

POLICY BRIEF



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This Policy Brief is a publication of United Nations Development Programme (UNDP) Uzbekistan, which outlines the rationale for choosing a particular policy alternative or course of action in a current policy debate. Its target audience is policymakers, the donor community, independent analysts and other development stakeholders. The views expressed in this Policy Brief are those of the authors and do not necessarily represent those of UNDP or UNDP policies.

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Small business development in Uzbekistan: barriers and opportunities

This Policy Brief is one in a series of analytical reports related to issues of improving investment policy in Uzbekistan. The series has been prepared within the framework of the preparatory assistance phase to the UNDP project on *Support to Investment Policy for National Development*, in conjunction with the Center for Economic Research (CER)¹. The authors would like to thank the following: Ziyodullo Parpiev and Elena Danilova-Cross, of the UNDP Country Office in Uzbekistan, for their continuous support; Ben Slay, Pascal Bonzom and Nick Maddock of the UNDP Regional Center in Bratislava, and peer reviewers Akmal Abdurazzakov, Kamolkhon Inomkhodjaev and Ulugbek Kamaletdinov, for their valuable comments and suggestions that contributed to the improvement of this Policy Brief.

1. INTRODUCTION

The financial crisis that erupted in the second half of 2008 has already turned into a global economic recession. The primary mechanisms by which the crisis has been transmitted from the developed to the developing countries are a reduction in flows of remittances, private capital and trade. These factors are already affecting the economic and social situation in Uzbekistan, the economic growth of which during the last few years has depended strongly on export growth, favorable prices for major export goods, and growth in remittances received from Uzbek migrant workers.

Forecasts for 2009 show negative GDP growth for Uzbekistan's main trade partners, Russia and the European Union, at 6.5 and 4.8 percent respectively.² This could translate into a decline in exports from Uzbekistan. Coupled with falling demand and/or falling world prices for raw materials (e.g. oil and gas), agricultural products (e.g. cotton, fruits and vegetables), and most finished goods (e.g. automobiles), it threatens to reduce both the revenues of export-dependent enterprises and inflows of hard currency into the country.

The absence of verifiable, current data on labor migration and remittances makes it difficult to assess quantitatively the impact of the

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¹ All reports can be found on the websites of UNDP (www.undp.uz) and CER (www.cer.uz).

² For Russia, see IMF forecast, July 2009 (<http://www.imf.org/external/pubs/ft/weo/2009/update/02/>); for European Union see IMF forecast, June 2009 (<http://www.imf.org/external/russian/np/sec/pr/2009/pr09193r.pdf>).

above factors on Uzbekistan's social and economic situation, especially the impact on the most vulnerable layers of the population.³ However, it is already clear that the period of crisis and recovery will be long, and that Uzbekistan will not remain unaffected.

In the long-term, there is a clear relationship between high levels of private investment, high rates of economic growth, improvement in the competitiveness of the economy⁴ and speed of poverty reduction.⁵ Therefore, the strategy for crisis mitigation and recovery should be based on the mobilization of internal resources (savings of the population and the government) in order to stimulate the domestic private sector. Emphasis should be put on the small- and medium-sized enterprise⁶ (SME) sector, as it is less capital- and more labor-intensive and flexible, and thus more effective for poverty reduction under capital-constrained conditions.

At present, a number of constraints (that reflect imperfections in legislation and inefficiencies in the current economic policy), are preventing Uzbekistan from realizing its full potential for private investment and the more effective utilization of investment potential in the development of SMEs. At the macro-level, this is an inefficient utilization of national savings, part of which is frozen in state reserves and part of which is the general population's non-bank savings. At the micro-level, there are numerous transaction costs and barriers facing entrepreneurs in the course of their business activities.

This Policy Brief attempts to provide a concise analysis of the constraints faced by the SME sector in Uzbekistan, as well as an assessment of investment potential in the sector. The analysis is based on official statistics, previous research and a number of recent enterprise surveys.

1. SAVINGS AND INVESTMENTS: WHAT IS THE POTENTIAL FOR PRIVATE SECTOR GROWTH?

Investments represent an important potential source of growth for all economies, and their potential depends on the savings⁷ of households and domestic enterprises. The higher the rate of savings, the more might be invested. An analysis of the dynamics of savings and investments helps to answer two questions: 1) is the level of savings adequate to allow sufficient private sector growth during the period of crisis and recovery?; and 2) are those savings being used effectively?

³ A deeper macroeconomic assessment of the impact of the global crisis on Uzbekistan's economy, particularly in relation to the reduction in remittances of migrant laborers, can be found in: Chepel, S., "Impact of the Global Crisis on Uzbekistan: Mechanisms and Measures for the Mitigation of Risks", in *Journal of Market, Money and Credit*, No.6, 2009.

⁴ CER, "Key Elements of Effective Investment Policies in Developing Countries: Prospective Avenues for Uzbekistan", 2007.

⁵ UNDP, "Unleashing Entrepreneurship: Making Business Work for the Poor", 2005.

⁶ There is no formal definition of a medium-sized enterprise in Uzbekistan. According to Cabinet Decree No. 439 of October 11, 2003, the classification of enterprises and institutions into "small", "medium" and "large" is determined on the basis of the number of employees. The threshold number of employees varies by sector, and is set at 25, 50 and 100 employees, respectively. For the purpose of this report, the internationally-accepted definition of small- and medium-sized enterprises (SMEs) is used and, under this definition, medium-sized enterprises are presumed to be significantly larger than they would be on the basis of the Uzbekistan classification. However, additional analysis is needed to determine the most appropriate upper limit for the definition of a "medium-sized enterprise" in the Uzbek context.

⁷ The difference between gross disposable income and current expenses (or, on a micro-level, final consumption).

