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Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

A blank in a table indicates that the item is not applicable;

A slash (/) between dates representing years, e.g., 1994/95, indicates a financial year;

Use of a hyphen (-) between dates representing years, e.g., 1994-1995, signifies the full period involved, including the beginning and end years.

Reference to "dollars" ($) means United States dollars, unless otherwise indicated.

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UNITED NATIONS PUBLICATION

INVESTMENT POLICY REVIEW SERIES

1. **Egypt**
2. **Uzbekistan**
3. **Uganda**
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PREFACE

The UNCTAD Investment Policy Reviews are intended to familiarize Governments and the international private sector with an individual country's investment environment and policies. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review for Uzbekistan was undertaken in collaboration with the Organisation for Economic Co-operation and Development, and with the support of the United Nations Development Programme. The national counterpart was the Uzbekistan Foreign Investment Agency.

The review was carried out through a fact-finding mission in November 1997. The mission held meetings with relevant Government ministries, research institutions and members of the international community based in Tashkent. Foreign companies were interviewed and inputs from the investors' perspective were received from the American Chamber of Commerce in Tashkent and the Confederation of British Industry, London.

The fact-finding mission was comprised of Khalil Hamdani and Jörg Weber (UNCTAD), Frédéric Wehrlé (OECD) and Rory Allan (Transborder Investment and Advisory Services Limited). The team was assisted by Erkin Djalilov. The report was prepared by Rory Allan, assisted by Jörg Weber. The report takes account of data and all legislative and regulatory changes as of 31 July 1998.

It is hoped that the analysis and recommendations emanating from the review will promote awareness of the investment environment, contribute to an improvement of policies and catalyse increased investment in Uzbekistan.

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ABBREVIATIONS

CBI	Confederation of British Industry
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
EIU	Economist Intelligence Unit
FDI	Foreign Direct Investment
FIA	Foreign Investment Agency of Uzbekistan
FSU	Former Soviet Union
GDP	Gross Domestic Product
GKI	State Property Management Committee
MFER	Ministry for Foreign Economic Relations
OECD	Organisation of Economic Co-operation and Development
UNCTAD	United Nations Conference on Trade and Development
VAT	Value Added Tax

EXECUTIVE SUMMARY

Since its independence in 1991, Uzbekistan has made careful progress in the transition from a centrally-planned to a market economy. Recognizing that foreign direct investment (FDI) can contribute to Uzbekistan's growth and development, and also ease the country's transition to a market-based economy and integration in the world economy, the country has welcomed foreign investors. Foreign direct investment increases the levels of fixed capital formation and also, by constituting an inflow of foreign capital, has a beneficial effect on the balance of payments. Investors have shown particular interest in Uzbekistan's manufacturing sector, which it is hoped will increase the standard of these facilities. Most importantly, an FDI package brings scientific, technical and managerial skills into the country, vital in the transformation of Uzbekistan's industrial sectors. The combined benefits of FDI would allow the country's industrial sector to gain international competitiveness, increase employment opportunities of higher remuneration and, through forward and backward linkages, develop Uzbekistan's small and medium enterprise (SME) sector.

Uzbekistan has indeed had some high profile successes in attracting FDI, especially from a small core of internationally well-known strategic investors. However, on a broader basis the country appears to be underperforming, both in terms of other comparable member countries of the Commonwealth of Independent States (CIS) and in terms of its own potential.

Uzbekistan has innate strengths as an investment destination, although these are not unique for the Central Asian region. At the same time, the country currently shows several economic and investment policy weaknesses that appear to have led to investment levels well below the country's potential. For the future, Uzbekistan is therefore confronted with both a danger and an opportunity. The *opportunity* is to take full advantage of the country's abundant natural and human resource endowments and to become the preferred investment destination in the region for industries and services which serve the domestic and regional markets and beyond. The *danger* is that Uzbekistan might fall behind, rather than move ahead of, regional competitors in improving the investment climate and might be increasingly passed over in terms of future FDI inflows into the region. This is further accentuated by the fact that even the current low absolute levels of FDI inflows appear fragile due to the high historic share of FDI coming from Asia, where a number of home countries are facing economic difficulties.

Uzbekistan's foreign investment law is liberal. Foreign direct investment is welcomed and by law most businesses are open to FDI. For the most part, foreign investors are treated at least as well as national investors both under the law and in practice. Uzbekistan has established a legal framework to provide important rights and assurances to foreign investors and has avoided serious disputes with investors of the kind which have occasionally soured the investment climate elsewhere in the region. Indeed, Uzbekistan has introduced taxation incentives to encourage FDI.

To some extent, the present modest levels of FDI are due to Uzbekistan's deliberate choice of a transition policy of economic reform that has so far precluded fundamental privatization of the utilities and major State enterprises. As a transition economy, Uzbekistan has embraced the market system more ambivalently. This is reflected in pervasive government intervention in foreign exchange and trade management as well as in the country's approach to negotiating commercial terms with foreign investors.

Despite the liberal foreign investment law, prospective foreign investors find it arduous and time-consuming to establish acceptable commercial terms with State enterprises and ministries. There are likely to be inconsistent and non-transparent outcomes. Some investors believe that more coordination of the Government machinery would improve the investment process. But the underlying problem appears to be a lack of an industry investment policy that would settle views among ministries and provide a route map of the terms and opportunities available to interested investors.

On balance, in current circumstances the *danger* is more likely to be realized than the *opportunity*. The present report reviews this situation and provides for a possible path towards grasping the opportunity. It sets out, in part I, with a description of the trends in economic activity against the background of Uzbekistan's reform objectives and growth of the private sector in the post-Soviet era. The role that FDI is now expected to play is reviewed and Uzbekistan's performance in attracting FDI is discussed. Investors' views of the country's strengths, weaknesses and opportunities are identified and reviewed.

Part II reviews the enabling legal regime for foreign direct investment, followed by an analysis of the specific standards that are set for foreign investors and of those generally applicable laws and policies towards business that will be of particular interest or concern to foreign investors. The incentives available to foreign investors are discussed. Attention is then given to the Government's operational arrangements which have been put in place to facilitate and promote foreign investment and to regulate its establishment. Finally, an overall assessment is made of the policy and operational framework.

Based upon the findings of this analysis, part III sets out ***ten recommendations*** for the Government of Uzbekistan to consider to improve the climate for FDI in order to further boost the country's attractiveness for FDI. The reforms are aimed at achieving regional best practice in order to establish Uzbekistan as the prime foreign investment destination in Central Asia. This ambitious goal would take at least two years to complete.

The recommendations address policy and administration concerning foreign investment entry; regulatory and tax policy; measures to improve the competitive provision of business services; and investment promotion issues.

CHAPTER I

NATIONAL OBJECTIVES AND COMPETITIVE POSITION

A. NATIONAL ECONOMY

1. Economic performance and reform

Along with the other CIS countries, Uzbekistan has suffered a decline in real GDP since the break-up of the former Soviet Union. However, the Government has managed economic reform very conservatively in order to reduce or at least slow this decline. This objective has been pursued with relative success. Uzbekistan's 1997 real GDP is projected by EBRD to be 86 per cent of its level in 1989 compared with 56 per cent in all CIS countries combined. Uzbekistan has also performed better in this regard than its regional neighbours in Central Asia (table 1).

There is wide disparity in independent estimates of recent and current economic growth in Uzbekistan. EBRD estimated that real GDP in Uzbekistan increased by 1.6 per cent in 1996 and by 1.0 per cent in 1997 and forecasts real growth of 2.5 per cent in 1998. A comparison with estimates for neighbouring countries suggests that Uzbekistan is being outpaced by Kazakhstan (moderately) and by Kyrgyzstan (significantly), while it is also possible that Turkmenistan began to significantly reverse its serious decline in 1998.

Table 1. Real GDP trends

Country/region	Projected (real) GDP 1997 (1989 = 100)
Uzbekistan	86
Kazakhstan	58
Kyrgyzstan	60
Tajikistan	36
Turkmenistan	51
CIS	56

Source: EBRD (1997).

The cautious approach of Uzbekistan to reform is reflected in its comparative ranking in EBRD's transition indicators. These indicators measure progress in enterprise privatization, liberalization of markets and trade and financial sector reform and development. Measured by these indicators, Uzbekistan has implemented less pro-market reforms than either Kyrgyzstan and Kazakhstan but more than either Turkmenistan or Tajikistan (EBRD, 1997, p. 14). In relation to private-sector share of GDP, Uzbekistan takes a centre-ground position among its neighbours, and particularly lags behind the much more accelerated market reform programme of the Russian Federation (table 2).

Table 2. Comparative size of the private sector, mid-1997

Country/region	Private sector share of GDP (per cent)*
Uzbekistan	45
Kazakhstan	55
Kyrgyzstan	60
Tajikistan	20
Turkmenistan	25
CIS	70

Source: EBRD (1997), p. 14.

* Rough estimates.

The very recent trend noted by EBRD is that Kazakhstan and Kyrgyzstan have maintained or perhaps accelerated the reform progress, including in the area of large-scale privatization which provides attractive targets for FDI, whereas Uzbekistan is reported to have slipped back.

This more cautious approach towards opening the economy to private ownership is likely to reduce the attractiveness of Uzbekistan to FDI in two ways. The first effect is indirect. The investment climate appears to be less congenial than would be presented in a more pro-market economy. The second effect is direct. Strategic enterprises, including significant export-oriented enterprises in the natural resources and utilities sector, are prime candidates for FDI, but these sectors have been substantially precluded as FDI targets in Uzbekistan. For Central and Eastern Europe as a whole, FDI arising from privatization accounted for almost 49 per cent of total FDI flows in the period 1989-1994 (UNCTAD, 1996, p. 6).

2. Economic structure and national development objectives

Uzbekistan's economy, particularly its export industries, is oriented towards commodity production. Uzbekistan is a leading world producer of cotton and gold, and is a significant miner and processor of non-ferrous metals and producer of natural gas. In 1995, 77 per cent of exports were raw materials (EBRD, 1997, p. 65). The manufacturing industry was selectively developed under the Soviet Union and was only to a limited extent based on further processing of raw materials. Only 15 per cent of cotton output is processed locally, although the petrochemical industry is rather more developed and automobile and domestic appliance manufacturing has recently commenced. The country's capital goods manufacturing includes agricultural machinery and aircraft engine production.

There is a strong feeling within the Government that the industrial structure which was applied to Uzbekistan whilst it was within the FSU overemphasized agriculture, and cotton in particular. In 1996, agriculture provided 23 per cent of GDP, 41 per cent of employment and 50 per cent of exports (EIU, 1997). The Government wishes to make a decisive change in this inherited pattern of economic activity and is strongly committed to the accelerated development of manufacturing. Accordingly, the Government's sectoral development priorities are, in descending order, manufacturing, mining and agriculture. Furthermore, the Government gives priority to investment that is export-oriented or import-substituting and does not encourage trading and distribution businesses.

B. OBJECTIVES, TRENDS AND PERFORMANCE IN RELATION TO FOREIGN DIRECT INVESTMENT

1. Foreign-direct-investment objectives

The Government is eager to attract FDI in support of its development priorities and is keen that there be active participation by national Uzbek entities in the operation of new or restructured businesses involving foreign investors. Interviews with Government officials gave a strong sense of official thinking as:

(i) During the Soviet era Uzbekistan was delegated the low value-added job of commodity producer and could not develop the technology or the skills for broad industrial development;

(ii) Industrial development must now be heavily promoted and FDI is an important vehicle for achieving a leap forward after long neglect of industry;

(iii) Participation by Uzbek business partners is required alongside FDI in order that the historic neglect of Uzbek industrial technology and skill development can be overcome; and

(iv) A range of incentives will be offered to foreign investors to encourage their participation.

The industry priorities of the Government for attracting FDI are:

- Further processing of commodities, including agricultural, mineral and hydrocarbon primary products;
- Manufacture of advanced technology equipment, including computing, tele-communications and aerospace;
- Manufacture of pharmaceuticals and medical equipment; and
- Tourism industry (FIA, 1998).

The Government's approach is therefore to selectively admit and encourage FDI in order to make up for deemed deficiencies in Uzbekistan's inherited economic structure.

