Chapter 1. Fiscal Setup and Government Spending

Uzbekistan's economy, society, and government are being transformed. Enhanced efficiency and quality of government spending, increased transparency, and better institutions for public finance management are essential for delivering high quality public services, maintaining macroeconomic stability, and supporting stronger economic growth. This note discusses three fiscal policy challenges the government faces. First, to understand the full size of government and implement credible fiscal policy, the authorities need a consolidated fiscal program that covers all public spending. At present, off-budget spending is as large as on-budget spending but information on the former is neither easy for the government to compile regularly nor available publicly. Off-budget spending often does not require parliament approval and does not benefit from government monitoring. The lack of a consolidated fiscal program makes it difficult for the government to have a comprehensive view of government revenue and spending and prepare the sustainable medium-term budgets mapped to clear development priorities. Second, better quality of expenditures is essential for ensuring value for taxpayers' money but the most important spending categories, including education, investment spending, and public employment, lack indicators to assess if spending produces the desired results. And third, government institutions and their operating frameworks still lack the capacity to support a well-functioning public sector. These include budgeting and reporting, fiscal risk assessment, investment management, internal control, and internal and external audit. Public sector laws, regulations, and business processes need to be revamped to bring public financial management in line with good practices.

Context

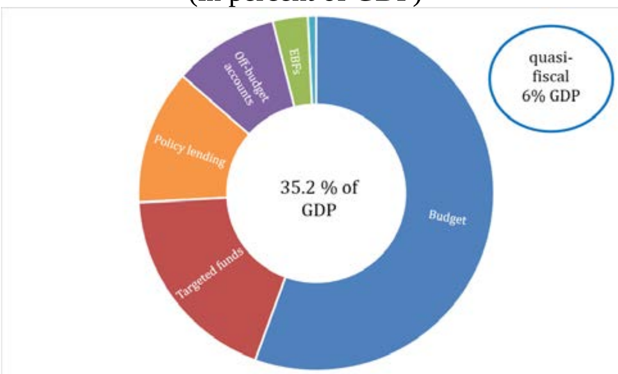
A capable government is crucial for development, but too large a government can overwhelm the economy and make it difficult for a dynamic private sector to develop. In addition, there are areas where the government needs to do more – such as delivering quality services and infrastructure and ensuring a level playing field for private companies, and areas it needs to do less – such as subsidizing unviable enterprises, providing untargeted subsidies to households, or limiting competition.

Uzbekistan's consolidated government spending – spending both on-budget and off-budget -- is substantial and amounted to 35.2 percent of GDP in 2018; including quasi-fiscal losses, spending amounts to at least 41.2 percent.[1] Spending off-budget in 2018 was larger than spending on-budget, underscoring the system of budgeting that the authorities are working to reform (Figure 1.1 and Table 1.1). The expenditures on-budget cover only the central and local governments, including some of the former state-targeted extrabudgetary funds that have been consolidated into the central government in 2018 and 2019. The spending off-budget includes

[1] The calculations in this document use the recently 2018 GDP number. Reflecting largely the inclusion of parts of the non-observed economy, GDP for 2018 is 19.3 percent larger than the projected 2018 GDP used before February 2018. Measured relative to the 2018 GDP projection, the consolidated government spending amounted to 46.7 percent of GDP in 2018.

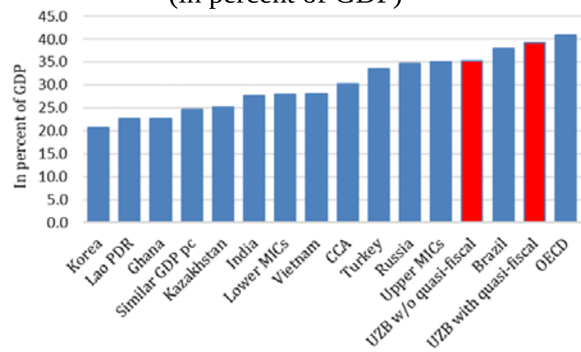
outlays by the remaining extrabudgetary funds (EBFs); the off-budget accounts of budgetary organizations; government investment spending financed by foreign project loans; policy lending by the Uzbekistan Fund for Reconstruction and Development (UFRD), the government, and foreign lenders; and estimates of the quasi-fiscal losses of state-owned enterprises (SOEs).[2]

Figure 1.1. Uzbekistan: Consolidated General Government Spending, 2018
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.
Note: Central and local governments, extrabudgetary funds, off-budget accounts, capital spending financed by foreign loans, policy lending, and estimates of quasi-fiscal losses.