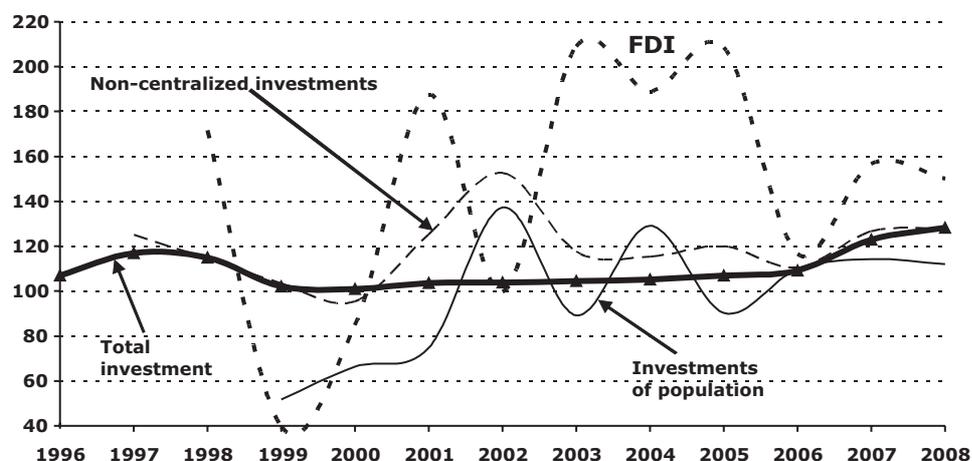
The share of investments funded out of the state budget fell from 26 to 9 percent between 1996 and 2008, and in 2008 amounted to only 2.1 percent of GDP. This is the result of economic liberalization and a gradual movement of the state away from a direct role in allocating funds for investment. Such a movement must be *compensated by a corresponding increase in the private sector's share of investments*. Therefore, in order to ensure the long-term sustainability of high economic growth rates, it is necessary to create conditions that will support the rapid growth of investment by the private sector.

1.1. Investment Dynamics: What Drives Current Economic Growth?

The existing statistical reporting system in Uzbekistan does not record domestic private investments as a separate indicator. Investments are divided into "centralized" (which includes investments financed out of the state budget and under a sovereign guarantee) and "not centralized" (FDI and investments of households and enterprises, including SMEs). The "not centralized" investments and their components are considered to represent the main potential of private investments, both domestic and foreign.

Statistics show that "not centralized" investments were the main source of growth of the level of investment in Uzbekistan during the last decade. Their share in total investments grew from 40-45 percent in the mid 1990s to 80 percent in 2008. Their average annual growth rate between 1996 and 2008 was, at 14.6 percent, significantly higher than the growth rate of total investments (8.7 percent), as well as the growth rates of other important economic indicators - GDP (at 5.3 percent) and industrial output (at 7.1 percent). This indicates a gradual, but stable increase in the importance and contribution of non-state investment sources in the economic development of Uzbekistan.

Figure 1: Investment Dynamics, 1996-2008.
(in real terms, percentage change on previous year)



Source: Data of State Statistics Committee

However, as Figure 1 shows, the two main components of non-centralized investments - investments of population and FDI - have been very volatile. Such volatility, *in light of their important role in supporting positive economic growth, may have a significant*



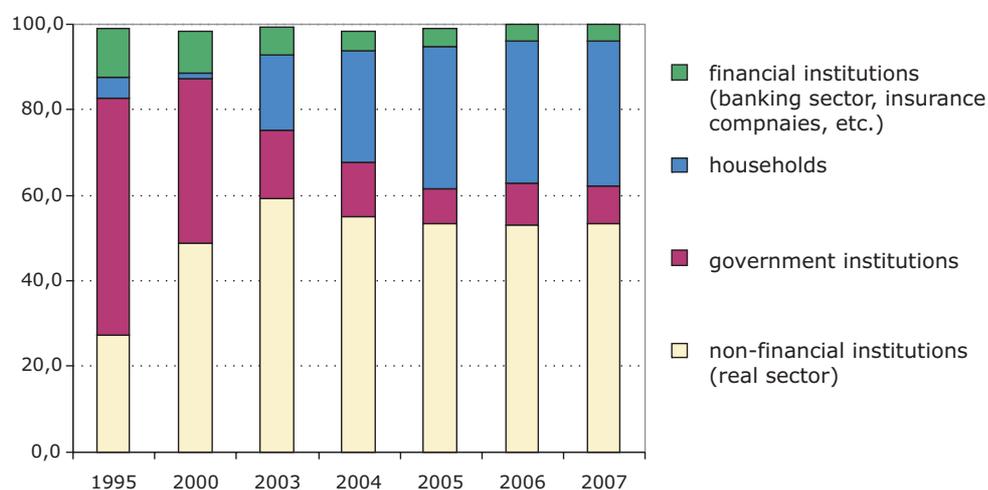
negative impact on the dynamics of GDP and become a serious source of instability for the economy in general.

1.2. Savings Dynamics: Are Resources Sufficient?

Uzbekistan enjoys *favorable trends in gross savings*: between 1995 and 2007 gross savings grew from 27 percent to 41 percent of Gross National Disposable Income (GNDI). In the mid-1990s, the main sources of savings were the public sector and real sector enterprises (non-financial institutions) - see Figure 2. The real sector's contribution to the growth of savings was, however, not steady: its share in total savings grew from 30 percent in the mid-1990s to over 60 percent in 2002, and then dropped slightly to 53 percent by 2005.

Such changes in the composition of gross savings were caused by a significant fall in the share of public savings (from 55 percent in 1995 to 8 percent in 2005) as a result of a reduction in the tax burden, the acceleration of privatization, and the rapid growth in the share of households (which started in 2001 and by 2005 had reached one-third of total savings). Unfortunately, no significant measures have yet been taken to facilitate a more effective deployment of the Uzbek population's growing savings towards the development of the real sector. An ineffective banking sector and stock exchange has led to an imbalance between savings and investments, as well as to ungrounded price rises for real estate and cars which, in recent years, have become the population's main investment goods.

Figure 2: Composition of Gross Savings, 1995-2007
(as percentage of gross savings).

