic and foreign) finance, or a preferential regulatory regime. For instance, in the fertilizer sector, the government allocates annual production quotas and imposes nonessential price controls. When combined with significant SOE presence, these interventions can stifle incentives for the private sector to invest.[13]

Figure 4. 6: New business density and GDP per capita (2006–18)



Source: World Bank staff based on World Bank Entrepreneurship dataset and World Development Indicators dataset.

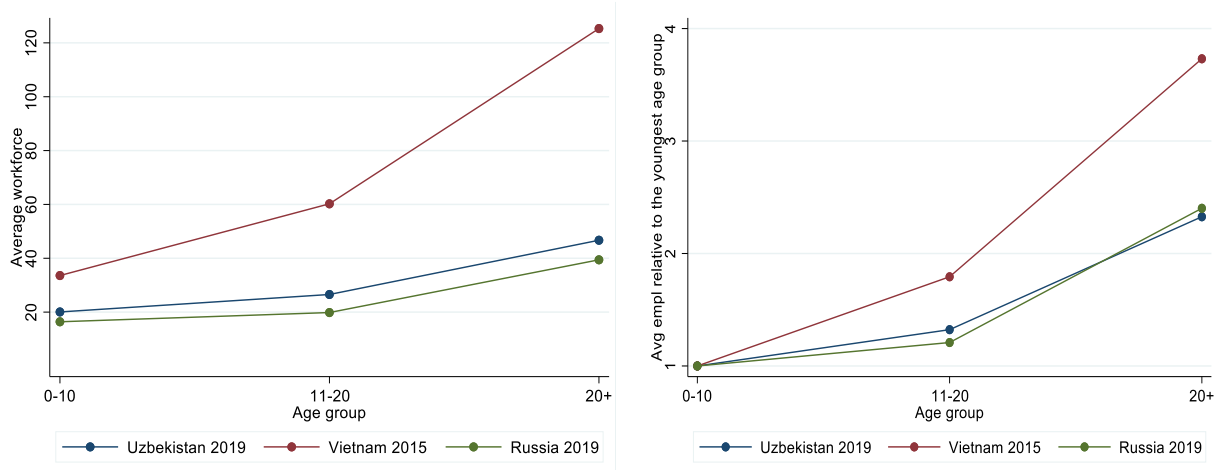
The post-entry performance, another relevant aspect of entrepreneurship, has also been disappointing. WBES data reveals that the Uzbek formal private firms have not grown as fast as those in key comparators and tend to stay small as they age. The entry of new firms is just half of the story; they need to thrive once they enter. In this regard, a crucial driver for economic development is the speed with which the average business grows over its lifecycle (Hsieh and Klenow 2014; Eslava, Haltiwanger, and Pinzón 2019). Drawing on the latest round of WBES data, Figure 4.7 presents the average age of (surviving) formal private firms against the average number

[13] For further discussion about the fertilizer sector, see World Bank (2019b)

of employees for Uzbekistan and two selected transition economies, Vietnam and Russia. Results suggest that, for all three countries, younger firms are smaller (in terms of workforce) than older ones. This result is consistent with patterns of selection and learning, as firms tend to learn about their operations and productivity over time.[14] Differences in (employment) size in relation to Uzbek firms widen as firms age: Uzbek formal private firms up to 10 years old employ on average only 20 workers, compared with 33.6 in Vietnamese peers; this gap of 13.6 employees grows wider to 78.6 employees for firms that are 20 or more years old. Consistent with this finding, the analysis of the employment growth profile across firms' age groups suggests that Uzbek firms grow at a slower pace as they age when compared with the same peers: the ratio of average employment at age 20+ to average employment at 0–10 is much higher in Vietnam than in Uzbekistan: 3.73 in Vietnam compared with2.32 in Uzbekistan.[15] For Russia, this ratio is 2.4. These results suggest that Uzbek private firms struggle more to expand their activities as they get older. As a result, Uzbekistan has an overabundance of small firms compared with peers (Figure 4.8): the share of Uzbek firms at low levels of employment is larger than in Poland and Russia, while the density of larger firms is lower in Uzbekistan. This is not because firms tend to be younger in Uzbekistan than in these comparator countries; rather, it seems to reflect that Uzbek small private firms are relatively old, reinforcing the perception of a stagnant private sector in the country.[16] In fact, a sizable proportion of small firms in Uzbekistan are not young: according to the 2019 WBES data, 50 percent of formal private firms have a maximum of 20 employees, and 44.8 percent of these firms are at least 10 years old (Figure 4.9).

Figure 4.7: Average employment by firm age: Uzbekistan vs. selected peers

(a) Absolute value (b) Relative to average employment for firms ages 0–10



Source: World Bank staff elaboration based on the WBES data.
Note: To minimize volatility, the top percentiles (of firm size times sampling weights) were removed for each country.

[14] According to different models of business dynamics, firms "learn" about their productivity over time, so efficient firms invest and expand, while less productive ones stay small, shrink, or exit the marketplace. See, for instance, Jovanovic (1982).
[15] This means that, in Vietnam, firms that are 20 or more years old are 3.73 times larger than firms up to 10 years old. In Uzbekistan, this ratio is 2.32.
[16] In fact, firms' average age is almost similar across these three countries: 11.34 years old for Uzbekistan in 2019, 11.40 for Russia in 2019, and 11.22 for Vietnam in 2015.

Consistent with this finding, employment in the formal private sector has been growing much faster among young firms, no matter their size. This shows the importance of young establishments for employment generation. Drawing on WBES 2019 data, Figure 4.10 displays annual employment growth in Uzbekistan during 2016–19 across size and age groups. Results show that employment growth increases with size and declines with age, but employment growth differences are much more noticeable along the age dimension. Specifically, firms of all sizes grow faster in their early years: on average, young firms, in the 0–4 years and 5–9 years age groups—are net employment generators for (almost) all size classes.

Figure 4.8: Employment distribution of formal private firms: Uzbekistan vs. selected peers

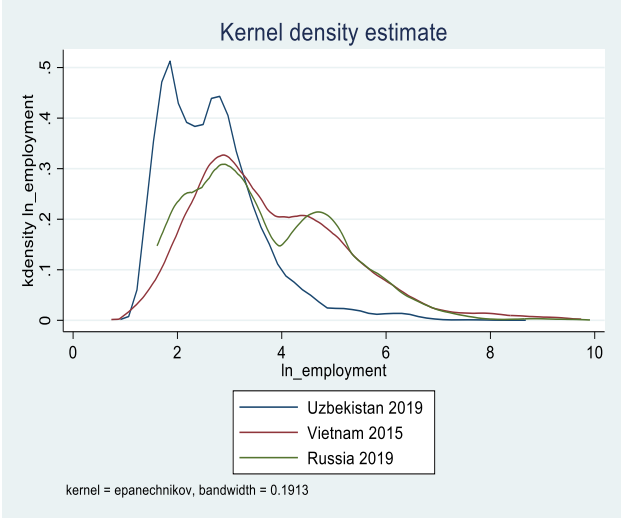
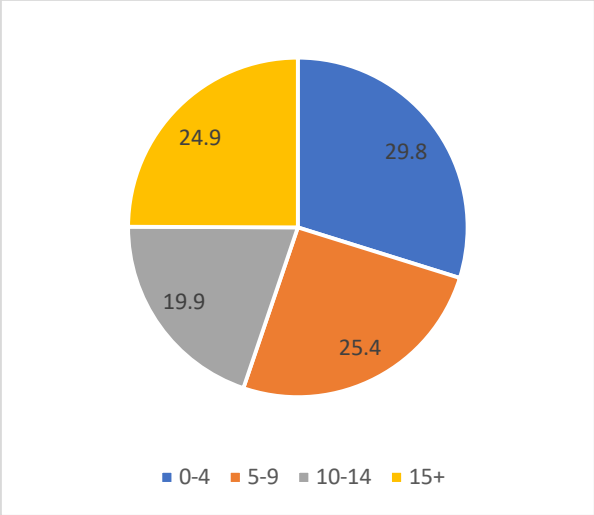


Figure 4.9: Composition of formal private small firms by age group in Uzbekistan, 2019



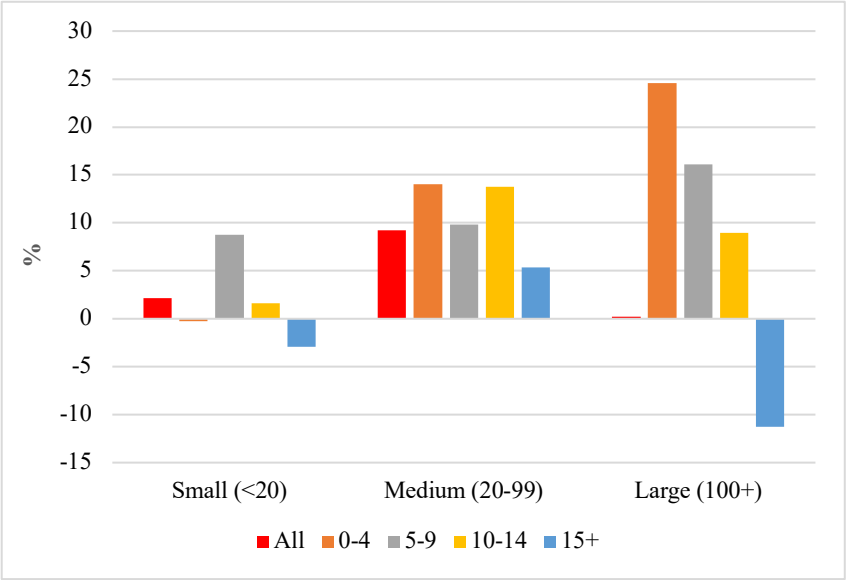
Source: World Bank staff elaboration based on the WBES data.
Note: Survey weights were applied.

Simultaneously, revenues per worker of formal private firms have been contracting over time at a faster pace than in key regional peers. The overall increase in employment has not been accompanied by sales expansion. As a result, labor productivity—defined as sales revenue per worker—decreased continuously in the past decade, with an annual decrease of 1.2 percent during 2010–13 and a decrease of 6.7 percent during 2016–19. When put in perspective, the magnitude of the latest annual drop was much larger in Uzbekistan than in key Central Asian peers: a decrease of about 2 percent in Kazakhstan and Tajikistan. The decline was also larger than in Russia and Poland (Figure 4.11).

Falling productivity reflects a subdued performance in other domains of entrepreneurship. Insufficient trade exposure is one of them. There is vast empirical literature showing a positive association between exporting activities and productivity premia. The two main mechanisms underlying this relationship are self-selection into the export market and learning by exporting. WBES data suggest that the private sector in Uzbekistan may be failing to realize trade gains: as displayed in Figure 4.12, only 5 percent of formal private firms are classified as exporters (those that export directly at least 10 percent of their sales), well below the regional average (15.8 percent). Those firms (within the manufacturing sector) that manage to export are typically large

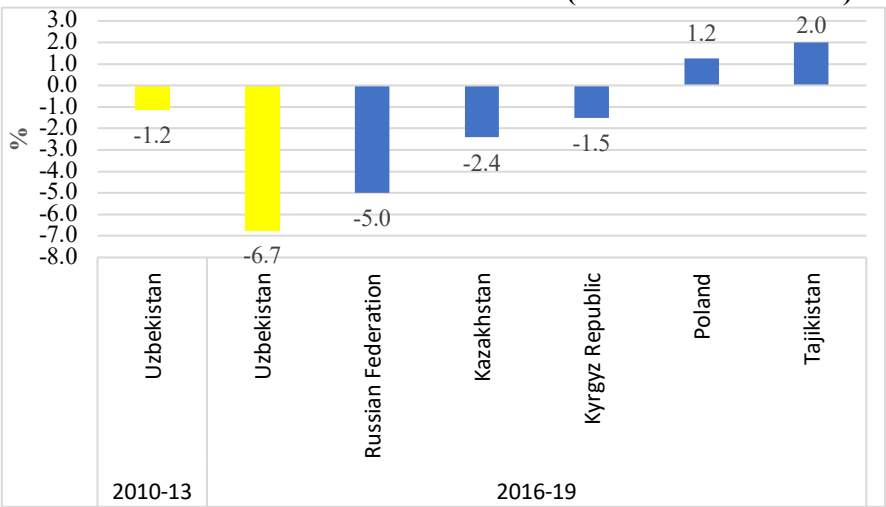
(141 employees on average) and are indeed able to extract substantial productivity dividends: they experienced an average annual productivity growth of 3.5 percent during 2016–19.[17]

Figure 4.10: Annual employment growth in the formal private sector in Uzbekistan, by firm size and age (2016–19)



Source: World Bank staff elaboration based on WBES data.
Note: Survey weights were applied.

Figure 4.11: Annual labor productivity growth in the formal private sector: Uzbekistan vs. selected ECA countries (2010–13 and 2016–19)



Source: World Bank staff elaboration based on WBES data.
Note: Survey weights were applied.

[17] During the same period, the annual productivity growth of non-exporters was -8.5 percent.

Figure 4.12: Share of formal private firms exporting directly at least 10 percent of sales, 2019

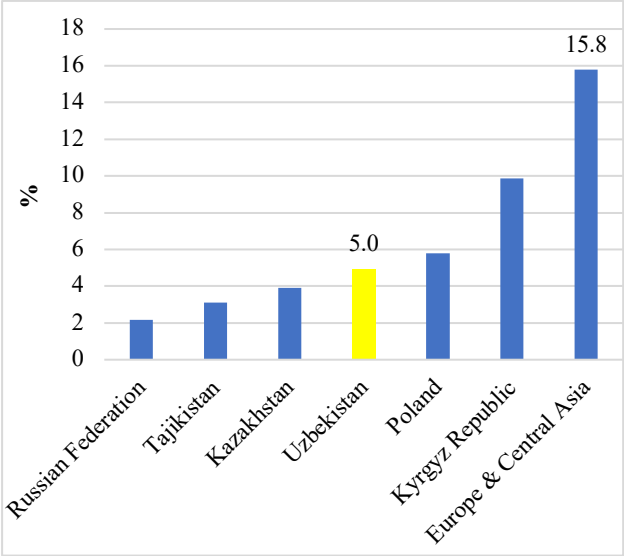
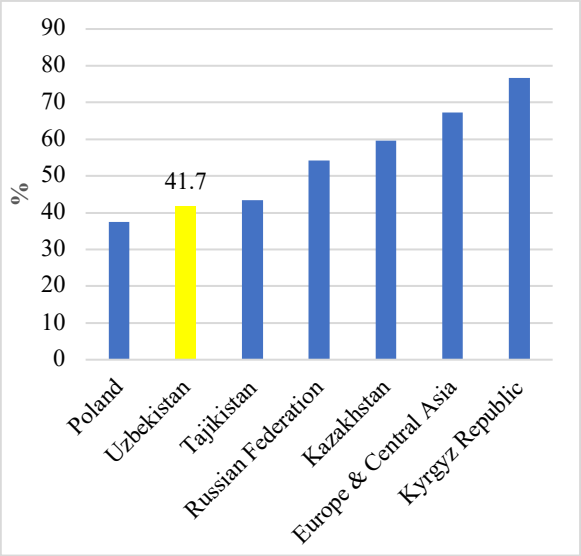


Figure 4.13: Share of formal private firms using material inputs and/or supplies of foreign origin, 2019



Source: World Bank staff elaboration based on WBES data.
Note: Survey weights were applied. *Tabulations apply only to manufacturing firms.

The low intensity of innovation inputs and outputs is another salient feature of Uzbekistan's formal private sector. By introducing process and product innovation, firms can improve the goods and services they offer while increasing demand and reducing production costs. All these outcomes affect productivity.[18] The ultimate effects on productivity will result from the efficiency through which firms transform innovation inputs (resources devoted to innovating) into innovation outputs (new products, ventures, or processes). In this regard, the WBES data suggest that the innovation landscape among formal private firms in Uzbekistan is underdeveloped, both in inputs and outputs. First, very few firms engage in R&D activities: only 4.5 percent of formal private firms against 9.4 percent in the ECA region (Figure 4.14). Likewise, the adoption of basic digital technologies (in business-to-consumer services) is very low: only 26.2 percent of formal private firms in Uzbekistan have their own website, well below the regional average (62.8 percent).[19]

This suggests that the private sector has not been able to tap into the demand-scaling and productivity-enhancing opportunities that the use of digital solutions is expected to bring. On the positive side, though, the adoption of existing knowledge embedded in foreign technology—a less costly and risky option for acquiring and accumulating knowledge—is higher in Uzbekistan than in the ECA region: 20.8 percent of private manufacturers report using licensed foreign technology against 16.5 percent for the region on average. As for innovation outputs produced by the private sector, the performance of Uzbekistan seems to be below its potential: on average, formal private firms in the country are 34 percent less likely to have introduced a new product or process than the average country in the ECA region over the 2019-2016 period (Figure

[18] Innovation can also affect aggregate productivity (in the economy) through the "between component," since innovating firms can grow more than others and displace existing inefficient firms.
[19] The WBES also maps the level of adoption of another type of digital technology: use of emails to connect with suppliers and customers. However, this information is not available in the 2019 round of the survey, only for the 2013 round.

15). While this statistic does not explain the quality of innovation, it does indicate a low performance. However, there are some "pockets" of excellence. Again, foreign ownership plays a vital role: data indicate that foreign-owned companies are 67 percent more likely to introduce innovation than their domestic counterparts.

Figure 4.14: Percent of formal private firms that spend on R&D, 2019

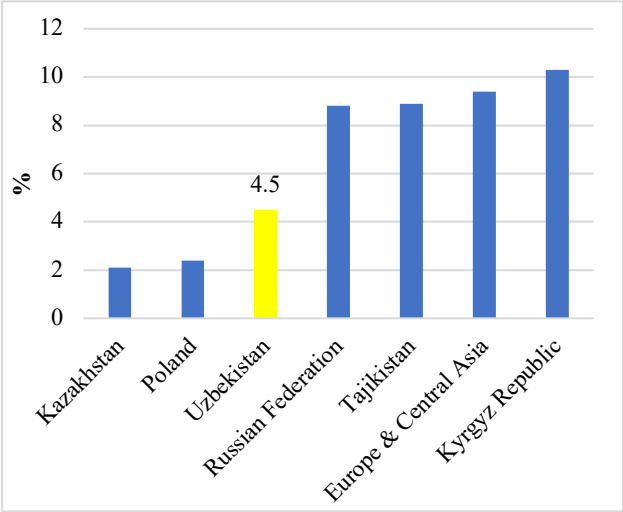
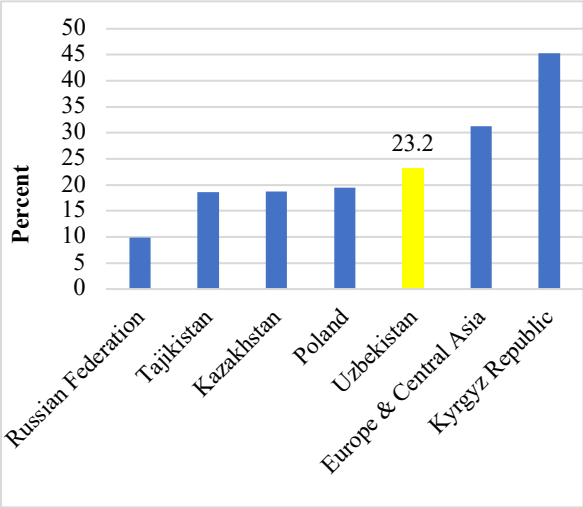


Figure 4.15: Percent of formal private firms that introduced a new product/service, 2019



Source: World Bank staff elaboration based on WBES data.
Note: Survey weights were applied.

Figure 4.16: Firm capabilities: Uzbekistan vs. selected ECA countries, 2019

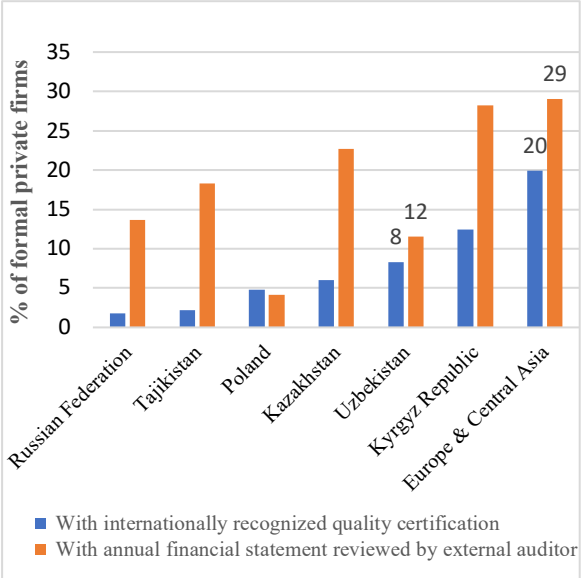
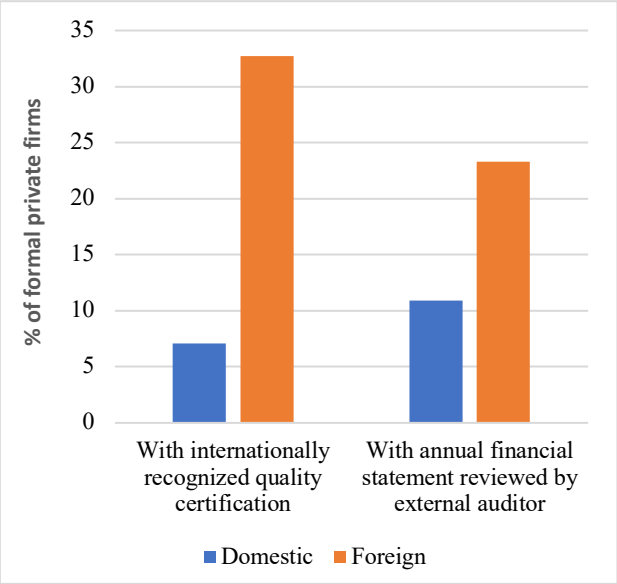


Figure 4.17: Firm capabilities in Uzbekistan: domestic vs. foreign-owned firms, 2019



Source: World Bank staff elaboration based on WBES data.
Note: Survey weights were applied.

Low innovation performance owes to underdeveloped firm capabilities. Firms' ability to identify opportunities, manage the associated risks, formulate growth strategies, and then introduce innovative products or processes depends on their capabilities. Multiple capabilities are necessary: basic human capital, managerial capabilities, technological capabilities, and actuarial capabilities.[20] The WBES data show that Uzbekistan's private formal firms underperform in several measures of firms' capabilities. For instance, Figure 4.16 shows that only 8.2 percent of formal private firms have internationally recognized quality certification, considerably below averages for the ECA region (around 20 percent). The share of formal private firms that have their annual financial statement reviewed by an external auditor in Uzbekistan is lower than in other Central Asian economies; however, it is higher than in Poland. Again, foreign-owned companies stand out as outliers. Compared with domestic peers in the formal private sector, foreign-owned firms are 4.6 times more likely to have an internationally recognized quality certification and 2.1 times more likely to have their financial statements assessed by an external auditor (Figure 4.17).

B. Factors Inhibiting Entrepreneurship and Firm Growth

The previous section showed different symptoms of the weak entrepreneurship performance in Uzbekistan. Most revealing was that formal private firms do not grow as they age, reflecting a stagnant private sector. This is important because a key difference between more and less developed countries lies in the speed at which the average business grows over its lifecycle.

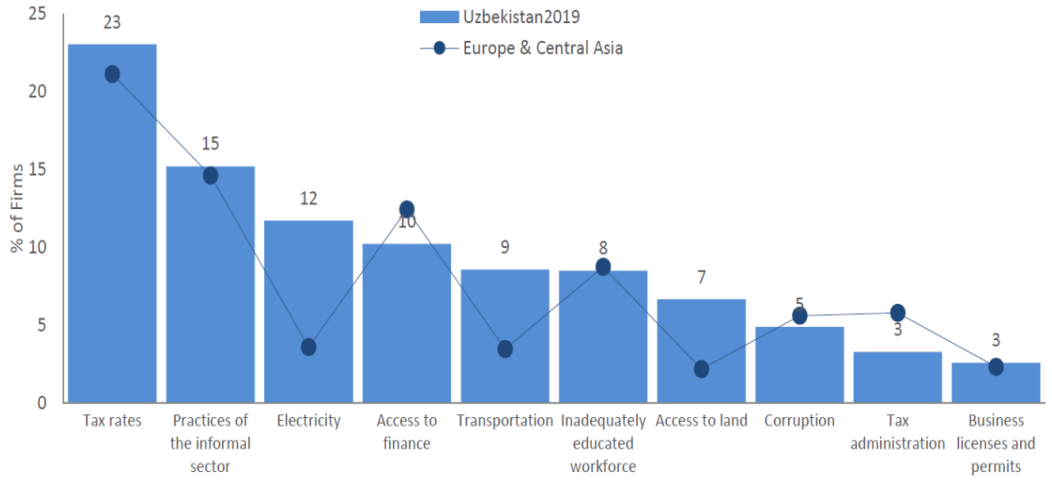
The fact that firms are struggling to grow suggests that their productivity and performance are not being rewarded. This reflects the existence of a distortive business environment that impedes the allocation of resources toward firms with higher productivity and growth potential. Conceptually, if firms "learn" about their productivity over time, it would be expected that efficient firms invest and expand, while less productive ones stay small, shrink, or exit the market (Jovanovic 1982, Hopenhaynís 1992). However, resource allocation does not occur naturally when the business environment is distorted, but rather allows underperforming firms to survive and/or de-incentivizes efficient firms to grow. In fact, Hsieh and Klenow (2014) show that firm growth patterns vastly diverge across countries because of distortions that impede resource allocation toward firms with higher productivity and growth potential.

Besides limited competition in product markets, other factors have been hindering private sector development. Tax rates are listed as the most relevant obstacle for private sector operation in Uzbekistan and might be incentivizing firms to stay small; tax rates have been reduced since the latest Enterprise Survey, however. According to the 2019 WBES data, 23 percent of formal private firms in Uzbekistan rank tax rates as the highest business obstacle (Figure 4.18). Tax administration is also listed among the top constraints. The latest World Bank CPSD (2018)[21] revealed that the tax system penalized some firms' growth due to its dual tax treatment with simplified slabs for small firms. As a result, many firms chose to split into several smaller subsidiaries to avoid the high tax rates under the complex tax rule. More recently, the World Bank

[20] See Cirera and Maloney (2017) for a general conceptualization of the necessary capabilities to innovate and grow.
[21] World Bank (2018).

Doing Business 2020 report showed some progress with the "paying taxes"[22] indicator in the past few years, moving from a 76.9 score in 2019 to a 77.5 score in 2020. This might reflect the reforms implemented in 2019, which reduced the corporate turnover and labor tax burdens in favor of a more equitable and efficient tax regime on profits and consumption. Further analysis is needed to assess whether these recent reforms were able to remove the distortions that reduce incentives for firms to grow.

Figure 4.18: Top ten business environment constraints, 2019



Source: Extracted from https://www.enterprisesurveys.org/en/data.

Practices of the informal sector are listed as the second most relevant obstacle to private sector development. This obstacle is likely to cause detrimental effects for formal firms' market dynamics and productivity and can over penalize small firms. The negative effects of informality on the performance of the real economy have been widely discussed and documented.[23] The key mechanisms underlying this negative association are the "unfair" advantage held by informal firms and the resource misallocation these firms generate.[24] The real level of informality is very hard to measure in any economy. However, to get some sense of informality in the private sector, the WBES asks firms that are all formally registered[25] a series of questions about their interactions with the informal sector of the economy, and the firms' registration status when they started their operations. These data reveal that virtually all formal private firms operating in 2019 began their activities as formal entities (Figure 4.19), suggesting that the transition from informal to formal

[22] The "paying taxes" indicator of the World Bank's Doing Business covers the taxes and mandatory contributions that a medium-size company must pay in a given year as well as measures of the administrative burden of paying taxes and contributions and complying with post-filing procedures.

[23] See for instance, La Porta and Shleifer (2008), De Mel et al (2011), Djankov and Murrell (2002), and more recently Mendi and Costamagna (2017), Amin (2021), and Amin and Okou (2020).

[24] Because informal firms do not pay taxes and do not comply with costly regulations, they have an "unfair" advantage, which allows them to charge lower prices and "steal" market share from the formal firms, lowering the profitability of the latter. In addition, the informality diverts resources away from the formal to the informal sector, even if formal firms do not compete directly with informal ones.

[25] In the case of Uzbekistan, the surveyed firms are all registered as businesses with the local authority (*khokimiyat*) and obtain the certificate of state registration.

sector is not recurrent in Uzbekistan.[26] Also, data reveal that despite being cited among the highest obstacles for business operations in the country, competition from the informal sector affected a small proportion (22 percent) of formal private firms in 2019 when compared with the regional average (37 percent) (Figure 4.20). Not surprisingly, small firms are more likely to experience this type of competition pressure, a pattern detected in almost all ECA countries under comparison (the exceptions are Tajikistan and Russia). It is worth highlighting that these numbers do not reflect the real effects of informal practices on formal firms' performance in Uzbekistan.

Figure 4. 19: Percent of formal private firms formally registered when they started operations

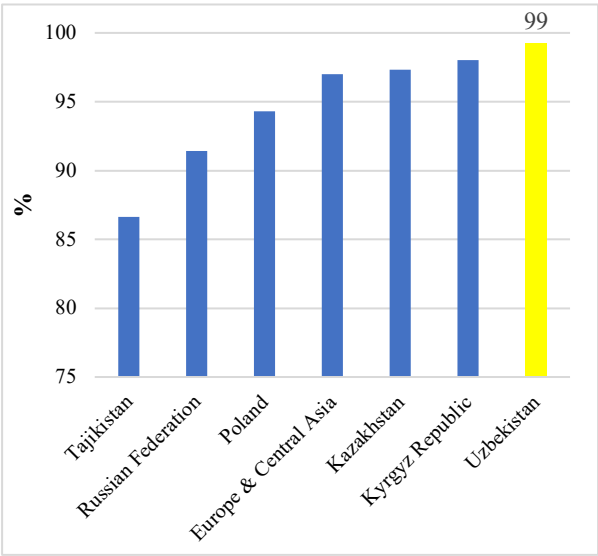
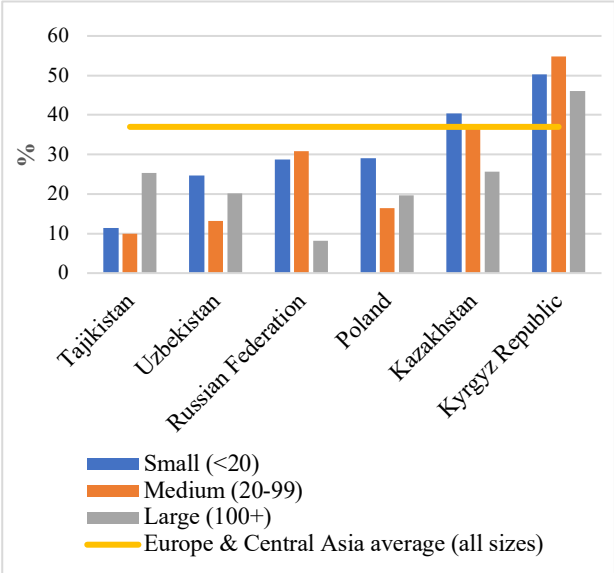


Figure 4. 20: Percent of formal private firms competing against unregistered or informal firms, 2019



Source: World Bank staff elaboration based on WBES data.
Note: Survey weights were applied.

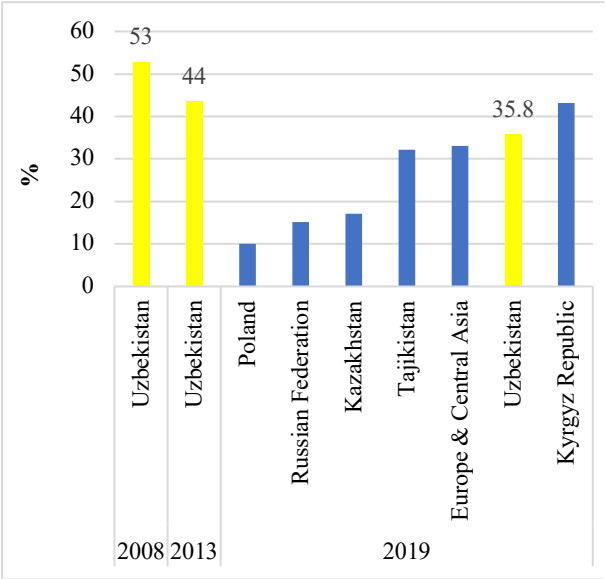
Access to electricity represents another major burden in the business environment. Access to infrastructure and related services directly impacts firms' production costs and, therefore, firms' competitiveness, both in domestic and international markets. Despite having a substantial hydrocarbon endowment, Uzbekistan suffers from electricity shortages. According to WBES data, the likelihood of experiencing power outages in Uzbekistan has been decreasing in the past years; however, as of 2019, it was still high compared with the regional average (Figure 4.21-4.22).

Access to finance represents another constraint for formal private sector operations. Better access to credit makes it easier for entrepreneurs to innovate. Conversely, credit constraints may deter technological upgrading and limit firms' export orientation. Recent empirical analysis shows that the availability of finance, and financial development, in particular, is more important for productivity growth in sectors that are intensive in intangible assets (Demmou et al 2019). Despite the credit boom since 2017, access to finance is still listed as the fourth highest barrier to formal

[26] This result might suggest that informality-to-formality transition is not that frequent in Uzbekistan. Further analysis is needed to understand the relative costs of operating in the informal versus formal sector. In principle, these relative costs go beyond profit tax rate and include the (monetary and time-related) costs associated with rule of law, corruption, etc.

private sector development in Uzbekistan (Figure 4.18). Formal private firms' use of Uzbekistan financial services is considerably lower than the regional average. For instance, the use of deposit mobilization services by formal private firms is the lowest among comparator countries (Figure 4.23). The same firms are 67 percent less likely to have a bank loan or line of credit than the "average country" in the ECA region (Figure 4.24).

Figure 4.21: Percent of formal private firms experiencing electrical outages, 2019



Source: World Bank staff elaboration based on WBES data.
Note: Survey weights were applied.

Figure 4.22: Number of electrical outages in a typical month, 2019

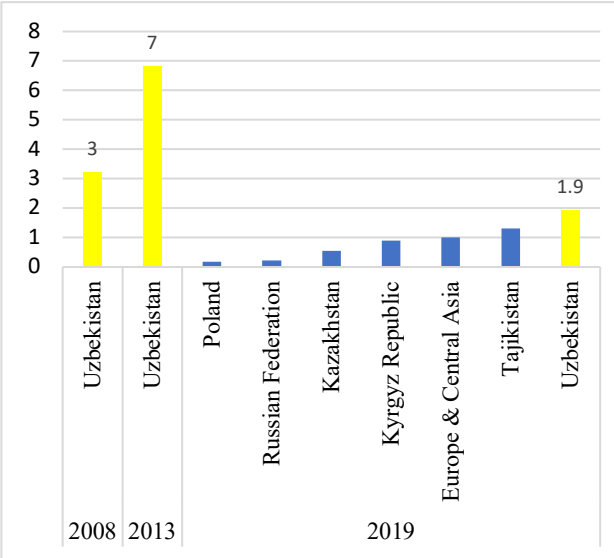


Figure 4.23: Percent of firms with a checking or savings account, 2019

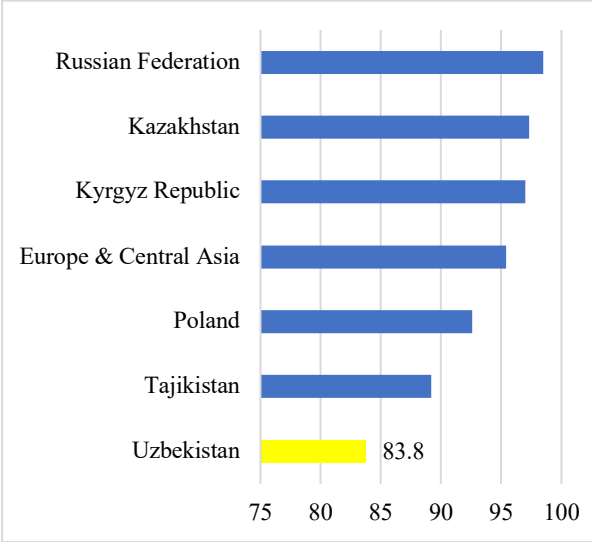
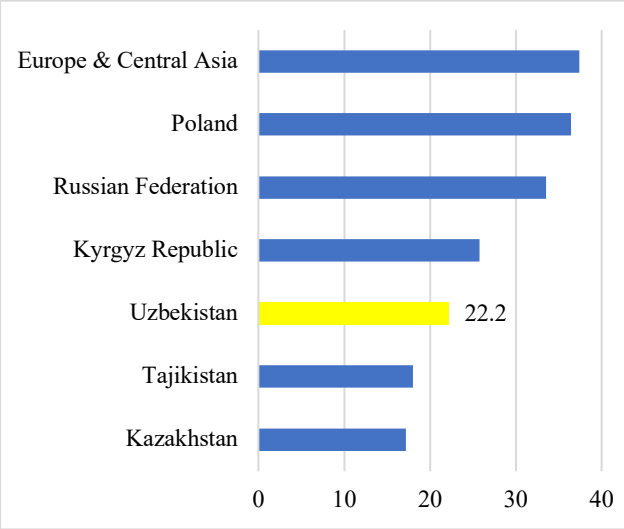


Figure 4.24: Percent of firms with a bank loan or line of credit, 2019



Source: World Bank staff elaboration based on the WBES data.
Note: Survey weights were applied.

C. The Path Forward

The government has undertaken important reforms to strengthen market functioning in the past few years. However, the degree of competition in Uzbek product markets is still perceived as weak compared with key peers. Against this backdrop, the entry of new firms into the formal sector—a standard proxy of entrepreneurial activity—has improved in the past few years. However, it is still well below the ECA averages and is lower than predicted by its income per capita. Labor productivity of the formal private sector has been falling in the past years. Falling productivity reflects a lackluster performance in other entrepreneurship domains: insufficient trade exposure (both from the export and import side), low innovation, and weak firm capabilities.

These results reinforce the need to develop a comprehensive policy agenda to streamline the business environment and boost private sector development in Uzbekistan. Pressing reforms and policies include six main areas:

Boosting competition in product markets is key. This goes beyond reducing administrative barriers to entry. It is important to push for complementary pro-competition reforms, tackling discriminatory interventions and regulations that unlevel the playing field, especially in markets where SOEs compete against private firms. Uzbek SOEs continue to enjoy preferential access to land, infrastructure, credit, state support, and contracts and until recently also foreign exchange. In this context, strengthening competitive neutrality is a must, so no undue advantage is granted to market operators—private or state-owned. Controlling state aid to avoid favoritism and minimize distortions on competition is also important. All these factors reinforce the need to continue to streamline the competition policy framework in Uzbekistan. The government has taken its first steps in this direction. The next steps include amending the Competition Act of Uzbekistan and streamlining the AMC's organizational structure to align its overall framework with international best practices. The current draft of the Competition Act touches on a wide range of topics covered by a sound antitrust law: it regulates anticompetitive practices, establishes a merger control regime, and also has rules governing state aid, the participation of SOEs in markets, public procurement, and a comprehensive set of advocacy powers that can position the AMC as a competition champion within the government. However, there is scope to boost effectiveness through legal amendments, development of implementation rules and guidelines, and actual implementation.

It is important to ensure that the tax regime does not penalize firm growth. Tax rates and the administrative costs of tax compliance are key concerns of businesses. According to WBES data, 23 percent of formal private firms in Uzbekistan rank tax rates as the highest business obstacle; tax administration is also listed among the top constraints. The reforms implemented in 2019 reduced the corporate turnover and labor tax burdens in favor of a more equitable and efficient tax regime of profits and consumption. This is certainly an improvement. However, it is not clear whether these reforms could reduce the distortions that inhibit firms' growth incentives. A wide range of countries rely on some form of special tax regimes geared toward smaller firms. While this practice can be beneficial to incentivize formalization, it can distort the strategic behavior around eligibility thresholds and reduce incentives to grow beyond a certain size. This adds to the fragmentation of economic activities (by reducing the benefits of economies of scale and scope) and allows inefficient firms to continue to operate. Given that formal firms in Uzbekistan do not grow as they age, there is a need to reassess the tax system and ensure that tax rates and administration are balanced enough to stimulate firm growth. According to best practices, and to

encourage firms' growth, the tax system should tend toward simplicity, gradual increases in the tax cost with the size of firms (so as not to discourage growth), and reduction of marginal tax rates (to encourage investment and employment in growing and large companies) (OECD 2004).[27]

Creating conditions that help firms formalize is important, but not at the cost of thwarting private sector activity; it is better to have informal private firms than no private firms. Competition from the informal sector can erode the profitability needed for formal firms to invest in new productivity-enhancing technologies or innovate, especially in weak property rights enforcement. But the size of the informal economy depends on several factors: the overall business environment (which may be too burdensome for formal firms), the total economic cost that a firm must bear to abide by the law, the burden of taxation, and the economic benefits that firms enjoy by complying with the law. Policies to reduce informality need to cover multiple angles: making the labor market more flexible, reforming social protection, rationalizing the tax system, and making the regulatory framework and the justice system more efficient (Loyaza 2018). In parallel, it is important to ensure that conditions create good formal jobs so informality can regress in the long run. The evidence presented in Bruhn and McKenzie (2014) shows that reducing the cost of registering a firm has a small impact on informal firms' formalization; however, it does increase the chances that new firms will be formal. Despite its caveats and limitations, the WBES data suggest that the transition from the informal to formal sector is not happening in Uzbekistan, so informal firms are largely created as informal and remain informal. Therefore, as important as it is to encourage firm formalization, it is also important to support the creation and growth of productive formal firms.

Advancing pro-competition reforms in the banking sector is crucial for streamlining access to finance, a key driver of private sector development. Facilitating access to finance will help spur dynamism in the economy, innovation, and job creation (see Chapter 6 for more details).

Advancing pro-competition reforms in the electricity sector is also key to updating aging infrastructure and improving the quality of services so firms have reliable access to inputs. The government has been implementing reforms in the electricity sector to transition toward a market-based approach that enhances efficiency (refer to Spotlight 2).

Introducing active policies to support firms' growth can play an important role in tackling entrepreneurship's anemic symptoms while alleviating business environment weaknesses. While all reform areas highlighted above are addressed, it might be worth implementing specific policies that tackle Uzbek entrepreneurship's weaknesses. Business support measures should follow an important principle: prioritize firms' growth potential and performance. Any support instrument that offers benefits conditional only on firms' size might be inefficient, as they disregard growth prospects. This does not mean that most small or medium firms should be ignored. The fundamental aspect is to define the right targeting criteria for business support measures, given that public resources are limited. Finding these criteria is not easy, since enterprises are extremely different in terms of performance and attributes. Therefore, an in-depth and careful analysis—preferably with administrative-level data—is needed to unveil high-growth firms' characteristics and, even more important, to identify firms most likely to succeed (not only to survive) and benefit from government support by growing and creating jobs. As for the type of support provided, it is key to go beyond financial tools. Provision of financial support can be

[27] OECD (2004). OECD Employment Outlook, Chapter 5: *Informal Employment and Promoting the Transition to a Salaried Economy*. Paris: Organization for Economic Co-operation and Development.

counterproductive if firms cannot detect good investment opportunities and internalize the benefits of adopting new technologies and innovating, or if firms are not able to access markets to sell their new products and services. For this reason, it is vital to combine financial instruments with nonfinancial support measures designed to fortify firm capabilities and improve market access.

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Annex 4A.1: The World Bank Enterprise Survey Dataset

The WBES data provide a representative sample of the non-extractive, non-agricultural, formal private economy with five or more employees, comparable across 144 countries. To be included in the survey, firms need to have at least five employees and operate in the manufacturing sector or one of the selected services sectors. Services include retail, wholesale, hospitality, repairs, construction, information, communications technology (ICT), and transport. Not included in the survey are agriculture, fishing, extractive industries, utilities, and some services sectors (such as financial services, education, and healthcare). Also not included are firms with 100 percent state ownership. In Uzbekistan, the 2019 WBES interviewed 1,239 firms.

Table 6A.1: WBES sector coverage in Uzbekistan (2019)

Excluded	Included
SECTORS Agriculture Fishing Mining Public utilities Financial intermediation Public administration Education, health and social work	SECTORS Manufacturing (all subsectors) Construction Motor vehicles sales and repair Wholesale Retail Hotels and restaurants Storage, transportation, and communications IT
ADDITIONAL CRITERIA • < 5 employees • Informal firms • 100% state-owned firms	ADDITIONAL CRITERIA • 5+ employees • Formal (registered) firms • Minimum of 1% private ownership

Chapter 5 External Trade and Integration

Uzbekistan has made remarkable progress since 2017 in opening its economy to foreign trade. Unification of the multiple exchange rates, reduction in import tariffs, and trade liberalization were among the first reforms the authorities implemented in late 2017. Removing the surrender requirements for exporters and allowing access to foreign exchange to importers with progressively increased limits created stability in the foreign exchange market and enabled firms to boost investment with imported machinery and equipment. These reforms were accompanied by the abolition of export bans on certain food products, including for horticulture, and domestic reforms that allowed farmers to shift from growing cotton and wheat to higher value added fruits and vegetables. Restrictions and tariffs have been reduced markedly, non-commodity exports have increased substantially, and imports have surged with availability of foreign exchange and the economy's transition to market. Dependence on commodities – while still high – has declined. The country's logistics performance has improved, and non-tariff barriers have been progressively reduced, as Uzbekistan is strengthening the economic integration with its neighbors after years of near autarchy. Uzbekistan has made WTO accession a priority in its development strategy; this is the area where the country needs to make progress faster and connect to the world. Besides WTO accession and stepped up regional trade and economic integration, the authorities are working to improve the country's customs administration and facilitate enterprises' connections to global value chains, including through reducing the cost of ISO certification for SMEs.

A. Exchange Rate Unification And Liberalization

On September 5, 2017, the government unified the multiple exchange rates and allowed unlimited non-cash foreign exchange transactions for businesses. Due to the previous excessive protectionist measures, businesses had limited access to foreign currency, which made imports challenging, stimulated the grey economy, and resulted in multiple exchange rates. The Law on Currency Regulation (ZRU-573), which fully liberalized currency operations, current cross-border and capital movement transactions, was approved on October 22, 2019. With the exchange rate unification and liberalization, the authorities also abolished the so-called foreign exchange revenue surrender requirements by exporters at the official exchange rate, whereby a substantial part of the earnings of exporters was *de facto* expropriated by the government.

As a result of the reforms, enterprises can purchase foreign currency for current transactions without restrictions, including for imports of goods and services, repatriation of profits, and others. In accordance with the new legislation (ZRU-531 of March 2019 and ZRU-573), all businesses, including foreign investors, are guaranteed the ability to convert local proceeds into foreign currency and transfer it to foreign bank accounts. The Uzbekistan authorities may stop the repatriation of a foreign investor's funds in cases of insolvency and bankruptcy, criminal acts by the foreign investor, or when so directed by an arbitration or a court decision. Banking regulations mandate that the currency conversion process take no longer than one week. In 2019, businesses reported no delays with conversion into foreign currency and transfers abroad.

B. Import Tariffs and Export Bans

The authorities have reduced import tariffs substantially since 2018. Between 2017 and 2018, the government reduced import tariffs for about 8,000 items (out of 10,800), of which about 5,000 were eliminated.[1] These and follow-up measures reduced the average import tariff from 14.9 percent in 2015 to 7.5 percent in 2020. The export bans on flour, rice, meat, and vegetable oil was eliminated, as was the quota on exports of fresh fruits and vegetables. A simplified customs regime ("green corridor") was introduced for export of fruits and vegetables from Uzbekistan on bilateral agreements with several countries, including Russia, Kazakhstan, and the Kyrgyz Republic. As a result, import tariffs have been cut for almost all product groups during the reforms in 2017-2020 (Table 5.1). Uzbekistan does not apply tariff quotas.

Table 5.1: Uzbekistan: MFN Import Tariffs, 2015 and 2020 (simple averages, in percent)

Product Groups	2015	2020
All products	14.9	7.5
Agriculture products	19.0	11.4
Non-Agriculture products	14.2	6.9
Animal products	15.3	6.9
Dairy products	15.6	10.1
Fruit, vegetables, plants	29.2	17.7
Coffee, tea	15.3	10.9
Cereals and preparations	18.7	11.5
Oilseeds, fats & oils	7.9	4.0
Sugars and confectionery	24.6	10.7
Beverages and tobacco	30.9	32.1
Cotton	10.0	0.0
Other agricultural products	10.5	2.8
Fish and fish products	5.0	6.2
Minerals and metals	14.5	5.2
Petroleum	16.7	0.4
Chemicals	9.3	2.5
Wood, paper, etc.	14.9	6.2
Textiles	24.5	13.8
Clothing	30.7	28.1
Leather, footwear, etc.	16.2	12.0
Non-electrical machinery	4.8	1.8
Electrical machinery	12.4	6.4
Transport equipment	13.1	7.7
Manufactures, not elsewhere specified	17.3	5.2

Source: Ministry of Investment and Foreign Trade of Uzbekistan, WTO (https://www.wto.org/english/res_e/statis_e/daily_update_e/tariff_profiles/UZ_E.pdf)
Note: MFN tariffs apply to 48 countries. Tariffs applied on imports originating in non-MFN countries are double the MFN tariffs.

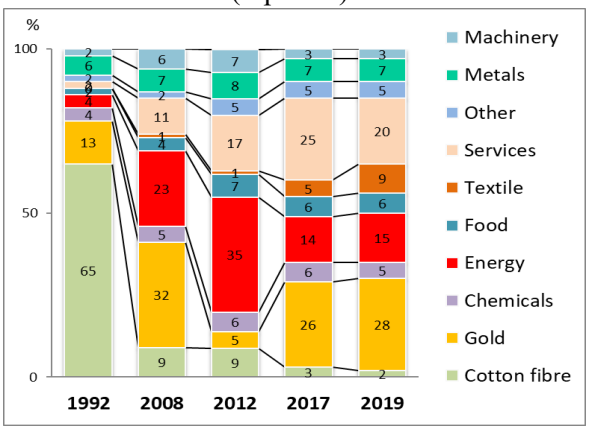
[1] See Presidential Resolution #3303, September 2017 "On Measures to Further Streamline the Foreign Economic Activity of the Republic of Uzbekistan" sharply reduced customs duties on more than 8,000 categories of imported goods. This included zero rates of customs payments for 3,550 items and a modest excise tax for 1,122 items. See also Tsereteli (2018), *The Economic Modernization of Uzbekistan*, Central Asia-Caucasus Institute Silk Road Study Program," pp. 25 et ss; https://silkroadstudies.org/resources/pdf/SilkRoadPapers/2018-04-Tsereteli-Uzbekistan.pdf.

C. Foreign Trade Since the Start of Reforms

As a result of the trade reforms and the rapid opening up of the country, external trade has surged and the share of commodities in exports has declined. Exports rose 39 percent in US dollar terms from 2017 to 2019 before falling 6 percent in 2020 as a result of the border closures and other restrictions related to COVID-19 (Figure 5.1). Imports rose much faster than exports, reflecting a jump in government-supported modernization of SOEs supported by UFRD loans and pent-up demand for consumer goods (Figure 5.2). As a result, the large trade surplus in 2016-2017 has shifted to a trade deficit since the start of reforms. Exports of manufactured goods that had lower government protection before the reforms have picked up while those of products in very competitive global industries – such as cars – have slumped. Exports of textiles, garment, and carpets increased from 9 percent of total exports in 2017 to 9.3 percent in 2019. Exports of fruits, vegetables and processed food rose from 7 percent of total exports in 2017 to 8.5 percent in 2019. The share of non-commodity exports in total exports increased from 12 percent in 1992 to just under 50 percent in 2017-2019 (Figure 5.3).

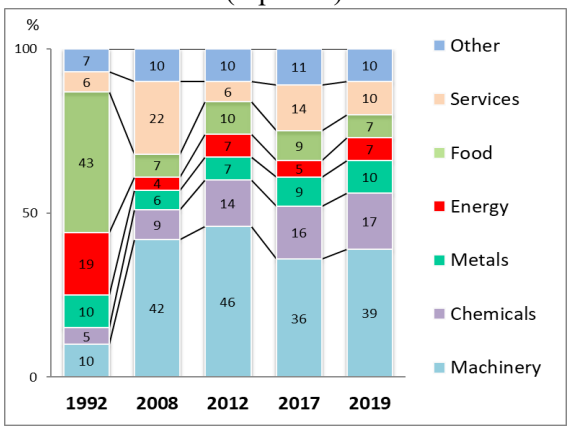
Trade in services increased significantly in 2017-2019. The highest growth in services exports was in transport and tourism, which contributed almost all the growth in services exports in 2019. Tourism exports increased as a result of the visa liberalization, improving relations with neighbors, and the growing popularity of Uzbekistan as a tourism destination. The number of foreign citizens who visited Uzbekistan increased from 2.2 million in 2016 to 6.7 million in 2019. The number of direct jobs in Uzbekistan's tourism sector increased from 96 thousand in 2016 to 121 thousand in 2019. To overcome the skills shortage, entry of foreign professionals to Uzbekistan was allowed from December 2018. From 2019, skilled foreign professionals are subject to a personal income tax that is only 50 percent of the established tax rate for residents. The main impediments to services trade development include the domination of state-owned companies in air and railway transport, and financial markets.