Figure 1.2. Comparisons of Government Spending
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.
Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan.

Government spending in Uzbekistan – a lower middle-income country – is higher than in most of its relevant comparators. Consolidated government spending without quasi-fiscal losses is 7 percent of GDP higher than lower middle-income countries on average, as large as the average for upper middle-income countries, and 8 percent above the average for countries with similar GDP per capita (Figure 1.2). To be sure, Uzbekistan's level of spending reflects the legacy of the economic model that is now being substantially reformed. The starting point underscores both the large role of the government in the economy and the challenges that the authorities must address as they advance their agenda to optimize the government footprint in a way that delivers value for money, supports the building of adequate government capacity, and leave ample room to the private sector.

The large share of policy-based lending and the quasi-fiscal losses of SOEs reflect the government's support to capital-intensive industry that generates little employment and foreign direct investment. Quasi-fiscal losses of the SOEs amount to at least 6 percent of GDP, the same magnitude as policy lending to SOBs to prop up SOEs. There could be some double counting in these numbers, but the magnitude is modest. Quasi-fiscal losses are likely to be much larger if all SOEs are included in the calculation and the recovery price used as a benchmark includes not just operations and maintenance, but also debt servicing, amortization, and a profit for the SOEs. These are combined with tax expenditures for the benefit of SOEs of about 6 percent of GDP, resulting in fiscal support to government-owned enterprises that is more than a third of consolidated government spending. Reforming the SOEs while rationalizing this extensive

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[2] We use the term "consolidated general government" to denote all on-budget and off-budget spending. The IMF uses that term to denote the budgetary government plus policy lending; this amounts to two-thirds of the fully consolidated government spending.

support will require a determined yet judicious approach, coupled with improved social protection for the vulnerable.

Adequate time series data to analyze the trends in consolidated government spending over time is missing. As a result, most of the subsequent discussion of spending trends uses only part of consolidated spending: spending on budget plus policy lending. These two items amounted to 24 percent of GDP in 2018, or 60 percent of consolidated government spending.

Table 1.1. Uzbekistan: Consolidated General Government Spending, 2018
(in percent of GDP)

	Budget	Targeted funds	EBFs	Off-budget accounts	Foreign financed investment	Policy lending	Consolidated spending without quasi-fiscal losses	Quasi-fiscal losses	Consolidated spending with quasi-fiscal losses
Expenditures	19.5	6.5	1.1	3.4	0.3	4.3	35.2	6.0	41.2
of which:									
wages	9.5			1.0			10.5		10.5
pensions	0.9	4.9	0.0	0.1			5.9		5.9
capital spending	2.4	1.3	0.7	0.6	0.3		5.2		5.2
other	6.8	0.3	0.4	1.7		4.3	13.5	6.0	19.5

Sources: Uzbekistan authorities and staff estimates.
Note: Budget (central and local governments), state-targeted and other extrabudgetary funds, off-budget accounts, capital spending financed by foreign loans, policy lending, and estimates of quasi-fiscal losses.

Trends in the General Government Balance and Spending[3]

The authorities have kept the budgetary government in surplus since the early 2000s. From near balance in 2003, the surplus of the central and local government surged along with commodity prices by 2010 and fell by 2015. In 2018, the surplus rose to 2.2 percent of GDP, the largest since 2010 and half a percentage points better than in 2017, even though reported growth slowed (Table 1.2). This reflected a larger increase in revenues than in spending because of the exchange rate devaluation and higher commodity prices and restraint not to spend all the improved tax collection.

Because of markedly larger policy-based lending, the deficit of the general government rose substantially from 2003 to 2018. The increase in policy lending reflected stepped-up flows from the government and the Uzbekistan Fund for Reconstruction and Development (UFRD) to banks to onlend to SOEs, one of the authorities' preferred method of supporting public companies. These flows have been augmented by increased housing transfers from the government to SOBs to also onlend and, since the start of reforms, of equity injections by both the UFRD and the government into the banks. In 2018, the increase in policy lending offset the higher budgetary surplus to keep the general government deficit – as measured by the authorities and not the consolidated deficit – little changed.

