Chapter 2. Tax Expenditures in Uzbekistan

Uzbekistan offers several tax incentives and exemptions – called tax expenditures – which impose a large direct fiscal cost to the budget. Further, Uzbekistan's tax incentive policy leads to substantial monitoring cost for the government, as the process involves enterprise-specific procedures Finally, 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.

Context and Recent Developments

Definition of Tax Expenditures

Tax expenditures are the revenues forgone due to tax exemptions and incentives. Tax incentives are measurable benefits that governments provide to specific taxpayers or groups of taxpayers, with the goal of encouraging them to invest in favored sectors or regions. Tax expenditures further influence the character of such investment and in some cases, they reduce the tax burden on specific taxpayers. Benefits can sometimes be nontax, such as grants, loans, or rebates to support business development or enhance competitiveness. In Uzbekistan, there are tax expenditures on VAT exemptions, income taxes, and customs duty exemptions. In this report, we use tax incentives and tax expenditures interchangeably, even though tax expenditure is the revenue foregone while tax incentives are the instrument that results in foregoing such revenue.

Tax incentives around the world

Tax incentives in one form or the other are used by nearly all countries in the world. Table 2.1 shows the prevalence of the different tax incentives among the 153 countries surveyed. Tax holidays are prevalent in all regions except the OECD countries. This reflects the gradual move away from the use of tax holidays among the developed countries due to their ineffectiveness in aligning the incentives of increased investment with the tax benefits. Super-deductions – an incentive where deductions are allowed for more than the actual cost of certain expenses – are most prevalent in South Asia mainly to reduce and subsidize the cost of investment, especially investments in R&D and training, and for defraying start-up capital costs.

Tax holidays offered by countries in Eastern Europe and Central Asia (ECA) largely follow those of other regions. There is much higher prevalence of reduced tax rate regimes and all countries use tax incentives within Free Economic Zones or Special Economic Zones. Further, there is a lower prevalence of investment allowances which is a superior form of tax incentive as compared to tax holidays. Investment-linked incentives increase with the investment size while in the case of tax holidays, the tax incentives do not change with the size of the investment. Nearly half of the countries in the ECA region provide tax incentives in a discretionary manner. This means that tax incentives are provided on a case-by-case basis through an administrative process and not automatically through the law and via the filing of tax returns. Discretion on provision of tax incentives reduces the efficacy of the investment policy regime as it creates a barrier for the investment opportunity because investors need to go through approvals which is costly both in terms of time and money.

Table 2.1. Prevalence of Income Tax Incentives around the World

	# of countries	Tax holiday/ Tax exemption	Reduced tax rate	Investment allowance/ Tax credit	R&D tax incentive	Super-deductions	SEZ/Free zones/ EPZ/Freeport	Discretionary process
East Asia and Pacific	12	92%	75%	67%	83%	33%	92%	83%
Eastern Europe and Central Asia	17	88%	71%	18%	53%	6%	100%	41%
Latin America and the Caribbean	24	92%	33%	50%	8%	4%	71%	42%
Middle East and North Africa	15	80%	40%	13%	0%	0%	80%	40%
OECD	34	12%	32%	65%	76%	21%	68%	35%
South Asia	8	100%	38%	75%	25%	63%	63%	38%
Sub-Saharan Africa	44	80%	64%	77%	11%	18%	66%	77%

Sources: James, S. (2018). "Tax and non-tax incentives and investment: Evidence and Policy Implications," Investment Climate Advisory Services. World Bank Group.

Uzbekistan offers all the incentives commonly used around the world except investment allowances, investment tax credits, and R&D incentives. R&D incentives are becoming increasingly used around the world, including in ECA (Table 2.2), Uzbekistan does provide incentives for "Innovative Techno-parks" with the purpose of encouraging investment into innovative technologies including chemicals, bio-technology and information technology (Appendix 2.1). The country also offers Free Zones as an important part of its investment strategy and uses a discretionary approach in providing tax incentives.