Figure 5.1: Structure of Exports, 1992-2019
(in percent)



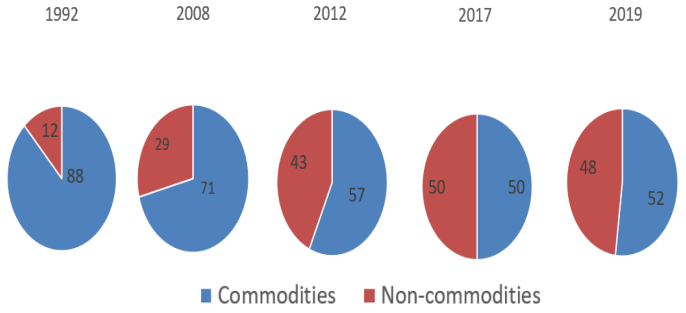
Source: Uzbekistan authorities, World Bank staff calculations.

Figure 5.2: Structure of imports, 1992-2019
(in percent)



Source: Uzbekistan authorities, World Bank staff calculations.

Figure 5.3: Trends in Commodity vs. Non-commodity Exports, 1992-2019



Source: Uzbekistan authorities, World Bank staff calculations.

Export diversification has also occurred within the commodity segment. The share of cotton fiber in overall exports has declined dramatically, from 70 percent in 1991 to about 3 percent in 2019-2020. Until 2016, most of the decline in cotton exports was offset by a surge in exports of natural gas – at the expense of substantial rationing at home –and copper (Figure 5.1). Since the reforms, the dramatic surge in gold exports has largely offset the continued decline in cotton shipments and the contraction of gas exports. All in all, commodities continue to account for more than half of all shipments abroad.

The geography of exports has also been diversified. In 1990-2016, Uzbekistan's main trading partners were Russia and other CIS countries, but in recent years, China has become the main trading partner of Uzbekistan. China accounted for 18.1 percent of Uzbekistan's foreign trade in 2019, followed by Russia with 15.7 percent. Uzbekistan's trade with Tajikistan, previously declining precipitously, more than doubled from 2017 to 2019.

The government is trying to diversify exports through attracting foreign direct investment mainly in the areas of processing of natural resources and building local production capacity. Tax incentives for foreign investment are essentially the same as for local enterprises participating in an investment, localization, or modernization programs. Enterprises with significant investment in priority sectors or registered in one of free economic or special industrial zones can expect additional benefits. On February 20, 2020, the government announced a plan to require localization of personal data storage, in line with the Law on Personal Data (ZRU-547), adopted on July 2, 2019. The law adopted on March 20, 2019 (ZRU-531) has considerably simplified repatriation of capital invested in Uzbekistan's industrial assets and securities. According to the new rules, foreign investors that have resident entities in Uzbekistan can convert their dividends and other incomes to foreign currencies and transfer them to their accounts in foreign banks. Non-resident entities that buy and sell shares of local companies can open bank accounts in Uzbekistan.

As non-member of WTO, Uzbekistan's exports are facing high import tariffs in trading partners. This represents one of the main reasons for Uzbekistan to work towards WTO accession (see Table 5.2), despite the recent EU decision to grant to Uzbekistan the preferential access to the EU markets through the Generalized Scheme of Preferences (GSP), i.e. lower tariffs for products imported from Uzbekistan from April 10, 2021.[2] Despite significant tariff and non-tariff barriers for non-WTO members, trade liberalization globally has now progressed to the point where protected sectors are the exception rather than the rule in most developed and developing countries that are members of WTO, and the greatest constraints for Uzbekistan are internal rather than external. The most important barriers to Uzbekistan's exports are domestic rather than the international.

[2] https://trade.ec.europa.eu/doclib/press/index.cfm?id=2263

Table 5.2: Average import tariffs (MFN) faced by Uzbekistan's export in main trading partners, 2015

	Simple Average	Weighted Average
Agricultural Products		
China	17	18.7
Kazakhstan	9.9	8.0
Bangladesh	16.7	0
Russian Federation	9.7	10.2
Turkey	21.8	24
Non-agricultural Products		
Switzerland	1.4	0
China	7.0	3.2
Turkey	5.0	2.1
Russian Federation	8.6	8.8
Kazakhstan	10.0	4.1

Source: World Trade Organization.

D. Trading Across Borders, Logistics, and Trade Facilitation

As a landlocked country, Uzbekistan faces high trading costs, compounded by poor – although improving – logistics, time delays, and uncertainties imposed by present trade regulations. Uzbekistan improved its ranking on the Trading Across Borders indicator of the World Bank's Doing Business from 168th in 2018 to 152nd in 2020 out of 190 countries.[3] Uzbekistan was noted as a top reformer in 2020. Among the recognized reforms, the introduction of risk-based inspections and simplifying import documentary compliance stood out. But this is still the lowest ranking among neighboring countries, except Afghanistan. The average Europe and Central Asia ranking is 53. According to the Doing Business, the time to export is 128 hours (a significant reduction from the 208 hours in 2019) and the cost $570 (unchanged).

Uzbekistan has improved its logistics. According to the World Bank's Logistics Performance Index (LPI), Uzbekistan's rating improved to 117th in 2018 from 129th in 2016.[4] Its rank is still below most neighbors, including Kazakhstan (71), Russia (75), and the Kyrgyz Republic (108). The relative rankings have remained approximately the same over the past six years.

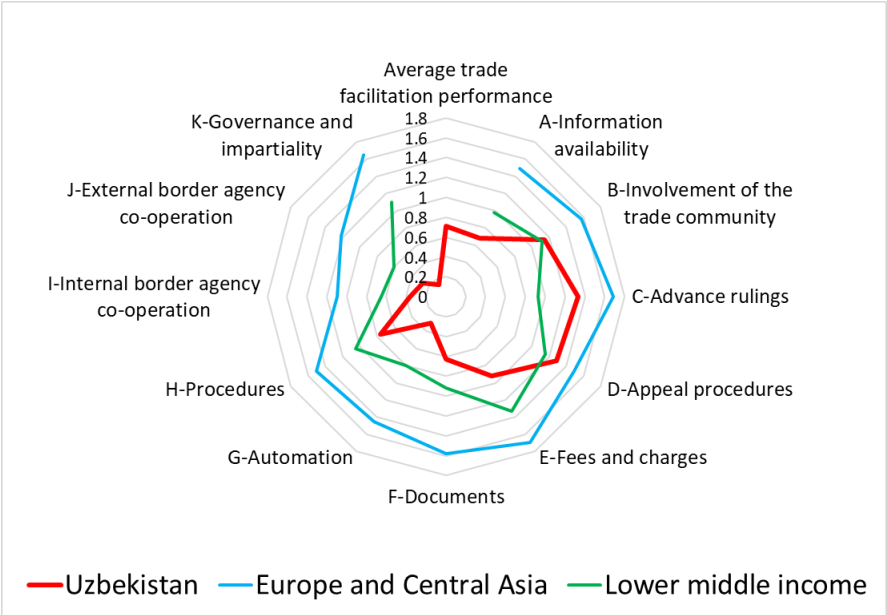
Uzbekistan appears to be most closely aligned to the Trade Facilitation Agreement of WTO measures on transparency and less closely aligned on coordination and cooperation among the border agencies, governance and impartiality. The Five-Year Strategic Action Plan

[3] The Trading Across Borders Indicator of the Doing Business Report records the time and cost associated with the logistical process of exporting and importing goods. It measures the time and cost (excluding tariffs) associated with three sets of procedures—documentary compliance, border compliance and domestic transport—within the overall process of exporting or importing a shipment of goods. Further information concerning the method and data used to calculate the Trading Across Borders Indicator can be found at: http://www.doingbusiness.org/en/doingbusiness.

[4] The LPI is published every other year and analyzes countries across six components: the efficiency of customs and border management clearance; the quality of trade and transport infrastructure; the ease of arranging competitively priced shipments; the competence and quality of logistics services; the ability to track and trace consignments; the frequency with which shipments reach consignees within scheduled/expected delivery times. The LPI relies on an online survey of logistics professionals – multinational freight forwarders, main express carriers, as they are best positioned to assess how countries perform. In 2018, the LPI scored 160 economies.

(Presidential Decree #4947 of February 7, 2017) and several presidential decrees in 2019-2020 set out the current reform directions for customs and other border authorities and aim for significant reduction of export and import clearance times (by 5 times and 2 times, respectively). These reforms include measures consistent with the TFA and the WBG's gap assessment report, such as introduction of customs post-clearance audit; improvement of the preliminary declaration procedure (pre-arrival declaration); extended use of risk management as basis for control by customs and the technical border agencies; improvement of the economic operator program; development of customs financial guarantees; and introduction of a Single Window system with participation by all border agencies by 2021. In many instances, the legislation is in place, but implementing regulations and/or procedures are missing, and practical implementation is not taking place or only partially so. According to the OECD Trade Facilitation Indicators, Uzbekistan is lagging in most indicators compared to the average of the lower middle-income group and to the Europe and Central Asia regional peers (Figure 5.4). The shortfall is especially pronounced on governance and impartiality and border agencies cooperation (e.g. publication of customs annual reports, including financing of the customs administration, sanctions against misconduct of border agency staff, internal audit mechanism).

Figure 5.4: Uzbekistan, Trade Facilitation Indicators



Source: OECD (https://www.compareyourcountry.org/trade-facilitation/en/1/default/UZB/default)

Critical gaps on the WTO trade facilitation agreement remain. These include[5]: (i) A risk-based system of control has not yet been implemented by customs and other border agencies; (ii) A customs post-clearance audit function has not yet been established; (iii) The simplified and expedited clearance procedures envisaged by the TFA are not implemented in full; (iv) A National Trade Facilitation Committee to lead the trade facilitation reform agenda has not yet been established; (v) Greater efforts are required to coordinate the control and inspection actions of government agencies to reduce their regulatory impact on trade, and (vi) Information required by

[5] WTO Trade Facilitation Agreement: Uzbekistan Assessment. - World Bank, February 2019, p.iv-v.

the TFA is generally published, including on the internet, but not in a single location and not always in a user-friendly format. Thus, Uzbekistan could consider the following initial actions to address these gaps: (1) Formally establish and operationalize the National Trade Facilitation Committee; (2) Develop a multi-year National Trade Facilitation Strategy; (3) Conduct a Time Release Study that measures the average time taken between the arrival of goods and their release; and (4) Conduct a comparative analysis of customs current pre-arrival declaration and simplified clearance processes in Uzbekistan against the international best practices.

E. WTO

The government recently made WTO accession one of the main priorities in Uzbekistan's Development Strategy for 2017-2021. Uzbekistan's working party for WTO accession was established in December 1994 and met for the first time in October 2005. Negotiations resumed in 2018, and the working party met for the second time in July 2020. The working party reviewed the foreign trade regime of Uzbekistan on the basis of the updated Memorandum on the Foreign Trade Regime (MFTR) and updated the WTO members on legislative developments in the areas of taxation, currency regulation, investment, competition policy, sanitary and phytosanitary (SPS) measures, technical barriers to trade (TBT), intellectual property (IP) and customs. The WTO members provided comments and questions in August 2020 and Uzbekistan was requested to submit responses, including the completed questionnaires on state trading and on import licensing procedures, draft notification on industrial subsidies and agriculture domestic support tables. The WTO Secretariat is to prepare a factual summary of the points raised, which would serve as the basis for further examination of Uzbekistan's foreign trade regime by the working party. Uzbekistan was urged to regularly update its Legislative Action Plan and to submit translated copies of the WTO-related legislation in order to allow members to have a precise and comprehensive picture of the status of legislative reforms.

The WTO accession will bring tangible results to the Uzbekistan's economy. WTO members have lower tariffs and other barriers with each other than with countries outside the WTO and each WTO member is granted a Most Favored Nation (MFN) status, meaning that all members must treat each other the same way and not offer preferential trade benefits to any one member without giving it to all. WTO's trade dispute resolution mechanism is also of substantial value to WTO members.[6] In Uzbekistan's case, agriculture may be a huge beneficiary of WTO membership. As food and textile exports of Uzbekistan have been growing in recent years, understanding and dealing with the evolving standards for food products is essential for agricultural trade to expand. Uzbekistan, as a WTO Observer, has already started to participate in the Consultative Framework Mechanism on Cotton and has benefited from the knowledge of improvements being contemplated for cotton development assistance.

High costs linked to trade across borders can be lowered through the implementation of the Trade Facilitation Agreement (TFA) that WTO members agreed and that came into force on February 22, 2017. Uzbekistan's neighbors –Kazakhstan, Tajikistan, and the Kyrgyz Republic –are already in the process of implementing the TFA, while Uzbekistan can ratify the TFA upon its WTO accession. Out of 36 measures, there is full alignment on 10 measures, substantial on 8, and partial on

[6] https://www.thebalance.com/wto-membership-benefits-and-importance-3306364#

12.[7] Uzbekistan appears to be most closely aligned on the TFA measures on transparency (63 percent) and governance (56 percent), such as publication, enquiry points, and public comment on proposed laws and regulations. Uzbekistan is less closely aligned to the TFA measures concerning coordination (25 percent) and cooperation among the border agencies (53 percent).

As public procurement is one of the most important topics on WTO accession, Uzbekistan has made public procurement more open for foreign companies, but gaps remain. Article 4 of the new public procurement law (approved in April 2021) promotes equal right for foreign bidders: "a participant in procurement procedures (the participant) is an individual or legal person who is a resident or non-resident of the Republic of Uzbekistan, taking part in the procurement procedure as a contender for public procurement." However, Article 16 states: "If at least three domestic manufacturing enterprises take part in public procurement of goods (works, services), along with foreign suppliers, these domestic manufacturing enterprises may be granted by decrees, regulations and orders of the President of the Republic of Uzbekistan of privileges and preferences used in the evaluation of proposals, unless otherwise provided by international treaties of the Republic of Uzbekistan." These preferences were introduced initially during the COVID-19 pandemic in November 2020 (Cabinet resolution #41 of January 29, 2021 "On measures to support local producers"), but subsequently were introduced into the new law on public procurement. In November 2020, temporary price preferences of 15 percent were granted to local producers in public procurement on 529 products, if two or more local producers, along with foreign suppliers, participate in a tender.

F. THE PATH FORWARD

Uzbekistan's future prosperity depends crucially on its integration into the global trading system. WTO accession is the highest priority to achieve such integration. In addition, there are other important areas for the government to address – but most of them will ultimately be supported by the WTO accession negotiations and will, in turn, help advance them.

Advance WTO accession negotiations

The accession process itself is long and complex, involving wide-ranging legislative and executive actions that require extensive human resources and institutional capacities. In this regard, the government needs further support in developing its negotiating positions and drafts of the mandatory documents, specific sectoral laws and regulations as required by the WTO rules, in particular with regards to the Sanitary and Phytosanitary Measures (SPS), Technical Barriers to Trade (TBT) and Trade Facilitation (TF), Trade-Related Aspects of Intellectual Property Rights (TRIPS) and other specific agreements of the WTO. The WTO members will likely request reduction of what they consider to be excessive trade barriers and may raise questions about other trade-related policies, including state ownership and privatization, pricing policies, state-owned enterprises with explicit and implicit subsidies, and others. One critical issue is how to ensure coherence in the pursuit of Uzbekistan's domestic economic reform agenda, anchored by WTO accession process, while also coordinating policy measures, including sequencing, domestic inter-

[7] WTO Trade Facilitation Agreement: Uzbekistan Assessment – World Bank, February 2019.

ministerial coordination, and stakeholder consultations. Critical recommendations here include focusing on issues that can be negotiated successfully, using experience of recently acceded countries to learn from their accession process and avoid their mistakes, and using technical assistance provided by developed WTO members.[8]

The international organizations and bilateral donor community can help with training staff, computerizing procedures, customs modernization, SPS and TBT implementation. Uzbekistan has to advance technical cooperation and capacity building measures from donors to cover the remaining stages of the accession process, including the preparation of answers to questions, documentation, support a WTO-relevant domestic policy, legal framework and enforcement mechanisms, and enhancing capacities to effectively complete its accession negotiations. There is need to identify, mobilize, and coordinate technical assistance support to facilitate and accelerate ongoing Uzbekistan's accession in collaboration with development partners.

Improve customs administration and logistics

The biggest stumbling block for improving trade facilitation in Uzbekistan is the cross-border cooperation and coordination of the activities of border agencies (e.g. customs, food and drug administration, agriculture and livestock, health, security), harmonization of data and computer systems, and systematic sharing of control results among neighboring countries at border crossings to improve the risk analysis, border control efficiency and trade facilitation. Uzbekistan needs border management with better coordination mechanism (of import, export or transit transactions), collaboration (in information exchange) and connectivity (ICT platforms, e.g. Single Window) to improve trade facilitation.[9]

The State Customs Committee of Uzbekistan has to implement the risk management system at the road, railway, and air border customs posts, implement a "Single Window" customs information system at border customs posts, and improve the telecommunications infrastructure of the customs bodies in terms of the quality and speed of receiving, transmitting and processing information and trade-related clearance processes. This include the implementation of the automated information system "E-Transit", "E-TIR", facilitate data exchange of cross border information with neighboring countries, and implement the system for issuing a customs inspection certificate through mobile applications. Uzbekistan also needs to conduct a comprehensive transport and logistics infrastructure needs assessment study that allows the country to develop a plan for the extension, modernization and integration of the air/truck/rail cargo ports and hubs for contemporary container traffic, logistics centers and cold storage facilities to reduce excessive time and cost for export and import and eliminate frequent congestions, waiting times and demurrages.

[8] Jovan Jekic. 2019. WTO Accession Process. – USIAD Presentation in Tashkent on June 24-26, 2019.

[9] Violane Konar-Leacy. Coordination, Collaboration and Connectivity for Better Border Management. – World Bank, October 5, 2017 (https://blogs.worldbank.org/trade/coordination-collaboration-and-connectivity-better-border-management)

Provide advisory services and reduce the cost of ISO certification for SMEs

As information barriers about foreign markets are identified as crucial barriers to exporting by SMEs in Uzbekistan in 2017 and 2019 World Bank surveys, expansion of advisory and training services and sector-specific market studies can help build knowledge of target markets and identify niches for Uzbekistan's SMEs, including about market potential and product certification. For example, targeting the EU, Japan, South Korea, the Middle East (especially UAE), India and Iran, including study industry and product trends, clients, specific requirements/standards, competition and competitors in those markets, sales forecasts, and distribution channels. The Uzbekistan export promoting agency has to expand such services to SMEs as well and strengthen the monitoring and evaluating of the impact of export promotion activities through surveys of exporters to better understand their difficulties and needs.

As SMEs in Uzbekistan mention the high cost of certification and limited access to certification services as a barrier to export, the recommendation is to invite more international certifiers to Uzbekistan and further build certification capacities at Uzstandart. The government could establish modern laboratories in line with international standards in order to boost the export of the agribusiness sector. It could also develop regular training to help SMEs reach the new standards and obtain certificates.

Assess the distributional impacts of trade

The best practice of countries that acceded to the WTO suggest conducting an economy-wide impact assessment of the WTO membership, including impacts on jobs and incomes of the population. On this basis, the authorities could implement appropriate mitigation measures As trade liberalization will increase competition in the Uzbekistan's domestic market, much more jobs and incomes will be created in private firms of the competitive subsectors, and some jobs and incomes in the non-competitive subsectors and non-viable SOEs will be lost. In addition, more stringent international requirements, especially in the advanced countries, for 'green' and environmentally sustainable products may have implications for Uzbekistan's export potential. Uzbekistan has joined the EU GSP+ arrangement and it commits to effective implementation of the 27 core international conventions on human and labor rights, environmental protection, climate change, and good governance, which will positively impact the Uzbekistan's socio-economic development. Uzbekistan has accelerated its integration into the global trade and value-chains that require the enhanced human competences and continued skills upgrading of its large low-skilled labor force. Investing in skills to specialize in technologically advanced products of Uzbekistan's comparative advantages will help increase the attractiveness of the country for the efficiency-seeking foreign direct investment and create more well-paid jobs and move up the global value-chains.

Spotlight 2. Agriculture

Uzbekistan's agricultural reforms carried out since 2017 have been impressive. Many reforms have changed Uzbekistan's agri-food sector: liberalization and promotion of foreign trade, support to horticulture sector development, adoption of the long-term agricultural modernization strategy, increased attention to the livestock subsector, recognition of unique problems of smallholder dehkan farms, and reforms of the state order system for cotton and wheat production and marketing. Yet, this is only the beginning of the transformation, as Uzbekistan is catching up with long-overdue reforms to transition from a planned to a market economy.

The initial reforms have shown good results, including the increase in agricultural growth and agri-food exports. Agricultural growth in 2020 reached 3 percent despite the COVID-19 pandemic, about the same as in 2019 but higher than the 0.3 percent growth in 2018. Nonetheless, this expansion is still much lower than in countries such as China and Vietnam. Between 1990 and 2000, when they started their reforms, their agriculture grew by 4 percent a year on average, faster than Uzbekistan today. Doubling Uzbekistan's horticulture export between 2017 and 2019, for example, has been impressive. But compared with Vietnam, Uzbekistan has just begun its export-oriented journey. Vietnam's agri-food exports in 2019 amounted to $42 billion, which was generated from 11.5 million ha of cropland (arable land and permanent crops). Uzbekistan has 4.5 million ha of cropland, but in 2019, its agri-food exports amounted to $3.4 billion, including cotton fiber, textile, and garments. Thus, a hectare of cropland in Vietnam generates $3,650 of exports, while in Uzbekistan only $760.[1]

A. Agricultural Reforms 2017–2020

This spotlight presents the recent agricultural reforms, shows their impacts, and offers suggestions for a new generation of agricultural reforms for Uzbekistan for the next five years. The list of the needed reforms is still long, due to inaction in the past, while some reforms initiated during 2017–20 still need to be implemented effectively to deliver results and avoid policy reversals. Prioritization is informed by Uzbekistan's Strategy for Agricultural Development 2020–2030 (hereafter, "Agricultural Strategy") and the global experience, with focus on East Asia. Key reform areas ("what") should include: (1) effective implementation/completion of the reforms in the cotton and wheat subsectors; (2) more sustainable livestock sector development; (3) increase in the efficiency of farmland use; (4) development of the financial sector to be capable of handling large costs and overcoming risks of agri-food sector financing; (5) improvement of the quality of agricultural public services in line with the Agricultural Strategy; and (6) modernization of irrigation and drainage systems. The COVID-19 pandemic has added urgency to the need to modernize agriculture and induce more resilient, inclusive, and sustainable growth, which needs to be achieved under the tighter fiscal space in the aftermath of the global pandemic.

[1] World Bank staff estimates based on World Development Indicators data.

The success of agricultural reforms will depend on their effective implementation. "How" to implement the reforms is as important as "what" to reform. Global experience provides some guidance to Uzbekistan's policymakers, building on which success will be determined by their attention to: (1) empowerment of farmers and prioritization of farm incomes over other objectives; (2) strengthening of land tenure security and giving farmers full freedom over production decisions; (3) long-term commitment to investment in public agricultural programs and implementation capacity of the Government of the Republic of Uzbekistan institutions; (4) leadership and ownership by the Ministry of Agriculture (MoA) and other government institutions to implement donor projects; and (5) thinking green and climate-smart about agricultural development.

In 2017, Uzbekistan's agriculture sector was characterized by significant production and market distortions that led to low productivity and exports. Agriculture was the largest economic sector, accounting for about a third of GDP and a quarter of the workforce (who were among the poorest). Since the early 1990s, farmers operated under a centrally planned state production system that allocated farmland for production of mainly cotton and wheat and set production and procurement targets. Cotton and wheat farmgate prices were below the world market prices, and in 2016, the farm taxation through low output prices was estimated at 1.5 percent of GDP.[2] Farmers had no say in what seeds and technology to use on their fields, being forced to use blanket-input use recommendations developed centrally, untailored to local environmental, soil, and water conditions. Prior to 2017, more than 70 percent of arable land was allocated for state-controlled production of cotton and wheat, commodities that generate lower profits, are less labor intensive, and have much lower labor productivity than most horticulture products suitable for production in Uzbekistan. Cotton and wheat consumed 90 percent of water in agriculture (and 75 percent of water used in the entire country), more than 80 percent of mineral fertilizers, and more than 90 percent of agricultural public expenditures, totaling 2.1 percent of GDP in 2016.[3]

State-led cotton and wheat production and the limited diversification of agriculture were a missed opportunity. Uzbekistan's agriculture has high potential to increase value added and productivity through more climate-resilient and efficient cotton and wheat production and increased horticulture[4] and also livestock production. Horticulture is highly productive and has substantial job creation potential, generating 50 percent of the value of crop production and 40 percent of gross agricultural output from about 10 percent of the total arable land.[5] Poor public services, high taxation, and government monopolies on fruit and vegetable exports left the sector in neglect. With cotton and wheat accounting for a large use of all water resources, the sector was also at significant risk to the effects of climate and environmental change. Livestock sector generated 50 percent of agricultural GDP, but its growth was the result of the rapidly rising livestock numbers, scattered among thousands of very small farmers and rural households, and not

[2] Uzbekistan Agricultural Public Expenditure Review (2019), World Bank.
[3] *Cotton Taxation in Uzbekistan: Recent Developments and Reform Agenda* (2018), Uzbekistan Agricultural Public Expenditure Review (2019), and *Reforming the Wheat Sector in Uzbekistan* (2019), World Bank.
[4] Uzbekistan Country Private Sector Diagnostic (2019), International Finance Corporation, World Bank; *Central Asia's Horticulture Sector: Capitalizing on New Export Opportunities in Chinese and Russian Markets* (2020), World Bank.
[5] Uzbekistan Agri-Food Job Diagnostic (2020), World Bank.

the outcome of the increase in their productivity. This created a large environmental footprint and rising demand for feed. Public services for animal husbandry and animal health hardly existed.

The reforms in agriculture began immediately along with the country's economic liberalization in 2017. Starting with incremental reductions in cotton and wheat growing areas in 2017, a big wave of reforms in 2017 and 2018 removed all export restrictions on horticulture products (Box S2-1) and liberalized bread prices. Further reductions in cotton and wheat growing areas continued,[6] along with the slow easing of land restrictions. In addition, almost all areas assigned for cotton production were transferred to contract farming with private textile companies (that is, cotton-textile clusters) that facilitate raw cotton production and process cotton into higher value products.[7] In 2019, wheat and cotton farmgate prices, set by the state, largely converged with market prices, and the majority of cotton lint exported was processed (85 percent in 2019 against 50 percent in 2015).

Box S2-1. Reforms in Horticulture Sector during 2017–20

Reforms in 2017 and 2018 included:

- Abolishment of the export monopoly of the state-owned enterprise (SOE) "Uzagroexport."
- Abolishment of the mandatory sale of 25 percent hard currency earning and permission to keep 100 percent value of earned currency in the SOE's account.
- Reduction from 10 to three days to receive certificate and register the contract at the customs for horticulture exporters.
- Permission to use any transport for exports, not only railroad
- Establishment of "green corridors" at the border crossings
- Elimination of the minimum export prices.
- Removal of the full prepayment requirement for export contracts outside of Uzagroexport..

These policy reforms are complemented by the increased public investments in access to credit for horticulture farmers and agribusinesses (more than $1 billion of the donor-financed credit lines) and export facilitation, and are complemented by the recent new programs (mostly started in 2020 and supported by donor financing) to: (1) strengthen the delivery of core agricultural services (research, extension, sanitary and phytosanitary measures, etc.); (2) promote inclusion of smallholders in horticulture value chains; (3) provide support to horizontal (cooperatives) and vertical (clusters) coordination; and (4) build efficient agrologistics and the food safety system.

Sources: Uzbekistan authorities and Bank staff.

At the end of 2019, the agri-food sector received a boost from the adoption of the ambitious Strategy for Agriculture Development for 2020–2030.[8] Recognizing the imminent threats posed by environmental issues such as water shortages, land degradation, and climate change, and acknowledging the weak performance of the sector due to the ineffective administrative/control approach, the Agricultural Strategy set out an ambitious and transformative agenda.

The government vision articulated in the Agricultural Strategy is to develop a competitive, market-based, diversified, and export-oriented agri-food sector that will increase farm

[6] In 2016, the cotton growing area was 1,255,000 ha. In 2020, it declined to 980,000 ha, or by 22 percent. The largest decline in cotton growing area occurred in 2018, when it fell by 11 percent compared with 2017. The decline in wheat growing area was much more modest; during 2016–20, it fell by only 4 percent.
[7] *Assessment of Cotton-Textile Clusters in Uzbekistan* (2018 and 2019), World Bank.
[8] It was approved by the Decree of the President of Uzbekistan #PP-5853 on October 23, 2019.

incomes, create new jobs, enhance food security, and ensure sustainable use of natural resources through nine priorities. These are: (1) enhance food security of the population; (2) create a favorable environment for agribusiness and value chains; (3) decrease state involvement in sector management and enhance investment attractiveness; (4) encourage rational use of natural resources and environmental protection; (5) develop modern public institutions; (6) diversify state expenditures; (7) develop research, education, and advisory services; (8) develop rural areas; and (9) develop transparent statistics and information systems.

The Agricultural Strategy has moved quickly from vision to implementation by tackling the biggest and most binding constraint to further change in the agriculture sector. In March 2020 (Presidential Resolution #4633), the government abrogated the state procurement quota system, which previously had required all cotton produced in the country to be surrendered to the state, and for all cotton growing areas to meet stringent annual production targets. With historically severe penalties (including the loss of land use rights) levied against farmers who missed the target, the policy was widely viewed by observers as a binding constraint to ending forced and child labor in the cotton sector. The targets were also viewed as contributing significantly to agricultural practices that were environmentally damaging and discouraged adaptation to climate risks. With the end of mandatory state procurement, farmers have increased freedoms to determine, based on market conditions and availability of technologies, how and how much cotton to grow. However, the sale of raw cotton so far has been permitted only to the organizers of cotton-textile clusters; this is supposed to accelerate technological change in the cotton value chain, including through provision of advisory and other services to farmers. Farmers will also have increased freedoms in determining cost-optimal cotton harvesting, the most common of which being the non-harvesting of residual cotton after the main harvest.

The reform of the wheat, flour, and bread sector has also been underway. In March 2020 (Presidential Resolution #4634), the government announced the end of the state procurement quota system for wheat production starting from 2021. The resolution abolished the state production and procurement targets, as well as state farmgate prices, to be enacted in 2021. Due to the COVID-19 pandemic, which negatively affect food security in Uzbekistan, the implementation of this reform has been delayed by at least a year. The abrogation of the state procurement quota system would complement the bread price liberalization in 2018 and the liberalization of wheat flour prices in 2019. Public grain stocks, totaling 1.7 million tons in 2021, will replace the state procurement (3.2 million tons in 2020) and be redesigned to mitigate excessive wheat price volatility[9] arising from fluctuations in domestic wheat production[10] and a large import dependency from Kazakhstan,[11] which keeps restricting wheat and flour exports from time to time.[12]

The authorities are also restructuring agricultural public expenditures. While the support to cotton and wheat production through subsidized credit and irrigation water delivery dominates agricultural public expenditures, shifts are occurring to support a broader agricultural

[9] *Public Grain Stocks in Uzbekistan* (2020), World Bank.
[10] In 2017, Uzbekistan produced 6.9 million tons of wheat. In 2018, the wheat production fell to 6.0 million tons, increasing to 6.8 million tons in 2019 and declining to 6.5 million tons in 2020 (USDA data).
[11] During 2015–20, Uzbekistan imported from Kazakhstan about 2.8 million tons of wheat (and flour in wheat equivalent), accounting for almost 40 percent of wheat consumption in Uzbekistan.
[12] Kazakhstan restricted export of wheat and flour in 2020 during the COVID-19 crisis. It also banned export during the 2008/09 global food crisis.

development. From 2021, credit support has been extended to vegetable production. Direct payments to farmers for growing cotton on poor quality soils were discontinued in 2019. More funds have been allocated for fixed capital formation supporting farm investments in drip irrigation or farm asset modernization through matching grants. Several support programs became available to *dekhan* farms, which were excluded from any state support in the past. And more funds were dedicated to the provision of public services such as agricultural knowledge and innovations system (AKIS). All these shifts are still relatively small, but they are right steps in the right direction.

Other less visible, yet also transformational changes have occurred in the past few years, accelerating in 2020. The water deficit has not been just recognized, but for the first time the government began extending support to enhance adoption of water-saving technologies in cotton and horticulture production. For this purpose, the national budget provided 120 billion soms in 2019 and 132 billion soms in 2020 to co-finance investments in cotton's water-saving technologies. Another 80 billion soms were provided in 2020 for horticulture's water-saving technologies along with the legal requirements for all intensive orchards to include drip irrigation and other water-saving technologies as a part of an investment package. A draft of the livestock subsector strategy was prepared in 2020; it would provide a strategic framework for more resilient, inclusive, and sustainable development of this subsector, important for advancing the country's diversification and food security agenda. Inclusion of small farms and women, largely ignored in the past, has become a policy issue and priority, with *dehkan* farms and women entrepreneurs getting more access to affordable credit and public services. Recent years have seen more efforts to integrate small farms into horticulture and livestock value chains through public programs supported by donors (EU, IFAD, and World Bank). And, farmland tenure security got a boost from legalization of land sublease to *dekhan* farms to produce secondary crops and the draft law on *dekhan* farms with the provision for allowing them to receive additional leased land, which is currently prohibited. All these changes and actions provide a strong foundation for further agricultural reforms with transformative impacts.

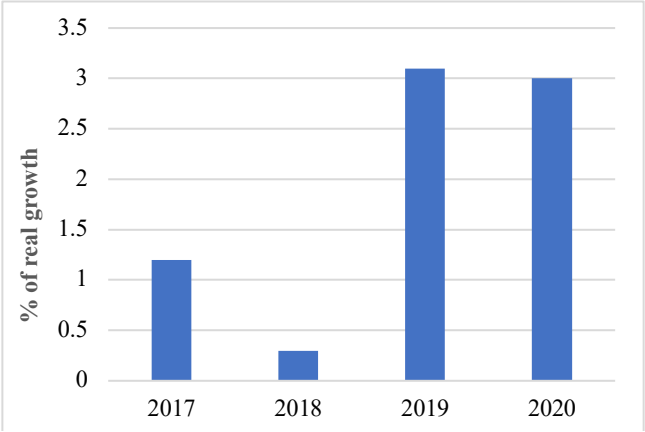
B. Initial Impacts of the Agricultural Reforms

Since 2017, a steady reform program has helped trigger a recovery in agricultural growth. After years of stagnation, and reflecting the strong supply response to reforms, the sector grew by 3.1 percent in 2019 (Figure S2-1) despite a reduction in the total sown area by 2.2 percent. In 2020, despite the COVID-19 pandemic, agriculture was the main driver of growth, increasing by 3 percent vis-à-vis 1.6 percent real GDP growth.

Horticulture exports have been the driver of this turnaround. Exports almost doubled in less than three years, from $570 million in 2017 to $1.2 billion in 2019. In 2020, the horticulture exports were hit by the COVID-19-induced restrictions and the lower purchasing power of consumers in Kazakhstan and Russia, traditional export destinations. Exports, thus, declined by 12 percent in 2020 compared with 2019. At the same time, the number of importers has expanded rapidly, with Uzbekistan's horticulture exporters entering new markets in Austria, Azerbaijan, India, Japan, Malaysia, South Korea, Turkey, Turkmenistan, Ukraine, and the United Kingdom. Many horticulture processors and exporters received Global GAP or HACCAP certification to be able to meet the requirements of these new markets.

Area under permanent crops such as fruit orchards has increased, using land freed from cotton growing. In 2016, fruits were grown on 280,000 ha. In 2019, the fruit growing area increased to 324,000 ha. In addition, traditional orchards with low productivity are being gradually replaced by intensive orchards with much higher productivity.

Figure S2-1. Agricultural growth in Uzbekistan, 2017–20



Source: State Statistics Committee of Uzbekistan.

Cotton and wheat producers benefited from higher farmgate prices, increasing their incomes. Since 2017, cotton prices grew as part of the reform price adjustment (Table S2-1). In 2020, the state farmgate price was replaced by the market-based price formation, supported by minimum prices that set the floor to protect farmers. Wheat prices also grew, almost threefold in nominal terms between 2016 and 2020. The cotton price increase during this period was fourfold. Farm income was partially reduced by the growing input prices, but net effect for most farmers was positive and significant.

Table S2-1. Farmgate prices of cotton and wheat under state order system, 2016–20

	2016	2017	2018	2019	2020
Average farmgate price for raw cotton, ’000 soms/ton	1,218	1,880	3,250	4,300	4,550
Average farmgate price for wheat, ’000 soms/ton	504	550	750	1,450	1,550

Source: World Bank staff estimates based on data from the Ministry of Finance of Uzbekistan.
Note: In 2020, the price for cotton is the market-based minimum farmgate price.

Employment has remained stable at 27 percent of the total labor force. In 2019, the sector employed 3.6 million people. Agricultural diversification helped many workers benefit from the shift in cropland from production of low-value cotton to production of high-value (and more labor intensive) horticulture products, offering wage workers and farmers better earning opportunities. Horticulture value chain investments since 2017 have helped create productive and inclusive jobs in greenhouses, intensive orchards, storage, processing, and packaging facilities. More diverse agricultural production supported the food processing industry, where employment increased from 86,000 in 2016 to 107,000 in 2019 (27 percent increase). In the textile and garment industry, employment grew from 128,000 in 2016 to 202,000 in 2019 (59 percent increase).[13] Average wages and productivity in food processing and garment industries are higher than that in primary agriculture, so job creation there as a result of agricultural diversification is a sign of successful structural transformation.

The quality of the cotton sector’s employment has. Uzbekistan was known globally as a country that used forced labor in cotton production, which resulted in Uzbek cotton’s boycott by global garment retailers. This image has changed significantly since the start of the reforms. The share of

[13] Uzbekistan Agri-Food Job Diagnostic (2020), World Bank.

forced labor in cotton production dropped from 14 percent in 2015 to 6 percent in 2019,[14] a result of the government reforms and the higher productivity of cotton pickers triggered by rising wages.[15] The abolishment of the state order system in 2020 led to further reduction in the use of forced labor to 4 percent in 2020.[16] For the first time in Uzbekistan's history, some provinces and districts used little or no forced labor at all. A systematic use of forced labor in Uzbekistan has come to an end, but the remaining "small islands of forced labor" still must be eradicated.

C. International Experience

Uzbekistan is taking its own road in the reform process, having had an opportunity to observe and learn from the rest of the world. Relevant for the country is the experience of transition countries during the 1990s and the experience from reforms in East Asia, notably China and Vietnam. China started reforms in agriculture in 1980s, followed by Vietnam with its Doi Moi economic reforms launched in 1986. While the reforms in Russia and Ukraine led to the collapse of agricultural GDP and its recovery to post-independence levels only in the early 2010s, agriculture kept growing in China and Vietnam without interruption during the reforms (Figure S2-2). Even recently, their agriculture continued to grow faster than in Russia and Ukraine.[17]

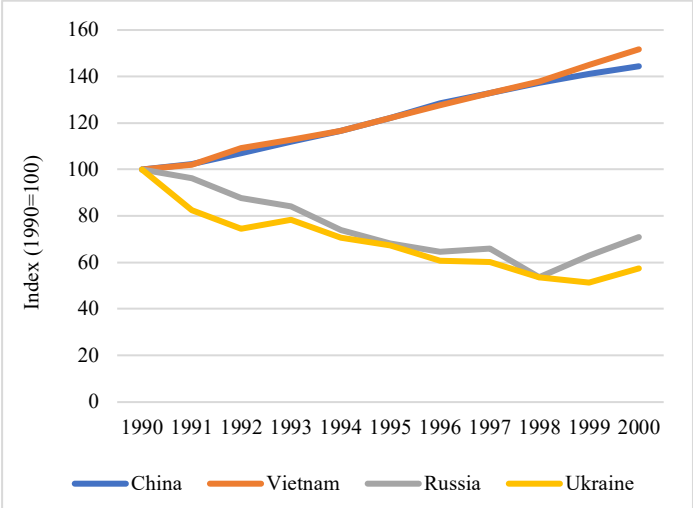
Agricultural GDP in the post-Soviet countries was falling until 1998, bottoming at 50 percent of the 1990 agricultural GDP. These countries abolished the old institutions and arrangements without creating new ones or at least without making transitory arrangements to moderate adjustment costs. They overlooked the complexity of interlinkages between various elements of their state production system, and between the reforms of the real economy, the banking sector, and SOEs, the same challenges that exist in Uzbekistan today. In China and Vietnam, on the other hand, agricultural GDP in 2000 was 50 percent above the 1990 level. These countries conducted reforms sequentially, addressing problems in turn and experimenting with pilots before introducing country-wide changes. Agriculture grew annually by an average of 4 percent between 1990 and 2000. The authorities were actively involved in working with smallholder farmers and recently with agribusinesses, adjusting public policies and investment along with administrative procedures to react to the evolving needs of the agri-food sector and consumers.

What have been the key features of the overall economic and agricultural reforms in China and Vietnam? Let's start from a strategic approach to overall reforms before diving into agriculture-specific ones. In some ways, China and Vietnam followed many of the prescriptions mainstream economists recommended. The countries opened up for trade and foreign investment, gradually liberalized prices, diversified ownership, strengthened property rights, and kept inflation under control. Continued macroeconomic stability allowed high savings to be turned into high investments and rapid urbanization, which in turn triggered rapid structural change and productivity growth. But China and Vietnam used their unique ways of implementing reforms.

[14] *Third-Party Monitoring Report* (2020), International Labour Organization.
[15] Average wage of the cotton pickers doubled, from 450–700 soms/kg of cotton, in 2017 to 1,000–1,200 soms/kg in 2020.
[16] *Third-Party Monitoring Report* (2021), International Labour Organization.
[17] During 2010–19, the average annual growth in agricultural GDP in Russia and Ukraine was 2.7 percent. In China and Vietnam, it was 3.2 percent.

Their gradual, experimental way to reform their economic system, especially in the early days, sharply contrasted with the reforms in Eastern Europe and the former Soviet Union. Two areas are important to highlight in this respect.[18]

Figure S2-2. Changes of agricultural value added in selected countries, 1990-2000



Source: World Development Indicators.

First, gradualism and sequential reforms. Reforms in China and Vietnam developed gradually, starting in the rural areas with the household responsibility system and township and village enterprises, and some initial steps to open up the economy to foreign trade and investment, which only started to play a significant role about 10 years after the start of reforms. When the overall broader reform strategies emerged, they were also implemented gradually and experimentally rather than comprehensively. Pilots were set up, rigorously assessed, and rolled out nationally only if they had proved successful. There were several reasons for this gradual approach to reforms: (1) gradualism was a means to circumvent political resistance against reforms, and administrative procedures for new implementation arrangements could be tested; (2) gradual, experimental reform was a pragmatic approach in the heavily distorted environment of socialist economies, in which "first best" solutions were unlikely to apply; and (3) experimental reform may have suited the East Asian culture well as a means to avoid loss of face: if an experiment did not work, it could be abandoned as an experiment rather than considered a policy failure. And gradual strategy reinforced the credibility of reforms over time: by taking one step at a time, and starting with those most likely to deliver results, the governments built up their reputation for delivering on reform.

Second, decentralization and incentives. Decentralization of local government became a powerful tool for progress within the confines of central political guidance. The provinces and local governments received increasing authority over investment approvals, fiscal resources, and policies. Provinces, municipalities, and even counties were allowed, even encouraged, to experiment with reforms in specific areas, and successful experiments then became official policy and were quickly adopted throughout China and Vietnam. In a way, by decentralizing, these countries turned into a laboratory for reforms.

In the area of agricultural reforms, more narrowly, the following points are worth noting:[19]

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[18] See Hofman, B. 2018. "Reflections on Forty Years of China's Reforms." Speech at the Fundan University's Fanhai School of International Finance. Washington, DC: World Bank; and World Bank Group. 2016. *Sustaining Success: Priorities for Inclusive and Sustainable Growth*. Systematic Country Diagnostic of Vietnam. Washington, DC: World Bank Group.

[19] World Bank Group. 2016. *Transforming Vietnamese Agriculture: Gaining More from Less.* Vietnam Development

Removal of agricultural distortions. In China, in the early 1990s, farm prices of many products were well-below the world market level, similar to what was recently the case in Uzbekistan. However, during 1995–97, the taxation of agricultural prices was removed, and by 2015–17, China moved to supporting agriculture in a big way through high farmgate prices (achieved through import tariffs and quotas) and agricultural public expenditures (Figure S2-3). The authorities understood that sustaining a significant increase in agricultural productivity is impossible without incentives and support for farmers, at least through fair farm output prices, which have been on the long-term decline globally anyway. The move from taxation to support of agriculture has been similar in Vietnam, with the exception that Vietnam did not provide direct subsidies to farmers, as China did, focusing instead on support to farmers through general support programs.

Public investments in core agricultural programs. Both countries have invested substantially in core agricultural programs (see Figure S2-4 for China), including in rural infrastructure (especially irrigation and drainage). In China (Vietnam), the annual budget for development and maintenance of rural infrastructure increased from $1.3 billion ($190 million) in 1995–97 to $10.2 billion ($475 million) in 2015–17. They also made significant investments in agricultural knowledge and innovations, which are critical to raise agricultural productivity. China increased these investments from 0.3 percent of agricultural GDP in 1996 to 0.5 percent in 2017. In Vietnam, this figure was 0.3 percent in 2017. For comparison, Uzbekistan's public investments in agricultural research and extension services in 2019 were a meagre 0.04 percent of agricultural GDP.

Figure S2-3. Evolution of agricultural support in China, 1995–2017

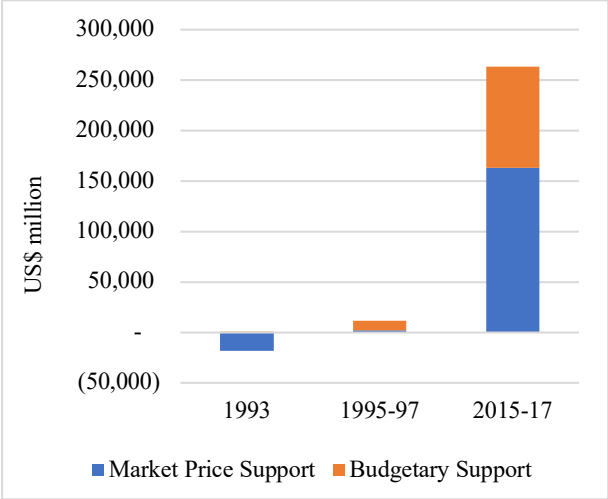
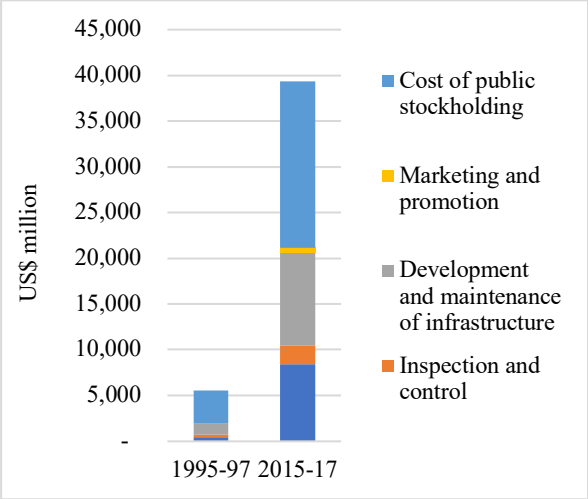


Figure S2-4. Evolution of general support programs in China, 1995–2017



Source: Organization for Economic Co-operation and Development (OECD).

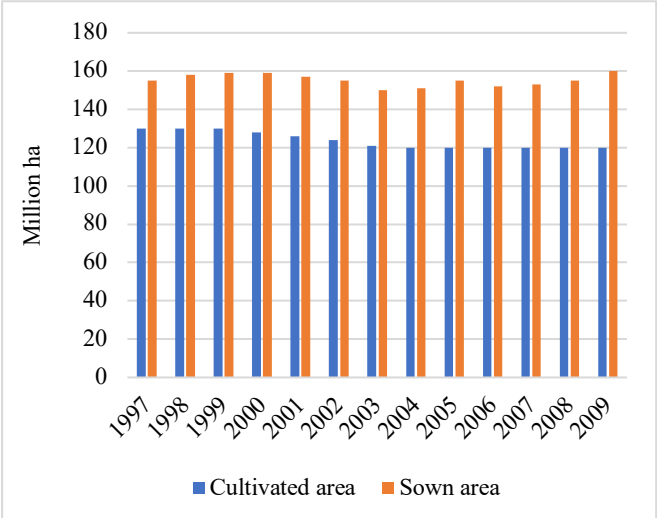
In both countries, farmland is a very limited asset (similar to Uzbekistan) and it is getting smaller over time due to the increased demand for land from cities and nonfarm industries. That is why multiple cropping, that is, getting several crops within a year, helped in keeping sown areas stable even when the cultivated area was declining (see Figure S2-5 for China). Agricultural

Report. Washington, DC: World Bank Group; Eliste, P. 2021. "Chinese Food Systems: Outlook and Opportunities." Presentation, Washington, DC: World Bank; Christiaensen, L. 2012. *The Role of Agriculture in a Modernizing Society: Food, Farms and Fields in China* 203. Washington, DC: World Bank; and OECD reports on Agricultural Farm Support.

research and extension were developed in close collaboration with donors and the international research community. In recent years, the focus of agricultural public programs has shifted to promoting climate-smart agriculture and greening of farming practices, especially to reduce the use of inputs, which were overused in these countries in the past.[20] In addition to having the higher budget funds, the strength in delivery of agricultural extension services in both China and Vietnam has been a result of their close links to research, the strong vertical chain of command from central to local governments with a clear division of roles and responsibilities. Yet, an excessive focus on increasing the use of inputs to increase yields has generated significant environment and human health costs, including the refusal of consumers to buy local "polluted" food, which now needs to change its reputation from "dirty" to "clean." This mistake should be noted by Uzbekistan.

Inclusion of small farmers in agri-food value chains. More recently, both countries have begun to proactively support integration of smallholders into agri-food value chains. Chinese and Vietnamese agriculture is dominated by very small farms, averaging less than 1 hectare. Self-organization and vertical coordination of these small farms have not been occurring automatically, thus reducing the benefits of agricultural diversification and generation of higher value addition pursued by the authorities. Small farms in these countries have performed well in increasing production and enabling the export of bulk undifferentiated commodities, but they have failed in a new environment induced by urbanization and more affluent consumers, where effectively competing depends on the ability of farms and firms to deliver food and other products with reliability and with assurances relating to quality, safety, and sustainability.

Figure S2-5. Cultivated and sown areas in China, 1997–2009



Source: China Statistical Yearbook 2010.

In Vietnam, for example, the agri-food export increased from $17 billion in 2010 to $42 billion in 2019, but more than 80 percent of agri-food exports remain bulk agricultural commodities. Recognizing the need to correct market failures that precluded effective participation of smallholders in modern value chains, both China and Vietnam have been proactively helping farmers achieve economies of scale and reduce transaction costs through land consolidation, supporting horizontal (farm cooperatives) and vertical (productive partnerships, clusters) coordination through matching grants for investment and capacity building and targeted/conditional credit lines, and strengthening public and private sector capacity to ensure safe food demanded by domestic and foreign consumers. The long-term commitment and the use of various support instruments in an integrated manner to achieve results

[20] The consequences of over-intensive use input and natural resource use—both for the environment and for farmer profitability—are increasingly coming into view. Some environmental problems are now adversely impacting both productivity and the international position of exportable commodities.

have borne fruit even in most traditional subsectors, such as rice production. Vietnam is the third largest exporter of rice, but traditionally it produced and exported ordinary rice, with various broken degrees, which fetched $350–450/ton on world markets.[21] The export of more valuable glutinous and jasmine rice, which fetch much higher prices, was small, at 17 percent of total rice export in 2013 (Table S2-2). In 2020, however, after implementing the programs for linking paddy rice farmers with rice mills over many years, the share of glutinous and jasmine rice in total rice export grew to 60 percent.

Table S2-2. Vietnam rice export by grade, '000 tons, 2013–20

	5%	10%	15%	25%	100%	Glutinous	Jasmine	Unknown	Total
April 2013	279.0	8.9	121.8	69.4	64.0	39.5	73.2	17.9	673.7
Nov. 2020	88.2	0.5	18.0	4.8	0.5	97.0	105.9	24.7	339.1

Source: USDA estimates.

