



**UNIVERSITY OF  
STIRLING**

Entrepreneurship and Business in Uzbekistan:  
Historical Perspective and Current Obstacles

A thesis submitted for the degree of

**Doctor of Philosophy**

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By

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## **DECLARATION**

In accordance with the Regulations for Higher Degrees by Research, I hereby declare that the whole thesis now submitted for the candidature of Doctor of Philosophy is a result of my own research and independent work except where reference is made to published literature. I also hereby certify that the work embodied in this thesis has not already been submitted in any substance for any degree and is not being concurrently submitted in candidature for any degree from any other institute of higher learning. I am responsible for any errors and omissions present in the thesis.

Candidate: \_\_\_\_\_

Toshtemir Majidov

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## Abstract

Entrepreneurship has become one of the most researched areas in recent years. Its importance has increased further by the emergence of the ‘transition countries’, the countries of Eastern Europe and the Former Soviet Union. As the transition countries strived to overhaul their economic and political systems in order to bring them in line with the rest of the market based economies, entrepreneurship and private sector development became the focus of the transition debate among the scholars and policy makers.

A major part of the scholarly interest centred on the factors that hindered the development of the entrepreneurial sector. Numerous surveys of entrepreneurs and business owners have highlighted extensive lists of the most common obstacles to the development of enterprises. While the international organizations have concentrated on these reported obstacles, some members of the scholarship community have identified much more fundamental issues that both stifle the entrepreneurship development and encourage rent seeking behaviour.

This study has used the theory of the allocation of entrepreneurial talents to explore the roots of the most commonly reported obstacles that the entrepreneurs face in the context of economic and political transition in Uzbekistan. We use historical evidence in conjunction with the

contemporary survey data and our own interview results to establish the relationship between the ‘rules of the game’ that determine the system of talent allocation and entrepreneurship development. Our conclusions support earlier claims made by Baumol (1990) regarding the importance of the system of incentives and punishments in the development of entrepreneurship.

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## Chapter One: Introduction

The first recognition of entrepreneurship as a phenomenon in the literature is still hotly debated. Most of the Western scholarship community tends to credit Cantillon as the economist to give the first serious attention to entrepreneurship in his analysis in a 1755 essay.

However, it was not until Schumpeter (1934) that a comprehensive theory of entrepreneurship outlining its role in economic development was put forward. Not only did he explain the term of entrepreneurship in a greater detail than anyone else before, but he also developed a dynamic equilibrium model of economic development centred on entrepreneurship.

His theory of 'creative destruction' puts the entrepreneur at the centre of economic progress by introducing innovations and challenging the existing order of things by bringing about 'new combinations'. In particular, he described five types of activity as being entrepreneurial: introducing a new product; introducing a new method of production; opening of a new market; securing a new source of raw material or half-manufactured product; introducing a new organization of industry.

Later contributors have greatly expanded Schumpeter's theory since then, one of the most notable contributors being Drucker (1985) who put significant emphasis on the innovation side of entrepreneurship.

Baumol (1990), on the other hand, pointed to the weakness in Schumpeter's general definition of entrepreneurship. He claimed that that definition could easily be used to describe some activities which are equally new and innovative but unproductive or often counterproductive and illegal. He offered a theory of allocation of entrepreneurial talent between productive and unproductive entrepreneurship, with the countries managing to channel their entrepreneurs into productive activities achieving much higher growth levels. He effectively incorporated the existing theories of rent seeking behaviour into entrepreneurship theory.

Murphy, Shleifer, and Vishny (1991) follow Baumol's logic but propose to extend the theory to all activities and develop the theory of 'allocation of talent' rather than just entrepreneurship. Their main argument is that all activities and sectors compete for the same group of talented people in every given country, and the attractiveness of any given activity and sector is determined by its payoff, prestige and costs (these may include also include punishments in cases of illegal activities that offer very high payoffs) relative to the rest of them.

They argued that the countries where productive activities were most attractive to the most talented achieved higher growth levels compared to the countries where rent seeking sectors dominated and consequently their economies stagnated. The rent seeking sectors, having attracted the most talented people, will start expanding and consuming more of every other resource and squeezing the productive sectors in the process.

In this study we will apply these theories to the Uzbek economy under three different political and social contexts. First we will look at the Uzbek

economy and society before the October Revolution and discuss the validity and implications of the talent allocation theory in the context of a backward, feudal society dominated by the religious institutions.

Then we will analyze the effects of the changes in the ‘Rules of The Game’ and social upheaval resulting from the October Revolution and the emergence of USSR.

Finally we will discuss entrepreneurship, talent allocation and the ‘Rules of the Game’ in the independent Uzbekistan focusing on the negative effects of the suboptimal allocation of entrepreneurial talent.

The territory where present day Uzbekistan is located belonged to three different khanates (kingdoms). Although the ruling elite in all three of them were ethnic Uzbeks, the population was very diverse in both the language and culture. The society was dominated by a minority of feudal aristocracy, the Begs<sup>1</sup> (Lords) and a large body of Muslim clergy.