This picture is consistent with the earlier summary of transition trends. Large-scale privatization (i.e. where Uzbekistan has established an industry) is lagging because the Government appears to place less priority on private investment where Uzbekistan has an established domestic industry. Private investment, in particular foreign direct investment, may be given most attention by the Government where it is responsible for ground-breaking industry development. This is not fully apparent from the standard tax incentives offered to investors but is likely to be reflected in forms of favourable treatment for individual investors (including exclusive market arrangements or simply a big head start). By inference there may be less consideration by Government of the benefits of FDI in improving the competitiveness of established domestic industry.

2. Foreign-direct-investment flows

Approximately 3,500 enterprises with foreign investment have been registered in Uzbekistan, of which some 1,700 are reported to be operational (FIA, 1998). The latter include some substantial joint ventures with major international companies (Daewoo, BAT Industries, Newmont and Coca Cola). However, in aggregate, Uzbekistan currently attracts very small flows of FDI in absolute terms, in relation to the size of its population and in comparison with the rest of Central Asia (table 3).

Table 3. Foreign-direct-investment inflows (net)

	1989-1996		1996		
Country/region	Total (Millions of dollars)	Per capita	Total (Millions of dollars)	Per capita	Percentage of GDP
Uzbekistan	156	7	50	2	1
Kazakhstan	3,067	187	1,100	67	5
Kyrgyzstan	147	33	31	7	2
Tajikistan	55	10	13	2	1
Turkmenistan	544	118	129	28	5
CIS	12,480	44	4,702	17	1

Source: UNCTAD, based on EBRD (1997), IMF, central banks and EBRD estimates.

The Government records much higher levels of FDI inflows, however. This is because the Government adopts a very broad definition of "foreign investment" which includes not only FDI as internationally understood, but also foreign credits to State enterprises (see box 1). Neither definition is inherently right or wrong but it is important to distinguish between them. This review is concerned with flows of FDI (in accordance with the international definition) which reflect the willingness of foreign business to commit to active equity

Box 1. Investment statistics

The Ministry of Macroeconomics and Statistics provided the UNCTAD/OECD team with the following statistics of recent and projected foreign investment (in millions of dollars):

	1994	1995	1996	1997*	1998*
FDI inflows	25	425	830	1,700	2,560

* Estimate/forecast.

Upon discussion of these statistics with the Ministry it became apparent that its statistics include foreign credits obtained by State enterprises to finance investment. Indeed these credits may make up the bulk of financial flows recorded by the Ministry as foreign investment.

The Ministry's concept of foreign investment differs significantly from the internationally accepted definition of foreign direct investment which excludes foreign credits to non-controlled entities. International agencies define FDI as "an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy . . . in an enterprise resident in an economy other than that of the foreign direct investor" (UNCTAD, 1996, p. 219; see also IMF, 1993).

investment in business in Uzbekistan and to bear the commercial risks entailed. Credits to State enterprises are ultimately a matter of lenders taking sovereign risk.

3. Sources of foreign direct investment

Uzbekistan does not profess any preferences among countries as sources of FDI. No information has been made available on the sources of the present stock of FDI. The flows of FDI for 1997 show that a considerable amount of investment is derived from emerging markets (table 4). Malaysia and Indonesia together accounted for one third of FDI in that year. The Asian economic difficulties may well reduce future levels of FDI, if 1997 is indicative of overall trends in geographic sourcing of FDI.

Investment sourced from Japan made a minor contribution in 1997. This is unfortunate as Japan is by far the largest investor in the Asian region. It appears that Uzbekistan has not yet established itself as a key destination for Japanese FDI. The United Kingdom and the United States were the only significant sources of investment from developed countries.

Table 4. Sources of foreign direct investment, 1997

(Percentages)

Region/country	FDI flows
Developed countries	**59.1**
United Kingdom	36.6
United States	10.5
Turkey	7.1
Japan	2.7
Israel	1.4
Switzerland	0.7
Germany	0.1
Developing countries	**37.0**
Malaysia	26.3
Indonesia	4.9
Korea, Republic of	3.3
Syria	1.6
Korea, Democratic Republic of	0.9
Other	3.4
EBRD	3.3

Source: UNCTAD, based on FIA, 1998.

4. Sectoral distribution and types of foreign direct investment

Foreign-direct-investment inflows have largely been concentrated on manufacturing activities and telecommunications (table 5). Investments in the primary sector which offer prime advantages are as of now untapped. Among the established or imminent foreign investments in Uzbekistan one can discern four types:

(i) *Strategic investments*: These investments are those which fit the strategic vision of both the Government and the foreign investor. For the Government, they establish a new or significantly improved industry and for the foreign investor they accord with a strategic plan to gain a prominent or dominant position in a new

Table 5. Sectoral distribution of FDI stock, 1997

(Percentages)

Sector	FDI stock
Primary sector	**1.8**
Agriculture	0.8
Oil	0.7
Secondary sector	**55.4**
Light industry	40.8
Chemistry	3.5
Food processing	2.9
Building materials	2.0
Tertiary sector	**43.2**
Telecommunications	36.1
Construction	4.1
Financial services	1.8
Other	1.2
Undisclosed	**6.2**

Source: UNCTAD, based on FIA, 1998.

market. Investments by Daewoo (in automobile assembly and component manufacturing), BAT (cigarette manufacturing) and Coca Cola (beverages) are investments of this type. These investments are selectively but strongly encouraged by the Government.

(ii) *International market investments*: These are investments for which the foreign investor has a range of potential host countries worldwide and will invest in those countries which offer the clearest advantages. Natural resource investments fall into this category as does the whole range of export-oriented manufacturing, commodity production and service opportunities. Uzbekistan has not yet attracted significant FDI of this kind. The Government has not geared itself to actively creating the conditions to attract such investments. There are likely to be industries, especially in the natural resources sector, where Uzbekistan does potentially offer attractive FDI targets.

(iii) *"Toe in the water" investments*: These are relatively small investments that are made by foreign investors (which may be substantial international companies) in order to test the investment climate and to gain experience. Such investments may be "spin-off" or value-adding ventures with established Uzbek industry. For example, Unocal is considering the addition of specialized facilities to produce lubricants from an existing oil refinery. The Government supports but does not strongly solicit such investments where they are seen to produce new products which can be exported or save imports. The Government is most unlikely to encourage such investments, including those proposed by major international companies, where they are essentially for domestic trade or distribution (see below).

(iv) *Small, trade and service-oriented investments*: Small-scale foreign investments, especially those which are formed to import and distribute consumer goods, are not favoured by the Government. Also, foreign investment in the service sector is not actively encouraged. In both cases there may be a reluctance to introduce competition to established State operators.

Where foreign investment entry is supported by the Government, foreign investors may be guided to form joint ventures with Uzbek State or private entities which may also retain preferential business opportunities.

5. Performance of foreign direct investment

It is much too early to judge the extent to which established FDI is having the impact desired by the Government on the local economy. With regard to the introduction of improved technology and skills some tentative observations can be made, however.

There is some evidence from the interviews that the "strategic investments" as defined above are introducing improved technology and also new skills to a motivated workforce. At least one strategic investor is actively planning to encourage its foreign suppliers to relocate to Uzbekistan and so introduce backward linkages. On the other hand some non-strategic investors are dissatisfied with the cost and quality of local supplies and services but have so far not taken proactive measures to bring about improvements.

The Government hopes that the formation of joint ventures will encourage the transfer of business skills. However, the evidence of the interviews is that local partners have been passive management partners and are relied upon more as contacts with Government.

Foreign direct investment does not appear to introduce more competition. The "strategic investor" notion tends to result in the entry of a single foreign investor into an industry. The strong guidance to foreign investors to form joint ventures with established State enterprises further restricts the likelihood that FDI will promote competition.

C. STRENGTHS, WEAKNESSES AND OPPORTUNITIES [1]

1. Strengths

Uzbekistan is, of course, regarded by foreign investors as an emerging market rather than a developed market and its strengths are viewed from that standpoint. The following factors were highlighted as Uzbekistan's strengths in interviews with established and prospective investors (see box 2):

Attractive natural resource endowment

Uzbekistan has attractive unexploited resources of minerals and hydrocarbons and attractive exploration potential for additional discoveries. The country has a clear strength in gold mining potential. However, its attractiveness for base metals mining is less clear. The Almalyck Kombinat which is the major base metals miner, reports low grades for its operating and undeveloped deposits. Uzbekistan also has significant upstream hydrocarbon development potential, especially for gas.

Uzbekistan also has abundant resources of land which is suitable for agriculture, however some areas are heavily dependent on irrigated water which may have a high economic cost.

Relatively large domestic and regional market

With a population of nearly 23 million, Uzbekistan is seen as presenting a sizeable market for investment in consumer goods and for services especially where distance or transport costs provide some natural shield from foreign supply. The interviews did not strongly identify Uzbekistan as a potential regional base for the provision of goods and services.

Box 2. The investors' view

The assessment of Uzbekistan as an economically viable and profitable, as well as politically stable environment for strategic investments was shared by all interviewed foreign investors. In addition, factors such as the country's abundance of natural resources, its favourable climate conditions, the absence of organized crime and the absence of excessive bureaucracy as compared to other CIS countries appear to have positively influenced investment decisions. Emphasis was also placed on the country's endownment with skilled labour, its highly literate population and the entrepreneurship of its populace.

In addition, individual investment decisions took into account the respective business environment, especially in the area of consumer products and services that were long neglected under the centrally-planned economy. Here, investors had (and have) a very positive outlook on future growth prospects in the country, including Uzbekistan's role as a potential export platform.

Educated, skilled and motivated workforce

Existing foreign investors in Uzbekistan are uniformly impressed with the levels of education and skills of the workforce and their high level of motivation.

Social and political stability

Uzbekistan is socially a highly stable country. There is a high level of ethnic homogeneity with around three quarters of the population being ethnic Uzbeks (EIU, 1998). There is also a high level of law and order and an absence of organized crime, all of which are regarded as very helpful factors by the foreign investment community.

There has also been a high degree of political continuity. Uzbekistan has not been subject to the abrupt and violent changes in government which have often undermined the investment climate in other emerging markets. Moreover, there is continuity in the leadership of the key ministries which deal with investors and that leadership is impressive and articulate in promoting Uzbekistan to foreign investors.

2. Weaknesses

The interviews were conducted principally with *established* investors or those which are well advanced in negotiations for entry. By definition, this set of investors would be less likely to pinpoint intrinsic weaknesses than *potential* investors which have identified weaknesses and accordingly stayed away (see boxes 3 and 4).

In interviews, geographic location was not strongly identified as a strength or as a weakness. On the other hand, the "man-made" weaknesses in public policy and management were almost uniformly, and often vehemently, identified by existing investors as significant weaknesses.

Geographic location

Uzbekistan is double landlocked which is a significant weakness for the development of hydrocarbons and base minerals for export and for any industry based on the processing of imported commodities for re-export. The Government has sensibly emphasised Uzbekistan's position as the crossroads between East and West implying an ability to supply either markets, and to benefit from being a linkage in trade between the areas. On the other hand, Uzbekistan can be perceived as being equally remote from the major markets of both East and West. Also the old patterns of overland trade which constituted the Silk Road have been largely overtaken by maritime and air transport.

Uzbekistan's dependence on other countries for overland transportation (road, rail and pipeline) is a significant current weakness for attracting FDI in upstream hydrocarbons and base metals.

On balance, Uzbekistan's landlocked position must be considered a weakness in attracting inward investment for global markets. To counterbalance this, Uzbekistan is a large and central country in the Central Asian region which is a potential strength. However,

Box 3. In the eye of the beholder: doing business in Uzbekistan?

Uzbekistan ranked the highest in terms of business interest among recently surveyed British companies that have not yet established business links there. Relative to the number of British companies that are already present in the country, however, Uzbekistan ranks only 4th among the Central Asian republics selected for this survey. Its ranks 3rd when put in relation to the number of companies that have established “good contacts” with Uzbekistan (see box table).

Box table

Country	A	B	C	C / A	C / B
Azerbaijan	71	73	205	2.89	2.81
Kazakhstan	180	171	268	1.49	1.57
Kyrgyzstan	58	63	225	3.88	3.09
Turkmenistan	42	57	180	4.29	3.16
Uzbekistan	111	96	282	2.54	2.94

Source: Information provided by the Confederation of British Industry.