[3] The discussion in this section is based on the general government presentation – the government budget and policy lending.

After declining substantially from 2003 to 2017, budgetary government spending (excluding policy-based lending) rose in 2018. The decline in budget spending through 2017 was substantially larger than the drop in revenues during that period and was driven by a reduction in on-budget investment spending, reduced on-budget subsidies, and lower social safety spending (line "Expenditures" in Table 1.2) In 2018, by contrast, almost a year after the start of reforms, budget spending rose substantially and reflected an increase in on-budget public infrastructure outlays and larger disbursements for social programs and rural development.

Table 1.2. Uzbekistan: General Government Budget, 2003-2018
(in percent of GDP)

	2003	2005	2010	2015	2016	2017	2018
Revenues	**27.9**	**25.6**	**30.8**	**28.0**	**25.4**	**24.7**	**27.9**
Expenditures	**27.6**	**25.4**	**26.5**	**26.5**	**23.8**	**22.9**	**25.6**
Socio-cultural spending	7.7	8.3	9.1	10.8	9.6	9.2	10.0
Social safety net	6.8	6.8	8.6	6.9	6.0	5.5	5.0
Economy	2.7	2.7	2.1	1.9	1.7	1.7	1.9
Public administration	0.5	0.5	0.7	0.8	0.8	0.9	1.0
Public investment 1/	4.8	3.4	2.8	2.1	1.9	2.0	2.4
Interest	0.4	0.3	0.1	0.0	0.0	0.0	0.1
Other	4.6	3.5	3.6	4.0	3.8	3.6	5.3
Balance	**0.2**	**0.2**	**4.3**	**1.5**	**1.6**	**1.8**	**2.2**
Policy based lending	**0.6**	**0.4**	**1.6**	**2.6**	**2.1**	**3.6**	**4.3**
General government balance	**-0.4**	**-0.2**	**2.8**	**-1.0**	**-0.5**	**-1.8**	**-2.1**
Memorandum item							
GDP (billion Soums) 2/	11,806	19,108	74,153	210,183	242,496	302,537	407,514

Source: Uzbekistan authorities, IMF, and Bank staff estimates.
1/ Includes public investment as in the budget document and spending by the road fund.
2/ 2003-2010 GDP figures are revised up by 20 percent in line with the national accounts' revision by Uzbekistan authorities for 2015-2018.

Economic Classification of Spending

Lack of data allows only a limited analysis of the economic classification of government spending. Outlays on public wages are clear outliers relative to comparator countries and capital spending would be an outlier if policy-based lending – most of which ultimately supports investment projects – is included.

- **Wages:** Consolidated budget wage outlays amounted to 10.5 percent of GDP in 2018, almost as high as in the OECD on average and larger than in relevant comparators (Figure 1.3). Uzbekistan's wage bill is as high as the average for the countries of resource-rich Middle East and North Africa and Sub-Saharan Africa and above the average for the other developing regions. Both wage and employment are drivers of the high wage bill. The wage outlays include spending on salaries explicitly identified this way in the budget (9.5 percent of GDP) and off-budget wage outlays. While there is no comprehensive data on public employment, analysis of some of the ministries indicates that public wage levels are above private wages, but the latter are likely substantially understated. Further work is needed to assess the relationship between outsized spending on wages and the efficiency of public administration. (See the Wage Note for more details and policy options).

Figure 1.3. Consolidated Wage Spending
(in percent of GDP)

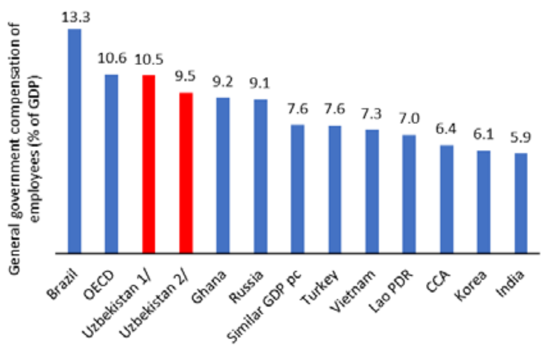
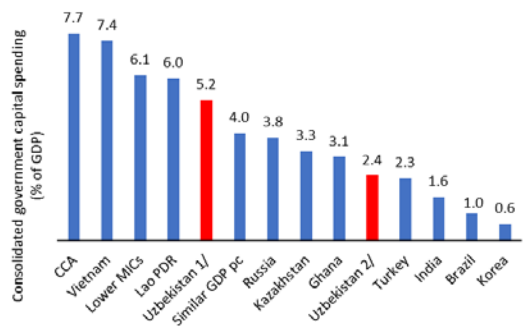