The economy was backward and agriculture – based, with a large trading sector, the heritage of being an important part of the Silk Road. The political system centred on the monarch and his close associates as well as the clergy whom monarch regularly consulted and gave enormous support.

The educational system consisted of religious schools and colleges which taught a little bit of general knowledge within their Islamic curriculum. It was a society where people largely inherited their parents’

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<sup>1</sup> Beg is the word used in most of the Turkic nations to refer to aristocrats (roughly comparable to the lord in English) who were masters of regions, towns etc. They either inherited their status or were appointed by the monarch in charge. Different pronunciations such as *Bek*, *Bey* also exist.

status and jobs. Children of aristocrats that held official positions expected to be succeeded by their children (except for daughters).

The business community consisted mainly of merchants, some aristocrat – industrialists, and Non-Muslims (mainly Jews and Indians) who dealt with businesses like alcohol, gambling, and banking, all of which were prohibited for locals by religion. Smaller businesses were predominantly self-sustaining farmers and craftsmen. For the talented youth, who were not born into an aristocratic family, the routes to upward social and economic mobility were limited to the religious schools.

Therefore, it is not entirely surprising that the kind of people who would fit into the descriptions actively promoted by the disciples of Schumpeter, emerged predominantly among the graduates of religious schools and independent merchants who regularly travelled around the world.

Those pioneers, who are often referred to as *Jadids* (after an Arabic term meaning ‘new method’) opened new style schools, introduced new ideas, technologies, published books, opened newspapers, theatres and called for modernization in every other aspect of the everyday life in Central Asia.

Most of the things that they introduced and the things that they aspired to achieve were inspired by their sense of inferiority in the wake of the Russian Invasion which exposed the large gap in the level of development between Russia and the occupied lands.

Being devout Muslims, educated at religious schools, they continued to believe that any progress should be achieved within the

framework of Islam. Another reason for upholding Islamic ideology might have been the hope of attracting the support of fellow Muslim countries in their struggle against the Russians. This explanation seems to be more valid, given the fact that most of the Jadids have decided to join the communist ranks after it became clear that they could not get any help from outside.

The October Revolution and subsequent establishment of the Communist rule in Uzbekistan changed the Rules of Game dramatically. The criteria for success and opportunities for the talented were significantly different from what they were before the revolution.

The Soviet authority nationalized all sectors of economy and set out to remove the existing elite from all positions of power and prestige, as opposed to the previous administration which supported the existing elites and empowered them to keep them in control of the local population.

Members of the local elite had a tough choice of either leaving the country or undergoing an incredible regeneration by denouncing their religious affiliations and joining the Communist Party.

Some of them did decide to stay and join the party organs and made good progress until Stalin came to power and started his collectivization drive in the late 1920s.

The Soviet authorities had somehow tolerated having some members of the old elite whom they considered as class enemies during the first decade in power while training new generations of party activists selected almost exclusively from poor workers and peasants.

In 1937, Stalin ordered a major purge of the party cadre and replaced everybody with smallest of the ties with the old elites with a new generation of 'yes men'.

This system, established and perfected by Stalin until his death 1953, functioned virtually unchanged until the 1980s.

The system was centred on the Communist Party which was in charge of every aspect economic, political and social life in the country. In every region, local party leader was made directly in charge of and responsible for the results of the regions economy.

The Soviet system was supposed to have encouraged entrepreneurial and creative activities greatly by removing the financial risks of starting new ventures as all the companies were started and owned by the state. But in fact the system discouraged entrepreneurship by removing the financial benefits of starting a successful venture.

Unlike the previous systems in Central Asia, the Soviet rule made the career paths for talented people very clear and straightforward. It was clear what was required to get promoted and to stay at top positions and what rewards could be expected.

The Standard career path for talented youth started at school with the children's communist organization, called the 'children of October' referring to the October Revolution. Then they would join Komsomol, the youth branch of the Communist Party. The most distinguished activists of those organizations would be recruited to Party administration after graduating from one the top universities. After gaining a few years of experience working at lower levels of the party branches they would be



sent back to specialized party schools. The graduates of the party schools would be appointed to high level party posts.

The rewards for reaching such heights would include much better living standards compared to the rest of the population, in addition to the power and prestige attached to running high level party posts. While their main salaries were much higher than the national average, their luxurious life style was maintained by a network of special stores and discount housing, leisure facilities.

All of those rewards were tied to the posts the officials held and they only enjoyed them as long as they stayed in their positions. They were not allowed to accumulate and get rich in the same way the successful people in the market economies were allowed to. This system of rewards had important implications for the way the elites approached their jobs.

They would go to extraordinary lengths in order to keep their positions. Such high costs associated with losing important position coupled with the unrealistically ambitious plan targets unlocked amazing levels of creativity in the Soviet politicians and managers. Unfortunately, very little of that creativity was directed into productive activities.

