POLITICAL OBSTACLES TO ECONOMIC REFORM IN
UZBEKISTAN, KYRGYZSTAN, AND TAJIKISTAN:
STRATEGIES TO MOVE AHEAD

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OVERVIEW

Several key political obstacles to economic reform have been identified in what is now a burgeoning literature on the political economy of reform, including the government’s fear of popular backlash and lack of technical expertise, multiple institutional veto players, individual and aggregate uncertainty, vested interests in the status quo, and the relative weakness of the potential winners of reform vis-à-vis the losers. [See Table 1 below for details.] The overriding focus of this literature to date is on how political leaders can successfully implement and then sustain economic reforms in the face of formidable opposition from those who will suffer the most from these reforms -- at least at the initial stages; that is, the population at large as well as strong sectoral and organized interest groups that benefit from status quo policies. The remedies this literature offers, therefore, are largely aimed at reducing or eliminating popular opposition to reform -- either, for example, by insulating the government and employing technocrats, sequencing reforms to identify winners and compensating the losers of reform, or building coalitions with the winners. [See Table 1 below for details.]

In Uzbekistan, Kyrgyzstan, and Tajikistan, however, the greatest political obstacles to economic reform do not come from below, but rather, from above -- that is, from vested interests within the government itself. These vested interests vary to some degree in each state, but are primarily central, regional, and local elites “inherited” from the Soviet era. These elites, moreover, do not resist reform because they fear revenge at election time from the disenchanted masses, but because they fear the loss of their own economic, and hence, political power. Because the majority in these three countries is employed in the agricultural sector, for example, the bulk of the population stands to gain the most from further reform. Yet, central ministries, regional governments, and kolkhoz (collective farm) chairman resist market-based initiatives (such as the privatization of land, rational use of water, and an end to mandated crops and production quotas) that would wrest their control over crop production and distribution, which is tied to both their economic well-being and political power. Local farmers, however, have a strong interest in seeing all of these changes made, but little or no political opportunity to express their interests -- whether through organized protest or a transparent decision-making process. In the agricultural sector, therefore, the international donor community should adopt a bottom-up approach that targets reform at the farm level, for example, by expanding farmers’ access to production inputs and supporting groups that represent farmers’ interests. In addition to creating incentives to move beyond subsistence farming, such reform will also need to address technical and infrastructural problems, for example, by supplying functioning water meters and supporting the creation of private sector networks for new machinery.
<table>
<thead>
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<tbody>
<tr>
<td><strong>1. Leadership</strong></td>
<td></td>
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<tr>
<td>a) Lack willpower b/c fear backlash at the polls</td>
<td>• Insulate reformers (and the reform process) from the masses</td>
</tr>
<tr>
<td>b) Lack the technical capacity</td>
<td>• International pressure (either through contingent loans or requirements for joining trade organizations)</td>
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<tr>
<td>c) Lack visionary leadership</td>
<td>• Wait for an economic crisis, which will induce a “learning effect”</td>
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<td></td>
<td>• Employ technocrats</td>
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<td><strong>2. Institutional</strong></td>
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<tr>
<td>a) Democracy = lag in benefits (“J-curve”) and popular backlash at the polls</td>
<td>• Insulate reformers (and the reform process) from the masses -- see above</td>
</tr>
<tr>
<td>b) Multiple veto players = more difficult to enact (unpopular) reforms</td>
<td>• Reduce number of veto players -- e.g. by establishing a strong executive</td>
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<tr>
<td>c) Electoral cycles = danger of policy reversal</td>
<td>• Reformist governments should utilize the “window of opportunity” to push through reforms as quickly as possible -- e.g. after a crisis</td>
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<td><strong>3. Uncertainty (Individual and Aggregate)</strong></td>
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<tr>
<td>a) Status quo bias</td>
<td>• Aggregate: Sequencing of reforms -- e.g. development of private sector precedes reform of the state sector</td>
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<td>b) Increases risk for policy/decision-makers</td>
<td>• Individual: “Big Bang”/Shock therapy -- i.e. to overcome status quo bias or sequencing to identify the winners and losers</td>
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<td>c) Increases opposition to reform from losers as well as winners due to individual uncertainty</td>
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<tr>
<td><strong>4. Losers</strong></td>
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<tr>
<td>a) Vested interests in the status quo (most commonly, sectoral interests/importers and labor unions) block economic reforms</td>
<td>• “Big Bang” approach/Shock therapy</td>
</tr>
<tr>
<td>b) Resistance dominated by aggregate uncertainty</td>
<td>• Compensate through transfers and make a credible commitment to maintaining them over the course of reform</td>
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<tr>
<td>c) Danger of policy reversal</td>
<td>• Sequencing and Gradualism/Partial reform</td>
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<tr>
<td></td>
<td>• Wait for a crisis to build popular support for reform</td>
</tr>
<tr>
<td><strong>5. Winners</strong></td>
<td></td>
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<tr>
<td>a) Resistance dominated by individual uncertainty</td>
<td>• Identify and build coalitions with the winners</td>
</tr>
<tr>
<td>b) Interests are dispersed/not organized</td>
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The core solution, then, is to either co-opt them through less costly side-payments (i.e. in terms of their impact on reform) or to cultivate those interests that are motivated by market incentives. In Central Asia, eliminating these vested interests is highly unlikely given the political constraints of well-entrenched authoritarian regimes and patronage systems that support the status quo. Despite several external shocks that have produced social and economic crises -- albeit to differing degrees -- for example, the three Central Asian governments in question for the most part have not responded by unilaterally embracing economic reform.\textsuperscript{1} In most cases, economic and social crisis has encouraged governments to retreat from reform, and instead, to continue to rely on and strengthen existing patronage networks that obstruct reform (see Jones Luong, 2002 for details). Co-opting these vested interests is possible, though also politically problematic for similar reasons. Cultivating those interests that are motivated by market incentives seems to be the most viable strategy and is therefore worth employing, yet has not been fully explored. In short, this requires that the international donor community work together to target farmers, SME owners/managers, and regional/local officials in their reform efforts.

Although some combination of the second and third strategies would be more sustainable over the long term, this would involve greater fiscal and administrative decentralization. While the experiences of other countries have shown that there are some clear advantages to decentralization (see, e.g. Weingast, et al., 1995), the case for decentralizing authority is not clear-cut (see, e.g., Rodden and Rose-Ackerman, 1997) -- particularly in post-communist states (see, e.g., Jones Luong and Way, 2001). First, in many cases the necessary infrastructure to ensure the effective allocation of resources (or even the tracking of expenditures) at the local and regional level is not yet in place. Before advocating greater fiscal decentralization, then, the international community must direct its efforts at creating this infrastructure, as it is already doing in Kazakhstan and Kyrgyzstan (see, e.g., USAID, January 2002). The international community can also bolster the accountability of regional and local leaders by continuing to support the development of an independent judiciary and strengthening its role in the adjudication of disputes, as well as to prioritize more effective audit processes and budgetary control. Ensuring greater accountability at the local and regional levels also requires political decentralization -- i.e. the election of local and regional leaders. In this respect, Kyrgyzstan has made the most progress by holding local elections for village and town akims in December 2001.\textsuperscript{2} Secondly, greater fiscal decentralization in particular is likely to be strongly opposed by the central governments in each state. Most prefer to maintain a unified budgetary system in which the central government collects and then redistributes revenue to the regions. Even in Kyrgyzstan, which has been the most open to international efforts at decentralization and has received the most technical assistance (other than Kazakhstan) to develop an intergovernmental transfer system, the central government has resisted fiscal decentralization (USAID, January 2002, p.44). Finally -- and perhaps most importantly -- decentralization requires a strong central government (Way, 2000; Jones Luong, forthcoming). This is both the rationale for

\textsuperscript{1} These external shocks include the collapse of the Soviet Union, which initially hit Kyrgyzstan and Tajikistan much harder than Uzbekistan, the August 1998 financial crisis in Russia, and the civil war in Tajikistan. In addition, according to all the standard economic indicators, the economies of all three Central Asian states were undoubtedly in a state of crisis after independence. (See Jones Luong, 2002, Chapter eight, for details.) For example, by 1992 -- the first year after the transition -- the GDP in all three countries had dropped by over 10 percent since 1989. Thus, awaiting another crisis is not likely to induce economic reform.

\textsuperscript{2} President Akaev initially proposed holding local elections in December 2000; pilot elections were held at the beginning of 2001.
decentralization (i.e. the need to guard against a predation from the center) and crucial to the success of decentralization because the central government must have the administrative and legal capacity to assure economic actors that it can enforce contracts and property rights as well as to regulate inter-regional economic activity (see, e.g., Montinola, Qian, and Weingast, 1996). Decentralization in Tajikistan and Kyrgyzstan, wherein the central government is relatively weak vis-à-vis regional interests, then, may not only undermine the goals of decentralized authority, but also risk greater instability. Instead, in these two countries in particular the donor community must focus on strengthening the central government at the same time that it supports the development of a productive relationship between the regional/local governments and the private sector. Local governments and SME owners/managers are increasingly coming to realize that they have a mutual interest in promoting business climates conducive to private sector development. The international donor community can reinforce this positive trend through providing public administration training for regional/local officials and facilitating productive dialogue and linkages between these officials and the private sector.

Alternatively, some might advocate that the international community continue to push for large-scale privatization as a means to create new economic interests. In theory, this would not only complement efforts to dissipate the power of vested interests by improving the climate for the development of SMEs, but also is likely to accelerate the effects of such efforts. As the case of Russia seems to indicate, even if privatization was initially conducted in a nontransparent fashion, it would eventually generate interests vested in strengthening the legal and regulatory environment for businesses.³ This seems to be an especially appropriate strategy in Central Asia since one of the fundamental problems is that political and economic actors and interests are still one in the same. Moreover, transition economies have displayed the best growth records where privatization was pursued in conjunction with the development of new firms so it would make sense to pursue these two strategies simultaneously (see, e.g., World Bank. 2002).

Privatization of state enterprises, however, is by no means a cure-all for what ails these countries. As the experience of other “transition” countries demonstrates, the way in which privatization is carried out has a huge effect on its economic results. In particular, those countries that performed best privatized to “individual investors or concentrated groups of strategic investors through open, fair, and transparent methods” (World Bank. 2002, p.72). While the conventional wisdom that privatization to insiders has been a total failure needs to be reassessed in light of recent improvements in Russia, the problems of privatization to diffuse owners who lack capital and managerial experience (i.e. voucher privatization) remain salient (see, e.g., World Bank, 2002). The fact that Kyrgyzstan opted for voucher privatization, for example, accounts for a large part of its relatively poor record on restructuring state enterprises. Attempts to implement privatization and restructuring have also been stalled in Kyrgyzstan due to weak central state capacity and the aforementioned vested interests in the status quo at the local and regional levels. This suggests another disadvantage to advocating centrally orchestrated reform when the central government itself is too weak to implement it, particularly in Central Asia wherein the common practice is to adopt and implement policies that strike a careful balance between central and

³ The oil sector’s influence on the new tax code is a case in point. See Jones Luong and Weinthal, 2002.
regional interests and authority.\textsuperscript{4} The exchange rate policy in Uzbekistan and the international reputation of rampant official corruption in Kyrgyzstan and Tajikistan, moreover, provide a formidable obstacle to attracting “strategic investors” in Central Asia. In addition, growth in transition economies is attributed more to the emergence and success of new firms than to the restructuring of old enterprises. Thus, privatization should not be viewed as a substitute for promoting the development of SMEs. Moreover, in Central Asia it makes sense to focus reform efforts on the agricultural sector, particularly if the primary goal is poverty reduction because, as aforementioned, the majority of the population is employed in the agricultural sector and the degree of industrialization is quite low in comparison to other parts of the former Soviet Union. Industry is also concentrated, such that a strategy of promoting reform from below is more conducive to addressing the needs of specific regions with large state enterprises.

This leaves empowering potential winners of reform at the local and regional levels as the most viable and indeed desirable strategy for overcoming political obstacles to economic reform and moving ahead. Of course, the main disadvantage to this approach is that it is likely to produce results only gradually, or in the medium- and long-term, and so requires a long-term commitment.\textsuperscript{5} In patronage-based societies, however, the empirical evidence strongly suggests that significant liberalization political and economic does not occur from above unless there are strong pressures from below (see, e.g., Bratton and van de Walle, 1994). Yet, it also has several distinct advantages. First, it can be done in conjunction with current efforts aimed at encouraging the central government to adopt and implement reform. In fact, it may be that the only way to accelerate reform is to work at the local and regional levels because the key vested interests at the central level will not benefit from rapid or dramatic change. For reasons delineated above, exclusive focus at central level is counterproductive when in fact most of these governments are weak -- both in absolute terms and relative to regional governments. In none of these countries (even Uzbekistan, which arguably is the strongest of the three states) can the central government implement reform alone; rather, it often faces resistance from below. Secondly, reforms achieved in this manner are more likely to be sustainable over the long-term because they involve building broad coalition in support of economic reform.

Because open trade is crucial to building markets, these efforts must also be coupled with promoting sustained inter-state cooperation aimed at facilitating free trade. Inter-state economic cooperation in the areas of border security and eliminating barriers to trade is integral to improving the business climate and providing economic opportunities for SME development in all three states. Promoting trade liberalization will also make the drug trade less attractive by increasing the potential for legitimate trade.\textsuperscript{6} At the present time, the illicit opium trade enjoys relatively open access (for the right price and with the right contacts) while multiple (official and unofficial) trade barriers exist for other, less durable crops. Yet, promoting inter-state trade has proven to be an extremely difficult task, particularly since the incursion of armed militant Islamic groups into southern Kyrgyzstan (August 1999, August 2000), Uzbekistan (August

\textsuperscript{4} This does not, however, preclude privatization. Privatization of the energy sector in Kazakhstan, for example, was the result of a compromise between the central government and akims in energy-rich regions. See Jones Luong and Weinthal, 2001.

