The Uzbek government’s attempt to decrease the share of economic activity in the informal economy failed to recognize that its growth is a symptom of a deeper problem: excessive government controls over basic economic activity. Rather than providing incentives for small businesses to enter the formal economy, the government imposed new controls over banking and trade that infringe on property rights and has unintentionally compounded the growth of the informal sector. In order to confront the true problem, Uzbekistan needs to reverse its course, work on legitimizing the property rights of its entrepreneurs, and incorporate the voice of business into future economic policy-making.

In 2001, Uzbekistan embarked on a self-proclaimed economic reform program aimed at accelerating its transition to a market economy that better complied to international standards. A key goal of the Uzbek government was to decrease the share of the economy operating outside the formal system of licensing, taxation, certification, and other administrative barriers to business. By the end of 2003, however, the government’s ambitious program had unnecessarily damaged the Uzbek private sector. The good intention of increasing the number of legitimate small- and medium-sized enterprises (SMEs) succumbed to the ill effects of poorly designed legislation and overregulation.

Promising steps have taken place in recent months as the Uzbek government has reconsidered several onerous measures, but many barriers to enterprise development and economic growth remain firmly in place.

The Informal Economy in Uzbekistan
In a country where private property was once outlawed, today private businesses constitute a fairly large share of the Uzbek economy. Although the European Bank for Reconstruction and Development estimates that the private sector makes up approximately 45% of Uzbekistan’s GNP, this figure excludes the shadow economy. Conservative World Bank statistics place the informal sector in Uzbekistan at a modest 34% of GNP, however many Uzbeks would argue that the actual figure is much higher, totalling almost half of the private sector activity in the country.

With roughly half of the private economy operating outside the law, the Uzbek government’s interest in formalizing more enterprises is evident. However, despite the government’s efforts aimed at helping business, new SME registration has drastically dropped from 40,000 in January 2001 to 15,000 in June of that year, according to the World Bank. Businesses in the informal sector do not pay taxes, yet have very high operating costs aimed at bypassing the law. These costs are directly
passed on to the consumers. Such a large share of informal business activity not only deprives government of revenue, but undermines its very authority.

Informal businessmen sacrifice legal title of their property, the protections of the courts, the ability to contract, and the use of their property as collateral for bank loans. The price is steep. Why do so many small scale entrepreneurs make that trade-off?

While operating in the shadow economy is not cheap for businesses, it can be significantly less expensive than entering the formal sector, say entrepreneurs. Bribe-seeking Uzbek government officials regularly make it clear that paying them under the table is more advantageous than paying the full burden of official taxes or fines. While remaining in the shadow is costly, entering into the official economy is even more so. The complicated documentation procedures for obtaining official licenses require businessmen to run through a bureaucratic maze. The exorbitant costs expended in pursuit of legal requirements directly subtract from time spent on gainful and productive business activities.

Any cursory examination of the informal sector quickly reveals that it is merely the symptom of a much more serious disease: overregulation. Regulations that set excessively high barriers to property ownership and its use by its rightful owner tie down the wealth of the country. Bureaucratic overregulation in the form of taxation, licensing, certification, registration, and other numerous administrative procedures that require mandatory permission at every step places a heavy burden on the entrepreneur. Government-made barriers to the establishment of valid property rights trap assets in less than fully productive uses.

The successful path taken by many countries similarly confronted by large informal economic sectors has been one of recognition – legitimizing the assets held by informal entrepreneurs by expediting the titling process. This approach infuses the economy with new wealth by transforming physical property into capital; assets built up through hard work can now serve as collateral for loans necessary for business expansion. And more work is put into improvements once property is owned and protected.

Uzbekistan Tackles the Informal Sector
In stark contrast to that proven approach, the Uzbek government sought not to legitimize the businesses of informal sector, but to eliminate them outright. The good intention of decreasing the share of the economy operating in the shadow economy produced the bad consequence of affronting half of all private sector activity in Uzbekistan. Uzbek law provides few incentives for businesses to expand. Taxation rates are assessed disproportionately to business growth, and there are no laws on depreciation or deductions associated with business enlargement. In effect, entrepreneurship is discouraged because the marginal costs of growth outweigh the possible benefits.

In setting out to constrict the avenues used by businesses in the informal sector, Uzbek legislation has also made life harder for thousands of officially licensed small- and medium-sized enterprises that rely on the same means of business. The effect has been to push many legitimate businesses into the informal sector in an attempt to bypass new, more restrictive rules eating into their viability as businesses.