Table 2.2: Tax Incentives in Developing Europe and Central Asia, 2018

	Tax holiday/ Tax exemption	Reduced tax rate	Investment allowance/ Tax credit	R&D incentives	Super deduction	SEZ/ Free Zones/ EPZ/Freeport	Discretion
Albania	x	x		x	x	x	x
Armenia	x	x				x	x
Azerbaijan	x			x		x	
Belarus	x	x		x		x	
Bosnia	x		x			x	
Kazakhstan		x	x			x	x
Kyrgystan	x			x		x	
Macedonia	x	x				x	
Kosovo		x				x	
Moldova	x	x		x		x	
Montenegro	x			x		x	
Russia	x	x		x		x	x
Serbia	x		x	x		x	
Tajikstan	x	x				x	
Turkmenstan	x	x				x	x
Ukraine	x	x		x		x	x
Uzbekistan	x	x				x	x
Total: 17	**15**	**12**	**3**	**9**	**1**	**17**	**7**

Sources: James, S. (2018). "Tax and non-tax incentives and investment: Evidence and Policy Implications," Investment Climate Advisory Services. World Bank Group.

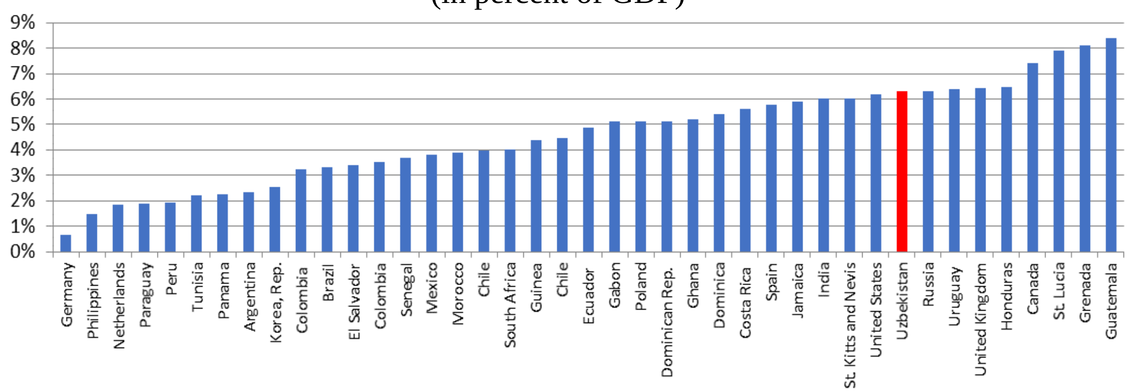
Revenue cost of tax incentives

Uzbekistan's overall tax expenditures amounted to 6.4 percent of the GDP in 2018, almost a third of budgetary revenues. This figure does not include exemptions on imports including customs duties, excises, VAT on import accruing to exempt taxpayers or final consumers. In general, the amount of tax expenditures indicates the potential for increasing government revenues if they were abolished. As the authorities advance their tax reforms, which include substantial reductions in tax rates, then the size of tax expenditures, or foregone revenues, will decrease automatically as the revenue foregone is relative to the actual tax or duty rates. However, there will still be a room for reducing the size of tax expenditures by eliminating company- or sector-specific tax incentives.

Tax expenditures vary greatly around the globe, from below half a percent of GDP in Germany to nearly 8 percent of GDP in Guatemala. Russia's tax expenditures also amount to 6.3 percent of GDP, but this estimate includes all taxes and customs duties (Figure 2.1).

Figure 2.1. Tax Expenditures Around the World

(in percent of GDP)



Sources: World Development Indicators and World Economic Outlook.

As with the overall direction of policy and directed credit, the largest share of tax incentives in Uzbekistan is for manufacturing (largely car production), mining, and finance. The authorities report that 17,246 enterprises benefited from 9.3 billion soms in tax incentives through the tax code, while 21,355 enterprises benefited from 6.4 billion soms in tax incentives through government decisions (Table 2.3).

Officially reported customs expenditures are oversized, as large as 7 percent of GDP in 2016 rising to 10 percent of GDP in 2018. The amount of tax duty exemptions within the overall customs expenditures amounted to 2.8 percent of GDP in 2016 compared with collected customs duties of 0.6 percent of GDP. The large size of customs expenditures, both in percent of GDP and compared to actual customs duty collected, indicates that Uzbekistan's legislation provides very high rates of customs duties, but presidential decrees and government regulations reduce these substantially.

The large size of customs expenditures should not be seen as a potential revenue source if they are abolished but as an opportunity to simplify the levies on imports and reduce the costs of compliance for importers and monitoring for the government. The size of the tax expenditure on customs exemptions needs further analysis as general reductions in duties due to international agreements or reductions that apply to all businesses would not be considered a tax expenditure. It is only when the individual decrees by which the customs exemptions are analyzed that a more precise estimate of the tax expenditure on customs expenditure could be arrived at.