\textsuperscript{5} In fact, it might be the case that all of the other strategies reviewed above also require a long-term commitment, so this so-called “drawback” is certainly not unique.

\textsuperscript{6} Another way to combat the illicit opium trade, of course, would be to support the conversion of poppy to legal uses (e.g. codeine and morphine), as is the case in Australia, India, and Turkey.
It is possible that security concerns will be lessened by the presence of U.S. troops in the region, but the barriers stemming from economic motivations (e.g. high tariffs) and corruption (e.g. border guards accepting bribes and arbitrary roadblocks) are likely to persist without international pressure and support to reduce them. Pressure would have to be directed at the central governments to change their official policies while support would constitute, for example, training and better salaries for border guards. Hence, overcoming these barriers will also require a long-term commitment on the part of international actors as well as coordination among them.

This paper is divided into three main sections -- one for each country (Uzbekistan, Tajikistan, and Kyrgyzstan). Although these three countries share the same core political obstacles to economic reform described above, there are important differences among them regarding the level of commitment to economic reform, the specific problems they face in adopting and/or implementing reform, and hence, the relevant solutions. For example: Kyrgyzstan has by far the best record on economic reform, while Uzbekistan is the state with the greatest coercive and infrastructural capacity to implement economic reform; Kyrgyzstan and Tajikistan face both higher levels of debt and official corruption than Uzbekistan; and the lack of access to information about laws and regulations impedes the development of SMEs most often in Uzbekistan and Kyrgyzstan. Some indication of their different degrees of progress in adopting market reforms (both compared to one another and to other former Soviet republics) are presented in Table 2 below. The reader should keep in mind, however, that these indicators only reflect progress on paper that may not translate to actual practice -- a common problem across transition countries. Thus, each of the following section details the particular situation in each country and concludes by offering a separate set of recommendations for each country. There is no overall conclusion.

Table 2: EBRD Transition Indicators

<table>
<thead>
<tr>
<th>Country</th>
<th>1995</th>
<th>1999</th>
</tr>
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<tbody>
<tr>
<td>Kazakhstan</td>
<td>2.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>2.9</td>
<td>2.8</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>2.6</td>
<td>2.5</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>1.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>1.1</td>
<td>1.4</td>
</tr>
<tr>
<td>Ukraine</td>
<td>2.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>2.4</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: EBRD Transitions Report, 2000. Range of scores is 1-4 based on a simple average of eight indicators; 1 = no market reforms and 4 = conditions equal to a developed market economy. Highest score in 1999 was Hungary with 3.7 and the lowest was Belarus with 1.5.
PART I: UZBEKSITAN

In sum, the Uzbekistani government’s chosen path of gradual economic reform amounts to the centralized accumulation and distribution of resources -- including access to scarce foreign exchange and production inputs -- in order to maintain state control over the production, pricing, and trade of key commodities and to finance an import substitution strategy to develop selected industries. These policies have served both to reinforce pre-existing and to create new vested interests in the status quo, including: 1) government officials, such as central ministers, regional and local hokims, and farm chairman, who benefit politically as well as personally from their privileged access to economic resources and excessive administrative responsibilities, 2) state designated importers, who are the “net winners” of the multiple exchange rate system that has been in existence since late 1996 because they can purchase foreign currency at an appreciated exchange rate, and 3) those industries included in the government’s public investment program, as well as large joint ventures with foreign investment, which receive special tax breaks and access to subsidized credit and production inputs.

At the same time, the government’s attempts to maintain control over all aspects of the economy and to continue to direct economic development from above have fostered several potential sources of support for economic reform. First and foremost this includes the “net losers” of current economic policies -- producers and exporters of state procured commodities. Among the hardest hit in this first group of “losers” are farmers, who are subject to land distribution quotas, fixed prices for their output that are well below the market rate, and production targets -- as well as confiscation of any excess production when others fail to meet these output targets. Second, SME owners/managers also suffer from a variety of government policies -- including implicit and explicit taxes as well as very limited access to production inputs and credit -- that place them at a severe disadvantage vis-à-vis subsidized industries. A less obvious group that incurs losses from the current system includes various government officials at the regional and local level, whose income and authority has been increasingly threatened due to the intensification of central control over the economy and inter-governmental fiscal relations.

Because these groups’ interests are hurt the most from the current economic policies, they also have the most to gain from economic reform. Efforts at inducing and sustaining economic reform should therefore be aimed at turning these “losers” into “winners” or, put differently, should focus on cultivating the potential winners of reform and building coalitions among them. Yet, this task is complicated by several features of the economic reform process in general and Uzbekistan’s political system in particular that induce a strong “status quo bias” (Fernandez and Rodrik, 1994).

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7 This section benefited enormously from informal discussions with staff in the World Bank’s Tashkent office, as well as interviews with numerous local scholars/researchers, officials, lawyers and business consultants, farmers, entrepreneurs, leaders of small business and farmers’ associations, and representatives of international NGOs in Andijon, Kokand, Fergana, and Tashkent.
8 There are essentially three exchange rates: the auction rate, the commercial bank rate, and the black market rate. The first two are official rates set by the government. Although the government recently (April 2002) made important efforts toward unifying the exchange rates, as I will explain below these are insufficient to either abolish this system or all of its externalities.
9 According to the most recent legislation, two-thirds of cultivable land must be allocated to cotton and wheat.
In addition, there are two other major obstacles to reform that must be overcome. First, there is a pervasive belief among officials at all levels that the government should and must play an interventionist role in the economy. This sentiment is intimately tied to both their overriding fear of social and political instability arising from unemployment and their distrust of the private sector (and the population in general) to know what is in the best interest of either the country’s economy or its population. It is also clearly reflected in the government’s development strategy of resisting any market-oriented reform in agriculture, where the bulk of the population is employed, and using agricultural production and exports to subsidize industrial development. Returning for a moment to the issue of status quo bias raised above, government officials are not only uncertain and risk averse regarding the losses they will incur economically if they embrace reform, but more importantly the losses they might incur politically. Second, entrepreneurs lack sufficient information and knowledge about laws and regulations and even about how the legal system works and how to use it, which not only leaves them unable to protect their legal rights as well as to avoid unnecessary or unlawful payments (e.g. bribes) and harassment by local-level officials, but also unable to influence the legal process. This also exacerbates the status quo bias because these potential “winners” of economic reform are less informed (than, for example, potential “losers” of economic reform) about how they would benefit from mobilizing to change current policies.

Despite all these obstacles, the international donor community can take several steps -- some more radical than others -- to advance economic reform in Uzbekistan. These include:

- Maintaining a presence in the country to promote longer time horizons and continue to pressure the government;
- Shifting focus to the regional/local level to target farmers, SME owners/managers, and regional/local officials;
- Supporting existing NGOs, including government-sponsored business and farmers’ associations, by soliciting their input and including them in Bank projects and activities;
- Laying the foundations for sustainable economic reform by actively supporting the development of the private sector more broadly;
- Providing comprehensive public administration training for government officials at all levels to shape attitudes concerning the state’s role in the economy and improve the implementation of laws;
- Improving the quality of and potential for data collection at the regional and local levels to enhance knowledge of economic conditions and the need for reform; and
- Financing the publication and distribution of information to both the population and regional/local government officials in a timely manner.

I discuss both the obstacles to economic reform and possible strategies to overcome them in greater detail below.
OBSTACLES TO REFORM

The primary obstacles to economic reform in Uzbekistan consist of:

1) Vested interests in the status quo and a political system that disproportionately advantages these interests,
2) Pervasive government attitudes concerning the prescribed social and economic role of state versus non-state actors, and
3) Entrepreneurs’ limited access to information on relevant laws and regulations and experience with using the legal system.

Vested Interests and Status Quo Bias

Since independence, Uzbekistan’s economic development strategy has increasingly relied on three essential and integrally related mechanisms: first, a system of implicit taxation and subsidies; second, centralized control over the production, pricing and export of key commodities (cotton, grain, gold, and energy); and third, a system of explicit taxation and subsidies. The overarching agenda is to tax the agricultural and energy sectors, as well as exporters more broadly, in order to subsidize the development of selected domestic industries, such as manufacturing, telecommunications, mineral extraction, chemicals, textiles and food processing. What is particularly troubling is that, although it is becoming clear that this strategy is not producing the desired effects, it has persisted nonetheless – and largely for political reasons. The willingness to support an import-substitution strategy through a growing deficit and foreign borrowing have been linked directly (and some argue unequivocally) to severe economic crises in other developing countries (see, e.g. Rodrik, 1996, pp.14-15).

Foreign Exchange Regime

The central feature linking all of these mechanisms together is the foreign exchange regime, which was reintroduced in September 1996 and then rapidly institutionalized after a sharp drop in cotton prices and declining foreign currency reserves called into question the government’s brief experiment with currency and trade liberalization from 1995 to 1996. In order to control both the supply and demand of foreign currency, the government has set artificially high exchange rates and strictly regulated both the supply and demand of foreign currency at these rates. There are essentially three exchange rates that operate in Uzbekistan: the auction rate and commercial rate, which are set by the central government, and the black market rate. To maintain supply, the government requires that exporters surrender some portion of their foreign currency earnings; those exporting state procured commodities must relinquish all of their hard currency earnings while those exporting other commodities must relinquish 50 percent. To control demand, the government limits access. Foreign exchange at the auction rate is available

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10 For example, Uzbekistan has had to take out loans to cover the costs of subsidizing selected industries.
11 The recent (April 2002) devaluation of the som applied only to the commercial exchange rate, which was lowered from 920 soms/U.S. dollar to 1,400 soms/U.S. dollar -- approximately the same as the black-market rate of 1,450 soms/U.S. dollar. Access at both this rate and the auction rate remains restricted.
12 Note that the percentage for non-state exporters was raised from 30 to 50 in 1999. There are also some important exceptions to this rule, which will be discussed below.
to a restricted list of importers -- primarily those importing capital goods, which is also intended to reduce the amount of scarce foreign currency that is used to import consumer goods and thereby support the development of domestic industries.\footnote{For this reason, excise taxes on certain imported goods, such as consumer electronics, alcohol and tobacco, detergents and lubricants, are also very high.} Commercial banks, exchange bureaus, and a select group of licensed traders are given access to the commercial bank rate, which before the recent devaluation (April 2002), was approximately 12 percent higher than the auction rate.

The most direct beneficiaries of this foreign exchange regime are clearly state designated importers, who are subsidized through their access to hard currency at an appreciated exchange rate. Yet, it also benefits the central government, which can exploit the difference between multiple exchange rates to service its foreign debt, and government officials in the central ministries and state customs agencies, who can use their administrative capacity to issue foreign exchange licenses and quotas, and to approve and register import contracts, in order to benefit their own friends and family and/or to line their own pockets. These implicit subsidies will continue despite the government’s recent decision to lower the commercial exchange rate to near the black market exchange rate because the government’s control over demand and supply to foreign exchange essentially remains unchanged. The system of centralized procurement remains intact and exporters -- with the important exception of SMEs exporting decentralized goods\footnote{This exception was made as of June 22, 2001. See ?????????????? ????????? ??????????? ???????????, 22 ???? 2001 ?,., N 263.} -- are still required to surrender a portion of their hard currency. Thus, importers of state procured commodities both and the central government will continue to receive privileged access to cheap dollars at the auction rate and control the supply of foreign exchange.

Conversely, the net losers of the current regime are exporters, who pay a large implicit tax by forcibly surrendering their foreign exchange earnings at the overvalued official rate. Exporters of state procured commodities (or centralized exporters) are the hardest hit because, as mentioned above, they must surrender their hard currency at both a lower rate (i.e. the auction rate) and a higher portion of their earnings. Recent changes, including the aforementioned reduction in the commercial exchange rate and the government resolution (June 2001) that abolished the currency surrender requirements for SMEs, have the potential to increase the gap between centralized and non-centralized exporters. While this recent legislation has already shown some signs of giving a boost to exporting SMEs, this particular group has suffered and will continue to suffer under the current regime due to its inability to secure reliable access to foreign exchange.

**Implicit Taxes and Subsidies**

Its significance notwithstanding, the currency regime is just one part of an intricate system of implicit taxes and subsidies that serve to benefit selected importers and producers at the expense of exporters, SMEs, and the agricultural sector. These include subsidized and directed credits, subsidized production inputs, production quotas, as well as price and wage controls. Clearly, the principle beneficiaries of this system are the industries that receive subsidies in the form of access to cheap credit and production inputs, such as energy, including those designated in the government’s public investment program as well as large joint ventures with foreign investment. Government officials are also among the chief beneficiaries of this system because they continue to enjoy privileged access to and control over the bulk of the country’s economic resources, and
thus, retain a key source of their power and status under the Soviet regime. This is particularly true of regional and local level officials (hokims as well as farm chairmen), whose power base throughout the Soviet period relied on their exclusive role in allocating and distributing scarce resources (see Jones Luong, 2002, Chapter three, for details). Among the most important of these resources -- then and now -- are those used in agricultural production, primarily for cotton but increasingly for wheat as well (see Weinthal, 2002, Chapter five, for details).