Strengthening land tenure security. The farmland use approach in China and Vietnam is the same as in Uzbekistan—farmers are land users of the state-owned land. Both countries also have a crop placement system for rice growing (and wheat growing in China), similar to Uzbekistan's crop placement system for growing cotton and wheat. China and Vietnam also proactively coordinate farm production decisions due to their dependence on irrigation: water is delivered to irrigation blocks, each of a hundred hectares, with many plots of smallholder farmers. The main differences with Uzbekistan are related to: (1) the strong security of land user rights; and (2) the role of market forces to allocate land to more efficient users through land rental. Land users have long-term leases, for 50 years in Vietnam, for example, and the state order system with production targets was abolished in both countries in the early years of reforms. Farmers cannot be evicted from their land because they do not meet production targets or fail to reach a certain crop yield. Rice- and wheat-producing farmers in China instead receive subsidies to keep producing these crops, that is, compensation from the state to produce less profitable crops. Farmers can lose their land only if they pollute or misuse land according to the law—a short list of clearly defined criteria. Land rental, especially advancing in China, helps with land consolidation and moving land to more efficient users. The trend in China's land rental, from 3 percent of agricultural land in 1996 to 24 percent in 2013, continues going up, although both countries remain below the averages for the developed countries: 30 percent in Japan, 45 percent in South Korea, and above 60 percent in Germany and France.

The experience of China and Vietnam, along with the experience of the post-Soviet transition economies, provides important lessons for Uzbekistan. The country seems to have already been using them, for example, by implementing reforms gradually and by picking "easy wins" first before moving to more difficult reforms. Uzbekistan's Agricultural Strategy underpins this focus shift and creates a strong foundation for continued reforms, emphasizing the next generation reforms ("what"), similar to those outlined above. There is a growing consensus among Uzbek agricultural policymakers on those priority areas that: (1) more and better public investments are needed for agriculture to deliver on inclusive and resilient growth; (2) markets and competition are critical to build a strong agri-food sector; and (3) smallholders, especially women, require

[21] According to the FAO, Vietnam's jasmine rice cost $486/ton in 2020, while the export price of better quality Thai jasmine rice averaged $1,062/ton. The average export price of Vietnamese glutinous rice in 2020 was $574/ton.

tailored public support to benefit from new economic opportunities being created by economic liberalization and reforms.

There are several important implications from the global experience for Uzbekistan's "how to" decisions. The first is *empowering farmers*. Increasing farm incomes and farm wellbeing should be the key priority of agricultural development and food security policies. If farmers do not receive remunerative market prices for their outputs and they do not have freedom of production and marketing choices (or they are not compensated from the budget for not having that freedom), they will not realize their potential. Uzbekistan must complete the agricultural price liberalization (for wheat); induce competition in the cotton market to let supply and demand factors determine its price, not the state; and refrain from reintroducing farmgate price controls. The second is *strengthening land tenure security*. Land user rights must be vigorously protected, with farmers facing a risk of losing these rights only in a few, clearly defined instances, such as environmental damage/pollution or bankruptcy. The third is committing to *long-term investment in public agricultural programs and improved implementation capacity*. Small-scale agriculture requires many more public programs than large-scale farms, and these programs need to be well executed to achieve results. Capacity and organization of public staff to deliver these programs should be instantly improved through training and administrative adjustments. The fourth is having *a long-term view of public investments*.

Getting a nationwide result on the ground on generation and adoption of modern farming technologies or improved sanitary and phytosanitary measures requires time. This is especially true in the context of the currently limited public sector capacity in Uzbekistan due to the past underinvestment in agricultural research and extension and the legacy of limited reforms in the past. In turn, it requires a long-term commitment from the government to patiently finance such measures. The fifth is *taking leadership and ownership by the MoA and other* government *institutions to implement donor projects*. The donor-financed projects account for most capital investments and credit lines outside of cotton and wheat subsectors. Yet, the donor projects, even the recipient-executed ones, are not yet fully "owned" by the MoA's departments and other government agencies responsible for project implementation; these projects are implemented by outsourced consultants. The situation is even worse with donor-executed projects, which are largely off the MoA's radar. While consultants/experts are very much needed to help implement the projects, technical staff of the MoA and other government agencies should be closely involved in supporting and shaping implementation of the donor projects and responsible for the projects' outcomes. And the sixth is *thinking green and climate-smart now*. The experience of East Asia shows that a strategy of "harming now and cleaning later" is expensive and damaging to the reputation and competitiveness of the agri-food sector. Supporting climate-smart and green farming should become Uzbekistan's priority today to avoid costly cleaning activities tomorrow.

D. THE PATH FORWARD

While economic transformation is underway—including a shift of the economy from lower value-added (cotton and wheat) to higher value-added (horticulture and livestock) agriculture and the pace of reforms is rapid, fundamental reforms and institution-building are still needed. Elevating sustainability to the top of the transition agenda is needed; this will not

only help accelerate the shift toward a more competitive, resilient, and inclusive economy, but can also help Uzbekistan build back faster and better from the COVID-19 crisis.

Significant market and institutional constraints still need to be addressed to increase resource efficiency and climate resilience in agriculture. A list of the remaining reforms is still long, due to inaction in the past, while some reforms initiated during 2017–20 still need to be effectively implemented to deliver results and avoid policy reversals. The key agricultural reforms for 2021–25 should include the following measures:

Effectively implementing and completing removal of state control over the cotton and wheat subsectors. The March 2020 Presidential Resolutions to dismantle the state procurement quota system in the cotton and wheat subsectors have set a good foundation for triggering transformative changes in Uzbek agriculture, such as achieving more market-based and sustainable cotton and wheat production, increasing farm incomes, and ending forced labor's use in cotton harvesting. Implementing these reforms effectively is critical for achieving the desired outcomes. The assessment of the cotton sector reform implementation in 2020 found that while cotton production became more market-based as a result of the reform, the way in which cotton production contracts between farmers and owners of cotton-textile clusters were prepared and monitored was not much different from the previous practice of the state production contracts.[22] A redesign of the commercial contracting process is urgently needed. Efficient raw cotton pricing was hampered by the lack of a competitive fiber market, a result of the current organization of cotton-textile clusters, and political considerations in setting minimum farmgate prices were amplified by the COVID-19 pandemic.

Ensuring that cotton-textile clusters meet their investment commitments and help farmers increase their incomes through capacity building and on-farm investments, fully eradicating forced labor, and consequently removing the boycott of Uzbek cotton by global retailers are other remaining outcomes that need to be achieved. Achieving them may require further reforms, for example, of the current cluster model. If the model does not deliver results on incentivizing farmers, fully eliminating the use of forced labor, and reducing fiscal pressure, the existing cluster arrangements should be adjusted. One option is to make farmers decide whether to join a cluster or produce cotton independently, selling it to any buyer. As long as the government continues the provision of agricultural (advance) financing to cotton and wheat farmers or replaces it with other incentives, their production will sustain with or without clusters. Competition would allow a market-based formation of cotton prices and help induce more responsible behavior in the organizers of cotton-textile clusters, incentivizing them to "fight" for farmers through best services and cotton-buying offers. These market-driving forces need to be better used in Uzbekistan.

In addition, the state order system for wheat will be abolished sooner or later. Monitoring the implementation of the announced changes, including the operation and management of public grain stocks, along with specific actions to mitigate wheat price spikes,[23] and the enhancement of spatial wheat market efficiency,[24] are important tasks for successful reform implementation.

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[22] *An Assessment of Uzbekistan's Implementation of the Cotton Sector Reforms in 2020* (2020), World Bank Group.

[23] *Public Grain Stocks in Uzbekistan.* (2020), World Bank Group.

[24] *Study of Wheat and Flour Market Integration in Uzbekistan* (2020), World Bank.

Transiting to a sustainable livestock development. The development of a livestock subsector, which is critical to diversification and food security in Uzbekistan, needs to move to a much more sustainable path. The past growth in livestock production was largely achieved by increasing the number, not the productivity, of livestock. Meat and milk prices kept rising, along with meat imports', which indicates the growing deficit of livestock products. In Uzbekistan, meat is a core part of the traditional diet and cropland is limited; consequently, only 10 percent of the land is used for fodder production, and meeting the deficit in livestock products and reducing their prices by continuing to increase livestock numbers is unsustainable. Pressures on pastures and land resources from overpopulated, unproductive livestock is immense, making the livestock sector the largest greenhouse gas emitter in agriculture even though the sector is failing to meet the rising demand for meat and milk. The Strategy for Livestock Development, currently under finalization, could create a foundation for more integrated and sustainable livestock sector development; concrete actions will determine its implementation success. Critical actions for the government in this area include: (1) increasing the fodder base as a share of total cropland, which implies less land will be available for cotton or wheat production; (2) refraining from output subsidies and instead financing public programs such as animal nutrition, health, and breeding to sustainably increase livestock productivity while incentivizing farmers to keep fewer more productive livestock heads; (3) paying high attention to animal health services to reduce the risks of investing in livestock, including through regional cooperation and the One Health approach to zoonotic diseases; and (4) tailoring public provision of animal husbandry services to the needs of smallholders, who own the largest number of livestock heads, while proactively integrating them into modern livestock value chains.

Increasing the efficiency of farmland use. The crop placement system practiced in Uzbekistan prevents an effective use of farmland. The government makes decisions on where to grow what. At the central level, the decision is limited to cotton and wheat growing areas. Yet at the regional levels, land placement for other crops is also common, largely enforced by the delivery of irrigation water. Cotton growing areas have been reduced since 2017, but the competing demands for farmland make the current administrative system for land allocation unsuitable for the needs of modern Uzbek agriculture. Horticulture needs more land, and livestock needs it even more, as discussed above. Food security depends on wheat prices, so reduction in wheat growing areas is to be avoided. The growth of cotton yield is slow, thus further reduction (if any) in cotton-growing areas should be gradual.

How to manage these competing demands when all subsectors need more land, not less? Decisions on crop allocation need to be delegated to farmers, who make production decisions based on their skills and knowledge, access to input and output markets, and relative prices. Some kind of crop placement system is still logical to maintain for perennial crops and where the delivery of water for irrigation requires coordination of crop choices—but in most cases, it should be phased out, as stated in the Agricultural Strategy.

Efficiency of farmland use can also be increased through improved land tenure security. Key reforms required in this regard are: (1) establishing transparent and just mechanisms for the cancellation of farmland user rights based on a limited set of objective criteria (for example, hazardous waste or land abandonment, disregard for environmental protection and pollution), but not on crop yield commitments, soil fertility, maintenance, etc.; (2) expanding auctions for farmland rights supported by the strengthened land cadaster infrastructure and management

capacity; and (3) introducing subleasing/renting farmland and ensuring that *dehkan* farms can increase their holding by leasing farmland (currently prohibited).

Improving access to affordable agricultural finance. At present, most farmers and agribusiness lack the collateral required to access traditional credit, while the banks provide very little agricultural credit. Production of cotton and wheat continues to be financed by the state through advance loans from the MoF's State Fund for Agricultural Support. The recently launched privatization of the financial sector would provide the agri-food sector with private capital flows and facilitate new financial product development and adoption of new technologies. What is additionally required to improve access to affordable financing is the establishment and implementation of nontraditional instruments such as leasing, partial credit guarantees, agricultural crop receipts, and warehouse receipts to increase collateral options suitable for farmers. Furthermore, public programs could provide more targeted credit support to currently underserved vulnerable groups (small farms, women, youths). Using conditional credit lines coupled with matching grants and capacity building could help address some of the market failures that lead to limited access to financing for these groups.

Strengthening delivery of public agricultural services. As market distortions in the agricultural sector diminish, the key challenge to supporting the sector's growth, transition, and inclusion comes from the quality and effectiveness of public agricultural programs. These include education, research, and advisory/extension programs (for example, AKIS), farmland soil and water testing for precision agriculture, animal breeding, livestock registration and traceability, sanitary and phytosanitary measures, food safety, support to farm cooperation (horizontal coordination) and productive partnerships (vertical coordination), market information systems, agrologistics, and other programs included in the Agricultural Strategy. Digitalization of these agricultural programs provides multiple opportunities to move forward faster and more effectively. Most of the programs were chronically underfinanced or neglected in the past, but with the adoption of the Agricultural Strategy in 2019, a consensus on "what" needs to be financed was largely reached, and a large amount of funds has been already secured (that is, the World Bank's Agriculture Modernization Project and the EU's Agricultural Budget Support). The main challenges going forward will be "how to" do it, including a sequence of activities, their horizontal and vertical coordination among the government institutions at central and local levels, and the practical application of the relevant international experience to the context of Uzbekistan, including on promoting climate-smart adaptation and mitigation efforts of farmers to avoid the costly mistakes of negligence of the impact of climate change on agriculture made in other countries. Most programs will require public investments over several years to show results, so the long-term commitment of the government to finance the agricultural programs will be critical, especially given the significant past underinvestment and the resulting weak capacity of the staff of the MoA and other public institutions, which now needs to be strengthened.

Promoting more efficient water use and a more sustainable irrigation. Agriculture in Uzbekistan is almost entirely dependent on irrigation. And Uzbekistan is among the most water-stressed countries in ECA—it has relatively low levels of water availability per capita and high-water resource dependency. Moreover, climate change is expected to severely aggravate the country's water stress. Despite this, Uzbekistan is one of the least efficient users of water in the world, with pricing that fails to reflect scarcity and use, and an irrigation system caught in a vicious cycle of inadequate operation and maintenance, low cost recovery, and low agricultural productivity.

About 1.3 percent of GDP is spent on irrigation and drainage, a significant amount.[25] While the government has undertaken reforms, including increasing water prices and a Presidential Decree requiring cost recovery, tariffs remain far below cost-recovery levels. Undertaking further reforms to exercise and impose a cost-recovery water tariff will be critical to: (1) establish a price signal to promote more efficient resource use; (2) enable irrigation water management institutions and water utilities to finance maintenance and investment; and, as a result, (3) put the system in a position to attract private investment. However, further tariff increases can only be realistically implemented along with improvements to service coverage and quality. This will require institutional reforms and capacity building to strengthen the autonomy, incentives, and accountability of service providers. Opportunities exist to attract private investment in the water sector, but will also depend on further reforms, including separating the operational and regulatory functions in the sector. In the short to medium term, the government needs to support investment in the sector to renew and expand the existing outdated infrastructure.

[25] Uzbekistan Agriculture Public Expenditure Review (2019). World Bank.

Chapter 6. State-Owned Banks and the Financial Sector

Uzbekistan has embarked on vital reforms of its banking sector, the dominant part of its financial system. International experience indicates that Uzbekistan needs to continue strengthening its institutions to help mitigate the systemic vulnerabilities generated by the rapid deepening of credit markets since economic liberalization started several years ago. Weak corporate governance, lingering directed lending, and capacity gaps faced by the banking supervisor are the key areas for reforms. As reforms advance, the banking sector can soon become an important driver of private sector investment, productivity, and inclusive growth. Without these reforms, the country could see systemic risk accumulation reaching the point when a banking crisis becomes unavoidable.

A. Overview of Uzbekistan's Financial Sector

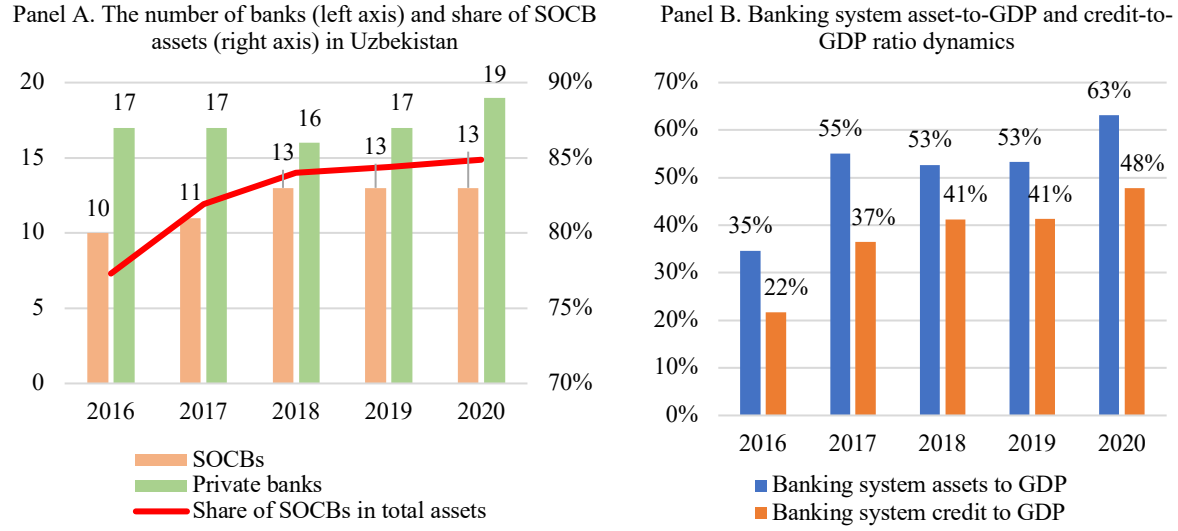
The primarily state-owned banking sector dominates Uzbekistan's financial system. Commercial banks account for more than 95 percent of total financial sector assets. Thirteen state-owned commercial banks (SOCBs), out of a total of 32 commercial banks, hold 85 percent of total sector assets and 88 percent of total credit as of end-2020 (Figure 6.1 Panel A). The three (six) largest SOCBs account for almost 50 (70) percent of total sector assets. The government is the sole or vast majority (over 90 percent) shareholder of these SOCBs via various state agencies and public companies (the Uzbek Fund for Reconstruction and Development, UFRD), the Ministry of Finance (MoF), the State Assets Management Agency (SAMA), other public agencies, and state-owned enterprises). The UFRD is the largest SOCB shareholder because its funds have often been used to replenish SOCBs' equity. However, as of 2020, the formal responsibility to exercise shareholder rights over SOCBs on behalf of the government and all its agencies was transferred to the MoF.

SOCBs had traditionally focused on intermediating funds from the government to provide credit to priority sectors and state-owned enterprises at below-market interest rates. SOCBs funded their lending activities predominantly with long-term funds, whether from the government, the UFRD, and foreign bank credit lines, rather than local deposits. Until recently, almost half of the SOCB loan portfolio comprised loans to budget organizations and state-owned enterprises (SOEs), many of which distort competitive private sector development and are the subject of recent government reform.[1] Preferential lending—about 80 percent of the total loan book in 2018— was provided to priority segments such as low-income housing and to support entrepreneurship, agriculture, and other sectors. Such funding and loan structure suggest that SOCBs largely continue channeling public sector funding to public sector entities and policy loans. As such, SOCBs conduct only a limited assessment of borrowers' repayment capacity when originating preferential loans, mostly checking compliance with program eligibility criteria. This practice reflects the political mandate to grant those loans and the soft budget constraints due to the availability of UFRD funding and equity injections.

[1] See more details in Mariana Lootty and Gaukhar Ospanova, 2021. In July 2020, the government issued a presidential decree setting comprehensive milestones to promote competition in the country. The decree touches on the key constraints affecting the development of competition in Uzbekistan including significant and distortive state aid and the significant presence of SOEs in competitive markets and lack of playing field.

Private banks are small and have mainly served the private sector, mostly on commercial terms. The 19 private banks in operation (two of which were licensed in 2020 and one in 2019) are very small, with an average equity of $48 million.[2] The median size of private banks in terms of assets is $110 million, compared with $1,520 million for the median of the SOCBs. Their small size prevent the private banks from realizing economies of scale comparable to the SOCBs and reaching an efficient scale of operation, as evidenced by the significantly higher ratio of operational costs to assets reported by private banks (5 percent) compared with SOCBs (3 percent). The loan portfolio of private banks amounts to less than 60 percent of their total assets, on average, while liquid assets and interbank exposures amount to about 30 percent. Unlike SOCBs, private banks fund their operations mostly through retail deposits that account for more than 60 percent of their liabilities. The remaining funding is from foreign banks and international development financial institutions (about 15 percent) and SOE and government deposits (about 9 percent).

Figure 6.1: SOCBs have traditionally dominated Uzbekistan's banking sector



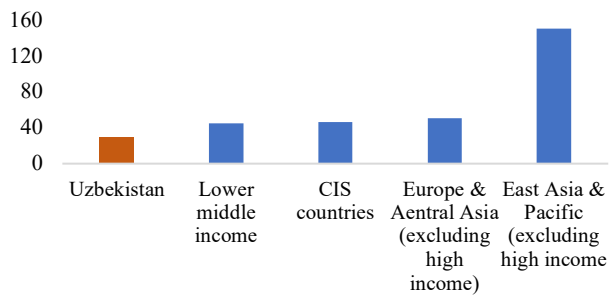
Source: CBU Bulletin.

There are virtually no financial sector alternatives to banks, due to the underdeveloped nonbank financial organizations and capital markets. There are 61 microcredit organizations (MCOs) and 63 pawnshops operating in the market, accounting for just 0.2 percent of banking sector assets. MCOs provide microfinance services (that is, microloan, microcredit, and micro-leasing) and factoring, while pawnshops provide short-term microloans backed by movable collateral (mostly gold). There are more than 100 leasing companies, the leasing portfolio of which accounts for 1.7 percent of banking sector loans. The top five leasing companies have more than 70 percent of the market share. Capital markets are virtually non-existent. The insurance sector is also small and dominated by state-owned financial institutions. From the 28 insurance companies, the three largest state-owned companies alone account for 36 percent of total premiums. Major insurance products include compulsory motor insurance, compulsory employer's liability, contractor's all-risk insurance, property insurance (against pledges and all types of catastrophes), agricultural insurance, and export credit insurance.

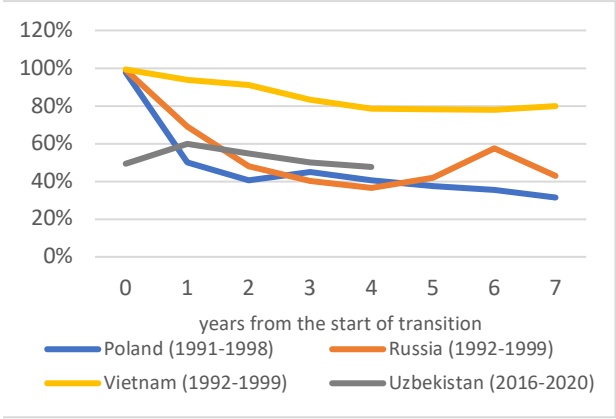
[2] The smallest private banks has equity of only $14 million and the larger ones of $60-130 million.

Figure 6.2: Benchmarking Uzbekistan's financial deepening to peers shows a gap but the country may be growing credits too fast, risking a possible banking crisis

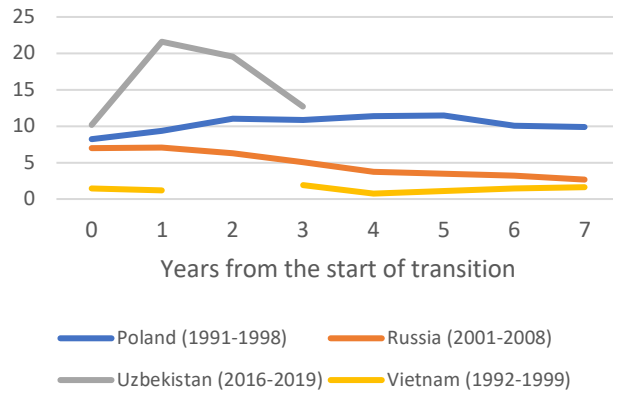
Panel A. Domestic credit to private sector (% of GDP)



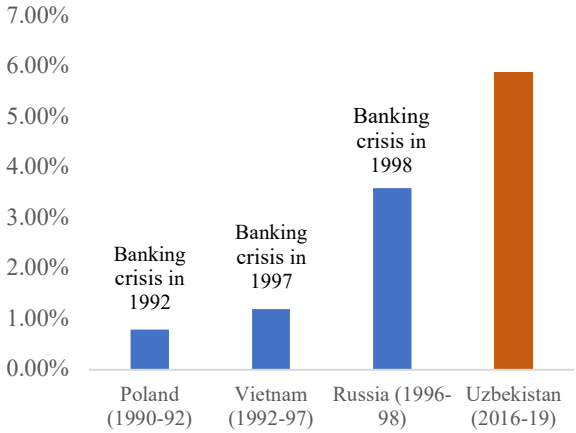
Panel B. Top 3 Bank Asset Concentration (%)



Panel C. Credit to government and SOEs / GDP (%)



Panel D. Average annual growth in domestic credit to private sector relative to GDP growth



Sources: IMF, World Bank (2019); FinStat (2021), Laeven and Valencia (2014).
Note: Credit to GDP in 2019: ECA, EAP, CIS countries, lower middle-income countries, Uzbekistan, in ascending order. Transition year for Russia is also selected based on data availability. In panel B,C data are from the start of transition or earliest available.

Although financial depth lags peers, credit has already expanded too fast, creating risks to financial stability Although the private sector is not yet developed and vibrant, its transactions, investments, and innovations must be adequately financed to boost productivity and equal access to economic opportunities—especially for micro-, small- and medium-sized enterprises (MSMEs). By a broad measure of financial deepening, Uzbekistan is behind the averages for East Asia and the Pacific (EAP) and Europe and Central Asia (ECA) countries, but also the averages for Commonwealth of Independent States (CIS) countries and the lower middle-income countries (MIC) peers (Figure 6.2 Panel A). At the same time, Uzbekistan shows moderate bank concentration and high share of loans to SOEs and the government compared with former transition countries (Figure 6.2 Panel B). The concentration in ownership and control is effectively higher because all large banks are controlled by common government policies. Such concentration weakens competition in financial intermediation because of

excessive market powers that big banks and the government hold. The large share of lending to state enterprises by state banks funded from state (non-market) resources can further impair allocative efficiency of the banking system. Benchmarking the credit growth of Uzbekistan to the historical experience of transition countries shows that Uzbekistan's credit is growing too fast. Fast credit growth is a factor that helps predict future banking crises, including in transition countries. Countries like Poland, Russia, and Vietnam grew their credit much less rapidly than Uzbekistan in the early stages of transition and still experienced banking crises and systemic instability (Figure 6.2 Panel D). Hence, Uzbekistan faces a tough balancing act: to let its financial debt converge to peers while not going too fast to crash.

B. Banking Links to the Real Economy

Because SOCBs have largely operated as public-sector development agencies—serving SOEs and priority sectors—much of the population and private firms lack access to suitable financial services. As in other transition economies, SOCBs mostly acted as channels for the state to implement its credit plan, and grant mainly subsidized lending to specific sectors and SOEs, rather than true banks that allocate resources to the most productive uses based on risk-return market signals. Until very recently, the boards of SOCBs were dominated by senior public officials without the required knowledge and experience in banking as well as the time and operational independence to duly carry out their roles. Consequently, the SOCBs lacked any proper risk management capabilities and relied on frequent capital replenishment by the state when liquidity or capital shortfalls emerged. The banking sector has had little incentives to mobilize households' savings. Broad money accounted only for about a fifth of GDP (well below the two thirds of GDP in countries at similar income levels by end-2018). The history of cash shortages, restrictions on currency conversion, and disruptions in payment systems has eroded the trust of the population in the banking system and reduced demand for deposits.

Access to financing for MSMEs remains a significant challenge in Uzbekistan compared with peer countries. According to the World Bank Enterprise Survey, only about 22 percent of Uzbek firms had access to a loan in 2019 compared with the average of 28 percent for lower middle-income countries and 38 percent for ECA countries.[3] MSMEs also lack access to an appropriate range and quality of financial products. One reason is that credit providers don't employ proper cash-flow analyses, advanced credit risk management methods, and credit scoring systems in their lending decisions. They mostly rely on high collateral requirements and relationship lending.

Restructuring and privatization of SOCBs to change their business models is critical for Uzbekistan's economic transformation. The banking sector reform is essential for achieving three main objectives: (1) to preserve financial stability; (2) to improve financial sector efficiency; and (3) to enhance access to finance for firms and individuals. In the absence of banking sector reform, including of corporate governance and risk management, and business models, the system could experience financial distress, which eventually could compromise economic stability and hamper economy-wide reform efforts. Banks' business models must be transformed to discourage the reliance on public sector funding and its repercussions for efficient credit allocation and urgent deposit mobilization. Privatization and restructuring of state-owned banks (SOBs) will trigger

[3] Account ownership is quite high among MSMEs—about 84 percent compared with 95 percent in ECA countries.

more efficient allocation of resources to productive investments and wind down the practice of distortive directed lending that enables the survival of unviable firms.

Financial sector reform is also essential for supporting social cohesion and shared prosperity by advancing financial inclusion and access to economic opportunities. As the Uzbek economy undergoes sweeping reforms and private sector growth restrictions ease, many firms will seek external financing to scale up and grow. Improving MSME access to finance will help spur dynamism in the economy, innovation, and job creation. Advancing financial inclusion of individuals and MSMEs can help many more seize better development opportunities, boost MSME productivity, and share prosperity much more widely. It can also improve household and MSME resilience to shocks and help empower marginalized groups, such as women, youth, and rural communities.

C. The Global Experience with Banking Reforms

There is no strong rationale for having a large state commercial banking sector. Ownership of multiple commercial banks by the state around the world is rare. The consideration of providing a safe haven against financial instability, helping firms and households weather the impact of economic downturns, the presence of market failures, and the need for performing some developmental functions may provide a rationale for having one or few public banks. However, the benefits of a strong state bank presence should be weighed against the potential for distortionary effects in the long term.[4] These distortionary effects include misallocation of credit, impediments for effective reallocation of labor and physical capital across firms, and ultimately reduced productivity growth in the medium to longer term.

Restructuring and privatizing SOCBs must be matched with institutional strengthening to avoid subsequent costly financial crises. The experience of many countries shows that financial liberalization, when not paired with proper regulation and supervision, has led to banking crises.[5] The probability of banking crises conditional on financial liberalization is higher than the unconditional probability of banking crises. The experience from transition economies highlights the importance of strengthening financial sector institutions for successful economic transitions. For example, Poland, one of the transition leaders in ECA, implemented early on numerous reforms to strengthen the financial sector's institutional capacity—including developing prudential and supervisory regulation, passing a new securities law, and revising national accounting standards—before gradually privatizing the SOCBs (See Spotlight 1). By contrast, Russia pursued privatization while leaving many financial market infrastructure gaps unfilled. Its banking activity surged ahead of the strengthening of regulatory and supervisory capacity and underperformed its peers in subsequent growth.

Institutional capacity needs to be strengthened to ensure sustainable credit growth. Uzbekistan is advancing reforms on its path toward a functioning market system and operating financial sector infrastructure. However, amid the fast credit growth and high share of state-ownership in the banking sector, the institutional capacity must be further strengthened to improve the private sector access to finance while mitigating the risk of a future banking crisis. Therefore,

[4] "Transition Report 2020-21: The State Strikes Back," (2020), EBRD.
[5] Carmen Reinhart and Kenneth Rogoff (2013). "Banking Crises: An Equal Opportunity Menace."

improving the CBU's capacity to carry out its proper "gatekeeper" function, improving its supervisory and resolution frameworks, and reforming the state-owned banks will be key to ensuring that only financially strong and reputable shareholders enter the banking system and to fostering the safety and soundness of the financial system.

In 2019, Uzbekistan made strong progress in implementing structural reforms in the banking sector. In October 2019, the country enacted new laws on the central bank, and on banks and banking that provide a robust legal basis for developing a modern bank regulatory and supervisory framework. In December 2019, large SOE preferential loans funded through UFRD resources were transferred out of the SOCBs' balance sheets back to the UFRD. This reform has much improved the capital positions of SOCBs, decreased exposure to foreign currency risk, and paved the way for further banking sector reforms and eventual privatization of most SOCBs. Further, measures were taken to wind down the practice of preferential lending, with the introduction of interest rate subsidy mechanisms where needed. All directed lending programs have been concentrated in three SOCBs that will remain in the public domain in the foreseeable future.

In 2020, the country adopted the banking sector strategy 2020–25. The strategy's implementation roadmap includes actions to advance SOCBs' privatization and restructuring (most SOCBs are to follow a two-stage privatization with international financial institution, IFI, support), micro- and macroprudential oversight of the financial sector, the development of an ecosystem of nonbank financial providers (via the adoption of a new law on non-bank financial institutions), and the adoption of a comprehensive strategy for financial inclusion.

The ownership function for SOCBs and the oversight of SOCB restructuring and privatization was centralized in the MoF within a dedicated SOCB department. This department's objectives are: (1) minimize the scope for political interference and bring greater professionalism to the state ownership role; (2) promote consistency in applying corporate governance standards and in exercising the state ownership role across SOCBs; (3) achieve greater transparency and accountability in SOCB operations through better performance monitoring; (4) decrease the state share in the banking sector through the privatization of select SOCBs to strategic investors based on transparent and competitive international tenders; and (5) conduct privatization with a systemic approach to competitively serve various parts of the economy while ensuring system diversity for stability purposes. Strengthening the capacity of the MoF SOCB department will be key to the effective implementation and coordination of banking reforms.

Several IFIs have been invited to work with some of the largest SOCBs to help prepare their privatization. The adopted strategy envisions privatization of at least six SOCBs by 2025, including full privatization of three SOCBs to strategic investors. This reform will increase the private banks' share in total banking system assets from 15 percent to 60 percent and their share of deposits in total bank liabilities from 40 percent to 60 percent. The IFIs have either already started working or are in the process of negotiating cooperation with the largest SOCBs to ensure their due transformation and prepare them for subsequent privatization.

The central bank is taking steps toward improving its regulatory and supervisory framework. Following the adoption of the laws on the central bank as well as banks and banking, the CBU has self-assessed its regulatory and supervisory framework against the global standards (the Basel

Core Principles). The comprehensive assessment identified the main weaknesses in the supervisory approach and the regulatory framework. Since mid-2019, the CBU has started addressing key prudential challenges (asset classification, capital), and measures were taken to bring the banks in compliance with the established rules. A draft risk-based supervisory manual has been developed, and gradual transition to risk-based supervision has been piloted with four banks. The system of early supervisory interventions to address problems at banks in a timely manner is under preparation by the CBU. Numerous regulations have been developed in accordance with international standards, including on bank licensing, corporate governance, risk management, a large exposures framework, prudential reporting, and liquidity risk.

In line with experience of former transition economies, financial sector reforms in Uzbekistan have been complemented by reforms to support private sector development. In successful transition economies, policies that promote market-based competition, improve business environment, and attract foreign investments have been adopted alongside banking sector reforms. For example, Poland adopted a series of broad and ambitious reform plans including the codification of a new Act to promote foreign investment and the adoption of a bankruptcy legislation to impose hard budget constraints to SOEs (see Spotlight 1 and Chapter 4). These policies supported the development of a private sector that the reformed and improved banking system can help thrive and become more competitive.

D. The Credit Boom Since the Start of Economic Liberalization

The 2017 economic liberalization triggered a credit boom at rates beyond sustainability. The economic liberalization pushed the banking sector into a rapid credit growth driven by both demand factors (such as increasing retail and private sector demand) and supply factors (larger state funding). After the 110 percent growth in 2017—partly reflecting the 50 percent currency depreciation--credit grew at about 50 percent per annum in nominal terms in 2018 and 2019, slowing down to only 30 percent in 2020 because of the COVID-19 crisis (Figure 6.3 Panel A). Both state and private banks have experienced a credit boom (Figure 6.3 Panel B). Thirteen banks, including three large ones, have doubled and four small- and medium-sized banks tripled their balance sheets over 2018–20. Lending to industrial enterprises and individuals contributed the most to the 79 percent nominal credit growth over 2018-2020 (23 percentage points, pp, and 19 pp, respectively), followed by lending to the agricultural, transport, and communications sectors, each with 12 pp contribution. The credit to private sector in Uzbekistan grew from 12 percent of GDP in 2016 to 30 percent of GDP in 2019, an annual growth of around 6 percentage points. This is more than three times the average annual growth experienced by other transition economies such as Poland, Russia, or Vietnam during the initial years of transition.[6]

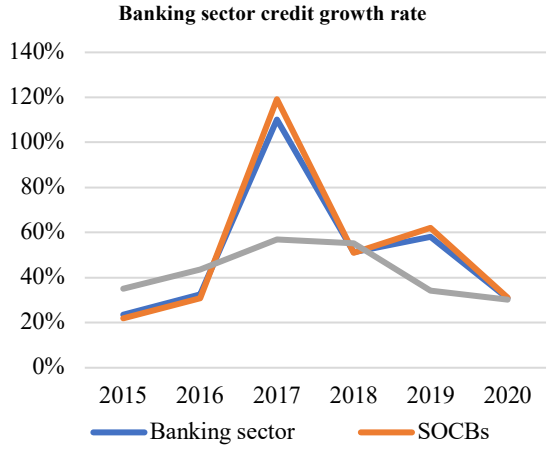
The room for aggressive lending opened further with the "cleanup" of SOCBs' balance sheets from policy lending at the end of 2019. Traditionally, SOCBs have relied on frequent recapitalization by the UFRD when their capital buffers were depleted due to excessive lending. The removal of UFRD-funded SOE loans from the banking sector and the conversion of some UFRD loans to banks into equity at the end of 2019 boosted the capital buffers of SOCBs by about 8 percentage points. Unintentionally, the increased capital buffers supported further aggressive

[6] Credit to private sector (as a share of GDP) barely grew in Poland from 1990 to 1995, grew at a rate of 1.1 percent per annum from 1996 to 2001 in Russia, and grew at a rate of 1.1 percent from 1992 to 1997 in Vietnam.

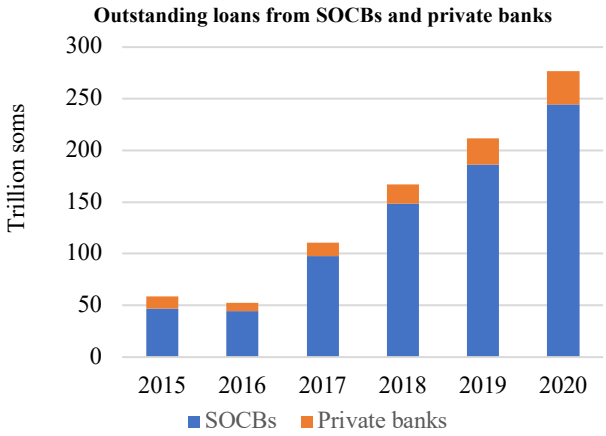
credit growth throughout 2020. Several banks (mostly SOCBs) exhibited excessive growth of their loan portfolios in 2020—at a rate of 50–80 percent.

Figure 6.3: Uzbekistan's banking sector credit growth

Panel A. Bank loans have grown sharply in recent years.



Panel B. Amid fast growth of bank loans, SOCBs have accounted for about 90 percent of bank loans since 2015.



Sources: CBU, World Bank staff calculations.

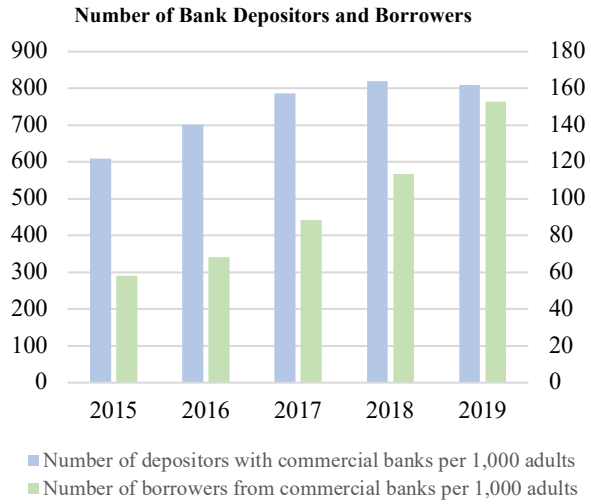
The CBU estimates reveal signs of credit market overheating. The CBU estimates that the credit-to-GDP gap reached 2-5 percentage points over the last several years.[7] When a credit-to-GDP gap exceeds 2 percent, many countries impose a countercyclical (add-on) capital buffer. The broader macroprudential goal is to both contain the excess of aggregate credit growth that builds up systemwide risks and create an additional cushion for banks to be able to absorb much of the losses that can arise because of excessive credit growth. The CBU has also concluded that while credit indebtedness of the population is relatively low, credit growth is not in line with the income growth of the population, reflecting overoptimistic attitudes toward credit.

The strong credit boom, while precarious, helped boost the private sector's access to financial services. While the number of depositors gradually increased from 609 per 1,000 adults to 809 per 1,000 adults by 2019, the number of borrowers from commercial banks almost tripled, from 57 per 1,000 adults in 2015 to 152 per 1,000 adults in 2019 (Figure 6.4 Panel A). The 2019 World Bank Enterprise Survey data indicate that only 5.8 percent of firms see access to finance as a major constraint, well below levels for regional and income peers (17 percent and 26 percent, respectively). However, the survey also shows that only 22 percent of firms have a bank loan or credit line (24 percent in 2013), well below the 28 percent average for lower middle-income countries and 38 percent for ECA. Over the past few years, the share of loans provided to small businesses and sole entrepreneurs has varied around 30–40 percent of total lending, while the share of lending to individuals has been steadily increasing. Despite these positive developments, banks continue providing a limited range of credit products to MSMEs—most of them with high collateral requirements. Mid-sized firms have the greatest unmatched needs for finance and are more likely to be credit-constrained compared with small and large firms (Figure 6.4 Panel B).

[7] Deviation of the credit to GDP ratio from its long-term trend as per the methodology proposed by the Bank of International Settlements. See https://kun.uz/ru/80313994.

Figure 6.4: Access to finance advanced on the back of fast credit growth

Panel A. Access to finance improved in recent years.



Sources: IMF FAS, World Bank Enterprise Survey.

Panel B. MSME access to finance (%)

	UZB	ECA	All Countries
Percent of firms with a checking or savings account	84	95	89
Percent of firms with a bank loan/line of credit	22	37	33
Proportion of loans requiring collateral	96	71	77
Value of collateral needed for a loan (% of the loan amount)	166	175	199
Percent of firms identifying access to finance as a major constraint	6	16	26

Source: World Bank Enterprise Survey, 2019 data.

THE REORIENTATION OF LENDING BY THE SOCBS TO THE PRIVATE SECTOR

The SOCBs have also started their transition from a conduit for on-lending of state funds to SOEs on preferential terms toward financing the private sector enterprises and individuals. The share of loans provided to SOEs and budget organizations has markedly decreased (Figure 6.5 Panel A). Following the transfer of UFRD-funded loans off the SOCBs' balance sheets at the end of 2019, this has resulted in a remarkable decrease in the share of SOE loans in the total stock of SOCB loans (Figure 6.5 Panel B). Loans to SOEs have been replaced with loans to individuals and private companies. However, state-funded and -directed lending to priority sectors (such as *dehkan* farms, low-income housing loans, loans to support entrepreneurship, etc.) remained in place and are not captured in the SOE lending in Figure 6.5.

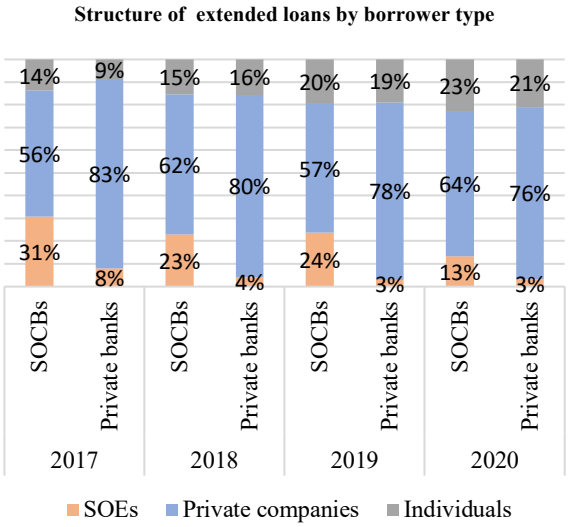
The government began to wind down the preferential lending by SOCBs that, if sustained, could help reduce market distortions. To wind down policy lending by SOCBs, the government restricted all state-directed lending below the central bank's reference rate from January 1, 2020.[8] The measure also envisions full liberalization of interest rates starting January 1, 2021, with the introduction of interest rate subsidy mechanisms where needed. Furthermore, only three SOBs (People's Bank, Mikrokreditbank, and Agrobank) will be able to lend under public credit programs using funding from the state budget and UFRD funding.[9] As a result of these measures and earlier measures, the outstanding preferential loans as a share of total SOCB loans decreased from 77 percent at end-2018 to 50 percent at end-2020 (Figure 6.6 Panel A) and commercial lending increased (Figure 6.6 Panel B). Effective implementation of this policy in the future will help

[8] Presidential Decree #5877, "government loans for mortgage lending and the production of raw cotton and grains temporarily exempted."
[9] According to Presidential Decree #ПП-4498.

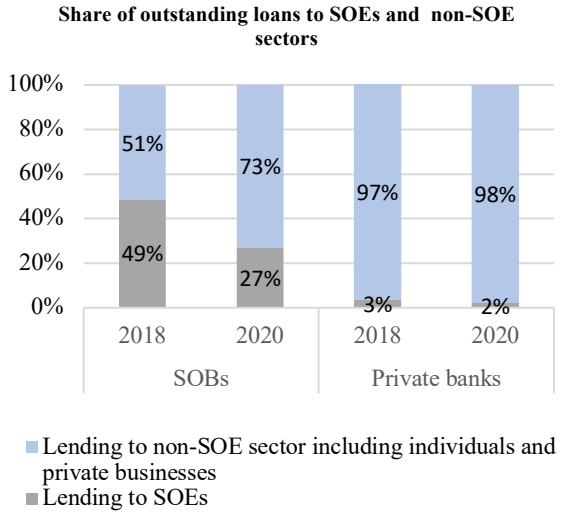
reduce market distortions created by the preferential lending and contribute to improved monetary policy transmission.

Figure 6.5: SOCBs reduced their exposure to SOEs and increasingly lend to the private sector

Panel A: New lending of SOCBs was increasingly directed to private companies and individuals over recent years.



Panel B: Share of loans to SOEs in the total stock of SOCB loans has decreased significantly.



Sources: CBU, World Bank staff calculations.

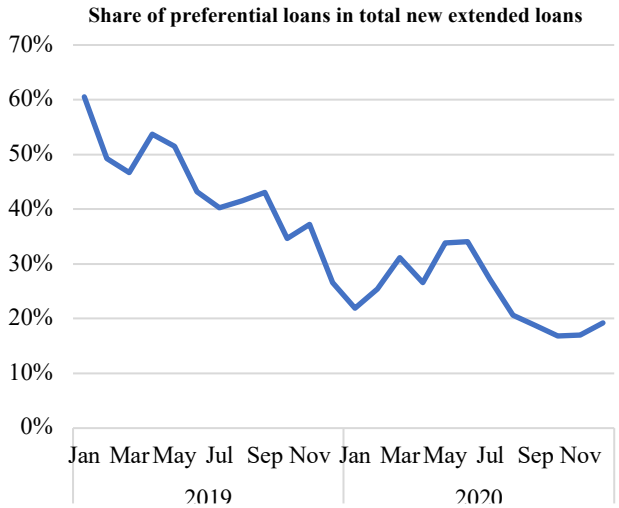
Anecdotal evidence, however, suggests that considerable directed lending by SOCBs to the economy continues, including as part of the COVID-19 crisis response. Several SOCBs (Xalq, Turon, Agro, and Mikokredit) lent aggressively in 2020—showing credit growth of 50–80 percent compared with 25 percent in other banks. Although part of this credit growth happened under state programs funded by the UFRD (in the cases of Xalq, MKK, and Agro), another part was most likely directed by the government. A similar situation may be observed at other SOCBs, albeit to a lesser extent. The fact that the "directed" loans are in most cases provided at "commercial" rates—that is, at or slightly above the CBU base rate—and do not officially fall under state lending programs, makes them practically untraceable. These "hidden" directed loans contaminate the balance sheet of SOCBs and risk derailing the SOCB restructuring and privatization efforts. Because they are not properly underwritten, they may necessitate another round of SOCB balance sheet cleanups at high fiscal costs.

In 2020, the government started implementing its 2020–25 banking sector reform strategy focusing on improving the corporate governance of the SOCBs. The strategy outlines an implementation roadmap to prepare at least six out of 13 state-owned banks, representing 45 percent of assets in the banking sector, for privatization between 2021 and 2025. As part of improving the corporate governance of the SOCBs, more than 20 new and independent board members were appointed in the SOCBs. Although private banks have on average smaller boards than the SOCBs, their boards traditionally included more independent, female, and foreign board members than the boards of SOCBs; this gap is decreasing (Figure 6.7). Much remains to be done in the SOCBs because boards must set up functional secretariats and specialized board committees, and enhance coordination and information sharing, among other needed improvements.

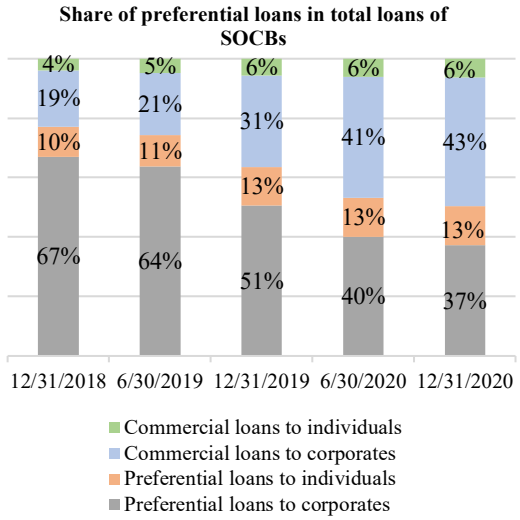
Importantly, CEOs—still politically appointed—must start reporting to the boards and become accountable to them rather than to government officials.

Figure 6.6: SOCBs reduced preferential lending in recent years

Panel A: government's policy to wind down preferential lending has resulted in a significant decline in preferential loans.



Panel B: government policy to wind down preferential lending has resulted in a gradual and significant increase of commercial lending in the SOCB credit portfolio

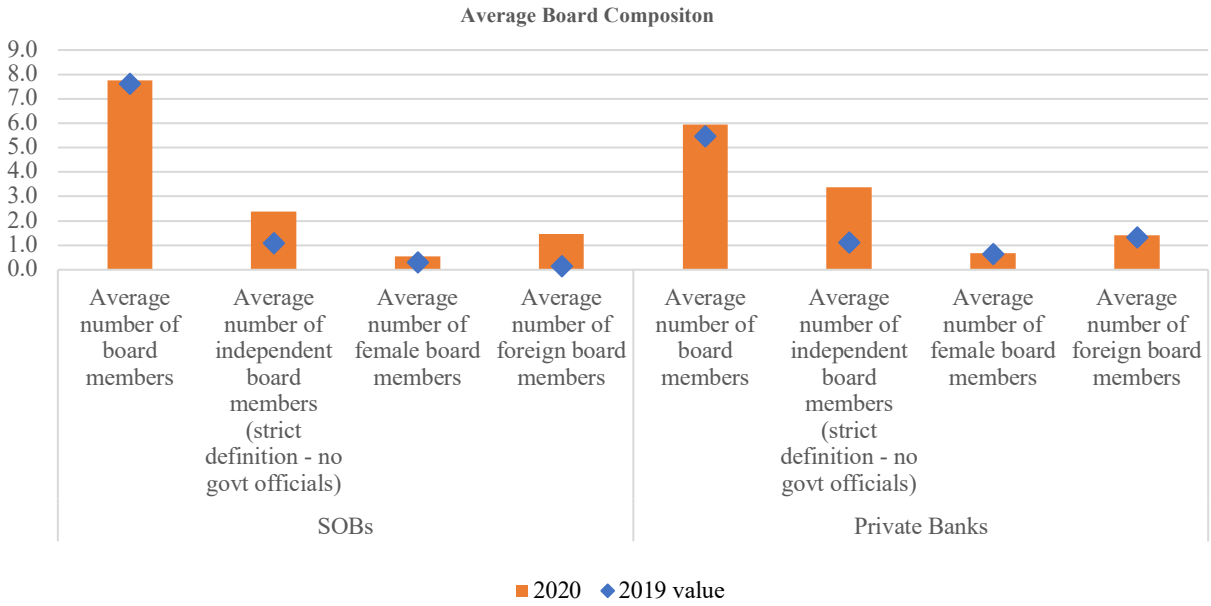


Sources: CBU, World Bank staff calculations.

A weak governance at and around SOCBs makes the banks continuously underperform private banks on profitability. The average pre-tax return on assets for the SOCBs during 2015–20 was 1.6 percent, compared with 4.2 percent for the private banks (Figure 6.8 Panel A). Similarly, the average net return on equity was 10 percent for the SOCBs and 25 percent for the private banks.[10] The lower profitability of the SOCBs is mainly caused by smaller net interest margins (due to a higher share of preferential loans) and lower non-interest income (Figure 8 Panel B). On the upside, SOCBs benefit from lower operational costs thanks to the larger scale of their operations. At 50 percent on average during 2015–20, the cost-to-income ratio of SOCBs is much lower than the 70 percent average in peer countries. The efficiency indicators of SOCBs reflect the business model oriented to corporations, lacking technology in banking operations, product diversity and innovation, risk management, and marketing, as well as low industry salaries matching the low specialization of staff.