Figure 1.4. Consolidated Capital Spending
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.
Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan. Uzbekistan 1 includes consolidated government wage bill and capital spending and Uzbekistan 2 includes only on-budget wage bill and capital spending.

- **Capital spending:** Consolidated government capital spending – both on-budget and off-budget – amounted to 5.2 percent of GDP in 2018. This is lower than the 7.7 percent of GDP average of regional comparators in the Caucasus and Central Asia and at the lower limit of the public investment level that the Growth Commission Report identified as a feature of fast-growing economies.[4] The government capital spending is not always well-allocated across sectors. In addition to government investment, there is substantial investment by SOEs, most of which is financed by directed lending from the UFRD and the government. The PER's initial analysis suggests three main priorities for the government. The first is the need to increase public investment both to help repair existing infrastructure and to connect better urban and rural areas. Second, for investment spending to be efficient, the authorities need to streamline the institutional setting of public investment management and reduce the duplication of units for planning, execution, and monitoring. Public investment – using both public or private finance – should be undertaken only if a project provides value to society, it is affordable to the taxpayers and users, and the operation is sustainable once the asset is operating and private investment is not available. (See the Note on Public Investment Management for more detail). Third, all off-budget investment spending must be

[4] Growth Commission. 2008. Growth Report. Report. https://openknowledge.worldbank.org/handle/10986/6507. The report indicated that the governments of the 13 successful countries it studied invested 5-7 percent of GDP.

consolidated into the budget, including government expenditures financed by international financial institutions and government guaranteed disbursements to SOEs.

- **SOE subsidies**: SOEs continue to dominate the economy, employment, and bank credit. As in most transition economies, however, on-budget subsidies to SOEs in Uzbekistan are modest but off-budget and quasi-fiscal support is extensive. Explicit subsidies are small and amount to about 1 percent of GDP. In addition to the on-budget subsidies, support to the SOEs includes: tax and customs preferences and exemptions (see the Note on Tax Expenditures), public investment for the benefit of SOEs funded by the budget under the public investment program, low input prices charged by other SOEs, and subsidized credit funded by the UFRD, the government, or international financial institutions with government guarantees. The large range of support makes it difficult to get a clear and comprehensive picture of government support provided to SOEs and SOBs. There is also no clear picture of any payment arrears between SOEs (see the Note on SOEs). We estimate that quasi-fiscal activities of the SOEs could be as large as 4 percent of GDP based on data from the electricity, natural gas, and water and sewage companies. Quasi-fiscal losses are likely to be much higher if district heating, railroad and air transport, the irrigation companies, and the SOBs are considered (the team does not have data on these companies). As the government moves to put the support to enterprises and the banks on the budget, this would allow the government to understand better the trade-offs in the reform process.

Functional Classification of Spending

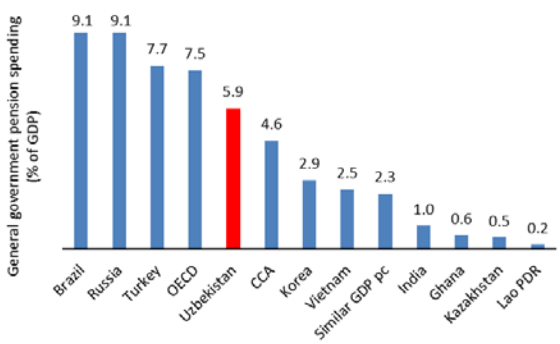
The analysis of the functional classification is similarly limited by lack of data. The salient features of the functional classification are as follows:

- **Education:** Uzbekistan's education spending as a share of GDP is one of the highest in the world. Government education spending amounted to 5.4 percent of GDP in 2017 and 5.9 percent in 2018, more than in Kazakhstan, Russia, Turkey, countries with similar incomes, regional peers, and the OECD. About a third of the government budget is dedicated to education, an amount little changed over the last decade. Even relative to the consolidated government expenditures that are twice as large as the government budget, education outlays amount to about 15 percent of total spending, more than the average for Europe and Central Asia and the OECD. Lack of consistent data on education achievements does not allow the authorities to make a connection between spending and outcomes. A very large share of education spending is dedicated to primary and secondary school education; it will be important for the authorities to pay more attention to pre-school education and improving the technical skills of workers. Allowing more private tertiary education institutions could help achieve better outcomes with same level of overall public expenditures on education (See the Spotlight on Education for more details).

- **Healthcare:** Government spending on health in Uzbekistan is not unlike that in lower middle-income countries and the average for the Caucasus and Central Asia. Both as a share of GDP (2.2 percent) and as a share of budget expenditures (less than 8 percent), health outlays are modest. Relative to the overall consolidated government spending, health outlays are well below any of the relevant comparators and closer to what India and Lao spend. Health indicators are like those of regional peers and below income peers. Spending more and better on health will be important to boost human capital (See the Spotlight on Health for details).

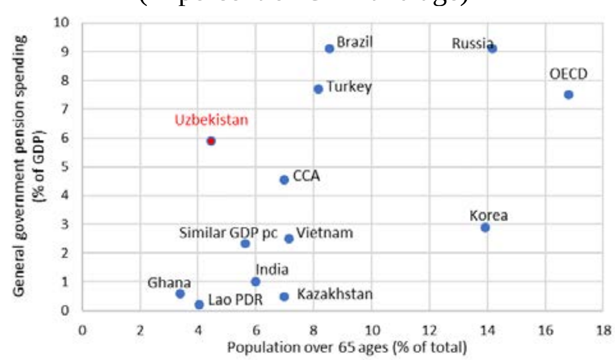
- **Pensions**: Government pension spending in Uzbekistan is higher than in relevant comparators both as percent of GDP and as a share of budget expenditures (Figure 1.5). Uzbekistan spends more on pensions even relative to countries with similar share of older people in the total population (Figure 1.6). Nonetheless, pension adequacy is low and the payroll revenues that financed the PAYGO system have been inadequate given substantial informality. For the first time ever, the government is planning a transfer from the budget to the pension fund in 2019 to offset the loss of revenues resulting from the tax reform. The transfer is planned to amount to 1.2 percent of GDP or 17 percent of pension spending. Analysis of the adequacy, coverage and sustainability of the pension fund could be undertaken in the future. Suffice it to say now that the budget subsidy is changing the nature of pay-as-you-go pensions. Financing social protection from general revenues is an appropriate channel to consider given high informality.[5]

Figure 1.5. Uzbekistan: Pension Outlays
(in percent of GDP)



Sources: Uzbek authorities and staff estimates.
Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan.

Figure 1.6. Comparison of Pension Outlays
(in percent of GDP and age)



Sources: Uzbek authorities and Bank staff estimates.
Note: CCA: Caucasus and Central Asia; Similar GDP pc denotes countries with GDP per capita within 10 percent of that of Uzbekistan.

Intergovernmental Relations

Subnational governments (SNGs) play an important role in providing public services in Uzbekistan. Because of the country's highly centralized structure, SNGs have little autonomy over revenue management and resource allocation and act as an extension of the central government. The intergovernmental system remains highly centralized with discretionary transfers based on political negotiations and historical inertia. This setup does not create the incentives for efficient management of resources and improvements in the quality of public services. To address these challenges, as a first step, the government may consider increasing the predictability of transfers by introducing rule-based allocation mechanism, reviewing and clarifying expenditure

[5] World Bank. 2019. The Changing Nature of Work. http://www.worldbank.org/en/publication/wdr2019

assignment across levels of government, and providing greater fiscal autonomy to subnational governments.

Uzbekistan's central-local government structure is one of administrative deconcentration. In such a structure, subnational governments play a role as the central government's agent in the regions and are accountable to the central government. Resources are transferred to the local governments while allowing them little autonomy or discretion in decision making. Uzbekistan's system of subnational finance has changed little since independence. In contrast, many developing and transition countries have embarked on fiscal decentralization, including Poland and Indonesia, and neighboring peers such as Ukraine, Georgia, and Kyrgyz Republic (See Note on Intergovernmental Relations for more details).