In addition, this system benefits government officials at all levels not only by generating excessive administrative responsibilities but also by reducing downward accountability. As is well known, implicit fiscal regimes are based on a lack of transparency between the government and the governed (or, perhaps more accurately, the rulers and the ruled) -- the latter cannot hold the former accountable for what does not officially exist and is therefore difficult to quantify. For example, although it may seem that farmers are also among the beneficiaries of this system because they receive implicit subsidies through access to scarce goods such as land, water and irrigation networks, seeds and fertilizer, and machinery/farming equipment. Yet, they also pay a high tax in the form of price controls and production quotas, as well as the arbitrary confiscation of excess production, that appears to offset any gains they receive from access to cheap inputs.

This access is also officially limited to a certain group of farmers -- those working on restructured state and collective farms, or shirkats, and private farms -- and is becoming increasingly less reliable as more production inputs are informally diverted to dehqans (or individual farmers) as well as the private plots of shirkat and private farmers, all of which are exempt from production targets.  

Not surprisingly, other than exporters, the group that incurs the highest costs of Uzbekistan’s implicit fiscal regime is SMEs. SME development -- particularly in production -- is greatly constrained by directed credits and inputs because they are both unable to gain reliable access to needed credits and inputs and to compete with large enterprises and JVs that receive these subsidies. In a recent report, moreover, the World Bank estimates that as a result of the system of implicit subsidies, “small enterprises [in Uzbekistan] have to pay three times more for foreign exchange to finance their imports than do large state enterprises” (World Bank, 2002, p.xx). The foreign exchange regime combined with implicit taxation of exports and import restrictions has shifted resources away from production, such that most SME growth is in trade. Other forms of implicit taxation that SMEs confront on a regular basis include aforementioned licensing requirements and harassment from local officials, particularly tax and regulatory authorities.  

Explicit Taxes and Subsidies

Finally, there is a system of explicit taxation and subsidies that also benefits selected importers and producers at the expense of SMEs and dehqans. In this case, the government uses a

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15 See Thurman and Lundell, 2001, for details on farm restructuring. Of course, the diversion of resources from state farms to individual (a.k.a. garden) plots is also a continuation of a Soviet practice. There are signs, however, that it is becoming more pervasive as local officials get desperate for sources of income. I will discuss this more below.

16 Note that SMEs who participated in the BEEPS survey report paying bribes to public officials in order to get licenses and permits, etc. more frequently than large firms.

17 Consider the fact that licenses are issued for “up to five years” and can only be issued in Tashkent.
combination of granting special tax rates, exemptions, and tax holidays to support selected sectors, particularly industries that are part of the public investment program and JVs with foreign investment that are engaged in related projects. It also maintains high excise taxes on goods exported for hard currency, such as cotton and energy, and certain imported goods that would otherwise compete with domestically produced goods. At the same time, income and VAT tax rates for SMEs are very high, exemptions are rare, and permissible deductions for business development expenses and depreciable assets do not exist. For obvious reasons, SMEs have responded by hiding their income—e.g. by maintaining two sets of accounting records and only putting a portion of actual profits into the bank—and in the words of many entrepreneurs “keeping a low profile,” which amounts to not investing in growth. Rather, the overwhelming incentive is to remain as small as possible, and thereby, to avoid not only excessive taxation but also harassment by the local administration (hokimiat) for contributions to extra-budgetary funds and various public works projects. The explicit tax regime for individual entrepreneurs (or micro-enterprises/firms) is much more favorable because (as of August 1999) those engaged in specified activities (e.g. hairdressing and manicuring, catering, and video tape sales), can opt to pay a fixed lump-sum tax rather than the litany of republican and local taxes to which other SMEs are subjected under the general taxation regime. It is not surprising, then, that these are reportedly the fastest growing form of SMEs. (See Figure 1 below.) Yet, their contribution to employment—by definition—is extremely limited and the majority (outside agriculture) are involved in services and trade, which are less likely to generate substantial employment than, for example, manufacturing enterprises.

Figure 1: Newly-Registered SMEs in Uzbekistan, 1999-2001

Source: World Bank staff.

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18 It also encourages SMEs to keep a steady amount of money in their bank accounts so as not to “invite the suspicion of local authorities” as to why their income either decreased or increased.
20 This was the sentiment across interviews with local business associations and researchers. In January 2001, for example, over 20 percent of newly-registered enterprises were micro-firms.
Building Support for Reform and the Status Quo Bias

While the vested interests (or “losers” of economic reform) described above represent a formidable challenge to reform, those who suffer most from current policies (or the “winners” of economic reform) -- exporters of state procured commodities, SMEs and farmers -- offer a potential source of support for reform. Overcoming vested interests and building coalitions with the “winners,” however, is not an easy task in any country. In Uzbekistan, this is complicated by a political system that increases the inherent costs of challenging the status quo. Two related issues are particularly important here.

The first concerns the impact of uncertainty on status quo bias. As Raquel Fernandez and Dani Rodrik (1994) argue, economic reform is often forestalled by an inherent status quo bias due to who will actually be the “winners” and who will actually be the “losers” from reform. In Uzbekistan, the political system exacerbates the usual degree of uncertainty and therefore the risks involved in supporting economic reform. The political and economic system, actors, and interests are closely intertwined, such that even if there are net economic gains to changing the current economic policies, the perception is that there are much higher political costs. The nature of economic policy in Uzbekistan, then, is to maintain control while also allowing government officials as well as entrepreneurs and farmers to make minor legal and illegal “adjustments” in order to relieve any political pressure. This makes it difficult for any group or set of interests to classify itself as either pure winners or losers in the status quo and thus in the future. Consider the following examples:

- Producers and exporters of state procured commodities “win” from tax exemptions and subsidized inputs but “lose” from having to surrender hard currency earnings.

- Decentralized producers and exporters (SMEs) “lose” from the foreign exchange regime and lack of access to directed credit and subsidized inputs but “win” from their ability to export legally -- without having to surrender hard currency earnings -- and to export illegally.

- Farmers “lose” from centralized agricultural policy that dictates what they must grow and the government purchase price but “win” from preferred access to subsidized inputs (for shirkats and private farmers) and/or through the existence of informal supply and information networks (for dehqans and farmers with private plots) and illegal export markets.  

- Regional and local leaders “win” from their continued control over scarce resources and ability to extract unofficial payments, but “lose” from their limited ability to expand their tax base and sources of legitimate revenue.

To the extent that these groups are able to receive some benefits under the current system, they are likely to avoid the risk of forfeiting these relative gains even if it might mean maximizing

21 Although dehqans officially have last priority in the distribution of production inputs, they are in fact receiving more access informally because they are willing to pay and/or have ties to the local administration. In this sense, shirkats and private farms are becoming the biggest losers as resources are increasingly diverted to dehqans and private plots, and hence, individuals rather than the collective. This creates an even greater dispersion of these potential “winners,” which is discussed below.
their gains in the future -- particularly when that future is itself uncertain due to the arbitrary, non-transparent, and centralized nature of government decision-making.

In addition, local level officials -- including hokims and farm chairmen -- are appointed and removed by whoever occupies the executive office directly above them and are rotated frequently.\textsuperscript{22} (Refer to Table 3 below.) They are thus inclined to support policies that enable them to maximize their gains in the short-term, rather than those that are only likely to pay off in the long-term. In other words, there is a strong incentive to take what you can while you can rather than to support policies that contribute to future economic growth. These gains, moreover, are both political and economic, which (as I outline in the following section) are so closely intertwined in Uzbekistan (and throughout post-Soviet Central Asia) that they are virtually impossible for officials to disentangle. As a result, the short-term thinking that fosters corruption and anti-market behavior is prevalent.

Table 3: Regional Hokim Turnover in Uzbekistan, 1993-2002

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of replacements</th>
<th>Average number of years each hokim served</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andijan Oblast</td>
<td>1</td>
<td>8.0</td>
</tr>
<tr>
<td>Bukhara Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Jizzak Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Ferghana Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Karakalpakstan Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Kashkadarya Oblast</td>
<td>4</td>
<td>2.0</td>
</tr>
<tr>
<td>Khorezm Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Namangan Oblast</td>
<td>2</td>
<td>4.0</td>
</tr>
<tr>
<td>Navoi Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Samarkand Oblast</td>
<td>4</td>
<td>2.0</td>
</tr>
<tr>
<td>Surhandarya Oblast</td>
<td>4</td>
<td>2.0</td>
</tr>
<tr>
<td>Syrdarya Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Tashkent Oblast</td>
<td>3</td>
<td>2.7</td>
</tr>
<tr>
<td>Tashkent (city)</td>
<td>4</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>3</strong></td>
<td><strong>3.0</strong></td>
</tr>
</tbody>
</table>

Source: Data compiled jointly by Alisher Ilkhamov and Pauline Jones Luong, based on Appendix II in Jones Luong, 2002 and the Pravo database.

The second concerns the relative political strength of those who benefit the most from current policies (i.e. the potential “losers” of economic reform) vis-à-vis those who suffer the most from current policies (i.e. potential “winners” of economic reform), which also induces a status quo bias. Another reason that economic reform is often obstructed is that potential “losers” are more capable of organizing to effectively block economic reform because they tend to be concentrated and well-informed whereas the potential “winners” tend to be dispersed and uninformed. While Joel Hellman (1998) and Hector Schamis (1999), for example, are correct in pointing out that

\textsuperscript{22} Some regional hokims, such as the hokim of Andijon, have remained in their posts for several years. (The real question that remains to be explored is whether the tenure of a hokim has any relationship to his orientation toward reform. This will be discussed further below.)
this is not necessarily the case in all countries and political contexts, it is very much the case in Uzbekistan where the bulk of current “losers” and thus potential “winners” -- i.e. farmers and entrepreneurs/SME owners -- are widely dispersed. These potential “winners” are also at a serious disadvantage due to the limited access to information and the fundamental lack of transparency in Uzbekistan, which will be discussed further below. The very nature of implicit fiscal regimes makes it difficult for citizens to hold their governments accountable for its policies because the actual extent and intended effect of such policies is not known. Local officials also suffer from information asymmetries in this and other respects: first, because they also are unable to measure the impact of such policies on the economy and population under their jurisdiction; and second, because they lack the autonomy and capacity to collect reliable data in order to get a clear sense of the real economic situation in their respective regions, districts, cities, villages, and farms.

Compounding such problems is the fact that these groups lack both access to the government decision-making process and an effective coordinating mechanism through which they might advocate economic reform. Since 1992, when the Uzbekistani government began actively crushing any organized political opposition, there has been little or no opportunity for groups to organize independently of the state (see Jones Luong, 2002, Chapter four, for details). The government has instead mimicked the Soviet policy of mobilizing popular participation in centrally-created (or transformed) political and social organizations, including pro-presidential parties (e.g. Ozbekistan Halq Demokratik Partiyasi), neighborhood committees (the mahalla) and, more recently, business chambers (e.g. the Chamber of Entrepreneurs) and farmers’ associations (e.g. the Dekhkan and Farming Enterprises Association, or DFEA). 23 The coordination problem also applies, though less starkly, to government officials at the regional and local level who can play some role (albeit a minor one) in the policy-making process by serving as deputies in the national parliament (Olii Majlis), where they recently blocked President Karimov’s attempts to control the majority of seats through the newly-created party Fidokorlar (or “the dedicated”), 24 but continue to face many barriers to collective action. 25

Despite these obstacles, the potential “winners” are an important source of support for economic reform that can and should be cultivated. Local officials, SMEs and farmers have a common interest in reform that is disguised by the implicit fiscal regime and the system of “adjustments” that has developed over time in response to the negative externalities of current economic policies. This common interest can be cultivated in the short-term by revealing the net losses that are masked by contradictions in the existing system and the net gains that will be generated from reform. Under the current system, these groups are already collaborating to circumvent central dictates that restrict their economic activity, which include the diversion of directed inputs away from shirkats and private farms that receive state orders, to dehqans and private plots that do

23 On pro-presidential parties, see Jones Luong, 2002; on the mahalla, see Abramson, David. 1998; and on the DFEA, see Thurman and Lundell, 2001.
24 For details, see Ilkhamov, 2000.
25 As during the Soviet period, hokims (former obkom first secretaries) can and often do serve simultaneously as deputies in the national legislature (former Supreme Soviet). Yet, because the parliament convenes only a few times a year, it is not an effective coordinating mechanism. This will continue to be the case despite recent changes to the electoral law, which establishes a bicameral parliament in which the upper chamber is composed of representatives from regional, district, and town-level legislatures (maslikhats) and convenes a few times a year, similar to the former unicameral parliament it replaced.
not,\(^{26}\) and paying and accepting bribes as an alternative to onerous licensing and registration procedures.\(^{27}\) Yet, their interests would be better served by working collectively to push for the full privatization of production inputs,\(^{28}\) including land and access to irrigated water, and an effective licensing and registration process.

Their common interest in reform can only be sustained over the long-term, however, through the creation of institutions that encourage long time horizons -- such as property rights, fiscal decentralization, and local elections -- and channel political demands effectively. The current system fosters too much uncertainty for any of these groups to risk sacrificing current gains to invest in future ones. The centralized appointments system and frequent rotation of local officials in particular increases the political and economic risks of supporting reform not only for local officials but also for SMEs and farmers who rely on their personal relationships with local officials.\(^{29}\) The introduction of fiscal decentralization and local elections would greatly reduce this uncertainty by making the reciprocal relationship that already exists between these groups much more explicit so that each could hold the other accountable. The system of implicit taxation and subsidies would become less enticing to regional and local officials, for example, if they expected to get a larger share of the revenue generated from explicit taxation and economic growth, the bulk of which currently goes directly to the central government.