[10] Small private banks have a higher return on assets but a similar return on equity as SOCBs due to their lower leverage.

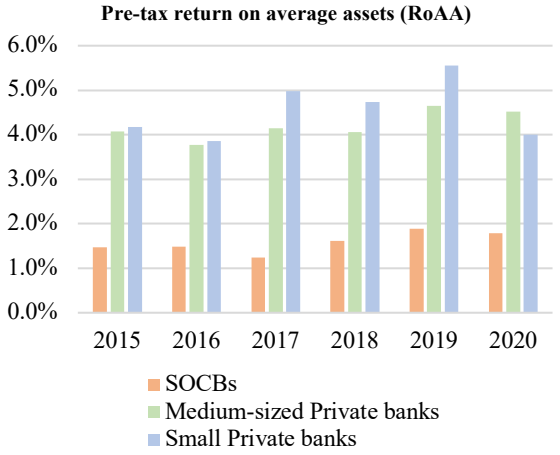
Figure 6.7: SOCBs have fewer independent, foreign, and female board members than private banks, but have progressed to include more such board members in 2020



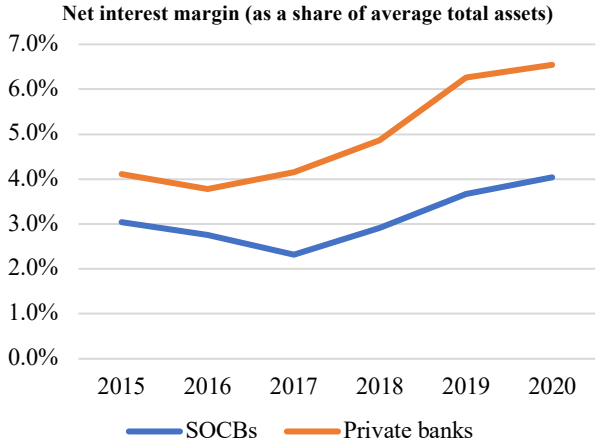
Sources: CBU data, World Bank staff calculations.

Figure 6.8: SOCBs are much less profitable than private banks

Panel A: SOCBs have lower RoAs than private banks.



Panel B: SOCBs have lower net interest margins than private banks.



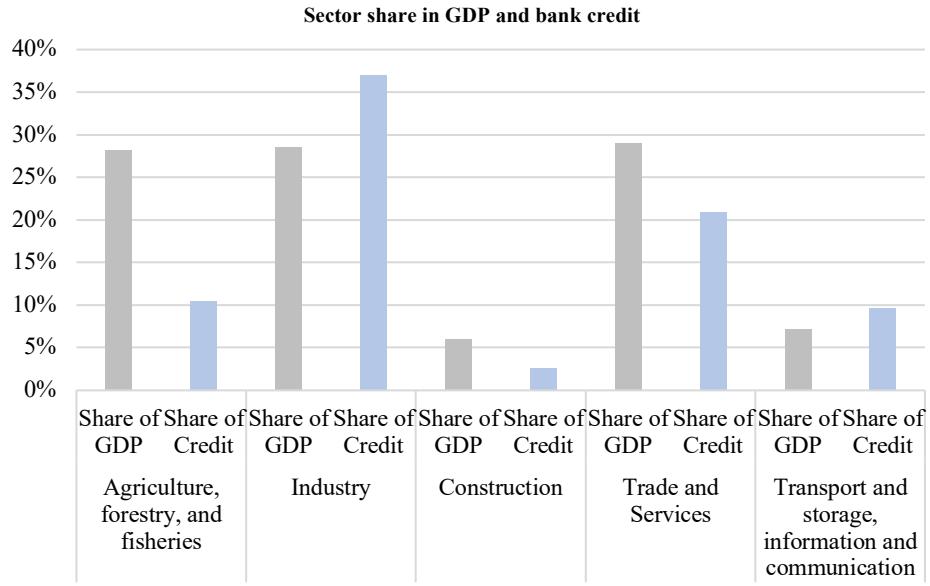
Sources: CBU, World Bank staff calculations.

The underdeveloped and uncompetitive nature of Uzbekistan's banking market is reflected in the generous interest margins of private banks. Interest rate spreads on credit portfolios have been relatively high and increasing in the private banks over the past four years, reaching almost 7 percent, compared with 4.3 percent and 4.7 percent of median net interest margin in ECA and the lower middle-income countries, respectively. The SOCBs' net interest margins are significantly lower, but also increasing—reflecting a gradual shift from preferential to commercial

lending.[11] With privatization of the banking sector (which will bring more competition) and increased financial literacy and transparency, the interest rate spreads may ultimately contract, negatively affecting the current high profitability of banks in the medium term. This may eventually raise the need for banking sector consolidation in the future.

The shortcomings in bank governance, continued policy lending, and the low competitiveness of banks translate into financial sector inefficiency that causes credit and capital misallocation. As a result, some sectors may receive much less credit than warranted by their productivity growth (Figure 6.9). For instance, the industry and transport sectors—full of inefficient SOEs – may be receiving too much credit, especially from the SOCBs. By contrast, some other sectors such as trade and services receive disproportionally much less lending from the SOCBs compared with private banks.[12] However, the varying credit intensity of individual sectors plays a role, and a deeper assessment is needed to identify potential credit gaps and overheating.

Figure 6.9: Trade and service sectors receive less attention from bank lending than their share in the economic output of the country suggest



Sources: CBU, World Bank staff calculations.

E. Structural Challenges and Risks to Macro-Financial Stability

The expansive credit boom has increased risks to financial stability. The rapid credit growth is even more worrying because of poor credit underwriting standards, risk management capabilities, and weak corporate governance in the banks, especially in the SOCBs. The limited financial

[11] The higher net interest rate margins of private banks can be partly explained by their higher risk-taking , and partly by virtually non-existent preferential lending in the private banks' portfolio—such lending is still significant, albeit decreasing, for SOCBs. The ratio of risk-weighted assets to total assets averaged 88 percent for private banks and 79 percent for SOCBs during 2018-2020.

[12] By end-2020, only 5 percent of SOCBs' outstanding loans were to the retail/wholesale trade and public food sector, compared with 22 percent of private banks' outstanding loans. By contrast, nearly 50 percent of SOCBs' loans went to the industry and transportation sector, compared with 35 percent of the private banks' loans.

strength of shareholders in the young private banks also adds to the worries. Should system-wide risks materialize, the government will be called to financially support both the SOCBs and private banks—at a significant cost to taxpayers—to avoid a boom-to-bust reversal. Banks must strengthen credit origination and underwriting processes by paying increased attention to borrowers' repayment capacity, which would naturally moderate their credit growth. Moderating credit growth is particularly important in banks slated for privatization. The central bank must exercise pressure on banks to improve credit underwriting standards and risk management.

The liquidity buffers of SOCBs are being depleted by aggressive lending. Although the liability structure of the SOCBs appears more long-term and stable than that of the private banks, the SOCBs' liquidity buffers have reached critically low levels. The ratio of high-quality liquid assets to total assets decreased from 15.4 percent at end-2018 to 9 percent by end-November 2020—with several banks falling below the minimum regulatory threshold of 10 percent (Figure 6.10).[13] The liquidity position of several SOCBs worsened in 2020 also due to reduced credit repayments as a result of credit deferrals provided by banks as part of the COVID-19 mitigation measures. Drawdowns of current and deposit accounts, as well as some off-balance commitments, brought further liquidity strains. To mitigate these liquidity pressures, the central bank introduced liquidity support tools for banks (short-term liquidity support loans and irrevocable credit lines). The CBU also takes proactive measures to bring the banks into compliance with the established liquidity ratios and has strengthened the liquidity coverage ratio methodology starting in February 2021 in line with the Basel III standards.

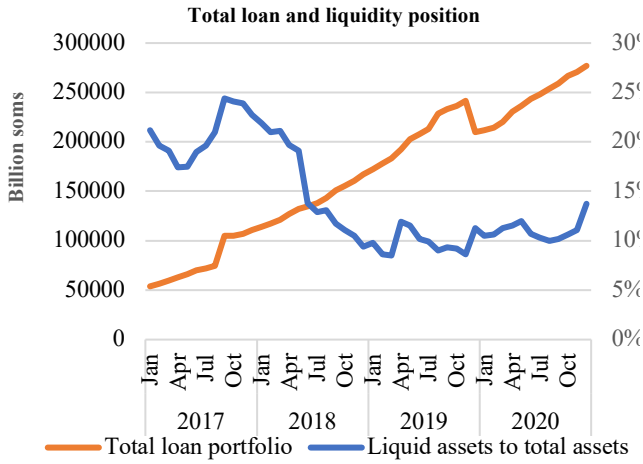
SOCBs rely mostly on credit lines from foreign banks to finance their operations, while private banks rely mostly on private deposits. As of end-2020, the SOCBs mobilized 55 percent of funding through credit lines—slightly down from the 63 percent in 2018 (Figure 6.11 Panel A). While more than 50 percent of those credit lines were funded by the government (the MoF and the UFRD) in 2018, this share declined to 30 percent in 2020. Existing credit lines are mostly provided by foreign banks and IFIs, and some SOCBs were also able to raise funding through Eurobond issuance. SOCBs funded less than 15 percent of their operations with deposits of individuals and private firms. By contrast, private banks received more than half of their funding from private depositors and relied on credit lines for less than 25 percent of their funding. Although deposits are not the SOCBs' main funding source, they still attract 72 percent of total deposits in the economy—just because of their size.

The long-term funding enables SOCBs to lend long term, mostly to SOEs, while private banks and companies have been constrained in long-term. SOCBs' access to long-term credit lines helped them issue long-term loans to meet the financing needs of SOEs in sectors that require long-term financing such as transportation and communication and industry. By end-2020, 47 percent of loans from SOCBs had a maturity of five years or more, compared with just 8 percent for private banks. Private banks relying on deposit financing cannot afford to take material liquidity risks from maturity transformation. As a result, private companies—especially medium-sized—could be deprived of adequate access to investment financing.

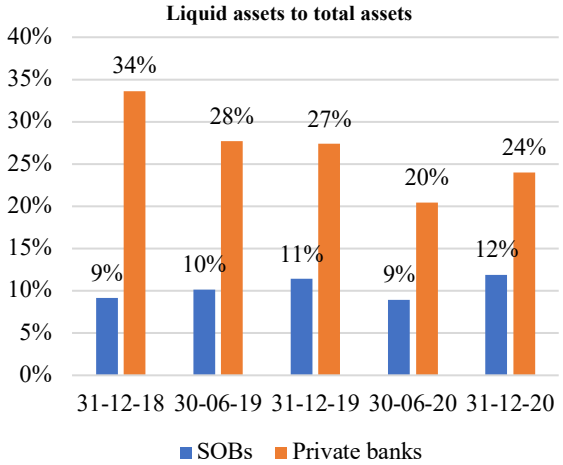
[13] By end-December 2020, the ratio increased to 12 percent as a result of Eurobond issuance and other attracted funding by SOCBs.

Figure 6.10: The liquidity buffers of SOCBs are low and decreasing

Panel A: Rapid credit growth has resulted in reduced liquidity buffers of the banking system.



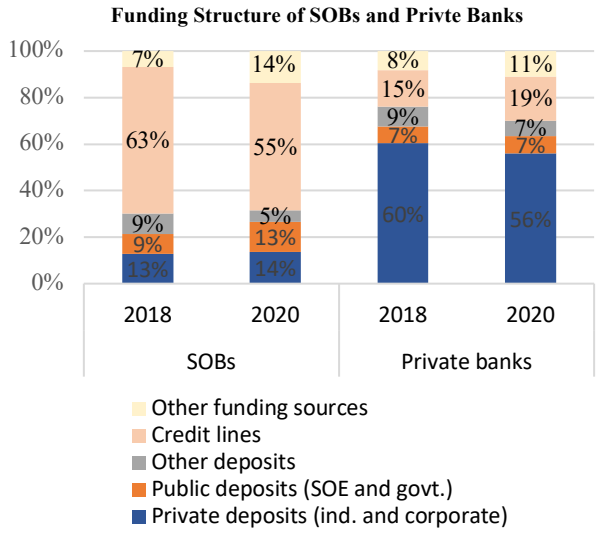
Panel B: Private banks hold significantly higher liquidity buffers than SOCBs.



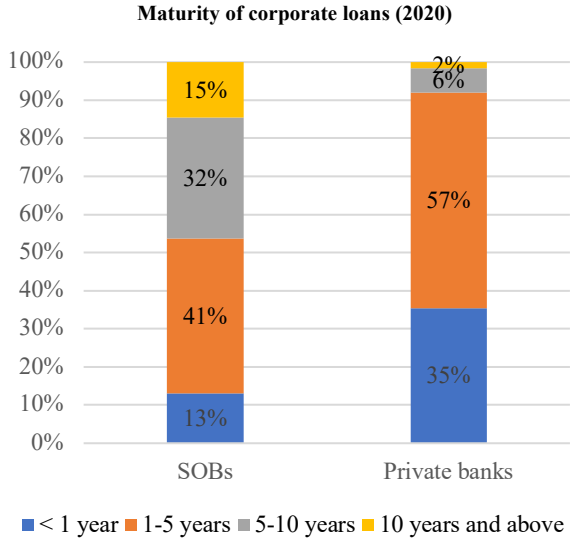
Sources: CBU, World Bank staff calculations.

Figure 6.11: SOCBs rely heavily on funding by credit lines, which help them extend long-term loans

Panel A: SOCBs primarily rely on credit lines, while private banks use private deposits



Panel B: SOCBs provide more long-term loans than private banks do



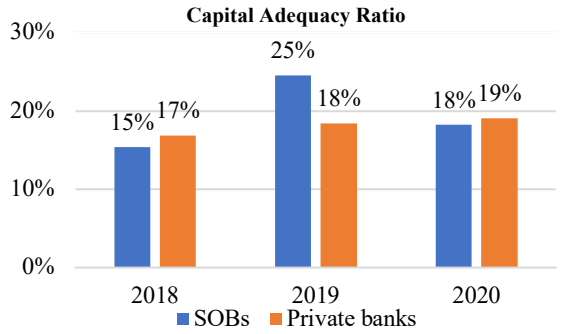
Sources: CBU, World Bank staff calculations.

SOCBs have enjoyed high capital buffers thanks to the 2019 cleanup of policy lending, but their buffers are being depleted incredibly fast by aggressive lending The SOCBs used 7 percentage points of their capital in 2020 to extend additional loans—presumably to counter the repercussions of the COVID-19 economic crisis (Figure 6.12). While this could be the right role for the SOCBs, the SOCBs slated for privatization need to manage their portfolios carefully like

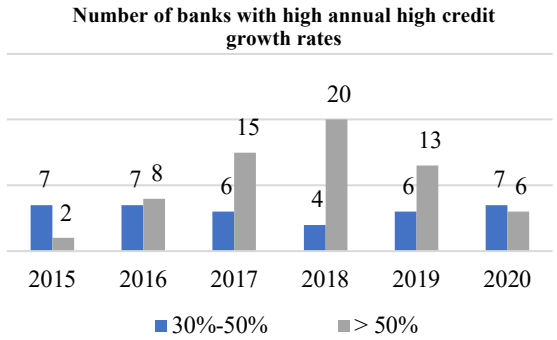
proper commercial banks. Instead, six banks showed credit growth greater than 50 percent in the midst of the crisis, and another seven banks grew their credit by more than 30 percent (Figure 6.12 Panel B). These credit growth rates cannot be achieved with proper underwriting—not even in more advanced banking systems. The combination of weak governance and internal controls, and hidden policy lending, provides for double trouble when banks recklessly push out money and misallocate capital in parallel.

Figure 6.12: SOCBs appear well capitalized, but excessive lending is fast depleting capital buffers

Panel A: SOCBs appear to be well capitalized, although the buffers have been depleted due to rapid credit growth.



Panel B: Aggressive lending is exhibited by several banks.



Sources: CBU, World Bank staff calculations.

Low officially reported nonperforming loan ratios, which banks report after loan deferrals have ended, overestimate capital buffers, and risk continued aggressive lending without any further risk-taking capacity. Nonperforming loans (NPLs) in the Uzbek banking sector traditionally have been low (1–2 percent) because: (1) loans to several large SOEs used to be restructured and granted regulatory forbearance in their classification; (2) many of the loans granted under public programs have long grace periods and their true quality is yet unknown; and (3) rapid growth of the loan portfolio obscures the signals of actual credit quality. As a response to the COVID-19 outbreak, temporary deferrals were provided for loan repayments by firms and individuals until October 1, 2020. The reported NPL ratios decreased from 2.3 percent in March 2020 to 2.1 percent by end-2020, which is not consistent with the results of the World Bank Group Business Pulse Survey of summer 2020, showing that 37 percent of responding MSMEs anticipate or have already fallen in loan arrears. [14] Rising accrued interest on bank balance sheets indicates that the reported NPL figures do not reflect the true picture of loan servicing. Overall, the low quality of reported NPL data, as well as bank credit history sharing through the credit registry, must be addressed to foster stability and efficiency in the banking system.

The highly concentrated and dollarized loan portfolios of the three largest SOCBs top up the exposure of the banks and the system to financial stability risk. For the three largest SOCBs, the share of large loans comprises 46 percent of total loans by end-2020, with the five largest borrowers covering 26 percent of their loan portfolio.[15] The portfolio concentration has declined from 64 percent in 2018 thanks to the SOCB balance sheet cleanup from UFRD-funded SOE loans in 2019 but it remains significantly higher than the 16 percent for private banks (Figure 6.13 Panel A). High concentration coupled with the

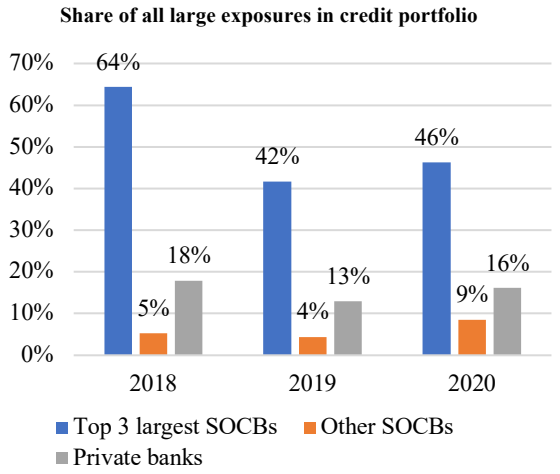
[14] Several SOBs underwent asset quality reviews (AQRs) in 2020 and others will undergo AQRs in 2021 as part of the banking system transformation efforts. These exercises may reveal additional capital shortages that will have to be addressed.

[15] The regulation defines a large loan as a loan that exceeds 10 percent of a bank's Tier 1 capital.

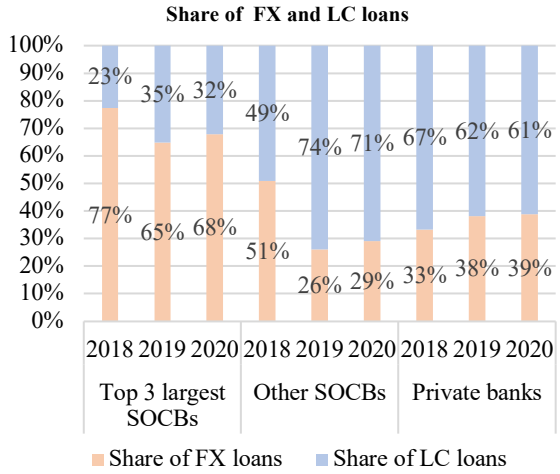
dollarized credit portfolios of the large SOCBs expose the banks to greater solvency risks (Figure 6.13 Panel B). Namely, a potential large currency devaluation can cause the failure of large borrowers to repay their loans, as borrowers' income is mostly in som, apart from the commodity exporters. To mitigate this risk, the authorities are targeting that the dollarization of bank loan portfolios should decline from the current 50 percent to 45 percent by the end of 2021. As a result, banks—and especially the three largest SOCBs—will need to cut new foreign exchange lending and refocus on local currency borrowing and lending in 2021. The concentration risks could be tackled by enabling a framework for syndicated lending, including with foreign banks.

Figure 6.13: Large SOCBs have highly concentrated and dollarized loan portfolios

Panel A: Even after the policy lending cleanup, large SOCBs show a much higher share of large exposures than private banks.



Panel B: Largest SOCBs have a large share of foreign currency loans.



Source: CBU, WB staff calculation.

F. The Path Forward

Uzbekistan started vital reform in the banking sector. The financial liberalization must be matched with institutional strengthening to avoid costly financial crises, and the CBU has been improving its regulatory and supervisory framework to this end. Based on international experience, it is important that the government complement banking reforms with reforms of the SOEs and the business environment and by strengthening competition.

The most pressing reforms to help the banking system provide the credit the economy needs for its successful transition to market without destabilizing credit booms include the following main areas:

SOCB governance and policy lending. SOCBs—at least those at the top of the privatization list—must be freed from political interference in their lending, preferably through a Presidential Decree. All remaining official and "hidden" directed lending should properly registered under the "directed lending portfolio" and reported in the SOCBs financials so that the supervisor (CBU), the owner (MoF), investors, and the public can monitor the dynamics of their volume and quality. The MoF must clearly define developmental mandates for SOCBs that will remain in public ownership, establish transparency and accountability mechanisms for the provision of "public services" by SOCBs and the associated fiscal costs, and improve their digital capabilities.

Credit risk reporting, management, and oversight. The CBU should improve its credit quality oversight by conducting thematic reviews related to credit quality (such as of bank underwriting practices). Over time,

the CBU should build the capacity for conducting targeted horizonal reviews of credit quality and broader asset quality reviews across banks. This initial review and gradual capacity building are needed to better understand the extent and dynamics of nonperforming loans and the implications for bank capital buffers. CBU should improve the classification methodology for NPLs (or broadly, assets) to also include a forward-looking dimension and enforce its application by banks. It should also strengthen the oversight of the quality of credit reporting to the registry and the credit information sharing. The CBU should put pressure on all banks to strengthen corporate governance, internal controls, risk management, and underwriting standards. It should continue strengthening its supervisory capabilities for banking market entry, supervision, exit, and crisis preparedness.

Deposit mobilization. Uzbekistan's banks are not as successful at deposit mobilization as they should be, including because of historical distrust of the public toward their services. In tandem, the banking system is enjoying access to credit lines from the government—especially the SOCBs—and has more recently managed to attract foreign debt financing also in local currency. The incentives for mobilizing domestic deposits are thus weak. In the medium to long term, Uzbekistan will need to rely more on supplemental financing of its development through foreign savings. However, the mobilization of domestic deposits can make the funding structure of banks more resilient and help households and firms build financial wealth and self-insure against risks (WDR 2014). In turn, more resilient households and firms lower the credit risk for banks.

Product development. There are several products that the market, with the help of the authorities, could develop in the short term to help strengthen the resilience of credit intermediation. For example, to help alleviate credit concentration risks and help CBU implement tougher standards, the framework for loan syndication, including with foreign bank participation, could be improved. While recently the banks have been able to attract foreign financing in som, foreign currency financing will continue. Developing the hedging market (OTC or organized through the stock exchange) could help mitigate the exposure of banks and borrowers to foreign currency risk. Further, the agriculture sector is a major part of Uzbekistan's economy and a part that can also be competitive in the long term. Sustained competitiveness will require agri-financial products that the market could develop with public policy support, such as tailored financing reflecting the seasonal specifics and catastrophic insurance to cope with climate risks as well as mitigate the credit risk of agricultural financing. The banking system should continue promoting fast digital payment sand solutions to help with e-commerce and the broader market digitalization and integration.

Chapter 7. State-Owned Enterprises

The state dominance of the Uzbek economy across most sectors – a legacy of the central planning – creates misallocations of labor and capital, burdens the state budget, limits competition, and constrains private sector development. About 2,800 state-owned enterprises (SOEs) owned directly by the central government account for about 18 percent of employment, 20 percent of exports, and their output is equivalent to about 50 percent of GDP. The financial performance of these large enterprises remains mixed. In 2020, four the largest SOEs were among the ten most profitable state enterprises, and three of the largest SOEs were among the top ten loss-making ones. In 2020, the President approved an SOE reform action plan that intends to keep 71 strategic enterprises in state ownership, privatize promptly about 600 others, and restructure a further 500 SOEs for subsequent privatization. The remaining SOEs will be merged, transformed into public institutions, or liquidated. The privatization of these 1,100 SOEs is a priority for the government over the next several years. Improving the governance of those enterprises that remain in state ownership is another important priority, and that will require the introduction of hard budget constraints and ensuring that the risks from the banking system's exposure to them is substantially reduced and appropriately managed.

To ensure success of the reforms, the government will need to focus on the following priorities: (i) adopt two foundational laws, the Law on Privatization and the Law on State Property Management; (ii) estimate and disclose the fiscal costs of SOEs; (iii) launch large-scale privatization under clear and legislated procedures; and (iv) continue establishing proper corporate governance, financial reporting, and performance management mechanisms in the largest SOEs that will remain in state ownership.

A. INTRODUCTION

For a quarter century after independence in 1991, Uzbekistan remained a closed and centrally planned economy with low private sector participation. The country relied on an import substitution growth model, based on heavy state dominance in key sectors of the economy, such as energy, mining, agriculture (cotton, wheat), industry (chemical, automotive, pharmaceutical) and services. In 2016, the state contributed more than 60 percent of GDP, and the private sector was weak and largely informal.

Since 2016, Uzbekistan has laid the foundation for reducing the state's role in its economy and for growing the private sector. The authorities have aimed at a significant decrease in the number of SOEs and the creation of conditions for attracting investment and growing the private sector. While the legislative reforms are in progress, the emergence of a strong, competitive, and dynamic private sector is still constrained by the state-led economic development model. Uzbekistan is embarking on its first major privatization in its post-Soviet history. In the last four years, the country has initiated privatization of small scale SOEs,[1] while the privatization of large

[1] Defined as SOEs with net assets value below the equivalent of $9,500.

SOEs is yet to begin. With many examples from Europe and Central Asia of privatization captured by well-connected "insiders," Uzbekistan is taking the necessary steps in laying the proper foundations for the privatization procedure based on sound legislation and transparent implementation mechanisms. The challenge is not to allow this process to take much longer than warranted and delay privatization further.

The SOEs presence in Uzbekistan's economy is pervasive. There are about 2,800 SOEs directly owned by the central government (also called tier-1 SOEs). They account for about 18 percent of employment, 20 percent of exports, 50 percent of output, and generate very little in terms of overall value added. about half of Uzbekistan's GDP. Most state-owned assets are concentrated in the 15 largest SOEs, which dominate the most important sectors of the economy and whose total assets amount to about 57 percent of GDP. The financial performance of these large enterprises is mixed. In 2020, the four largest SOEs were among the ten most profitable state enterprises: JSC Uzbekneftegaz (oil and gas), JSC Almalyk Mining and Metallurgical Company (mining), JSC Uzmetkombinat (steel), and JSC Uzavtosanoat (automotive). Three of the largest SOEs were among the top 10 loss-making state enterprises in 2020: JSC UzTransGaz (oil and gas), JSC Uzbekistan Airways (air transport), and JSC Uzbekkumir (coal). The net financial performance of the largest 15 SOEs was positive in 2019, with profits amounting to a paltry 1.2 percent of GDP, offsetting losses of the loss-making SOEs that amounted to about 1 percent of GDP.

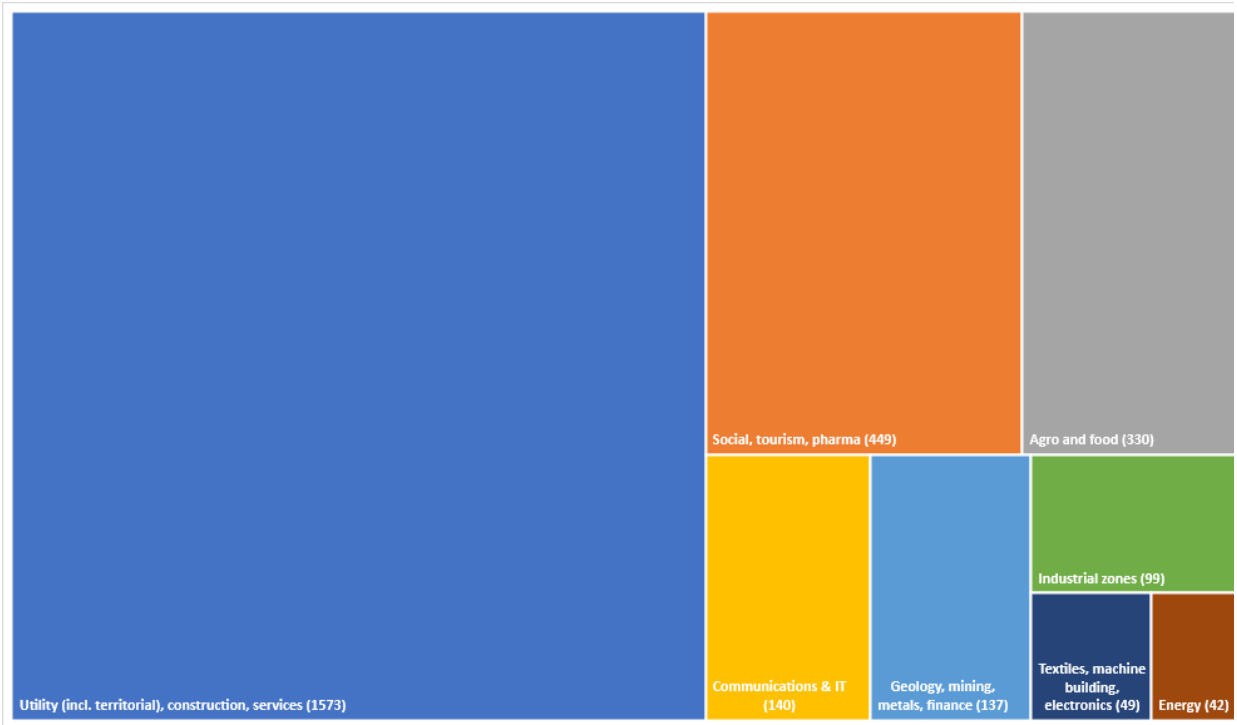
SOEs generate virtually no net value added for the economy. The dominant source of financial losses for the largest SOEs was from natural gas and hot water distribution companies, accounting for about two-thirds of total losses (see the Annex for details). The government identified about 30 SOEs as the largest and strategic SOEs, which have significant impact on budget revenues through taxes and dividends, but also pose substantial fiscal risks, bear the largest expenses, and hold social responsibilities.

In 2020, the President approved an SOE reform action plan that is based on the government's comprehensive stock take of centrally owned SOEs.[2] Out of 2,800 centrally owned SOEs, 71 will remain in strategic state ownership, while almost 600 will be promptly privatized. The gradual SOE reform plan aims to privatize about 1,100 SOEs, or 40 percent of existing SOEs by number. Other SOEs will be merged, transformed into public institutions, or liquidated.

The government has identified 71 SOEs as strategically important and plans to keep them in state ownership. Such SOEs operating in key sectors will be reformed to align their corporate governance structure, financial reporting, and audit and disclosure requirements with international good practices (Figure 7.1). The government is also planning to complete the separation of policymaking, regulatory, and ownership functions over such SOEs to minimize the conflicts of interest that arise when these roles are combined, especially in sectors where the private sector is present.

[2] Decree of the President of Uzbekistan #6096, October 27, 2020.

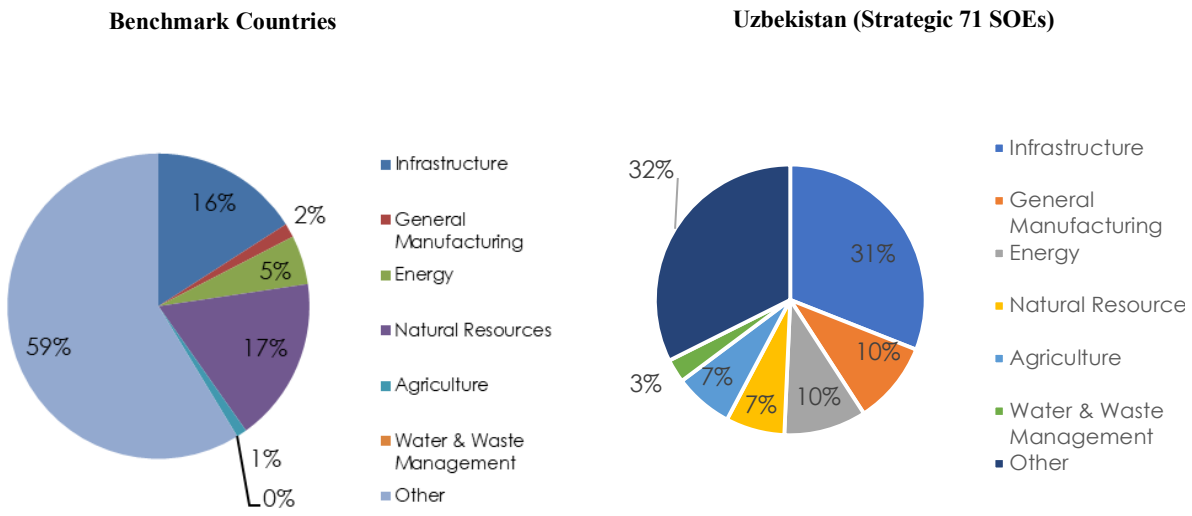
Figure 7.1: Sectoral Distribution of SOEs in Uzbekistan



Source: State Assets Management Agency (2020).

Uzbekistan aims to retain a larger presence in sectors that, in developed economies, would typically be dominated by private participation, such as general manufacturing and agriculture. Figure 7.2 breaks down by sector the 71 Uzbek SOEs that are considered for continued state ownership and compares them with the relative composition of SOE portfolios from several benchmark countries: Germany, Lithuania, Norway, and Sweden. The comparison suggests that even after the majority of SOEs are privatized or liquidated, the government will keep a larger SOE presence in sectors that are primarily private in developed markets, such as the agriculture, chemicals, metal production, and machine building. The number of infrastructure SOEs may be considered comparable, as the figure below includes 17 separate regional road SOEs that should be consolidated into a single entity. Should this change be made, the number of strategic infrastructure SOEs would decrease to 12 percent (or six SOEs), which is comparable to the developed markets proportion. The category "Other" on both graphs includes a variety of SOEs, such as those in telecommunications, postal services, research, science, space technology, and gambling.

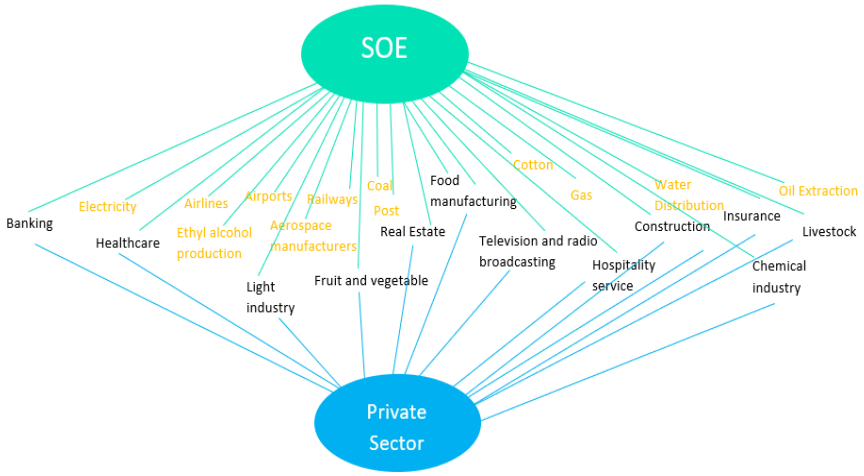
Figure 7.2: Number of SOEs by Sector (in percent)



Sources: Decree of the President of Uzbekistan #УП-6096, October 27, 2020; *Corporate Governance of State-Owned Enterprises in Europe and Central Asia Survey* (December 2020), World Bank.
Note: Benchmark countries include Germany, Lithuania, Norway, and Sweden.

Uzbekistan's SOEs continue to enjoy preferential access to land, infrastructure, credit, state support and contracts, and until recently, to foreign exchange. SOEs exercise monopoly powers in many sectors where the private sector could play a more active role (for example, agriculture, public transport, airlines, general manufacturing). In addition, many SOEs operate together with the private sector in various subsectors—such as light industry, fruits and vegetables, hospitality services, chemical industry, banking, and insurance—but enjoy preferential access to land and cheap (domestic and foreign) finance, or a preferential regulatory regime.

Figure 7.3: Mapping of Private and SOE Dominated Sectors

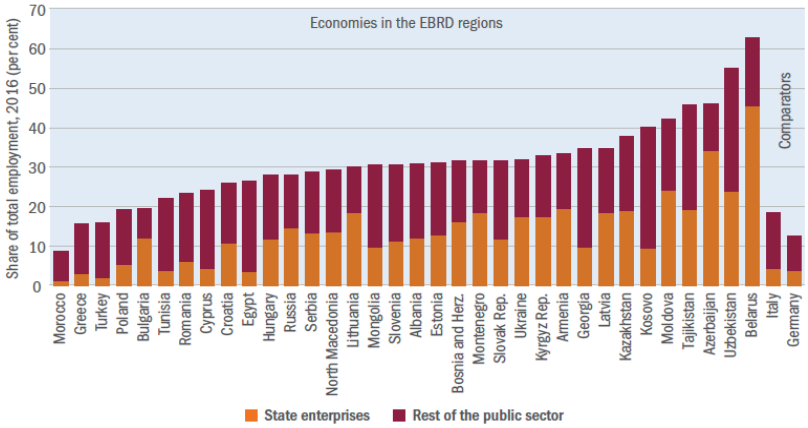


Sources: 2020 World Bank Systematic Country Diagnostic (forthcoming); publicly available information as of April 2019.
Note: Yellow highlights sectors/subsectors with SOE participation only.

Many large SOEs create significant market distortions because they fulfill mandates of sector regulators and policymakers, creating obstacles to competition with the private sector. Moreover, such conflict between the state's ownership role and its policymaking and regulatory functions leaves SOEs vulnerable to being used to achieve short-term political goals to the detriment of their efficiency. Presently, SOEs' executive decision making is embedded in the government structure, restricting their autonomy and exposure to the market. This, along with the preferential access of SOEs to finance and inputs, legal protections in certain sectors that provide monopoly rights, dual operational and policy responsibilities in key sectors, and weak corporate governance, allows SOEs to operate with significant advantages compared with the private sector firms.

SOEs remain important employers, providing a considerable percentage of the total employment and leading in the share of public sector employment in the ECA region. According to the European Bank of Reconstruction and Development (EBRD), Uzbekistan is one of the leading countries in ECA in terms of public sector employment as a share of total employment, behind only Belarus (Figure 7.4). Interestingly, Uzbekistan's public sector employment is split almost equally between SOEs and the rest of the public sector (44 percent versus 56 percent), while in Belarus and Azerbaijan, for example, SOEs dominate. As noted in the World Bank's *Corporate Governance of State-Owned Enterprises in Europe and Central Asia Survey*, developing countries employ a significant part of their labor force in sectors that could perform well under private ownership, such as manufacturing and agriculture.[3]

Figure 7.4: SOE and Public Sector Employment in ECA, 2016



Source: 2020 EBRD The Transition Report 2020-21: The State Strikes Back.

Explicit on-budget subsidies to SOEs were small, about 1 percent of GDP in 2018, but there were at least an additional 6 percent of GDP in quasi-fiscal deficits that underpin the SOE operating model. These quasi-fiscal deficits (QFDs)—uncompensated expenses from below-cost-recovery prices, inefficient collections, and technical losses—are largely concentrated in the public utilities (electricity, gas, water, district heating), but are also generated by SOEs operating in commercial sectors such as chemicals and fertilizers. Even with these QFDs, 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 the lack of

[3] https://openknowledge.worldbank.org/handle/10986/35011.

investment for maintenance, are significant and above international norms. Losses in natural gas supply were estimated at 1.2 percent of GDP in 2018. Losses in drinking water supply reach 35 percent of the volume supplied and cost about 0.47 percent of GDP in QFDs. Electricity transmission and distribution losses are about 20 percent, costing about 0.24 percent of GDP in QFDs. These technical losses are higher than in comparator countries (Tajikistan with 0.19 percent of GDP, Bulgaria with 0.15 percent, Romania with 0.14 percent, and Pakistan with 0.10 percent).

According to estimations by the World Bank's 2019 Uzbekistan Public Expenditure Review (PER), many SOEs provide goods and services at regulated prices, often at below cost-recovery levels, as part of public service obligations and without compensating budgetary subsidies. On-budget subsidies to SOEs amount to around 1 percent of GDP. But SOEs also receive support from the government through tax and customs preferences. The public investment program finances part of SOEs' investment and that is not recorded explicitly in the budget. The quasi-fiscal deficits of SOEs are estimated at about 4 percent of GDP in a sample of key sectors (natural gas, electricity, water), but could be much larger for the economy. By depriving SOEs of substantial financial resources, quasi-fiscal deficits reduce SOEs' ability to invest, which reflects on inadequate maintenance and significant technical losses in utility networks.

State-owned banks subsidize SOEs through the Uzbek Fund for Reconstruction and Development (UFRD). A large share of directed lending happens via a complex process of on-lending—from UFRD via state banks to SOEs through government-financed concessional loans in foreign and domestic currency. This quasi-fiscal activity of SOBs is estimated at 1.7 percent of GDP.[4] Since its establishment in 2006, the UFRD has played an important role in financing industrial development through concessional loans to SOEs, but at a high cost to financial sector efficiency and stability. The UFRD has recapitalized banks and restructured large SOE loans on several occasions and with growing frequency since 2017. By mid-2019, UFRD was the largest shareholder of and lender to the banking system, accounting for about two thirds of preferential lending through the banks.

Official data on Uzbek SOEs, including on their aggregate financial information and contribution to the economy, remain incomplete and require significant refinement. Despite Uzbekistan's rise in the World Bank Statistical Capacity Indicators,[5] granular data on SOE performance, revenue as share of GDP, tax and dividends contribution, and sectoral analysis are missing. The lack of data is recognized in the recent reports on SOE governance in Uzbekistan, including the World Bank's *Corporate Governance of State-Owned Enterprises in Europe and Central Asia Survey* (December 2020) and the Asian Development Bank's *State-owned Enterprises in Uzbekistan* (January 2020). Better data management and consolidation and analysis of the data collected from SOEs financial and non-financial reporting are necessary for benchmarking and improving the potential of public sector and SOEs. Greater effort is required to

[4] *Public Expenditure Review for Uzbekistan.* https://www.worldbank.org/en/country/uzbekistan/publication/per The quasi-fiscal subsidy associated with concessional lending to SOEs can be assessed by using as a 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, the authors estimate the quasi-fiscal subsidy to be 1.7 percent of GDP.

[5] Uzbekistan improved its statistical capacity indicator from 48.9 (2016) to 67.8 (2020), but still lags ECA's indicator average of 76.4 (2020): https://datatopics.worldbank.org/statisticalcapacity/SCIdashboard.aspx.

establish proper collaboration between the Ministry of Finance, the State Assets Management Agency, the Statistics Committee, and the State Tax Committee to operationalize the processes for SOE data collection, processing and analysis, enabling informed decision making for the government, and improving the potential of public sector.

B. SOE Reforms: Legislation Update

Since 2017, the government, with the support of the World Bank and other development partners, has taken important initial steps to reduce the role of SOEs in the economy. For example, the government has adopted legislation for strategic SOE reform and privatization, as well as centralizing and strengthening corporate governance, ensuring financial transparency of large SOEs, and addressing institutional weaknesses. The government adopted measures requiring its two biggest and costliest (in terms of explicit and quasi-fiscal deficits) SOEs –Uzbekenergo and Uzbekneftegaz—to adopt international financial reporting standards (IFRS) and be audited by reputable firms. Progress has been substantial, with both utilities introducing the required changes to their accounting and financial reporting practices and disclosing their audited IFRS-based financials starting in 2018.

Until recently, SOEs managed the regulatory and operational functions in several sectors (for example, transport, and chemicals), which created conflicts of interest and led to discriminatory practices. Also until recently, ownership, policymaking, regulation, and sector operations in transportation, energy, and telecommunications were the responsibility of vertically integrated sector SOEs. This arrangement had a significant effect in shutting out private sector participation in these sectors. Recent reforms in the energy, mining, and transport sectors have separated policymaking, regulatory, and sector operational functions through the establishment of sector-specific line ministries and regulatory bodies. Further reforms will be needed to replicate this move in other sectors that maintain vertical integration of all responsibilities.

To institutionalize the SOE ownership function and centralize oversight, the government established and empowered the State Assets Management Agency (SAMA) to carry out the ownership function over centrally-owned SOEs. At the same time, Uzbekistan is transitioning from a decentralized ownership model to a dual model while undertaking an ambitious reform of its oversized SOE sector. During this transition, operational management and oversight of SOEs are still performed by both SAMA and the line ministries. At the same time, the ownership function is gradually being transferred to SAMA, which is working on building proper corporate governance architecture and introducing a system of centralized financial oversight of SOEs' performance. Since 2019, all SOEs must report to SAMA, which is mandated to act as SOEs' shareholder, develop and implement an SOE ownership policy, implement good corporate governance practices, appoint SOE board members, monitor financial performance, and develop and enforce key performance indicators, taking over these functions from the line ministries. This work is ongoing with an active assistance from the international organizations, including the World Bank. SAMA is also tasked with delivering a massive privatization program.

The Ministry of Finance carries out the same shareholders' functions with respect to the state-owned banks and 32 largest SOEs in the country. From October 2020,[6] the MoF has established two specialized departments to carry out the ownership and oversight of SOEs and SOBs, presently being staffed and trained to carry out these functions effectively. While this policy measure is important for instilling good corporate governance practices, thorough oversight, and stronger fiscal discipline over the most strategic assets, there is room to leverage the expertise of both departments and to synergize the work that is currently ongoing with both SOEs and SOCBs.

Other measures that have been adopted aim at strengthening SOEs' corporate governance and improving their financial transparency. Such measures include: (1) reducing the number of unitary enterprises by corporatizing SOEs and converting them into joint stock companies; this step would place corporate SOEs on the same footing with their private sector peers in terms of corporate governance, financial reporting, audit, and disclosure requirements; (2) updating the corporate governance code and introducing it among the 60 largest SOEs; (3) mandating transition to IFRS for the largest private and state-owned entities in Uzbekistan starting in 2021; and (4) also starting in 2021, establishing individual websites by SOEs to host important information on each entity, including board and management composition, quarterly and annual financial information, and key performance indicators.

Following a comprehensive inventory of all SOEs, the President of Uzbekistan approved a set of measures to transform the corporate governance of large SOEs and privatize a substantial number of smaller SOEs. The SOE strategic mapping process lasted for about one year and was finalized in October 2020 with Presidential Decree #6096 aimed at reducing the state's share in the economy and improving the performance and governance of large SOEs:

- The first part of the resolution sets out ambitious corporate governance improvements that 32 of the largest (by valuation) SOEs must implement within the next year under the purview of the MOE: the adoption of IFRS, requirements for annual independent audits, and the preparation of corporate improvement and financial recovery strategies (with support from competitively sourced management consulting expertise). In addition, all large SOEs must obtain an international credit rating in 2021.
- The second part identifies 39 medium-size SOEs that will remain under the SAMA mandate and will undergo restructuring to improve their operational performance and financial transparency.
- The third part lists the 62 medium-size SOEs that will undergo pre-privatization valuation and due diligence to be offered for sale on an individual basis.
- The fourth part identifies a list of 479 smaller SOEs, about 17 percent of all SOEs by number, for immediate valuation and sale through a competitive and transparent online auction. The enterprises are valued at less than UZS 100 million (about $10,000) each and were selected

[6] Decree of the President of Uzbekistan #УП-6096, October 27, 2020.

based on their poor financial performance and the existence of domestic private sector capacity that can absorb the operations of these enterprises.

- The fifth part of the resolution identifies a list of state property (assets) for privatization via online auction platform.

The 2020 Presidential Decree set an ambitious agenda for the reform and divestiture of 2,800 SOEs, but work is ongoing with the finalization of the new legislation on State Property Management and Privatization. The government has already started divesting minority stakes in SOEs and smaller assets via an online platform and is aiming to privatize several larger SOEs in 2021. Adoption of a new Privatization Law will help improve the legal framework for selling larger enterprises. Meanwhile, the government should continue working with reputable advisors it has hired to help restructure the largest SOEs that will remain in state ownership and prepare other SOEs for sale through an open, transparent process. A new State Property Management and Privatization Law will help instill clear ownership principles for SOEs that will remain in government hands, and separate the state's roles as an owner, regulator, and policymaker toward such SOEs.

In March 2021, the government approved the SOE Ownership Strategy and a detailed roadmap for its implementation for 2021-2022. The SOE Ownership Strategy provides a vision for SOE reforms in the country and builds on sound underpinning, including the Organisation for Economic Co-operation and Development (OECD) *Guidelines on Corporate Governance of State-Owned Enterprises* and the World Bank *Corporate Governance of State-Owned Enterprises: A Toolkit*. The strategy outlines the government's objectives for SOE reforms and states the agreement to undertake the steps necessary to implement the complex reforms, including: (1) provide a rationale for SOE ownership; (2) establish types and categories of state ownership; (3) segregate regulatory and ownership functions; (4) set out major corporate governance policies; and (5) develop SOE financial accountability mechanisms, as well as transition policies to market-based mechanisms.

The largest SOEs have been corporatized and basic elements of the corporate governance structure are in place. SOEs are commonly incorporated in one of the following three legal forms: (1) a joint-stock company (JSC); (2) a limited liability company (LLC); or (3) a state unitary enterprise[7]. JSCs are the primary form used to incorporate major SOEs in key sectors of the economy, while their subsidiaries are commonly incorporated as JSCs, LLCs, or unitary enterprises. All JSCs, private- and state-owned, fall under the requirements of the Law on JSCs and Protection of Shareholder Rights.

Most of Uzbek SOEs' are now governed by their supervisory boards, led by high-profile civil servants. State representation on SOE boards is justified when SOEs are charged with important public policy objectives, yet it is becoming a good practice, especially among the OECD member

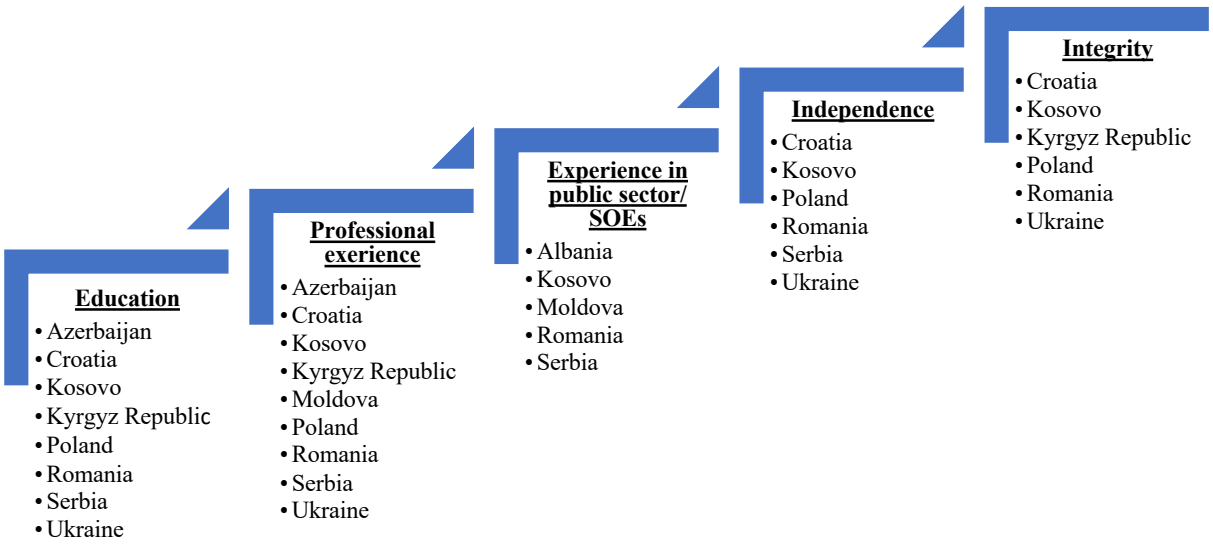
[7] Legacy legal form, remnant of the Soviet legal system referring to an unincorporated state enterprises. This unique form implies that the assets—and the liabilities—of such entities do not belong to them, but rather to the state directly. Although some countries limit their governments' liability through regulations, they would still bear the secondary liability on the obligations of such entities, if the entities' property were insufficient to clear their debts. Therefore, potential bankruptcy or an interruption of the operations of any such enterprise represents potential risks and contingent liabilities for the government.

countries, to reduce undue state influence by limiting the type or number of public servants who may serve on an SOE board. Therefore, the government will need to gradually reduce civil servants' participation on SOE boards to closer align corporate governance structure with best practices.[8] Government representatives may lack the necessary qualifications, industry experience, and even time to be effective board members. Civil servants are typically appointed to pursue government policy goals. Therefore, when a government representative is appointed directly from the relevant line ministry, the board is more vulnerable to conflicts of interest, as the appointee may pursue policy objectives rather than act in the best interests of the SOE. Together, these factors weaken an SOE board's autonomy, accountability, and access to relevant industry and specialized skills.