Note:
A =Number of companies that are active in the country with existing investment or business
B =Number of companies that have established good contacts
C =Number of companies that are interested in business and / or investment opportunities

That Uzbekistan is being “outranked” by its immediate neighbours Turkmenistan and Kyrgyzstan in these two latter categories might of course be only a reflection of the largely untapped investment potential of Turkmenistan and Kyrgyzstan (as indicated in the low absolute levels of foreign business involvement in these two countries). However, it could also be a reflection of a more cautious approach on the side of investors, especially since the experience of business partners and / or competitors that have already ventured into establishing a business presence in a foreign country also count, *ceteris paribus*, in the investment decision-making of internationally active firms. This can take a more direct form, as is the case with “associated” FDI of suppliers and services companies that follow lead investors into a country (UNCTAD, 1995) (see also above, section B.5), but also expresses itself indirectly as the views of business partners and / or competitors form a crucial part of a country’s image as a business location abroad.

Box 4. Investors’ concerns

In December 1997, the Trade and Investment Committee of the American Chamber of Commerce in Uzbekistan undertook a survey amongst its members, aimed at documenting the daily operating problems faced by foreign firms currently operating in Uzbekistan, so as to be in a better position to apprise the Government of Uzbekistan of the concerns raised by the foreign business community. The survey, published in February 1998, identified several areas of immediate concern:

1. Currency convertibility and exchange regulations
2. Import contract registration
3. Restrictions on the use of funds in local bank accounts
4. Business registration and licensing
5. Bureaucratic culture and reprisals
6. Customs delays; and
7. Currency surrender requirements.

In addition, the survey highlighted some industry-specific concerns related to insurance laws, rules and restrictions; taxes; and barriers to investment in the natural resources sector.

the commercial relationship with regional neighbours has not been sufficiently developed to make this an actual strength.

Inappropriate economic controls

Uzbekistan is undergoing a significant financial crisis which is not being managed by modern policy tools. The Government has adopted an approach which results in restrictions on access to foreign currency and on imports combined with an overvalued official exchange rate.

This approach feeds through to perceptions of a difficult climate in which to conduct day-to-day business and raises longer term concerns about the ability to repatriate profits and service debt.

"Red tape"

Investors claim to have encountered excessive "red tape" and other delays which hinder the establishment of new investment, the conduct of ordinary business operations and reinvestment.

Government regulation is intrusive and changes in regulations are perceived as frequent and unpredictable.

Non-transparency

Investors believe that there is non-standard and non-transparent treatment of businesses in Government decisions. They also detect a degree of official corruption. Investors interviewed encountered several cases in which bribes were reportedly solicited by officials.

There is frequently a lack of clarity on the rules and how to comply with them.

There is a lack of credibility of official information. Examples of this include official information in relation to natural resource endowments and to the state of the nation's finances.

Cost and poor quality of essential business services

Many key business services are provided by State-controlled entities and these are perceived as being of high cost and poor quality. For example, it is reported in a publication widely read by prospective investors that the telephone call failure rate is 90 per cent and that line penetration is only 7 per 100 (EIU, 1998). An investor in the natural resources sector believes that development and operating costs in that sector are 10-15 per cent higher than in competing locations even before account is taken of conversion of foreign currency at the official exchange rate to pay local costs such as wages. Another investor reports the cost of chemical supplies and of basic printing and packaging which are supplied locally to be up to 100 times the equivalent cost in the home market.

3. Opportunities

Uzbekistan is presented with two strategic opportunities: the freedom presented by independence to develop industry in accordance with national advantage and the opportunity to become the preferred investment location in the region.

The preferred location for a regional market of 53 million people

Uzbekistan has the opportunity to become a production and service base for the wider regional market. It is central in the region and provides a relatively large home market. In addition, Tashkent has the opportunity to be the regional office for professional and trade service firms although Almaty is currently the preferred location. In the longer term one regional capital may develop as the key financial centre and capital market for the region.

This opportunity was very weakly identified in the interviews and there was no case of the regional market being a dominant reason for investing.

New freedom to develop in accordance with national interests

It is highly unlikely that the central planners of the FSU fully or correctly identified all the industries in which Uzbekistan has commercially attractive opportunities. Economic distortions and political considerations also had a bearing on identification and implementation of potential new investments.

In addition, Uzbekistan as an independent country now has the freedom to develop new export markets and to utilize new sources of supply of investment and advanced technology.

In interviews, a number of investors stated that they were attracted to Uzbekistan by the opportunity to be the first foreign investor in their area of business in the country. Pioneering investors have been attracted by the opportunity to establish a head start on competitors or to take advantage of particularly favourable niche opportunities as Uzbekistan emerges from the economic distortions of the FSU. These niche opportunities include the opportunity to supplant traditional sources of supply from the FSU and to apply new technology, for example to raise agricultural yields or to improve mineral extraction from difficult ores.

4. Overall assessment of current competitiveness and foreign-direct-investment trends

Uzbekistan has a substantial natural and human resource endowment and a relatively large population which provide a platform to attract higher levels of FDI than it has so far received. These strengths are not unique in the Central Asian region. Uzbekistan is not intrinsically a more attractive FDI destination than Kazakhstan in relation to all of these endowments. Other regional countries also possess substantial natural and human resource endowments.

Uzbekistan has the opportunity of becoming the preferred regional location for FDI due to its size and central location within the region. Again, however, it does not possess an intrinsic advantage over Kazakhstan in this regard.

The resource endowments of Uzbekistan are constrained by its remoteness and the expense of overland transportation of bulk commodity exports. These disadvantages are shared to a greater or lesser extent by other Central Asian States although Uzbekistan suffers in particular by being double landlocked.

The natural strengths of Uzbekistan are vitiated by weaknesses in the policy and administrative regime governing business. These weaknesses are major obstacles to accelerated FDI. They are also prevalent throughout much of the region and help to explain why there is as yet no clear "winner" among the Central Asian States as the preferred FDI destination. There is still an opportunity for Uzbekistan to become that "winner" if it chooses. Nevertheless, these weaknesses pose a real danger that the current under-performance in attracting FDI will persist or potentially weaken further, especially bearing in mind the significant sourcing of FDI from Asian countries which are experiencing economic difficulties.

Note

[1] This review is based substantially on interviews with existing foreign investors and the results of a survey of investor attitudes conducted by the American Chamber of Commerce in Tashkent.

CHAPTER II

POLICY AND OPERATIONAL FRAMEWORK FOR FOREIGN DIRECT INVESTMENT

A. POLICY FRAMEWORK FOR FOREIGN DIRECT INVESTMENT

1. The permissive framework

Foreign direct investment into Uzbekistan is governed by the "Law on Foreign Investments" and the "Law on Guarantees and Measures for Protection of Rights of Foreign Investors", both of 30 April 1998 (the "foreign investment law").[1]

The foreign investment law permits foreign investors to invest in any business activity which is not otherwise prohibited by legislation. There appear to be no business activities from which the foreign investment law, or any other law, precludes foreign investors in order to reserve such activities exclusively for national investors. There are a number of activities for which licences are required but these appear to be a standard list of areas involved with national security, public health and safety, natural resources, financial services and professional practice for which both local and foreign participants would need to obtain a licence.

Foreign investors may invest through the usual legal forms including the acquisition of real property, the establishment of branches and through shareholding in Uzbek companies. It is not a legal precondition of investment that nationals have any ownership interest except in banking where foreign ownership is limited to a maximum 49 per cent interest. In practice, the Government strongly favours joint ventures of foreign investors with local partners (see box 5).[2] Of the approximately 3,500 registered enterprises with foreign investment only 380 were majority-owned by foreign investors in 1996 (FIA, 1998, p. 10).

An Uzbek enterprise which is at least 30 per cent foreign owned and has a charter capital equivalent to at least US$ 300,000 is termed an "enterprise with foreign investment". The latter requirement has recently been reduced to US$ 150,000.[3] An enterprise with foreign investment is required to register with the Ministry of Justice in order to "obtain the rights of a legal person". The Justice Ministry is required to effect prompt registration.

Box 5. Local ownership policy

In an interview, Mr Makhudjon Askarov, First Deputy Minister of Foreign Economic Relations, said that the Government seeks 50/50 joint ventures between foreign investors and national partners. The Government views the significant equity stake for the national partner as ensuring full participation and acquisition of skills for the national partner. He sees FDI as not just about creating jobs; Uzbeks want to learn and be able to compete.

The foreign investment law thus provides a framework which appears to be substantially open for foreign investment in all forms and in all areas of business available to a national investor. The entry requirements appear to be straightforward, the performance requirements are minimal and investors are guaranteed the right of exit and fund repatriation.

The interviews conducted with investors suggest that in reality there is not a simple permissive environment for foreign investment. In practice, the Government is highly interventionist at the entry level for individual investors. This occurs in a process as follows:

1) Foreign investors will typically need to negotiate with the Government key matters, including the acquisition of existing State-controlled assets, joint venture agreements with state-controlled enterprises, the application of tax incentives and the right to import raw materials for manufacturing. The input of the relevant Ministries, including the Ministry of Foreign Economic Relations is both broad in scope and very detailed. The scope of these negotiations is well beyond the usual regulatory issues which concern Governments and is in part a reflection of the low level of privatization of the economy;

2) The foreign investment law has been supplemented with policy initiatives, principally tax measures, designed to encourage foreign investment. The prevailing sentiment encourages prospective investors to seek incentives;

3) Enterprises with foreign investment (the principal vehicle for FDI) are required to register with the Ministry of Justice. The registration procedure, while ostensibly a formal approval of documents by the Justice Ministry, is in fact the culmination of what amounts to a case-by-case approval of foreign investment based upon a prior negotiation of the depth and scope referred to above. The process is made quite explicit in the requirement that where the intended investment programme exceeds US$ 20 million the proposed enterprise with foreign investment cannot be registered unless approval is obtained from the Cabinet of Ministers. This accounts for the paradox that the Justice Ministry states that it can register an enterprise within days of receipt of correct documentation while the foreign investment community states that it takes many months, sometimes over a year, to "register" a foreign investment.

A major issue in the negotiation of a foreign investment is the valuation of assets contributed by the national partner. The valuation of State assets is based upon a formula applied by the GKI which appears to take insufficient account of wear and tear on assets or of market principles. This has become highly contentious among the foreign investor community and appears to be problematical throughout all sectors of interest to foreign investors (see box 6).

This is not to say that the de facto case-by-case approval is in place because Uzbekistan is anti-foreign investment. Quite the contrary is the case, as seen by the range of protections and incentives available to foreign investors. But the extent of prior negotiation required shows that the Government has very firm ideas as to the direction and profiles required from foreign investment, as noted in section B.1 above. In effect, the package of protections and benefits may only be available for those investments which the Government deems to be appropriate. The foreign investment policy appears not to be guided by market-economy principles.

The Government has been reluctant to privatize strategic enterprises including the major mineral and hydrocarbon producers and the utilities. Cotton farming may also be "off limits". The Government is more interested in promoting joint ventures in ancillary activities in which the dominant State enterprise enters into a partnership with a foreign investor which provides capital and advanced technology. Core State assets are in practice unavailable to foreign investors.

In a fundamental sense then, the current Uzbekistan foreign investment policy seeks to graft selected foreign investment onto the economy in designated industries and offers substantial protections and benefits to the selected foreign joint venture partner.

Box 6. Valuation of State assets contributed to joint ventures

Potential investor "A" in the natural resources industry stated that the Uzbek parties to the proposed joint venture were negotiating for a 50 per cent ownership interest based on their contribution of the assets from existing operations. The Government valuation is based on a formula followed by the GKI. In the view of "A" the contributed assets have a value to the joint venture far lower than suggested by the GKI valuation method. Further "A" has found considerable inflexibility in the application of the formula.

Potential investor "B" in the agricultural sector stated that the valuation undertaken by the GKI of State assets to be brought to the venture was one problem area which was causing protracted negotiations.

Investor "C" in the utilities sector believes that the State valuation of local assets in a joint venture is "totally out of line with economic reality".

Investor "D" in the industrial sector believes that the GKI approach yields valuations of State assets up to 5-6 times higher than the market value and seems to take no account of the concept of depreciation. This investor says that the GKI is inflexible and can hold up investments while other ministries concerned would like to proceed. Also the wish to obtain value for existing assets creates a bias against greenfield projects. The Government prefers to sell "old" State assets (in particular unfinished factories left over from the former Soviet Union); this is reinforced, according to this investor, by the fact that Ministers are directly responsible and accountable for selling off assets under their control, and non-working assets heavily affect their budget allocations.