KEY CHALLENGES

Large Tax Expenditures

Tax incentives and exemptions impose a large direct fiscal cost to the budget. In addition, Uzbekistan's tax incentive policy leads to substantial monitoring cost for the government, as the process involves discretionary procedures Most importantly, the efficacy of these tax incentives is in doubt because they do not appear to have boosted foreign direct investment, domestic investment, or business creation. The government appears to provide many tax incentives without a cost-benefit analysis on whether existing incentives have been effective in accomplishing their intended goal.

Large and not Transparent Off-Budget Spending

Off-budget spending is substantial, accounting for half of consolidated general government spending in 2018.[6] Half of government operations are not subject to the same budget processes, monitoring, or accountability. The Ministry of Finance does not have a comprehensive view of all government spending when making decisions. In specific cases – for example, public investment – different agencies consider, plan and engage in spending. Public wages are paid from both budgetary and off-budgetary sources, resulting in disparate compensation for the same work and lack of a level playing field. While most schools receive broadly similar financing per student from the central government, schools in less affluent areas have smaller off-budget accounts and are not able to compensate their teachers as well as schools in better-off areas.

The bulk of off-budget spending is carried out by extrabudgetary funds (EBFs) which accounted for 27 percent of consolidated general government spending in 2018 and off-budget accounts whose outlays amounted to another 10 percent. Uzbekistan's extrabudgetary funds (EBFs) – which numbered 47 at the end of 2018 – fall into five categories:

(1) <u>State targeted funds.</u> These funds are included in the budget document, they are on the Treasury Single Account (TSA) but are not consolidated into the budget. In 2017, there were 7 state targeted funds presented in the budget document not consolidated into the budget. Of these, one fund was consolidated in the 2018 budget

[6] Data for earlier years are incomplete and not comparable.

and in three more were consolidated in 2019. The three state targeted funds that remain outside the budget are: the pension fund, the employment fund, and fund for support of privatized enterprises. Spending by the four EBFs consolidated into the budget in 2018 and 2019 is equivalent to 13 percent of on-budget spending, indicating the measurable progress achieved by the government in consolidating EBFs.

(2) Six EBFs not included in the budget document that are on the TSA.

(3) Twenty-three EBFs outside the budget document but not on the TSA. While their balances and spending are modest – for example, expenditures in 2018 amounted to 0.6 percent of GDP – placing these EBFs on commercial banks has helped support the banking system following the 2017 devaluation. Bringing these EBFs on the TSA is important for transparency and proper cash management, as the authorities may support the banking system in other ways, if needed.

(4) Fifteen EBFs that belong to various ministries. These include the Fund for Developing Systems for Tax Management, Fund for Basic Education, and others. The authorities have not shared data on these EBFs. Including them in the spending estimates will result in even larger government spending. It is essential that these EBFs are also brought on the TSA.

(5) In addition, many of the SOEs, especially those that had the rank of ministries until recently and that are transformed into ministries now, such as Uzbekenergo which was transformed into the Ministry of Energy in February 2019, have EBFs that are not on the TSA and not within the scope of the MOF monitoring.

The 2020 budget consolidated on-budget 18 EBFs and the Fund for Reconstruction and Development and intend to consolidate all other EBFs in the future. So far, progress has been not as fast as initially intended, but the process does take time. The authorities are encouraged to make steady progress in this area, including by not creating new EBFs even if they are intended to speed disbursement or are intended to function as little more than disbursement accounts.

In addition to the EBFs, there are as many as 20,000-30,000 off-budget accounts of budgetary organizations. All of these are on the TSA. Spending from these accounts amounted to as much as a tenth of consolidated government spending in 2018. A quarter of the spending from these accounts was for wages, including bonuses and other allowances, and almost as much was for capital outlays, including office equipment.