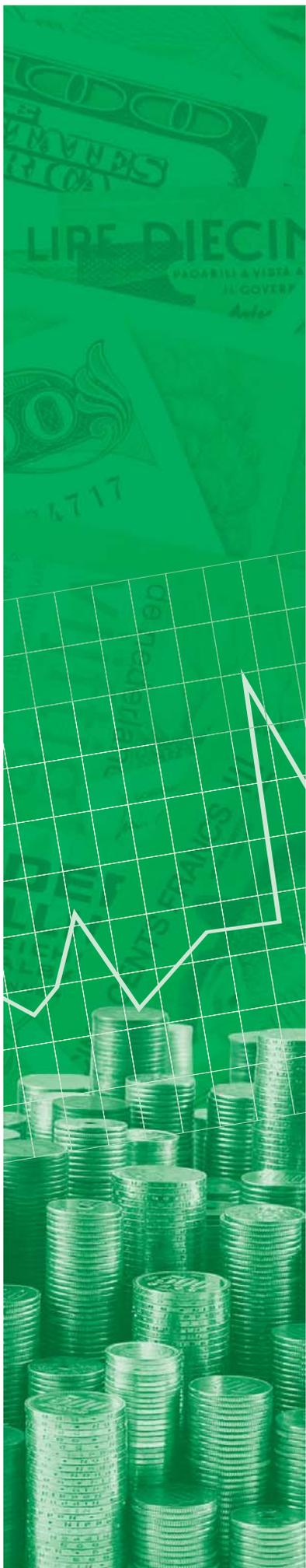


Source: State Statistics Committee of Uzbekistan

1.3. Imbalance between Savings and Investments: Causes and Consequences

Official statistics indicate that the level of savings in Uzbekistan is almost double the average for developing countries overall.⁸ However, in Uzbekistan there is a *significant imbalance between*

⁸ See sample of 75 developing countries in CER, "Key Elements of Effective Investment Policies in Developing Countries: Prospective Avenues for Uzbekistan", 2007.



gross savings and capital investment, while in most other developing countries the gap between these indicators is very small, fluctuating in the range of -2 to +2 percent of GDP.⁹

In 2001 the level of savings in Uzbekistan (as a proportion of GDP) was almost 10 percentage points below the level of investments, and in 2002 savings and investments were equal. After that, savings grew at a faster rate than investments, in every year, and in 2005 savings exceeded investments by 17.4 percentage points.

Such a large gap either indicates that a considerable investment potential has accumulated in the country in recent years, or reflects a large shadow economy and volume of illegal imports.

In the first case, one of the *adverse macroeconomic implications of such a gap is unused growth potential*, as a large part of savings (approximately 42 percent) is not employed for economic development, employment generation and income growth. Moreover, the *possibility of capital outflow*, primarily illegal, *remains high*.

In the second case, the gap represents a *vivid reflection of the poor business climate*, which pushes a considerable proportion of private enterprises into the shadow economy.

In both cases, *the imbalance shows the need to revise the current economic policy* in order to improve the business climate, create an enabling environment for increasing the incomes of the population, and facilitate the subsequent deployment of those incomes towards private sector development.

1.4. How to Ensure Maximum Returns?

In the future, economic growth, a reduction in the tax burden and a high rate of labor migration will make households the major source of national savings. Combined with falling levels of foreign investment and credit, this implies a strengthening of the role of households in providing the private sector with the necessary resources for investment. Therefore, *implementing measures that facilitate a more efficient use of these resources is a priority in the short-term*.

Under the conditions of high unemployment and limited availability of capital, especially during the period of crisis and recovery, accelerated growth of the SME sector could assist in social as well as economic stabilization. Indeed, the SME sector can provide a higher level of employment at a relatively low cost, thus producing the greatest impact in terms of poverty reduction. Moreover, SMEs are more flexible, and thus better able to adapt to a changing external environment. Growth of SMEs in the manufacturing sector could also accelerate the economic diversification process, which is important for ensuring the long-term sustainability of economic growth in Uzbekistan.

⁹ CER, "Improving Investment Policy in Uzbekistan: Assessment of the Potential of Private Investments and Mechanisms to Intensify its Mobilization", 2008.



The development of the SME sector is one of the priorities of the state's economic policy. The role of SMEs in the economy is becoming increasingly important: in 2007 SMEs accounted for 45.7 percent of GDP and 72.3 percent of employment. However, despite recent improvements in quantitative indicators such as these, many of the qualitative characteristics of the SME sector remain to be improved.

The majority of SMEs operate in the services and agricultural sectors, and their contribution to the development of the manufacturing sector is limited. Moreover, the product range of SMEs involved in manufacturing is generally limited to either raw materials or lightly-processed goods that tend to be produced using simple technologies and have low value-added, and thus are uncompetitive on the world market. The poor quality of many SMEs' products and services is also reflected in the small size of SMEs' share in foreign trade (less than 10 percent). At the same time, only 4.7 percent of SMEs participate in foreign economic activities.

In order to ensure the sustainability of economic growth in the long-run, SMEs need to be given support to manufacture more goods with higher value-added. Markets for goods with medium to high technological complexity have the highest growth potential, whereas the share of goods with a low level of technological complexity has remained almost unchanged over the last 30 years, and the share of resource goods (raw materials) has been constantly declining.¹⁰

International experience has shown that the state can play a major role in facilitating the movement of SMEs towards the use of modern industrial production processes.¹¹ In addition to stimulating competition and removing barriers to private sector development, the state must create an environment that is conducive to the development of modern and technologically-advanced manufacturing processes within the SME sector.

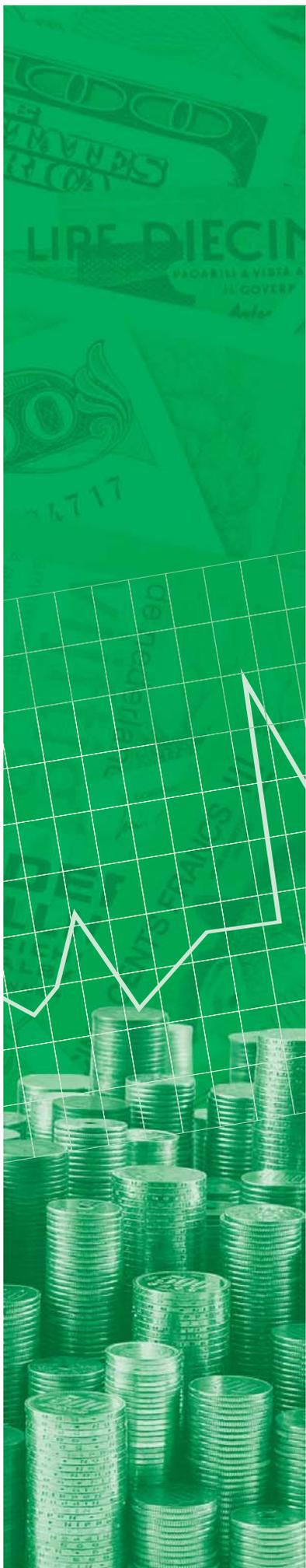
2. BARRIERS TO GROWTH OF THE SMALL- AND MEDIUM-SIZED BUSINESS SECTOR

The business environment in general and for SMEs in particular has improved significantly over the last several years in Uzbekistan. This is in part due to a reduction in the tax burden, a reduction in the incidence of administrative intrusion into business activities, the simplification of the process of registering and operating a business, and a reduction in the number of procedures required to register and operate a business. However, the results of numerous recent surveys reveal the existence of considerable barriers to the growth of the SME sector in Uzbekistan: for example, a recent study ranked the quality of Uzbekistan's business environment as 138th in the world (out of 181 countries).¹²

¹⁰ Proceedings of the seminar on manufacturing sector competitiveness that was held in Moscow on November 2, 2004.