2. Specific standards of treatment

The foreign investment law contains general guarantees of equal national treatment and further assurances of rights and protections on matters such as expropriation and profits repatriation which are of specific interest to the foreign investor. Among the protections is an assurance that new legislation which would worsen the position of foreign investments will not apply for 10 years after the investment is made (if otherwise, compensation will be made). Further it is provided that foreign investors can choose to adopt more favourable terms of any subsequent legislation.

It may not be clear to a prospective foreign investor who seeks to invest through ownership in an Uzbek enterprise whether certain protections, such as those against expropriation and adverse changes in legislation, apply to the enterprise or only to the foreign shareholding. In this regard there may be a distinction between an “enterprise with foreign investment” and other enterprises.

In the event of a dispute with the State there is recourse to national arbitration unless there is an agreement with the State which provides for international arbitration. Experienced foreign investors will want to have recourse to international arbitration in the event of disputes with the State. Major investors will want to know how willing the Government is to enter into agreements with foreign investors which provide for international arbitration and how readily judgements can be enforced. Uzbekistan has entered into bilateral investment treaties with 22 countries and has acceded to the ICSID convention.

Foreign investors will also want to know where the Government stands on permitting State enterprises to enter into meaningful investment contracts which provide for international arbitration. It has been suggested in interviews that the Government claims sovereign immunity for State enterprises in relation to the enforcement of arbitration awards.

The foreign investment law has several exclusive provisions (in article 12) for enterprises with foreign investment in relation to rights to import and export and foreign currency arrangements. Their intention appears to be to provide treatment at least as favourable as national treatment (although a provision on “Currency self-repayment” is obscure in the English translation).

There appears to be only one instance in which the foreign investment law provides less favourable terms than national treatment for enterprises with foreign investment, stipulating that where the chartered fund is not “formed” within a year of registration the company will deemed to be insolvent (article 28). This could appear threatening to a foreign investor and is not compatible with the spirit of the rest of the legislation. A previous provision which granted national shareholders the right to acquire the foreign investor’s shares, at “market price”, in the event of disposal (article 29) has been removed.

By implication, the variation from national treatment does not apply to other enterprises which, although they have some foreign ownership, fall outside the definition of an “enterprise with foreign investment”. These are likely to be smaller enterprises (with a charter capital of under US$ 150,000) but could also include very large enterprises which have less than 30 per cent foreign ownership. Presumably in the latter case it is assumed that the foreign investors are portfolio investors.

In today's terms, the foreign investment law provides most of the minimum assurances that a foreign investor would expect in relation to national treatment. There are no particularly advantageous provisions for foreign investors in the law, except for the 10-year guarantee against adverse legislative change, which itself is flawed (as discussed below).

Prospective investors are unlikely to be clear as to the status of small and medium-scale enterprises i.e. those which would not fall within the definition of "enterprises with foreign investment". For example, is an enterprise with a charter capital of US$ 100,000 and 100 per cent owned by a foreign investor covered by the guarantee against nationalization or covered by the 10-year stability provision? Or is such an enterprise to be treated exactly as one which is entirely nationally owned? In practice, the interviews revealed a strong Government dislike of small and medium enterprises, especially those which are involved in distribution and trading. Certainly the registration procedure is localized and erratic and there is no supportive environment for the establishment of small and medium-scale enterprises by foreign investors.

The interviews conducted sought to establish whether the treatment promised in the foreign law is being honoured in practice. There is ample evidence from the interviews that in day-to-day business foreign investors are treated at least as well as national private investors (although there is some suspicion that the tax authorities unduly target the "rich foreigners"). Certainly there is an absence of discriminatory laws. But "national treatment" is providing little comfort to foreign investors when the general standard of treatment of business is regarded as being poor (as discussed extensively below). Foreign exchange arrangements are a prime case.

The interviews revealed two guarantees in the law which the Government is in danger of breaching. The first is the guarantee on repatriation of profits which is being caught up in the general foreign exchange difficulties. Few investments have matured to the point of being able to pay dividends and the guarantees have yet to be put to a sustained test. Nevertheless, established foreign investors feel that there would be little chance of obtaining the foreign currency required to repatriate dividends. The Government has informally indicated that they would be wasting their time in applying.

The second is the 10-year stability provision which is well intentioned but problematic. From a Government standpoint it is very far reaching. It covers all foreign investments and appears to guarantee stability in relation to all areas of public policy except in relation to matters of national security. This ties the hands of Government for a very long time and invites difficulties. Already there have been difficulties with new taxes and increased rates of taxes[4] as established investors claim a right to retain the original arrangements. From an investor standpoint such an assurance is not of bankable value unless it is contained in an agreement with the State. The Government is understandably reluctant to enter into such agreements in all cases.

3. General standards of treatment

This section reviews generally applicable standards which are of particular interest and concern to foreign investors.

3.1 Foreign exchange arrangements

The som is not freely convertible to hard currency. It is heavily rationed by the authorities at an artificially high exchange rate in order to manage a balance-of-payments problem which emerged in 1996. It is not uncommon in emerging markets for the local currency to be readily convertible to hard currency for current account payments such as for imports while capital account transactions (investment and debt service) involving foreign exchange are subject to prior approval. The more progressive emerging markets are reducing the need for approvals for foreign exchange transactions and doing away with the practice of official setting of the exchange rate.

Uzbekistan has however regressed in its approach to foreign exchange arrangements:

- The exchange rate is set officially at what is widely regarded as a substantially overvalued rate;

- There is no assurance that foreign currency will be made available promptly to business for day-to-day operational requirements. Indeed, access is limited and highly uncertain; and

- The Government has made it clear that it has views as to the priority purposes for the allocation of foreign exchange. For example, consumer goods imports have a low priority. The Chairman of the National Bank told a 1997 London conference of investors that Uzbekistan did not want to "export gold in return for chewing gum".

The severe administrative rationing of foreign currency began in response to a currency crisis in 1996 and the Government has stated that it is temporary. Foreign investors in particular have been assured that foreign currency will be made available for purposes which the Government deems to be of high priority (such as to import production inputs and capital equipment). This has led to selective application of quarterly foreign exchange quotas which is highly disruptive to business, and appears to be discouraging the reinvestment of earnings (see box 7).

There is a partial foreign currency retention arrangement for exporters which remains one marginally liberal feature of the foreign exchange regime. Generally, retention accounts must be retained onshore. Such accounts are presumably helpful in ensuring foreign currency availability for imports (although imports are themselves subject to a registration procedure) and other foreign payments for those foreign investors which are in businesses which earn foreign currency. The foreign investment law also appears to provide that the export proceeds from selected industries engaged in "own production" may retain all their foreign currency receipts, net of taxes.

The overall foreign exchange regime has an impact on the investment climate beyond the consequences to those investors now in place. It reflects poorly on macroeconomic management competence (showing the Government as unwilling to address the root causes of the balance-of-payments difficulties). It shows the Government as preferring administrative controls to market realities. And the Government is seen as being willing to impose administrative burdens on investors in quite ordinary operational matters.

The restrictions on foreign currency convertibility unfortunately only serve to position Uzbekistan down market as an emerging market investment destination. More bluntly, they are a public relations disaster so far as attracting FDI to Uzbekistan in a wide range of industries is concerned.

Foreign investors in the mineral and petroleum industry have experience in carving out bankable foreign exchange arrangements in countries with severe currency inconvertibility. If world class assets are on offer they will not necessarily be deterred from investment if acceptable arrangements can be agreed. These will involve the right to retain export proceeds in offshore accounts under agreed reporting arrangements and to remit to Uzbekistan only that foreign exchange required for local costs and taxes (usually at least 50 per cent of gross proceeds). Arrangements such as these could be an extension of the principles governing the retention of export proceeds from own production.

Box 7. Business expansion and currency conversion

The issue of currency conversion has created obstacles for the expansion of foreign affiliate activities in the country that are to be financed from reinvested earnings.

For example, investor "A" launched its first two projects to reinvest earnings involving currency conversion in June 1996 (for a total of US$ 300,000). It took 29 months to complete this transaction, due to bureaucratic delays and changes in government regulation. According to the investor, the concept of an individual, case-by-case submission and approval process in contract registration and its subjective and non-transparent handling makes it in fact easier to repatriate profits (as guaranteed by the FDI law) than to reinvest earnings.

Investor "B" faced a similar problem in obtaining a currency conversion quota for imports of raw materials and capital goods. Again, the quota system, characterized by the investor as too bureaucratic and too cumbersome, limited the foreign affiliates' expansion plans that were based on strong demand and positive supplier inquiries. As a result, the investor deems the system to be encouraging the repatriation of earnings and discouraging reinvestments.

If the principle of offshore retention is not accepted there is international precedent to suggest that agreements providing specific rights of access to foreign currency are difficult and time-consuming to negotiate and are liable to break down and cause serious disputes. Peru discovered this in some celebrated cases in the 1980s.

3.2 *Taxation and tax incentives*

The principal features of the fiscal regime in Uzbekistan are set out below.[5]

(i) Tax on profits

From the introduction of a new Tax Code on 1 January 1998, the standard rate of profits tax for an Uzbek entity is 35 per cent except for a rate from 3 per cent to 20 per cent for agricultural enterprises. The standard rate is thus broadly in line with tax rates in the likely key home countries from which foreign investment will originate. Dividends, interest income and royalties received by an Uzbek entity are taxed at 15 per cent. There is no provision for consolidation.

The base for calculation of taxable income is not designed to be favourable to new investment. Depreciation rates are low and there is the unhelpful treatment of loss carry-forwards found elsewhere in the CIS. Such losses can only be deducted against a (mandatory) reserve build-up, and deducted from, historic taxable income.[6] This treatment increases the payback period for new investment which generates losses in the start-up period. In addition, there are certain restrictions on deductions for labour, entertaining, advertising and loan interest costs which would be seen as irksome, and potentially onerous, by foreign investors. Foreign exchange gains are taxable and in an era of high inflation and som depreciation this is likely to cause difficulty to some exporters.

There are very substantial concessions for investors, principally in the rates of profits tax, which directly or indirectly benefit foreign investors. The current concessions are summarized below.

(ii) "Production" enterprises with foreign investment

Uzbekistan has decreed specific profits tax concessions for industrial (as distinct from trading or service) enterprises which are enterprises whose output is at least 60 per cent of "own" production. Where such enterprises have more than 50 per cent foreign ownership they are taxed at rates of 16 per cent or 20 per cent depending on the size of the charter capital (although this concession may not survive the new Tax Code). There is also relief from tax on profit which is reinvested. Further, any industrial enterprise with more than 30 per cent foreign ownership which is included in the Foreign Investment Programme may receive a 7-year exemption from profits tax.

There is a specific incentive for initial foreign investment geared towards export or import-substitution. Newly established industrial enterprises with more than 50 per cent foreign ownership which produce exports or import-substitutes are exempt from income tax for the first two years of commencing production.

(iii) Other concessions

There are further concessions available irrespective of the nationality of ownership of an Uzbek enterprise. Several are likely to benefit foreign investors:

* Reductions in the standard rate of tax by 25 per cent and 50 per cent in the first and second years of establishment, respectively, provided the business is not commerce or an intermediary or procurement activity;

* Reduction in the standard rate of tax by 50 per cent if more than 30 per cent of revenues are from exports;
* Exemption from tax on profits related to increased export revenues. This incentive does not apply to traditional Uzbek exports such as cotton, hydrocarbons and minerals;
* 1-5 years exemption from taxation of profits from use or licensing of intellectual property rights; and
* Development costs (qualifying investments) may be immediately debited but not so as to reduce taxable profits by more than 50 per cent in the year. But, unhelpfully, unused deductions cannot be carried forward.

This menu of concessions, including those specific to foreign investors, are clearly targeted towards manufacturers, farmers and mineral producers and away from traders and other service operations.

The tax rates indicated above apply to Uzbek legal entities. It appears that, commencing from the adoption of the new Tax Code, those foreign investors who derive Uzbek taxable income through an unincorporated permanent establishment may be subject to a standard rate of 35 per cent.

(iv) Withholding taxes

The new tax code applies withholding taxes at rates which are broadly in accordance with current international norms. The principal standards rates are 15 per cent for dividends and interest, and 20 per cent for royalties, rents, lease income, management fees and other income.

The dividend withholding rate may be reduced to 10 per cent for any foreign shareholder which owns more than 10 per cent of an Uzbek company.