Why do governments create EBFs or off-budget accounts? Some EBFs, such as the pension fund, exist both in Uzbekistan and many other countries, because of a discrepancy between the multi-year time horizon of the fund and the annual horizon of the government budget.[7] In other cases, there may be an attempt to ring-fence certain revenues. In recent years, it seems that some new EBFs have been created in Uzbekistan to speed up procedures, cut through red-tape, and provide higher salaries for employees. The motivations are clear but removing certain operations from ministries or other budgetary units to spur disbursements hurts the capacity building needed in the public institutions and the reform efforts to make these institutions more agile. Further,

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[7] Radev, Dimitar and Richard Allen. 2010. Extrabudgetary Funds. https://www.imf.org/en/Publications/TNM/Issues/2016/12/31/Extrabudgetary-Funds-23841

adding EBFs increases public employment and the overall public wage bill, without providing competitive salaries to all public employees. We note this is of concern to the authorities. Further, as most of the EBFs are not subject to the normal budget procedures, creating new EBFs this results in a loss of aggregate expenditure control by the Ministry of Finance (MoF) and reduced transparency that may lead to inefficiency or misuse of funds.

The situation is similar with the off-budget accounts. As in most other economies before transition began, the government allowed all budgetary institutions, from ministries, to extrabudgetary funds, to schools and hospitals, to create off-budget accounts. The original idea was simple: originally, under the system of budgeting that prevailed in the region and in Uzbekistan, all revenues were channeled to the Ministry of Finance and every budgetary institution received a subsidy from the budget: budgetary institutions were not allowed to collect their own revenues. This system of budgeting started to be relaxed in recent decades in Uzbekistan and the government allowed budgetary institutions some leeway to raise their own revenues, provided these accounts were on the TSA. These funds are outside the budgetary control, however, and there is no central monitoring how the money is spent.

Public Finance Management Not in Line with Good Practice

PFM is being reformed but it still needs to catch up with good practices. The link between the annual budget and the government strategy is weak. A budget calendar exists, but there is no guidance to line ministries on ceilings for their budget submissions. The concept of development programs is not well-developed and lacks performance information. The internal control framework, managed through the MOF, is dominated by control and inspections, with a heavy reliance punishment. With respect to external audit, the Chamber of Accounts (COA) does not cover material issues and systemic and control risks. The focus of external audit is on detecting formal violations, recommending corrective actions, and levying penalties, instead of analyzing systemic issues. Overall, these approaches heavily emphasize compliance over performance, and thus are not consistent with modern public sector management practices. The lack of financial statements that adhere to internationally recognized accounting standards also limits the performance of the COA. While the COA delivers the audit of annual budget execution on a timely basis, its approach is not in accordance with international auditing standards.

The authorities have made progress revamping weak fiscal reporting and accountability. In late 2018, the MOF created a GFS and Fiscal Transparency Division. The unit has begun compiling GFS-compliant data for the government budget and is collecting information on all EBFs, off-budget accounts, and the unitary enterprises (the SOEs that are fully owned by the central government). The authorities are working on strengthening the medium-term fiscal framework, as well as on strengthening the elaboration of the fiscal policy objective and the analysis of the performance of the budget, especially in the relationship between inputs and outputs. Compiling and publishing a consolidated budget that includes all on-budget and off-budget spending is still in progress, creating challenges for the authorities in executing its fiscal policy, limiting the accountability for public spending, and constraining the transparency of fiscal operations.

The ministries and units involved in public investment management do not have adequate capacity to identify, develop, appraise, execute, and monitor infrastructure projects,

including those financed through PPPs. A fundamental challenge that needs to be addressed is that the development of the Public Investment Program is only weakly linked to the regular budget preparation process, essentially separating the responsibilities for capital expenditures from maintenance, implementation and performance.

POLICY OPTIONS

Tax and Customs Expenditures

Tax expenditures needs to be reduced and substantially simplified. The reduction in tax expenditures will provide substantial fiscal space to accommodate potential spending pressures in the process of enterprise restructuring and to help bolster the social safety net. Besides fiscal space, the reduction in tax expenditures will help reduce the inefficiencies produced by exemptions and incentives granted to individual companies. These tax expenditures not only have not brought additional inflows of foreign direct investment, they likely have stymied new business entry. While motivated by good intentions, many of Uzbekistan's tax expenditures do not make good industrial policy, as they favor large, inefficient, and long-established enterprises.