Recent legislation has choked much business activity, particularly that of small and medium enterprises. Wholesale operations with strong political connections were boosted by new decrees, while significantly reducing competition from smaller wholesalers and traders. When passing these new decrees, legislators proclaimed their commitment to spurring the economy through the promotion of SMEs and the creation of badly needed jobs by fostering a healthier business environment, increasing economic growth, and generating much needed tax revenue.

However, rather than providing incentives for informal businesses to enter the formal economy, the government imposed regulations of control and protectionism that habitually infringe on property rights. In addition, the local business community believes that these regulations were designed with a short-term vision and were intentionally written in vague and often contradictory language. In addition, when businesses are not encouraged to expand, they are unable to provide employment opportunity, badly needed in Uzbekistan. Consequently, the new regulatory framework that emerged has practically devastated local businesses, sharply increased informal sector activity, and has had a traumatizing effect on the local economy.
The Climate Worsens

In many transitional economies, and Uzbekistan is no exception, government policies that aim to improve the entrepreneurial climate often neglect or overlook property rights. President Islam Karimov has proclaimed on numerous occasions that small business is the driving force in the nation’s transition to a wealthy state; hence SMEs must be treated accordingly. In January 2003, President Karimov decreed that private sector growth is key to Uzbekistan’s economic development and must be supported by measures directed at encouraging private property ownership. However, the true entrepreneurial climate contains little incentive for ownership and entry into the formal economic sector. In fact, many critical barriers to entrepreneurship include a series of severe limitations to private property. Uzbek entrepreneurs today are not free to buy and sell property and dispose of the fruits of their labor as they see fit, thus contributing to an unpredictable economic climate and further debilitating chances of economic progress.

Shuttle (cross-border) traders comprise much of the lifeblood of Uzbekistan’s economy. If cross-border trade is to enter the official economy, the government must be held to its word and conditions for SMEs must be improved by reducing their administrative and financial burdens. Recognizing the need to legitimize cross-border trade and deter smuggling, SMEs should receive incentives to emerge from the gray sector.

Over the last several years, entrepreneurs say many good laws were written in support of SMEs. Unfortunately, the unintended consequences have promoted stagnation, rather than growth. Entrepreneurs in Tashkent complain of unbridled property rights abuses that consist of harsh restrictions in banking transactions, difficult access to sufficient credit, excessive licensing and registration demands, corrupt customs officials, inaccessibility to raw materials, and a legal framework that discourages competitiveness and maintains artificially high prices on everyday goods.

In theory, it is quite possible that these regulations were well-intended: boosting local industries, creating jobs, decreasing the informal sector, and increasing business opportunities would spark the engine of economic growth, eventually allowing Uzbekistan to compete in the global market.

In reality, these regulations penalized the victims of an overregulated, overtaxed, corrupt system rather than addressing the root causes of Uzbekistan’s failing economy. For example, higher tariffs and increased bureaucratic requirements were designed to reduce smuggling and stop poor-quality imports from China and other neighboring countries, in turn decreasing the informal economy and supporting local industries. However, because these regulations are costly and ineffective, small cross-border traders have been shut out and have been driven into the informal sector to find means of bypassing the new government controls.

Access to Cash Restricted

Restricted access to cash, hampered by a crippled banking system, has significantly curtailed the amount of business activity in Uzbekistan. Withdrawing money from the bank is now only permitted under a narrow set of circumstances that is closely monitored by bank staff. Despite the fact that entrepreneurs are withdrawing their own money from their own bank account, if the reasons cited for withdrawal are incompatible with the narrow categories under which withdrawal is permitted, cash cannot be had. Despite more recent legislation adopted in August 2002 stating that cash should be made available to the account bearer on first request, banks continue to dispense cash according to outdated legislation. Entrepreneurs believe that this is due to a lack of an enforcement mechanism within the new law itself; hence, banks follow the only procedure ever provided, which belongs to the “superceded” legislation. Even though most basic transactions must be executed via a bank transfer mechanism, still buyers and sellers frequently arrange supplemental cash payments outside the legal system in order to avoid documenting the true value of goods and services, and thus reducing their formal tax liability. This type of “banking system” encourages SMEs to maintain their “accounts” as cash sitting unproductively in their private safes.