Besides, because the Soviet enterprises were all owned by the state and did not have to be profitable, most of them were operating at unsustainable levels.

When it became clear that the system had failed, Gorbachev, the then head of the Communist party of USSR, decided to abandon the whole system and introduce a market based system with private ownership and open markets.

At first he was met with strong opposition, as the members of the Soviet elite were more worried about preserving their privileges than the greater good of the country.

But the momentum shifted in favour of the reforms as the bureaucrats realized the opportunities which the reforms would open for their own personal enrichment. The subsequent state capturing campaign saw some of the top party officials, enterprise managers, and high - ranking army and security service officers emerging as multi millionaires as the Soviet Union collapsed as a political and economic entity.

Uzbekistan's leadership, which has obediently followed Moscow's lead in everything since Stalin times, watched quietly until the time when it became very obvious that the Union collapsed before declaring independence in August, 1991.

But, Uzbekistan still stuck with Russia in terms of economic and monetary arrangements until the introduction of a new currency in 1994. Initially, the Uzbek government did much better than any other transition country in terms of halting the economic crisis and stabilizing both political and economic situations.

This was achieved by preserving most of the economic and political structure largely unchanged. First the disgraced communist party was renamed as the People's Democratic Party, and the administrative structure was kept unchanged with the new party inheriting the commanding position of the old one. Then the party rule was abolished altogether in favour of the revived pre-revolutionary administrative system of regional mayors that

replaced regional party secretaries. However, most of the former party secretaries stayed on in the new position.

The government even tried to replace communist ideology with the newly created 'Ideology of Independence', where developing and preserving Uzbekistan as an independent nation became the new overarching goal of the nation.

The President, who was the leader of the old communist party, became the symbol of nation and protector of its independence. Hence, loyalty to the President became synonymous with the loyalty to the nation.

The rules of the Game changed dramatically again. The brightest students no longer could expect a straightforward rise to the top by the traditional routes. Under the new system based on strong presidential rule, closeness to the 'centre of power gravity' became the new main criteria for success. The system was replicated in every region where power was concentrated in the hands of regional mayors.

Although the command economy was formally abolished and market based institutions were established, most of the Uzbek economy still remained under state control and the mayors are still in charge of both economic and political administrations of their respective regions.

As a result, there is no significant economic and political power outside of the control of the administrative apparatus. The success of those that do exist outside depends on the level of their closeness to the administrative apparatus.

Hence, the highest position in every region is the position of the mayor and the highest payoff in terms of material well being, prestige and power

can also be achieved only by the mayor. The mayors not only manage the public assets but also can interfere, at will, into any private enterprise's affairs.

The success and rewards of the others then are closely linked to their closeness to the mayor and his administration<sup>2</sup>.

For aspiring young talent therefore, the primary goal should be to join the ranks of the administrative officials and try to go as high up as they possibly can. The way into the ranks of the administrative officials goes through the top institutions of higher education (IHEs). Going to the top of IHEs is not as easy as it used to be during the Soviet time. Higher education is not free for all in the independent Uzbekistan and the increasing living expenses in the big cities, where the most of the top IHEs are located, add to the costs of education.

However, the large number of applications per placement at those top IHEs indicates that the population of Uzbekistan still considers education as a good investment. The admission process is administered centrally and the multiple choice questions selected from pre-published study manuals give the talented youth from even disadvantaged families enough chance to get through.

While at university aspiring individuals should strive to forge useful connections to get promising job placements with the headquarters of the big state enterprises and ministries.

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<sup>2</sup> They are, of course, a large number of proprietors who operate at self a sustaining level without much interference from the authorities. However, they are not considered to be truly entrepreneurial, as their primary aim in business is to sustain their consumption level not reinvest and expand. Therefore, they are often referred to as proprietorships rather than the all important entrepreneurship.

Working at these big institutions not only gives them valuable experience but also important connections. The Rules of the Game in Uzbekistan favour those who are skilful in forging useful connections and winning favours of their superiors.

Those who manage to get promoted to the levels of middle management can apply to study for a postgraduate degree at the Academy for State and Social Construction under the President of Uzbekistan. This is an institution that was created 'to educate future leaders' similarly to the old party schools. Graduates of the Academy often get appointed to high ranking administrative posts. Although the academy plays an important role in the elite regeneration, it is not the only way to the top.

At the highest level, the role of powerful interest groups seems to be all important. The interest groups are a loosely defined network of likeminded top officials who support each other in their common push for power and influence (See also Alesina and Tabellini (1988) on the involvement of bureaucrats and politicians in these power struggles). (The power groups are often formed based on the regional allegiances, although that is not strictly always the case.)

The power groups lobby for political and economic power and strive to get 'their guy' appointed to every important position when it becomes vacant. Therefore, in order for anyone to get appointed to those positions they have to enlist the support of one of the powerful interest groups.