**Government Attitudes**

In sum, there is a pervasive attitude among officials in Uzbekistan that that the government must control the economy from above. This attitude is based on the belief that the government -- and not the private sector -- knows what is in the best interest of the population and should play an interventionist role in the economy in order to protect or promote those interests. It is clearly reflected in a set of policies orchestrated to prop up large state-owned industries at the expense of SMEs and the private sector more generally and the resistance to market reform in the agricultural sector. It is also reflected in the government’s attempts to be closely involved in the economic activities of SMEs.\(^{30}\)

There is also an overwhelming belief that the best way to maintain social and political stability is to maintain employment -- even at the expense of economic efficiency and growing poverty because wages are so low and often go unpaid.\(^{31}\) From this point of view, relying on the private sector for growth is very risky because it reduces government control over the economy and will undoubtedly involve high unemployment -- at least in the short run -- since the large state-owned enterprise currently employ (at least officially) almost half of the working population and are the

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\(^{26}\) Note that this is the primary reason cited for the greater productivity of dehqan farms than shirkats and private farms. Of course, garden plots were also the most productive during the Soviet period for similar reasons.

\(^{27}\) This is the case despite the recent changes to expedite registration mentioned above.

\(^{28}\) Note that some inputs are already privately supplied -- e.g. for construction and machinery via imports from Russia. The system of domestic suppliers, however, is not well developed, largely because it operates underground.

\(^{29}\) Since independence, the average tenure of regional hokims, for example, has been 2-3 years. The Andijon hokim (Kayum K. Khalmirzaev), who has served in that position since 1993, is the only exception. See Table 2 for details.

\(^{30}\) State banks, for example, are not only used to collect taxes but also act as “senior partners” when providing credits to SMEs.

\(^{31}\) Wages are much lower for workers in state-owned large enterprises and SMEs and on shirkats and private farms than in privately-owned SMEs and for dehqans. Note: This can probably be verified by looking at the Family Budget Survey (FBS). I cannot verify it myself because I do not have access to this data.
largest employers across sectors. (See Table 4 below.) Not surprisingly, then, the state is reportedly the full or primary share-holder in over half of all SMEs and it is these particular SMEs that provide the largest number of jobs (about 50 percent) among SMEs. From this vantage point, it also makes sense to extract high taxes as well as bribes and other excess payments from privately-owned in order to avoid forcing large state-owned enterprises to pay taxes -- that is, to exploit SMEs and farmers to keep failing industries afloat. Thus, despite the growth of SMEs in Uzbekistan, if such attitudes persist SMEs are unlikely to have the positive effects on economic growth that they have had in other transition economies.

Table 4: Employment by Enterprises across Sectors, 2001

<table>
<thead>
<tr>
<th>Total employed</th>
<th>Large</th>
<th>Medium</th>
<th>Small</th>
<th>Microfirms</th>
<th>Dehqans and farmers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>8983</td>
<td>4515.9</td>
<td>151</td>
<td>175.3</td>
<td>428.3</td>
</tr>
<tr>
<td>Industry</td>
<td>1145</td>
<td>563.5</td>
<td>38.8</td>
<td>50.8</td>
<td>39.6</td>
</tr>
<tr>
<td>Agriculture and forestry</td>
<td>3093</td>
<td>1618.2</td>
<td>22.9</td>
<td>27</td>
<td>244.2</td>
</tr>
<tr>
<td>Transport and communication</td>
<td>382</td>
<td>249</td>
<td>1.8</td>
<td>2.4</td>
<td>4</td>
</tr>
<tr>
<td>Construction</td>
<td>676</td>
<td>217.6</td>
<td>20.8</td>
<td>25.8</td>
<td>26.6</td>
</tr>
<tr>
<td>Trade and public catering</td>
<td>754</td>
<td>144.5</td>
<td>24.6</td>
<td>42.5</td>
<td>72.7</td>
</tr>
<tr>
<td>Consumer services</td>
<td>251</td>
<td>127.6</td>
<td>5.7</td>
<td>4.5</td>
<td>3.7</td>
</tr>
<tr>
<td>Health care</td>
<td>587</td>
<td>433.5</td>
<td>4.1</td>
<td>3.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Education, culture, art, science</td>
<td>1146</td>
<td>985</td>
<td>9.2</td>
<td>4.7</td>
<td>4.1</td>
</tr>
<tr>
<td>Finances, credits, insurance</td>
<td>51.3</td>
<td>45</td>
<td>3.9</td>
<td>1.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Governing bodies</td>
<td>125.8</td>
<td>83.7</td>
<td>15.6</td>
<td>8.2</td>
<td>18.3</td>
</tr>
<tr>
<td>Others</td>
<td>771.9</td>
<td>48.3</td>
<td>3.6</td>
<td>4.7</td>
<td>10.4</td>
</tr>
</tbody>
</table>

Source: World Bank staff.

These perverse incentives are especially acute at the regional and local level, where the structure of the economy is accompanied by and serves to reinforce a set of expectations about the proper role of subnational leaders or the obligations they must fulfill. In the Soviet centrally-planned economy, there is a well-established expectation both among subnational leaders and their respective constituents that they must provide basic social services, including jobs and housing as well as free access to healthcare and education. This is a potentially powerful source of resistance to market reform because subnational leaders may expend considerable effort to maintain subsidies and operate under a soft-budget constraint if they feel a sense of responsibility to provide a minimum level of subsistence to the population within their jurisdiction. Subnational

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32 This is an approximation; exact percentage needs to be verified.
33 For details, see Transitions, 2002.
leaders’ sense of “responsibility” may also extend to “protecting” the region’s economic interests, which for regions where the local economy depends on a single industry and/or sector, may serve to reinforce political incentives to continue the system of implicit taxation and subsidies. Because they are considered profitable and are often politically powerless, emerging SMEs are thus tempting targets of predatory behavior. The need to meet immediate social demands, then, could be an important source of excessive taxation and regulation at the local level that is often overlooked. Indeed, many SMEs report that they are frequently asked to contribute to the budget for repairing hospitals, building schools, etc. -- though is it difficult to know how pervasive this practice is or how it varies across regions without comprehensive survey data.

Control over the economy, moreover, is integrally related to the political power and status of government officials throughout Central Asia. Under Soviet rule, the rents extracted from the sale of cotton supported an elaborate patronage system in Central Asia that, in turn, served as the basis for a system of social and political control. (See Figure 2 below.) In the agricultural sector where reform is most needed, for example, central ministries, regional governments, and kolkhoz (collective farm) chairman resist market-based initiatives (such as the privatization of land, rational use of water, and an end to mandated crops and production quotas) that would wrest their control over crop production and distribution, which is tied to both their economic well-being and political power. For regional and local officials, moreover, providing basic social services is an important source of maintaining political support, which is based on long-standing patronage networks (see Jones Luong, 2002, Chapter three, for details). They thus feel obligated to continue to provide such services – even if only in name -- regardless of the economic costs and without concern for greater economic efficiency. At the same time, as financing such services is increasingly being delegated to the local level through unfunded mandates, these officials feel compelled to extract revenue from whatever non-government source they can. As noted above, SMEs are the most likely contender. Regional and local officials thus attempt to monitor closely the development of SMEs and often seek to control their activities.34

34 As one interviewee commented: “There are too many officials in my country who are responsible for controlling rather than helping small business.”
Figure 2: The Role of Cotton in Forging Reciprocal Relations under Soviet Rule

Adapted from: Weinthal, 2002, p.98.
Yet, there are signs that the attitudes of government officials are changing and that they vary greatly across and within regions. Local academics/researchers, for example, claim that it is now possible to discuss currency deregulation openly with the central ministries whereas it was impossible from 1996 through 1999. At the regional and local level, some officials are starting to take farmers and farmers associations more seriously -- that is, to engage in dialogue with them, learn from them, and take their concerns and ideas into account. More striking, however, is that fact that officials in several regional -- including Namangan and Surkhandarya -- have been not only allowing microcredit programs to operate even though they are technically illegal but also fully supportive of their development. This suggests that some officials are more willing to take risks and experiment with the private sector. Clearly, the reasons behind this variation need to be explored further. One possible explanation that was frequently advanced by local and international NGOs, however, was the tenure of officials. Many argued that it took a few years to build up good relations with and win the confidence of regional and local officials. Sometimes the same effect could be achieved, however, if the individual advocating a particular reform was a former official him/herself. This is the case with the Women’s’ Business Association in Kokand, for example, which reportedly has had a very cooperative relationship with government officials from the start. Another way to explore the reasons behind this variation would be to set up pilot decentralization projects as has been done in the Pavlodar region of Kazakhstan.

**Limited Access to Information**

The final major obstacle to economic reform in Uzbekistan is the limited access to information. For those SME owners/managers and farmers who have personal connections, obtaining information about the latest laws, resolutions, and decrees is not a problem. It is also not problematic for those who can afford to hire a business consultant, which is becoming increasingly popular. However, the vast majority lacks this basic information and the means to acquire it, and is not knowledgeable either about how the legal system works or how to use it. This suggests that the problem is not the legal environment per se, but accessibility to legal information and knowledge. Independent lawyers and consultants interviewed argued that, particularly over the past two years, Uzbekistan had developed a sound legal base for the development of SMEs, but the problem was one of empowering entrepreneurs to actually utilize this legal base to protect their rights. The experience of many successful businessmen, who noted in interviews with the author that they are able to “protect themselves” from government interference and harassment simply by “know[ing] their legal rights and responsibilities,” supports this conclusion. These entrepreneurs felt empowered by their knowledge to “say no” to predatory officials. Indeed, harassment by regional and local officials seems to be inversely related to one’s level of legal knowledge.

While some organizations exist that provide legal information and advice to entrepreneurs, they are not sufficient to meet the growing demand. Nor can they afford to publish and circulate all the necessary materials on a regular basis without charging hefty fee, which some are unwilling or unable to pay. Even if such legal services were widely available and affordable, the problem of timing still remains. Many entrepreneurs and business association leaders complain that they are only informed about legal changes that affect them after the fact – that is, once they are already in place such that they have no time to influence or resist these changes. This
undoubtedly adds to the information and coordination problems described above. It also impedes their ability to make long-term business plans.

Moreover, the lack of information and knowledge also applies to regional and local officials, who also claim that they are often not informed in a timely manner about legal changes or how to implement them. For example, some officials claimed that they were not aware of the government resolution passed in August 2001 that streamlined the registration process by significantly reducing the bureaucratic steps involved as well as time and costs to businesses. Thus, it has not lead to wholesale improvements in the business climate for SMEs because of the variation in implementation both within and across regions. It is quite possible that this lack of informal and knowledge is not a matter of capacity but rather “convenience,” since they can use it to extract excess payments or fines from entrepreneurs. Yet, the limited capacity of many regional and local administrations makes it difficult to adjudicate between these two possible explanations.

STRATEGIES FOR OVERCOMING THESE OBSTACLES

The international donor community can cultivate potential “winners” of economic reform in Uzbekistan and help to build coalitions among them in several ways. The simplest way is to maintain a presence in the country, which will help to elongate the time horizons of those groups that will incur the heaviest risks from supporting reform. However, the international donor community can also play a more active role by empowering the potential “winners” vis-à-vis the “losers” of economic reform. This requires a shift in focus to the regional/local level, where three particular groups should be targeted: farmers, SME owners/managers, and regional/local officials. Each of these groups has an independent interest in reform that is obscured by their collective response to perverse incentives. Only through structured interaction will they come to realize and achieve their collective interest in economic reform. The international donor community should therefore sponsor roundtables and support other channels for repeated interaction among these three groups.

According to research conducted by the Center for Economic Research (CER) and the Institute for Social Research, farmers and SME owners/managers broadly support market-based initiatives, such as private property and an end to mandated crops, production quotas, and directed inputs. Farmers in the Ferghana Valley, for example, reportedly have a strong preference for growing what they consider “traditional” crops (e.g. fruits and vegetables) rather than cotton or wheat. There are clear signs that some farmers desire change to such a degree that they are willing to incur the serious social and financial risks of leaving shirkats and paying membership dues for services in order to operate independently. In particular, the dehqans are the natural constituency for economic reform because they already operate according to a private system -- e.g. they lease land, can legally grow what they want, and have to secure their own inputs on the private market. As noted above, dehqans are actually the primary source of a burgeoning black market for production inputs because officially they received last priority from

36 Some hokims are better about disseminating such information is a timely manner. The mayor of Tashkent, for example, is one such hokim. His location in the capital city, however, may account for this.
37 The current pattern seems to be that only the poorest or socially ostracized farmers are willing to do this, as is the case for example in the Black Earth region spanning across Ukraine and Russia. See Allina-Pisano, 2002.
directed inputs such as water and land and are willing to pay market rates. They are also extremely productive, and yet, have a limited ability to expand their economic activity under the current system -- e.g. because they cannot officially hire employees.

Regional and local officials have a more mixed record of support for market reform. Yet, they are growing signs that they are increasingly frustrated with the current system and willing to embrace some change to improve their own financial situation and the local economy more broadly. The income and authority of regional and local has become increasingly threatened due to the intensification of centralized control over the economy and the mode of inter-governmental fiscal relations. Specifically, the central government has increased its claim to cotton revenues that were once more evenly shared between the central and regional governments, while at the same time imposing unfunded mandates on regional governments for social service provision. For reasons elaborated above, this clearly jeopardizes the political and economic position of regional and especially local officials, who feel the greatest pressures from above (regional officials) and below (the population). There is evidence -- albeit limited -- that regional resistance to handing over cotton and wheat production is growing as a result, forcing the central government occasionally to resort to sending the militia to monitor crop production. Regional and local officials have also sought additional revenue by imposing various levies on the local population in the form of unpaid wages, road fines, and marketplace duties, illegally appropriate collective farms’ assets and lands, and leasing land to households on commercial terms -- including some of land that the central government has officially reserved for cotton and wheat.