These severe restrictions on cash have driven numerous small- and medium- enterprises out of business because of their reliance on the cash-and-carry commerce. For example, when a small sewing company operating in Tashkent was contracted by a large factory to manufacture uniforms, the particular fabric material required for the uniforms was available only through import. The factory agreed to advance the sewing firm 600,000 Uzbek Sum to obtain the sewing materials by transferring the money into their bank account. However, it was not able to withdraw the cash in order to make the purchase. All efforts on behalf of the owner of small business to obtain the materials legally failed, as no material-supplier accepted non-cash payment. Consequently, the contract could not be fulfilled.
Import and Export Opportunities Curtailed

As illustrated by the negative experiences of the small sewing operation, the Uzbek government’s policies have had a particularly devastating effect on SMEs engaged in export/import business. A drastic drop in private business activity among small producers was caused by the Cabinet of Ministers’ November decree strictly limiting cash transactions between SMEs. Shuttle traders traditionally pay other shuttle traders to import materials from abroad, thus creating a significant amount of commerce among SMEs. Today, those who carry goods into the country must also be responsible for any further commercial activity on these goods. In other words the new policy on “you brought it in, you sell it” leaves businessmen little time for actual travel to find the goods, leaving them little income during this time. Local citizenry has seen this impact in the hiked prices of goods at their markets. Legislators point to the availability of imported materials in larger stores. However, small businesses cannot buy from larger stores, as large stores only sell large quantities of material, not really servicing the needs of small businesses. Hence, SMEs are forced to operate within the informal sector if they are to remain in business.

Until recently, local exporters were obligated to secure either 100% payment in advance from the buyer or a letter of guarantee from the buyer’s bank before the transaction can be initiated. The government’s easing of this policy promises to aid small traders, but the full effects remain to be seen.

Abuse at the Hands of Customs

Small scale entrepreneurs who do continue to import or export face yet another major hurdle with certification requirements; customs remains one of the most problematic areas for entrepreneurs in Uzbekistan. In January 2003, the Customs Administration began to impose harsh measures on goods crossing the Uzbek border. Private cargo that does not completely comply with the excessive documentation requirements is subject to confiscation and sold on the spot to consumers or other trading companies at nominal prices with the proceeds going into the pockets of the border agents. Customs officers who are in clear violation of the law and ethical norms are seldom held accountable for their actions.

Sadly, this behavior is not confined to customs agents. The uncompensated seizure of property from businesses and individuals has been reported throughout the country. According to the U.S. Department of State, agricultural land is particularly vulnerable. In the commercial sector, stores that cannot furnish documentation proving that their consumer goods were imported legally are subject to having them seized as contraband.

Excessive Registration Requirements

For SME owners who insist on remaining within the formal economy, exhaustive registration and certification procedures further debilitate the export industry. Not only must the entrepreneur obtain excessive documentation from agencies scattered around town, but these agencies also require samples of the goods on which they conduct an “expertise process” to ensure compliance with international standards. While certification is a necessary part of doing business, excessiveness is choking business. Certification in Uzbekistan is an expensive and lengthy process costing entrepreneurs from $200-$500 and up to ten full days’ time. Ultimately, foreign investors tend to lose patience and abandon the deal. The result is that Uzbek producers and farmers forfeit traditional and new markets for their products, further lowering the local living standard and destabilizing the economy in the region.

Entrepreneurs complain that while a formal recognition of private property value exists in Uzbekistan, their rights are continuously violated with little repercussion, thus severely harming their businesses and, in the process, undermining the rule of law. Any attempts to thwart this ongoing abuse have usually resulted in heightened tensions between the entrepreneurs and the authorities, further deteriorating the relationship between government agencies and the business community.

A Market Reacts to Restrictive Regulation

When SMEs suffer, local consumers and the general population feel the effects. Entrepreneurial difficulties have led to a deteriorating standard of living in Uzbekistan because both international and domestic competitiveness has plunged. The government’s “protective measures” against low quality imports intended to shield local manufacturers and raise the standard for consumer goods has achieved the opposite effect by curtailing consumer choice of products and artificially limiting the range of goods available. Many locals believe that these measures aimed to satisfy the business interests of families with historical power bases in Uzbekistan. By supporting traditionally influential elites, the Uzbek government reduced competitiveness that drives economic growth.