The concept of an independent board member was introduced in Uzbekistan with the Corporate Governance Code in 2016. The code, whose implementation is optional, suggests that JSCs include at least one independent member on their supervisory board. The code proposes that independent directors account for at least 15 percent of the number of directors. At the same time, although compliance with the code is not mandatory and selective, the SAMA has made an effort to mandate around 60 SOEs to adopt the code.

SOE boards in Uzbekistan lack authority in some critical functions, such as to nominate, appoint, and dismiss the CEO. This authority is fundamental to ensure executive management's accountability to the board. CEOs directly appointed by the government tend to take instructions directly from political circles, circumventing the board, a practice that significantly weakens SOEs' corporate and public governance. To maintain the integrity of the board, good practice would require at least consulting with the board on the appointment of the CEO. Regardless of the procedure, appointments should be based on professional criteria and a competitive selection procedure.[9]

Figure 7.5. Requirements for a Candidate for an SOE Board of Directors



[8] *Corporate Governance of State-Owned Enterprises: A Toolkit* (2014), World Bank.
[9] *Guidelines on Corporate Governance of State-Owned Enterprises* (2015), OECD.

Source: World Bank. 2020. *Corporate Governance of State-Owned Enterprises in Europe and Central Asia Survey*.

Supervisory boards play a central role in the corporate governance of SOEs and are an integral part of the SOE financial accountability, controls, and transparency framework. The main role of the board is to act as a check on management, ensuring that the best interest of a company and its owners is upheld. SOE boards also have an important role in shielding management from political and government interference in SOE operations. SOE boards should be empowered with the authority and autonomy to guide strategic direction, monitor performance, and hold management accountable. These necessary elements enable boards to fulfill their fiduciary duties as expected by the SOEs and the general public, as the ultimate owners.

Many countries in the Europe and Central Asia region are taking steps to improve the composition and qualifications of SOE boards. Their governments are increasingly seeking to establish a legislative framework and clear process for board nominations and appointments. Their aim is to depoliticize the process, make it more professional and transparent, and ensure that boards have the competencies and objectivity they need to carry out their duties. The governments set the requirements for potential SOE board members (Figure 7.5), covering their education, professional experience, and sometimes their integrity. Clearly defined selection criteria for board members should lead to more professional and skilled SOE boards.

C. Financial Reporting, Transparency Requirements and Practices

The financial reporting framework in place in Uzbekistan before 2021 was out of date and hindered financial transparency of private- and state-owned enterprises. As of 2020, SOEs still produced financial statements according to the National Accounting Standards, which do not provide a true and fair valuation of their assets, liabilities, equity, or financial results. Some large SOEs—such as Uzbekenergo and Uzbkeneftegas—have begun to adopt the IFRS, but the experience so far shows that significant support and strengthening of internal accounting systems are needed for this process.

Starting in 2021, the government mandated that the largest entities—private and state-owned—adopt the IFRS.[10] So far in early 2021, only selected SOEs have adopted the IFRS, and their financial statements were made public. It should be noted that the adoption of internationally recognized standards and practices, such as the IFRS, will require significant human and financial resources, and will take time to implement fully. These SOEs should be provided hands-on support for this important task and recognized for their significant reform effort.

Adopting the IFRS both reduces adoption costs for individual countries and allows comparability of financial information across countries and sectors. It also prevents the lack of local capacity from leading to lower-quality national standards. The main international standards are shown in Table 7.1.

In Uzbekistan, SOEs are required to publish their annual reports and auditor's opinions. All entities (both listed and non-listed) except small and micro-entities are required to prepare

[10] Decree of the President of Uzbekistan #4611, February 24, 2020.

quarterly financial statements. All types of SOEs (unitary, joint-stock companies, limited liability companies, and state enterprises) use a uniform nationally based financial reporting set of statements, which comprises an income statement, balance sheet, cash flow statement, and statement on capital. While the income statement does not provide sufficient data to compile government finance statistics, the cash flow statement and balance sheet provide a satisfactory level of details on revenues and expenditures, financial transactions, and stocks of assets and liabilities, respectively.[11] Yet, such information is not aggregated for statistical purposes and is not available for a sector-level analysis.

Table 7.1: Main International Standards on Transparency, Disclosure, and Controls

Topic	International Standard	Standard-Setter
Financial reporting	International Financial Reporting Standards (IFRS) and IFRS for Small and Medium-Sized Enterprises (SMEs)	International Accounting Standards Board
Internal audit	International Standards for the Professional Practice of Internal Auditing	Institute of Internal Auditors
Internal control and risk management	COSO Internal Control–Integrated Framework	Committee of Sponsoring Organizations of the Treadway Commission
External audit	International Standards on Auditing (ISA) International Standards for Supreme Audit Institutions (INTOSAI)	International Auditing and Assurance Standards Board International Organization of Supreme Audit Institutions
Corporate governance	Principles of Corporate Governance SOE Corporate Governance Guidelines	OECD

Source: Corporate Governance of State-Owned Enterprises in Europe and Central Asia Survey (December 2020), World Bank.

Uzbekistan has established a rather early filing system for annual reports, which are due within three to six months after the end of the financial year. All companies—private- and state-owned—are required to file their annual reports much sooner than in most other countries in ECA. As a result, the reports are less informative and lack the proper quality of information.

Public access to information is legislatively regulated; however, enforcement is lacking. Uzbekistan requires companies, including SOEs, to publish their annual reports on their websites. This requirement is being legislatively strengthened from 2021 onward and has yet to demonstrate its effectiveness. All JSCs are required to publish their financial and non-financial reports on the Open Info platform,[12] although not all SOEs publish their data on the website. At the same time,

[11] *Uzbekistan: Strengthening Fiscal Transparency* (2019), IMF. https://www.imf.org/en/Publications/CR/Issues/2019/05/01/Republic-of-Uzbekistan-Strengthening-Fiscal-Transparency-46846.

[12] http://www.openinfo.uz/en/.

SAMA also publishes SOEs' financial information on its own portal, with about 1,360 presently covered.

An important step in improving SOEs' financial transparency would be a publication of an aggregate report on the SOE portfolio. Aggregate reports should provide an indication of the total value of the state's SOE portfolio and include a statement on the state's ownership policy and its implementation progress. Aggregate report should also contain other important information, including: (i) sectoral distribution; (ii) financial performance; (iii) performance-related financial and nonfinancial indicators; (iv) transfers or subsidies provided to SOEs, dividends received from SOEs; (v) summary of sales of assets; (v) information on the organization of the ownership function; (vi) overview of the evolution of SOEs and reporting on changes in SOEs' boards; and. Aggregate reporting does not need to duplicate the individual SOEs reports. To enable such reporting, the ownership agencies (SAMA and the MoF) need to concentrate their efforts on building up capacity to process and analyze the SOE data. Currently, there are no requirements for aggregate SOE reporting, while SAMA is aiming to produce the first such report for the 2020 financial year.

The system of SOE performance monitoring is largely in place. Since 2016, all SOEs have had to follow and report on a set of key performance indicators (KPIs). The KPI system of monitoring includes 13 mandatory KPIs and 13 supplementary ones; the former include earnings, costs, rate of return, liquidity, indebtedness, and ability to service debt. The performance of an enterprise is measured using the so-called "integrated efficiency indicator," which is computed as a weighted average of primary performance data. The total weighted score affects the SOEs' management remuneration.

The internal audit function is not fully developed in Uzbekistan, but the first steps have been taken in the right direction. In Uzbekistan, SOEs are not legally required to establish an audit committee. Uzbekistan mandates that joint stock or limited liability companies establish internal audit, but the country has no such requirement for unitary unincorporated state enterprises. At the same time, the country established a clear mechanism of subordination of internal audit to SOEs' boards or their audit committees, which aligns with good corporate governance practices.

It is considered good practice for SOEs to be subject to an independent audit by a reputable professional firm; the practice is only beginning to be implemented in Uzbekistan. An independent external audit contributes to the credibility of an SOE's financial reporting and provides reasonable assurance to the owner, investors, and the general public that the financial statements fairly represent the company's financial position and performance. In some countries, SOEs may be subject to regular audits by a state audit institution (SAI). However, the SAI's mandate differs from that of an independent auditor's, and the SAI does not generally provide an independent view on the fairness and completeness of the full set of financial statements. Many SOEs are audited by both the SAI and independent external auditors.

Uzbekistan adopted the International Standards on Auditing (ISA) from the start of 2020. The OECD guidelines recommend that all SOEs—regardless of their legal status and whether they are listed on a stock exchange —should report according to the internationally accepted accounting and auditing standards. The ISA was introduced by the President's Resolution in 2018, but the standards only took effect in 2020; therefore, it is too early to draw conclusions about their impact.

Several key issues need to be considered to ensure that the state, minority shareholders, and other stakeholders derive the maximum benefits from independent audits of SOEs;

- **Equal requirements for private and state-owned entities.** In all aspects of financial reporting and external audit, economically significant SOEs should be governed by the same rules and procedures as equivalent public interest entities (PIEs) in private ownership. For example, if private sector PIEs are required to have their financial statements audited in line with ISA, the same requirement should apply to economically significant SOEs.
- **Audit quality and regulations.** SOE auditors should fall under the same regulatory and professional framework as auditors of listed companies and banks. The framework should include requirements relating to external quality assurance, qualifications, ethics, and independence.
- **Publication and disclosure.** Independent auditors' reports should be published together with the complete set of SOEs' financial statements and accompanying notes.
- **SOE boards' communication with external auditors.** Financial reporting and audits should be subject to continuous scrutiny by SOEs' boards and their audit committees, as well as by ownership agencies.

Independent selection of the external auditor is crucial for ensuring a high-quality outcome. The selection of external auditors should be a transparent process that relies on a combination of qualitative requirements and price, and it should be free of undue management involvement. Uzbekistan uses open public tender for selecting external auditors for SOEs. A consequence of using the lowest quote as the key selection criterion is that little consideration is given to quality of bidders, including through a detailed review of audit teams' experience and capacity. This often results in poor quality and low value of audits, and thus weak accountability of SOEs.

D. Privatization Progress

While Uzbekistan has undertaken ambitious reforms that have delivered improvements to its business and investment climate, reducing the state presence in the economy has been slow. The government has experimented with various privatization processes since the late 1990s: over 3,000 SOEs have been fully or partially privatized since 2005, the earliest year data are available. However, these enterprises were small and did not have a significant impact on the economy.

The government will imminently start a larger and more strategic SOE reform and privatization process. Most recently, the main foundation of this process is the Presidential Resolution on measures to accelerate the reform of enterprises with state participation and privatization of state assets (October 2020), which provides a categorization of SOEs, including those SOEs where the government will divest. Moreover, the government has prepared a draft Privatization Law meant to consolidate the rules in this area.

During 2020, the government evaluated a group of 18 SOEs for privatization.[13] The entities that are now undergoing the pre-privatization assessment and due diligence rare from sectors where private participation would be typical. Most of the SOEs presently in the privatization process are small- to medium-size, but their privatization will set a precedent. Therefore, it is important to carry out this initial stage in accordance with good international practice.

While putting in place a robust legal framework for privatization would represent a major milestone, the current setup does not provide clarity on the institutional mandates for privatization. A "lead" authorized body for implementation of privatization has not been designated. Moreover, the existing legal framework does not address the accountability of the various institutions involved, nor does it provide clarity on the mechanisms for safeguarding the public goods aspect in privatization (supervision). To ensure the transparency, credibility, and efficiency of a mass privatization program, it is essential to set up and adopt an appropriate institutional framework as envisaged by the draft Privatization Law.

Being a latecomer to privatization of a predominantly state-dominated economy, Uzbekistan can learn from other countries under similar circumstances and avoid the mistakes they made. The widespread approach in transition countries was to privatize as quickly as possible, and thus mistakes were made: assets were often sold to connected "insiders" at low prices, institutions vital to support the market did not develop, and ambitions that privatization would lead to capital market development remained unfulfilled. In fact, the evidence on the benefits of privatization was the weakest for those countries in Eastern Europe, where privatization was implemented most rapidly.[14]

Box 7.1: The transitions in Russia and Poland in the 1990s

In Russia, rapid liberalization was economically and financially necessary to address massive price distortions and debt overhangs. But difficult initial conditions accentuated initial shocks which, together with a continuing lack of political consensus, slowed macroeconomic adjustment. Small privatization was easy and provided many benefits, but enterprises ended up being dominated by insiders. The legal/regulatory framework retained huge gaps for at least a decade, reflecting Russia's left-leaning legislature and bureaucracy. Implementation was even more problematic, due to Russia's near-total lack of "market memory." Desires to end medium/large SOE claims on public finances and fears of a communist resurgence drove the Yeltsin government to pursue rapid voucher privatization of medium/large SOEs. But insider dominance (inevitable, due to Soviet-era initiatives) and incomplete/ineffective market institutions limited post-privatization incentives for raising the competitiveness of these firms.

In Poland, medium/large privatization was slowed by worker resistance and public suspicion of FDI. It is not obvious, however, that this relative slowness hurt Poland's transition. Small privatization moved quickly and provided employment, competition, and consumer benefits, but was also dominated by insiders. Poland made notable strides in filling in its market infrastructure and developing its financial sector – aided by a stronger anti-communist popular consensus, availability of legacy laws, and greater market memory and exposure to the West.

[13] Decree of the President of Uzbekistan #4611, February 24, 2020.
[14] Meggison and Netter (2001).

Effective implementation of further SOE reforms and privatization measures could create significant room for private sector growth. The approved resolution sets out a strong commitment to strengthen corporate governance and begin the process of privatization for smaller and medium enterprises. The resolution specifies ambitious timeframes, with the bulk of the work to be done in 2021, pandemic conditions permitting. As a follow-up to this resolution, the government will also adopt several subsidiary regulations in the coming months to further clarify the government's framework for SOE liquidation, the conversion of SOEs into public–private partnerships, and privatization and restructuring decisions for several larger SOEs.[15] These measures, if successfully and transparently implemented, could create significant opportunities for the growth of small and medium private sector businesses across the country, while also improving the government's financial position and reducing fiscal risks.

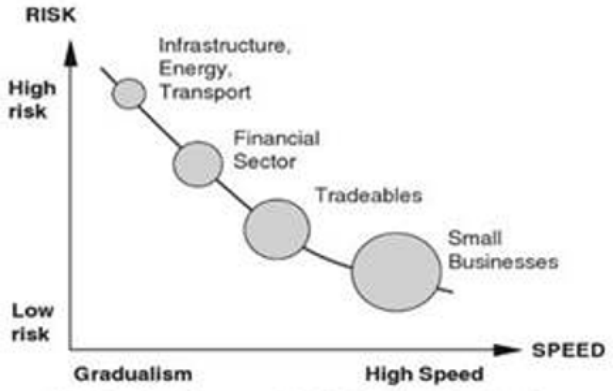
Lessons that Uzbekistan can learn from the experience of these countries include:

- Broader institutions are essential, such as rule of law, competition, market regulation enforcement, good governance, and regulation matter prior to embarking on a mass privatization program.[16]
- In order to have a just, transparent, and accountable privatization process, a comprehensive institutional framework is required, with three levels: the policy level, the implementation level, and the supervision level.
- At the implementation level, most of the countries in Eastern and Central Europe opted for a standalone privatization ministry and/or agency: "*a professional and informed authority, operating at arm's length from policy making and regulatory responsibilities, should steer the execution of the transaction in close coordination with decision makers, with the early involvement of key stakeholders including the company's board and management, external advisors, employees and labor groups and in communication with the public. The overall process should benefit from high-level political support and inter-ministerial dialogue to overcome bureaucratic inertia.*"[17]
- Small-scale privatization can be implemented quickly, while larger companies and the financial sector require much more effort (including restructuring) and time. The pros and cons of each privatization model require careful consideration. The privatization process for small versus large privatizations should differ**.** For small companies, the process should be simpler, with the preparation of an informational package and the sale through an auction. For larger companies in strategic sectors, the sale through a tender is more appropriate. Moreover, restructuring prior to privatization may be required (which could include a range of activities related to reorganization, optimization of employees, settling debts, corporatization, unbundling of networks, etc.).

[15] Over a thousand of the poorest performing SOEs are estimated to be potential candidates for liquidation.
[16] Guriev and Megginson (2005).
[17] *A Policy Maker's Guide to Privatisation, Corporate Governance* (2019), OECD. https://doi.org/10.1787/ea4eff68-en.

- The success of a privatization program largely depends on the quality of the SOEs being privatized. The government needs to assess its portfolio of SOEs, both those designated for privatization and those designated as "strategic," the latter of which may be of more interest to potential foreign investors. Basic information on finances—especially indicators of profitability and solvency—and employment are especially needed for informed assessment and discussion of privatization program design issues and alternatives. This would help address some important questions, such as whether all the SOE privatization objects are viable in their current business and how many might be of interest to foreign direct investors. A realistic assessment of prospects would guide decisions on how much to invest in a global road show and retention of high-level international transaction advisors.

Figure 7.6: An Overview of Privatization in Transition Economies: Speed vs. Gradualism



Source: *Privatization in Transition Economies: The Ongoing Story* (2007), editors Ira W. Lieberman and Daniel J. Kopf.

- Evidence suggests that the privatization of SOEs and the state-owned banks had a greater positive impact when it was complete rather than partial.
- Social implications (job losses) need to be carefully considered, and social measures should be defined and regulated early in the process, in consultation with labor representation.
- The potential interconnection between the operation of SOEs and SOCBs, including the resolution of nonperforming loans to SOEs, should be considered.
-

E. The Path Forward

The government of Uzbekistan is committed to reducing the state's share in the economy while keeping a limited number of large SOEs in state ownership. This process needs to be structured with care, strategically implementing the recent mapping of the SOE portfolio to fulfill the government's intent to: (1) keep certain entities for strategic or other reasons; (2) privatize; (3) restructure, merge, consolidate, or unbundle; or (4) close nonviable entities. This analysis and the adoption of the SOE Ownership Strategy are the foundation for "rightsizing" the SOE sector and bringing in private capital.

SOEs that will remain in state ownership must be held to the same requirements as private entities, and gradually transitioned to cost recovery and financial sustainability. To improve their operational efficiency and financial performance, SOEs should be put on equal footing with the private sector and commercialized. Mechanisms should be put in place to ensure sufficient operational autonomy of SOEs, stronger corporate governance, management incentives aligned with SOEs' financial performance, and enhanced transparency, including proper accounting and audit requirements.

Privatization needs to be implemented in a just, transparent, and accountable way. In order to do so, a comprehensive framework is needed. This includes a clear and predictable regulatory framework, institutional mandates that ensure accountability (policymaking, implementation, and supervision of privatization), applying an evidence-based approach to ensure clarity on SOE prospects for privatization, and putting in place measures that will ensure a social safety net for employees of SOEs who might be affected by privatization.

The following reform recommendations will set Uzbekistan on its ambitious goal to reduce the state's footprint in the economy and attract private sector participation. In this context, the proposed support activities will build the foundation for strategic assessment of the state's role in the economy and as an owner of SOEs.

Table 7.2: Reform Recommendations

Issue	Recommendation	Priority*
Corporate Governance		
Most of the SOEs' supervisory boards are led by high-profile civil servants.	Gradually reduce the civil servants' participation on SOE boards to closer align corporate governance structure with the good practices, and shield SOE management from political and government interference in SOE operations.	Medium term
Supervisory boards insufficiently active in strategy-setting, appointing, remunerating, and removing management boards, or assuming responsibility for efficient internal controls.	Supervisory boards need to be adopted more broadly and be empowered by legislation to properly exercise their functions and act as effective governance bodies.	Medium term
Board committees are rare at SOE supervisory boards in Uzbekistan; the board function is substituted by the annual meeting if the SOE has fewer than 30 shareholders.	Envisage supervisory board committees to support SOE supervisory boards in taking well-informed and considered decisions, i.e., audit committee, compensation committee, and other committees depending on the needs of specific SOEs.	Medium term
Lack of independent board members.	Introduce independent board members with the skills matching each SOE's long-term strategy and need. Consider engaging out-of-country expertise. Set professional requirements for the board members. Consider staffing board committees with board members possessing appropriate skills and experience, preferably headed by independent board members.	Medium term
Financial Reporting, Auditing, and Disclosure		

Timely adoption and enforcement of IFRS by SOEs. **Introduction of ISA-based audits.**	Follow the current plans to adopt IFRS by SOEs and enforce its use through appropriate measures. Enforce that SOE financial statements are audited under ISA, as required starting with the 2020 financial year.	Short term
Discrepancies in SOE accounting and disclosure practices.	Enforce SOE publication requirements, ensuring audited financial statements and management reports are publicly disclosed by SOEs.	Short term
Insufficient oversight of financial reporting requirements.	Perform periodic (at least yearly) review of each SOE's performance. Require SOEs to establish an auditing committee. Require unitary unincorporated SEs to establish internal audit (on a par with only the joint stock or limited liability companies). Improve scrutiny of financial reporting by requiring independent audits by reputable firms.	Short term
No aggregate reporting of the SOE portfolio.	Ensure that SAMA effectively undertakes the function of conducting centralized monitoring, analysis, and oversight function over SOE performance. Introduce SOE aggregate reporting (by SAMA). Develop an IT platform for aggregation and regular publication of large SOEs' financial statements.	Short term
Macro-Fiscal Implications, Public Service Obligations		
No information available on the fiscal costs of SOEs' core and non-core operations.	Disclose the quasi-fiscal activities of SOEs in both: (1) the government budget; and (2) SOE financial statements. Disclose non-core activities of SOEs for social spending, mandated by the government, separately from commercial activities–public service obligations (PSOs).	Short term
No system exists to estimate and manage budget implications of SOE PSOs.	Design and implement a system for compensating SOEs for PSOs transparently from the budget. Assess and implement an appropriate method of calculating the costs that generate quasi-fiscal deficits as	Medium term

	discussed in the OECD's *Accountability and Transparency Guide for State Ownership* (2010).	
SOEs are dependent on budget funding and bailouts.	Impose hard budget constraints for SOEs	Medium term
SOEs' dependence on SOCBs and directed lending is still substantial.	Gradually reduce directed lending to SOEs. Bank lending should be on the same terms for all companies, public and private.	Medium to longer term
Privatization Aspects		
The institutional and legal framework for privatization is fragmented and outdated.	Finalize and adopt the Privatization Law and detailed regulations, including institutional setup for policymaking, implementation, and supervision, as well as clear accountability of all actors.	Short term
Lack of an evidence-based approach to understand SOEs' prospects for privatization and inform methods and timing of privatization.	Collect and review basic information on profitability, solvency, and employment of SOEs to be privatized, to inform decisions on prioritization, methods, and timing of privatization.	Short term
Unclear safety nets strategy and measures for employees of SOEs that are subject to privatization.	The social impact of privatization must be assessed, and respective social nets designed and put in place. As the impact of privatization on employment can be significant, the strategy and social programs should be set at the highest level (Parliament/Cabinet).	Short to medium term
No medium- or longer-term plan for privatization established.	The existing privatization program is short term and does not set medium-term goals. A phased approach would entail: 1. Scaling up privatization of small SOEs through the e-auction platform in the short term. 2. Applying a medium-term phased approach for larger SOEs. Selected larger SOEs would be privatized in an initial pilot phase. This would allow identifying any regulatory or practical bottlenecks that could be corrected once the privatization process is scaled up for this category of SOEs.	Short to medium term

*Short term = within a year; Medium term = 1-3 years; Longer term = >3 years

Annex A7.1. Top 15 SOEs by Revenues, 2018–19

Name	Sector	Total Revenues (USD, million)	Net Profit (USD, million)	Total Assets (USD, million)	Total Borrowings (USD, million)	Employees (thousand)
SE Navoi Mining and Metallurgical Company (4)	Natural Resources	$3,405.60	$231.60	$2,055.00	$809.50	57.0
JSC Uzbekneftegas (1, 3)	Natural Resources	$2,756.66	$327.38	$9,260.15	$4,185.68	127.1
JSC Uztransgas (3)	Natural Resources	$2,215.94	$(234.55)	$4,239.72	$976.46	36.4
JSC Almalyk Mining and Metallurgical Company (1, 5)	Natural Resources	$2,015.86	$269.47	$2,495.27	$648.01	30.7
JSC Uzbekenergo (1, 2)	Energy	$1,139.44	$51.27	$4,824.53	$2,587.49	48.2
JSC Uzbekiston Temir Yullari	Infrastructure (Railways)	$920.18	$(39.91)	$3,939.35	$1,915.80	93.5
JSC Uzbek Metallurgical Plant (Uzbeksteel) (5)	General Manufacturing	$595.32	$39.90	$433.75	$113.49	9.8
JSC Uzbektelecom	Infrastructure (Communications)	$348.82	$1.52	$754.64	$345.29	15.3
JSC Navoiazot	General Manufacturing	$165.72	$4.48	$1,389.84	$1,194.04	30.7
JSC Uzbek Kumir / Uzbekcoal (6)	Natural Resources	$54.90	$(9.02)	$271.81	$164.99	No Info
JSC Uzbek Post (1)	Other (Communications)	$18.49	$(0.27)	$19.83	$2.30	7.5
JSC Uzkimyosanoat	General Manufacturing	No Info	$2.87	$230.03	$10.78	29.7
JSC UzAvtoSanoat	General Manufacturing	No Info	$48.80	$541.73	$24.59	24.0
JSC Uzdonmahsulot (1)	Food & Agro	No Info	$2.04	$629.71	$548.90	17.0
JSC Uzbekistan Airways	Infrastructure (Air Transport)	No Info	No Info	$1,976.74	$1,186.06	16.3

(1) SOEs' audited IFRS-based financial statements.
(2) JSC Uzbekenergo was unbundled in 2018, into three SOEs: JSC Thermal Power Plants, JSC Uzbekistan National Electrical Grid", and JSC Regional Electrical Grid.

(3) JSC Uztransgas was unbundled from JSC Uzbkeneftegas in 2018.

(4) Proforma IFRS for Gold Segment Only.

(5) Under trust management of SFI Management Group.

(6) Under trust management of Central Asia Energy LLC.

Annex A7.2. SOEs to Be Privatized in 2021

Name	Sector	State Ownership (percent)	Total Revenues (USD, million)	Net Profit (USD, million)	Total Assets (USD, million)	Employees (thousand)
LLC Fergana Oil Refinery*	General Manufacturing	100.0 percent	$328.17	$51.74	$89.03	No Info
LLC Coca Cola Uzbekistan**	Food & Agro	57.0 percent	$164.80	$23.44	$61.90	1.7
JSC Ferghana Azot**	General Manufacturing	48.0 percent	$133.86	$17.90	$119.16	7.5
JSC Tashkent Wine Factory	Food & Agro	51.8 percent	$58.90	$8.76	$23.38	0.8
JSC Quartz	General Manufacturing	89.5 percent	$27.94	$4.40	$37.51	2.3
JSC Nukus Wine Factory	Food & Agro	51.0 percent	$17.08	$2.58	$8.24	0.2
JSC Uzbekkimyomash	General Manufacturing	44.7 percent	$12.12	$0.15	$9.85	1.5
JSC Mastona	Food & Agro	51.0 percent	$5.97	$0.30	$1.57	0.2
JSC Shaxrisabz Distillery (Vino-Aroq)	Food & Agro	51.0 percent	$5.65	$0.68	$2.89	0.3
SE Qibray Alcohol Research Experimental Facility (Sharob ilmiy-eksperimental korxonasi)	Food & Agro	100.0 percent	$4.91	$0.24	$1.47	0.2
JSC Konvin	Food & Agro	51.0 percent	$4.13	$0.44	$1.26	0.1
JSC Urganch Alcohol (Sharob)	Food & Agro	60.3 percent	$4.10	$0.00	$1.71	0.2
JSC Uzbekistan Champagne	Food & Agro	51.0 percent	$3.97	$0.22	$1.46	0.2
JSC Kokand Mechanical Plant	General Manufacturing	64.1 percent	$3.57	$(0.86)	$3.52	0.6
JSC Khovrenko Samarqand Wine Factory	Food & Agro	71.2 percent	$3.50	$0.05	$1.01	0.2
JSC Jizzakh Plastic (Plastmassa)	General Manufacturing	85.8 percent	$3.38	$0.40	$4.55	0.2
JSC Kafolat Insurance Company	Financial Sector	49.3 percent	$3.36	$0.94	$18.77	0.2
JSC Sirdaryo Wine	Food & Agro	51.0 percent	$1.67	$(0.10)	$0.72	0.1
JSC Trest-12	General Manufacturing	51.1 percent	$0.00	$0.29	$5.89	3.3
JSC Electrical Rural Construction (Elektr qishloq qurilish)	General Manufacturing	53.4 percent	$0.00	$0.01	$5.64	1.1

* Under trust management with LLC Jizzakh Petroleum since 2019. Info obtained from UzAssets RFP.
** SOEs are in privatization process, not part of President's Decree, October 2020.

Spotlight 3. Energy

Energy reform is among the highest reform priorities for the government of Uzbekistan. Addressing the inadequate operational and financial performance of the energy state-owned enterprises (SOEs), removing infrastructure bottlenecks, and improving the institutional and market structure—these are some of the key areas of reform. In addition, the authorities need to revamp the policy and regulatory framework of the energy sector. Energy reform would address some of the most binding constraints to economic activity and private sector. It would also tackle one of the most pressing service delivery complaints of citizens. Financially viable, operationally efficient, and commercially-run energy SOEs would also help the energy sector attract private investment. A well-designed and -implemented energy sector reform program therefore has the potential to create more jobs, improve welfare, and demonstrate the responsiveness of government to citizen and business feedback through improved energy service delivery.

A. Context and Challenges

Uzbekistan ranks among the top countries in the world with large energy and mineral reserves, including natural gas, gold, copper, uranium, and coal. The country has significant potential in renewable energy, such as solar, wind, and hydro, that can cater to its growing energy needs while supporting a transition to a clean energy economy. Uzbekistan's strategic location also presents an opportunity for the country to become a regional hub for energy.

Uzbekistan's energy sector is a major contributor to the country's economy, accounting for about 25 percent of industrial output and 8 percent of GDP in 2019. Energy is a large source of export earnings; energy exports, predominantly of natural gas, accounted for 20 percent of total commodity exports in 2019. It is also among the largest job providers, employing about 150,000 people.

Uzbekistan is one of the most energy intensive countries in the world. While Uzbekistan's energy intensity declined by about 45 percent during the past 15 years, the country's energy use per unit of GDP is about 3 times higher than the average for the Europe and Central Asia region, two times that of neighboring Kazakhstan, and six times that of Germany. Thus, there are significant opportunities to improve economic competitiveness by enhancing energy efficiency, primarily in the largest energy-consuming sectors. Industry accounts for the bulk of energy demand (41 percent) followed by residential consumption (24 percent), agriculture (21 percent), commercial (11 percent), and others (3 percent). The International Energy Agency estimates that implementing energy efficiency measures has the potential to curb required generation by 10 percent by 2040. The demand for electricity is expected to grow from 61.2 TWh in 2018 to over 100 TWh in 2030.

The energy sector is undiversified and highly dependent on natural gas. Natural gas makes up 86 percent of total primary energy consumption and more than 80 percent of the fuel mix for power generation. It is a major source of commodity exports, but its existing proven gas reserves are becoming depleted (at the current pace of consumption, the existing proven gas reserves will be

depleted within about 20 years).[1] The system is therefore vulnerable, and the country is taking actions toward sustainable energy transition pathways. The price of natural gas for domestic consumption is kept at about 50 percent of the prevailing rate for international export, thus entailing significant implicit subsidies across the economy.

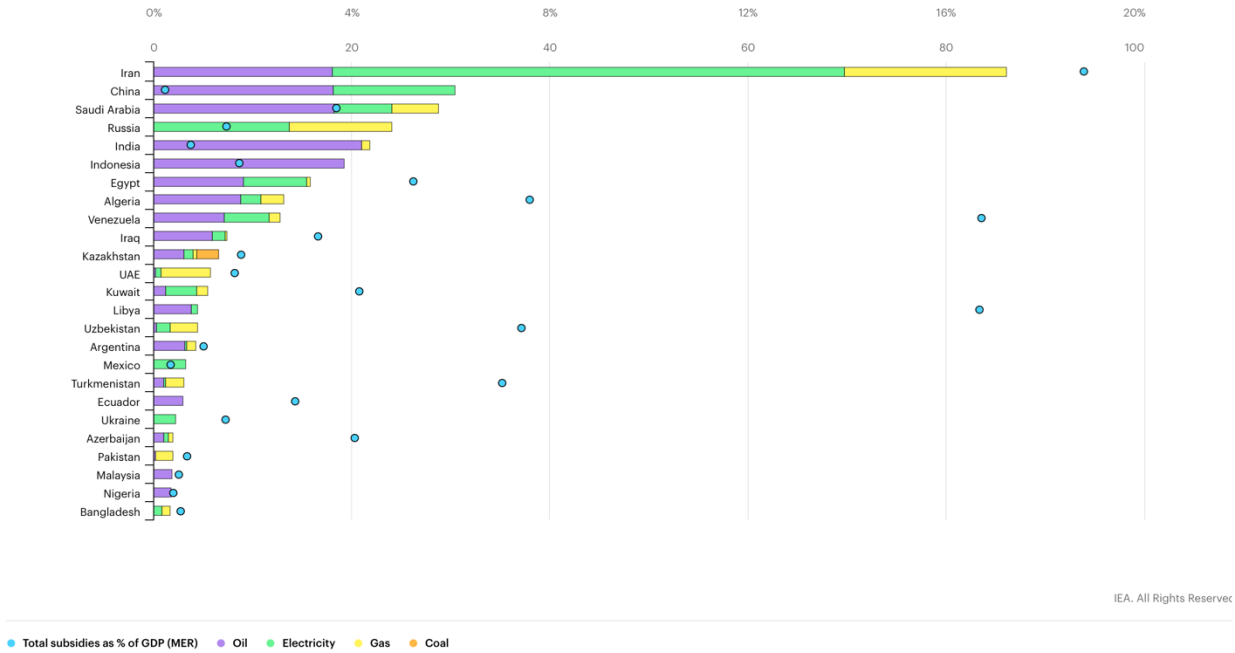
Renewable energy is a promising source of energy diversification, but is virtually unused. The estimated technical potential of renewables (3,494 TWh/year) is significantly higher than the current demand for electricity (61.2 TWh/year). Renewable energy is increasingly becoming economically competitive, but in Uzbekistan, its use is a small fraction of the potential and limited to hydropower. Factors constraining renewable energy development, particularly solar and wind, include the inadequacy of the institutional and planning framework, lack of transmission network capacity and power system flexibility, large subsidies to fossil fuels, financial weaknesses of unbundled electricity utilities (generation, transmission, and distribution), and absence of sustainable market-based financing of renewable energy investments.

The financial situation of the power sector has deteriorated over the past few years. The sector cash deficit was mainly caused by: (1) high technical and commercial losses, which are not fully recouped through the normative thresholds of losses established in tariff reviews; (2) relatively low collection rates (83-93 percent of revenue invoiced) until 2017, when the utility bill collection responsibilities were temporarily transferred to the Bureau of Forced Execution with enforcement authority; (3) increasing indebtedness in foreign currencies, which has added to the currency mismatch between the revenues and expenditures of the electric utility Uzbekenergo (UE) and the foreign exchange risk materializing after the currency devaluation in September 2017; and (4) below cost-recovery tariffs.

Despite the recent tariff reforms, energy subsidies accounted for around 7.4 percent of GDP in Uzbekistan in 2019. Tariffs for natural gas and electricity tariffs are not yet at the full cost-recovery level. Domestic gas prices are about 60 percent of cost and about half of the international export price. Currently, the average electricity retail tariff of about US¢4.2 /kWh (value-added tax inclusive) equivalent is not sufficient to recover the full cost of service, especially as the sector moves to increase capital investment to meet the growing demand. Also, once gas supply is no longer subsidized, power tariffs would need to pass through increases in gas prices to cover the higher cost of fuel. By phasing out its subsidies on gas and power, Uzbekistan has the opportunity to send appropriate price signals to consumers of energy, which will likely lead to a reduction in its excessive reliance on gas and in the overall energy intensity of its economy. Removal of fossil fuel subsidies will also make investment in renewable energy generation more attractive. Finally, it can release fiscal resources to be directed to other priorities. However, given the potential impacts of subsidy removal on households and firms, energy price reforms will need to be carefully managed. Social assistance to protect vulnerable households and energy efficiency programs to support firms are internationally recognized approaches to accompany reforms. Measures to improve the reliability and quality of energy supply will make price increases more acceptable, while effective communication with the public is essential to smooth the process (Figure S2-1).

[1] *BP Statistical Review*, 2019. Of course, there may be other substantial natural gas resources that are currently unexplored and unproven.

Figure S2-1. Countries with the largest energy subsidies, 2019



Source: International Energy Agency.

The COVID-19 outbreak has adversely impacted Uzbekistan's energy sector. This reflects a drop in demand because of the slowdown in economic activities; change in the demand profile (industrial versus residential); lower collection efficiency due to increasing payment delinquency; and supply chain disruptions, mobility restrictions, and delays for maintenance and infrastructure works. A preliminary assessment suggests that COVID-19 resulted in an $80 million cash deficit of the electricity sector.

Limited private financing and investment constrain the sector modernization. Financing to address the modernization needs cannot be met by the government alone. According to the Least Cost Power Generation Expansion Plan, supported by the World Bank, Uzbekistan requires an additional 15.42 GW in installed capacity by 2030 to meet expected increases in demand. This requires investments of around $15 billion by 2030, or around $1.2 billion per year on average. Similarly, investment needs in the gas sector are expected to be significant. For example, an upgrade of the aging gas transport and distribution system is estimated at around $1.5 billion. A gas masterplan is under preparation to define the required investments and estimate financing needs along the entire value chain. Raising private financing would be a feasible strategy, subject to improving the financial viability and creditworthiness of the energy utilities.

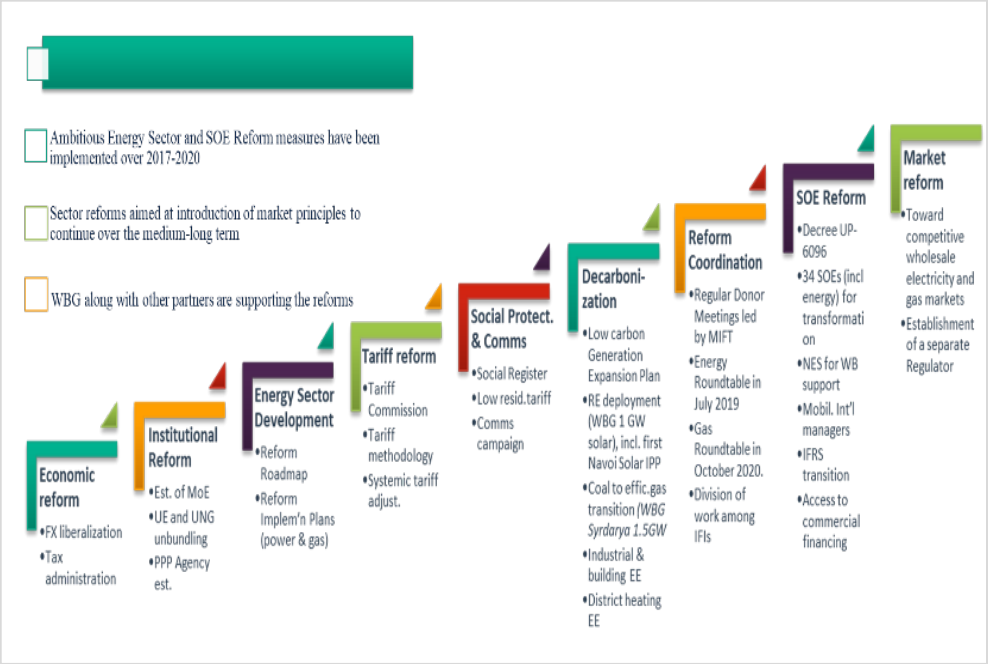
The energy sector institutional architecture has historically been a major constraint to its development and financial viability. Until mid-2019, the energy sector was managed directly by Uzbekneftegaz (UNG) and UE. They used to report to multiple deputy prime ministers, government ministries and agencies, and there was no clear delineation of policymaking, regulatory, and operational roles. There was no regulator to oversee the gas and electricity operations and quality of energy service delivery. These issues have begun to be addressed with the establishment of the Ministry of Energy (MoE) in 2019 and reforms to unbundle the vertically

integrated companies. Significant capacity building is required within the MoE so it can assume its responsibilities for policymaking and regulation in the energy sector, which also includes coal and nuclear power. Day-to-day operations are delegated to the unbundled UE and UNG entities, while reforms to open the sector to greater competition are designed and implemented.

B. Assessment of the Transition during 2016–2020

The authorities have initiated ambitious energy reforms that envisage introducing competitive market principles in the sector management and operations. Building on the Development Strategy for 2017–21 , the government has undertaken several critical reviews of the energy sector, based on which the following have been identified the key considerations for reform: (1) improving service quality and reliability; (2) leveraging private investment financing in power generation and distribution; (3) enhancing the financial viability of the sector; (4) improving transparency and accountability of sector entities; (5) unbundling UE as an initial step toward the adoption of a wholesale electricity market model in the future; (6) adopting good international practice (Figure S2-2). Ambitious reforms have been underway mainly in three key areas: (i) conventional areas, encompassing the upgrade and modernization of existing infrastructure and improvement of the energy supply reliability; (ii) energy market reforms, improvement of sector governance and intuitional setup, and corporate transformation of energy SOEs; and (iii) clean energy transition, especially through private sector participation.

Figure S2-2. Energy sector reforms in 2016-2020

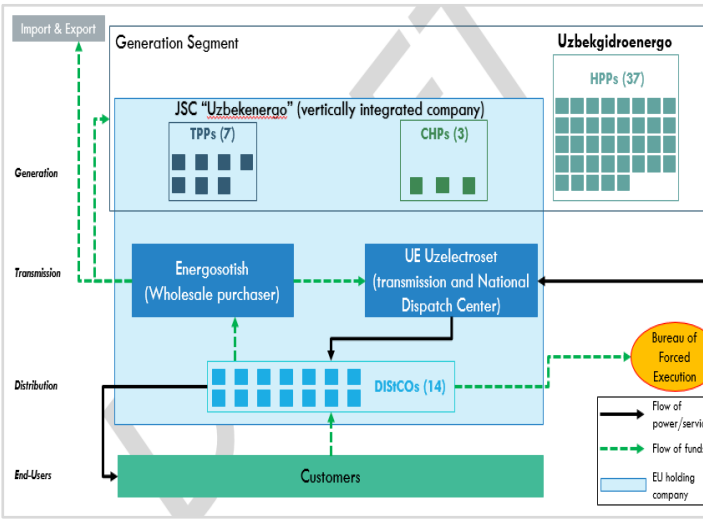


Source: World Bank team based on the government energy sector reform initiatives.

Sector oversight functions have been consolidated under the Ministry of Energy, which was established in February 2019. Before the establishment of the MoE, there was no clear

delineation of policymaking, regulatory, and operational roles, and no regulator existed to oversee gas and electricity operations. The MoE has assumed overall responsibility for policymaking and regulatory functions in relation to gas, coal, nuclear power, and electricity, while day-to-day operations have been delegated to the sector entities. As a priority, the MoE is tasked with designing and implementing reform measures for the electricity sector and creating an enabling environment for the establishment of a separate regulatory authority in the short to medium term.

Figure S2-3. Pre-unbundling electricity market structure

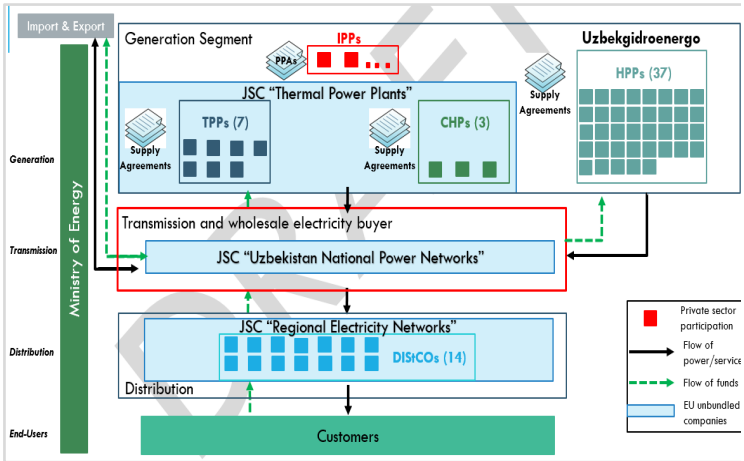


Source: World Bank based on the Presidential Resolution on unbundling of energy sector.

A Presidential Resolution required the unbundling of the vertically integrated unitary enterprises into separate companies in March 2019. These uncorporatized SOEs fully owned by the state government, were: Generation ("Thermal Power Plants" Joint Stock Company (JSC) [TPP]), Transmission ("Uzbekistan National Power Networks" JSC [NES]), and Distribution ("Regional Distribution Network" JSC [RES]) (Figure S2-3). The resolution also decided on the divestment of 99 noncore assets and their transfer from the sector utilities to the State Asset Management Agency. A similar Presidential Resolution, on the unbundling of UNG, the vertically integrated oil and gas company, was issued in July 2019. UNG was unbundled into Uzbekeneftegaz JSC (UNG; upstream, refining, and petrochemicals), Uztransgaz JSC (UTG; gas transmission), and Khududgastaminot JSC (KGT; gas distribution).

Electricity and gas tariff reforms have commenced and remain a top priority to build a solid foundation for the energy sector development. The Cabinet of Ministers issued a resolution in April 2019 that adopted a new electricity tariff methodology and established a separate tariff commission. It is setting out a path for tariffs to be regularly and systematically adjusted to full cost-recovery. A draft natural gas tariff methodology is also at the final preparation stage. Moreover, tariff adjustments in 2018–19 brought the weighted-average electricity tariff

Figure S2-4. Post-unbundling electricity market structure



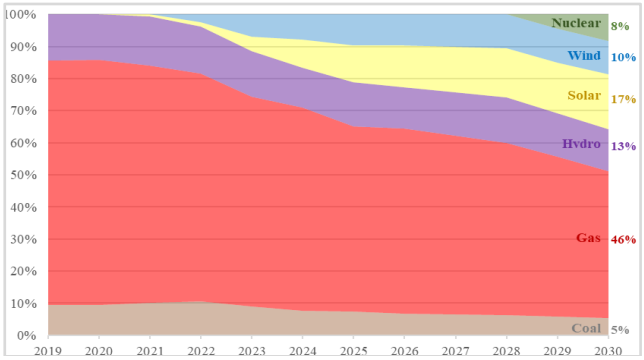
Source: World Bank based on the Presidential Resolution on unbundling of energy sector.

from 70 percent of cost recovery at the beginning of 2018 to 92 percent in 2019.[2] However, despite the recent tariff reforms, the current level of the weighted-average retail tariff of UZS 411/kWh (US¢4.2/kWh equivalent) is still insufficient to recover the full costs, mainly capital investments, especially as the sector moves to increase capital investments, predominantly into power generation assets to meet the growing demand for electricity.

Since the start of the reforms in 2017, the government has taken important steps to strengthen the financial transparency of the large SOEs and address institutional weaknesses. The government adopted measures requiring Uzbekenergo and Uzbekneftegaz to adopt international financial reporting standards and produce updated audited financial statements compliant with the new standards. Both utilities are nearly up to date and audits compliant with International Financial Reporting Standards. Furthermore, Presidential Decree #6096 from October 27, 2020mandates further reform actions to improve the financial, operational, and commercial performance and management of the SOEs, including the energy enterprises (for more detail, see Chapter 7)..

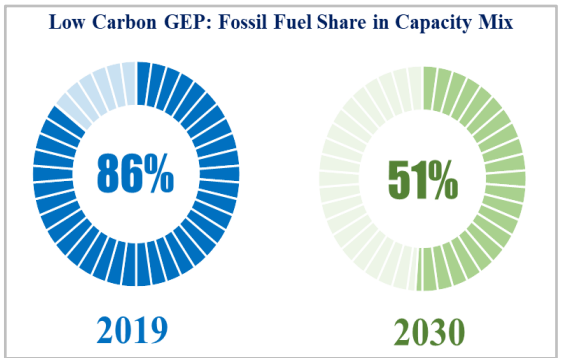
Figure S2-5. Electricity capacity mix

(percent of total)



Source: World Bank and government GEP

Figure S2-6. Low carbon GEP: fossil fuel share in capacity mix



Source: World Bank and government GEP

The government has started to focus on reducing greenhouse gas (GHG) emissions. Uzbekistan's nationally determined contribution (NDC) sets a mitigation objective to decrease carbon intensity (emissions per unit of GDP) by 10 percent by 2030 from 2010 levels. The NDC recognizes the important role of structural reforms to enable the strategic change in the long run, assigning high priority to energy efficiency and renewable energy measures, among others, from both the economic and the climate mitigation viewpoint. The NDC contains key energy-related actions, such as: (1) upgrading of power generation capacities with the introduction of efficient and low-carbon technologies; (2) deploying on a large scale renewable energy sources (solar, wind, small and micro hydro, biogas, and others); (3) making greater use of energy-efficient technologies in energy-intensive sectors, civil construction, and buildings; (4) eliminating natural gas leakages and flaring in the oil and gas sector; and (5) reducing losses in transmission and distribution networks.

[2] The first tariff increase occurred in November 2018 and made up a 45 percent increase for nonresidential consumers and a 9 percent increase for residential consumers. The subsequent tariff increase that became effective in August 2019 raised the electricity tariffs by up to 36 percent and 18 percent for nonresidential and residential customers, respectively.

To achieve the NDC goals, the government has taken initial measures for the development of renewable energy (RE) and enacted a new RE Law and transmission grid code in 2019. These developments recognize the country's large RE potential for diversifying the energy mix and emphasizing the need for clean energy transition. The government approved in April 2020 its 2020–30 generation expansion plan, which calls for the development of about 15 GW of net generation capacity (at an estimated investment cost of $14.7 billion) by 2030, of which 5,000 MW and 3,000 MW of solar and wind power, respectively. The government plan envisages the share of RE (solar and wind) in the country's power generation capacity mix to increase from 0.2 percent in 2019 to 25 percent in 2030 and the share of natural gas in generation capacity to decrease from 76 percent to 46 percent and for coal to contract from 9 percent to 5 percent. The increase in solar and wind power together with the reduction in fossil fuels in the generation mix would result in the reduction of around 13 million tons of CO_2 over 2020–30, compared with the "business as usual" scenario. Steps have been taken to replace the exisiting obsolete and carbon-intensive generation gas fleets with modern generation units, which are up to 50 percent more energy efficient and emit over 50 percent less carbon.

As part of the energy transition, the government envisions the use of public-private partnerships (PPP) to upgrade and expand the provision of infrastructure and basic services. The first 100 MW Solar Photovoltaic (PV) of Navoi Solar Independent Power Producer (IPP) project was developed under the World Bank Group Scaling Solar Program and yielded a competitive power purchase agreement (PPA) tariff of US¢2.67/kWh. Building on this success, the government has entered into agreements with the World Bank Group to support the preparation of additional 900 MW solar PV and 1,300 MW efficient gas-fired IPPs, and with the Asian Development Bank and the European Bank for Reconstruction and Development to support the preparation of additional 1,000 MW solar and 1,000 MW wind IPPs, respectively.

Box S2-1. Private investment trends in the energy sector in Georgia and Armenia

Similar to Uzbekistan, private sector participation in Georgia is a government priority. In recent years, the sector has received approximately $1 billion in private investment. Georgia has experienced remarkable reform progress since the 1990s, which has improved operating efficiency and financial conditions and promoted private investment. Since these reforms, the country's capacity has tripled to 3,600 MW, collection rates have increased by almost 70 percent, and the average hours of electricity supply per day has increased from 10 to 24. Further, the private sector has achieved a more predictable regulatory framework, with tariffs that allow the recovery of reasonable costs and return on assets.

Armenia also has benefited from private sector involvement. The country, which previously suffered from an electricity sector plagued by large implicit consumer subsidies and low collection rates, undertook efforts in the 1990s to reform the sector and attract private investment. Actions included relocating meters to prevent tampering, transferring the payment of utility bills to banks and post offices to reduce corruption, and implementing a strict disconnection policy for nonpayment. Collection rates increased significantly, and, following a public awareness campaign that explained the linkage between paying utility bills and a more reliable power source, tariffs more than doubled in the period 1995–99 to cost-recovery levels. These actions, together with the creation of a sector regulator, helped to instill private sector confidence, with $275 million invested in the sector during the past few decades.

Source: Private Participation in Infrastructure Database (https://ppi.worldbank.org/en/ppi), World Bank, 2016.