Relief is available under double taxation treaties in relation to dividends, royalties, management fees and contractor fees. Uzbekistan has concluded 12 double taxation treaties which include agreements with several of the key potential sources of investment. However, the Republic of Korea and the United States, and perhaps France and Malaysia are notable exceptions. The lowest rates (5 per cent for dividends, interest and royalties) have been set in the Uzbekistan / United Kingdom treaty.

(v) Customs duties

There has been incomplete information available for this review on rates of customs duty. It appears that *imports* from CIS countries in the free trade zone are duty free whilst a wide range of goods imported from other countries are dutied at 30 per cent. In some cases excise duties are applied to CIS imports which is unusual and rather against the spirit of a free-trade zone.

The application of duty rates of up to 30 per cent on capital goods and operating supplies represents a severe disincentive to export and import competing industries and runs counter to the other fiscal incentives designed to encourage these industries. Three concessions appear to be designed to mitigate this effect. First, the impact of import duties on *capital expenditure* costs is partially relieved by the exemption from import duty of contributions made to charter capital, a clumsy procedure which also applies elsewhere in the CIS. Secondly, the impact of duties on *operating items* would appear to be mitigated by the exemption for imports used for "own production" and for reprocessing for export. Thirdly, imports associated with projects exceeding US$ 50 million invested are permitted duty-free entry.

Import duties of 30 per cent are applied to a wide range of consumer goods. Presumably these are designed to have a protective effect but of course contribute indirectly to the overall cost of doing business in Uzbekistan.

Export duties apply to some raw materials and finished goods. Gold attracts a published rate of 20 per cent and most non-ferrous metals a rate of 40 per cent. Such rates would impose an impossible burden on investors seeking to produce these commodities for world markets and presumably relief is available. However, according to the Customs Committee export duties do not apply.

(vi) Value added tax and excise duty

Value added tax is applicable to most goods and services whether produced locally or imported. Exports, except those to other FSU countries, are zero rated. The standard rate of VAT is 20 per cent.

A very significant disincentive for investors is an inability to obtain cash refunds for excess input VAT or to offset the excess against other tax liabilities. In particular, VAT paid on the acquisition of assets is not refundable but must be added to the capital cost of the assets and depreciated. The introduction on 1 January 1998 of VAT on imports has worsened the position of investors in this regard.

Exports are zero rated except for exports to other CIS countries which is a strong disincentive to the expansion of intraregional trade. In the same manner, excise duties on exports are applied only on exports to CIS countries.

(vii) Employment-related taxes

The minimum rate of tax on personal income is 15 per cent and the highest marginal tax rate on personal income is 45 per cent which is applied to income in excess of 15 times the minimum wage. The personal allowance is equal to the minimum wage. These rates are within international norms as applied to the typical wage costs of Uzbek employees.

Expatriates are deemed to be resident if present in Uzbekistan for more than 183 days in a calendar year. For expatriate employees, for whom there are no special tax arrangements, the current tax scale results in the application of a 45 per cent rate to personal income in excess of the equivalent of approximately US$ 2,000 per annum. Thus equivalent levels of wage income are taxed much more heavily than in home countries. This will oblige employers to gross up expatriate remuneration in order to compensate for the additional tax burden in Uzbekistan or, more likely, to pay most of the remuneration offshore. These taxes boost the overall cost of expatriate employment quite significantly for those employers who fully declare expatriate remuneration in Uzbekistan.

Further, in accordance with the new Tax Code, typical expatriate concessions in emerging markets such as exemption from taxation on employer-provided housing, home leave and cars may no longer apply.

Employers also have significant payroll tax requirements for pension fund and related contributions which amount to an additional 40 per cent cost on top of wage costs. However, employers are exempted from the bulk of these contributions on behalf of expatriates.

(viii) Property tax

Property tax is levied at a rate of 4 per cent on the book value of fixed assets and intangibles of legal entities. Unlike in other jurisdictions in the CIS, property tax can be deducted for profits tax purposes.

Foreign investors may benefit directly or indirectly from concessions. All newly formed enterprises which undertake new investment are exempt for the first two years. And any Uzbek legal entity which attracts more than US$ 500,000 of foreign investment to its charter capital is exempt.

(ix) Road user tax

As in other CIS countries a road tax is applied. In Uzbekistan the rate is 1.2 per cent of turnover (0.4 per cent for trading companies). The rate of this tax has increased twice in the last two years.

(x) Other taxes

Other taxes include a tax on land and on water use (both taxed on established rate schedules) and a recently introduced environmental tax which is set at 1 per cent of production cost. As a form of property tax, land tax is waived for the first two years of establishment of an industrial enterprise with foreign investment.

Local authorities benefit from property and land tax, although the rates are set by the national authorities. In addition local authorities have rights to impose a limited range of minor taxes.

(xi) Sectoral tax policies

Certain sectors have specific provisions which vary their fiscal treatment from that described above.

Tourism investors in key cities qualify for a reduced rate of profits tax for the first three years after establishment and other concessions.

Agricultural enterprises can obtain a concessional sliding-scale rate of tax on profits of 3 per cent to 20 per cent depending on their level of profitability.

Banks are subject to the standard rate of 35 per cent tax on profits and apparently do not benefit from any other concessions available to enterprises with foreign investment. However, banks have received complete exemption from tax on profit, property, land and road use since 1994.

Mineral resource producers are subject to royalty-like taxes on natural resource use and for natural resource replenishment. Applicable rates, applied to sales value are set out in table 6.

Table 6. Mineral royalty rates

Payment for use	Rate (per cent)
Gold	7
Other metals	n.a.
Oil	17.5
Natural gas	26.4

Source: FIA, 1998.

In combination with the road user tax and the environment tax some of these royalties may be high by international standards, especially those for gold and base metals. However, royalty rates are likely to be negotiable.

In addition to the above sector-specific taxes and incentives, high priority industries which are included in the *Foreign Investment Programme* could qualify for incentives such as a 7-year exemption.

It is probable that the Government has granted additional incentives to individual high-profile or high priority investors. These incentives are negotiated with investors by the Ministry of Foreign Economic Relations, supported by the Tax Committee. From 1998 all special arrangements must be ratified by the Parliament.

(xii) Fiscal regime: overall impact

From the standpoint of a prospective investor the overall fiscal regime could be assessed as follows:

1) The rate of profits tax is reasonable by international standards. However, the tax base does not adequately encourage new investment due to the poor treatment of loss carry-forwards and the unattractive rates of depreciation (especially in an inflationary environment). The restrictions on deduction of labour and other costs are not rational, although similar to practice elsewhere in the CIS.

2) The structure of business taxation is burdensome to business due to the application of significant taxes on assets, turnover and production costs rather than on profit. The lack of a refund system for excess VAT exacerbates this problem, especially for new investors. Moreover there appears to be increasing resort to this type of tax. This creates a strong deterrent to business which competes internationally by exporting or producing import substitutes and especially where these are low margin / high volume businesses.

3) However, the standard fiscal regime appears to apply to few investors in view of numerous and significant concessions which appear to be available on application and the prospect of further concessions to major investors upon negotiation.

4) In reality, it appears difficult for an investor at the outset to judge what the overall fiscal sharing with the Government will be for any proposed investment. The fiscal package itself will depend on the applicability of known incentives, the ability of the investor to negotiate additional entitlements and the volatile ongoing nature of tax policy. Moreover, the Government share of the cake comprises two elements in reality: the fiscal package (which may entail the giving of a number of incentives) and the level of enterprise ownership for the State partner. Business views the latter as based on inflated values of contributed assets (which can involve a considerable free “take” for the Government). These parameters are effectively established on a case-by-case basis after considerable negotiation of give and take.

5) There is a bias in the fiscal regime against small and medium-scale enterprises and an especially strong bias against service, trade and distribution businesses.

From a host country standpoint some important issues are presented:

1) A proliferation of fiscal incentives and individual deals is taking place with little systematic consideration of their costs and benefits. The coherence and integrity of the fiscal regime is breaking down. Better targeting of fiscal incentives is needed, based on a revised business-friendly general fiscal regime. The Department of Macroeconomics and Statistics does not keep records of the tax revenues actually paid by foreign-owned enterprises which have been established. Nor does it have a considered view of how much potential investment is lost because prospective investors have not been sufficiently motivated or persistent to negotiate satisfactory arrangements.

2) The apparent high valuations sought for State assets contributed to joint ventures may be a means of recouping revenues foregone through tax concessions. These valuations have become a fiscal device. It needs to be considered whether these are an appropriate fiscal device.

3.3 Trade policy

Uzbekistan’s import regime is highly restrictive and bureaucratic. Import contracts must be registered. The respective registration procedures appear to change frequently and are difficult for many business people to comply with. These appear to be part of a concerted programme by the Government to slow down the import of goods which it regards as non-essential.

There are also quotas on the export of selected products of importance in Uzbekistan, including certain ferrous and non-ferrous metal products, crude and refined petroleum, and cotton fibre and lint.

Enterprises with foreign investment are entitled to export “products of their own production” and to import “products for their own needs” provided such products are approved by the Government. This is intended as a concession to foreign investors but actually speaks of a highly restrictive approach to a fundamental requirement of business. The concession specifically excludes other forms of foreign investment and all other businesses which act as service providers and suppliers.

Uzbekistan applied to join the World Trade Organization (WTO) in 1995, but has yet to begin the accession procedures (i.e. until mid-1998 the initial memorandum on the Foreign Trade Regime had not been submitted). The process of conforming to WTO rules which bear on rates of duties, the efficacy of customs administration, the freedom to export and import and foreign currency arrangements would require significant liberalization that would also be highly beneficial to the investment climate. It will not only improve the investment climate but provide the comfort of long-term stability of more liberal arrangements.

3.4 Competition policy

With so much of the economy still owned by the State, Uzbekistan is still developing its competition policy.

It appears that the generation of free competition is a low priority. In law there is almost no restriction on the ability of foreign investors to compete with other national businesses or each other. In practice, foreign investors are guided towards forming joint ventures with existing (usually State-owned enterprises). It is quite possible that certain foreign investors have been given exclusive market rights.[7]

The investor interviews point to a significant level of restrictive practice with favouritism to Government ministries which still have influential business functions. There is a high level of restrictive practice in commercial banking and insurance industries which is designed to give a business advantage to State institutions.

3.5 Company and other commercial law, including accounting and reporting standards

Uzbekistan has adopted a company law which provides for the formation of open and closed joint stock limited liability companies and for the relevant rights of shareholders.[8] Legal provision has also been made for general and limited partnerships.[9] Interviews raised no issue with these laws and foreign investors have not had the problems with breach of shareholders' rights which have been much publicized in other CIS countries.

New accounting rules were introduced in 1995 and 1996.[10] Uzbekistan is generally reckoned to be ahead of other CIS countries in the adoption of an accounting law and accompanying regulations which embody certain internationally accepted accounting principles such as "going concern" and the accruals principle. More importantly, it has achieved the separation of financial accounting from tax accounting under the revised production cost regulation as a crucial step to eventually adopting international accounting standards. However, the problem of company arrears has prevented the complete implementation of the accruals principle. Enterprises with large "accounts receivable" which are not collectable are still on a "cash" basis. Uzbekistan has also adopted new formats for financial statements which are more familiar to western investors. Lastly, eventual adoption of international accounting standards will not solve the asset valuation problem. International accounting standards permit the historic cost method to value fixed assets, but they also require assets to be written down for obsolesence or impairment. Also depreciation lines should be in line with the useful lives of the assets (CIS countries have normally used extremely low rates). However, asset valuations even if adjusted using international accounting standards will not necessarily produce a realistic "market" valuation which cannot be done based solely on accounting.

Open joint stock companies are required to publish their annual financial reports.

3.6 Expatriate employment

Uzbekistan has a liberal approach to the employment of non-citizens in the sense that there appear to be no direct measures to limit the ability of foreign investors to hire expatriate staff. There are no explicit twinning or localization programmes. However, there is (perhaps as a corollary) little mitigation of the tax burden faced by companies in the hire of expatriate personnel as discussed in section 3.2 (vii) above.

3.7 Protection of intellectual property and trademarks

Uzbekistan has enacted laws on patents and for the protection of copyright and trademarks and is a party to relevant international bodies and conventions. Uzbekistan's perceived commitment to these protections would be strengthened by membership of WTO.