¹¹ CER, "Improving Investment Policy in Uzbekistan: Assessment of the Potential for Private Investments and Mechanisms to Intensify their Mobilization", 2008.

¹² IFC, "Business Environment in Uzbekistan as Seen by Small and Medium Enterprises", 2009.



2.1. High Transactions Costs for Conducting Foreign Economic Activities

Currently, the most significant constraints on private sector development in Uzbekistan lie in the area of conducting foreign economic activities. Of particular importance are the high costs for transportation of imports/exports, difficulty accessing foreign exchange, and high level of customs duties and payments.

2.1.1. High Transportation Costs

Uzbekistan has one of the highest levels of freight transport costs in the world. The cost of importing a container to Uzbekistan is, on average, around USD 4,600, whereas the corresponding average for the whole Eastern Europe and Central Asia region is only around USD 1,774. Uzbekistan's comparatively high level of costs is only partly justified by the country's landlocked status and absence of direct access to sea ports, since it is one of the highest even among countries without direct access to sea ports.

The amount of official payments made when exporting is also very high, totaling approximately USD 3,100 per container, compared to a regional average of around USD 1,582. In comparison, Chinese exporters pay only USD 500, Pakistani - USD 611, Estonian - USD 730, German - USD 872 and Turkish - USD 990.¹³ Moreover, the average period of time spent on export procedures in Uzbekistan is 44 days, whereas the average for developing countries overall is only 29 days.¹⁴ This large difference can in no way be attributed to Uzbekistan's geographic location.

The main reasons behind the high level of freight transportation costs are: complex and lengthy customs clearance procedures, the high level of depreciation (and, hence, poor condition) of transportation infrastructure (both automobile and railroad networks), and distant location from the major transportation corridors.

Importantly, the problem of distant location from transportation corridors is not a consequence of geographic distance, but that the regional transportation system was designed and constructed before the independence of countries in the region and, therefore, without taking their national interests into account. For example, at present the railroad freight transportation between Uzbekistan and China is conducted through the Drujba station on the border between Kazakhstan and China, and along this route the distance between the Uzbek and Chinese borders is over 2,000 km; in contrast, the distance between the town of Karasu (on the Uzbek-Kyrgyz border) to the Chinese border is less than 280 km. The construction of a railroad connecting the Uzbek rail network with the Chinese (Andijan-Kashgar route) could not only decrease transportation costs, but also significantly increase the transit potential of the Central Asian region.¹⁵

¹³ World Bank, Doing Business Report (<http://www.doingbusiness.org/ExploreTopics/TradingAcrossBorders>) (data for 2009-2010).

¹⁴ CER, "Key Elements of Effective Investment Policies in Developing Countries: Prospective Avenues for Uzbekistan", 2007.

¹⁵ ADB, "Central Asia: Re-evaluation of the Regional Transport Strategy", 2003.

2.1.2. Access to Foreign Exchange

The long-discussed difficulties involved in converting the Uzbek national currency into the hard currency needed for imports still remain. There are no formal limitations on the conversion of soums into foreign currency, but in practice there are long delays (of 3 to 6 months) in the review of applications. Such delays lead to serious tensions with suppliers abroad, many of whom then refuse to provide the additional benefits that are given to reliable customers, or even refuse to continue cooperation.

Moreover, the currency conversion procedure requires **freezing the equivalent of the requested amount of currency in the account for the whole application period**. During the lengthy application review period, inflation, volatile exchange rates and missed earnings (due to the funds being taken out of turnover), can create substantial costs and risks for entrepreneurs.

Recent surveys also show that this situation has deteriorated significantly since late-2008/early-2009¹⁶, and that since then many SMEs in the manufacturing sector have practically lost their access to currency conversion and have instead been forced to purchase necessary raw materials and components from local intermediaries who overcharge (which, in turn, leads to cost increases and subsequently to a deterioration in the enterprises' competitiveness).

2.1.3. High Rates of Customs Dues

Currently the average rate of customs dues (duties, excise, and VAT) in Uzbekistan stands at 41.7 percent¹⁷, which implies a high degree of import protectionism. The objective of these high tariff barriers is the protection of domestic manufacturers from foreign competition. However, in practice, the *negative implications of this approach outweigh their expected benefits*.

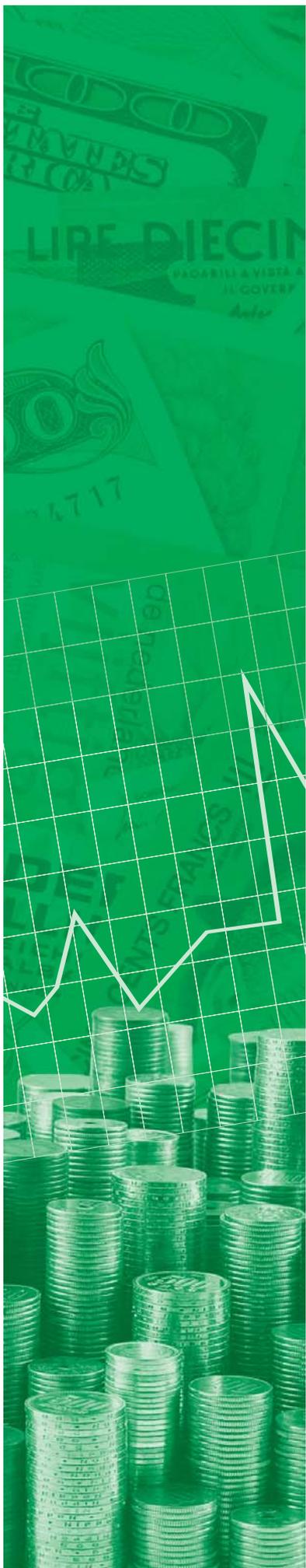
Firstly, bona fide importers, which are conscientious about paying the high customs dues, become uncompetitive on most markets as the actual market prices do not cover their costs. This implies that the existing system often leaves no option for importers other than to resort to informal schemes. The higher the customs dues, the stronger are the perverse incentives. This trend is strengthened by the large number of exemptions and preferences granted on a discretionary basis to only some companies.