Administrative elites in Uzbekistan depend on rent seeking income even more than the Soviet elites did due to the fact that the Uzbek elites do not have any of the extra privileges their Soviet predecessors enjoyed. They

also have a lot more freedom to extract rents from their positions given the Uzbek political system is not as strict as the Soviet system was. On the other hand, they now have freedom to accumulate and expand their earnings and build up business interests so they could carry on as private business owners should they lose their positions or in some cases, they can hide their earnings abroad.

But it is their dependence on rent seeking that is the main aspect of the system that is important for the purposes of our study. The reason for that is the fact that the authorities' reliance on rent seeking activities makes the life of smaller, independent entrepreneurs very difficult. Administrative officials competing for the same rent income in the same territory try various creative ways of extracting more rents in spite of the Central Government's efforts to improve the business climate for the smaller businesses.

The business landscape in every given region of Uzbekistan is dominated by the firms directly related to the top officials in the region and their close associates. The situation changes every time when there is change in the personnel of the top government offices.

In this study we analyze the Rules of the Game in Uzbekistan under three different political and economic systems and the implications of the changes in the Rules and regulation on talent allocation and entrepreneurship over time.

The next chapter will present a detailed overview of the theoretical foundations of the study, taking a closer look at the evolution of entrepreneurship theories over time.

Chapter three takes us back to the pre-revolution times in Uzbekistan, describing the economic, social, and political situations during the period preceding the Russian Invasion. We will also discuss the implications of the Russian Invasion of the region and the main characteristics of the system that the Russians established in Central Asia. We will then shift our focus on to the events that followed the October Revolution giving a special attention to the Central Asia's own Enlightenment movement, the Jadids. Finally, we will dedicate the remainder of the chapter to the discussion of the Soviet political, economic, and social systems and their role in shaping the managerial practices and choices.

Chapter four presents the overview of the performance of the Uzbek economy since independence, discussing the main policy directions and their results in terms of economic stabilization and growth.

Chapter five focuses on the state of entrepreneurship and small businesses in the independent Uzbekistan. This chapter includes the detailed discussion of talent allocation and the Rules of the Game, highlighting the role of the higher educational institutions.

Chapter six discusses selected obstacles perceived as problematic by local small business owners and managers. This chapter also presents the results of our interviews with the Uzbek business owners and managers conducted during the field trip in the summer of 2005.

The last chapter concludes the thesis by highlighting the main findings and offering our recommendation on the issue.



## Chapter Two: Theories of Entrepreneurship

### 2.1 Introduction

Entrepreneurship is the new 'gold rush'. Just like the original gold rush, entrepreneurship fever conquered hearts and minds of people in the 20<sup>th</sup> century.

With the success of the companies like Microsoft, IBM, Wal-Mart, Dell in the USA and Sony, Panasonic, Honda, Toyota in Japan, entrepreneurs topped the league of the richest people on the planet luring a lot more people into taking the risk of starting a new business. The phenomenal growth of American and Japanese economies after the Second World War was also largely the result of the emergence and rapid growth of new businesses.

Drucker (1985, p5) argues that the main reason behind the unprecedented success of the American economy during 1965-85 is the shift from a traditional 'managerial' to an 'entrepreneurial' economy. During that period SMEs in the US created about 40 million new jobs, while big institutions lost about 5-6million.

The contribution of entrepreneurs to the development of the American and Japanese economies was in fact much more than just creating jobs and increasing output. Their innovative efforts created whole new industries transforming the entire world economy. There are thousands of inventions and innovations made through private as well as government funded projects every year. Probably the best way of getting the greatest possible benefit, for the general public, from those discoveries, is to put them into

commercial use. In this sense, entrepreneurship can play an important role as a bridge between science and consumers.

In addition, entrepreneurship tends to increase the efficiency of economy by increasing competition.

There is a lot of discussion in the economic literature as to what entrepreneurship is and who the entrepreneurs are. Most of the arguments centre on the different ways in which different cultures treat entrepreneurship. Some have argued that entrepreneurship developed most in those countries where entrepreneurship is regarded as a desired occupation and success stories are well publicized. On the contrary, in the countries where entrepreneurship is not well respected, most of the entrepreneurial initiatives are likely to be misplaced and more businesses operate underground.

As for the motives of entrepreneurs to start new ventures, the literature tends to offer a broad classification:

- 1) 'Push' entrepreneurs – those who were forced into entrepreneurship by circumstances. These include those who lost their jobs or were laid off by their companies, people who had to find an extra source of income, even in some cases people who are excluded from the official labour market.
- 2) 'Pull' entrepreneurs – those who are lured into entrepreneurship by exciting business ideas, profitable opportunities etc.

Similarly, issues regarding the role and importance of Small and Medium-sized Enterprises (SMEs) attract considerable attention in economic policy discussions.

SMEs, as the end products of the entrepreneurial process, are usually viewed as agents of change in the economy. They carry innovations into economic activities, increase competition and create new jobs.

In most developing countries, SMEs constitute most of the private sector and play an important role in reducing poverty.