The government has also taken initial actions to bring in private sector participation in natural gas power generation projects, with a couple of deals concluded in recent years. The World Bank supported the design, tendering, and implementation of the country's first competitive

efficient gas project to power an IPP with the capacity of 1500 MW in the Syrdarya region. The project is currently under the tender process and is expected to reach commercial close by mid-2021 with commissioning in 2024 or 2025. Further initiatives are preparing the gas and electricity distribution segments for private sector participation.

Box S2-2. Turkey's key lessons learned on establishing a competitive energy market and an Energy Sector Regulatory Authority

The existence of a comprehensive legal and regulatory framework provides a legal foundation. However, time is needed to prepare a comprehensive regulatory framework and it should be dynamic. The Electricity Market Law in Turkey was adopted in 2001, market rules and secondary legislation were prepared two years later, and, only after these preparatory steps, the market was opened in 2003. As the market evolved, both the law and secondary legislation were improved through amendments. The existence of an independent regulatory authority with a sufficient technical capacity is among the key success factors.

Development of a power exchange (centralized platforms for energy trade) is a complex, multi-year undertaking. A step-by step implementation, starting with a temporary regulated balancing market to complex trading mechanism, took more than seven years. However, both operators and market players learned, and development was smooth.

The restructuring of state-owned energy companies was gradually implemented. Transmission network and system operation were separated from generation and supply business. Later, distribution and supply (retail) activities were also legally unbundled.

Turkish experience confirmed that, without cost-based pricing and an effective trading mechanism, private investment cannot be attracted to the market. Financial viability of power companies and distribution/retail companies are important for attracting market-based generation investments. A strongly established transmission system and the reliability of the transmission grid are as important as market trading arrangements for a well-functioning market and integration of renewable energy (RE) sources. Accordingly, the transmission company should also be financially strong and well-managed with independent/commercial decision-making rules.

Political commitment to and continuous government support of pursuing energy sector reforms are essential. The existence of local investors and a strong local finance sector/banking system could further facilitate the development of the market-based private investments.

Digitalization of the sector and real-time data management and communication are crucial for ensuring effective market operations. In this regard, modern digital solutions, such as transmission and distribution SCADA/ERP systems, ERP, optic-fiber based telecommunication network, among others, should be introduced.

Source: Turkey's Energy Transition: Milestones and Challenges, World Bank, July 2015.

The government also recently launched a plan for the next wave of institutional, market, and SOE reforms. This initiative aims to transition from the current single buyer to a competitive wholesale electricity market structure as well as to commercialize SOEs, including energy enterprises. In this direction, a draft Electricity Law has been drafted which outlines the key further institutional, policy, and regulatory framework improvements as well as the desired electricity market model.

C. The Path Forward

The energy sector has a central role in Uzbekistan's long-term economic development. As the implementation of energy sector reforms progresses, the key objective should be to ensure the security and reliability of the energy supply to meet the growing demand stemming from the rapidly growing economy and population. To achieve this target, more work needs to be done both on the supply and demand side of energy in the medium to long run.

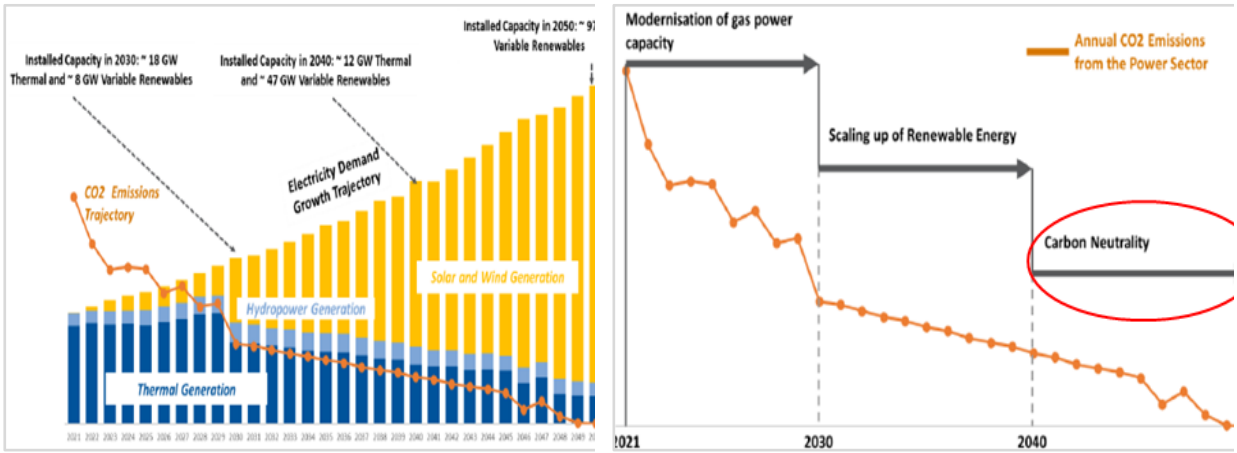
Going forward, the government needs to properly sequence the energy reforms in the following priority areas:

Advancing energy sector decarbonization. The government has initiated ambitious measures to move toward a *carbon-neutral energy sector by 2050*. In this regard, the government should further prioritize the development of RE and low-carbon technologies and align its power sector development with its commitments under the Paris Agreement. With support from the European Bank for Reconstruction and Development, the government recently developed a Carbon Neutrality Action Plan for the Uzbek Electricity Sector (building on the aforementioned World Bank Least Cost Generation Expansion Plan).

The electricity sector plan suggests several actions for achieving a carbon-free power sector by 2050 under the following five pillars: (1) electricity infrastructure transformation; (2) a regulatory framework to allow for renewable energy penetration; (3) subsidy reform and a carbon price mechanism; (4) campaigns to generate public support; and (5) environmental protection. Key specific actions may include: (1) continuing large-scale deployment of clean energy resources as well as replacing inefficient old coal and gas with low-carbon and gas-efficient modern technologies; (2) reducing the carbon footprint (gas flaring and venting) of the gas value chain; (3) deploying gas as a feedstock for hydrogen production in conjunction with carbon capture and storage (blue hydrogen) to kick-start the commercial production of low-/zero-carbon fuels with transitioning to green hydrogen in the long run. Potential repurposing of existing national and regional gas network for hydrogen transportation is another advantage for exploring and upscaling this new technology in Uzbekistan and Central Asia; (4) leveraging the private sector know-how, knowledge, technology, and financing in power and gas generation (exploration, production) and generation and distribution segments. These pillars would collectively result in diversification of the energy mix with reducing the reliance on coal and inefficient gas (of which reserves are depleting), and subsequently in decreased GHG emissions by the sector and the country, contributing to the Uzbekistan's NDC. Figure S2-7 describes the 2050 Carbon Neutral Energy Transition Pathway.

Figure S2-7. Carbon-neutral electricity sector of Uzbekistan by 2050

Generation capacity mix by 2050 | **Carbon-free power sector by 2050**



Source: Uzbekistan Carbon Neutrality Action Plan for the Electricity Sector.

Building upon the above-mentioned Roadmap, it is recommended that the government conduct an in-depth assessment of energy sector decarbonization, which would help inform decision-making on expanding the scope and depth of decarbonization initiatives. This assessment could also analyze and define the role of natural gas as a transitional fuel in Uzbekistan's decarbonization pathway. As a result, with support from development partners, the relevant Government Energy Sector Decarbonization Strategy and Implementation Plan should be adopted for realization.

Energy market development. The following key long-term conditions need to be established to advance the transition toward market-based and a well-functioning, competitive wholesale and retail energy market: (1) a legal and regulatory framework (enacted by an electricity law) describing the sector's institutional structure and the roles and responsibilities of market participants (laws, regulations, technical and commercial market rules); (2) a credible regulatory institution that will function based on transparent and sound regulatory decisions and processes; (3) fully completed corporatization and commercialization of generation/production, transmission, and distribution and supply companies; (4) financial sustainability of the generation/production and distribution companies; and (5) transition to fully cost-reflective and unbundled tariffs.

Box S2-3. Lessons from Vietnam's Energy Reform Experience

Vietnam's power sector has developed rapidly since the 1990s to become among the top performers in developing countries. This success has occurred mostly under a state-owned utility, Electricity Vietnam.

Select market-oriented reforms to date have also had some positive impact. By the late 1990s, the government realized the need to gradually introduce competition to ensure long-term sustainability without jeopardizing security of supply for the fast-growing economy. Vietnam's 2004 Electricity Law has provided the framework to develop a competitive power market, unbundle Electricity Vietnam, set prices that better reflect costs, promote private investment, and establish a regulatory authority.

Today, state-owned entities continue to dominate the sector. Whereas the power market is partially competitive, improved operational efficiency and financial performance of generators in this market have contributed to keeping generation costs relatively low. Plans are broadly on track for further extensive reforms, including a clean energy transition.

Lessons include that state-centric institutions can develop the energy sector with top-level government commitment, highly qualified staff, and consensus among sector institutions. Gradual reforms offer an opportunity to learn by doing, yet the sequence of reforms matters. Introducing market mechanisms ahead of other elements may limit the market effectiveness and even make subsequent reform steps more difficult.

Source: *Learning from Power Sector Reform Experiences: The Case of Vietnam,* World Bank, March 2020.

Private sector participation. The government is urged to prioritize the competitive and transparent PPP design and selection over bilaterally negotiated deals. This will help reduce the reputational risk and ensure better outcomes and management of contingent liabilities. Sector financial sustainability and tariff cost recovery is another precondition for a successful and bankable PPP program (refer to the next paragraph for the proposed actions). It is also recommended that the government initiate and maintain the impact assessment of IPPs being developed on competitive procurement and negotiated basis and their contingent labilities on the government fiscal space and balance sheet, in order to monitor and mitigate potential arising risks.

In addition, experiences show that, in the absence of a sustainable power market and a good track record, long-term power purchase agreements (PPA) are necessary to attract private investments for power generation projects and ensure supply security. Meanwhile, given that Uzbekistan has the target to transit to competitive energy markets, the number and capacity for PPAs should be

limited to the extent necessary for the security of supply. Otherwise, too many long-term PPAs could block the wholesale electricity market initiatives with limited or no incentives for the private sector to trade in the market. This could also add to the public contingent liabilities, thus limiting the government fiscal space.

Adequate capacity should also be built to better plan, negotiate, monitor and manage the risks and liabilities associated with PPPs. While the benefits of PPPs could be substantial, poorly negotiated PPPs may lead to very large liabilities and burden on the budget.

Box S2-4. Turkey's experience in attracting private participation in the energy sector

Turkey opened its energy sector to the private sector as part of an overall shift toward a market economy. The country embarked on a path to move from a state-controlled sector toward a liberal market economy, both in domestic markets and international trade.

The country first opened its energy sector to the private sector in 1984. However, simply removing the public sector monopoly proved insufficient and, in the absence of a solid legal and regulatory framework and a functioning energy market, progress remained limited.

Faced with the prospect of electricity shortages, legislative changes were made in 1994 and 1997 that provided for sovereign guarantees to attract private sector investment in electricity generation. About 8,550 MW was contracted under long-term power purchase agreements, with guarantees by Turkey's Treasury backstopping the public utility's payments. All contracts included "take or pay" clauses. This provided temporary relief but not a long-term solution to energy security.

Understanding the concerns with increasing direct and contingent liabilities on the government balance sheet, starting in the early 2000s, the Turkish government embarked on a market-based approach to attract private investment, instead of relying on more and more guarantees. Accordingly, favorable legal, regulatory, and institutional reforms were designed and implemented with the operation of a completive electricity market in 2003.

Although the initial response from prospective private investors was encouraging, it was ultimately insufficient to ensure electricity supply security, because retail tariffs were kept below cost-recovery levels through 2007. The introduction of a new, cost-based energy pricing mechanism in 2008 and a series of tariff adjustments in 2008–09 brought the power sector to financial viability, supporting a large volume of market-based generation investments and enabling the government to start a distribution privatization program.

The private sector's response to these development measures has been spectacular. Some 31,000 MW in new generation capacity has been developed without sovereign guarantees since 2008. This successful step-by-step experience of Turkey could also be leveraged in other countries, including Uzbekistan, adjusting to a country's priorities and needs in order to create an enabling environment and boost the private sector participation in energy sector development.

Source: *Turkey's Energy Transition: Milestones and Challenges*, World Bank, July 2015.

Subsidy reform and sector financial sustainability. Strengthening the electricity and gas sectors' financial sustainability is critical for Uzbekistan to reap the potential economic benefits of its energy resources. The following key actions will boost the sectors' financial outcome: (1) gradually adjust tariffs to cost-recovery levels; (2) provide social assistance to the poor to mitigate the impact of tariff reforms; (3) address technical and commercial losses; (4) improve demand and supply side energy efficiency; (5) improve the financial transparency and reporting of the sector utilities; (6) access commercial financing; and (7) design and implement robust communication campaigns.

Sector operational efficiency. Given the lead times involved in upgrading the physical infrastructure, it is important to continue to design and implement physical infrastructure upgrades to facilitate the commercialization of sector operations: (1) continue with physical infrastructure to ensure better service delivery for people, including transmission and distribution infrastructure

upgrade and expansion; (2) implement a loss reduction program across the electricity and gas supply chains; (3) launch a full-fledged introduction of modern IT solutions in the electricity and gas sectors (smart meters, SCADA/EMS, ERP);[3] and (4) strengthen regional energy connectivity and energy trade in Central Asia.

Developing the energy efficiency market. The government has been investing in energy efficiency, issuing policies, and passing laws and decrees that support the development of the energy efficiency market. However, there is a need to further develop the industry in order to *scale* the energy efficiency investments, primarily across the industrial and residential sectors. It is necessary to: (1) improve the policy, regulatory, and legal framework to promote private sector participation; (2) establish and operationalize sustainable financing mechanisms such as revolving funds; (3) take a leading role in applying innovative financing mechanisms to demonstrate the financial feasibility of such programs to the private sector; (4) adopt sector-specific energy efficiency plans/programs; (5) develop accreditation/certification systems for energy audits; (6) introduce standards and a labeling program; and (7) scale up the adoption of Energy Management Standards in industries under the ISO 50001 framework.

Institutional and capacity development. This should also be at the core of the reform initiatives, since the success—and more importantly, the sustainability—of the ongoing and envisaged reforms could be ensured through well-run agencies To this end, the government has to prioritize the following actions, among others: (1) develop and implement capacity building and training programs with resources for key ministries, regulators, and sector companies; and (2) establish an effective platform for sector planning and coordinating various activities by different stakeholders and development partners in the energy sector.

[3] SCADA: Supervisory control and data acquisition; EMS: Energy Management Systems; and ERP: Enterprise Resource Planning

Chapter 8. Social Protection

Strengthening social protection (SP) has been at the core of the reforms in Uzbekistan since the beginning of the transition. The government is on the right track with the modernization of social protection, but more is needed to consolidate the sector and move the SP system to the next level. Progress since 2017 includes significant improvements in social assistance (SA), labor market programs, social insurance, and social care services. In 2020, Uzbekistan started developing the National Social Protection Strategy to bring cohesion to the fragmented SP sector, expected to be adopted in December 2021. National-level developments in digital infrastructure for SA and the labor market are moving fast, accompanied by the expansion of coverage. The development of a digital ecosystem will inevitably transform the way policymaking is implemented in the SP sector. Although SA coverage has been increasing, it is crucial to ensure that all extreme poor are covered by low-income family allowances. Newly introduced labor-demand programs and ALPMs need to be evaluated, enhanced, made more effective and to cover more people. Developing and including adaptive elements in the design, implementation and financing of SP programs will help establish shock-responsive SP system prepared for emergencies.

There are several challenges that obstruct the performance of the social protection system in the country. Those include the fragmentation and low coordination in the sector, both in design and implementation of programs, and insufficient coverage of social assistance and active labor market programs. Pressing reforms include: (1) ensuring there is an adequate institutional arrangement for the SP system including integrated management of SP, the need for a national SP strategy, and adequate monitoring and evaluation framework; (2) ensuring all extreme poor are covered with effective social assistance; (3) developing adaptive SP system to ensure it is shock-responsive and forward-looking; (4) improving service delivery capacity in SP including strengthening capacity of employment support centers (ESCs) and improving the implementation of the Single Registry to minimize exclusion errors and expanding its functionalities; (5) progressing towards strengthening the link between social assistance and labor interventions to promote graduation from social assistance; and with social services to introduce case management and social intermediation, and (6) progressing with the development of the digital ecosystem to support evidence based design, coherence and effective implementation of SP programs.

A. Social Protection in Transition

Social protection in Uzbekistan pre-transition

Prior to the transition, the SP system in Uzbekistan was well developed, compared to other developing countries at the time, and included social insurance schemes (contributory), SA (non-contributory), and small labor market programs; however, it had its limitations— namely, low coverage of SA, ineffective public employment service, and training programs. Similarly to other transitional economies relying on full employment, ALMPs were basically nonexistent prior to 2018.[1] Pensions covered only the formally employed, and the system was not

[1] World Bank 2020. "Active Labor Market Policies in Uzbekistan." Washington, DC.

well suited for a large share of informal employment in the country.[2] SP was fragmented across implementing agencies, there was no SP framework, and M&E was almost nonexistent. The comprehensive process of market-oriented reforms that the government initiated was expected to: (1) exacerbate the growing poor population due to the dismantling of subsidies and climbing prices; (2) raise unemployment rates due to the changing labor market and the SOE reforms; and (3) increase job skills mismatching, because some of the workers wouldn't have the qualifications that a modern economy demands. To support people during the transition and to support the transition process itself, the Uzbekistan government announced the enhancement of safety nets as one of the five priorities of the reform process. The 2017 government mandate included as part of the reforms the "implementation of comprehensive targeted social support measures to minimize the negative effects of monetary policy on the living standard of socially vulnerable groups of the population."[3]

Social insurance programs were the largest part of SP, but because SA programs ensured coverage of the poor, they needed expansion. The biggest SA program was the three low-income family allowances with the same income threshold eligibility criteria and verification mechanisms but different benefit levels. The number of households receiving low-income family allowances continually declined in the years prior to the transition launch, and in 2017 was almost half the number of beneficiaries in 2013. However, since 2018, the government has been increasing the budget allocation for these programs, and the number of beneficiaries grew as well to reach more than a million households in 2020.[4] Apart from the ineffective setup of the program (running three programs that are de facto just one program), the concerns with the low-income family allowance program were the inclusion errors (partly due to the lack of a standardized way to impute income) and exclusion errors (the use of caps in budget and number of beneficiaries at the local level), inequity in benefit level allocation, and not optimal benefit amounts.[5]

Given the breadth of the reform agenda, stronger focus on labor market integration interventions, such as activation and labor demand policies, was needed. A modernized SP system was required for equity purposes and help the poor and vulnerable escape poverty. But it was also vital to develop and expand income protection and employment promotion programs to support those who become vulnerable because of the economic transition process and to support the transition itself with people with the proper skills.

Recent developments in social protection

Over the period 2017–20, the government launched a reform process in all areas of social protection (see Annex 1 for details). In SA, the main change was the piloting and roll out of the Single Registry to process three low-income family allowances, the main anti-poverty SA programs, and potentially cover other SA allowances and services. The Single Registry (piloted in 2019 and rolled out in 2020) is meant to improve the transparency in low-income allowances allocation. Increased coverage of the low-income family allowances and the national rollout of the

[2] "An Assessment of the Social Protection system in Uzbekistan, based on the Core Diagnostic Instrument (CODI)," a joint report by ILO, UNICEF, and the World Bank (2020).
[3] Presidential Decree No. UP-5147, "On priority measures to liberalize foreign exchange policy," September 2, 2017.
[4] Ministry of Finance data.
[5] *"World Bank. 2019. Uzbekistan Social Assistance Targeting Assessment. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/33163 License: CC BY 3.0 IGO."*

Single Registry are important milestones to establish an effective safety net system. SA also saw the significant expansion of public works. The social care services area centers on deinstitutionalization of children, reform of the shelters and rehabilitation centers for domestic abuse survivors, and overall better linkages of social services with the social benefits system. On the labor market programs side, in 2018, several ALMPs were launched, with significant emphasis on skills development on the national agenda. On top of that, LMIS is currently under development, which will further strengthen M&E, and job-matching opportunities. LMIS development will be the transformation of existing IT systems in labor market management, analysis, and policies. The introduction of active labor market measures and significant investment in trainings centers nationwide kicked off a new era of SP policy that focused on skills development and labor market integration. Over the past three years, the government introduced different active labor market programs (ALMPs), subsidies, and improved infrastructure for trainings that helped expand policies aimed at people's labor market integration. The new labor code is now under discussion in the Oliy Majlis. The pension reform concept is being prepared, with the focus on improving coverage of all types of workers and ensuring adequate benefit levels while keeping the system fiscally sustainable.

The Ministry of Employment and Labor Relations (MELR) is developing a LMIS with the objective to increase the quality and availability of labor market information and improve the performance management of employment services and active labor market programs. LMIS is based on the development of the two major IT systems: (1) the Unified National Labor System (UNLS) as the national IT system; and (2) the Integrated Single Window Office (ISWO) for the services provided by Employment Service Centers. ISWO's first version was developed in 2017, the first pilot took place in September 2017, and the rollout started in January 2018. In late 2018 and early 2019, the current (second) version of ISWO was developed and the rollout for all regions was done. The current version of the ISWO system manages the following services: (1) general job counseling; (2) job search facilitation; (3) training and retraining; (4) public works; and (5) registration for unemployment benefits. UNLS 1.0 was developed to register employment contracts and, from January 1, 2020, Uzbekistan began introducing mandatory registration of valid employment contracts concluded before January 1, 2020, and no later than September 1, 2020. In addition, on January 1, 2020, an electronic employment book was introduced, including information on the employment of workers, automatically generated in UNLS 1.0 based on the data contained in registered employment contracts. The plan is to further expand the UNLS and integrate it with an upgraded ISWO.

Several important policy developments were launched in 2020, among them the National Social Protection Strategy, the National Poverty Reduction Strategy, and the National Employment Strategy. The ongoing development of the National Social Protection Strategy preparation, kicked off in summer 2020, is an important initiative that will reduce sector fragmentation. The Ministry of Finance is leading the development of the strategy, collaborating closely with the Ministry of Health, Ministry of Public Education, Ministry of Higher and Secondary Specialized Education, Ministry of Internal Affairs, Ministry of Employment and Labor Relations, Ministry of Mahalla and Family Support, Ministry of Economic Development and Poverty Reduction, Pension Fund, General Prosecutor's Office, and others. A consultative working group comprising the aforementioned ministries, as well as United Nations agencies and the World Bank, has been created to ensure the comprehensiveness of the National SP Strategy and to align this work with some other ongoing national initiatives, such as the development of the

National Poverty Reduction Strategy, the National Employment Strategy, and the Vision 2030 for Uzbekistan. In February 2021 The President of Uzbekistan signed a decree "On measures to improve the system of social protection of the population of the Republic of Uzbekistan for 2021-2030" which among other things approves the Concept Note of the National Strategy of Social Protection (NSSP) for 2021-2030, and the draft roadmap.[6]

The performance of individual programs and the social protection system as a whole needs to be re-evaluated following recent reform. The performance of social assistance and insurance programs was last assessed using data from the 2018 Listening to the Citizens of Uzbekistan (L2CU) survey. The results found social protection coverage to be relatively high by international standards, and although some programs struggled with high exclusion error due to underfinancing, social assistance, and in particular the three low income family allowances, was relatively well targeted to the poor[7]. On average, the adequacy of SA programs was also rather high, though with significant variation among programs. Performance has not been systematically evaluated since because of lack of official household survey data capturing people's participation in SP program and benefit amounts received. The collection of the new official Household Budget Survey (HBS) 2020 was affected by the COVID pandemic which limits the reliability of the data. Monthly L2CU data collected since end of 2019 show an increase in the coverage of social assistance recipients due to the expansion of low-income family allowances and ad hoc benefits introduced to respond to the COVID-19 crisis[8]. It will be crucial to conduct a comprehensive performance assessment once the 2021 round of the HBS is completed as major sectoral reforms took place since 2018 which may have affected the performance of the social protection programs, including: (i) changes in the rules to determine eligibility to low income family allowances; (ii) changes in the procedures to apply and verify eligibility (now through the Single Registry in the full country); (iii) changes in the benefit amounts; (iv) increased budget allocated to low income family allowances, hence the coverage; (v) a significant increase in the scale of the public works program; (vi) introduction of several employment support programs. and (vii) the likely increase in the needs and demand for social assistance given the estimated income losses caused by the COVID-19 pandemic. Each of these factors may have affected the performance of the social protection system since the last assessment was completed.

Social assistance

The government is in the process of improving the efficiency and effectiveness of the SA system through developing the Single Registry and adjusting the system to reduce errors during beneficiary identification and selection. The main poverty-targeted social assistance programs in Uzbekistan are the low-income family allowances, which are now assigned and accounted in the Single Registry system. The program currently consists of three types of benefits: child allowance for families with children (younger than 2), child allowance for families with children ages 2–14, and low-income family allowance. The selection of beneficiaries is based on an income test and was previous conducted by local communities (mahallas). Since December 2020, application, selection and payment of beneficiaries are managed through the Single Registry (electronic information system) administered by the Pensions Fund under the Ministry of Finance. The introduction of the Single Registry has simplified and automated some aspects of the delivery

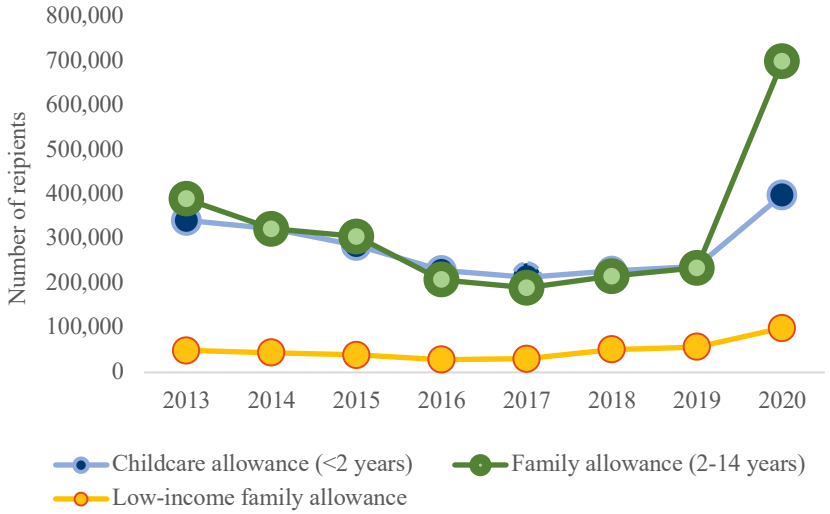
[6] President decree P-5634 17.02.2021 "On measures to improve the system of social protection of the population of the Republic of Uzbekistan for 2021-2030".

[7] *"World Bank. 2019. Uzbekistan Social Assistance Targeting Assessment. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/33163 License: CC BY 3.0 IGO."*

[8] High frequency L2CU data do not allow to conduct distributional analysis, meaning the coverage and incidence of social protection programs by the different quintiles/deciles of the population to determine whether social benefits go to the intended population.

chain of the program, such as registration, eligibility determination and payment (See Annex 8.2 for detailed changes).

Figure 8.1: Beneficiaries of the three low-income family allowances



Source: Uzbekistan PER 2021 (forthcoming).

The single registry is not only an essential operational tool to improve the accountability of low-income family allowances, but also expected to serve as a gateway to integrate other social benefits. The introduction of the electronic Single Registry has improved the accountability and monitoring of program results as well as simplified procedures for both applicants and program administrators. However, there are still considerable challenges to be addressed to improve programs outreach, targeting and recertification. In the medium term, the Single Registry is expected to serve as a gateway to integrate multiple benefits, including energy compensation benefit, transportation, health and education benefits, disability benefits and social care services. To achieve these objectives, the Single Registry will have to be complemented by an accurate and objective targeting system to reduce inclusion errors, but most importantly to ensure that all poor and vulnerable families have access and supported by social assistance (reduce exclusion errors). A World Bank assessment of the Single Registry monitoring data point to potential high exclusion errors among poor families (with income below the eligibility threshold) due to the lack of participation among working age members in employment programs and services provided by the Employment Support Centers under MELR, regardless of whether programs are offered to them or not.

Public works is also a large safety nets program in the Uzbekistan. In addition to the adoption of the national program for employment facilitation, in 2017, the government created the Fund for Public Works to provide temporary employment through public works and some labor market programs, like wage subsidies in private companies, substantially increasing its. It has been adapted rapidly during COVID-19 pandemic allowing to include new areas of work answering pandemic driven challenges, and to expand coverage.

Labor market programs

The Government has strengthened active labor market programs to support specific vulnerable groups. The range and coverage of ALMPs have been expanded significantly in the past few years, though the spending in such programs[9] remains low by international standards. Spending on these programs includes active (0.01 percent of GDP in 2019) and passive (unemployment benefits[10]—0.003 percent of GDP in 2019) labor market programs. ALMPs are relatively new in Uzbekistan, and overall spending on ALMPs was almost negligible prior to 2018.[11]

Several wage and entrepreneurship support subsidies were introduced in 2019 by the Ministry of Employment and Labor Relations. Among the newly introduced support are the retraining subsidy for employers who employ workers referred to by the Employment Support Centers; the subsidy to cover startup registration fees for the unemployed who want to start their own business; the wage subsidy for employers who hire vulnerable employees above the existing quota; and the greenhouse setup subsidy. As of 2021, the government is developing the concept of a national productive inclusion program, which would help support self-employment. All these measures are aimed at building market-relevant skills and addressing the skills mismatch during the transition to a market economy and creating startup opportunities for new entrepreneurships (which has been an objective of the government since the very beginning of the reforms).

MELR is in the process of establishing training programs and other measures to facilitate migration to other countries. Currently, about 2.6 million citizens of Uzbekistan are in labor migration, about 85 percent of them carry out temporary labor activities in the Russian Federation[12]. Consistent work is being carried out to establish the processes of external labor migration, to ensure the protection of the rights and interests of citizens traveling abroad to carry out temporary labor activities, to provide them with the necessary legal, social, information and advisory assistance and trainings as well as material support.

There is a strong focus on skills and entrepreneurship development in government priorities, but the relevant programs are fragmented, lack monitoring and evaluation. In Uzbekistan skills gaps have been found to hinder employment outcomes: formal employers have difficulties finding workers who have and can use in the workplace both cognitive and non-cognitive skills[13]. Thus, the focus on skills development in government policies is crucial, both for children through the early childhood development (ECD) and school curriculum, and through the labor market programs. With regards to the ALMPs, more evidence on the existing initiatives is needed to track the labor market outcomes of beneficiaries, and to understand better both the design and implementation limitations of programs. One of the clearly arising challenges is the need for stronger linkages between financial support and non-financial services. Current national programs

[9] Spending on public works is excluded from ALMPs, since they are considered a part of social assistance.
[10] Unemployment benefits are considered under labor market programs, not social insurance, because in practice, benefits are paid mostly to those without a work record.
[11] Public Expenditure Review forthcoming.
[12] Migration agency under the MELR administrative data.
[13] Ajwad, Mohamed Ihsan, Ilhom Abdulloev, Robin Audy, Stefan Hut, Joost de Laat, Igor Kheyfets, Jennica Larrison, Zlatko Nikoloski, and Federico Torracchi. 2014. "The Skills Road: Skills for Employability in Uzbekistan." World Bank. Washington, DC.

of entrepreneurship support do not offer additional services to complement financial support. At the same time, there are numerous government initiatives at smaller-scale organizations that are providing different types of skills, development projects, and trainings. The National System for the Development of Professional Qualifications, Knowledge and Skills (System of National Qualifications) is also being developed. It aims at bringing together the education sector and labor market. One of the tasks of the System of National Qualifications is to organize vocational training, advanced training, and retraining of the unemployed population, especially young people.

Pension system

The pension system of Uzbekistan is based on the principles of mandatory social insurance with contributory installments. The pay-as-you-go (PAYG) system prevails, and the mandatory funded component is negligible. The PAYG system retains some key parameters from Soviet times: a defined benefit scheme (DB); the retirement age set at 55 for women and 60 for men; the required service for full pension set at 20 years for women and 25 years for men.[14] Adherence to the DB scheme has its advantages; since the conditions are clear and familiar to the population, there are no structural gaps between the pensions of new and old participants. Taking into account the regional specifics of employment, the assessment of pension rights through years of service seems objective and suitable. Flexibility of the DB scheme is achieved by adjusting the rules for accounting of service duration and valorization of earnings.

The main shock for the pension system was the tax reform that began in 2019: the revenue loss to the pension system was envisaged at the budget projections for 2019. The Pension Fund completely lost two revenue items in 2019: insurance contributions of employees (the rate was at 8 percent of the wage) and contributions of companies relative to total sales (the rate of contributions in public social funds amounted to 3.2 percent of sales, of which 1.5 percent was transferred to the Pension Fund). Besides, starting from January 1, 2019, the rate of single social payment for private enterprises was reduced from 15 percent to 12 percent. Starting October 1, 2019, the Pension Fund stopped receiving contributions from the single tax payment of enterprises (these revenues started to flow into the local budgets).[15] The state budget slated 4.7 trillion sum to be transferred to the Pension Fund in case the latter could not meet its current obligations. By the end of 2019, the revenues from the single social payment exceeded the expectations by 18 percent.[16] Combined with considerable Pension Fund surplus from 2018, it became possible to avoid an apparent deficit and request of funds from the state budget. Reduction in the funding sources manifested itself in a decrease of revenues of the Pension Fund as a share of GDP: during 2015–18, tax revenues of the Pension Fund accounted for about 6 percent of GDP, while in 2019, this figure declined to 4.7 percent of GDP.[17]

The Government is aware that the pension system and the social protection system generally require greater transparency, and a transition is needed from the micro-management of the

[14] Law of the Republic of Uzbekistan "On State Pensions," September 3, 1993, city of number 938 the XII, as amended, https://lex.uz/acts/112312.
[15] The Tax Code of the Republic of Uzbekistan as amended by the Law of December 30, 2019, No. ЗРУ-599, with amendments and additions, https://www.lex.uz/acts/1286689.
[16] 2019 report of Extra-Budgetary Pension Fund under the Ministry of Finance of the Republic of Uzbekistan, https://www.mf.uz/media/file/funds/pensiya/brandbook/2019.pdf.
[17] Public Expenditure Review forthcoming.

programs to the automatization of procedure based on clear criteria. Specialists of the Off-Budget Pension Fund are drafting the Concept of Pension Reform, which is one of the programs of the general Protection Strategy for the period up to 2030. The following main points of the concept draft are: (1) a gradual increase in the retirement age; (2) a gradual increase in the minimum length of service required for the appointment of an old-age pension from the current seven to 15 years; (3) structural reform of the pension system, with the allocation of a component that ensures the payment of the state minimum pension and the insurance component; and (4) improvement of administration of IT, including sharing data with other authorities and providing online services.

Social protection challenges

Several challenges impede the fast-evolving development of the SP sector in Uzbekistan. The main challenge to modernize the SP sector in the country is the lack of common understanding of sector scope and the description of the social contract between the government and the population, as well as an unstructured long-term vison of the sector development. Furthermore, the SP sector also suffers because of the inadequate institutional arrangements for SP policy integration, implementation, and monitoring, and the lack of a strong M&E framework to inform policymaking, including financial allocations and budgeting decisions. On the social insurance side, the current system is primarily addressing formal sector workers regarding pensions and unemployment benefits. Another concern is the insufficient funding for SA and ALMPs, which prevents the programs from increasing the coverage. Spending on social safety nets (0.97 percent of GDP in 2019), ALMPs (0.07 percent of GDP in 2019), and social care services (0.04 percent of GDP in 2017–19[18]) have been increasing, but remain low by international standards (Figure 8.2).[19][20]

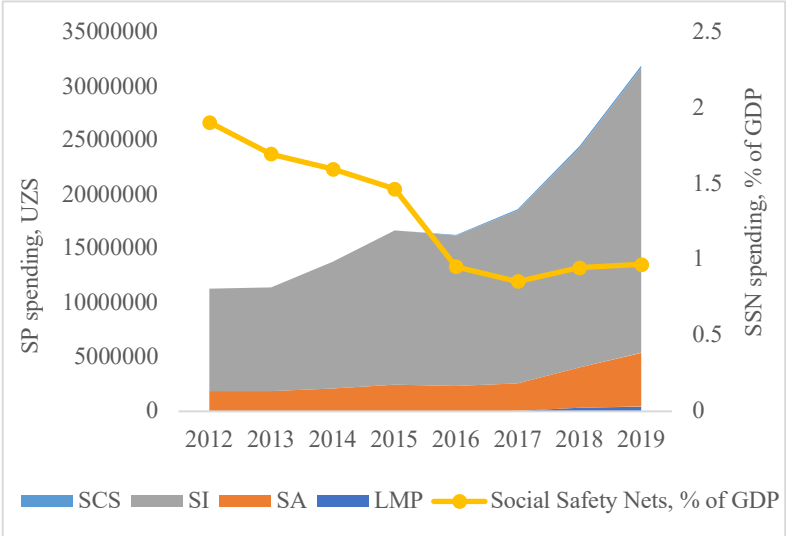
The lack of a strong monitoring and evaluation framework for the social protection programs remains an important gap in the way of thinking about the SP system in the country. It is crucial to collect and analyze administrative data on social protection programs. Currently, no agency in Uzbekistan is aggregating the actual expenditures and beneficiary numbers incurred by different social protection programs, and such data are not being centrally published. This is due to the lack of a nationally adopted M&E framework and strategy for SP. Program-level data are being collected at the local level, but because the data are often paper based, they can be disorganized and delayed, and IT limitations impede aggregation at the central level. As for the full universe of SP programs, the lack of an adopted national definition of social protection makes the scope of required data analyses unclear. The issue is exacerbated by the fact that several ministries are implementing separate SP programs.

[18] The estimated spending on social care services includes support of lonely elderly citizens and disabled people in boarding homes "Sakhovat" and boarding homes for disabled people "Muruvvat," orphanages and boarding schools for disabled children and children with special needs, home care services, and medical, social, and professional rehabilitation of disabled people. The number excludes expenditures on rehabilitations centers and shelters for the survivors of gender-based and domestic violence, due to the data constraints.

[19] "An Assessment of the Social Protection System in Uzbekistan," based on the Core Diagnostic Instrument (CODI), a joint report by ILO, UNICEF, and the World Bank (2020).

[20] Public Expenditure Review forthcoming.

Figure 8.2: Spending on SP



Source: Public Expenditure review, forthcoming.

The main anti-poverty programs – three low-income family allowances –need to be more efficient, specifically, they need to be merged into a single progressive benefit, which would have better targeting system focusing on the reduction of exclusion errors.[21] The program can be further improved by strengthening the links between cash transfers and labor market interventions for the beneficiaries focusing on promoting graduation, and with social services to introduce case management and social intermediation for participants. Beyond just the main anti-poverty program more coherent SP policy is needed in the country. The attention must be paid to greater integration between social assistance, labor market and social services interventions, moving towards a coherent approach to population support by gradually increasing case management options, and providing stronger support for particularly vulnerable groups.

Attention must be paid to the adaptivity and sustainability of various SP mechanisms to safeguard the population from the upcoming reforms (energy reforms, state-owned enterprise (SOE) privatization), as well as from any natural or human-made disasters. Uzbekistan needs to move to a modern SP system with priority in the short term focusing on 3 key areas: 1-Reforming the social benefits system by merging the 3 allowances complemented by better targeting and increased coverage; 2-introducing adaptability to the social assistance and labor market programs to address shocks and disasters that affect incomes and assets of the poorest; 3-Finalizing the SP strategy.

B. Experience From Other Countries

Transitional economies need to provide short-term support to populations adversely affected by the reforms (facing price increases or job losses caused by the transition), but also adapt the SP system, which often formerly relied on full employment. Before the transition, social protection in Eastern Europe, for example, in Poland, provided different types of benefits based

[21] Ad-hoc Note "Proposed changes in the design of Low-Income Family Allowances", World Bank, 2021

mostly on social insurance and labor force participation, with limited SA programs.[22] Multiple in-kind benefits and privileges were also provided to employees of SOEs. Following the transition, being employed wasn't considered obligatory anymore, unemployment was increasing, and the need for active and passive labor market policies became apparent. International experience shows, that SP reforms which accompany transition to full market economy require: i) targeted interventions to those who will suffer more, ii) support to ensure smooth consumption and purchasing power of beneficiaries, and iii) significant additional budget for a considerable period of time. The goal is to prevent people from falling into poverty, because it's always less costly keep them above poverty, it is much more difficult and costly moving them above the poverty line.

Undergoing transitions to modern economies, the countries had to adapt their social protection systems and enhance non-contributory programs. Countries undergoing transitions were mitigating the adverse impact of price liberalization by initially providing generalized subsidies; however, countries such as Estonia eliminated them quickly, and Poland, for example, kept them for a short time. The provision of support to the population was being transformed into a more targeted approach by increasing wages, SA benefits, and unemployment benefits spending. With the transition to a market economy and the risk of growing open unemployment, many countries introduced unemployment benefits, supported by significant higher budgetary appropriations. By 1993, Poland increased expenditures on unemployment benefits to 1.2 percent of GDP from 0.02 percent of GDP in 1990. Hungary, Latvia, and Rumania increased spending on unemployment benefits from 0 in 1990 to 1.4, 1.8, and 1.7 percent of GDP, respectively, by 1993.[23]

Non-contribution linked programs in former Soviet countries have expanded significantly. Countries increased child allowances significantly. Estonia boosted spending from 0.3 percent of GDP in 1991 to 1.8 percent of GDP in 1993, Poland was spending 2.7 percent of GDP on child allowances in 1993 (earlier estimates unavailable), and Latvia raised spending on child allowances from 0.7 to 2.4 percent of GDP. [24] Similarly, expenditures on pensions were expanded in the same period in Poland (8.1 to 14.9 percent of GDP) and Estonia (2.6 to 5.6 percent of GDP). Increased demand for social protection expenditures in turn raised the question of the higher required payroll contributions, and the need to further reform the newly established SP system. The decision for more contributory social protection benefits over non-contributory benefits was influenced by the cultural environment and preexisting conditions.[25]

Strong leadership and coherent SP policy is essential for successful implementation of SP reforms in the countries undergoing transformation. International experience points out that this is especially important when a country is undergoing digital transformation in the SP sector, resulting in the transformation of business processes as well. Turkey, for example, was in the rapid development stage of the Integrated SA System (ISAS) from 2010 to 2015. Turkey's experience

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[22] *Social Safety Nets: Issues and Recent Experiences* (1998), Chapter 12, "Poland.". Editors Ke-young Chu and Sanjeev Gupta. Washington, DC: International Monetary Fund.
[23] See Table 4.2: *Social Safety Nets: Issues and Recent Experiences* (1998). Editors Ke-young Chu and Sanjeev Gupta. Washington, DC: International Monetary Fund.
[24] See Table 4.2: *Social Safety Nets: Issues and Recent Experiences* (1998). Editors Ke-young Chu and Sanjeev Gupta. Washington, DC: International Monetary Fund.
[25] Tracy, Morgan A,. and Martin B. Tracy (1996). "The Impact of Market Economy Transition on Social Security and Social Welfare in Poland," *The Journal of Sociology & Social Welfare*: Vol. 23 : Issue 1 , Article 4.

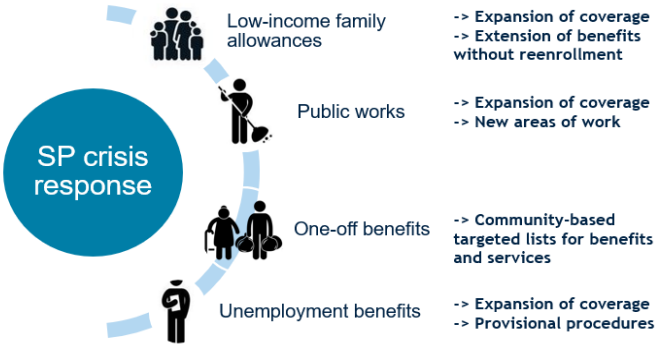
evidences the importance of high-level decision making and SP policy when creating such complex systems. Such organization allows for defining the future of SP support and the direction of modules development, and it also facilitates the required data-sharing agreements between the ministries, as well as the required legal frameworks. In Turkey, the department in the ministry that manages the registry performs both policy functions and database and system management functions. The team of engineers and developers also works with the SA and Solidarity Foundations, which perform the home visits on the ground. Thus, there is a team comprising members from the local beneficiary-facing level all the way to product development and policy oversight. [26]

C. Social Protection in Uzbekistan During the COVID-19 Pandemic

Linking social protection and disaster risk management is needed in the country to build an adaptive social protection. It can happen by developing a basic framework for adaptive social protection systems able to scale up quickly as a response to disasters, and then scaling down. Developing an adaptive social protection system requires specific instruments, institutional arrangements, and a third descriptive (non-actionable) category, government leadership. Adaptive instruments usually comprise three types, namely, (i) Adaptive programs (both in program design, delivery mechanisms: flexibility to scale up and down to better respond to disasters), (ii) Adaptive finance to ensure that SP programs can quickly respond to disasters, and (iii) Adaptive information[27.] Adaptive information should provide a better understanding of risks and vulnerabilities to different types and scales to inform corresponding interventions. For example, information on household compositions, risks and vulnerabilities combined with early warning information as well as pre-positioned risk financing, based on pre-defined triggers, can support the development and provision of rapid response appropriate to the disaster impact[28.] The development of IT systems and their linkages allow safety nets to expand faster and provide predictable and timely responses. Flexibility of SP system elements allow for faster and adequate (tailored) adjustments following a shock. It is also important to deliberate and put mechanisms in place that would ensure uninterrupted enrollment and delivery of the social protection benefits and services to the population in case the disaster affects the delivery chains.[29]

[26] *Turkey's Integrated Social Assistance System* (English). Washington, DC: World Bank Group. http://documents.worldbank.org/curated/en/515231530005107572/Turkey-s-integrated-social-assistance-system.
[27] "Adaptive Social Protection System Assessment in Central Asia: Uzbekistan Country Report", forthcoming
[28] World Bank. 2018. The State of Social Safety Nets 2018. Washington, DC
[29] "Sustainable Development in Uzbekistan: Supporting a Green Transition" SCD background note, forthcoming

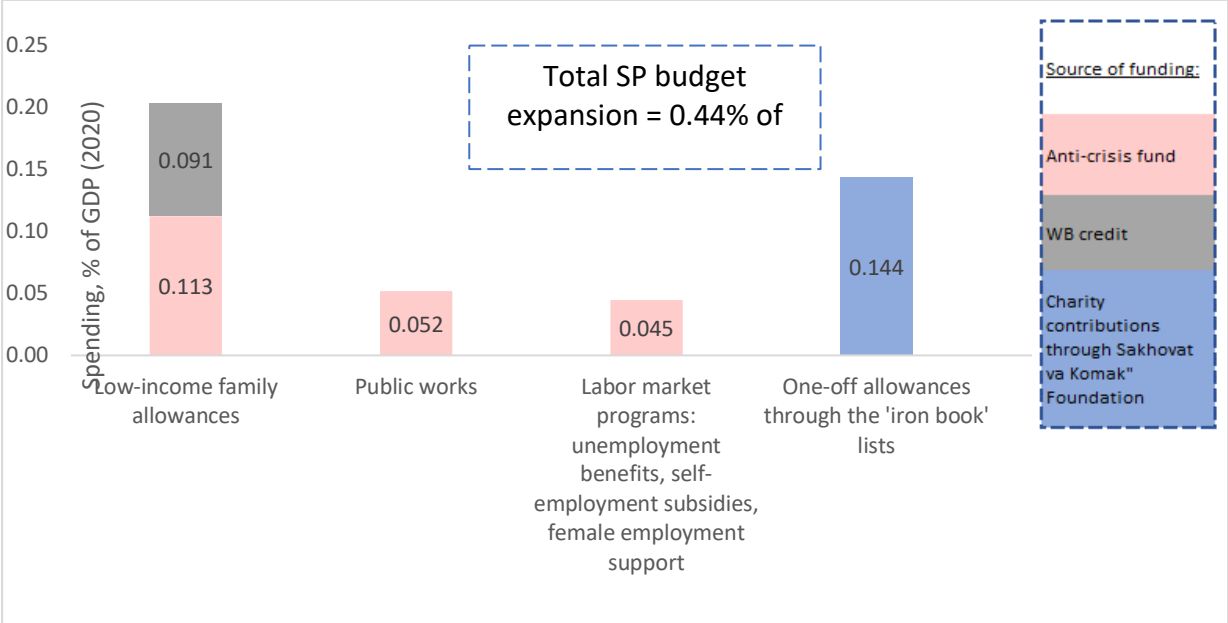
Figure 8.3: Uzbekistan's SP COVID response



Source: Author's compilation.

The SP system demonstrated the elements of adaptivity and was able to expand quickly during the recent COVID-19 pandemic. The Government significantly expanded SP programs during the pandemic, including low-income family allowances and public works programs, as well as simplified access to and increased duration of unemployment benefits toward the end of 2020, and expanded ALMPs (Figure 8.3). The expansion of social protection interventions required a substantial increase of budget equivalent to 0.44 percent of GDP in 2020,[30] which is about 45 percent of the total safety net budget in 2019 (Figure 8.4).[31] In 2020, the coverage of low-income family allowances reached more than 1.1 million beneficiary households (compared with about 530,000 in 2019).[32] Public works in 2020 supported more than half a million beneficiaries (in comparison with around 340,000 in 2019).[33] Additional one-time support was provided through community-based targeting through the mahalla (community group) lists called the "iron book". The same level of broader financing on the main SA program remains in the budget for 2021 as well.

Figure 8.4: Expenditures on additional COVID SP measures in Uzbekistan, 2020



Source: Author's calculation based on administrative data from the MoF.

[30] Authors' estimates based on Ministry of Finance data.
[31] Public Expenditure Review forthcoming.
[32] Ministry of Finance data.
[33] Ministry of Employment and Labor Relations data.

D. Social protection in Uzbekistan: Aspirations

Strengthening social protection has been at the core of the macro-reforms since the beginning of the transition, and this is the best practice. The Uzbekistan government embarked on implementing major reforms, and the SP system development was embedded in the process, not only to help support the population during the transition, but also to move SP to the next level. Both at the beginning of the market-oriented reforms and later during the COVID-19 crisis, the government acted to jumpstart the process of modernization and optimization of the social protection system. The next phase of SP system development needs to focus on higher sectoral coordination both in policy and implementation, which must be guided by a realistic and measurable National Social Protection Strategy, currently being prepared, and an adequate M&E system supported by strong IT and digitalization.

Among recent achievements are the initial phase of a comprehensive digitization project of the sector, introduction and enhancement of ALMPs, and increasing coverage of the poor by meaningful SA interventions. The roll out of the Single Registry, currently in progress, and further development of the LMIS, comprising two IT subsystems, will support both policy integration and implementation of SP programs and a stronger link between social assistance and labor market programs. Going forward, ensuring integration of the systems will enable building a link to the more comprehensive social protection sector, to be able to provide more tailored services and benefits to the vulnerable groups, and addressing the emerging challenges they face. Addressing existing challenges will help bring the SP system to the next level.

Overall, the social protection system needs adequate SP institutional arrangements, including an integrated vision and management of the sector (by a dedicated entity). Strong and effective links between social assistance and labor market programs, as well as social insurance and social care services will allow to better address many constraints vulnerable people are facing both from the design and implementation perspectives. The integrated approach will allow to implement strategies, programs and operational tools (like the ITs) to support vulnerable groups and inactive population to move from assistance or doing nothing to participate in the labor market and in income generating activities. Having an integrated approach will strengthen the link between interventions to better support vulnerable groups. Finally, only through an integrated approach, along with other reforms and adjustments in the SP programs, the Government will be better prepared for future shocks and disasters affecting incomes and assets of vulnerable groups.

Developing and using the M&E framework will help improve efficiency of SP policies and inform decision making. Decision making regarding social protection policies and programs should be informed by evidence and relevant data. On top of collecting administrative data, it is crucial to track performance indicators and analyze the impact of social protection programs in order to make sound and effective policy decisions, including regarding budget allocations. The lack of quality, relevant and updated data collection and monitoring may have negative implications: (i) it undermines the policy objectives and create a system in which the impact of the combined social protection programs is hard to evaluate, (ii) makes decision making to be based on subjective information, (iii) limits budget planning and program monitoring opportunities and (iv) results in lower cost effectiveness of social protection, as fragmentation prevents optimal administration.

Further modernization of social protection information systems and the digital ecosystem in Uzbekistan is needed to address several existing challenges and prepare SPJ systems for future shocks. Ongoing development of the digital ecosystem has to continue focusing on improving data quality, creating linkages, increasing quality of services for beneficiaries, and data security**.** Proper information systems can help reduce errors, decrease the transaction costs for applicants, and increase quality of service provision and better targeting accuracy. Developing comprehensive IT systems tailored to the needs of SP sector must continue integration of the Single Registry with other government databases, including the LMIS database.