Secondly, the growing scale of informal schemes undermines the effectiveness of the efforts to protect domestic producers, since it puts them in competition with foreign products imported informally without the payment of customs dues (and which, therefore, are relatively cheap).

Thirdly, the high degree of import protectionism imminently affects the access to and prices of the imported resources essential for the production of high-quality and internationally competitive domestic products. Thus, although Uzbekistan officially pursues a policy of export stimulation, exporters of finished goods suffer the

¹⁶ APIC, "Technical Report on the Survey of Entrepreneurs on Competition Policy" (working draft), 2009.

¹⁷ UNDP, "Improving Regulatory Mechanisms for Export-Import Transactions and Enhancing the Effectiveness of Customs Control" (Policy Brief), 2008.



most from the current situation. Protectionist policy, aimed at safeguarding the import-substitution oriented sectors, makes these sectors more attractive for investments. This, in turn, encourages a flow of material resources and labor away from export-oriented sectors and towards these sectors, thereby slowing the process of economic diversification. Moreover, limiting imports reduces the demand for foreign exchange, and, thus, leads to an overvalued exchange rate for the local currency, rendering export goods more expensive on external markets.¹⁸ As a result, the export potential of the country decreases.

2.2. Tax Policy and Tax Administration Costs

The competitiveness of developing economies and, thus, their attractiveness for investment, depends to a significant extent on the tax burden faced by producers. In Uzbekistan, despite tax reforms and the adoption in 2007 of a revised Tax Code, high taxes and social payments continue to remain significant barriers to private sector development¹⁹, with the amount of tax paid by the SME sector being one of the largest in the world.²⁰

The tax burden remains relatively high - the share of the state budget in GDP stands at 28 percent²¹, which is higher than the tax burden in successfully developing economies with comparable per capita income. For instance, in 1979-1996, when China was experiencing record economic growth (exceeding 10 percent per annum), the tax burden fell from 36 to 13 percent, and only after 18 years of record growth rates was it increased to 20 percent.

Furthermore, the current simplified tax system used for micro and small enterprises, along with the high level of social payments²², encourages enterprises to conceal the true number of employees and the level of wages, as well as to split up growing medium-sized enterprises into smaller entities.

However, medium-sized enterprises are more flexible than large ones in relation to issues such as launch of production and implementation of new technological and organizational processes. In addition, as opposed to micro and small enterprises, they have sufficient scale to undertake scientific research work, to influence the local labor market, to establish relationships with foreign partners, and thus, to be more attractive to investors. *These are the characteristics that make medium-sized production enterprises the critically important layer that determines the pace of change in the economy.* The extension to such enterprises of eligibility for the simplified tax regime would create an additional catalyst for the growth of the medium-sized enterprises layer.

The practice of providing various preferences and incentives to individual enterprises is still in place, creating an unfair playing field for those without such preferences and reducing motivation to invest and innovate. Unequal treatment constrains competition, creates

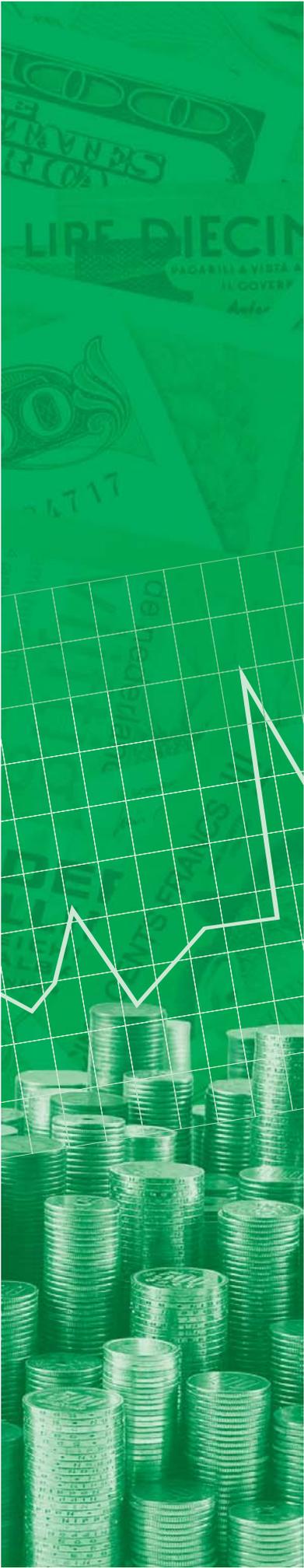
¹⁸ Ibid.

¹⁹ CEI, "Enterprise Surveys", 2006.

²⁰ IFC, "Business Environment in Uzbekistan as Seen by Small and Medium Enterprises", 2009.

²¹ CER, "Key Elements of Effective Investment Policies in Developing Countries: Prospective Avenues for Uzbekistan", 2007.

²² The Single Social Payment represents 24 percent of the total wage fund (total amount of wages to be paid), and there is also a minimum amount of this payment - which is equal to the minimum monthly wage per employee. For farmers' enterprises it was set at 50% of the size of the minimum wage.



barriers to entry for new enterprises, and thereby distracts the attention of businesses away from innovation, productivity improvements and cost reduction, towards lobbying to obtain, retain and multiply those incentives.

On top of the high tax burden, the system of tax administration has several weaknesses. Although the number of tax inspections has fallen significantly in recent years, their effectiveness in terms of the volume of revenue from underpaid (evaded) taxes remains low.²³ This is the result of the subjective selection of enterprises to be inspected by the tax officers, with the use of methods based on analysis of risks being practically nonexistent. Moreover, the relatively high level of corruption among tax officers²⁴ complicates the assessment of both the amount of underpaid taxes and the size of the informal economy.