Since the economic literature mostly agrees on the importance of SMEs, the real bone of contention between researchers recently became the issue of public support for SMEs and national as well as international cooperation in nurturing SMEs.

One of the main concerns in designing such support policies, then, becomes the question of definition of SMEs. The reason for this is that, depending on the criteria used in defining SMEs, the size and content of the SME sector can be completely different.

The criteria commonly used include such aspects as the number of employees, size of assets, annual sales, capital etc. The purpose of this chapter is to discuss the entrepreneurship theories and their relevance to our analysis. The chapter is organized as follows:

-First we discuss the role and importance of entrepreneurship, looking back to the historical development of the concept of entrepreneurship in the economic literature and its different interpretation across countries and cultures. In addition we review the literature on entrepreneurship qualities and the motives of economic agents who take on all the risks and challenges of going into new businesses.

-Then, we move on to the discussion of governmental support programs for entrepreneurship in different countries paying special attention to the circumstances that arguably make those efforts successful.

-In addition, we will also discuss ‘the Rules of the Game’, i.e. the set of legal and social norms in the society, and their role in shaping the country’s entrepreneurial landscape.

At the end we will try to draw some conclusions and specify the details of our theoretical frame for analyzing entrepreneurship in Uzbekistan.

## 2.2 The Evolution of the Term and the Concept of Entrepreneurship

Entrepreneurship is a multidimensional phenomenon. Therefore, it attracted the attentions of scholars from various disciplines. While all the researchers tend to agree on the importance of entrepreneurship in economic, social and political aspects of life, they vary a great deal in defining its essence and emergence.

The term first appeared in English as early as 1475, according to the Oxford English Dictionary, in its old spelling as ‘*entreprennoure*’, and was used to refer someone ‘who undertakes, manages, controls’ projects and events and ‘champions troops in battles’.

However, Cantillon is the one who is credited to have used it first in economic analysis in his famous 1755 essay (Casson, 1990). He was first to associate the term entrepreneur with the elements of risk and uncertainty. He maintained that the amount of risk and uncertainty involved in

entrepreneurial activities should be acknowledged and entrepreneurs be given due credit.

Jean Baptiste Say (1803) then clarified the concept of entrepreneurship further by separating the profits of capitalists from those of entrepreneurs (Hisrich and Peters, 1998).

Adam Smith(1776), although he did not use the term entrepreneur explicitly, was one of the earliest scholars to point out the importance of private entrepreneurial activity in economic development when he wrote about the merchant who promotes the interests of the society by pursuing his own interest.

Later Schumpeter (1934) developed a more comprehensive theory of entrepreneurship, putting it at the heart of economic development. He explained the role of Entrepreneurship in the context of innovation and change. He described economic growth as a dynamic equilibrium systematically disturbed and pushed forward by innovative efforts of entrepreneurs. They, having recognized opportunities for profitable business, bring about 'new combinations' that creatively dismantle the existing economic processes and push the equilibrium to a new level where it will stay until the new wave of entrepreneurial activities come along.

'Development in our sense is then defined by carrying out of new combinations. This concept covers the following cases: (1) The introduction of a new good – that is one with which consumers are not yet familiar – or of a new quality of a good. (2) The introduction of a new method of production, that is one not yet tested by experience in the branch of manufacture concerned, which need by no means be founded upon discovery scientifically new, and can also exist in a new way of handling a commodity

commercially. (3) The opening of a new market, that is a market into which the particular branch of manufacture of the country in question has not previously entered, whether or not this market existed before. (4) The conquest of a new source of supply of raw materials or half-manufactured goods, again irrespective of whether this source already exists or whether it has first to be created . (5) The carrying out of the new organization of any industry, like the creation of a monopoly position. (Schumpeter, 1934, p66)

So, in his view, entrepreneurs create new products, change the way existing products are produced or open a new market for existing products. In addition, entrepreneurs may discover a new source of raw material and reorganize industries and create monopolies. They could be business managers, traders, farmers or craftsmen. The emphasis, however, was on carrying out the ‘new combinations’ no matter where they were being carried out and by whom they were being carried out.

‘But what ever the type, everyone is an entrepreneur only when he actually “carries out new combinations,” and loses that character as soon as he has built up his business, when he settles down to running it as other people run their businesses.’ (ibid. p78)

Later contributors to the entrepreneurship literature also continued along a similar line i.e. emphasizing innovation, creative characteristics of entrepreneurship and how important those characteristics were for economic development (McClelland, 1961, Shapero, 1975, Drucker , 1985, Hisrich, 1986, Morrison, 1998).