Uzbekistan's Single Registry is currently in the early stages of development. Even though the single registry is operational in the whole country, the assessment of current business processes, software and targeting are ongoing, and the results will have to be further incorporated in the process to ensure smooth implementation of the programs. Currently all the applications and rejections of the three low-income family allowances are being processed through the registry. The database currently contains information on almost 2 million HH, or around 30 percent of the population. Uzbekistan's Single Registry has already developed four modules (three for low-income family allowances, one for online applications expected to become operational in July 2021). The President in his address speech in December 2020 committed to expanding the Single Registry and adding more modules, including for social care services to the system. Defining priorities of module development remains under discussion and requires centralized SP agency planning. Development of a comprehensive Registry and digitalization integration of similar platforms has the potential to provide support not only support social protection programs, but also other social services to the population and support social and digital inclusion. Countries are using social registries beyond social protection to also provide housing and utility subsidies and benefits, training and education programs including scholarship–based programs, subsidized health insurance, different social services, and productive inclusion programs.[34] Building the digital ecosystem will allow for the expansion of the scope and quality of services the government provides to the population. The design of social protection programs and their implementation and delivery systems should be simple, certainly from the beginning, and additional elements added only gradually, as the basic functions are working properly.[35] Turkey's experience (Box 1) highlights that digitization and interagency linkages are an integral part of any modern SP system.

Data protection and information security are key priorities for any national registry under development possessing personal information. It is important to heed lessons learned from other countries developing systems similar to the Single Registry. Up-to-date data are key in such systems. It is crucial, given the breadth of personal information integrated registries hold, to take all measures to ensure information security. The European Union developed a General Data

[34] Leite, Phillippe, Tina George, Changqing Sun, Theresa Jones, and Kathy Lindert (2017). "Social Registries for Social Assistance and Beyond: A Guidance Note and Assessment Tool." Social Protection and Labor Discussion Paper 1704, Washington, DC: World Bank. http://documents.worldbank.org/curated/en/698441502095248081/Social-registries-for-social-assistance-and-beyond-a-guidance-note-and-assessment-tool.

[35] Kathy Lindert, Tina George Karippacherili, Inés Rodriguez Caillava, and Kenichi Nishikawa Chavez. 2020. *Sourcebook on the Foundations of Social Protection Delivery Systems*. Washington, DC: World Bank. https://openknowledge.worldbank.org/handle/10986/34044 License: CC BY 3.0 IGO.

Protection Regulation affecting the development of data registries, which set international best practice for data protection and privacy.

Box 8.1: Modernization of the Digital Ecosystem in Social Protection in Turkey

Economic growth in Turkey translated into expansion and increased quality of basic public services; together these had a significant impact on poverty reduction. Traditionally, social assistance has been a small part of the SP system (0.57 percent of GDP in 2003), but with the economic growth, the scope of SA has been expanded, which translated into growing social assistance expenditures (1.33 percent of GDP in 2015). The growing number of SA initiatives led to fragmentation, which was becoming an impeding factor to the SA area development. Additional challenges for the Turkish SA included bureaucratic inefficiencies affecting both applicants and beneficiaries, lengthy processing times, and poor quality of information.

The rapid growth of SA initiatives in Tukey during 2005–10 and lack of a single coordinating ministry brought about a systemic change. Among the social assistance initiatives from 2005 to 2010 were the expansion and enhancement of existing SA programs (Turkey's flagship Universal Health Insurance program had an increase in disability pensions) and the launch of new ones (in-kind food and coal distribution, conditional cash transfers for education and health, as well as the provision of textbooks, school meals, and other SA programs). Eventually, the Ministry of Family and Social Policies (MoFSP) was created in 2011 to better coordinate various programs and increase efficiency in the fragmented sector. Since 2010, the government has been developing an extensive e-government system, administered by the MoFSP. The Turkish Integrated Social Assistance System (ISAS) oversees all steps of social assistance, from enrollment to financing and auditing. ISAS goes beyond that and also collects data for case management, community information sources data to verify social status of applicants, and even facilitates data exchanges with NGOs.

ISAS was expanded significantly by adding new modules during 2010–15 to enable a comprehensive approach to SP and beyond and better use of existing government systems. The ISAS system started with the development of a cash transfer module which was first piloted, then expanded, then other modules started being added up. All of Uzbekistan's Single Registry modules began with design and development, then progressed to pilot testing, and then to full rollout. This way, any module, software, or business process errors could be caught on a small scale rather than multiplying and reaching a national scale.

Source: *Turkey's Integrated Social Assistance System* (English). Washington, DC: World Bank Group. http://documents.worldbank.org/curated/en/515231530005107572/Turkey-s-integrated-social-assistance-system.

In terms of the effectiveness of the main anti-poverty targeted program we recommend consolidation of the three low income family allowances into one program and establishing a common structure for benefit amount[36]. It is efficient to harmonize the operational procedures and selection rules for the three family allowances. This would imply to have one application form, one way to assess vulnerabilities, one way to determine eligibility (which is already happening as the income eligibility threshold is the same for the three allowances), and a consolidated benefit structure or common rules to define benefit amounts for families that pass the income test. The reforms of the Single Registry represent a step towards harmonization procedures for low income families. However, what determines the benefit amount each eligible family is entitled to currently depends on the family composition.

SP programs need to be complemented by the development of case management and social mediation approaches. Case management plays an integral role in moving people from social assistance to income generation enabling better links between social benefits, social care services and activation programs. Poor and vulnerable people often face multiple challenges, therefore, assessing the barriers and providing tailored support and linking families or people to specific services might help tackle them. Such services can go beyond just SP sector, and also include

[36] Ad-hoc Note "Proposed changes in the design of Low-Income Family Allowances", World Bank, 2021

health or education related support, or even provide access to affordable and high quality childcare arrangements to increase female labor participation.

The shift to the market economy brings on certain challenges for employment. First of all, the reforms will cause higher unemployment due to the transformation of SOEs. There is need to provide different types of employees tailored SP support to address their specific needs and facilitate their reintegration into the labor market. Skills mismatch is likely to worsen because workers laid off from the SOEs might not have the qualifications that a modern economy demands. Qualifications level and potential mismatch, though, make up a broader challenge for the fast-changing country. Rapid modernization and opening of the economy require modern skills and qualifications competitive not only within but also outside the country. The balance between labor supply and demand side support will be necessary, which means complementing demand side support with ALMPs. Further emphasis on skill development is essential for the country's transformation and increasing workforce competitiveness abroad. Creating strong coordination and the involvement of the private sector in the development of curriculum and training implementation will be crucial for building labor market relevant human capital. Ensuring the participation of the private sector in the development and implementation of the ALMPs should help strengthen outcomes and maximize employability of people. A country that focused national policies on workforce development (WFD) was South Korea. Following the transition from a state-led economy to a market economy, South Korea has had a strong policy emphasis on workforce and skills development to support not only the population but also the country transformation (Box 2).

The Government of Uzbekistan is committed to workforce development. In the outline of the National Employment Strategy,[37] which is currently being finalized by the Ministry of Employment and Labor Relations, two priority pillars are: (1) increasing the coverage and quality of active labor market programs; and (2) developing professional education, including expanded collaboration with employers. There is a strong emphasis on skills development in the government policy priorities, including Uzbekistan joining WorldSkills, commitments to developing s training centers at almost every mahalla, and more. The National Qualifications System decree has been approved recently.

Box 8.2: Rethinking the approach to workforce development—Korea

Over time, the Government of Korea implemented a series of reforms aimed at improving oversight of the linkages between education, training and WfD systems. The reforms focused on development and implementation of national standards of the training's provision, curricula, and even the equipment for vocational education, which were applicable to both private and public training centers. Involvement of the private sector in the process was bringing in funding and demand for certain skills, reflected in the industry-relevant curriculum. The initial stages of reforms focused more on the standards/qualifications development (Korea's Vocational Training Standards, 1976; National Technical Qualifications Act, 1973; training levy system, 1976). The focus then shifted to provision of lifelong learning (development of websites for raising awareness, introduction of training grants from the Employment Insurance Schemes, 1995; and Individual Training Accounts, 2008; etc.). The government also moved to performance-based financing for training providers.

[37] Ministry of Employment and Labor Relations, presentation of the National Employment Strategy 2030 outline and priority areas.

One of the strong points of the Korean approach was the involvement of a wide range of actors in the process, including, apart from the government, which oversees service delivery, the industry, research centers, and private and public training providers. The main focus was again on collaboration between training providers and the industry; the relation links were institutionalized whenever possible. Examples include by developing cooperation between schools and the industry in order to allow workplace training, and the Vocational Training Research Institute using empirical-based evidence to tailor trainings to be able to address regional labor market needs. The programs were tailored to the needs of different groups. Programs were also developed specifically for working adults, high school graduates, and others. The emphasis was also on increasing the quality of service delivery by increasing competition among training providers, hiring heads of training institutions on a competitive basis, and those who worked in the industries. The monitoring framework was also developed for the training centers.

Adapted from World Bank, 2013. *Republic of Korea: Workforce Development. Systems Approach for Better Education Results (SABER)*. Washington, DC: World Bank. https://openknowledge.worldbank.org/handle/10986/16277.

Lee, Young-Hyun (2007). *Workforce Development in the Republic of Korea: Policies and Practices.* Tokyo: Asian Development Bank Institute

Regarding social insurance, the goal is to increase coverage by providing flexible and diverse pension system mechanisms as well as social security for workers in the informal sector. Pensions is the largest part of the SP protection system currently, therefore ensuring it functions well and parameters are fair, and also fiscally sustainable, is important. Uzbekistan's pension system is under pressure from demographic and economic factors that have a long-term impact. Aging population, large-scale informal employment and prevalent agricultural incomes, and a narrow range of jobs with paid employment and low earnings are causing an increase in the number of older people with increasing risks of poverty and their exclusion from the scope of the pension system. The priority development area for the pension system in Uzbekistan is in increasing the coverage by providing flexible and diverse social protection mechanisms.

Universal pensions guaranteed and financed by the state for the elderly, survivors, and people with disabilities are a useful tool to prevent extreme poverty. Such pensions are not tied to earnings and the amount of paid contributions, but, as a rule, are dependent on the duration of residence in the country and the availability of other sources of income. In the Nordic countries (Denmark, Finland, Iceland, Norway, and Sweden), such pensions are a separate payment and take into account the length of residence, marital status, labor pensions, earnings, and other income.[38] In Kazakhstan, a basic pension is paid, the amount of which depends on the subsistence minimum and the length of service. Armenia, Estonia, Greece, Kyrgyzstan, and Russian Federation add the base/fixed part to the total payment formula, where it is added to the insurance components. In Uzbekistan, the structural reform of the solidarity system, arrived at by introducing a universal state pension or adding a base/fixed part to the insurance pension formula, can replace existing social benefits for persons without seniority, as well as solve the problem of the Pension Fund deficit that emerged after the tax reform.

The pension system setup can be leveraged to stimulate the formalization of employment. For example**,** India's experience in subsidizing contributions can be useful to stimulate the creation of new wage employment and the formalization of labor relations. India periodically runs campaigns to encourage employers to hire workers for at least a small salary in order to involve

[38] Mutual Information System on Social Protection, MISSOC Comparative Tables (July 2020). https://www.missoc.org/missoc-database/comparative-tables/.

new participants in the pension system. The state provides a subsidy to fully cover the employer's contribution for employees who have been hired within the past three years, have not previously participated in any pension program, and have a salary not higher than the established threshold.[39] In many European countries, contribution subsidies are used to encourage employers to recruit people with reduced competitiveness, such as people entering the labor market for the first time or returning after a long break. In Uzbekistan, such subsidies can be envisaged, for example, for graduates of educational institutions without work experience.

Given the need for the full-scale development of the social insurance system in Uzbekistan, and given the undesirability of increasing the fiscal burden on wages, other means of financing need to be considered. It is advisable to consider the possibility of establishing the State Accumulation Pension Fund, following the example of the Central Reserve Fund of Singapore (Singapore's Central Provident Fund). Contributions to this fund are allocated to one of three accounts (regular, special, medical), depending on the age of the participants and the amount of savings. Regular account funds can be spent on housing, life insurance or mortgage insurance, and tuition fees. Means of the medical account can be used to pay for medical services or hospitalization. The funds of the special account are intended specifically for pension savings, but if there is a sufficiently large amount, the "surplus" can be used to invest in financial products related to pensions. Participants or others on their behalf can make contributions in excess of the mandatory amount, for which the state provides tax incentives. When a participant reaches age 55, the savings from the regular and special accounts are combined and transferred to the pension account.[40] The advantage of such a reserve fund is precisely its multipurpose orientation. Such multipurpose funds also exist in Malaysia and some other Asian countries.

Examples of using pension savings in the event of loss of earnings, for special expenses or other force majeure circumstances, exist in many other countries. For example, Mexico allows participants to use part of their pension savings in the event of unemployment. Australia, Iceland, Peru, and other countries have allowed pensioners to access some of their retirement savings during the COVID-19 pandemic.[41] For Uzbekistan, the development of a mandatory funded pension component may be a good opportunity to expand the list of covered social risks, including insurance against unemployment and temporary disability.

E. THE PATH FORWARD

Further development of the sector needs to focus on several aspects:

- **Ensure there is an adequate institutional arrangement for the SP system.** Overall, the social protection system needs adequate SP institutional arrangements, including an integrated vision and management of the sector (by a dedicated entity). Such entity needs to establish a clear and codified accountability and coordination structure to

[39] "India Expands Pension Subsidies for Low-Income Workers" [(June 2018). https://www.ssa.gov/policy/docs/progdesc`/intl_update/2018-06/index.html.
[40] "Singapore Introduces Government Match for Provident Fund Catch-up Contributions" (March 2021). https://www.ssa.gov/policy/docs/progdesc/intl_update/2021-02/index.html#singapore.
[41] "Focus on International COVID-19 Induced Reforms" (April 202). https://www.ssa.gov/policy/docs/progdesc/intl_update/2020-04/index.html.

modernize SP architecture and monitor outcomes. Finalizing the national SP strategy, developing M&E framework, and defining M&E responsibilities are the basic building blocks for any effective SP system that are currently also missing.

- **Ensure all extreme poor are covered with effective social assistance.** We would recommend harmonizing the operational procedures and selection rules for the three family allowances and propose to establish a simple tiered flat benefit structure that would determine family benefit amounts based on the household size (on a per capita basis) and age of members for families that pass the income test. The exclusion errors stemming from resource limitations significantly undermine the effectiveness of social assistance programs in poverty reduction. All households that are de-jure eligible for the program based on the outlined selection criteria should have de-facto access to the benefits. This essentially means that the funding for the low-income family allowance program will vary depending on the particular year's needs.
- **Move towards developing adaptive SP system to ensure it is shock-responsive and forward-looking.** We recommend defining and using in the three strategies that are being developed (Social Protection Strategy, Employment strategy and Poverty Reduction strategy) the adaptive approach to social protection, poverty reduction and employment, define the role of this approach, and mechanism for preparing, preventing and responding to emergencies, including steps for short-term and long-term growth. Adaptive social protection programs could be linked with risks analysis to be able to plan and address needs/shocks faced by households and reduce the eligibility determination burden in cases of emergency.
- **Improve service delivery capacity in SP.** The capacity of employment support centers (ESCs) needs to be strengthened. The implementation of the Single Registry also needs to be further developed to minimize exclusion errors and expand its functionalities including to progress towards strengthening the link between social assistance and labor interventions to promote graduation from social assistance; and with social services to introduce case management and social intermediation.
- **Advance the development of the digital ecosystem to support evidence-based design, coherence and effective implementation of SP programs.** Further development of the single registry and the labor market information system and increasing the linkages between the two will help collect information for better targeted more effective interventions. However, there is a room for further advancing the system by integrating additional data. For example, poverty risks maps allow estimating potentially vulnerable households. And integrating climate hazard and risk maps to the single registry allows in advance mapping of the poor and vulnerable households to be affected by climatic chocks to be able to prepare and cost targeted response which will be required

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Chapter 9. Education

Uzbekistan's economic growth has not translated into job creation. According to Uzbekistan's Human Capital Index, a child born in the country today will be only 62 percent as productive when she grows up as she could be if she enjoyed complete education and full health. Despite a favorable population structure, without empowering the younger generation through investing in their education and health, a dramatic economic transformation will be challenging. Learning outcomes were improving before the pandemic, but significant learning loss has occurred, requiring serious efforts to recover and move the system forward. The following areas have been identified as priorities for the education service delivery to function successfully and for policies to achieve its objectives:

- *Enhancing the qualifications of the teaching workforce and ensuring alignment between the different levels of education in teacher preparation and professional development.*
- *Improving school management and modernizing the learning environment and orienting the education processes toward strategic skills and outcomes.*
- *Improving system governance and financing, including proper autonomy to schools, vocational education providers, and higher education institutions within an accountability framework to improve cost-effectiveness and labor market relevance.*
- *Creating COVID-19 related just-in-time solutions to help the government cope with challenges in providing quality education to avoid further education losses and long-lasting deficiencies in learning.*
- *Expanding the potential of the education system through (i) nurturing the private sector and introducing innovations using public-private partnerships; (ii) improving credibility and recognition of selected national education institutions as hubs for excellence and incubators for ideas and discovery; (iii) strengthening the role of education in support of the national vision on skills to bring foreign direct investment to Uzbekistan; and (iv) strengthening partnerships and twinning between national and international well-recognized institutions to exchange ideas and students, conduct joint research, and open the national programs to the world.*

A. Background

The Constitution of Uzbekistan (1992) guarantees the "right to education" to all through its Article 41: "Everyone shall have the right to education. *The state shall guarantee free secondary education23. Schooling shall be under state supervision.*" Further, the Law of the Republic of Uzbekistan "On Education" of 1997 (revised in 2007), the National Programme on Personnel Training, and the National School Education Development Programme, adopted in 2004, defined the legal and policy framework for education in the country until recently. The Law on Education (1997) assures free and compulsory secondary education, which has resulted in high enrollments at secondary school levels.

Initially, the approach to public education philosophy was affected by the national radical approach to transition to a market economy, in that Uzbekistan chose a delivery system based on a closed and centrally planned process. The approach at the time was incapable of sustaining productivity and growth or of creating enough jobs for a growing young population, leading to substantial outward labor migration. The drivers of the old economic model were no longer sustainable to meet the country's needs. Since then, Uzbekistan steered a process of fast-paced, all-encompassing, and wide-ranging market-oriented reforms. Education service delivery was further emphasized in the Development Strategy of 2017–21, in which a shift to a broad market-oriented reform program was adopted. It included five relevant priority policy areas: (1) enhancing state and public institutions; (2) securing the rule of law and reform of the judicial system; (3) promoting economic development; (4) fostering social development; and (5) ensuring personal and public security through interethnic and religious tolerance and constructive foreign policy. The Uzbekistan government reiterated that timely and effective implementation of the Development Strategy was a top priority of all government bodies and their officials. As a result, several actions were implemented representing a major first step for the country's strategy to achieve equitable growth and jobs. This entailed major structural changes that presented both opportunities and challenges.

The new strategy laid the foundations for the country to set the base for a more productive, innovative, inclusive, and stable society in the longer term. As a result, four actions were prioritized for boosting growth and human development: (1) enhancing the quality of education, and healthcare and nutrition to strengthen the nation's human capital; (2) prioritizing economic flexibility and entrepreneurship; (3) scaling up technological access and innovation; and (4) fostering social participation and cohesion. Enhancing the quality of education was intended to be a key driver for boosting growth and human development, leading to a true demographic dividend. It was also indicated that boosting its human capital will require enhancing access to and quality of essential services, particularly in early childhood development, general secondary and tertiary education, job skills development, etc.

The education driving principles in Uzbekistan have been in a state of continuous change during the latest years. While the country's commitments to international goals, especially the UN's Sustainable Development Goals related to education (e.g. SDG 4) brought new long-term goals for the education sector, the Uzbekistan National Action Strategy 2017–21 provided priority areas for aligning sectoral goals. The commitment of the new leadership that assumed office of the country has been reflected in the presidential decrees and government resolutions aimed at improving the education sector that have been issued at regular intervals.

V**arious presidential decrees and government resolutions have been enacted**. In 2015, the government committed to the implementation of *Transforming Our World—The 2030 Agenda for Sustainable Development* and the Sustainable Development Goals and to its monitoring framework. To support member states in their implementation of the 2030 Agenda and the SDGs, the UN Development Group initiated in 2016 the "Mainstreaming, Acceleration, and Policy Support (MAPS)" approach. The MAPS approach was designed to initiate a process for addressing the challenges and complexities of sustainable development collaboratively, over the longer term. Accordingly, the government has decided to align the SDGs with the national development policy framework by: (1) aligning the implementation of the National Action Strategy with the coordination of SDG nationalization efforts and applying a long-term approach to development

planning; (2) developing SDG baselines and target values that reflect national aspirations to 2030; and (3) gradually integrating the SDG targets and indicators into central, sectoral, and regional strategies, as well as into annual legal, budgetary, and reporting processes (in both the executive and legislative branches). After that, the president signed the *Presidential Decree on Uzbekistan's Development Strategy 2017–2021*, which approved the *National Action Strategy on Five Priority Development Areas 2017–2021*. The Action Strategy was developed as a five-year strategic plan developed by the new government, which assumed office in 2016, on the basis of a comprehensive study of topical issues, analysis of the current legislation, law enforcement practices and the best international practices, and following public discussion. The National Commission for Implementation of the Development Strategy, headed by the president, is responsible for its realization. Of particular interest for education is priority area 4, which includes four sub-areas:

- Consistent increases in real income and job creation.
- Improvement of the social security system and healthcare, and of the socio-political activity of women.
- Implementation of targeted programs to build affordable housing, and development and modernization of road transport, engineering, communications, and social infrastructure, ensuring the improvement of living conditions of the population.
- Development of education and science.

As a result of the commitments to targets in education, in 2018 the State Inspection for Supervision of Education Quality (SISQUE) was established under the Cabinet of Ministers. SISQUE worked with the three ministries of education—the Ministry of Preschool Education (MPSE), the Ministry of Public Education (MoPE), and the Ministry of Higher and Secondary Specialized Education (MHSSE)—as well as other related ministrie, on the revision of the Law on Education (1997). SISEQ also consulted various international organizations such as UNICEF, UNESCO, and the World Bank in the process to understand international treaties on the rights of children to education. The revised law includes, in addition to the 35 articles, 30 new articles, focusing on:

- A stronger focus on realizing inclusive education.
- Lifelong education and health education.
- Independence of the private sector.
- Independence of higher education institutions (heis)
- A new requirement of centralized data-gathering from universities under the head of each heis, in order to ensure reliability, validity, and comparability of data.

The *National Programme for Personnel Training* was created to address a series of issues in the education system. These included: the gap between the knowledge and skills acquired by the students and the requirements resulting from democratic and economic transformations, the shortage in highly qualified pedagogical staff, the insufficient quantity of qualitative didactical materials and methodological and scientific literature, and the absence of close and mutually beneficial cooperation between the educational system and science and industry. The *Resolution on State Standards* of 1998 established standards that are binding for all educational institutions. The standards define the requirements for personnel training, the content of education, the level of

knowledge of graduates of educational institutions, the teaching and study load, and procedures and mechanisms for the evaluation of the work of educational institutions. Among the goals of the state standards are to guarantee the high quality of education and of the preparation of staff for the economic and social transformations of the country, and the democratization, humanization, as well as an increase of students' knowledge about legal and economic matters.

The *Programme for the Preparation, Re-orientation and Further Training of Qualified Pedagogical and Technical-Pedagogical Staff of the System of Secondary Specialized Professional Education for the Period until 2010* aimed at raising the overall level of qualification and professionalism of staff working in secondary specialized professional education. This was to be achieved, among other things, through a close cooperation with the industry and the development of distance education systems. With the *Resolution on the State Examination Centre* of 2004, the government established the center and tasked it with testing for admission to educational institutions, controlling the quality of teacher preparation, ensuring the efficiency of the educational process, as well as evaluating graduates' knowledge in terms of state standards and requirements of the country. The 2006 *Resolution on the Further Development of the System for Re-training of Pedagogical Staff* specified the requirements for the in-service teacher training system and foresaw a feedback mechanism between the requirements for in-service teacher training and the monitoring of training results. The resolution also defined the skills required of a modern teacher, such as the ability to teach and educate in a humanitarian way and to control and evaluate students' progress in an objective manner. The resolution further specified the skills needed by teachers at the pre-secondary general secondary, secondary specialized professional, and higher education levels. Teachers were also mandated to undergo training no less than once in three years.

The *Law on the Guarantees of the Rights of the Child* of 2008 stipulated the right to free general secondary education and secondary specialized professional education for children with disabilities. The state is mandated to take appropriate measures to guarantee education for socially vulnerable children who require special pedagogical approaches. Children with physical or mental impediments have the right to education and upbringing in educational institutions according to specially developed educational programs and in line with their physical and mental abilities and parental wishes. Based on the interests of the child and the recommendations of the medical commission, parents of children with physical or mental impediments have the right to choose between a regular and a specialized educational institution. However, this medical model of defining disability is not, in the present-day world, in alignment with the international understanding of disability-related issues. In December 2016, through the *Presidential Decree on Measures Aimed at Further Improvement of the Pre-School Education System in 2017-2021*, the government approved a *Program for Further Improvement of the Preschool Education System* from 2017 through 2021, with the goal of reforming the quality of preschool education. This national program aims at: (1) creating conditions for a comprehensive intellectual, emotional, aesthetic, and physical development of children, based on best international best practices; (2) improving the quality of preschool education, and preschool children readiness, based on widely adopted international practices; (3) establishing half-day groups in preschools for children ages 5–6; (4) improving the curricula and syllabi for preservice and in-service training of preschool teachers through modern educational technologies and methods; and (5) improving the material and technical infrastructure conditions of preschools institutions, including the construction of new preschools in rural settlements and the provision of equipment, furniture, teaching and learning

materials, and multimedia tools compliant with modern requirements. In 2017, the government announced an ambitious plan to expand access to preschool education with the aim of achieving 100 percent enrollment for children ages 5–6 by 2021. Starting with the 2021–22 school year, it will be compulsory for all 6-year-old children to be enrolled in preschool education. This measure is being implemented in a phased approach, which started in a few regions of the country in the 2019–20 school year. Within this context, the government established the Ministry of Preschool Education (MOPSE) in September 2017 to play the lead role in the expansion of early childhood development in Uzbekistan and govern this core subsector of the education system.

The *Presidential Decree on Measures for the Further Development of the System of Training and Supply of Qualified Staff to Secondary Specialized Professional Education Institutions* of 2021 highlights the insufficient qualifications of school directors and teachers at academic lyceums and vocational colleges. The resolution addresses the widespread practice of hiring school management and specialized pedagogical staff without due attention to their qualifications. While the policies mentioned above were developed over a period of more than 20 years since independence, the past couple of years have seen many policy decisions coming from the government to reform various subsectors of education.

Recent measures (2017–18) provided additional options and choices for expanding access and promoted competition to enhance quality and improve responsiveness to labor market demands. Uzbekistan has also enhanced the system structure to improve the relevance of general secondary education. Until 2017, general education in Uzbekistan consisted of nine years of compulsory education (Grades 1–9). By 2019, compulsory general secondary education was expanded to 11 years. However, students can still choose to attend academic lyceums instead of general secondary schools for grades 10 and 11, although the study program for academic lyceums has been condensed to two years. In other words, compulsory general secondary education could involve 11 years in a general secondary school or nine years in a general secondary school plus two years in an academic lyceum. Started in the 2019–20 academic year, graduates of Grade 11 can choose to continue their studies in vocational colleges, as detailed below. The reformed structure of the system means that students now have three pathways to complete their pre-university education: (1) 11 years of general secondary education; (2) nine years of general secondary education + two years in an academic lyceum; or (3) 11 years of general secondary education + 0.5–2 years in a vocational college.

The government continued to improve system management and qualification standards. This was in line with the 2018 *Presidential Decree on Additional Measures to Improve the Management System of the Public Education* ,which introduced new management mechanisms and quality standards in the educational process, increasing the prestige of the teaching profession in the society and improving the material and technical condition of educational institutions. *The Presidential Resolution on the Measures of Raising to the New Quality Level of the System of Spiritual-Ethical and Physically Harmonious Education of the Youth, Its* Learning *and Upbringing*[1] discusses: (1) increasing teacher salaries; (2) giving preferences to teachers and their families for obtaining bank credits, housing, automobiles, etc.; (3) protecting and increasing the status of teachers in society; (4) prohibiting all activities related to attracting school staff to forced

[1] PP-3907, dated 14 august, 2018.

labor; and (5) prohibiting all school controls and inspections of school activities and documentation by various state and regional organizations not related to educational process, etc.

Through the *Resolution on Measures for the Implementation of New Principles of Management in the System of Public Education*, the government approved a new organizational structure of the Ministry of Public Education, as well as the *Program of Measures on Further Improvement of the Public Education of the Republic of Uzbekistan* for 2018–21. The midterm measures highlighted in the *Program of Measures of Resolution* were aimed at: (1) improving legislation, including development of the *Law on the status of a teacher* and development of a draft of normative acts regulating the activities of non-state general education organizations; (2) improving the quality of education and the introduction of innovative educational technologies; (3) introducing information and communication technologies in the system of public education, including a new funding mechanism such as per capita vouchers from the 2019–20 school year, development and approval of programs of measures for the further implementation of EMIS, and computerization of educational institutions for 2019–20 with the identification of specific sources of funding; (4) improving the teacher training system, including the introduction of a new course on "Management in Public Education" in higher educational institutions from the 2019–20 school year; and (5) improving the material technical provision of educational institutions, including the development and approval of the state program "Modern School[2]" for reconstruction, overhaul, and equipment of educational institutions for 2020–22, implementation of complex repair of heating and lighting systems of individual educational institutions using a mixed financing mechanism.

A number of measures were adopted to reform the system of methodological support of teachers. The Reform Agenda aimed also at strengthening the role and responsibility of the Ministry of Public Education and to improve the financing of public education by transferring to the MoPE responsibility for financial management, including the establishment of the *Fund for the Development of School Education* funded in part from the non-budgetary *Fund for the Development of the Material and Technical Base of Educational and Medical Institutions* under the Ministry of Finance (MoF).

Uzbekistan is in the process of reforming its Secondary Specialized Vocational Education (SSVE). The government aims at making it more flexible and aligned with the labor market. In the context of extending general secondary education to 11 years of study, as described above, admission to vocational education will be available only for graduates of compulsory general secondary education (after Grade 11), on a voluntary basis. The programs in vocational colleges will last from six months to two years, depending on the specialization. Furthermore, the recent reform aims to improve the vocational college network based on national and regional economic development priorities, the labor market forecast and technological development, and trends. It is expected that the number of vocational colleges will be substantially reduced, from around 1,400 to around 800 colleges, including through the organization of multidisciplinary colleges, by providing targeted training programs in high-demand specializations.

[2] building secondary schools of a new type and stage-by-stage adaptation of previously constructed buildings to modern requirements, the use of modern pedagogical technologies in the educational process and development of competition in the educational services market.

The SSVE system is also being reformed to better support continuous vocational education and training for adults. The recent reform of the SSVE subsector includes the transfer of administration of vocational colleges to ministries other than the Ministry of Higher and Secondary Specialized Education, as well as to public agencies or enterprises operating in the same sector under which training programs are offered. By subordinating vocational colleges to other organizations in the same sector, it is anticipated that vocational colleges will be better able to respond to the skills needs of specific industries. The SSVE reform also promotes the provision of adult training in existing vocational colleges, including vocational training and retraining for the unemployed. This change is aligned with international best practices in lifelong learning, under which vocational colleges play the role of training provider.

The higher education system is managed by the Ministry of Higher and Secondary Specialized Education (MOHSSE). Several other governmental agencies play different roles in the management of this subsector in addition to the MOHSSE. These include, among others, the Cabinet of Ministers, which makes strategic decisions for this subsector; the Ministry of Economy, which decides on the number of student places available in higher education; and the State Testing Centre, which is responsible for quality assurance. The *Law on Education* (1997) regulates the higher education system in Uzbekistan. More specifically, the Presidential Decree[3] from May 2011 focuses on improving quality, teaching infrastructure, and management of the sector. In addition to the aforementioned Presidential Decree 2204 regarding research, Decree No. 371 by the Cabinet of Ministers, from 2012, introduced a new approach to the assessment of quality in the sector, moving away from a focus on inputs to start looking at outputs.

B. EDUCATION'S ROLE DURING THE TRANSITION IS STILL DEVELOPING

Uzbekistan's young and growing population is an advantage for the country, if children and youth have access to quality education. The country's population has doubled since 1980 and is approaching 32 million (31.96 million, 2018). This brings the potential for a period of high and prolonged growth, boosting prosperity and reducing poverty and inequality. However, the working-age population is already growing at a slower pace, and Uzbekistan's demographic transition has already started. Efficient investments in human capital are imperative to enable the country to maximize its chances of a growth and employment spurt soon, setting the base for a more productive, innovative, inclusive, and stable society. Uzbekistan is heading in this direction in the context of reforms guided by the Development Strategy 2017–21.

At present, children in Uzbekistan receive around 11 years of schooling, and most of the country's population age 25 or older have, on average, received at least a decade of formal education. However, less than 30 percent of children ages 3–6 have access to an early childhood education program, the quality of secondary education is unknown, and less than a tenth of the youth who complete secondary education make it to higher education today in Uzbekistan. To ensure that Uzbekistan is well positioned to reap a demographic dividend, children and youth must receive enhanced education and training, in terms of both quantity and quality. While there have been noticeable improvements in access, equity, and quality, the COVID-19 pandemic has been

[3] No. 1533.

significantly impacting Uzbekistan's economy, reducing growth, and creating additional external and fiscal financing needs. Before the outbreak of the pandemic, the education system was struggling to provide high-quality education to all. According to a recently completed TIMSS-[4]like learning assessment supported by the World Bank, conducted by the government in 2019, students in Uzbekistan performed 46 points (more than a year of schooling) below the average for students in Europe and Central Asia.

Figure 9.1: Population growth, 1950–2100
Population (in millions)

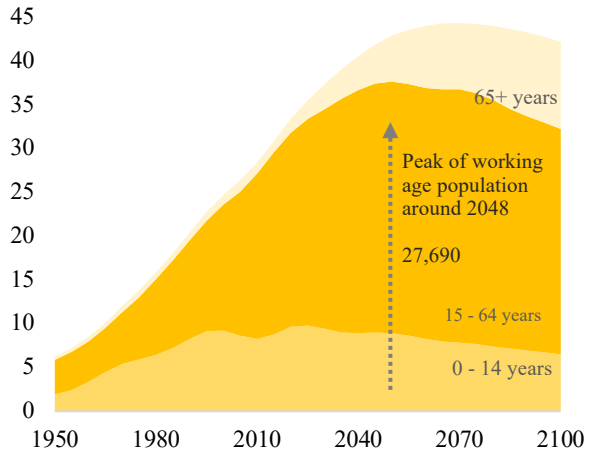
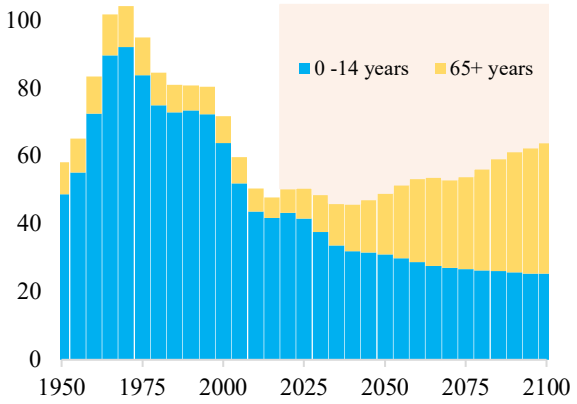
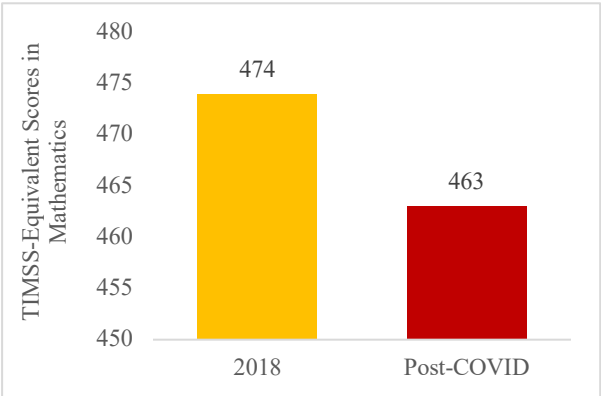


Figure 9.2: Total dependency ratio, 1950–2100
(Dependency Ratio (percent)



Source: United Nations, Department of Economic and Social Affairs, Population Division.

Figure 9.3: Estimated impact on TIMSS-equivalent scores due to COVID-19 (in 2019)



Source: World Bank.

Despite the need for students to improve, COVID-19 has forced Uzbekistan to close schools and transition its 6.1 million students to emergency remote learning. At the same time, Uzbekistan has set an ambitious goal of becoming a "top 30" education system worldwide by 2030. Uzbekistan's success in realizing its wide-ranging economic reforms will be driven by its ability to develop productive human capital and empower its people to contribute to national development. Unfortunately, the education system is not delivering on its promise—nearly three of four firms report inadequate skills as a significant constraint to business development. The quality and relevance of education is poor, the linkage between industry and academia is weak, curricula and teaching methods are outdated, financing is inefficient, and there is inequitable and low access to higher education. Hence, reform is needed

[4] Trends in International Assessment of Mathematics and Science.

immediately to guide the post-COVID-19 learning recovery process with long-term progress measures to achieve Uzbekistan's education system goals.

The Uzbekistan government realizes the need for a well-designed and executed strategy to guarantee results and value from investment in education. Building human capital is a national priority set forth in the plan for increasing public education development. The government's 2030 plan has laid the path to inclusive and equitable access in education. Much has been accomplished in the past few years, including: (1) the successful piloting and launch of the mandatory school preparedness program for 6-years-olds; (2) the piloting of self-financing at 10 higher education institutions; (3) the commitment to participate in international assessments (including PISA in 2022); (4) the revision to the education law to underline lifelong learning; (5) participation in public-private partnerships; and (6) the creation of an enabling environment for the private sector in education.

However, the system faces serious capacity and implementation challenges. While the concept for the development of all three subsectors of education has been approved, it is ambitious, with several targets set for 2030. To this end, the strategic vision aims to ensure equitable access, relevance and skill development, and quality and assessment as the building blocks for the human capital development agenda. The three ministries will need to build capacity quickly to execute the strategy and implement the plans within the timeframe.

Unfortunately, the education system is not delivering on its promise—nearly three of four firms report inadequate skills as a significant constraint to business development. The quality and relevance of education is poor, the linkage between industry and academia is weak, curricula and teaching methods are outdated, financing is inefficient, and there is inequitable and low access to higher education and the quality of graduates are short of the expectations of the labor market based on the Higher Development Index (at 58% in 2019) developed under the current Higher Education Modernization Project. Prior to the pandemic, the Human Capital Index for Uzbekistan was 0.61. This indicates that the future productivity potential of children born today will be about 40 percent below what they could have achieved with better education and full health services. In recent years, increasing life expectancies and decreasing mortality rates have increased Uzbekistan's proportion of youth under the age of 24 to 45 percent of the total population. With this distribution, the country is currently well positioned to reap the economic benefits from an employment spurt, provided it makes the required education investment now.

Poor institutional capacity and ineffective governance are significant hurdles to overcome. The overall capacity of Uzbekistan's education system remains to be strengthened in areas such as strategic planning, human resources management, financial management, budgeting, and quality monitoring and evaluation, as good school management is associated with better educational outcomes. Few quality professionals exist in any of these areas in the three ministries of education. Moreover, the roles and responsibilities of the ministries add challenges to the design and implementation of programs and policies. These ministries and the recently established State Inspection for Supervision of the Quality of Education (SISQE) do not work in close collaboration on critical matters such as student assessment and teacher development. There are also overlapping functions between these four organizations, causing significant inefficiencies. Along with this, an absence of evidence-based decision making is prevalent, as the availability, quality, and reliability of essential data aren't consistent across the levels of education.

There are issues with enrollment, relevance, and financing strategies in higher education. Higher education enrollment in Uzbekistan is significantly low, at 12 percent, while higher education displays the highest average private rates of return compared with other levels of education. Increased higher education enrollment is a strategic direction, as economic expansion has encountered a shortage of graduates. There is misalignment between supplied skills and market needs. Uzbekistan's education system has produced graduates with skills misaligned with the needs of the labor market and relevant economic sectors. Along with this, inadequate investment in human capital has left a portion of the workforce poorly equipped for rapid technological change. Analyses show that the quality and relevance of higher education remain growing concerns. Additionally, Uzbek women's participation in higher education relative to their male counterparts is markedly low. In the 2017–18 academic year, the gross enrollment rate for women was 6 percent. In contrast, in the rest of the world, women's enrollment rates have reached parity with or surpassed those of male students. Additionally, Uzbek women's enrollment in higher education is below that in neighboring countries, including Tajikistan, which made significant progress in enrolling more women in universities over the past decade. Furthermore, Uzbek women's presence in science, technology, engineering, and mathematics at the higher education level is also lower than men, which is concerning because holders of tertiary degrees in these disciplines tend to earn higher wages and are more likely to be employed.

There **is inadequate quality assurance to guide the system and ensure high performance.** Uzbekistan's education quality assurance system does not conform to commonly accepted international standards. The current systems in place are limited in their data collection and do not track internal efficiency indicators, such as repetition of classes and dropout rates. This absence of data makes it challenging to link the curriculum, teaching practices, and the needs of the labor market. Uzbekistan's higher education system has few and weak links to international academia, and thus is not able to internalize the rapid developments in curriculum modernization, pedagogical and research practice, and training regimes that are the hallmark of modern university systems in the developed and frontline developing countries. Additionally, with no ability to track students after graduation, educational institutions lack a monitoring framework to assess the quality of their services. Low levels of internationalization affect higher education quality, as having few linkages with international academia reduces the chance of learning exchanges.

C. Recent Developments in Education Are Promising but Fragmented

Uzbekistan's education system comprises multiple decision makers. It is currently managed by three ministries: The Ministry of Preschool Education (MPSE), which was established in 2017; the Ministry of Public Education (MoPE); and the Ministry of Higher and Secondary Specialized Education (MHSSE). Several other governmental agencies play different roles in the management of higher education. The current education system comprises 12 years of mandatory schooling, with 11 years at general secondary education (GSE), preceded by a year of preschool, which became mandatory in March 2020.

At present, education in Uzbekistan is in a state of flux as the government sustains its commitment to revamping its education system. The reforms aim to expand access to preschool and higher education while also improving the quality of general secondary and secondary specialized education. The Education Sector Plan 2019–23 addresses developmental priorities formulated in alignment with international education commitments, and integrates the SDG targets

and indicators. It does so by including SDG baselines and target values that reflect national aspirations to 2030, while gradually integrating the SDG targets and indicators into central, sectoral, and regional strategies, as well as into annual legal, budgetary, and reporting processes, in both the executive and legislative branches.

Low access to preschool education is a major challenge in Uzbekistan's education system. Sustained for the past decade at approximately 29 percent, and lower in rural areas, the preschool enrollment rate for children ages 3–7 is low by international standards. Critically low enrollment rates are observed in regions with a higher degree of vulnerability and higher population growth rates, reinforcing the need for increased access to preschool education. Poor quality of infrastructure and lack of perceived value of preschool education are barriers to access to education in early years. The introduction of a low-cost (half-day) model of service provision contributed to an increase of more than 50 percent in the enrollment rate in rural areas. While access to preschool education is currently low, the government is reforming the system to expand service provision in partnership with the private sector in urban areas. Provision in rural areas will continue as a major responsibility of the government. It is committed to total enrollment for 6-year-olds in a mandatory last year of preschool education. In 2017, the government embarked on an ambitious plan to expand access to preschool education, aiming to achieve 100 percent enrollment for 6-year-old children by 2024. Starting in the 2021–22 school year, preschool enrollment of all 6-year-old children will be compulsory.

In general secondary education, the reforms focused on improving quality, mainly through better teaching conditions and practices, but the fruits are still to be seen. Presidential Decree 2018[5] proposes, among other things, short- and medium-term goals aimed at increasing the status of teachers and incentivizing performance of teachers and school principals. Salaries of the principals and vice-principals of GSE schools that have a high rate of admission of graduates to universities and professional education institutions will receive a bonus pay in the range of three to 12 of the minimum payouts for labor. By 2024, the monthly salary of high-performing teachers will be gradually increased up to 15 times the minimum payout for labor. Incentives for performance will imply that teachers of the winners of international scientific Olympiads will be promoted to the highest qualification category. The mentioned decree also focuses on teachers' professional development and proposes to expand distance learning programs, which are being piloted for 11,000 teachers in Syrdarya region in 2020 and will be piloted in Bukhara, Samarkand, Fergana regions and the capital city of Tashkent next year. Compulsory and free provision explains the nearly universal coverage in this level of education. Enrollment in GSE has remained high over time and has slightly increased since the academic year 2015–16.

Secondary Specialized Vocational Education

Uzbekistan has been reforming its Secondary Specialized Vocational Education system to conform to international standards, but a mismatch with the labor market still exists. In accordance with Presidential Decree No. 5812, "On additional measures to further improve the professional education system," starting from the 2020–21 academic year, a network of educational institutions will introduce a new system of primary, secondary, and vocational education programs in accordance with the International Standard Classification of Education.

[5] No. 6108.

These programs will last from six months to two years, depending on the specialization, and will target both employed and unemployed learners. These changes are aligned with international best practices in lifelong learning. It is worth mentioning that enrollment at this level within the Uzbekistan system is high and on par with the rates of European countries such as Austria and Poland, but the skill level produced is not fully complete.

One of the most pressing issues in higher education in Uzbekistan is access, which is currently very low, despite the existing high demand. In fact, the gap between demand for and admissions to higher education is increasing over time. Higher education enrollment in Uzbekistan is significantly low at 12.6 percent. The enrollment rate is lower for women than men. Increased higher education enrollment is strategic for the country, and the government is committed to increasing the enrolment rate to 50 percent by 2030. Uzbekistan's economic expansion has encountered a shortage of higher education graduates. In the past three years, 43 new HEIs have been established, bringing the total number of HEIs to 122. This includes 28 local and 15 foreign HEI branches, as well as five nongovernmental HEIs: Kokand university, Tashkent International University, British management university, TEAM university, and AKFA university. Changes in higher education have experienced slower progress compared with other subsectors. A per capita financing mechanism was introduced in 2010, and the formula includes compensatory coefficients. These coefficients are jointly determined by the MHSSE and MoF every year. In 2012, quality assessment for the sector was moved away from an input-focused approach to an output-oriented one, setting the basis for the creation of a university ranking, first published in August 2018.

The Uzbekistan government is still struggling to foster innovation to ultimately promote economic growth. The country wants to become a "top 50" in the Global Innovation Index by 2030. In September 2018, the government adopted the Strategy for Innovative Development for 2019–21, which is designed to improve research excellence; strengthen the links between education, science, and industry; and increase public and private investments in innovation, research and development, and modern technologies. Gross expenditures in research and development are expected to quadruple from 0.2 percent to 0.8 percent of GDP from 2018 to 2021.

D. LESSONS FROM RELEVANT COMPARATORS

Case 1: South Korea's expansion of the delivery of education services over time, with a focus on skills and employment for all

Over the past two decades, Korea has taken bold steps to improve education: it accommodated a surging demand for better education, ensured students from all socioeconomic levels did well on examinations, made primary and secondary enrollment rates nearly universal since about 1990, and achieved a current 86 percent rate of young Koreans` enrolled in higher education programs. There was an unprecedented increase in primary and secondary education from around 1975 to 1990, when the country also grew at a rapid rate. A commensurate growth in tertiary education took place thereafter and continues to date. This expansion can be explained by a number of convergent factors: cultural and historical reasons, economic growth, value placed on education, and government policies that promote educational achievement. A long tradition of Confucianism has established a society in which the scholar sits at the top of the social hierarchy and the attainment of knowledge is considered a priority. The educated person in Korea, thus, is highly respected. However, even ordinary Koreans could enjoy the respect and privileges of this highest

class by passing the Kwageo (a rigorous civil service examination that pays little heed to consanguinity and political ties) to become civil servants. This democratization of talent has put great stock in the power of education to transform lives. Alongside this, a national drive against Japanese occupation from 1910 to 1945 placed a lot of emphasis on the importance of economic self-reliance and national cultivation through education. This resulted in the establishment of approximately 3,000 private schools across the nation, which bolstered the Korean education system. The devastating Korean War that followed left the country bereft of any social, physical, or economic capital. The recovery process was done on Korea's own terms and through hard work.

The dramatic growth of the Korean economy has also contributed significantly to the value that Koreans place on higher education. In the past 25 years, the country has realized an extraordinarily high rate of return from education investment, hovering around 10 percent. Secondarily, there is a large and growing wage premium attached to obtaining higher education in Korea. In 2007, for instance, college graduates earned up to 2.5 times more than their colleagues with a junior high school degree. With the rapid industrialization of the country, Korea's labor market is highly segmented along educational background. As such, obtaining higher education is seen as essential for entering the primary labor market. Partially as a result of this relationship, in addition to the tradition of Confucianism, education is associated with positions of power and influence: graduates from 10 major universities have almost three fourths of the high-ranking government positions. The government also shows a consistent commitment to investing in education: the Ministry of Education has a budget of $29 billion, six times what it was in 1990. This accounts for about 20 percent of the central government expenditure. Koreans, as well, are willing to spend on education. The Korean government spends 3.4 percent of GDP on formal schooling; when taking private and informal schooling into account, the amount nears 10 percent. Teachers are part of that investment: Organisation for Economic Co-operation and Development (OECD) statistics place Korea 10th in rankings of entering teacher salaries. After 15 years of service, Korean teachers moved up to third place, demonstrating that the investment grows significantly over time.

As in other high-performing nations, teaching in Korea is a highly competitive occupation. Teacher preparation programs for elementary school teachers have a limited number of places and selective entry, while no limits are set for students interested in becoming secondary school teachers: all can enter a preparation program, though only 20 percent find employment as secondary school teachers. Selectivity for the elementary program means that there is not much competition for jobs; elementary schools have barely as many candidates as there are teaching vacancies. Teachers work less than 600 hours per year; however, class size ranges from 37 to 50 students. Local teachers' associations exist at the city and province levels. The Korean Federation of Teachers Association is the central representative of these associations and meets annually with the Ministry of Education and Human Resources Development to discuss teachers' welfare. Three teachers' unions also exist. The position of school principal has been held in high regard until recently, when the teachers' unions began to call into question the selection process and the verification of candidates' abilities.

The Korean school system is a 6-3-3-4 system; that is, six years of primary school, three years of junior high, three years of senior high school, and four years of college. The system contains national, public, and private schools. The administrative structure to oversee education consists of federal governance as well as regional and local control. However, the system overall is highly

centralized. For instance, the Ministry of Education and Human Resources Development dictates the national curriculum, which, along with regional guidelines, only allows individual school principals to choose their own goals.

The curriculum has undergone major revisions seven times since 1954. This was done to "reflect the newly rising demands for education, emerging needs of a changing society, and new frontiers of academic disciplines." The most recent update, known as the Seventh Curriculum, aims to prepare students for the knowledge-based, globalized 21st century. To that end, it emphasizes individuality, creativity, and knowledge of Korean culture as well as other cultures. Covering grades 1 through 10, students can choose their own courses in their final two years of high school. All students study English beginning in primary school and continue through high school, where additional foreign language classes are offered.

Case 2: Poland's success at modernizing and streamlining the education system toward skills and competencies at all levels in alignment with the local and global marketplace

In 1945, the number of Poles unable to read and write was estimated at 3 million. In the early 1950s, all levels of Polish education were plagued by shortages of buildings and teachers. The education reform was an important demand of the widespread Polish demonstrations against Stalinism in 1956. The government education policy began the first period of the postwar education reform. In the vocational program, agricultural training schools were added, and technical courses were restructured to afford greater contact with actual industrial operations. During the modern era (1989 to today), the political transformation was accompanied by the changes in the educational system. Poland launched a major education reform in 1999. The two main pillars of the reform have been to delay the choice of following a vocational track by one extra year, with a shortening of the maximum duration of this track by another year, and changes in school curricula. The delay was in response to an emerging knowledge economy and rapidly changing labor market needs. An increase in general knowledge could provide the future working-age population with more transversal skills and the capacity to adapt to changing contexts. In the case of Poland, the choice was to increase the number of hours dedicated to reading.

With regards to the curriculum, the decision was to implement a concept of core curriculum. The concept aimed to provide schools with an extensive scope for autonomy and responsibility; schools were asked to build their own curricula, within a predetermined general framework, while balancing three dimensions of education: acquiring knowledge, developing skills, and shaping attitudes. The reform of the curricula was designed not only to bring about change in the content of school education but, more significantly, to change the teaching philosophy and improve the professional culture of schools.

The curricula reform also included a greater number of hours spent on language instruction for all students. In 2000, only 1 percent of Polish students received more than four hours of language class, while in 2006, 76 percent of students received more than four hours of language class.