Today, the new import/export restrictions have choked market competition, and, because they do not extend to large companies, discriminate against SMEs. According to law, wholesale businesses must
have holdings (including cash) in the amount of their trade operations, which are asking them to have approximately 6000 times the amount of minimum wage salaries in their holdings. Of this, cash reserves must be approximately 2000 times the amount of minimum wage salary. For large businesses with monopolies on resources, production and materials, these measures had little effect, but small and private businesses were very severely adversely affected.

At present, for example, a resident in Tashkent will pay on average twice the price for everyday consumer goods, such as butter or bread, than a resident in Moscow despite the fact that the average Uzbek salary is only a fraction of that of a Muscovite. Paying 1,400 Uzbek Sum (about $1.50) for a stick of butter out of an average monthly salary of about 18,000 Uzbek Sum (about $20) has led to a significant deterioration in the living standard.

Even attempts at some levels of government to ameliorate the plight of entrepreneurs has been undermined by the national government’s enforcement of restrictions. In February 2003, the Tashkent city government converted a sports stadium into an open-air market, where the first 200 booths were allotted at no charge and the rest were sold. The intent, once again, was to revive small business at any cost by allowing booths to operate without cash registers. After the market thrived for three months, state authorities found this arrangement to be illegal, and all market activity ceased. Citing the Cabinet of Ministers decree requiring the use of cash registers, booth vendors were offered two options: either use cash registers or give up their lots (without compensation). By using cash registers, these vendors would move from the semi-formal market into the formal one – an unprofitable proposition for most because of the high costs of doing business legally. Hence, most chose to give up, depriving wholesale and retail trade of its most profitable venue for business. This move affected the whole country, since entrepreneurs nationwide traveled to Tashkent to do business. Up to 80% of goods produced in Tashkent were sold to buyers from outside the capital city. Uzbek businessmen suggest that commerce levels sunk as much as 5-10 percent compared with August 2002 due to this single event.

These and other restrictive measures have led to a staggering rise of the gray sector. These problems are only a brief illustration of the barriers to entrepreneurship that exist in Uzbekistan today as a result of the legal framework that strips businesses of the rights to utilize their resources most optimally. This legislative framework has drastically decreased competitiveness, spiked prices to artificial highs, and fostered an unhealthy consumer marketplace that negatively affects the whole country. With little national long-term economic planning and weak regional economic cooperation, the investment climate in this Central Asian nation has suffered significantly.

Entrepreneurs maintain that until there is a level playing field accompanied by rule of law, the economy of Uzbekistan will continue to decline. Because of this, many local businesses have moved their activities to neighboring countries. In Kazakhstan and Kyrgyzstan, the private sector accounts for a significantly larger share of GDP. Unfortunately for Uzbekistan, it loses much-needed investment to safer markets.

Opportunity for Recovery

Many entrepreneurs and economic experts correctly identify the massive informal sector as the foremost barrier to economic progress and reform in Uzbekistan; however, the government’s attempt to address this impediment has unintentionally exacerbated the problem.

To reverse the country’s economic slide, the following three steps should be taken. First, the SME business sector needs immediate relief from the myriad regulations imposed that hinder business growth. It is encouraging to see that the Uzbek government has undertaken some initiatives in this regard. The recent easing of the requirement that exporters receive full payment in order to export their goods removes one ill-designed measure. The formal introduction of currency convertibility was also a step in the right direction.

Second, in order to reduce the number of enterprises operating informally, new legislation must provide entrepreneurs with incentives to operate within the formal sector. Most importantly, ownership issues lingering from the post-Soviet privatization of state assets must be resolved. The surge in credit accompanying the availability of undisputed property as collateral will infuse the economy with new functioning capital.

Finally, in the future the voice of the business community needs to be heard when legislation is being written. These unfortunate results came about from policies made behind closed doors with little
private sector participation (or the participation of only a favored business elite) to supply information about the practical effects of changes. True economic reform is possible only when the private sector is widely represented in transparent policymaking to reflect the best interests of the wider citizenry.

Elena Suhir is the Center for International Private Enterprise’s Program Officer for Eurasia. This article is based on personal observations and interviews conducted with Uzbek business owners and managers during visits to the country over the course of 2003.

The Center for International Private Enterprise grants permission to reprint, translate, and/or publish original articles from its Economic Reform Feature Service provided that (1) proper attribution is given to the original author and to CIPE and (2) CIPE is notified where the article is placed and a copy is provided to CIPE’s Washington office via mail, e-mail, or fax.