The limited evidence available also suggests that their willingness to support market-based initiatives, to promote a positive business climate for SME development varies both across and within region, and to advocate some form of fiscal decentralization. Additional data is needed, however, to assess the type and degree of variation. 38 Once this is known, the variation can be exploited in two ways: first, by determining what accounts for this variation and whether these factors are replicable; and second, by increasing contact among those regional/local officials who are more receptive to reform to increase their ability to develop their mutual interests and to coordinate effectively.

Another way that the international donor community can cultivate these potential “winners” is to strengthen existing NGOs, including government-sponsored business and farmers’ associations, by soliciting their input and including these groups in the projects and activities that they sponsor. This will encourage the government to take these organizations more seriously and bolster their attempts to become more independent from government control. Although these organizations were originally established by government decrees and initially operated with government funding, many of them have become increasingly independent. The Women’s Business Association, for example, played an active role in establishing credit associations throughout Uzbekistan long before they received official government approval, and the Chamber of Entrepreneurs raises funds through providing legal services and advice to entrepreneurs for a small fee. Both organizations also draft proposals to the government based on the concerns of their members and clients.

38 In this regard, the results of the recent IFC survey would be a useful starting point -- despite the low number of respondents (60-100) per each region. Unfortunately, I do not have access to this data.
Others have served as the basis for more independently-minded business people and farmers to form their own smaller organizations within these structures (or sub-structures). These sub-structures have enabled farmers in Andijon and businessmen in Ferghana, for example, to develop informal networks that supply information and access to a growing market for production inputs. Their effectiveness is limited, however, because there is no movement toward formalizing these networks as legitimate small businesses, for example, or using them to influence the current legal environment. Rather, the main purpose of these networks is how to operate successfully within the existing environment and in this regard they provide a very useful service. Yet, if enabled to grow in size and number, they could eventually serve as an effective coordination mechanism among SME owners/managers and farmers as well as between them - first at the regional/local level and then at the national level - as they have done, for example, in Poland. This would have a positive economic effect as well as a political one.

Supporting these structures and other NGOs would also have an important long-term effect because it would help to lay the foundations for sustainable economic reform. As support for reform and mechanisms to coordinate the various interests of those who support such reforms grows, the government’s ability to renege on those reforms, once in place, is seriously compromised. The development of SMEs, particularly in the agricultural sector, will also help to soften the blow of reforms, such as privatization of inputs, and hence, resistance to such reforms, by creating an alternative system to fill the void left by the dissolution of the government monopoly on supply and fixed prices.

To address the second major obstacles to economic reform in Uzbekistan - government attitudes concerning the state’s “proper” role in the economy - the international donor community can provide comprehensive public administration to officials at all levels. As many NGOs and government officials noted in interviews, there is a fundamental irony in the fact that NGOs actually have more access to business and market-related training (through international NGOs) than do government officials. Thus, they are often ahead of them in terms of knowledge and experience. To promote effective coordination and positive interaction between governments and the private sector, moreover, the International donor community should include business and farmers’ associations and other NGOs in these training sessions. These NGOs could take an active role in such sessions by demonstrating the results of their efforts and activities, particularly concerning their role in generating employment, which has been known to have a positive impact on government attitudes, for example, in both Tajikistan and Kyrgyzstan. One of the first areas for such training should be fiscal decentralization in order to explain both how it works in other post-communist countries (including not so post-communist China) and its benefits to government officials. Government officials have little comparative knowledge as to how fiscal decentralization works and are more familiar with its disadvantages than its advantages.

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39 This varies widely by location, but in general these associations tend to function with greater independence and have better relations with local officials in the Ferghana Valley. More research and data collection is needed to establish both the nature of this variation and the causes behind it.

40 In Poland, informal networks have become formal suppliers of goods by effectively coordinating the supply and demand of various SMEs. See, for example, McDermott, 2002.
This training should be coupled with a concerted and mutual effort on the part of the Bank and the central government to improve the quality of and potential for data collection at the regional and local levels. This will improve the government’s understanding of both the economic situation at the regional and local level and the likely effects of fiscal decentralization and other economic reforms.

The third and final major obstacle to economic reform -- limited access to information -- can be addressed by financing the publication and distribution of information to both the population and regional/local government officials in a timely manner. For reasons given above, this will help ensure that new laws, resolution, and decrees are enforced more effectively. If existing organizations and networks -- e.g. the Women’s’ Business Association and the Chamber of Entrepreneurs -- are utilized to publish and distribute these materials, moreover, it will also contribute to strengthening these organizations’ financial independence and their role in promoting economic reform. Such organizations currently have the desire to play such a role but lack sufficient funding, technical equipment, and staff to realize this goal. At the same time, the donor community should support the development on an independent local media as an alternative source of information and analysis.

PART II: TAJIKISTAN

Tajikistan faces several more structural and political impediments to economic reform than either Uzbekistan or Kyrgyzstan. Its economy -- the weakest in all the Soviet republics and post-Soviet states -- has been devastated by five years of civil war (1992-1997), followed by the Russian financial crisis in 1998, and a series of severe floods and then droughts over the past few years (1998-2000). Not surprisingly, it is also the poorest of all the Soviet successor states with the greatest degree of dependence on the former Soviet economy. At the time of the Soviet Union’s collapse, the Tadzhik Soviet Socialist Republic (TSSR) received nearly 50 percent of its budget from Moscow, most of which was spent on social welfare, ran proportionately the largest deficit on inter-republican trade due to its dependence on other republics for raw materials and energy supplies, and exhibited the highest levels of social distress based on indicators such as high birth rates and infant mortality (for details, see Rubin, 1993 and 1994). These economic and social conditions were exacerbated by independence and the civil war that followed shortly thereafter.

In addition, the civil war interrupted the country’s state-building process, such that at the end of the 1990s it remained a weakly institutionalized state, and plagued by widespread poverty, rampant corruption, and regional fragmentation fueled by economic monopolies and drug and weapons trafficking. The coalition government that emerged from the peace process in 1997, moreover, remains fragile (for details, see, e.g., ICG, 2001).

41 This section benefited enormously from interviews with numerous local scholars/researchers, officials, lawyers and business consultants, farmers, entrepreneurs, leaders of small business and farmers’ associations, and representatives of international NGOs in Dushanbe and Khujand. I am especially grateful to Zarina Abdushukurova and her colleagues at the IFC office in Khujand.

42 For details on the causes and consequences of the civil war, see, e.g., Rubin 1993 and Akiner, 2001.

43 Tajikistan is considered one of the 20 poorest countries in the world. According to various sources, approximately 80 percent of the population lives below the poverty line. For details, see, e.g., Falkingham, 2000, and Republic of Tajikistan: Poverty Assessment, 2000, and Government of the Republic of Tajikistan, June 2002.
As a result, Tajikistan lacks a coherent economic policy; the weakness of the central administration and regional challenges to the central government constrain its ability to formulate and implement broad, consistent, economic reform. Although it has made some progress toward liberalizing its economy on paper, many of these changes do not function in practice due to the resistance of vested interests, particularly at the regional and local levels. In contrast to Uzbekistan, for example, there are no official state quotas for cotton production and the central government does not fix the selling price. Nonetheless, de facto production quotas and artificially low prices are enforced by local officials, who use various tactics at their disposal including withholding inputs from farmers who refuse to grown cotton and blocking farmers’ access to external markets. The central government has also introduced farm restructuring, but progress has varied greatly across the regions (see, e.g., World Bank, January 2001, pp. 39-42) and direct interference of local officials in private farmers’ decisions continues (Government of the Republic of Tajikistan, June 2002, p.25).  

At the same time, despite sweeping privatization of small enterprises, a growing private sector in retail trade and services, and the sharp decline of industrial output overall, medium and large state-owned industries continue to play the dominant role in Tajikistan’s economy at the expense of small business development (see, e.g., World Bank, January 2001, pp. 20-21). For example, although they have been reduced in recent years (2000-2001), directed credits and subsidies to these industries have persisted (see, e.g. Government of the Republic of Tajikistan, June 2002, p.27). This is largely the result of the central government’s reluctance to cede control over industrial production, which is highly concentrated in non-ferrous metals, because it provides substantial employment and a source of guaranteed income and barter as well as the means through which to provide social protection to the population, and thus, some financial and political independence from the regions.

In addition to the constant struggle between central and regional authorities for control over key economic resources, there are several other manifestations of Tajikistan’s fragmented state. First, official corruption is rampant. This includes a robust drug and weapons trade, which thrives with the support of quasi-government officials at all levels and, according to UN representatives in Tajikistan, is linked to approximately 30-50 percent of the country’s economy, as well as arbitrary transit fees on legitimate goods that serve as a major impediment to intra-regional trade. Second, the legal and regulatory environment is very weak, both in terms of the adoption of laws and regulations to support the development of the private sector and the implementation of these laws and regulations at the local level. An extensive licensing and taxation system, for example, enables local officials to extract excess financial contributions from SMEs. As in Uzbekistan, this is exacerbated by the limited access that SME owners/managers and farmers have to information on relevant laws and regulations. The ability of SMEs to grow and proliferate and for farmers to develop their businesses beyond subsistence is further constrained by the obstructions to transit, both within and outside of the country due to the aforementioned internal corruption as well as to the closure of borders with Uzbekistan.

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44 Unfortunately, it is impossible to assess the variation and degree of government interference without survey data.
45 Although Tajikistan’s private sector is small by comparison to the other former Soviet republics, with a “share in [the] economy [of] around 30 percent of GDP” (Tajikistan: Towards Accelerated Economic Growth, 2001, p.v), considering the devastation of the civil war and the huge impediments to interregional and international trade, it is quite robust and should serve as a source of optimism for reform. The number of SMEs in particular is also grossly underestimated by official sources.
Thus, the political obstacles to economic reform in Tajikistan are daunting. Yet, they are not insurmountable. They can be overcome through several simultaneous strategies:

- Supporting the central government’s current efforts to restructure public administration to increase efficiency and improve its financial monitoring capacity as a way to smooth the transition to greater decentralization.
- Introducing extensive civil service reform to increase transparency in hiring and reduce the use of payments in exchange for “lucrative jobs,” such as border guards and customs officials.
- Strengthening reciprocal relationships between the government and the private sector.
- Cultivating those interests that stand to benefit most from economic liberalization -- farmers and SME owners/managers as well as officials in non-cotton producing regions.
- Providing market incentives for regional elites to support private and non drug- or weapon-related economic activity.
- Targeting impoverished rural areas and specifically border regions for economic development and financing/micro-credit programs.
- Financing the publication and distribution of information to both the population and regional/local government officials in a timely manner.
- Working with local officials and neighboring governments to reduce barriers to transit.

I discuss both the obstacles to economic reform and possible strategies to overcome them in greater detail below.

**OBSTACLES TO REFORM**

The main political obstacle to economic reform in Tajikistan is the absence of a fully functioning state. Although there has been some in strengthening government control in recent years, there remain serious threats to state consolidation and continued peace from regional fragmentation and official corruption. The five year long civil war that left between 60,000 and 100,000 people dead and cost the country approximately US$7 billion officially came to an end in 1997 with a peace treaty, which granted amnesty to members of the United Tajik Opposition (UTO), provided for their assimilation into a unified army, and established a coalition government between the government and the opposition forces in which 30 percent of all administrative positions were reserved for the UTO (for details, see, e.g., Accord, 2001). While this peace treaty and its gradual implementation -- for example, through subsequent presidential (1999) and parliamentary (2000) elections -- has served to reduce some hostilities and restore some stability to the country, particularly in the southern regions, it has not served to fully consolidate the Tajikistani state.

First of all, most former UTO members are not satisfied with the current arrangement. Many refused to join the government and now accuse those who agreed to serve in the government, for example, of having been co-opted by President Imomali Rakhmonov. Many also complain that

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46 The UTO was formed in November 1994 by the Islamic Renaissance Party (IRP), the Movement for Islamic revival in Tajikistan (MIRT), the Democratic art of Tajikistan (DPT), the Coordination Center of Democratic Forces of Tajikistan in the CIS and the United Association of Tajik Refugees, but was allegedly dominated by the IRP and MIRT. Its leader was Said Abdullo Nuri, who played a key role in the peace process and is currently the leader of the IRP. See, e.g., Accord, 2001 for details.
since the end of the war, elites from the southern district of Kulob (Kulyab) -- the president’s original power base -- have dominated key political and economic positions, although there are some signs that this is changing.\(^{47}\) Many others, particularly elites from the northern region (Sughd, formerly Leninobad), consider themselves to be underrepresented in the current government. This is a particular cause for concern because the origins of the civil war are in precisely this kind of dominance by one region during the Soviet period, which bred resentment from the other excluded regions (see, e.g. Atkin, 1997; Rubin, 1993; Schoeberlein, 1994).\(^{48}\) It is also a concern because this type of personalized government hiring breeds patronage, corruption, and vested interests opposed to reform.