Overall, Poland registered substantial gains in PISA scores over time, rising from 470 points in 2000 to 490 in 2003, and again to 495 in 2006 and 513 in the latest PISA, conducted in 2018. Analyses of the factors contributing to Poland's students in PISA have found that the

increase in hours of instruction accounted for 48.8 percent of the total test score improvement from 2000 to 2006. This was much more important than the most significant personal characteristic, having a computer at home, which explained 17.1 percent of the total test score improvement. The major achievements during the transition included:

- The educational system was decentralized, and as a result, schools gained more autonomy and became more involved with the local environment.
- A major achievement regarding the secondary education structure was the decrease in the number of pupils obtaining only vocational education and the increase in the number of graduates with secondary and higher education.
- Modernization of the educational system was achieved with the change in educational structure (the introduction of the gymnasium) and the curriculum reform (Dolata 2005).
- Increased participation in international educational assessment programs, such as the Progress in International Reading Literacy Study (PIRLS), PISA, International Adult Literacy Survey (IALS), and the Programme for the International Assessment of Adult Competencies (PIAAC) programs. Today, 15-year-old students in Poland perform above the OECD average in science, reading, and mathematics in PISA.
- New lifelong learning options were put in place. Rapid development of technology and changing working patterns forced the adult population to constantly raise their educational achievement. Adult skill levels have improved considerably: between 1994 and 2012, Poland attained the largest increase in adult literacy proficiency among the 19 countries for which similar data are available.[6] As one of the EU member states, Poland participates in the implementation of the Community Lifelong Learning Program (LLP)[7] through sector programs such as Comenius (school education), Erasmus (higher education), Grundvig (adult education), and Leonardo da Vinci (vocational education and training).
- Another initiative worth mentioning is the University of the Third Age, whose aims are the education and stimulation of retired members of the community—those in the "third age" of life. Some study groups do not have a prepared syllabus but draw on reports of current affairs in their topic subject to prompt conversation and research. Some groups are designed to cross disciplinary boundaries: combining society, technology, and science. Some groups aim to bridge the generation gap in the field of information technology, opening up an exciting new world to many who might have been oblivious of it otherwise. Another initiative, from 2010, is the University of the Second Age for persons 45+, whose aims are to fill the gap between the First and the Third Age education in the lifelong learning system and to combat the social exclusion of marginalized groups.

Case 3: Estonia's journey to reform the system in support of teachers and school in a decentralized fashion and producing significant learning gains

Estonia, Latvia, and Lithuania provide excellent case of how former USSR republics established new education policies and institutions appropriate for democracy and market

[6] https://www.oecd.org/skills/piaac/Skills-Matter-Slovenia.pdf.
[7] Established on the basis of Decision No. 1720/2006/EC of the European Parliament and Council, November 15, 2006.

economies. Estonia has made remarkable achievements for a country that gained independence only in 1991. Since that year, the Estonian economy has grown nearly eightfold, with a well-developed IT sector central to that growth. Part of its growth strategy was the development of an education system equipped to support a high-tech, high-skill, high-wage economy.

Estonia has made tremendous progress. Key reforms have included developing a new national curriculum and incrementally adapting it to the needs of a new economy; revamping teacher education to focus more on innovative teacher practices, expanding mentorships and requiring all teachers to have a master's degree; and strengthening vocational education and training. Since 1998, Estonia's national strategy has been to create an information society. As part of this strategy, the Tiger Leap project was created to provide all schools with computers and Internet access. The ProgeTiger program, launched in 2012, built on Tiger Leap by providing schools with instructional resources and teacher professional learning to develop students' digital literacy skills. The ProgeTiger program continues today and is focused on building skills in three areas: design and technology, engineering sciences, and information and communication technologies. In 2014, the government adopted the Lifelong Learning Strategy 2020 to guide education reforms for preschool, primary and secondary education, higher education, and adult learning. The strategy called for a focus on the acquisition of learning skills and creativity, developing competent and motivated teachers and school leaders, creating lifelong learning opportunities matched to the needs of the labor market, and ensuring a digital focus and equal opportunities to participate in lifelong learning.

Great reform steps have taken place in the Estonian educational system:

- There have been changes in the contents of studies, educational systems, and the organization of education as a whole. In the transition period, national curricula for preschool education and general education, together with the Standard of Higher Education, have been drawn up, and the importance of fields of training has changed both in vocational and higher education.
- A network of educational institutions has emerged that reacts flexibly to changes in the number of students, and most institutes of the former Academy of Sciences have been merged with universities.
- The importance of the private sector has considerably increased in the entire educational field, and the proportion of paid studies has gone up in public universities.
- Reform in vocational education is being carried out in order to prepare personnel qualified to play a part in the modern development of Estonian society. During the first years of reform in vocational education, 1996–2000, a social agreement was reached concerning ways to reorganize vocational education, and preconditions were created for the direction in which the development of the system should move.
- Estonia has signed international framework agreements that will secure its inhabitants equal opportunities for participation in the European educational sector and labor market. These include the Bologna and Sorbonne declarations, which created a common European higher education area, and the Lisbon convention on the recognition of certificates of higher education and certificates allowing access to higher education. The country has also passed the Act on the Recognition of Vocational Qualification Acquired in a Foreign Country.

- Qualification standards have been raised in order to ensure that only those with accepted pedagogical qualifications may teach.
- A national curriculum framework, adopted by the government September 27,1996, has given to each school the right and obligation to develop its own curriculum, taking into consideration the features particular to the school and the region, as well as the wishes of students.
- A system of external evaluation for study results has gone into effect—for example, tests at the end of various stages of study to determine standards, graduation examinations at the end of basic school with uniform materials, state examinations in upper secondary school—and conditions have been created that allow students with special needs to study in ordinary schools.
- The teaching of Estonian to different age groups of other ethnic groups has become more efficient.

Estonia emerged as a top performer on PISA 2012, ranking in the top tier in science and close to that in reading and mathematics among all PISA participating countries and regions. Among EU countries, Estonia ranked close to the top in all three subjects. By 2018, two PISA administrations later, Estonia had risen to among the top performers in the world in all three subjects and the highest performer in Europe. In addition, Estonian performance is relatively equitable with respect to socioeconomic background. Estonia has the highest percentage of resilient students in the OECD, defined as students in the lowest quartile of socioeconomic status who perform in the highest quartile on PISA within their own country. And the share of low-performing Estonian students in reading on PISA 2018 was less than half the OECD average.

Case 4: Turkey's transition to expand the reach to provide quality education opportunities to all

Turkey dedicates a higher-than-average share of national wealth to education. The education system in Turkey has shown remarkable improvement since 2003 in terms of better student performance and reduced inequality, with a concurrent and sustained increase in enrollments. The country's scores in the three PISA disciplines (reading, math, and science) increased sharply between 2003 and 2018. At the same time, inequalities in student performance have decreased, as the gains in PISA scores have come overwhelmingly from low and medium achievers.

Most of the progress in the education system since 2003 has been the result of a combination of the overall socioeconomic progress being made in Turkey and increased effectiveness in the delivery of education. The country's rapid economic growth has improved the socioeconomic conditions of the population and led to the gains in all PISA disciplines. This is because the delivery of education services has become more effective in the period between these PISA tests, improving the schooling provided to almost all Turkish students and thereby reducing inequalities.

The government's educational policies have contributed to the improvements in education outcomes. This includes curriculum reform, phased modernization of teaching and learning materials and practices, stronger focus on measuring learning outcomes through large-scale national and international assessments, and enhanced monitoring and evaluation systems.

- With growing participation, Turkey has successfully recruited sufficient numbers of teachers while strengthening qualification levels; in TALIS 2018, much larger shares of school leaders and teachers in Turkey held a bachelor's degree than in 2008. Since 2016, support for novice teachers is reinforced through formal induction and probation.
- Turkey has increased the quality and range of evaluation and assessment information available at the system level and strengthened institutional capacity to handle that information.
- School evaluation, both internal and external, and teacher appraisal are common practice in Turkey and occur more regularly than on average across the OECD; efforts to make these processes more development-focused are underway.
- While Turkey has a comparatively large and highly centralized education system, within the Ministry of National Education, strategic planning practices are in place at the central and local levels, directed by a five-year vision. Established structures encourage stakeholder participation where broad multi-stakeholder bodies at the central and local levels meet regularly.
- The tertiary sector has grown considerably, and quality assurance has also been strengthened in recent years. Efforts to ensure one university per province had a positive impact on regional development.

Recently, responding to the COVID-19 pandemic and looking beyond, Turkey invested in Safer Schooling and Distance Education with equity interventions for the most vulnerable students, mitigating the learning loss due to COVID-19 school closures. The Ministry of National Education focused on:

- Emergency connectivity and IT infrastructure for education in emergencies by expanding the country's e-learning digital education platform. This also supports the development and rollout of a new digital education system for the future.
- Digital content for safety and quality by providing goods, services, consultants, training, and small refurbishments to support the distance education content, during the period of school closures due to COVID-19, for a gradual return to classroom-based teaching, and to strengthen blended teaching and learning (classroom-based and online).
- Institutional capacity for education technology resilience to strengthen capacity for the coordination, management, and monitoring and evaluation and for the continued delivery of safe and equitable digital education services.

E. PATH FORWARD

Improving education and training with the aim of enhancing the young population's skills, can indeed boost Uzbekistan's competitiveness and reap benefits from this demographic dividend. The next phase of the economic transition could benefit from investment in education focusing on:

- Strengthening the core foundational, socio-emotional, digital and advanced skills relevant of relevance to the labor market. These skills need to be better embedded in primary and

secondary education levels. It is also important to fill in the gap between the two ends of the education system and financiers to invest in the education system at its core, general education, and at the same time to support the transition to higher education to have enough pipeline for reaching smart growth within an advanced economy with a solid workforce. Uzbek institutional environment is struggling with capacity bottlenecks – most striking is the insufficient use of data in targeting and monitoring employment programs and not tracking students, missing outreach, and mentoring services. Institutional coordination between stakeholders in charge of demand- and supply-side measures at the ministerial and regional level is of crucial importance. The lack of institutional coordination between the line relevant ministries and different regional agencies and horizontal, between education, employment, and social services leads to chronic fragmentations and disparate interventions. There are some structures in place, but the government mostly uses them to provide information and plan, without a substantive process of involvement and cooperation with impact on employment. Hopefully, the most recent measures that the government planned by 2024 will use an integrative approach. There need to be also institutionalized opportunities in lifelong learning as part of the agenda for transition for re-skilling and up-skilling that can be used to explore more on the partnerships created between industry and education and training providers8.

- Interventions aimed at improving the alignment of education with the needs of the emerging economy, including the increasing need of higher-level skills and a focus on curriculum, teachers, and assessments update and enhancement. This also need to be accompanied with transformations at schools to become better accountable for results. Solutions should revolve around school management and leadership, with special attention to school autonomy and the development of accountability systems, including strengthening the system's governance.
- Further investments are needed to be directed to higher education, professional programs and lifelong learning opportunities that can build on general education strengthening with more alignment to the economic growth agenda. Increasing participation and ensuring adequate support to students' transitioning from secondary to higher education and collecting information regularly on employment patterns through graduate tracer studies are key. Strengthening higher education offerings and create "world class" programs in selected areas of study and research in alignment with the economic prospects. Finally, improving research productivity and collaboration between universities and industry is of high national interest. Mechanisms for allocation of resources and incentives and for the operationalization of research commercialization can be introduced.
- Support and continue the reform of the public financing of education and use evidence-based mechanisms. There is a need to improve system governance and financing, including proper autonomy, accountability for results, and assessment. Education should follow the same recommendations related to: i) undertaking a functional review of the three Ministries of Education to guide improvements to its efficiency, analytical capacity, and business processes; ii) increase transparency through publication of the budget, its execution, public investments in education, and iii) increase parents, students and community involvement in the public oversight of the school and university budgets. At the same time, continue the reform

[8] Abdul-Hamid, Husein. "Education Excellence Towards Improved Human Capital in Uzbekistan), 2021 (Report, World Bank ASA P174517.)

that already was initiated with delegating more responsibility to the line ministries in education and providing per capita financing while strengthening the EMIS that is mandatory to create evidence-based policies or reliable tools to be used in analytical work.

- In the short term it is important to creating COVID-19 related just-in-time solutions to help the government cope with challenges in providing quality education to avoid further education losses and long-lasting deficiencies (see **Learning Recovery after COVID-19 in Europe and Central Asia: Policy and Practice**). These recommendations include specific measures for mitigating learning losses and preparing for full school reopening. There is a need to design and implement structural reforms to make education systems more resilient and, in the process, improve students' educational performance. Recommendations are also given for longer-term actions with the potential to transform education by strengthening learning and improving learning equity in the future.

Chapter 10. Health

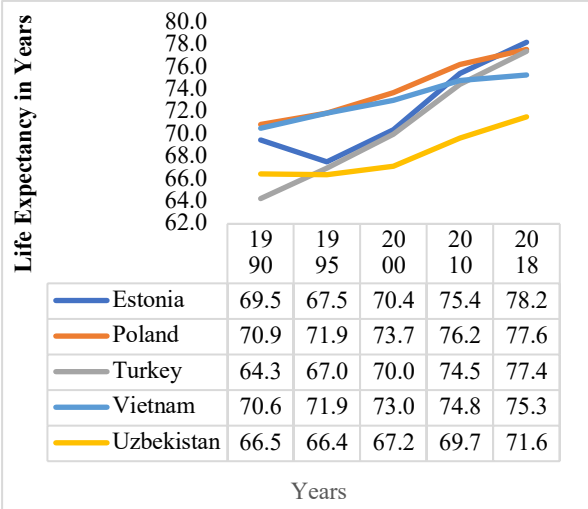
Since 2017, Uzbekistan has taken steps to reform its health sector to improve both the performance of the health system and health outcomes. A 2018 Presidential Decree (No. 5590) set the vision for the national health reform agenda and identified several key reform areas - health financing, integrated care, and quality of care. Health reforms are at an initial stage. On health financing, the government committed to increasing government health financing from 7.9 percent of total government spending in 2018 to 15 percent by 2025 (or 5 percent of GDP). The government also initiated a pilot project in one of the regions, Syrdarya, to test and adapt various financing tools and mechanisms to help leverage health financing to foster efficiency and effectiveness improvements in the health system. On integrated care, the government has preserved and strengthened its vast network of health facilities (over 1,200 hospitals and 6,000 outpatient facilities) that can serve as a strong foundation for building an integrated, accessible health system and initiated an integrated care pilot centered on the primary level. In quality care, the government has made efforts to improve national governance structures, notably at the Ministry of Health (MOH), quality of health workforce, and use of financing tools in quality improvement. Based on the progress, Uzbekistan has taken some steps to improving health system performance, access to quality care, and closing a financing gap, but more work is needed. In the coming years, the government aims to expand reform initiatives nationwide by scaling reform pilots in health financing and integrated care to the entire country, where the focus will shift to ensuring evidence-informed decisions and successful implementation.

A. Health Outcomes

Health outcomes are improving, but room for significant growth remains. Health outcomes are critical health system performance measures along with care experience and efficiency measures.[1] While Uzbekistan has achieved significant improvements in global health outcome measures since it became independent, there are still substantial gaps compared with the outcomes achieved in well-performing health systems. For example, life expectancy, a global measure of population health, is below the Europe and Central Asia (ECA) regional average and substantially below the outcomes reported in Organization and Economic Co-operation and Development (OECD) countries. Uzbekistan's progress in improving life expectancy from 1990 to 2018 (5.1-year increase) is also behind the progress observed in selected countries in transition, such as Estonia (8.7-year increase) and Turkey (13.1-year increase) (Figure10.1). Neonatal mortality dropped from 30.9 neonatal deaths per 1,000 live births in 1990 to 9.9 in 2018, a significant improvement. But the current rate is still nine times the rate reported in Estonia, 3.5 times the rate of Poland, and double the rate of Turkey (Figure 10.2).

[1] Berwick, D.M., T.W. Nolan, and J. Whittington (2008). "The Triple Aim: Care, Health, and Cost." *Health Affairs*.

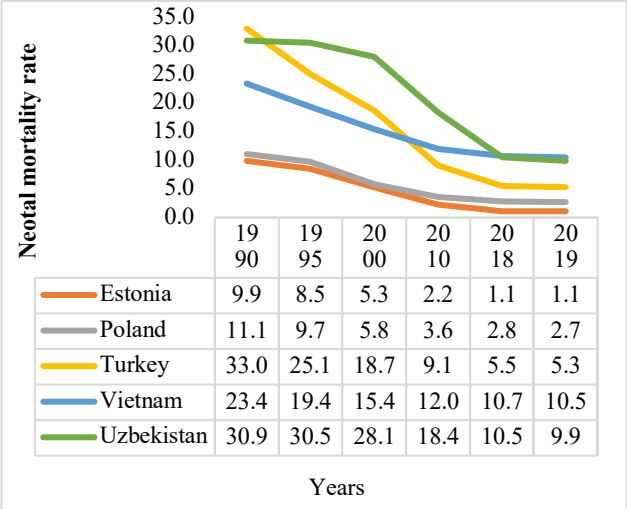
Figure 10.1: Life expectancy in selected countries, 1990-2018
(In years)



	1990	1995	2000	2010	2018
Estonia	69.5	67.5	70.4	75.4	78.2
Poland	70.9	71.9	73.7	76.2	77.6
Turkey	64.3	67.0	70.0	74.5	77.4
Vietnam	70.6	71.9	73.0	74.8	75.3
Uzbekistan	66.5	66.4	67.2	69.7	71.6

Source: World Development Indicators, World Bank.

Figure 10.2: Neonatal mortality in selected countries, 1990-2019
(Per 1,000 live births)



	1990	1995	2000	2010	2018	2019
Estonia	9.9	8.5	5.3	2.2	1.1	1.1
Poland	11.1	9.7	5.8	3.6	2.8	2.7
Turkey	33.0	25.1	18.7	9.1	5.5	5.3
Vietnam	23.4	19.4	15.4	12.0	10.7	10.5
Uzbekistan	30.9	30.5	28.1	18.4	10.5	9.9

Source: World Development Indicators, World Bank.

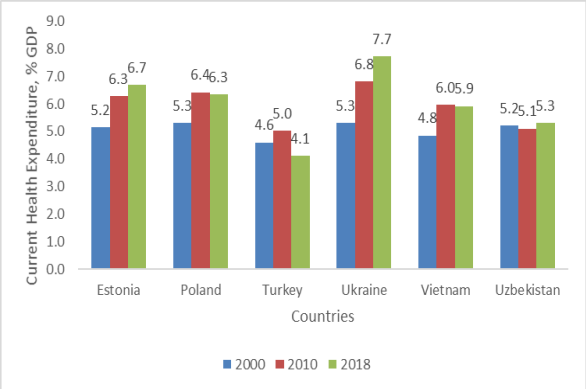
B. Health Financing

Health financing reform is high on the government reform agenda. After multiple stalled efforts over the past two decades, the government has taken several bold steps to reform health financing. This effort is well justified and timely, given that Uzbekistan has only rarely used health financing mechanisms to facilitate improvements in the health system or promote provider effectiveness and efficiency. Since 2017, the government has issued several high-level policy documents that identify priority health system issues and set out directions and goalposts for health financing reform.

In the past two decades, public and private health expenditures have been at a stable but low level of about 5.2 percent of GDP. By contrast, most countries in transition saw substantial growth in health expenditures over the same period. For example, in Estonia, health expenditures as a share of GDP increased by approximately 29 percent, in Poland by 19 percent, in Vietnam by 23 percent, and in Ukraine by 45 percent. In absolute terms (measured in current US dollars) health expenditures saw a twofold increase in Uzbekistan compared with a sevenfold increase in Estonia, a fourfold increase in Poland, a sixfold increase in Ukraine, and an eightfold increase in Vietnam. While Uzbekistan's per capita spending was at the same level as Ukraine's and twice the spending in Vietnam in 2000, in 2018, Ukraine's spending was three times and Vietnam's spending about two times the spending in Uzbekistan. In 2018, Poland's per capita spending in absolute terms was about 10 times and Estonia's about 20 times the spending in Uzbekistan (Figure 10.4).

Figure 10.3: Current health expenditure as a GDP share in selected countries, 2000-2018

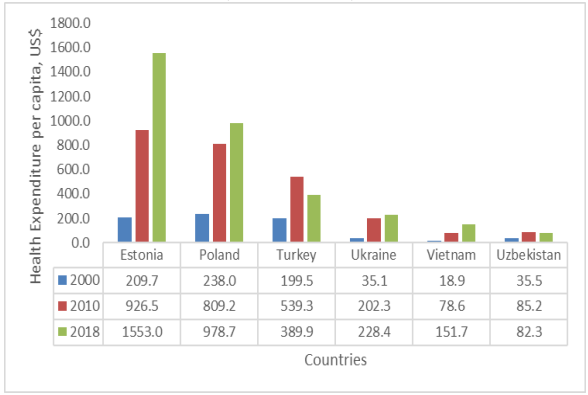
(%)



Source: World Development Indicators, World Bank.

Figure 10.4: Health expenditure per capita in selected countries, 2000-2018

(Current US$)



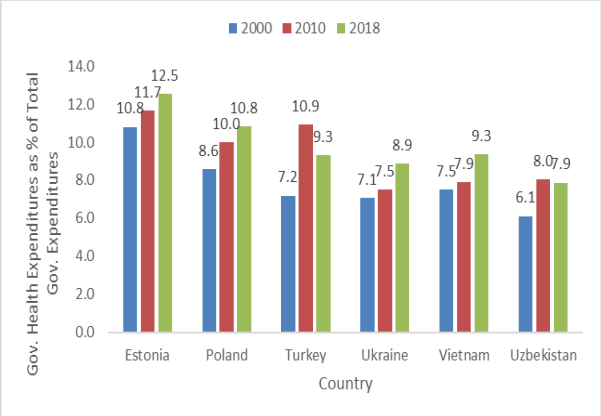
	Estonia	Poland	Turkey	Ukraine	Vietnam	Uzbekistan
2000	209.7	238.0	199.5	35.1	18.9	35.5
2010	926.5	809.2	539.3	202.3	78.6	85.2
2018	1553.0	978.7	389.9	228.4	151.7	82.3

Source: World Development Indicators, World Bank.

Government health spending is very low and leaves large gaps in coverage for essential services. Government health expenditures amounted to only 2 percent of GDP in 2018, or about $31 per person, substantially limiting the coverage of essential medical services (Figures 10.5). By contrast, in the same year, government health expenditure amounted to 4.9 percent of GDP in Estonia, 3.7 percent in Ukraine, and 2.7 percent in Vietnam. In current US$ terms, government health expenditure doubled over the past two decades in Uzbekistan, while Poland and Vietnam saw four-fold and ten-fold increases, respectively (Figure 10.6).

Figure 10.5: Government health expenditure as a share of total government expenditure in selected countries, 2000-2018

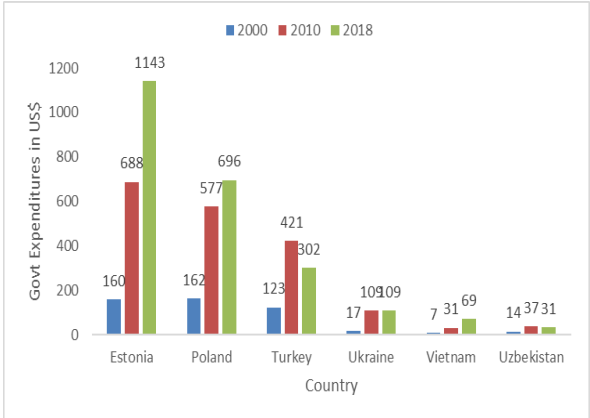
(%)



Source: World Development Indicators, World Bank.

Figure 10.6: Government health expenditure per capita in selected countries, 2000-2018

(Current US$)



Source: World Development Indicators, World Bank.

Increasing government health expenditure is critical for improving health outcomes. In developing countries such as Uzbekistan, low public health spending limits the government's options for providing many cost-effective preventative and life-saving interventions, including medicines to treat noncommunicable diseases and critical procedures for cardiovascular or oncology conditions. With low government spending and in the absence of a country-wide

contributory insurance system, the population must spend out-of-pocket to access those essential services. This, in turn, leads to unequal access to services and suboptimal use of preventive services. At the same time, Uzbekistan's sizeable informal labor market may render a contributory system infeasible. Therefore, increased government spending provides the best hope for improving the utilization of critical services such as pharmaceuticals in primary care, preventive screening services, and chronic disease management programs. Numerous studies show that increased financial coverage of health services improves access to and use of essential health services and strengthens chronic disease management and outcomes, population wellbeing, and self-reported health.[2]

The government's new commitment to increase government health financing to 5 percent of GDP and 15 percent of all government spending by 2025 is timely and commendable but not devoid of risks.[3] The commitment is an opportunity to expedite the development of a health financing framework and detailed expenditure plans that could help increase the efficiency of spending while the overall health envelope grows. Without such a framework, a rapid increase in health spending may lock the government into non-efficient spending. Increased health spending is in sync with health financing trends in the comparator countries. For example, in Poland, the government committed to increasing government health financing to 6 percent of GDP by 2024 from 4.6 percent in 2017.[4]

Implement Evidence-Informed Health Financing Tools and Mechanisms

The government aims to shift from a tax-based command-and-control system to a non-contributory tax-funded health insurance model. The establishment of mandatory health insurance is now considered a primary reform objective in the national reform plan for 2019–25.[5] Several critical elements of this model, such as a purchaser-provider split, new provider payment methods, and strategic purchasing, are being set up. The Ministry of Health has launched a pilot of the new financing model in the Syrdarya region with support from the World Health Organization (WHO). The proposed health financing tools and mechanisms aim to incentivize better health outcomes, reduce inequities, lower costs, and foster integrated team-based health care. However, there is a shortage of in-country analysis on how the new financing model can help improve health outcomes, efficiency, and equity in the existing health system, given its specific problems and constraints.

Uzbekistan will need to carefully consider the costs, benefits, time, and expertise required to establish and successfully operate a non-contributory health insurance model. First, the model's success will depend on the country's ability to raise additional taxes to increase the health budget. Second, health insurance-based financing can be costly, as it requires complex systems to implement and operate, thus diverting already limited healthcare resources from care delivery to

[2] Sommers, B.D., A.A. Gawande, and K. Baicker (2017). "Health Insurance Coverage and Health—What the Recent Evidence Tells Us." *New England Journal of Medicine*.
[3] Presidential Decree No. 5590, "On complex set of measures to cardinally transform Uzbekistan health care system," December 7, 2018.
[4] Sowada, C., A. Sagan, I. Kowalska-Bobko, and others. Poland: Health System Review. World Health Organization (2019).
[5] Presidential Decree No. 5590, "On complex set of measures to cardinally transform Uzbekistan health care system," December 7, 2018.

administration. In countries with social health insurance (such as the Bismarck systems), the health systems, over time, built capacity and increasingly sophisticated mechanisms to align resources with health needs, prevent fraud, contain costs, and improve responsiveness. In countries with command-and-control-based health systems (such as the Semashko/Beveridge systems), detailed national planning, norms, and rigorous oversight are used to support these critical health system functions. When shifting from the command-and-control system to new purchasing models that increase provider autonomy and competition, devolve decision making, and ease administrative rigidities, building sufficient capacity and learning can be costly and time-consuming. In the absence of such capacity, detriments from the new purchasing model may outweigh its benefits. In Uzbekistan, mandatory health insurance and new purchasing models are expected to be put into operation under accelerated timelines, which may leave insufficient time to address capacity needs. For example, the health insurance pilot is expected to be tested for only 1.5 years with a national roll-out immediately following.

Many of the benefits expected from a health insurance system may not materialize when built on tax-based command-and-control health systems. For example, in a health insurance system, contracting or purchasing relationships between the purchaser (health insurance fund) and provider (hospitals, health facilities, clinics) play a critical role in achieving health system performance improvements. In theory, such contracts can help the purchaser shape and influence provider behavior by specifying the services to be delivered, their volumes, and mode of delivery – this specification should then improve performance and eventually outcomes. However, contracting may have a limited role/value in tax-based health systems where provider autonomy is minimal, as is the case in Uzbekistan. Many Eastern Europe and former Soviet countries that instituted health insurance systems still have no selective contracting in place and use the contracts with providers as a formal basis for service reimbursement rather than as a tool to shape provider behavior and improve performance. In Poland, for example, public hospital networks that account for over 90 percent of the hospital budget are automatically granted contracts for four years, and provider behavior is still primarily guided through norms and regulations and monitored through regular reports.[6] In Uzbekistan, both the newly established health insurance fund and health facilities financed by the state are all government-owned and have to follow strict government regulations and norms, leaving little room for provider autonomy and selective contracting. For purchasing contracts to work, they would need to be accompanied by increased autonomy of providers and a fundamental change in how health personnel is recruited and managed.

C. Integrated Care

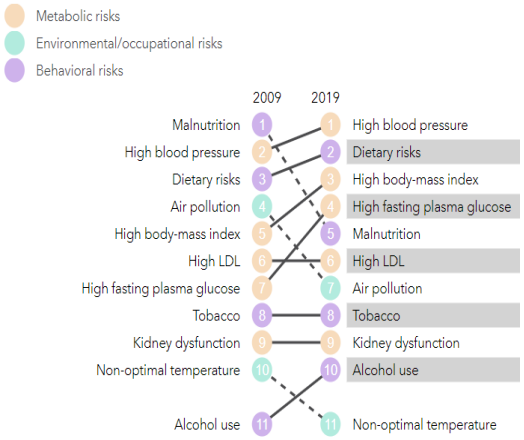
Changing Burden of Diseases

Uzbekistan is undergoing an epidemiologic transition to a state where unhealthy diet, low physical activity, and obesity are prevalent and noncommunicable diseases and injuries are becoming the leading causes of death. In 2019, nine of the top ten risk factors contributing to

[6] Sowada, C., A. Sagan, I. Kowalska-Bobko, and others. Poland: Health System Review. World Health Organization (2019).

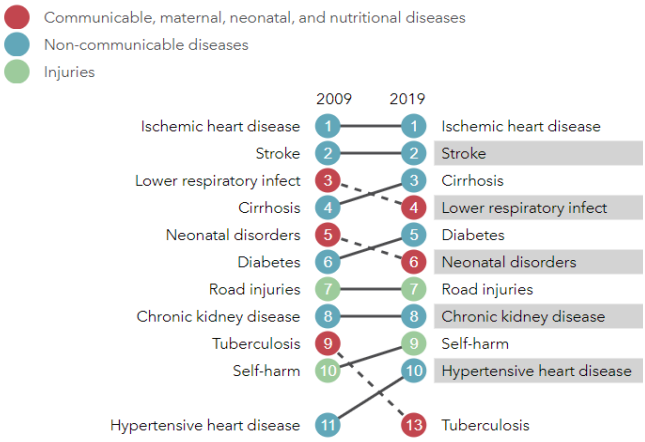
disability-adjusted life years were metabolic and behavioral (Figure 10.7). Eight out of the 10 leading causes of mortality and morbidity are chronic conditions and injuries (Figure 10.8).[7]

Figure 10.7: Top 10 contributors to disability-adjusted life years[8] in Uzbekistan, 2009-2019



Source: Global Health Data Exchange, Institute for Health Metrics and Evaluation, 2019.

Figure 10.8: Top 10 causes of deaths in Uzbekistan, 2009-2019



Source: Global Health Data Exchange, Institute for Health Metrics and Evaluation, 2019.

Changes in risk factors and the burden of diseases require a paradigm shift in the way service delivery is organized. Managing chronic conditions and injuries requires a shift from care delivery system that is focused on episodes toward an integrated system that takes a holistic view of patient needs and helps manage conditions across levels of care (primary, secondary, and tertiary) and overtime. Integrated care also requires integration within each level of care so that multidisciplinary teams can manage the complex care needs of patients with chronic conditions. In this move toward integration, healthcare delivery should be redesigned to create value-based, physician-led team care that puts patients at the center. Integrated care requires incorporating professionals in medical, social, and behavioral services to support patients and communities in making long-term health behavior changes. The horizontal and vertical integration to create patient-centered, value-based team care is a complex process that requires enabling infrastructure and environment, including appropriate policy framework, health information technologies, financing mechanisms, and local technical expertise.

Primary Care Centered Team-Based Integrated Care

While the Uzbekistan health service delivery system has solid foundations, its current setup is not well suited to deliver integrated, holistic care. On the positive side, a vast network approximately 1,200 public hospitals and 6,000 outpatient clinics ensures comprehensive geographic coverage for primary and specialized care services and forms the backbone of the

[7] Vos, T., and others (2020). "Global Burden of 369 Diseases and Injuries in 204 Countries and Territories, 1990–2019: A Systematic Analysis for the Global Burden of Disease Study 2019." *The Lancet*.
[8] Disability Adjusted Life Years (DALYs) are the sum of years of potential life lost due to premature mortality and the years of productive life lost due to disability.

state's national care delivery system. Despite the strong foundation, fundamental flaws in how the care delivery is organized and financed undermine the care delivery functions necessary for preventing diseases, managing chronic conditions, and establishing patient-centered care. For example, various care levels are fragmented and operate independently and often against each other rather than in synergy, frequently due to perverse incentives to integration that are embedded in the system. Anecdotal evidence suggests that the specialized care facilities that provide care on a fee-for-service basis overuse services to maximize their profits. About one-third of ambulance calls are made for the conditions that can be handled at the primary care level, indicating deficiencies in the integration of primary and ambulance care. Primary care is often not structured to deliver the kind of team-based care needed to effectively manage chronic conditions. Effectiveness measures for each level of care are not available, thus holding no one responsible for the poor performance of the system.

Uzbekistan has made progress in setting a policy framework and vision for a new integrated primary care-centered care delivery system, but given the complexity of integrated care, a successful implementation may still be a challenge. A 2018 Presidential Decree set out a vision and national reform agenda.[9] It identified a lack of integration among different levels of care and gaps in prevention and health promotion as priority issues for the reform agenda in coming years. In 2020, a subsequent Presidential Decree formally launched a primary care-centered, integrated care pilot that, among other things, set out to establish (1) primary care teams that include a general practitioner, a physician assistant on internal medicine, a physician assistant on pediatrics, a patronage outreach nurse, and a midwife; (2) inpatient and specialized outpatient facility hubs; and (3) a benefits package.[10] These efforts are similar to care integration efforts underway in many countries, including Estonia, Poland, and Vietnam. At the primary care level, in 2017, Poland launched a pilot program (PHC PLUS) to explore different care integration models with a focus on team-based care delivery, where primary care teams expanded to include care coordinators, dieticians, and health educators, among others.[11] The implementation period for the pilot ends in 2021, with data on the effectiveness of various models feeding into the decision on the national roll-out. Other countries, such as Vietnam, are in the early stages of care integration, with care integration still limited to high policy documents and little cohesive effort at the operational level.[12]

Increased support for tackling major health determinants is emerging at the policy level. The role of medical services in determining overall health is relatively limited: only about 10-20 percent of health is due to health services, while social determinants of health, such as socio-economic, environmental, and behavioral determinants are responsible for the remaining 80-90 percent[13]. Over the past few years, Uzbekistan issued several national-level documents to prioritize prevention and social and environmental determinants of health. For example, a Presidential

[9] Presidential Decree No. 5590, "On complex set of measures to cardinally transform Uzbekistan health care system," December 7, 2018.
[10] Presidential Decree No. 4890, "On establishing a new care delivery model and state health insurance mechanisms," November 12, 2020.
[11] Kurpas, D. (2020). "Challenges in Implementing Integrated Care in Central and Eastern Europe—Experience of Poland." *International Journal of Integrated Care*.
[12] Teo, H.S., and D.L. Huong (2020). Improving Efficiency in the Health Sector: An Assessment of Vietnam's Readiness for Integration of Care. World Bank
[13] Hood, C. M., K. P. Gennuso, G. R. Swain, and B. B. Catlin (2016). "County health rankings: Relationships between determinant factors and health outcomes." *American Journal of Preventive Medicine*.

Decree issued in 2020 sets out to establish a nationwide screening system to identify individuals at high risk for chronic conditions, such as hypertension, diabetes, and myocardial infarction.[14] The decree also aims to integrate health promotion specialists into the primary care system by placing them in primary care facilities, closer to patients and the primary care workforce. Still, little information is available on how these staff would be financed. The decree also establishes a national-level interagency commission on disease prevention and public health at the Cabinet of Ministers level. Another Presidential Order, also issued in 2020, aims to promote a healthy lifestyle among the population by directing local governments to build pedestrian and bike paths in all regional and district level cities, procure new sports equipment for all schools, and promote sports and healthy lifestyles on all TV channels.[15] However, structural improvements and policy visions are not sufficient to bring about behavioral changes, so that the government efforts should also focus on selecting and piloting evidence-based and sufficiently resourced interventions, and setting up rigorous evaluation systems to facilitate data-driven course correction.

The health workforce plays a critical role in improving population health and patient experience and lowering care costs. The health workforce focus should be at the core of health system redesign, as physician and nurse dissatisfaction and burnout are shown to impact quality care, patient experience, and worker retention. Given the importance of the workforce, key health system objectives in many countries have been expanded to include the improvement of health worker satisfaction as a health system objective.[16] While data are lacking in Uzbekistan, globally, as many as 50 percent of practicing physicants report burnout or high stress, leading to significant challenges in attracting and retaining qualified staff. Paperwork and administrative tasks are the leading causes of stress and burnout; some studies suggest that physicians may spend two hours on clerical and administrative tasks for each hour spent with patients.[17] While these causes are likely a factor in Uzbekistan, the low remuneration of health workers is perhaps the most important factor contributing to physician burnout and stress. On average, physician monthly salaries in the public sector are about $200, markedly below the remuneration levels for professionals in other sectors and the private health industry. The low remuneration levels are at the core of an outflux of experienced health professionals from state facilities to the private sector, contributing to a gradual evolution of the state's health sector into "poor service for the poor."

As overall government health spending increases, primary care funding should cover all essential services and reverse the outflux of workers. The current underfunding of primary care is associated with an undersupply of many cost-effective interventions and missed opportunities for health improvement. More and better primary care has been associated with improved health outcomes and lower total costs of health services.[18] Well-organized and -funded primary care focusing on prevention and management before the onset or in the early stages of diseases will lead to future decreases in mortality and morbidity and associated reductions in the need for high-cost care, such as hospitalizations and complex procedures. While data for Uzbekistan is not

[14] Presidential Decree No. 4891, "On strengthening public health," November 12, 2020.
[15] Presidential Order No. 6099, "On strengthening health promotion," October 30, 2020.
[16] Bodenheimer, T., and C. Sinsky (2014). "From Triple to Quadruple Aim: Care of the Patient Requires Care of the Provider." *The Annals of Family Medicine*
[17] Sinsky, C., and others (2016). "Allocation of Physician Time in Ambulatory Practice: A Time and Motion Study in 4 Specialties," *Annals of Internal Medicine*.
[18] Starfield, B., L. Shi, and J. Macinko (2005). "Contribution of Primary Care to Health Systems and Health." *The Milbank Quarterly*.

available, elsewhere, increasing primary care physicians by one per 10,000 population has been associated with a 6 percent decrease in all-cause deaths, a 5.5 percent decrease in inpatient admissions, and a 10.9 percent reduction in emergency department visits.[19] [20] Despite the importance of primary care, in Uzbekistan, it has been chronically undervalued, with the share of primary care in total government health spending at 26 percent, below the 33 percent spending (median) reported for low and lower-middle-income countries.[21]

Integration efforts in Uzbekistan's hospital sector are overdue and should take a holistic view. The hospital sector is very fragmented, with inpatient care provided by a multitude of hospitals at the district, regional and national levels. There are vertical specialized systems/networks for managing emergency care needs, tuberculosis, HIV/AIDS, heart problems, urinary problems, and others. There are also general hospitals at district and regional levels with many service overlaps. Each level and system has its own incentives, sometimes for keeping patients in, other times for keeping patients out, but only very rarely to provide high-quality care. The Syrdarya pilot aims to test a new hospital care delivery model that minimizes overlaps and centralizes services within a region. The pilot needs a rigorous monitoring and evaluation system to track the right measures of efficiency, outcomes, and patient experience.

Uzbekistan should expand health IT to support clinicians in delivering integrated, holistic care. The current health IT efforts prioritize the digitation of the paperwork. However, health IT is not about digital paperwork but rather about helping clinicians make better care decisions and share information with patients and other care providers. Health IT should support clinicians with clinical and administrative workflow, patient engagement, and clinical decision-making to improve acceptance and have a meaningful impact on care. Often when the focus is on paper digitization, the priorities shift that lead to dissatisfied health workers, service disruptions, and even harm to patients. Importantly, the digitization will also help with filling immense gaps in data that are critical to inform reform initiatives.

D. Quality of Care

Quality of care is an important contributor to health outcomes and care efficiency. Without quality, access is unlikely to improve health outcomes and may even be harmful. For example, substandard quality of care for a selected set of conditions is responsible for up to 15 percent of deaths in low-income and lower-middle-income countries (LMIC).[22] One out of ten hospitalized patients in LMIC acquires care-associated infections. The economic toll from wasted resources is of the utmost importance in LMIC, given the limited resources available for healthcare. While evidence on the economic impact in LMIC is sparse, even in developed countries, a large part of

[19] Kravet, S.J., and others (2008). "Health Care Utilization and the Proportion of Primary Care Physicians." *The American Journal of Medicine*.
[20] Zhan, C., and others (2004). "The Effects of HMO Penetration on Preventable Hospitalizations." *Health Services Research*.
[21] Vande Maele, N., and others (2019). "Measuring Primary Healthcare Expenditure in Low-Income and Lower Middle-Income Countries." *BMJ Global Health*.
[22] *Crossing the Global Quality Chasm: Improving Health Care Worldwide.* National Academies of Sciences, Engineering, and Medicine (2018).

health spending is believed to go to waste; in the US, the waste is estimated to range from 20 to 30 percent.[23,24]

The limited available data suggest there are significant gaps in quality of care in Uzbekistan. Avoidable/amenable mortality is an often-used concept to estimate the extent to which healthcare systems can improve population health by quantifying mortality that is considered amenable to health services, both in terms of access and quality. Available data on amenable mortality suggest both underuse and quality of care as significant contributors to high avoidable mortality in Uzbekistan. For example, in 2018, over 42,000 lives (about one-quarter of all deaths) are estimated to be lost due to non-/underuse of needed care and substandard care quality (Table 10.1). Substandard care is responsible for 58 percent of amenable deaths, while the remainder is due to underuse of services. While performing better than Vietnam, Uzbekistan still shows a considerable untapped potential compared with Turkey, where amenable mortality rates are only half those reported for Uzbekistan.

Table 10. 1: Amenable mortality for selected countries, 2018

Country	Population (2018)	Deaths Preventable, by Population Level Interventions	Deaths Amenable to Healthcare	Amenable Deaths Due to Poor Quality	Amenable Deaths Due to Nonuse
Uzbekistan	32.9 million	36,658	42,851	24,721	18,130
Turkey	80.8 million	24,030	33,489	16,526	16,962
Ukraine	44.6 million	104,362	71,081	44,202	26,879
Vietnam	95.5 million	41,222	87,651	52,256	35,395

Sources: Kruk, M.E., and others (2018). "Mortality Due to Low-Quality Health Systems in the Universal Health Coverage Era: A Systematic Analysis of Amenable Deaths in 137 Countries," *The Lancet*; and World Bank population data.

Over the past several years, Uzbekistan has taken several necessary steps in establishing a national quality improvement system. Quality care, defined as care that improves outcomes and is consistent with the current knowledge, requires a quality workforce and a national quality improvement system.[25] Quality improvement involves a set of complex tasks requiring a long-term system-level effort for sustained success. The structural and regulatory changes are often essential preconditions for quality improvement. Since 2017, the government has initiated several key structural changes. For example, the Department of Quality Control, the Quality Standards Development Unit, and the Department of Licensing and Accreditation have been added to the MoH structure to take on key quality improvement functions.[26] Performance-based financing is being piloted to foster quality improvement in primary care. Still, several essential pillars – including a national quality improvement strategy, situational analyses, and a roadmap that guides system-level efforts and continuous quality data collection and reporting - are still missing.[27]

[23] Lyu, H., T. Xu, D. Brotman, and others (2017). "Overtreatment in the United States," *PLoS One*.
[24] *Tackling Wasteful Spending on Health.* OECD (2017)
[25] Institute of Medicine (US) Committee to Design a Strategy for Quality Review and Assurance in Medicare (1990), Lohr, KN, editor. Washington, DC: National Academies Press.
[26] Presidential Decree No. 4847, "On measures to further strengthening national governance of health care," October 2, 2020.
[27] *Handbook for National Quality Policy and Strategy: A Practical Approach for Developing Policy and Strategy to Improve Quality of Care*. World Health Organization (2018).

Continuous availability of reliable and valid quality measures is critical to understanding the current state of quality, designing, implementing, and evaluating quality improvement and learning interventions. Unfortunately, little is known about the quality of care in various care areas in Uzbekistan due to a lack of a national effort on continuous collection and reporting of quality measures. While the country has systems to routinely collect administrative health data, data on quality of care is not systematically collected. Local expertise to identify appropriate quality measures and design nimble data collection and reporting systems is also lacking. Numerous standard quality measures have been developed and implemented internationally and are available for use. Using internationally validated metrics would also allow the Uzbekistan health system to benchmark its performance and learn from well-performing systems.

Finally, the government should make the quality of care a top responsibility of the MoH and regional health authorities. In the absence of accountability, systems-level quality improvement efforts will stall, and quality of care will remain patchy in the country. The MoH should develop a national quality improvement strategy to provide the framework and guide concerted national and regional quality improvement efforts. The strategic objectives and milestones should be used as performance metrics for healthcare leadership at all levels.

Improving the Quality of the Health Workforce

Since 2017, the government has taken several ambitious steps in improving the quality of the healthcare workforce. In 2020, it instituted a nationwide financial incentives program to improve English proficiency among medical graduates. Currently, any medical student who obtains a nationally determined minimum score in internationally administered English proficiency tests receives monthly top-ups equaling about 100 percent of the base stipend. This effort will help improve physicians' access to up-to-date medical literature, which is severely restricted due to limited English proficiency among healthcare personnel and the shortage of up-to-date local medical resources. The government also initiated a new financial incentives program to attract and retain foreign-trained faculty in medical training institutions. As part of this program, medical school faculty members who received formal training from any of the top 200 highest-ranking universities would be eligible for up to $1,000 monthly salary top-ups. At the global level, the last decade has seen significant advances in the delivery of medical education and the emergence of innovative international medical education and reference platforms (e.g., Lecturio and Medscape). These developments present as-of-yet untapped opportunities for Uzbekistan to leapfrog in workforce training by integrating the new methods and platforms into its medical and continuing professional development (CPD) curricula.

While anecdotal evidence is abundant, valid and reliable data on the quality of medical training and the effectiveness of CPD in Uzbekistan are lacking. Adequate knowledge and competency of the healthcare workforce are vital to improving the quality of care. The lack of reliable, valid, and benchmarkable metrics on physician knowledge and skills in Uzbekistan does not permit continuous evaluation and course correction in medical training. Many well-performing health systems have rigorous knowledge and skills assessment systems, such as the United States Medical Licensing Exam (USMLE) in the USA, the Professional and Linguistic Assessment Board (PLAB) in the United Kingdom, and the Medical Council of Canada Qualifying Examination (MCCQE) in Canada. These assessments are developed using rigorous psychometric and testing techniques and aim to ensure minimum quality at entry and help evaluate the performance of

training programs. While routine assessments are an integral part of basic medical education and CPD in Uzbekistan, the assessments lack standardization because they are mostly administered by the medical education institutions that deliver training. The quality of testing varies from institution to institution and has limited use for international benchmarking. Uzbekistan is already working to implement international assessments in education (for example, the Programme for International Student Assessment) to permit objective evaluation of school performance. A similar effort in medical training is urgently needed to accurately assess the quality of training and drive the national medical education reform agenda.

Regulate Quality in The Private Sector

Healthcare is one of the areas where markets fail, and thus government interventions are warranted in the regulation of the private sector.[28] Government private regulations play an important role in ensuring access and quality of services in the private sector. While overly intrusive government oversight may hamper innovation and restrict access to care, a lack of oversight might also harm patients and waste resources. As the government sets to expand the private sector's role in healthcare delivery and shift state secondary and tertiary care providers toward self-financing, strengthening the MoH regulation capacity to ensure that it compensates in the areas where markets fail is of immediate urgency. Without an adequate public policy, the private sector and self-financed public facilities will maximize their profits, not population health and equity, so that the production of services/goods of low quality (that is, wasteful or even harmful) are often delivered.

Abundant anecdotal evidence suggests substantial physician- and private sector-induced demand for inappropriate diagnostic services, medications, and devices. Over the past few years, the government allowed the private sector in healthcare to expand substantially, albeit without adequate capacity growth in health sector regulation. In 2020, there were approximately 6,000 private healthcare organizations, an almost twofold increase from about 3,500 organizations in 2017. The types of services permitted in private health facilities also expanded, from 50 to nearly all 177 service sets.[29] However, over the same period, the MoH's capacity to regulate and provide oversight to the private sector did not keep up with the growth in the number of facilities and services they offer. With the limited government oversight in care quality, plenty of anecdotal evidence is now out to indicate that the private sector is increasingly driving healthcare costs by incentivizing inappropriate care to maximize profits. State specialized care providers, many of which now also increasingly operate on a fee-for-service basis, have strong incentives to deliver volume over quality and appropriateness. While the MoH has broad oversight over state health facilities, its oversight of the private sector is very restricted by government blanket regulations aimed at minimizing government interference in the private sector. In this context, a Georgia example is illustrative. After relaxing its oversight over the private sector following a shift to private health care delivery, it significantly stepped up its regulatory role in 2012 to control provider behavior and minimize inappropriate care[30] While a strong MoH capacity to control

[28] Arrow, K.J. (1978). "Uncertainty and the Welfare Economics of Medical Care." *Uncertainty in Economics*.
[29] Presidential Decree No. 2863, "On measures to further strengthening private health sector," April 4, 2017.
[30] Rechel, B., E. Richardson, and M. McKee (2014). "Trends in Health Systems in the Former Soviet Countries." *European Journal of Public Health*, 24.

profit-driven behavior is urgently needed, the regulation capacity that improves quality and supports innovation rather than hampers it needs strengthening.

E. THE PATH FORWARD

Since 2017, Uzbekistan has launched an ambitious reform plan to address its existing and emerging health care challenges. The health reforms are still in the early stages of developing a national policy and piloting various tools and mechanisms. As Uzbekistan strives to transition its health system towards universal access and high-quality, patient-centered care at a reasonable cost, a few critical factors will shape the outcomes of the reform efforts and their impact on the population's health outcomes.

In health financing, the government will need to increase government health spending while simultaneously raising its effectiveness and efficiency. The authorities will need to carefully select and adopt health financing tools and models based on evidence of their effectiveness, the current health system setup, implementation options, and maintenance costs. Increased financing and service coverage have been shown to improve financial security and health outcomes, including self-reported health. Instead of an abrupt health financing overhaul, a gradual staged implementation of selected financing and purchasing tools and mechanisms with proven effectiveness should be the focus of the health financing reform agenda. The desired functionality and outcomes such as fund pooling and increased efficiency should drive the choice of financing tools and mechanisms. Strong monitoring and evaluation systems should be set up from the outset to understand the working and impact of the financing pilot before making decisions on a national roll-out.

A shift toward an integrated, holistic healthcare delivery system should be expedited. A service delivery redesign that drives integration among and within the levels of care, prioritizes cost-effective care, and strives toward patient-centeredness is at the core of the national reform vision. In the immediate future, this would require increased allocation of funds to primary care and cost-effective interventions and removing perverse financial incentives that impede care integration. Also, expanding primary care teams will not be sufficient to drive improvements in the absence of detailed evidence-informed changes to the benefits package, outcomes-driven financial incentives, and routine monitoring of the quality of care. As the government sets out to pilot a new regional integrated care model in Syrdarya, it should also establish a strong monitoring and evaluation system to disentangle *the new integrated care model* effects from *the new health financing model* effects and ensure that national roll-out decisions are based on sound evidence. Finally, health information technology should support continuous care, quality improvements, and physician-patient communication across the care continuum to deliver optimal patient care, while fulfilling critical data needs during the conceptualization and implementation of the reform agenda and beyond.

In quality of care, the government should prioritize the implementation of critical pillars of a national quality improvement system. Sustainable quality improvement requires a culture change in the health system, and several foundational blocks are crucial for fostering such a change. Over the short and medium-term, Uzbekistan will need to establish a continuous quality care data collection and reporting system, strengthen local expertise in the analysis and governance of quality of care, and reform medical education and CPD. Without these quality improvement

pillars, the culture change is unlikely to happen, and sustainable quality improvement may become an elusive goal. Reforms in medical education and CPD need to be closely aligned with the developments in well-performing health systems to rapidly improve and ensure the quality of the healthcare workforce. Finally, with the substantial increase in private sector players over the past few years, the need for rigorous government regulation of the quality of care in the private health sector is more urgent than ever; however, the effort should be aligned with a broader MoH capacity-building on the regulation of the private sector that goes beyond the quality of care.