Uzbekistan sees foreign investment as an important vehicle for introducing new technology and firm adherence and enforcement of these protections will be necessary to attract foreign investment which embodies advanced technologies.

No concerns about enforcement of intellectual property rights were noted in the interviews with existing foreign investors. The interviewees noted some reluctance however on the part of the Government to approve the import of advanced (and therefore expensive) equipment in preference to equipment produced domestically.

3.8 Environmental protection

Uzbekistan as a newly independent nation inherited some very serious environmental problems including the internationally known problems of the Aral Sea.

It is understood that environmental rules are strict but are not necessarily applied.

In interviews, existing and prospective foreign investors noted an expectation by the Government that new joint ventures formed from existing State industries would rectify existing environmental problems. This in practice tends to mean that the cost will fall on the foreign partner which is providing the new venture. Further, this policy can be an open-ended liability which a foreign investor would be reckless to accept.

There is also a tendency for the Government to hold foreign investors to higher environmental standards than local (usually State-owned) enterprises. This is disappointing for foreign investors but not a discouragement as all serious foreign investors are aware that they will in any case be held to high environmental standards by their shareholders and lenders and by international pressure groups.

3.9 Health and safety standards

Existing foreign investors have noted in interviews that the legal standards to protect the health and safety of employees and the public are high but are not consistently enforced on Uzbek national enterprises. Enterprises with foreign investment may quite rightly be held to proper standards and although quite consistent with the law there can be, as on the matter of environmental protection, an element of double standards. It was also noted in the interviews that there is a need to modernize the detailed regulations on standards to take into account more modern technical solutions which foreign investors can provide.

B. ADMINISTRATIVE PROCEDURES AND PRACTICES

1. Entry process

The formal entry procedure for foreign investment is deceptively simple. Registration as a foreign investor appears to be required only if the investment takes place through an enterprise with foreign investment. State registration of an enterprise with foreign investment takes place at the Ministry of Justice (at the national level where the charter capital exceeds US$ 500,000; otherwise at the regional level). This procedure is based on submission of formal legal documentation. In principle, registration cannot be refused if that documentation is in order. In practice, State registration is the culmination of an investment negotiation with the ministries concerned.

Where the intended investment exceeds US$ 20 million the approval of the Cabinet of Ministers is required as a further precondition of State registration.

In effect, case-by-case approval by Government is required for FDI of any significance.

The process of approval is cumbersome and protracted, almost open-ended, and requires a great deal of effort between the inception of investment negotiation to final approval. The interviews conducted suggest that Uzbekistan now compares unfavourably with Kazakhstan, the principal regional competitor for FDI, in relation to ease of entry. On current trends, this is likely to worsen in the future.

In interviews the foreign investment community identified a number of problems which underlie the difficult entry approval process:

- It is necessary to negotiate with a number of ministries which are not necessarily fully coordinated;
- There are significant differences in view between the different ministries which can lead to rivalries and “turf battles”;
- There is little delegation of authority to make decisions, resulting in an overloaded top echelon of decision makers;
- The Government has adopted non-commercial views on matters such as asset valuation;

- There is unfamiliarity and impatience with the commercial and legal provisions of investment agreements which are required by foreign investors to be of international standard and there is needless dispute on standard provisions; and

- In some cases, bribes are solicited.

No doubt the prospect held out to significant investors that special tax and other arrangements can be negotiated has also contributed to these difficulties in the entry process. (Box 8 summarizes the difficulties which have been encountered by one prospective investor.)

Box 8. Entry process

A prospective investor has been negotiating an investment agreement for more than 18 months. Negotiations have been prolonged on matters such as the valuation of State assets, management control, and the stabilization of key commercial terms through an agreement with the Government. The investor believes that the process is complicated by the centralization of decision-making — "there are only one or two decision makers in the entire Government".

The key coordinating role is undertaken by the Ministry of Foreign Economic Relations. Investors will deal extensively with the relevant line ministry (which may have commercial as well as regulatory functions) and with the GKI when State asset sales are involved. The Foreign Investment Agency is expected to play a facilitating role. Significant prospective investors may receive extensive high-level political attention, including a meeting with the President, and the commencement of negotiations based on a memorandum of understanding with the Government.

There is no suggestion that the difficulties in concluding entry negotiations are caused by lack of attention or application by the ministries. On the contrary, key officials are overworked.

It seems entirely possible that the entry process will become even more difficult in the immediate future. In the face of severe currency exchange restrictions and administrative intervention in trade, prudent investors will be strongly motivated to negotiate assurances of trade and currency access as a condition of investing. These “carve outs” are likely to entail very demanding entry negotiations.

Further, some experiences of existing investors show that the tax system is volatile and the assurances of 10-year stability cannot be taken for granted.[11] Indeed more than one established investor has found it not wise to assume that published incentives will automatically apply if the criteria are met, although a reading of the legislation would suggest otherwise. One interviewee has suffered tax penalties for a faulty assumption that a tax holiday applied. Future investors may well want to nail down the applicable incentives and assurances more firmly. This will further complicate the entry process.

2. Investment promotion [12]

Investment promotion is spearheaded at a high level within the Government. The Prime Minister and Minister for Foreign Economic Relations, the Chairman of the National Bank, the head of the FIA and very senior officials of the line ministries travel overseas regularly to meet investor groups and make themselves available to meet business delegations visiting Uzbekistan. The investor conferences held abroad and the organized visits to Uzbekistan by business delegations are well attended and well received due to the high level support they receive within the Government. These events are used to expose prospective investors to broad opportunities and those investors which show interest in major or innovative projects receive ongoing encouragement from senior Government figures.

Selected investors come to be regarded as strategic investors and receive continued high-level contact. Generally, however, investment promotion efforts are not supported by the presentation of highly focused and tightly structured investment opportunities. Investment promotion becomes reactive once initial positive contact is made. It is left up to the interested investor to propose terms. One exception has been the calling of tenders for gold-mining properties.

The FIA is dedicated to facilitating foreign direct investment but is unable to provide support to foreign investors in a way which overcomes the daunting policy weaknesses which they perceive in the investment climate. An important future role for the FIA will be to contribute a foreign investor dimension to economic and commercial policy development within the Government.

The investment promotion literature is poor. A number of Government agencies have published investment guides. These are meant to be helpful but are sub-standard, at least in the English versions. Unfortunately, none of the major accounting firms has published a guide to doing business in Uzbekistan. An English language guide was published by OECD in 1994 but, inevitably, there have been significant changes in laws and regulations since that time. A very useful general guide in English was recently published by the Confederation of British Industry.[13]

3. Administrative regulations

The foreign investment community finds that the regulations affecting business operations are frequently and abruptly changed with little notice and no consultation. Sometimes they are not well thought through. They can also be administered in an inconsistent and arbitrary manner, sometimes accompanied by requests for bribes by lower-level officials.

There is a tendency to use administrative requirements to pursue unrelated policy objectives. For example, some investors suspect that the import inspection procedures are designed to slow down the importation of goods which the Government believes are low priority. As another example, it is understood that enterprises with foreign investment are required to pay lease rental for land in Tashkent either in local currency or in hard currency, or in a combination of local currency and hard currency, depending on the extent to which revenues are in local or hard currency. Presumably this rule is intended to support the official currency market. For business, it adds to compliance costs and concerns.

C. POLICY COHERENCE

The Government has an evident desire to attract FDI to Uzbekistan. This is apparent from the lack of legal restrictions on foreign investment, the commitment of senior Government figures to promoting Uzbekistan abroad and the well-meaning fiscal incentives that are made available. The priorities of the Government are to attract private investment to export-oriented and import-replacement industries and special importance is placed on investments that introduce advanced technologies and / or pioneer new industries.

The results have so far been mixed and there is strong evidence that individual policies either fail to support the Government's objectives or in some cases actually work against these objectives.

First, the objective of attracting foreign investment is, to an undue extent, attenuated by the Government's own caution towards private investment and market economy principles. This is manifested in policies which retain a large commercial role for ministries and State enterprises and regulatory practices which are highly intrusive in normal business transactions such as imports. It is also seen in the Government's indifference to small and medium-scale enterprises especially those in trade and services which are seen as parasitical rather than as complementary to priority investments.

The recent management of the currency and trade has been a rather stark illustration to investors of the Government's policy instincts. For most investors it has greatly increased uncertainties and reduced commercial freedoms and has thus cut across the Government's intentions of creating a supportive investment climate.

Secondly, a number of individual policies are at odds with Government objectives and sometimes with one another including:

* The fiscal incentives for investment in export and import-competing industries are offset by the maintenance of an overvalued currency at official rates.

* The Government's unrealistic approach to fixing the value of assets contributed to new joint ventures is inconsistent with its willingness to give up revenue via fiscal incentives for the same transactions.

* The structure of taxation is not in line with objectives. In particular, aspects of profits taxation and the application of import duties and the treatment of VAT on capital goods are a burden on new investment. Further, the resort to taxes on assets and revenue tends to undermine the goal of encouraging investment for export and for import replacement.

Thirdly, the general welcoming tone for foreign investors is not adequately supported by settled and announced policies which enable investors to understand the terms and conditions which will apply in their industries. The resulting case-by-case approach can bring forward unreconciled policies from individual ministries and create an extended and difficult entry process for foreign investors. Thus the warmth of the welcome for foreign investors is often not matched by the ease of entry.

D. OVERALL ASSESSMENT OF POLICY AND OPERATIONAL FRAMEWORK

The principal findings of this review of the policy and operational framework are:

1. In law, Uzbekistan is substantially open to foreign investment but, in practice, prospective investors encounter substantial entry difficulties.

2. The foreign investment law contains important assurances of protections and rights to the foreign investor. However, the "guarantee" of no adverse legislative change overreaches.

3. The broad principles contained in the law on foreign investment are on the whole adhered to. For example, foreign investors do receive equal treatment with Uzbek nationals under the law. Indeed, foreign investors may receive in several respects better treatment than nationally-owned private sector entities. Investors state, however, that there is less consistent adherence to the specific commercial terms of agreements which they make with Government-controlled entities.

4. While the law on foreign investment is broadly adequate, the policies and practice in relation to foreign investment are poorly developed. There is excessive reliance on a case-by-case approach to the entry terms for foreign investors. This is in the context of a government system in which there is relatively little delegation of authority or willingness to take initiative at middle level.

5. There is a lack of standardization of key commercial terms governing foreign investment. Combined with the predilection for case-by-case negotiation of investment terms, the entry procedures impose substantial burdens on negotiators and decision makers within Government. This inevitably slows down the process of investment approval and can quite easily lead to inconsistent treatment among investors and a perceived lack of transparency in the process of settling investment terms.

6. There is a proliferation of incentives, which may be partly in place to overcome other deficiencies in the tax code and other aspects of commercial arrangements. Nevertheless there appears to be little analysis of the costs and benefits of such incentives in terms of attracting investment. Furthermore, the wide range of such incentives invites application for further incentives and exacerbates the problems which arise from the scope of the case-by-case process including delays in concluding entry terms and lack of consistency.

7. There are important commercial issues which are slowing and possibly deterring the inflow of FDI and which require review by the Government. The most persistent difficulty concerns the methodology of valuing State assets which are contributed to new ventures involving foreign investment. Other reported issues include a reluctance of the State partner to cede management control and in some cases a lack of clarity as to the responsibility for historic financial and environmental liabilities. Large potential investors report difficulty in securing bankable terms in relation to foreign exchange, taxes and contractual stability of such arrangements.

8. There has been some success in attracting flagship investors who are in a favoured position, and who may attract investment from suppliers. These are principally those with a strong strategic reason for locating in Uzbekistan. Other potential major investors are doing experimental investments or have deals on a caretaker basis. The natural resources and tourism sectors have not attracted FDI to their full potential. On the other hand, small and medium-scale investments have a lukewarm welcome, and are made to appear quite unwelcome in the trade and distribution industries. They do not seem to be regarded as complementary to investment in the primary and secondary sectors.

9. Uzbekistan has not sufficiently differentiated its investment policies and practices from those of other countries in the region. There is an opportunity to do so and probably the necessity to do so if Uzbekistan is to maintain an appropriate share of investment flowing to the region. It does not have outstanding natural advantages compared to other regional countries. It is stable but so are most other regional countries; it has a large population but so does Kazakhstan; it is central but no more so than some other countries.