Secondly, the strongest opposition to the current government continues to be regionally based. Gharm and the Karetegin Valley, for example, remain the Islamic Renaissance Party’s (IRP) strongholds, and its popularity is growing in the North, which has always been “considered the most secular region” (ICG, 2001, pp.7-8). This is also potentially very destabilizing. Tajikistan was never a well-integrated territorial and political unit, even during the Soviet period. In fact, the territory that the Soviet Union eventually allocated to form the Republic of Tajikistan was made up of regions that had little or no connection to each other -- culturally, economically, or even geographically -- and did not include the main centers of Tajik culture in Central Asia, Samarqand and Bukhara (see Rubin, 1993, for details). The civil war and its aftermath have served to exacerbate the cultural, economic, and geographical divisions among regions and to create regional fiefdoms funded by drugs and bolstered with weapons.

**Main Consequences of a Fragmented State**

The absence of a fully functioning state severely constrains Tajikistan’s economic reform process. As many who study the transition in the post-communist world have increasingly come to realize, state-building is actually the key to accomplishing political and economic reform (see, e.g., Holmes 1997; Jones Luong 2002; Linz and Stepan 1996; Olcott 1996; Sperling 2000; Stavrakis 1993; Stoner-Weiss, 2001; Way 2000).\(^{49}\) In short, this is because in the absence of effective central administration and the rule of law, the state cannot achieve the autonomy and capacity or build the public confidence necessary to design and implement a broad strategy for reform. In Tajikistan in particular, the weakness of the central administration has had several consequences. Most importantly, it has fostered two of the main factors that obstruct any effort at economic reform:

1) An on-going struggle among central and regional/local officials for control over key economic resources, and
2) Weak legal and regulatory environment, both in terms of actual laws passed and inconsistent implementation, due to the resistance of vested interests and rampant official corruption.

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\(^{47}\) Since the 2000 parliamentary elections, for example, Rakhmonov has made an effort to recruit advisers from the North. See ICG, 2001, p.4.

\(^{48}\) This argument is elaborated in Jones Luong, 2002,Chapter eight. Others have (erroneously) attributed this civil war to inter-clan and regional animosities. For examples, see Jones Luong, 2002, Chapter three.

\(^{49}\) Others take an even stronger stance that the types of states that emerge due to patterns of elite competition following independence determine whether countries pursue political and economic liberalization (see Grzymala-Busse and Jones Luong, 2002).
Central-Regional Struggle for Control over Resources

According to one close observer of politics in Tajikistan, the “central tenet of the government’s economic policy is to maintain control over the primary sources of income” (Author’s personal communication with WNGO representative, May 2002). While this may indeed be true, the problem with this statement is it fails to identify which government -- i.e. the central government or the regional? Divisions between the central and regional governments, both during and after the civil war, has manifested itself in the struggle to control key economic resources. Three sectors dominate the economy, and thus, serve as a potential source of state revenue: 1) non-ferrous metals, particularly aluminum, 2) electric power engineering, and 3) cotton. Control over the first two is concentrated in the hands of the central government, whereas regional governments have succeeded in capturing more control over the third. Yet, the struggle persists.

The central government is able to maintain greater control over the production of aluminum, which from 1992-1999 accounted for approximately 45% of total industrial output and exports (World Bank, January 2001, pp.17-18, 20), largely for both geographical and structural reasons. The largest aluminum smelting plant in the country (the Tursunzade Aluminum Smelter, or TADAZ) is located near the capital city (Dushanbe) in the Raions of Republic Subordination (RRS), where the central government generally has greater supervision. The production of aluminum also depends heavily on imported raw alumina, which is secured at the level of the central government.

The centralized system of electricity generation, concentrated at the Nurek power station just south of Dushanbe, and distribution built under the Soviet period is also more structurally conducive to central than regional control because it is not easily divisible. In addition, although the hydroelectric power is a primary export for Tajikistan, it does not yield cash income, but rather, is bartered for imports such as gas, electricity, and water from Uzbekistan. Thus, it also holds less value for regional warlords than cash crops such as cotton. The state company that supplies electric power (Bark-i-Tajik), moreover, is heavily in debt due to the prevalence of non-payment among industrial and household consumers -- particularly TADAZ (World Bank, January, 2001, p.25) -- although the collection rate improved substantially during 2002. Indeed, this is one of the primary ways in which the central government continues to subsidize industry. Electricity also serves an important source of political currency for the government by providing a relatively “free good” to the population, though there has been some effort to raise tariff rates and increase payments among households (World Bank, January 2001, p.25). For this very reason, jurisdiction over the power/electricity sector is often contested among central and regional officials. International donors working in this sector under contract with the central government have encountered obstacles at the local level. The mayor of Dushanbe, for example, had to approve the installment of new heating systems in schools even though the distribution of gas for heating is technically under the jurisdiction of the State Unitary Enterprise (Author’s personal communication with WNGO representative, May 2002).

The central government has also endeavored to maintain control over heavy industry as a whole, which in addition to non-ferrous metals and energy include coal, chemicals, and machine-building. The vast majority of medium and large industrial enterprises remain state-owned, thus earning Tajikistan “one of the highest levels of state participation in industrial production among the transition economies” (World Bank, January 2001, pp.20-21). Moreover, while there has
been some effort at restructuring, the continuation of directed credits and subsidies, the growth of huge arrears, the predominance of barter, and the failure to enforce bankruptcy laws have significantly curtailed the ability of this sector to contribute to growth. Overall, the industrial sector in Tajikistan has experienced a severe decline, high unemployment, and, as a result, and a significant shift in labor from industry to agriculture. This has also resulted in a large number of migrant workers seeking seasonal employment in Russia, Kazakhstan, and Kyrgyzstan, which currently remains unregulated, represents a net loss for Tajikistan’s economy (e.g. because the government has no effective way to claim remittances), and is increasing political tensions. Yet, there has been some movement to improve this situation and to protect migrant workers’ rights.

The reluctance of the central government to fully cede control over heavy industry, therefore, stems in large part from its desire to insulate itself from regional challenges by guaranteeing itself a source of income, barter, and social protection. There is a real fear that liberalization of industry will produce the same degree of regional control that has resulted from the liberalization of agriculture.

Liberalization in the cotton sector has been significant, particularly in comparison to Uzbekistan. The system of centralized procurement and export, along with the official government purchasing and export agency, Glavkhlopkoprom, was officially abolished in the mid-1990s. Officially, the price of cotton is regulated by the market and farmers are free to sell cotton either through Republican Cotton Exchange or directly to foreign buyers; ginneries were completely privatized as of 2001. Yet, the end of the state monopsony has not had the intended effects of liberalizing prices and increasing competition because regional monopolies have emerged in its place. In the two dominant cotton-growing regions -- Leninabad and Khatlon -- local officials use their authority to enforce de facto production quotas and artificially low prices by withholding inputs from farmers who refuse to grow cotton, blocking farmers’ access to external markets, and allocating the best land to cotton while leaving the worst land for growing food. They are also known to send inspectors out to farms periodically “to intimidate farmers… [and] to insure that those farmers who do receive inputs and credits are indeed growing cotton” (Author’s personal communication with WNGO representative, May 2002). Not surprisingly, farm restructuring has also proceeded at a much slower rate in these two regions than in other regions where cotton plays a minor role in the local economy -- e.g. Badakhshan and the RRS -- because local officials have blocked the redistribution and privatization of land to farmers (World Bank, January 2001, p.41; author’s personal communications with farmers). In 2001, however, the central government continued to transfer land titles to private farmers in an effort to continue these reforms.

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50 Over the past decade, “labor employed in agriculture increased by over 30%” (World Bank, January 2001, p.19).
51 The government has signed a bilateral agreement on the protection of migrant workers’ rights only with Kyrgyzstan, but Russia is the destination of over 80% of these migrants.
52 State orders for cotton were officially discontinued in 1996 and Glavkhlopkoprom was dissolved in 1998.
53 Cotton production is concentrated in two regions. Leninabad Oblast in the north contains about 30 percent of the total area under cultivation for cotton. Khatlon Oblast in the southwest (formerly divided into two oblasts -- Kurgan Tyube and Koulab) contains about 60 percent.
54 In interviews with the author, many described farmers growing wheat on steep hillsides for their personal consumption, as this was the only land made available for this endeavor.
55 Fifty percent of all arable land has officially been transferred to private farmers (Government of the Republic of Tajikistan, June 2002, p.16).
As in Uzbekistan, farmers in cotton-growing regions are thus the net losers of maintaining this system. Most often they are forced to grow cotton and sell it to local ginneries (often at a loss) in lieu of growing more profitable cash crops to bring to the local market or even food for their families because they need access to the production inputs (including land, water and financing) that local officials control. Private sources for some inputs exist, but because there is little competition farmers are forced to pay exorbitant prices. Credit is also extremely scarce for farmers who do not grow cotton. At the same time, they are subject to heavy taxation from local and central authorities. One way that the central government continues to derive some revenue benefit from cotton production is to impose a hefty excise tax on cotton. Thus, farmers are being squeezed on both ends.

**Weak Legal and Regulatory Environment**

The second main consequence of Tajikistan’s fragmented state is a weak legal and regulatory environment, both in terms of actual laws passed and inconsistent implementation. On the one hand, the legislative base for the development of SMEs across sectors is generally weak. One of the main reasons that farmers cannot secure private loans, for example, is that they have no legal right to transfer land use certificates in the event that they default on their loans. Without this collateral, the risk of lending is simply too high. Tajikistan also lacks comprehensive legislation on micro-lending/finance. Other factors that stunt the growth of SMEs include the explicit taxation regime, excessive bureaucratic interference (mainly through inspections), and licensing system. The increasing tax burden on SMEs, which are required to pay multiple national and local taxes -- payroll tax, social fund and pension fund tax, road fund, and property tax -- has led many SMEs to reduce their activities by registering instead as individual enterprises to reduce their tax burden or to refuse to register at all. This explains both the dramatic increase in individual enterprises after 1995 and the decline in SMEs overall since 1995. [See Figure 3 below.]

Excessive inspections by local authorities has had a similar effect. Prior to 1995, there was a large rise in the number of SMEs, but after 1995 they started to decrease dramatically because the number of organizations with the authority to inspect and fine small businesses increased. Business owners opted to be registered as individual enterprises and obtain licenses rather than to be officially registered as SMEs, or to officially shutdown their businesses. The licensing system, however, also imposes a burden on small business owners. There is a license (patent) for every kind of business activity (vid deyatel’nostї) so that businesses cannot easily engage in more than one type of business activity or switch between activities in response to markets. The license also has to be renewed on a regular basis.

**Figure 3: Growth of SMEs in Tajikistan, 1992-2000**

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56 Although the introduction of a single excise tax on cotton replaced numerous taxes in 1997, the tax burden has not been significantly reduced as a result.

57 Note that registering as an individual enterprise (IE) rather than as an SME restricts business growth and employment opportunities in the private sector because IEs are restricted from hiring employees.

58 The price of the license (patent) depends on the type of business activity and the length of time.
There is some indication that the legal and regulatory environment is improving, which may be linked in part to the recent presidential and parliamentary elections in which President Rakhmonov’s supporters won an overwhelming number of seats. Since then, Rakhmonov has reportedly made considerable progress in consolidating his power at the central level (see, e.g., ICG, 2001), and he appears to be using some of this power to further reform. In September 2001, the government consolidated two departments (inspection and taxation) into one new ministry -- the Ministry of Revenue -- in response to a meeting with business leaders at which they complained that the principle barriers to SME development were high taxes and registration that is “too complicated” and “expensive” (Author’s personal communication with Latego representatives, May 2002). As a result, the number of people employed as inspectors was significantly reduced.\(^59\) The central government has also displayed an interest in drafting legislation to support micro-lending/finance, for example, by participating in an IFC-sponsored roundtable on microfinance in Kyrgyzstan in February 2002. The following month, a presidential decree was issued which requires that all inspectors have an official letter from the government and show this letter to the SME owner/manager before they can conduct any inspections and limits the number of inspections.\(^60\)

On the other hand, vested interests at all levels of government resist implementing reforms that would reduce their political influence and economic gains and continue to exploit their positions to engage in rent-seeking activities. Local officials and their business partners who enjoy

\(^{59}\) One business leader commented to the author that, “before this, there were at least 1000 more people working on inspection and taxation than employed in SMEs.”

\(^{60}\) To limit the number of inspections, each inspector must register at the business before he can conduct an inspection. The business owner/manager then has the right to deny multiple inspections by the same organization.
monopoly rights in the cotton sector, for example, are unwilling to forfeit rents by supporting competition. As mentioned above, they are also prone to harass local businesses with frequent inspections to extract fines and bribes. Despite its recent commitment to reducing subsidies, the central government continues to distort market reforms, such as privatization and price liberalization, by often subsidizing failing industries through directed credits and arrears and not enforcing bankruptcy laws. Moreover, official corruption is rampant at all levels due to weak enforcement mechanisms, the prevalence of patronage and payments in hiring civil servants, low wages, and the lack of civil service reform.