However, Schumpeter, as well as most of his followers, seemed to have assumed that all the innovation and creativity would be carried out in the productive sector, within the accepted legal and social norms. They did

not address the cases when creative drive, with the magnitude the entrepreneurial drive of Schumpeterian entrepreneur, directed at illegal or quasi legal activities, generated as much profit as it would in the productive sector albeit with catastrophic side effects. One striking example was given in a recent book by Levitt and Dabner (2005), who compare the introduction of nylon stockings and crack cocaine in the US market. At face value, the invention of crack cocaine instead of regular cocaine would fit perfectly well into Schumpeter's definition of entrepreneurship, just as much as the introduction of nylon stockings instead of silk ones previously used. In both cases, it was a new product of superior or equal quality, but with much lower cost. In both cases, the resulting product was available and affordable for mass consumption. They both generated millions of dollars in profits. There was only one problem with crack cocaine though. It was immensely destructive for society, especially for the poorest members of it.

'Crack was so dramatically destructive that if its effect is averaged out for all black Americans, not just crack users and their families, you will see that the group's postwar progress was not only stopped cold but was often knocked as much as ten years backward. Black Americans were hurt more by crack cocaine than by any other single cause since Jim Crow' (Levitt and Dabner, 2005, p113)

Would it be right to call activities of this nature entrepreneurship? Baumol (1990), says 'yes', as it fits perfectly well with all the descriptions of the classic concept of it as invented by Schumpeter and as understood by just about everybody else. But, he (Baumol) introduces a new term for those

activities; he calls them 'unproductive entrepreneurship'. His arguments rest on the assumption that entrepreneurial efforts have a strong bias towards wealth generation, power and prestige rather than innovation per se.

Therefore, if profitable opportunities are plenty and easily exploitable in formal sectors of the economy then entrepreneurship will thrive in these sectors and economic development will follow. On the other hand, if opportunities present themselves in the informal sector or even in illegal activities, and penalties are small and easily avoidable, then the bulk of entrepreneurial activity will be directed towards that sector.

In that sense, Baumol extends Schumpeter's original theory to cover rent seeking activities.

'If entrepreneurs are defined, simply, to be persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige, then it is to be expected that not all of them will be overly concerned with whether an activity that achieves these goals adds much or little to the social product or, for that matter, even whether it is an actual impediment to production. (Baumol, 1990, p898)

In other words entrepreneurs will be pursuing the activities that deliver most rent and that will add most to their influence and reputation. The attractiveness of individual activities will then depend on the 'rules of the game' i.e. the political and legal framework, social values and personal convictions. Therefore, when the rules change, so will the attraction of certain activities. He gives examples from the Roman Empire and Medieval China, where political offices were much sought after and the economic



system was subsequently shaped around that framework. He contrasted that with Europe in the Early Middle ages when a military career was more attractive.

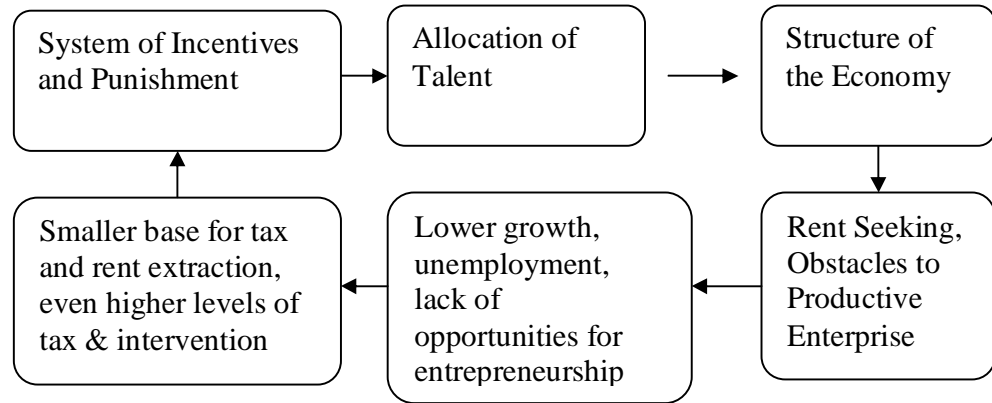
Murphy, Shleifer, and Vishny (1991) have taken it a step further to focus on the allocation of talent rather than entrepreneurship. Their argument is that talented people in every country have a variety of career options open to them and they will choose the ones which offer the best payoff for their abilities.

And the story does not stop there. The distribution of talent across various sectors will shape the economy determining its rate of growth and technological progress.

‘Which activities the most talented people choose can have significant effects on the allocation of resources. When talented people become entrepreneurs, they improve the technology in the line of business they pursue, and as a result, productivity and income grow. In contrast, when they become rent seekers, most of their private returns come from redistribution of wealth from others and not from wealth creation. As a result, talented people do not improve technological opportunities, and the economy stagnates. (Murphy, Shleifer, and Vishny, 1991, p505)

The effect of a rent seeking sector getting the best of the talent will result in the expansion of the sector which will consequently absorb more of every type of resource and the taxes imposed on the productive sector will discourage productive activities. Furthermore, because less talented people are left to work in the productive sector the rate of growth of that sector and technological change will be lower. The end result of all this will be a vicious cycle with rent seeking and corruption spiralling upwards, while the growth of the productive sector stagnating or growing very slowly. The following figure depicts this cycle.