Table 2.3. Tax Expenditures in Uzbekistan, 2017
(in millions of UZS and percent)

Sector of economy	Amount of incentives	Share (%)	According to the Tax Code: Number of enterprises	According to the Tax Code: Amount of incentives	By Government Decision: Number of enterprises	By Government Decision: Amount of incentives
Manufacturing	3,660	23.2	800	858	2,072	2,802
Other sectors	3,090	19.6	13,585	1,463	16,745	1,627
Oil/Gas/Mining	2,559	16.2	73	1,226	32	1,333
Finance including banking	2,212	14.0	511	2,194	129	18
Utilities/Power/Gas	1,714	10.9	81	1,714	16	0.3
Transportation	1,455	9.2	102	1,216	31	239
Services	438	2.8	670	339	250	99
Housing and construction	303	1.9	394	14	1,756	289
Agriculture	167	1.1	1,003	165	315	2
Government	157	1.0	27	152	9	5
Total	**15,755**	**100**	**17,246**	**9,341**	**21,355**	**6,414**

Sources: Uzbek authorities and Bank staff calculations.

Key Challenges

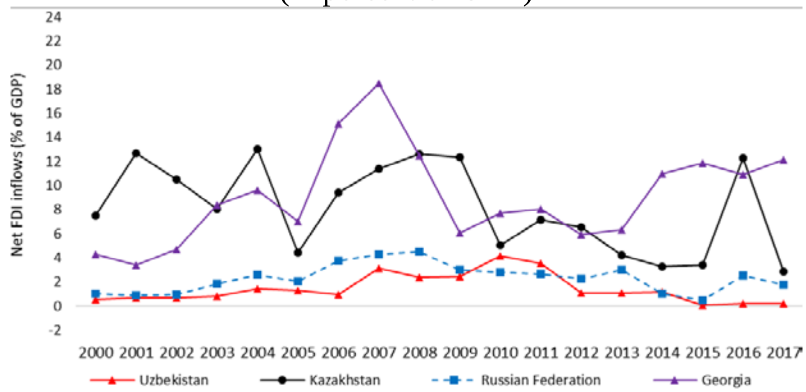
Evaluation of Uzbekistan's tax incentive regime

An evaluation of the tax incentives of Uzbekistan concludes that the country does not meet most good practices for tax incentives. The evaluation assesses both the policy framework and the outcomes of the policy (Table 2.4).

First, Uzbekistan offers many different tax incentives with the aim of attracting investment. Experience around the world has shown that broader investment policy that lowers the overall cost of doing business plays a much more significant role in attracting foreign direct investment (FDI). Investors value a stable economic environment, a strong rule of law, and effective property rights more than the availability of tax incentives. Despite the heavy focus on tax incentives, Uzbekistan attracted much lower FDI in recent years (Figure 2.2).

Second, several tax incentives are offered outside the tax laws: nearly a third of the overall tax benefits are provided by government decrees. The good practice is to have tax incentives provided through the tax laws to reduce the temptation of discretion and misuse. If incentives are provided in the laws, the incentives are subject to parliamentary scrutiny. Taxpayers also have the option of using the tax appeals process to air their grievances when the tax incentives are availed through the usual tax filing process.

Figure 2.2. Inflows of FDI to Uzbekistan and Neighbors
(in percent of GDP)



Source: World Development Indicators.

Third, providing tax incentives outside the tax code gives substantial discretion to the investment agencies. If an investor is uncertain whether a certain tax incentive applies, they could seek clarification or an "advance ruling" from the tax agency. A separate process outside the tax agency to scrutinize tax incentives results in duplication and hence is redundant.

Fourth, tax incentives should be automatically available through the filing of tax returns without the need for an additional pre-approval. In Uzbekistan, there are many procedures associated with the tax incentives which is not good practice. While these procedures are aimed at limiting the misuse of tax incentives, they are costly for investors. These procedures could alternatively be provided through the tax administration using a risk-based criterion. Duty exemptions could also be cleared in advance by the Customs committee without the need for a separate agency to pre-approve the duty exemption. Higher authorities could continue to do quality control by monitoring the tax and customs committees on the use and misuse of tax incentives.

Fifth, tax holidays provided either within the Free Zones or for specific sectors are inferior as compared to investment linked incentives and should ideally be replaced by the latter.

Sixth, to properly administer tax incentives, taxpayers need to file tax returns so that the tax agency have the required information to do so even if they do not have any taxable income.

Seventh, the tax administration needs to address any misuse of tax incentives through their audit policy including compulsory audit of any tax payers making claim of tax incentives of large amounts.