Customs expenditures are much larger than the tax ones and amount to as much as 10 percent of GDP. The large size of customs expenditures is not a potential revenue source but an opportunity to simplify the levies on imports, reduce the costs of compliance for importers, and the burden of monitoring for the government. The size of the customs exemptions needs further analysis, as general reductions in duties and excises due to international agreements or reductions that apply to all businesses would not be considered tax expenditures. It is only when the individual decrees by which the customs exemptions are analyzed that the authorities can estimate more precisely the customs expenditures.

Expenditures

Improving the quality of spending is essential for the success of Uzbekistan's reform process. As a priority, the government needs to develop an overall strategic framework and sectoral approaches. Further, improving quality and efficiency requires measurement, accountability, innovation, and incentives. There are two dimensions of efficiency: allocative and operational. On the former, the authorities need to align budget expenditures with strategic priorities and assess the cost and benefits of both the proposed and alternative uses of public funds. Sustainability is crucial: hard budget constraints need to be the norm, with incentives to reallocate spending to higher priorities. For example, the authorities need to decide whether spending two-thirds of public resources on secondary education is optional or more should be shifted to pre-school or higher education. Some of the challenges in strategic prioritization – and in producing quality spending – could also reflect investment-led priorities or undue power of government units

Operational, or technical, efficiency, assessed the relationship between budget inputs and outputs. Without proper objectives and measurement of the outputs, there is a tendency to control the inputs. In education, for example, lack of standardized testing to understand whether spending leads to the desired results makes assessments of operational efficiency or the quality of spending difficult at present. Strengthening external control of the spending by government units would help improve the efficiency. The Chamber of Accounts at present does not cover material issues and systemic and control risks. The focus of external audit is on detecting formal violations, recommending corrective actions, and levying penalties, instead of analyzing systemic issues. The internal control framework, managed through the MOF, is dominated by control and inspections, with a heavy reliance punishment. Overall, these approaches heavily emphasize compliance over performance, and thus are not consistent with modern public sector management practices.

Fiscal Framework

The priority in reforming the fiscal framework should be placed on consolidating all off-budget spending into the budget and subject it to the same planning, execution, and monitoring processes as on-budget spending. The consolidation does not imply that all EBFs must be dissolved when consolidated into the budget. On the contrary: some of the EBFs may keep their names, functions, and even the segregation of funds form the budget, such as the Pri-Aral Sea Fund and the Pension Fund. But they need to be on budget for consistency, transparency, and so that the MoF has a view of all fiscal operations when designing and executing fiscal policy.

The authorities will be well advised to move all EBFs and off-budget accounts on the TSA. This will allow the government to know its cash position at the end of each day. Although government debt is modest, the authorities may consider a minimum threshold on the government cash in the TSA. This may be called a fiscal reserve account and be intended to secure adequate cash for debt repayment or for financing any contingent liabilities.

All commercial banks that are licensed can service the budget. However, government deposits should not be held in commercial banks to support their balance sheets. Reforming the banking sector will need to be accompanied by the implementation of regulations on how the authorities can support the systemically important commercial banks in exceptional circumstances and how to resolve banks that are not systemically important.

Public Financial Management

The main reforms need to focus on the development and implementation of enhanced frameworks, capacity, and tools in several dimensions. The key ones include budget preparation, public sector accounting, public internal control and audit, external audit, and public investment management. A separate note will be produced on these issues, building on the recently completed PEFA. Efforts need to focus on the following:

- Strengthening the fundamental budget preparation process, capacity, and tools. Units managing current and capital spending need to be tightly linked. Performance indicators need to be implemented to help plan and monitor spending outcomes.
- Changing the culture of the MOF and line ministries from a control-and-command center to a strategic partner for change.
- Designing and implementing Uzbekistan's public sector accounting standard (UZPSAS) based on an International Public Sector Accounting Standards (IPSAS) diagnostics.
- Design of public sector internal audit regulations and procedures, developing a risk-based external audit framework.

- Development of a debt management strategy

These efforts are likely to result in substantial improvements in PFM performance. Budget preparation will change from being an incremental, mechanical exercise to a multi-annual strategy hereby ensuring that the government vision is translated into results. Public finance reports will be more timely, accurate, and relevant based on improved accounting and financial reporting regulations. The authorities' emphasis will be on addressing systemic and critical issues because of new internal and external audit frameworks, with improved effectiveness and efficiency of public services. Improving the quality of financial reports aligned with international accounting standards will result in improved management of fiscal risks.