Figure 2.1 The cycle of talent allocation, rent seeking and economic development



Countries with a considerable amount of natural wealth and a small goods market are especially known to be a fertile ground for rent seeking, the phenomenon known as ‘the curse of natural resources’ where countries sitting on a large amount of natural resources delay reforming their economies as the rents received from the sales of those raw material enable them to do so (see Kronenberg, 2004, for example for the effect of natural resources in transition countries).

The amount of wealth available for redistribution attracts a lot of talent and the development of productive sectors subsequently slows down. Winners in this case may then deliberately aim to weaken the property rights system in order to maximize rent extraction (Sonin, 2003).

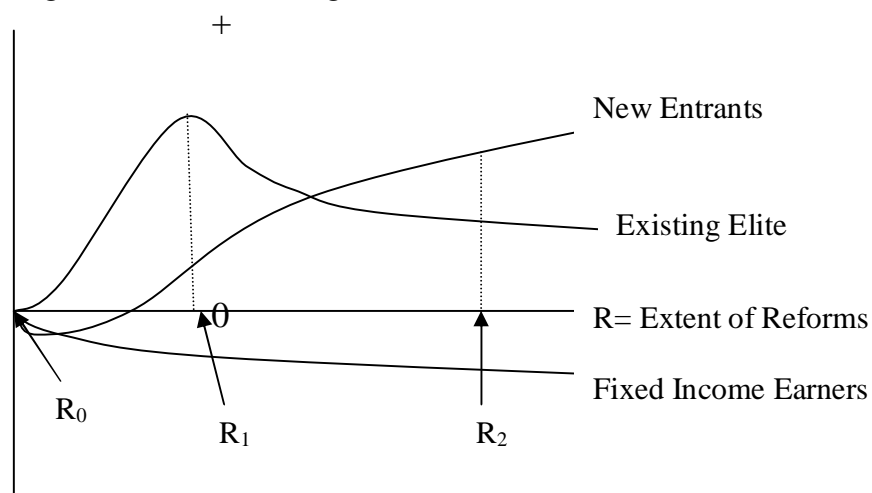
Frye and Shleifer (2001) named the resulting system as a ‘grabbing hand’ as opposed to Adam Smith’s invisible hand. The main characteristics of the ‘grabbing hand’ model are the prevalence of corruption, weak

property rights and excessive intervention by governments which are often above the law.

The resulting system will discourage genuine entrepreneurship and progressive economic reforms as the changes may compromise the privileged status of the existing elite. Countries thus will end up with ‘partial-reforms equilibrium’ with weak property rights and high levels of capital flight<sup>3</sup>.

The following figure illustrates the ‘partial reform equilibrium’ where the elite will support the initial stage of limited reforms, just enough to allow them to capture state assets, and will freeze the reform process at the point that maximizes their welfare gains.

Figure 2.2.1 Welfare gains from reforms in Transition.



Source: World Bank, (2002: 93)

<sup>3</sup> Speaking at the EBRD’s 2006 annual meeting Joseph Stiglitz claimed that the existing elite in former Soviet Union Republics got ‘the best of both worlds’ as they enjoyed ‘protected property rights abroad’ where they could keep the assets they captured due to the ‘weak rule of law at home’ (EBRD website, accessed on May 22, 2006).

The resulting equilibrium might not be an optimal one for the economy as a whole as the new entrants including entrepreneurs and Fixed Income earners like pensioners, teachers etc will loose out in the absence of full scale reforms.

### 2.3 Entrepreneurial Traits and Characteristics

A lot of attention in entrepreneurship research is given to the question of ‘what makes someone become an entrepreneur?’ or ‘how different are entrepreneurs from other people?’

The early studies on the ‘nature versus nurture’ issue emphasized the ‘inborn’ characteristics of entrepreneurs that helped them or rather drove them into entrepreneurial activities (Casson, 1990).

However, others argue that entrepreneurship is something that can be mastered by learning and practice. The proponents of this approach claim that anyone, who has the desire and determination, can become an entrepreneur.

‘It is not a personality trait; ... anyone who can face up to decision making can learn to be an entrepreneur and to behave entrepreneurially’ (Drucker, 1985: 23)

Shapero and Sokol (1982) classify entrepreneurs, based on their motives to become an entrepreneur, into two groups<sup>4</sup>:

‘Push’ entrepreneurs are those whose dissatisfaction with their current position, for various reasons unrelated to their entrepreneurial characteristics, pushes them to start a

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<sup>4</sup> Djankov et al., also classified entrepreneurs along similar lines but the terms they used were ‘entrepreneurs by necessity’ instead of ‘Push entrepreneurs’ and ‘entrepreneurs by opportunity’ instead of ‘Pull entrepreneurs’.

venture. The second type of entrepreneurs are 'Pull' entrepreneurs who are lured by their new venture idea and initiate venture activity because of attractiveness of the business idea and its personal implications.' Amit and Muller (1994: 28)

In other words, 'Push' entrepreneurs are those who are desperate to find a new source of income because, for example, they have lost their job.