Eight, tax policy makers including the parliament need to have the information as to the cost of the tax incentives to the treasury. Just as expenditure budgets are scrutinized, so should tax expenditures need to be scrutinized. To do that, tax expenditure statements need to be prepared as part of the budget process. These tax expenditure statements should cover all tax incentives under all the major taxes including customs exemptions.

Table 2.4. Assessment of the Tax Incentives in Uzbekistan

	Policy Criteria	Score	Comments
1	The tax incentives are used minimally and mainly to address market failures	No	There are many tax incentives provided through the tax laws as well as outside
2	Tax incentives are specified in the tax codes and not in other laws (except in the case of extractive industries)	No	Tax incentives are specified in the tax laws, however discretionary tax incentives are provided outside the tax laws including in decrees
3	Tax incentives are not offered in a discretionary manner outside the law	No	Discretionary tax incentives are offered on a case to case basis
4	Tax incentives provided in the laws are available automatically to the taxpayer	No	Taxpayers must go through an approval process to benefit from certain tax incentives
5	The tax incentives should, as far as possible, be linked to investment and tax holidays should be used as sparingly as possible	No	Tax holidays are one of the main tax incentives provided and investment linked incentives are not provided except via investment levels to qualify for longer period of tax holiday.
6	The taxpayers who benefit from tax incentives should continue to file tax returns even if there are not liable to pay any taxes	Yes	Requirement to file taxes is enforced even when there when there is no taxable income
7	The Tax administration is adequately trained to address issues of transfer pricing and misuse of tax incentives	Partially	No automatic audit of tax incentive cases
8	The tax expenditure statements are prepared on a regular basis to measure the costs of the tax incentives	Partially	The cost of tax incentives is estimated for 2017, however this is not done as a part of the regular budget reporting process

Sources: Framework provided in James (2018).

Outcome of the tax incentives policy

The Uzbekistan incentive policy has not helped increase significantly inflows of FDI. Hence, a rethink may be needed how to structure tax expenditures to produce results.

On a micro level, it is not possible to comment on the efficacy of the tax incentives directed to the various sectors from this data. An assessment of the need for tax incentives for sectors could be made if the return on investment for the specific sector or sub-sector is available. Tax incentives directed to highly profitable sectors could then be considered redundant while those that make marginal investments or first steps worthwhile would be useful.

However, a significant amount of tax incentives goes to the Oil/Gas/Mining sector which is a location or resource-based industry where tax incentives may be redundant. This is because location or resource linked industry is dependent on the location of the resource and tax incentives that generate resource specific rents. Investors who seek those resources would be willing to pay to access the resource. Box 2.1 provides useful guidelines for providing tax incentives. The primary goal is to ensure that the government provides a stable investment climate and make it conducive for businesses to invest and reduce their costs and make the return profitable.

Box 2.1. Checklist for Evaluating Tax Incentives for Investment

Tax incentives have been used as one of the main tools by the government to attract investment. There are several factors to be considered before tax incentives are provided. Justification for a tax incentive needs to pass all the following tests before it is recommended:

1. Would the investment come in anyway?
2. Would the tax incentive put existing businesses at a disadvantage?
3. Would the investment realize tax revenues after the tax incentives are exhausted?
4. Does the investment provide positive externalities?
    a. Direct jobs
    b. New technology or skills
    c. Infrastructure or public goods
    d. New industry
    e. Ancillary industries
5. Does the tax incentive create opportunities for tax evasion?
6. Does the investment cause negative externalities such as pollution?
7. Would this result in increasing demand for incentives by other investors?

In general, few investments satisfy most or all these criteria. The goal of the government should be to improve the investment climate and make it conducive for businesses to invest and reduce their costs and make the return profitable. It may be necessary for the government to look at the competitiveness of the overall tax system rather than use tax incentives in specific cases to achieve the same end.

Source: James, S. (2018).

POLICY OPTIONS

Prepare Tax Expenditure Statements as part of the regular budget process and make them public

A comprehensive tax expenditure statement prepared and published every year makes transparent the costs and beneficiaries of tax incentives. The systematic estimation of the revenue cost of the tax incentives in the form of a tax expenditure statement on a regular basis is a good start to highlight the problems and then begin to address them. This would help initiate a dialogue on the effectiveness of the tax incentives among policy makers and citizens and provide the same level of transparency as accorded to the expenditure side of the budget.