**Limited Access to Information**

Tajikistan’s weak legal and regulatory environment is compounded by entrepreneurs’ limited access to information on relevant laws and regulations and by their inexperience with using the legal system. Access to information is extremely limited. The Chamber of Commerce, a quasi-governmental agency, publishes laws and regulations only once a quarter (or 4 times a year) and all official information is prohibitively expensive to obtain for farmers and SME owners/managers. As a result, the majority of farmers are not aware of their rights regarding land use and access to inputs, and export markets. Most SME owners/managers are similarly unaware of the aforementioned recent improvements in the regulatory environment, and thus, are unable to protect themselves against arbitrary and excessive inspections. Unlike Uzbekistan, moreover, there are relatively few private consultants available to advise businesses on such matters. The NGO sector, however, is much more developed than Uzbekistan in this regard. Some NGOs -- most notably the National Association of Business Women in Tajikistan (NABWT), which provides micro-credits to women entrepreneurs throughout Tajikistan -- are already addressing this problem by publishing and disseminating relevant laws and decrees to their own clients. Their scope and financing for such activities, however, is limited. The media, which some have described as “active and relatively pluralistic” is also limited in this role both because newspapers are considered a luxury for most people in impoverished Tajikistan and because there is little access to media in the regions (ICG, 2001, pp.10-11).

At the same time, as in Uzbekistan, both struggling entrepreneurs and government officials -- particularly at the local level -- lack fundamental knowledge about how markets work. Some organizations, such as NASMB provide training and advise entrepreneurs on how to create business plans and advertise their products. Yet, the services they provide are hardly enough to meet the growing demand and their clients do not include local officials.

**Obstructions to Intra- and Inter-State Trade**

Legitimate trade --both within Tajikistan and between Tajikistan and its Central Asian neighbors-- is obstructed by official corruption, excessive documentation and checkpoints, high export/import tariffs and (formal and informal) transit fees on trucks and freight-carrying vehicles, and border closures. As a result, farmers and SME owners/managers encounter prohibitive transit costs, the growth of SMEs beyond local markets is stunted, and enterprises interconnected by common resources and suppliers are denied access to inputs. Barriers to intra-state trade include huge transportation costs due to local trucking monopolies, extortion on roads
and geographical constraints that are exacerbated by inter-state border closures. Several cities and districts within Tajikistan are connected only by crossing through Uzbekistan. In order to get to Khujand in the northern part of Leninabad Oblast from Panjekent in the southwest of Leninabad Oblast, for example, one must travel through Uzbekistan and four customs checkpoints where customs officials demand payment in case of in kind. This is a particularly difficult situation for the enterprises in several northern cities (e.g. Isfara and Kanibadam) that are interconnected by common resources and suppliers because transit costs through Uzbekistan are extremely costly.

Corrupt border guards and custom officials are a common feature throughout the region, but have become a systemic problem in Tajikistan where off-budget payments are often made to obtain these and other lucrative positions. As one member of the international community described, “Border guards own the ability to make a living, they take bribes and confiscate goods as salary” (Author’s personal communication with WNGO representative, May 2002).

The most severe barriers to trade, however, come from official rather than unofficial sources. Uzbekistan in particular has erected the greatest barriers to regional trade, and these have increased in recent years. Due not only security concerns after incursions by Islamic militants into its territory from Tajikistan via Kyrgyzstan in 1999 and 2000 but also to its fear of cheap imports from its poorer neighbors, Uzbekistan has implemented draconian methods to protect its border. These include laying mines along it border with Tajikistan, which has essentially destroyed a once vibrant local economy based on cross-border trade in the Ferghana Valley.

**STRATEGIES FOR OVERCOMING THESE OBSTACLES**

In order to propel reform forward in Tajikistan, the international donor community should focus its efforts on five key areas:

1) Improving Relations between Government and the Private Sector
2) Building Coalitions with Potential Winners
3) Supporting the Development of the Private Sector
4) Increasing Access to Information
5) Reducing Barriers to Intra- and Inter-State Trade

First, the international donor community should strive to build on the positive relationships that have been emerging between all levels of the government and the private sector, particularly business-oriented NGOs over the past year. Several of these organizations have established formal and informal partnerships with government officials and governing bodies. The National Association of Small and Medium Businesses (NASMB), for example, advises the central government on ways to increase employment and has partnerships with the Ministry of Labor, the official trade unions, and the Anti-Monopoly Committee. Most L NGO leaders argue that the government has become more supportive because they have realized that NGOs provide an array of important social and financial services without asking for money and can generate employment and relieve poverty. In the rural areas, where unemployment has swelled as a result of the huge shift in labor from industry to agriculture in recent years, local officials are particularly receptive to NGOs and even offer to supply them with scarce resources, such as free
office space. Others insist that the reason “there has been a 360 degree change in governmental attitudes” is that “international organizations have helped to raise the understanding of the local governmental structure about the benefits of NGOs” (Author’s personal communication with NGO representative, May 2002). From this perspective, they view the government’s recent adoption of the poverty reduction strategy devised by the World Bank and IMF as an opportunity to expand their role and gain greater government support for their activities.

Promoting productive dialogue and linkages between government organs and the private sector can also have a direct impact on the legal and regulatory framework. The aforementioned presidential decree that reduces the number of inspections for SMEs, for example, was introduced after a meeting between the president, business leaders, and NGO representatives. Similarly, the NASMB participates in roundtables with the Anti-Monopoly Committee at which it helps draft legislation concerning taxation and regulation of the private sector. Independent organizations such as the NASMB could also work with government organs at the local level to provide business training for both entrepreneurs and officials.

Another source of potential support for business interests is the national parliament (Majlisi Olii). Although the parliament is currently serving as a rubber-stamp for the decisions of the president, similar to the Olii Majlis in Uzbekistan, because the deputies represent a wider group of economic and local interests, empowering them might dilute the possibility for the a few central leaders in the executive branch to defend their own vested interests. These deputies could also represent growing interests of the private sector in a pro-market business environment, which includes tax and regulatory reform as well as the rule of law. In this regard, the international community should strengthen its efforts to push for greater democratic reform by advocating a stronger role for the legislative branch.

Second, the international donor community should cultivate those interests that stand to benefit most from economic liberalization in Tajikistan and help to build coalitions among them. These include farmers, SMEs owners/managers, and regional/local governments. Both farmers and SMEs owners/managers are increasingly showing signs of their readiness and desire to move toward a market economy. Officials in non-cotton producing regions are also more receptive to reform, particularly in the agricultural sector. As in Uzbekistan, coordination within and between these interest groups should be facilitated by sponsoring formal meetings, soliciting their input in projects and activities, and including them in sponsored projects and activities. At the same time, regional leaders in cotton-producing regions in particular must be encouraged to support greater competition by allowing greater entry and access. The international community could play a crucial role in pushing for continued monitoring of this process while empowering the farmers by providing a forum in which they can point out the inconsistency between the intent and application of the law when vested interest are sabotaging the process.

One concrete way in which the international community can cultivate regional leaders’ interest in market reform is to smooth the transition toward greater fiscal decentralization by supporting the central government’s current efforts to restructure public administration to increase

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61 This is not to say that the Anti-Monopoly Committee supports all market-based initiatives for reform. It has resisted reform such efforts in the energy sector, for example. What it does demonstrate, however, is that the committee is open to input from the private sector.
efficiency and improve its financial monitoring capacity. These efforts to restructure public administration, including the establishment of the State Committee for Financial Control in 2001, clearly signal the government’s desire to address some of these problems (for details, see e.g., Government of the Republic of Tajikistan, June 2002).

Third, the international community can support the development of the private sector not only by supporting judicial and administrative reform to help protect the rights of farmers and SME owners but also by supporting efforts to create the infrastructure to serve private farms and businesses. Supply networks, transportation services, and trade organizations are poorly developed in Tajikistan, and serve as prime area for the development of private activity.

Fourth, the international donor community can increase access to information by financing the publication and distribution of information to both the population and regional/local government officials in a timely manner. Existing NGOs can be strengthened by involving them directly in and/or expanding their efforts toward this endeavor. Financial and technical support should also be made available to promote the local media. At the same time, the government should be discouraged from providing these services through the Land Committee, as it does presently. This is another prime area for the development of private activity, as is evidenced by the proliferation of business consultancies in Uzbekistan.

Finally, the international donor community can stimulate private sector development by reducing barriers to intra- as well as inter-state transit and trade. This requires working actively with local officials and neighboring governments to find more economically efficient (and less deadly) ways to secure their borders. Toward this end, extensive civil service reform should be introduced to increase transparency in hiring and reduces the use of payments in exchange for “lucrative jobs,” such as border guards and customs officials. Border guards salaries might also be supplemented with international funds so that there is less temptation to extract bribes. The international community might also consider encouraging the central government to simplify tariffs in order to reduce opportunities for corruption, set targets for acceptable time delays at borders to monitor corruption, and eventually to work together with its Central Asian neighbors to establish a common customs area with no internal borders needing to be policed, as is the case in the European Union. Of course, the latter is only possible once its neighbors (particularly Uzbekistan’s) security concerns are sufficiently addressed.

**PART III: KYRGYZSTAN**

Kyrgyzstan has undergone much more extensive economic reform than either Uzbekistan or Tajikistan. Beginning in mid-1993, the central government launched a broad reform package that encompassed both its relatively weak industrial sector and relatively robust agricultural sector.

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62 This section benefited enormously from informal discussions with Carlo Segni, Consultant, World Bank office, Bishkek, and interviews with numerous local scholars/researchers, officials, farmers, entrepreneurs, leaders of small business and farmers’ associations, and representatives of international NGOs in Bishkek and Osh.

63 Kyrgyzstan’s industrial sector was one of the least efficient and least competitive in the former Soviet Union. As is the case today, it relied primarily on the agricultural sector for growth.
This reform package included macroeconomic stabilization, an open trade regime and WTO membership, price liberalization, and an extensive privatization program, resulting in the near complete transfer of all enterprises (approx. 97 percent) and over 50 percent of all land from state control to private ownership. More recently, the central government has introduced significant tax reform and made a commitment to improve fiscal management so as to reduce budget arrears (for details, see, e.g., World Bank, 2001).

Thus, Kyrgyzstan also has a much stronger foundation for the development of a market-oriented economy than either Uzbekistan or Tajikistan. It has made greater progress on both small-scale and large-scale privatization and enterprise reform, for example, than the CIS average (EBRD, 2000). Overall, it has also significantly reduced the direct role of the state in the economy as compared not only to the other countries in this study but also to its other Central Asian neighbors (EBRD, 2000). Moreover, these reforms have demonstrated promising economic results. Overall, Kyrgyzstan has experienced economic growth, albeit uneven, since 1996. GDP has increased annually since the mid-1990s -- from approximately 8 percent growth rate in 1996-1997 to approximately 3 percent in 1998-1999 and approximately 5 percent in 2000-2001 (EBRD, 1999 and USAID, 2002). Inflation has also declined significantly since the impact of the 1998 Russian financial crisis -- from 39.9% to 9.6% between 1999 and 2000 (USAID, 2002).

Nonetheless, it shares many of the same political obstacles to furthering reform with Uzbekistan and Tajikistan -- particularly with the latter country. Like its Central Asian counterparts, Kyrgyzstan relies heavily on agriculture, producing mainly livestock such as goats and sheep, as well as cotton, grain, and tobacco, which accounts for approximately half of its GDP. This sector has undergone significant reform and, as a result, productivity has increased in recent years. Local markets for inputs (including access to credit) and distribution (to domestic as well as foreign destinations), however, remain underdeveloped. As in Tajikistan, moreover, the bulk of the labor force has shifted from industry to agriculture, both because the former no longer operates at full capacity and because the latter offers them at least some degree of subsistence farming. Owing to the shortage of arable land in both countries, this has served as a common source of pressure for continued land (re)distribution. Further agricultural reform is also obstructed by regional and local leaders, who fear both the loss of control over scarce land and the outbreak of ethnic conflict.

Concerning the industrial sector, the primary obstacle is the weak implementation of reform at the regional/local level, where it is constrained by resistance from insiders, excessive taxation and regulation, endemic corruption, as well as the increasing barriers to foreign trade in recent years, particularly with Kazakhstan and Uzbekistan. The development and growth of SMEs in particular is also hindered by a burdensome system of

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64 Kyrgyzstan was the first state in the former Soviet Union to achieve IMF-guided macroeconomic stability and it is the only full member of the WTO (since 1998) in the region.
65 Kyrgyzstan took its first bold step toward land privatization in 1995 by extending land-use rights from 49 to 99 years. In 1999, it took its second bold step by adopting a referendum to amend the Constitution to allow full private land ownership.
66 By comparison, gold production from Kumtor makes up only 10 percent of GDP (IMF, 2000, p.7).
67 Both countries are primarily mountainous; less than 10 percent of their land is arable. Adding to this pressure is population growth, which continues unabated in the countryside (see e.g. Abazov, 2002).
68 The country’s arable land is concentrated in the southern regions -- particularly in Osh, where violent conflict erupted in the early 1990s between Uzbeks and Kyrgyzz over the allocation of farming land. For details, see, e.g., Elebayeva, 1991.
explicit and implicit taxation. This is revealed in the low number of officially registered SMEs -- approximately 1.8 per 1,000 people -- which has actually declined over the past few years.

Broad agricultural and industrial reform has had some impact on the country's standard of living and, according to a recent World Bank report, reduced “the number of poor people... by an estimated 300 thousand individuals between 2000 and 2001” across regions (World Bank, August 2002, p.vii). Inequality also declined (World Bank, August 2002, p.vii). Nonetheless, “[a] little more than 55% of the population still lives at or below the poverty line” (USAID, 2002) and rural poverty remains high, particularly in comparison with urban poverty (World Bank, August 2002, p.ix). Further poverty reduction, moreover, depends on the government’s continued commitment to reform so as to sustain and accelerate economic growth. Several actions can be taken by the international donor community to sustain the current level of economic reform in Kyrgyzstan and to promote further reform, including:

- Making economic reforms more sustainable by actively supporting the development of the private sector more broadly;
- Strengthening reciprocal relationships between the government and the private sector;
- Reducing corruption by introducing extensive civil service reform to increase transparency in hiring and reduce the use of payments in exchange for official positions;
- Creating market incentives for regional/local officials to support private economic activity and for both regional/local officials and farmers to resist participating in narcotics production and trafficking;
- Targeting impoverished rural areas and specifically border regions for economic development and financing/micro-credit programs;
- Financing the publication and distribution of information to both the population and regional/local government officials in a timely manner;
- Working with neighboring governments to reduce barriers to transit.