2.3. Limited Access to Financing

During the last five years the share of commercial banks in the composition of investments into the real sector of the economy was less than 5 percent, which demonstrates the under-utilized potential of the banking sector in the development of private entrepreneurship.

The share of entrepreneurs using formal credit to start a business and/or to support its growth and modernization remains at a very low level - under 10 percent.²⁵ Most entrepreneurs (over 90 percent) use only their own resources and informal borrowing. This reflects the difficulty of obtaining bank credit for starting and modernizing a business, as well as the high cost of finance.

Interest rates of 22-26 percent for commercial loans (and starting at 14 percent for lax credits) may not seem excessive in light of annual inflation rates of 7-12 percent. However, the real cost of finance is significantly higher, due to factors such as informal payments and the opportunity cost of time spent on administration, inadequate evaluation of collateral, short repayment periods (less than 3 years), and, most importantly for SMEs, that prices for many services, inputs and equipment are higher when paid for by wire transfer (rather than cash).

As a result, and due to their low level of average profitability²⁶, credit becomes an unfeasible option for many enterprises in the manufacturing industries. Moreover, obtaining credit is particularly difficult for manufacturing enterprises wishing to fund expansion and modernization of production methods.²⁷

Another important factor that prevents a wider and more efficient use of credit is that a significant proportion of real assets with market value, such as land plots, intellectual property, and

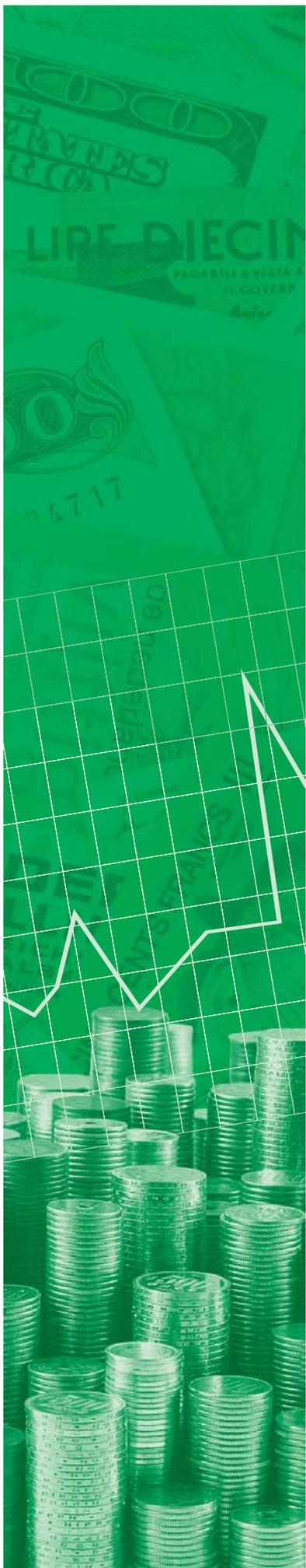
²³ UNDP, "Perspectives on the Implementation of the System of Risk Analysis for Conducting Tax Inspections", 2007.

²⁴ UNDP, "Impact of Tax Reform on the Prosperity of Micro and Small Businesses in Uzbekistan", 2008.

²⁵ Findings of the survey of entrepreneurs that was conducted by the CER in 2006.

²⁶ The average profit margin in the processing industries in 2006 was 25 percent, including: power industry (23.2 percent), car manufacturing and metalworking (18.6 percent), forestry, wood processing and cellulose-paper industry (29.8 percent), light manufacturing (11.5 percent), food (30.8 percent), and chemical and petrochemical industries (31.5 percent). At the same time, profitability in the following industries was significantly higher: oil and gas (96.1 percent), black metallurgy (35.5 percent), color metallurgy (140.6 percent) and construction materials (72 percent).

²⁷ IFC, "The Business Environment in Uzbekistan as Seen by Small and Medium Enterprises", 2009.



primary and secondary housing, cannot be effectively used as collateral, even at a below-market value. This disadvantages SMEs in particular, as many of them do not have adequate collateral or guarantors, and cannot obtain "administrative support" from associations or holdings. In addition, loan guarantee funds, which are often used in other countries for dealing with the problem of inadequate collateral of small businesses, are not used in Uzbekistan.

There are almost no alternative (non-bank) sources of borrowing for SMEs - although the number of credit unions and microfinance institutions is growing, the total amount of their resources remains insignificant, the maximum loan amount is very low, and the interest rates are significantly higher than at commercial banks. Therefore, despite significant potential in expanding consumer lending, these institutions cannot be relied upon to serve, in the near future, as a serious alternative to the banking system in facilitating the accumulation of savings and financing private sector investments.

The sector of investment and venture capital companies in Uzbekistan is also almost absent - the few operating investment companies are more interested in the potential "blue chips" of the Uzbek stock-exchange, or in investment opportunities abroad.

The stock-exchange has stagnated in recent years. At present, it lists only 11 companies, most of which are banks, and the annual turnover amounts to less than two percent of GDP.²⁸ Capitalization indicators of joint-stock companies are not well-understood by the general public and the stock market does not yet capture the interest of much of the population. This is partly due to the absence of "blue chips" in open circulation, inadequacy of quotations and corporate governance, and partly due to low levels of financial literacy among much of the population. Therefore, in addition to the legal requirements and difficulties involved in the process of 'going public', the stock exchange does not draw much interest from SMEs as a tool for attracting investment.