10. There is a lack of market orientation in the Government's approach to economic management. This is reflected in many areas of Government economic decision-making which affects business including restrictions on imports, restrictions on access to foreign currency for business purposes, the relative neglect of small and medium-scale private investment, the slow pace of privatization and the associated lack of competition or appropriate regulation in the provision of key services, and the administrative valuation of business assets. Ultimately, the Government takes a highly centralist view about the types of transactions which are good for the economy and applies a selective approach to the commercial sector, including foreign investors, on the basis of this view.

Notes

[1] The new foreign investment law of 30 April 1998 replaces, but substantially continues, the legal regime for foreign investment which was first enacted on 5 May 1994 and amended on 23 September 1994, 6 May 1995 and 30 September 1997.

[2] Any enterprise with at least 30 per cent foreign ownership is regarded as an "enterprise with foreign investment". One which is wholly owned by foreign investors is termed a "foreign enterprise". One which is less than 100 per cent foreign owned is termed a "joint venture".

[3] Prior to November 1996 a lower threshold of 10 per cent foreign ownership applied.

[4] The road user tax and import duties have both increased in the last two years; new taxes in the form of VAT and a pension fund levy have been introduced since 1997.

[5] For a more detailed summary of applicable taxes refer to the *Uzbekistan Taxation Guide* dated September 1997 that was prepared by Coopers & Lybrand and presented at the November 1997 London conference on "Doing Business in Uzbekistan". This summary, but not the comments thereto, draws on the Coopers & Lybrand report.

[6] The ability to build up a reserve from taxable income may apply only to enterprises with foreign investment and there are restrictions on the amount of tax relief.

[7] The Economist Intelligence Unit's 1997/98 country report states that UZBAT was granted a 5-year local cigarette production monopoly (EIU, 1997).

[8] Law on Joint Stock Companies and Protection of Shareholders Rights of 26 April 1996, as amended on 27 December 1997.

9 Law on Business Companies and Partnerships of 9 December 1992, as amended on 23 September 1994 and 30 August 1996.

10 Law on Bookkeeping of 30 August 1996.

11 It may not be clear to investors whether the 10-year stability guarantees apply only to the specific provisions of the foreign investment law or to a much wider context. Fiscal incentives which are subsequently amended are especially problematical because some were granted to investors by decrees made pursuant to the foreign investment law rather than the tax code.

12 A detailed review of investment promotion has not been made. A major project supported by EC-TACIS is under way to support foreign investment promotion.

13 Confederation of British Industry (1998). *Doing Business in Uzbekistan* (London: CBI).

CHAPTER III

POLICY OPTIONS AND RECOMMENDATIONS

A. A WAY FORWARD

Uzbekistan's current economic model makes it highly unlikely that it will maximize the flows of broad-based investment from abroad. An economic philosophy which only selectively favours private investment cannot ultimately be seen by outsiders as pro-foreign investment, even if particular foreign investors are treated well. The Government has a clear view about the economic development model which it wishes to pursue in the medium term but equally should recognize that the consequence is a distinctly suboptimal foreign investment policy in terms of the levels, and possibly also of the economic contribution, of FDI.

To a significant extent other regional Governments are also following a cautious approach to the introduction of market reforms. These are the natural competitors of Uzbekistan for FDI. It is recommended that the Government therefore identify the opportunities within the present economic model for adopting regional best practice especially on matters which impact those industries where it is actively seeking FDI. In other words, where can Uzbekistan, within the ambit of the current economic models in Central Asia, clearly adopt better policies and procedures than its neighbours? Uzbekistan has the opportunity to be "better than the rest" and thus differentiate itself from its neighbours as the best place to do business in Central Asia.

There are three obvious instances where Uzbekistan is at the forefront in the region, namely in respect of:

- The liberal provisions of the FDI law;

- National treatment of established foreign investors; and
- Reform of the accounting system. In the latter regard Uzbekistan has recently been described as the "golden boy" of the region.[1]

Views such as that expressed on the accounting system are very positive for the investment climate. But there are still many areas where Uzbekistan is far from being the best and indeed has a poor reputation. There is an opportunity to change this.

B. AN AGENDA FOR CHANGE: TEN PRINCIPAL RECOMMENDATIONS

Ten principal recommendations are set out below for change in the policy and machinery of Government to improve the FDI regime. They should be implemented in a manner which adopts at least the best practice in the Central Asian region.

It is of fundamental importance that the FIA takes the lead in ensuring that the foreign investment dimension of recommended reforms be taken fully into account. The FIA should be proactive in working with the line ministries as well as ensuring that the foreign investment community is consulted as policy is developed.

POLICY AND ADMINISTRATION CONCERNING FOREIGN INVESTMENT ENTRY:

(1) Develop and announce clear industry policies and standardized investment terms through **(a)** *development of policy statements for each key sector, and* **(b)** *preparation of model investment contracts for applicable sectors*

Prospective investors perceive the likely terms of investment to be something of a vacuum at the outset and a minefield once negotiations have commenced.

There are far too many open questions which the Government currently settles by negotiation on a project-by-project basis. This approach causes lengthy entry negotiations bedevilled with unsettled, obscure, differing or inflexible positions among ministries. The eventual outcomes lack transparency and possibly consistency of terms and may, therefore, form bad precedents.

The underlying cause of this problem is a lack of full development of industry investment policy by the Government. As a consequence there is both inadequate guidance to investors on an industry-by-industry basis and delay and indecision on the part of Government officials who are responsible for approving investments. The existing general legislation (such as the foreign investment law) and the occasional announcement of tax incentives and priority industries is not sufficient guidance to investors as to the terms that can be expected from investment in a particular industry.

The policy statements will, for each industry or sector, take into account and settle the various ministries' views and interests in line with Government objectives. They will set out authoritative and standardized terms and conditions for investment in each industry. If well prepared they would be of major benefit in smoothing the entry process.

Part of the problem is a lack of appreciation of the reasonable requirements of foreign investors in specific industries. This is certainly a factor in the apparent under-investment in sectors which should contain attractive opportunities for foreign investors. A second benefit of the preparation of industry investment policy statements will be the opportunity for the Government to consider in an international context the requirements of foreign investors.

The third benefit of the preparation of industry investment policy statements is that they will become one of the essential tools for future foreign investment promotion.

The issues to be covered in such investment policy statements would include:

- Statement of Government objectives;
- Fiscal arrangements, including special features, if any, applicable to the sector;
- Foreign exchange arrangements, including special features, if any, applicable to the sector;
- The regulatory framework for the industry;
- Investment terms applicable to foreign investors, including:
  * particular rights and protections available with reference to the sector;
  * modus operandi with established operations (competition versus partnership);
  * management control and shareholder relationships in joint ventures;
  * exit provisions;
  * the mechanisms for achieving Government objectives (forbid unacceptable terms or encourage desirable outcomes);[2]
- Operating terms, including:
  * rights to export and import;
  * access terms for key inputs, including land and utilities, and freedom to buy outside the State sector;
  * employment and social obligations.

In a number of cases it should be possible to supplement the policy statements with model investment contracts. This approach is, for example, adopted quite widely in other countries in the area of mineral and petroleum exploration and development. These will introduce a significant additional level of standardization of approach and can also be structured so as to enable selected key financial terms (in particular the acquisition value) to be established through a process of competitive bidding.

The priority in selecting industries for investment reviews and preparation of model contracts should be transaction-driven. That is, the process should be initiated in industries which are contained in the “A” list of divestment projects, as defined in recommendation 2 below.

(2) Adopt a market-based approach to State asset valuation

Inevitably much FDI will be accompanied by the acquisition of State-owned business assets due to Uzbekistan’s modern history as a centrally-planned economy. The Government has a large and potentially controversial divestment programme to undertake and understandably wants to exercise care to ensure that proper value is obtained for public assets which are divested.

On the other hand, foreign investors expect assets to be inexpensive in frontier emerging markets in order that high investment returns can be generated commensurate with the risk. For example, proven gold reserves may be acquired in the former Soviet Union for under US$ 10 per ounce compared with an acquisition cost of up to US$ 80 per ounce in more established emerging markets.

These differing expectations have created a wide gap in views about asset value which has become an obstacle to FDI.

It is recommended that the Government reforms the public divestment procedure as follows:

(i) Develop a market-based disposal programme for internationally attractive State assets and announce it as a significant policy initiative–the "A" list

It should be relatively easy for the Government to identify State assets (including State enterprises and mineral titles) which are capable of attracting international competition to acquire them and which it wishes to divest. These should be proactively tendered both locally and internationally in a competitive manner and not negotiated on a first-come first-serve basis. Professional advice should be sought on structuring the terms and soliciting investor interest. It is important to avoid structuring the terms in a way which avoids "no-bids" or "non-conforming bids" which show that preparations were inadequate or the Government's expectations are unrealistic. On the basis of the advice received, the Government must be prepared to offer to investors a number of terms which it has often been reluctant to accede to so far. Strategic investors are likely to require:

- Management control;
- A high level of economic interest;
- Known limits on liabilities such as tax and debt arrears, social support obligations, and existing environmental damages;
- Bankable foreign exchange arrangements;
- Contractual stability of the key commercial terms, including tax and foreign exchange arrangements (see recommendation No. 3 below).

Provided that the commercial terms are well structured, asset disposal values should be set by a competitive bidding process and not by a government formula. The Government's need to ensure proper value should be satisfied by the process of disposal not by a valuation formula.

(ii) Divest other enterprises or assets by local competitive tender and promote FDI only in those enterprises or assets which are already privatised by domestic tender –the "B" list

It is not practical to hold tenders to international standard for most of the assets which may be attractive to foreign investors. The Government should develop a "B" list of assets which could attract local investor interest and are in industries which may be attractive to foreign investors. It should hold domestic tenders under sensible commercial terms to dispose of these assets to the private sector. Foreign investors would not be excluded from such tenders but they would not be targeted to them.

Subsequent to privatization it would be up to the new private owners and not the Government to negotiate disposal or joint venture terms with foreign investors. The Government would be a regulator and promoter only.

Given the enormous difficulties caused by current asset valuation procedures the Government should not actively promote "B" list enterprises until they have passed through privatisation of ownership and management control. It is proving to be counter-productive to promote such assets directly to foreign investors.

(3) Refocus the 10-year stability guarantee

The foreign investment law provides that foreign investments will not be subject to adverse policy change for 10 years. This assurance is well intentioned but ill-advised.

As discussed above, the current guarantees could be construed as covering almost all areas of public policy and regulation. Further, they are applicable to all foreign investments, no matter how small. They tie the hands of the Government in implementing sensible policy changes across the board. And, as public policy develops over the years, stability arrangements can create barriers to entry in the domestic market by unduly favouring established firms over prospective new investors.

Of course this provision in a law is a statement of intent rather than a guarantee as it can itself be changed by future amendment to the foreign investment law. It does not give enduring comfort to investors. Such comfort can only be given by stabilizing terms in the form of an investment agreement between the State and an investor. The Government has on occasion entered into such an agreement. On the other hand, at least one prospective investment is deadlocked on this point.

It is recommended that the current provision in the foreign investment law be repealed in favour of a provision which authorizes the Government to enter into investment agreements providing for stability of terms in relation to a selective list of matters such as taxation, foreign exchange and export and import rights. In practice, the Government would enter into such arrangements only for large investments in high priority industries which fell within thresholds set by published criteria. Standard or model terms would be prepared and published as part of the investment reviews and model contract packages proposed in recommendation No.1.

The ability of Uzbekistan to offer proactively such arrangements on a transparent and orderly basis would be extremely well regarded by major foreign investors. In the early 1980s, Chile's willingness to offer contractual stability helped to transform its investment climate.

(4) Move from a universal to an exceptional basis for FDI approval

The problems being encountered by prospective investors in obtaining clearance to invest have led to suggestions that more *administrative* coordination is needed among the agencies which deal with the requirements of investors. In some countries this has led to the creation of the "one stop shop" foreign investor agency which is meant to handle the entire investment entry process. This approach is unrealistic as a single agency is unlikely to have all the skills, or be surrendered the necessary clout by the line ministries, to take over all the responsibility.

Another approach, which has been suggested, is to base a representative of each line ministry in a single building with the Foreign Investment Agency. This may have some merit as a promotional and facilitating tool but in no way obviates the need for investors to have access to the specialist expertise and authority in the relevant ministries.