I discuss both the obstacles to economic reform and possible strategies to overcome them in greater detail below.

OBSTACLES TO REFORM

In contrast to both Uzbekistan and Tajikistan, the primary impediments to further economic reform in Kyrgyzstan stem from several factors that inhibit the full realization of existing reforms. These include:

1) Weak Implementation of Reform
2) Predatory Business Environment and Official Corruption
3) Limited Access to Information
4) Trade/Transit Barriers and Contraband

Weak Implementation of Reform
Obstacles to the full realization of reform are particularly acute in the industrial sector. Inter-enterprise, wage, tax, and budget arrears as well as direct state subsidies to enterprises impede the willingness and ability of private and state enterprises to respond to market incentives. Enterprise arrears -- to both domestic and foreign entities -- and direct subsidies have increased, rather than decreased, since the introduction of privatization and enterprise reforms in the mid-1990s. Enterprise arrears have been on the rise since 1995, reaching approximately 6.3 percent of GDP by 1999 (IMF, 2000, p.8). Among these, the consensus is that the most severe are inter-enterprise and wage arrears. This is supported by data from the World Business Environment Survey (WBES) in which the highest percentage of “overdue payments” reported are for suppliers and workers. Like other arrears, both problematic for enterprise restructuring because they produce economic distortions. Yet, they also exacerbate other related problems that the Kyrgyzstani government is attempting to address with limited resources; inter-enterprise arrears contribute to tax arrears, while wage arrears contribute to widespread poverty (see, e.g., World Bank, 2000). Direct subsidies to enterprises have also increased steadily since 1994, and by 1999 reached 2.3 percent of GDP (EBRD, 2000), indicating state support for enterprises that have not fully adapted to new market conditions.

Unfortunately, the problem of arrears and subsidies is not limited to state-owned enterprises. Nominally private enterprises, particularly if they account for a significant amount of local employment, are often granted tax arrears by local authorities and, as in many Soviet successor states, also rely on non-cash transactions to remain in operation, which local authorities often help to coordinate. The fact that the primary mode of privatization in Kyrgyzstan was to transfer assets to managers and workers (or “insiders”), moreover, compounds this situation because many rely on pre-existing practices and networks either because they do not have access to the knowledge or capital necessary to invest in restructuring. According to the WBES, for example, although arrears as a whole more common among state-owned than private enterprises, wage arrears are almost equally common among state-owned and private enterprises.

The desire to protect domestic industry is strongest at the regional/local level, where subnational leaders expend considerable effort to maintain subsidies and operate under a soft-budget constraint because they feel a sense of responsibility to provide a minimum level of subsistence to the population within their jurisdiction. Those firms that participated in the WBES, for example, reported that arrears to local governments make up a higher percentage of their total “overdue payments” than do arrears to the national government. As in Uzbekistan, these leaders are motivated primarily by the fear of social unrest and the loss of direct control over scarce economic resources.

**Predatory Business Environment and Official Corruption**

At the same time, economic reform is constrained by a predatory business environment and endemic corruption among officials. Although Kyrgyzstan has undergone significant tax reform, for example, revenue collection suffers from low compliance (see, e.g., World Bank, 2001, for details). First, both high tax rates and the number of taxes encourage enterprises to underreport their real income to tax authorities. According to the WBES, for example, the majority of firms report only between 80 and 89 percent of total revenues to the tax authorities. High payroll taxes

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69 According to one entrepreneur, “there are 18 types of taxes officially but many more exist unofficially.”
in particular also limit firms’ incentives for increasing employment. Second, tax collection is low due to legislation outside of the Tax Code that creates additional taxes and fees for some firms and exemptions for others, including those in free economic zones, as well as weak enforcement (World Bank, 2001, p.8). As mentioned above, enterprise tax arrears continue to be high, although they have declined in recent years -- e.g. from 1.43 percent of GDP in 1998 to 0.76 percent of GDP in 1999 (IMF, 2000). Finally, significant tax revenue is lost owing to widespread official corruption. Of those firms that participated in the WBES, for example, the highest proportion of bribes spent on government “services” (almost 54 percent) was spent to avoid excessive taxation. The complicated licensing and permit system creates yet another layer of bureaucracy and thus opportunities for rent-seeking by local officials.\(^{70}\) The second highest proportion of bribes that firms in the WBES reportedly spent on government “services” (15.2 percent), for example, was spent on obtaining licenses. The proportion of bribes spent to avoid taxation and/or obtain licenses is especially striking when compared with the other post-communist states included in the study because it is much higher than the average (see Hellman, et.al., 2000, p. 41).

The negative impact of this environment is particularly acute concerning the development of SMEs, whose owners/managers encounter a heavy tax burden, multiple administrative barriers (e.g. licenses, permits, certification), and overwhelming control by bureaucracy (e.g. repeated inspections), thus driving them into the shadow economy. Representatives of entrepreneurs’ organizations interviewed by the author consistently cited the burdensome requirements to obtain licensing, permits, and certification, and frequent inspections by various local officials as the chief impediments to SME development. SMEs in Kyrgyzstan also reportedly spend a disproportionate amount of the total yearly income on unofficial payments to public officials. Many attribute this “special treatment” to the fact that, unlike large enterprises, SMEs do not enjoy the “protection” of regional/local leaders, both because they are considered to be more profitable and because they do not provide (at least individually) a high percentage of (visible) employment.\(^{71}\) To derive more revenue from SMEs, for example, local governments have created a surcharge on business licenses (460 som) that SMEs are forced to pay regardless of how much they paid for their original license.\(^{72}\) For those small businesses that paid only 100 som for their licenses, this is a huge amount of money.

More generally, the prevalence of corruption -- in the form of both public officials hiring their friends and relatives and bribe-taking -- constitutes a significant obstacle to business development in Kyrgyzstan (Hellman, et.al., 2000, p. 25).\(^{73}\) The incentives that these conditions create for entrepreneurs to exit the formal sector are revealed in the low number of officially SMEs -- approximately 1.8 per 1,000 people -- and the fact that is has actually declined over the

\(^{70}\) Currently, there are 29 types of licenses. Although this is still quite large, it is considered a vast improvement -- previously there were 64.

\(^{71}\) This is supported by the WBES data, but only in part. SMEs do spend a large amount of their income on unofficial payments. Over 20 percent of SMEs included in the survey reported that they spent more than 10 percent of their annual revenues on bribing public officials. Yet, over 30 percent of large enterprises included in the survey reported that they spent more than 10 percent of their annual revenues on bribing public officials.

\(^{72}\) The cost of a license depends on the size and type of business activity.

\(^{73}\) Regarding the first type of corruption, approx. 45 percent of firms in the WBES responded either that it was moderate or major obstacle. Regarding the second type of corruption, over 50 percent responded either that it was moderate or major obstacle.
past few years. Such a low number of SMEs in Kyrgyzstan is especially surprising given the fact that Kyrgyzstan’s private sector (i.e. NGOs) has been among the most active in the FSU, and certainly in Central Asia, since independence (for details, see, e.g., Anderson, 1999). It is also be a serious cause for concern because SMEs are the most likely form of business expansion and employment opportunity in Kyrgyzstan given its limited domestic market.

Endemic official corruption in Kyrgyzstan is related to limited civil service reform and local poverty as well as the lure of the drug trade. The latter form of corruption mentioned above (i.e. bribe-taking) has increasingly served as a strategy for coping with growing unemployment and widespread poverty. As in Tajikistan, officials often accept unofficial payments in exchange for “lucrative jobs,” such as border guards and customs officials. The recipients of such positions then view bribe-taking as their primary form of repayment. In addition, becoming involved in illicit drug cultivation (cannabis and opium poppy) and transit from Afghanistan (through Tajikistan) to other parts of the former Soviet Union, is often the only option for impoverished farmers, particularly those living in regions along the border with Tajikistan.

**Limited Access to Information**

As in both Uzbekistan and Tajikistan, one of the biggest obstacles to the development of SMEs is that most entrepreneurs “don’t know their legal rights or how to defend them” (Author’s personal communications with leaders of the Committee for Private Entrepreneurs). Their ability to obtain information about changes in relevant legislation or regulations through existing organizations that provide such information, moreover, is constrained by several factors. First, there is generally a low awareness of the value and benefits that business support services provide. Second, access to these services is limited, particularly outside of Bishkek and Osh. Finally, SME owners/managers have a strong their preference to remain anonymous because they fear the retaliation of local officials. Several entrepreneurs have claimed, for example, that when they filed an official complaint about repeated inspections at the local administration (akimiat) they were effectively “punished” by encountering twice as many inspections as previously. Unfortunately, unlike Uzbekistan, more knowledge can often lead to more rather than less harassment.

Perhaps more importantly, then, SME owners/managers and farmers as well as local government officials have limited access to information about private sources for production inputs, distribution, and access to markets (domestic and foreign) for their goods and services. Many farmers, for example, still view expanding beyond subsistence farming as too risky despite long-term leases for land and private land ownership. Similarly, local officials interviewed by the author believed it was necessary for each village to be self-sufficient, producing goods only for internal consumption.

**Trade/Transit Barriers and Contraband**

Although Kyrgyzstan has implemented an open trade regime, it has been unable to reap the full benefits due largely to political disputes with its neighbors. Strained relations with Uzbekistan have resulted not only in an uncertain supply of electricity but also in significant trade barriers. Although both countries agreed in the early 1990s to maintain a barter system whereby
Uzbekistan would provide Kyrgyzstan with gas in the winter in exchange for water during the summer growing season, this agreement has been violated repeatedly. At the same time, Uzbekistan’s efforts to guard its borders, for example, by laying land mines and requiring excessive documentation, have eradicated legitimate cross-border trade. Kyrgyzstan also has disputes with its other two biggest trading partners – Kazakhstan and the Russian Federation – involving unpaid debts and high import tariffs. In addition, Kyrgyzstani exporters encounter official bureaucratic hurdles (e.g. registration) as well as unofficial ones (i.e. bribes to custom officials) in all three countries, making it “much easier to import than to export” (Author’s personal communications with leaders of the Committee for Private Entrepreneurs).

These trade barriers have had a severely negative effect on Kyrgyzstan’s economy in general and SME development in particular. Exports declined sharply -- by almost 20 percent -- in 1999 due to both punitive tariffs imposed by Kazakhstan and frequent border closings by Uzbekistan (IMF, 2000, p.11). Trade with Russia also suffered as a result. At the same time, importers have turned increasingly to contraband to avoid high import duties in Kyrgyzstan. Trade difficulties thus provide another incentive for SMEs to exit the formal sector.

**STRATEGIES FOR OVERCOMING THESE OBSTACLES**

In short, the international donor community should concentrate on promoting the effectiveness of Kyrgyzstan’s economic reforms that are already in place. There are several ways in which it might accomplish this goal.

First and foremost, the donor community should facilitate dialogue and interaction between SME owners/managers and government officials -- particularly at the local level. In some cases, this involves building on existing links and organizations, while in others it demands creating them. Organizations that support entrepreneurs are generally at the initial stages of development, but are more advanced in Bishkek and Osh, for example, than in other parts of the country. Professional and trade associations are both more developed and active throughout the country, but are likely to be effective because they are too closely associated with the government. The purpose of such on-going dialogue and interaction should be both to foster their cooperation in monitoring the implementation of existing legal and regulatory framework and to increase SME owners/managers direct input into improving the legal and regulatory framework. Creating a feedback loop between government and business will become all the more valuable once local officials are all elected rather than appointed.74

Second, the international donor community should continue and expand its support for business training to include entrepreneurs as well as local officials. The combination of a more productive dialogue between local business and government and more business training opportunities will help to reverse the current trend of SMEs leaving the formal sector to enter the informal sector. Increasing the fiscal incentives for local; officials would also pave the way for less predatory behavior, and hence, more willingness for SMEs to rejoin the formal economy. The growth of tax-paying SMEs will also help to provide an alternative source of income to narcotics

74 Currently, only village leaders are elected but the intent is to institute elections for all local officials if this first so-called “democratic experiment” is successful.
production and trafficking for both regional/local officials and farmers. In this regard, efforts should be targeted at impoverished rural areas and border regions.

Third, the international donor community should also work together to continue and to expand its support for the private sector more broadly in order to make existing and future economic reforms more sustainable.

Fourth, as in Tajikistan, official corruption can be reduced through a combination of a) introducing extensive civil service reform to increase transparency in hiring and reduce the use of payments in exchange for official positions, b) supporting the development of an independent judiciary and strengthening its role in the adjudication of disputes, and c) prioritizing more effective audit processes and budgetary control at the central and regional levels.

Fifth, as in both Uzbekistan and Tajikistan, the international donor community should finance the publication and distribution of information to both the population and regional/local government officials in a timely manner. It should also support the development of independent organizations that provide such information to entrepreneurs.

Finally, inter-state trade barriers can be reduced by working actively with Kyrgyzstan’s neighbors to negotiate mutually beneficial trade agreements and to implement constructive border control measures that will alleviate mutual security concerns without impeding trade.
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