2.4. Protection of Property and Interests of Entrepreneurs

Uzbekistan has an ineffective system for protecting entrepreneurs' property rights, and the majority of entrepreneurs have limited confidence that the state will firmly protect their rights.²⁹

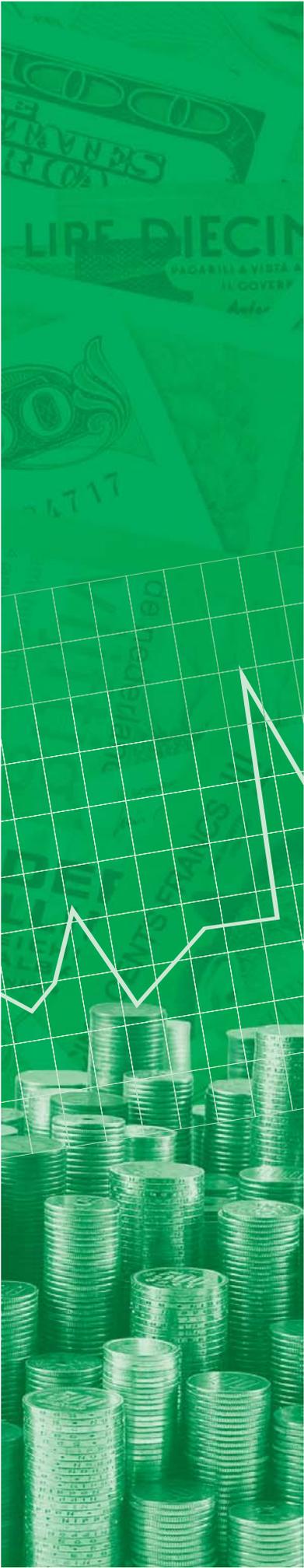
The main tool for the protection of entrepreneurs' rights is the judicial system. In contrast to the elaborate legal framework in place to protect government interests (in foreign trade transactions, tax payments, etc.), the level of protection of the interests of private entrepreneurs is more limited: the majority of entrepreneurs consider the risks of non-compliance with contractual obligations to be high.³⁰

Econometric analysis has provided some quantitative evidence that improving the mechanisms of protecting investor rights can boost the growth of private investments. Thus, an additional *inflow of*

²⁸ Center for Coordination and Control over the Functioning of the Stock Market in Uzbekistan, "Annual Report 2008" (<http://www.csm.gov.uz/index.aspx?id=1694>).

²⁹ CER, "Technical Report on the Survey of Managers of High-Tech Companies in the Tashkent Region", 2006.

³⁰ Ibid.



foreign investments of up to 2 percent of GDP can be realized if the degree of investor protection (measured by the number of lawsuits filed) is increased by one percentage point. Enhancing the efficiency of government institutions involved in the field of investor protection is particularly important for Uzbekistan: in 2007 the investor protection index stood at 3, which is significantly lower than the average of 5.5 for developing countries overall.³¹

2.5. Excessive Regulations and Intrusion

Over the last few years, Uzbekistan's private sector has seen a significant reduction in the level of the authorities' intrusion into its activities. In particular, the number of inspections by regulatory bodies has fallen, the inspection process has been streamlined, and the list of products and services subject to mandatory certification has been shortened significantly. However, several key constraints on SME development remain.

2.5.1. Certification and Licensing

Complicated procedures for obtaining various permits, approvals, licenses, certificates and standards continue to represent *major barriers to market access*. While, when launching new products, entrepreneurs in developing countries spend an average of 230 days to obtain a license, in Uzbekistan they spend 280-290 days.³² Estimates indicate that *reducing this period by at least 10 days could lead to an increase in private sector investments of 0.2 percentage points of GDP*.³³

High time and monetary costs for mandatory product certification and standardization are *especially painful for technologically-advanced companies*, and decrease motivation to produce new types of product or to improve the existing product range. Despite the considerable reduction in the number of products subject to mandatory certification, the list of such products still consists of over 600 entries. Furthermore, the certificate received must be periodically renewed, and this involves additional costs.

In addition to certification and licensing, there is another category of permits and approvals, which is related to the process of *launching or expanding a manufacturing business*. This is not related to registration procedures, which were substantially eased recently, but to the operational/post-registration stage of starting a business - obtaining various permits and approvals for the transfer of residential into non-residential premises, expansion of the territory of the enterprise or the trade outlet, etc.

³¹ CER, "Key Elements of Effective Investment Policies in Developing Countries: Prospective Avenues for Uzbekistan", 2007.

³² IFC, "The Business Environment in Uzbekistan as Seen by Small and Medium Enterprises", 2009.

³³ See Model No.2, Attachment 4, in CER, "Key Elements of Effective Investment Policies in Developing Countries: Prospective Avenues for Uzbekistan", 2007.

2.5.2. Banks as Tools for Administrative Control

Interaction between entrepreneurs and banks is mostly related to the state's policies in the areas of money supply and banking regulations. The banking system has become one of the tools used by the administration to exert pressure on private entrepreneurs, and banks, to the detriment of the development of their own businesses, are performing a number of alien functions.

In particular, difficulties in withdrawing cash from bank accounts, and, as a result, the observed difference between payments made in cash and by wire transfer, has long been a major problem. There are effectively two prices for almost all goods purchased in the country, with the price applicable to payment by wire transfer being 10-15 percent higher than the price for payment made in cash.

Entrepreneurs also highlight limitations on handling their own funds in their own bank accounts, requirements to relinquish cash to the bank, instances of cash being withdrawn from the account without the owner's consent, and banks' disclosure, to third-parties, of information about their clients' financial transactions.

In addition, concerns about the potential bankruptcy of banks have led to a virtual disappearance of competition among them, and there are no long-term strategies or high-risk operations. The banks are primarily involved with the redistribution of the free money supply, increasing their commissions on transactions and unilaterally increasing the cost of their services. As an example, in the period 2006-2009 the size of commissions on the payment of dividends grew more than sevenfold: from 2 to 15 percent.

2.5.3. Administrative Barriers faced by entrepreneurs in Accessing Markets and Raw Materials

In the process of selling their products and services, local entrepreneurs also encounter several barriers in terms of market access. Among these are restrictions on setting on a market (supply/demand) basis the prices for the products/services being sold (especially in the agricultural sector), barriers in transportation to and/or sales of products in other rayons and oblasts, and inspections by State Automobile Inspection (GAI) officers, especially at numerous road-blocks located at entrances to the oblasts and cities.

There are also major barriers that prevent access to important types of input. These include the ineffectiveness of formal and informal mechanisms of administrative distribution (e.g. for natural gas, electricity, seeds and fertilizers, cotton yarn), the monopoly position of manufacturers or importers (which results in higher than market prices for goods such as cement, roofing materials and metal), as well as difficulties in obtaining the foreign currency needed in order to import necessary raw materials and components.³⁴

³⁴ APIC, "Technical Report on the Survey of Entrepreneurs on Competition Policy" (working draft), 2009.