This report does not recommend significant change in the government machinery for dealing with investment entry. The largest pay-off will come from standardizing the treatment of investment terms through better policy development so as to reduce the range of issues requiring individual attention and negotiation and to provide clear policy benchmarks for government agencies in their dealings with foreign investors. There is a need to clarify and focus the roles of individual agencies with the government machinery as set out below.

At present *all* significant FDI is subject to an additional stage of approval over and above the regulatory and other approvals and agreements pertinent to its industry. A case-by-case approval system for FDI exists through the registration requirements for an "enterprise with foreign investment" and the requirement for Cabinet approval of any investment of over US$ 20 million.

This additional stage (sometimes described as "one more shop") has not itself been the source of delays and frustration felt by foreign investors with the entry process. This review suggests that the difficulties are principally the result of a lacuna in policy at the industry level and in the process of setting terms and conditions for investment.

However, there are grounds for the Government to reconsider whether it is useful to continue with this registration procedure. If the Government wishes to retain a mechanism to block foreign takeovers of existing Uzbek enterprises then there is a rationale for this device. But the rationale is not explicit and the registration procedure is ostensibly a quite formal documentary process. It would be helpful to intending foreign investors to know at the outset through reference to a Government policy statement the circumstances in which FDI would not be welcomed. It is only in the banking industry that formal conditions have been set.

On the other hand, the thrust of tax reforms recommended in this review (see recommendation No. 6 below) are to favour new investment rather than foreign investment per se. The adoption of this approach would obviate the need for a category of "enterprise with foreign investment" as a means of providing an attractive tax package.

Therefore, unless the Government wishes to retain in the FDI law a right to block takeovers, it could abolish the category of "enterprise with foreign investment" in favour of a project approach to approvals. Under a project approach the Government would require only to give approval where the sponsors of new investment projects request special treatment. Such special treatment would include the offshore account arrangements and the stability agreements which are recommended in this report or any special incentives. The Government would need to be selective in offering special treatment and it is entirely appropriate that its approval be given on a case-by-case basis. This process would be an elaboration of the present role of the Cabinet of Ministers in vetting all new investment projects exceeding US$ 20 million.

This reform could be a natural outcome of the adoption of other recommendations arising from this review. It would not, however, speed up the entry process unless attention is given to streamlining the other business approvals and agreements which must be secured by prospective foreign investors.

The legal implication of this recommendation is that the category “enterprise with foreign investment” would cease to exist under the foreign investment law. This would not affect the rights and protections afforded to foreign investors and to foreign investments as defined in the law. It would only require the specific incentives in the foreign investment law which apply only to “enterprises with foreign investment” to be eliminated and dealt with in the context of the other recommendations which have been made. These include the provisions of articles 16, 17 and 18 dealing with currency, export and import and customs duties. These provisions may include the 10-year stability guarantee in article 11; however, it is not clear whether this applies to an enterprise with foreign investment or only to the foreign investors in such an enterprise.

REGULATORY AND TAX POLICY:

(5) Give the utmost priority to improved foreign exchange and import arrangements and meanwhile have a “carve out” policy for major investments

The present foreign exchange and trade restrictions are very damaging to the investment climate of Uzbekistan. Whilst they continue they will undermine all other efforts to improve the policy and administrative regime for FDI. Their fundamental solution requires a changed approach to macroeconomic policy in which balance-of-payments management is handled by policy tools other than import licensing, rationing of foreign currency and multiple exchange rates. The use of rationing and licensing is a very dated tool which portrays Uzbekistan as well behind the rest of the world and indeed the region in adopting best practices.

There is no discrimination against foreign investors in these arrangements, although individual foreign investors in high-profile joint ventures may receive better treatment than others. However, notwithstanding a bias in favour of foreign investors, the arrangements are unsatisfactory.

The fundamental solutions lie in changed macroeconomic policies which are well outside the scope of this report. The aim should be to achieve as soon as possible normal business arrangements in which investors can freely import their requirements and readily pay for them at a market-related exchange rate.

In the longer term, the policy preparations required for membership of WTO will make a vital contribution to attaining and entrenching an investor-friendly trade regime. Uzbekistan has already begun its application for membership of WTO and could set itself the ambitious target of being the first Central Asian State to accede to WTO.

It is recommended that *immediate* steps be taken to enable major export-oriented investors to retain 100 per cent of export proceeds in offshore accounts.

Under such arrangements investors would only be required to remit to Uzbekistan and convert to som the funds required to pay local costs and taxes. These arrangements are very helpful to investors in obtaining project loan finance from international lenders because the lenders are able to utilize the offshore accounts to establish escrow accounts. They are also helpful in ensuring immediate access to foreign currency for imports.

This arrangement would replace the present partial foreign currency retention accounts which are currently permitted. The Central Bank would be able to monitor these accounts and ensure that they were set up only in reputable banks.

The proposed arrangement only recognizes the reality that international lenders will require foreign currency escrow accounts. Thus if announced as a policy initiative of the Government it would be a very positive and distinctive signal. It is a relatively costless measure to introduce. It would especially encourage investment in export-oriented industries, for example in natural resources where there appears to be significant under-investment given the potential of this sector.

These arrangements should survive the overall reform and liberalization of foreign exchange control. It will be many years before the som is regarded as a fully convertible currency. The damage has been too great to rely upon an improved general regime.

(6) Introduce a more robust pro-investment tax regime

It is important to restore coherence and stability to Uzbekistan's tax policy. The tax regime should be fair, transparent and consistently administered. Above all, the Uzbek tax regime should be no more burdensome than that of neighbouring countries.

There is no strong evidence internationally that frequent announcements of concessions encourage new investment (and even less so when there is a history of unforeseen new taxes). Investors will be more impressed by an attractive and stable tax regime which encourages new investment by reducing the early burden on cash flow and which is structured so as to tax profits rather than turnover or assets.

It is recommended that the following reforms of profits taxation should be considered for future investors:

- Remove all tax holidays and rate reliefs and replace these with accelerated capital allowances for investment. At the same time, remove the restrictions on deductibility of capital allowances and on losses carried forward;
- Allow full deduction of loan interest costs (with safeguards to prevent excessive gearing and rates on shareholder loans);
- Remove the petty and unnecessary restrictions on deductions for labour costs, entertaining and advertising; and
- Allow exporters to maintain their accounts and pay taxes in United States dollars.

It is *recommended* that the capital costs of new investment be reduced by the following reforms which would immediately lower investment costs:

- Reduce substantially the import duties on a wide range of imported capital items (and, consequently, abolish the exemption for contributions to the charter fund); and
- Entitle investors to prompt refund of excess VAT and create an effective system to administer the payment of refunds.

It is *recommended* that sector specific taxes (in particular mineral royalties and export taxes) be reviewed and fixed in accordance with international standards.

The following are possible reforms of other taxes which should be considered so as to put Uzbekistan in the forefront of regional best practice:

- Consider abolishing the property tax, the road user tax and the environment tax, none of which have a true economic rationale in their present form and can be a considerable burden on export business in particular. These reforms would have a budgetary cost and it would need to be considered to what extent this would be offset by a more rational overall tax structure or better targeted taxes (e.g. increased taxes on fuel in place of the road user tax);
- Regularize the taxation of expatriate personnel by (formally) taxing their earnings on a remittance basis. This should be a relatively costless reform as it is doubtful if all expatriate remuneration is declared at present.

The key outcomes of these tax reforms which will enhance the investment climate are:

- The focus on profits as the principal base of business taxation;
- The reform of profits taxation to make it pro-investment without the need for special incentives for foreign as distinct from domestic investors;
- The review of sector-specific taxes, such as mineral royalties, to ensure they are internationally competitive;
- A much reduced need for special incentives, given the above reforms; and
- The creation of standardized and transparent tax arrangements which relieve the need or opportunity for case-by-case tax bargaining.

MEASURES TO IMPROVE THE COMPETITIVE PROVISION OF BUSINESS SERVICES:

The cost / productivity profile of the Uzbekistan workforce is a real strength of the investment environment. However, there is evidence that this potential competitive advantage is weakened by the other local costs which may be unnecessarily high and of poor quality (see section 1.9). Measures to fully achieve broad competitive advantage in local business costs should be considered. Two recommendations are made in this regard.

(7) Open the State sector to private investment and competition

This review has not conducted an in-depth review of individual sectors. Nevertheless, there are indications of widespread State enterprise or ministry commercial activity on a restrictive basis. This includes but goes beyond utilities and encompasses the supply of imported agricultural and industrial inputs, the supply of cotton, the refining of gold and the provision of banking services among others. Some investors who would prefer to buy local inputs rather than import are deterred by the high cost and poor quality of local supplies.

Uzbekistan has quite deliberately adopted a cautious approach to market reform and privatization of industry and utilities. It is now, however, beginning to fall behind regional competitors in the introduction of competitive markets for business supplies and services and the benefits of new investment, modern management disciplines and advanced technology. For all but the largest "enclave" projects the vitality of foreign investment is highly dependent on the local market. It is recommended that consistent with national objectives a more active approach is taken in introducing private investment and competition.

(8) Cease discriminating against small and medium-scale foreign investors

The Government appears to be indifferent to the contribution which can be made by FDI in small and medium-scale businesses in the services' and trade sectors. Such businesses include a variety of office support services, import and export facilitation services, industrial maintenance and supply businesses, technical services and so on. These businesses are in many cases excluded from incentives and appear to have lower priority in obtaining import licences and foreign exchange.

Yet the availability of a network of effective support services is very important to prospective investors, including those in high priority sectors of the economy. The Government should encourage these providers to base their operations onshore and remove measures which discriminate against them.

The recently updated foreign investment law now appears to recognize the potential contribution of small and medium-sized enterprises, stating that additional rights and protections may be made available to foreign investors in these businesses.

INVESTMENT PROMOTION:

(9) Publish (ultimately) a Foreign Investment Policy Statement

Much of Uzbekistan foreign investment policy is unwritten and evolves on a case-by-case basis. If Uzbekistan tackles and completes significant reforms of the kind proposed, it should prepare a Foreign Investment Policy Statement of clarity and vision which sets out its national objectives, priorities and applicable terms in a manner which has a strong resonance with investors.

It should be a key part of the mission of the FIA to draft this Statement based on its close involvement with the industry investment reviews and the tax and regulatory reforms.

(10) Review the general investment promotion policy in the light of the Foreign Investment Policy Statement

In the current state of the investment climate a comprehensive investment promotion campaign would not be cost-effective. Bluntly stated, it would be a waste of money. Much higher and more urgent priority should be given to resolving the problems encountered by established and prospective foreign investors.

The range of reviews and reforms needed to create an investment climate which is clearly the best in the region is very extensive as illustrated by our recommendations. It is unlikely that an objective of achieving regional excellence in policy and operational conditions for foreign investment could be accomplished in less than two years.

In the meantime it would be sensible to proceed with a high-profile, well-structured and well-presented “A” list for public divestment. These will serve as landmark transactions and will begin the process of positioning Uzbekistan as the best investment destination in the region.

C. PRIORITIES FOR TECHNICAL ASSISTANCE PROGRAMMES

Based upon the recommendations in this report the highest short-term priority is for technical assistance in policy reform. Assistance for investment promotion is a lower immediate priority but will, in due course, be very important in promoting Uzbekistan as the best regional destination for investment and in preparing and presenting Uzbekistan’s specific investment opportunities to targeted prospective foreign investors.

The recommended priorities for technical assistance are:

- Provide expert support for industry policy reviews in order to improve policies and to prepare investment opportunities for promotion to foreign investors;
- Provide expert support for the review and amendment of tax and incentive arrangements;
- Conduct a regional survey of cost / quality of business services in order to (*a*) provide a benchmark against which to measure reforms, (*b*) obtain factual material for investors considering Uzbekistan as a regional location, and (*c*) promote Uzbekistan where its performance is superior;
- Provide international financial and technical advisers to support landmark privatizations on the “A” list;
- Provide expert support for the development of a Foreign Investment Policy Statement and associated changes in the foreign investment law; and
- Provide expert advice on strategies and support services for the promotion of SMEs that can create valuable linkages between the local economy and foreign investors.

Notes

[1] A speaker's comment at the conference on "Doing Business in Uzbekistan" held in London in November 1997.

[2] For example, in the commercial banking industry national participation is pursued by a fixed limit of 49 per cent on foreign ownership. An alternative approach is to offer incentives in order to encourage national participation.

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