Rationalize tax incentives

The government needs to conduct a cost-benefit analysis of each of the tax incentives provided. Based on this study, the government should remove any redundant tax incentives and modify others that are not working to its intended goal. Removing any underperforming tax incentives would create much needed fiscal space for the government. If the government reduces the tax incentives even by 20 percent, this would result in additional revenues of 1.3 percent of GDP. Cost-benefit analysis of the tax incentives needs to be done on a regular basis to assess whether the existing tax incentives have been impactful as well as cost-effective in fulfilling its intended goal.

Impose a minimum tax

An immediate withdrawal of tax incentives would apply only to new investment and the revenue impact would be limited. However, a minimum tax could be imposed to ensure that businesses benefiting from tax incentives pay at least a certain minimum amount of tax which could be a percentage of turnover or assets. This minimum tax could be credited against future tax liability of the business which would respect the government promise on the tax incentive as the government would provide the quantum of the tax incentive but only asks for future tax to be prepaid. This ensures that a level playing field is established across all businesses and reduces any excessive generosity of the tax incentive, if it results in no tax at all during the duration of the life of a business that benefits from a tax incentive. Lastly, it ensures that businesses remain invested after receiving the tax incentive rather than pack up and leave for the next investment destination offering tax holidays.

Appendix 2.1: Tax Incentives In Uzbekistan

Tax Incentive Name	Sector	Tax Incentive	Remarks
Foreign Investment into Priority Industry Incentive Presidential Edict № УП-3594 dated 11 April 2005	For Investment in the chemical and petro-chemical, engineering, food and alternative energy	Income Tax Holiday from 3 to 7 years; Includes exemption from: - Property Tax; - improvement of social infrastructure tax; - National Road Fund; - Integrated Tax for micro and SMEs	Outside Tashkent Oblast; no state grants used; foreign investment of at least 33 percent; foreign investment made in the form of new and modern production equipment; 50 percent of income generated is re-invested
Foreign Investment into Free Economic Zone Incentive	For Investment in Free Economic Zones	Income Tax Holiday depending on the value of the investment - 3 years (from $300,000 to $3 million) - 3 year (from $3 million to 5 million) - 7 years (from $5 million to $10 million) - 10 years (more than $10 million) Includes exemption from exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs	Tax stability clauses are also provided so as not to reduce the tax position of these investments
Pharmaceutical industry Investment Incentive Presidential Edict № УП-5032 dated 3 May 2017	For Investment in Pharmaceutical Free Economic Zones	Income Tax Holiday depending on the value of the investment Includes exemption from exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs	
Innovative Techno-parks Incentive	For investment in the Yashnabad techno-park for investment in chemical technology, bio-technology and material processing technology And in the Mirzo Ulugbek Innovation Center for innovative IT technology	Income Tax Holiday depending on the value of the investment. Includes exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs; improvement of social infrastructure tax; customs duties on select equipment.	
Tax incentives for Zones and Regions Presidential Decree No. PP-2843 from 17	For businesses in the - Karakalpakstan and Khorezm region - Small industrial zones (SIZ) - Samarkand city zone	For companies producing pharmaceutical products and electrical products, exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs	Small industrial zone - Invest at least $75,000 and annual income exceeds $32,500 (Yangier SIZ) - Invest at least $97,500 and annual

March 2017; Decree No. PP-2860; pp2973		Small industrial zones Exemption from unified tax and customs duty for 3 years (for Yangier small industrial zone) and 2 years for Tashkent small industrial zone Samarkand City Zone. Includes exemption from land tax, property tax; improvement of social infrastructure tax; the National Road Fund; and Integrated tax for micro and SMEs; improvement of social infrastructure tax; customs duties on select equipment.	income exceeds $75,000 (Tashkent SIZ)
Oil and Gas exploration and extraction Incentive	For foreign companies carrying out oil and gas exploration works including the foreign sub-contractors	Tax holiday for 7 years if joint venture company is established Exemption from contributions to all non-budget funds during the exploration period Residents supplying equipment or services are treated as exempt from VAT	
Export Incentive Presidential Decree #УП-5587 of 29 November 2018,	For exporters (except certain products) whose exports are more than 15 percent of their total turnover	The tax base for calculating income tax is reduced by the amount of exports	
Exemption from Customs Duties	- Property used for production by foreign investors with foreign participation of not less than 33 percent - Goods imported by foreign legal entities that made investments of more than $50 million provided the products are of their own production - Goods intended for work under a production sharing agreement -Technological equipment from a list of approved items or for inputs used for export		