CONCLUSIONS AND RECOMMENDATIONS

Returning to the question posed initially, on whether there are enough savings to allow adequate private sector growth during the period of crisis and recovery, the answer is clearly "yes". The current rate of national savings is sufficient to allow the sustainable growth of Uzbekistan's economy during the crisis and recovery. However, the realization of this potential growth is conditional upon the efficient deployment of savings.

The answer to the second question, which considers the extent to which the savings are efficiently deployed, is less clear. As the analysis has shown, the growing savings of the Uzbek population are not kept in the banking system, and available statistics do not allow an unambiguous assessment of the effectiveness and directions of their use. However, as mentioned earlier, signals such as soaring prices for investment goods (.e.g. land, real estate and cars) during the pre-crisis period, in light of the unattractiveness of placing savings into the banking system or investing in the stock market, testify to a lack of demand, and, thus, to significant unused investment potential.

In order to maximize the returns (in terms of economic growth and poverty reduction) to available domestic resources, under conditions of limited availability of capital and high unemployment during the period of crisis and recovery, the channels aimed at mobilizing savings and pouring them into the real sector need to be made more effective. In addition, the development of SMEs should be supported, and the share of informal economy reduced. For growth to be sustainable in the long-run, the state must pay particular attention to the development of manufacturing enterprises, which produce goods with higher value-added.

1. Improving the Effectiveness of Transformation Channels

To bring the growing savings of the population into formal economic turnover, households' and entrepreneurs' confidence in the banking system must be strengthened, and the banking system must become more attractive to potential savers and investors. Specific means of achieving this include ensuring exchange rate stability, providing a positive real interest rate on deposits and removing formal and informal limitations as well as fees on cash withdrawals. In the long-run, the accelerated development of the stock market, non-bank financial institutions, investment funds, and venture capital companies, should be promoted, and domestic founders of SMEs should be given exemption from income taxes. This would allow the development of an *alternative investment market*, in which innovative and rapidly developing private companies could obtain access to purely market-based non-banking financial instruments³⁵, and may also help to strengthen competition in the banking sector.

³⁵ For more details, see CER, "Investment Capacity of Uzbekistan's Stock Market: Constraints and Ways of its Activation", 2007.

2. Removing Barriers for SME Growth

The main recommendations aimed at the removal of barriers to SME growth are the liberalization of foreign trade, improving access to finance for start-up and expansion of businesses, reducing the tax burden and improving tax administration, removing administrative barriers to growth, and further limiting state intervention in business activities.

In the area of foreign economic policy, the critical issues are the liberalization of foreign trade and the improvement of the customs administration.

In the short-term, important measures include:

- streamlining and enhancement of the transparency of customs procedures, including regulation of the time taken for customs clearance, improvement of certification procedures for imported components and spare parts (particularly in terms of the recognition of foreign certificates), and simplification of the system of deferral of customs duties for SMEs;

- strict regulation of time for processing currency conversion applications, as well as the introduction of effective tools for export financing and insurance; considerable reduction in the tariff level (duties, excise tax and VAT)³⁶;

- exemption from payment of customs duties and VAT on a wide range of technological equipment;

- exemption from payment of customs duties on spare parts, operating supplies, raw materials and semi-finished goods that are intended as inputs into the production of new types of product;

- exemption of SMEs from the requirement, under export-import contracts, of upfront payment of 100 percent;

- provision of incentives for the development of the private transportation sector (including freight forwarding);

- simplification and streamlining of the customs legislation, including revision of the Customs Code into a law of direct action.

In the long-run, customs administration reforms are crucial, especially those aimed at reducing corruption in customs procedures, increasing the accountability of customs officers for the erroneous identification of goods and the violation of rules and time limits that apply to customs clearance procedures, and establishing a mechanism by which entrepreneurs can be compensated for expenses they have incurred through the fault of customs officers.

In addition, there are two key interventions that would improve Uzbekistan's transit potential and reduce transportation costs: improvement in the operational effectiveness of the State Joint-Stock Railway Company "Uzbekistan Railways"; and the optimization and modernization of internal transportation networks (both automobile and railroad), in order to improve their integration with the regional networks, and including construction of a railroad line between Andijan and Kashgar.

In the area of tax policy and tax administration, the tax burden on businesses should be further reduced, in order to increase their savings (which can then be invested into technological

³⁶ According to the econometric analysis, a reduction in import taxes in Uzbekistan to the level characteristic of the leading countries of the CIS (7-8 percent), would allow an additional inflow of FDI in the amount of 2.2 percent of GDP.



modernization and development) and reduce their incentive to operate in the informal economy. Measures employed in order to improve tax policy and administration should include the following:

- moving away from taxes on active fixed assets (in line with standard international practice). This would require a gradual transition away from property tax and towards real estate tax;

- further reductions in the rates of the Single Social Payment, as well as the reduction or abolition of the minimum payment (in the amount of one minimal monthly salary) for every employee;

- ceasing the practice of providing benefits and preferences to individual enterprises, instead applying them on a non-discriminatory basis, to all businesses in a particular sector that is being supported;

- raising the threshold for the number of employees that defines an enterprise as "small", thus allowing more enterprises to qualify for the simplified taxation system; providing manufacturing enterprises with additional incentives for growth and thus facilitating the formation of a layer of medium-sized private companies;

- tax administration reforms, especially those aimed at reducing corruption in tax inspections, increasing the accountability of tax officers for the violation of inspections regulations, and introducing risk analysis-based methods for the selection of enterprises for inspections.

In the banking and financial sector, excessive restrictions on SMEs' access to cash and the credit resources of commercial banks should be eliminated, and the development of alternative sources of financing for entrepreneurs should be supported.

In the short-run, it is necessary to:

- create clear and accessible mechanisms for incorporating the existing assets of the population (real estate, land, and property as collateral) into the economy, which is especially important for start-ups;

- establish an upper limit on commissions on banking transactions, as well as remove limitations on the use of cash by SMEs (both in order to reduce business operating costs);

- strengthen the penalties for disclosing information on the financial transactions of private enterprises without a court order, including to law enforcement agencies, as well as for withdrawing cash from an account without the consent of the owner;

- remove alien functions from banks, such as control over cash receipts.

In the long-run, it is important to provide additional incentives for small business growth, through the introduction of loan guarantee funds, and to promote the development of non-banking financial institutions (such as credit unions, microfinance institutions, and investment and venture capital companies) as alternative sources of support for private sector growth.