This category also includes those who do not have access to the formal labour market because of legal, language or cultural barriers, or were simply discriminated against, and therefore have to resort to entrepreneurship in order to support their livelihoods (Putz, 2003, Lerner and Hendeles, 1993)

Putz (2003) discusses entrepreneurial motivations in the context of the so – called 'immigrant business' phenomenon. He argues that the limited employment opportunities available for immigrants in Germany due to the language barrier and discrimination 'impelled them to self employment in order to secure their livelihood. He also points out that emergence of immigrant communities in itself may create other entrepreneurial opportunities in areas such as ethnic food and clothing. As a result, immigrant communities develop a unique sub-culture that encourages and supports self employment. It is this sub-culture that often makes some ethnic groups more entrepreneurial and inspires the stereotypes such as 'having business in their blood' (Putz, 2003: 555)

As for the 'Pull' type of entrepreneurs, they are rather driven by their new ideas and ambitions to become independent, wealthy and influential. This category also includes insiders such as members of the existing elite,

their families and friends, i.e. those with privilege, social networks and insider information, creating lucrative opportunities for business.

A 2003 Survey of Entrepreneurs in 41 countries conducted by the Global Entrepreneurship Monitor (GEM) showed that 93% of Entrepreneurs could be classified in one of the two categories, which they named as opportunity entrepreneurs (Pull) and necessity entrepreneurs (Push). 80% of all entrepreneurs categorized themselves as the opportunity entrepreneurs and 20% said they would consider themselves as necessity entrepreneurs. The majority of the entrepreneurs were 25 – 34 years old at the time they started their businesses and 80% of all entrepreneurs had a job when they started up their own businesses.

Those findings were supported by Djankov et al (2005) who found that the majority of Russian entrepreneurs came from relatively well – off families with around 20% of them being the children of company directors<sup>5</sup>.

Surveys have also shown that the ‘Pull’ (opportunity entrepreneurs) were more successful than the ‘Push’ (necessity) entrepreneurs (Amit and Muller, 1994). This is hardly surprising, given the fact that they are likely to be better educated and well connected.

Scase (2003) argues that it is the intentions for the future that are more important than the motives for starting. He distinguishes entrepreneurship from a mere ‘ownership of property and other assets which may be used for personal enjoyment, consumption or trading’ (p67).

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<sup>5</sup> The survey conducted by McCarthy et al (1992) had found that the fathers of 37.5% of their respondents were executives.

The economic surpluses from such activities, which he calls proprietorship, will be used to maintain a certain lifestyle and will be consumed rather than being accumulated and re-invested in the business.

As a result the businesses owned and run by proprietors remain small and often employ very few people from outside their families. In later chapters, we will discuss proprietorship and the reasons that cause the business owners to remain proprietors rather than pursuing expansive business policies in the context of transition.

## 2.4 Creating Entrepreneurial Environment

In the previous section, we discussed the essence and importance of entrepreneurship in economic development. As we have seen, there seems to be a general consensus among scholars and policy makers that the development of entrepreneurship should be encouraged and proactively promoted.

However, the conventional definitions of entrepreneurship are too general to use for policy purposes and therefore policy makers around the world, as well as international organizations, use various definitions of Small and Medium Sized Businesses (SMEs) as a proxy for entrepreneurship.

Besides, due to the nature of transition economies, SMEs make up most of the new private sector and consequently when they talk about ‘private sector support’ initiatives, in a transition context, they often refer to SMEs and entrepreneurship.

The argument in favour of deliberate intervention to support entrepreneurship is often justified by the fact that different countries, with otherwise comparable characteristics, seem to have different numbers of entrepreneurial start – ups (GEM 2003). The reason for those differences is that entrepreneurs face different obstacles in different countries. (See for example Pfeffermann and Kisunko 1999, World Bank 2001, UNECE 2003).

Staley et al. (1971), in one of the pioneering studies in entrepreneurship and SME support, developed a new venture creation model which emphasized four key aspects of new business creation.

The first aspect was creating opportunities for entrepreneurs to exploit. This would entail, among other things, allocating at least some of the government purchase orders to the new smaller businesses, inviting big international corporations to build new production facilities that create more business for local suppliers and distributors, and giving various privileges for smaller businesses and new start ups in certain sectors. Governments also should try to keep the administrative and legal barriers to minimum.

The second aspect concerns the ability to enterprise i.e. the ability of those, who spotted an opportunity for a business, to exploit the opportunity. This includes the general level of entrepreneurial and managerial expertise. Transition countries especially lack in this area as people in those countries did not have prior experience in running private businesses. Offering specialized management training may mitigate the problem.



The third aspect concerns the factors which we discussed earlier such as the propensity of a certain age group, ethnic group etc to get involved in new business start – ups. Traditionally in every society, certain groups, depending on income levels, cultural upbringing etc, tend to choose certain occupations. (Later we will discuss this issue in the context of the Soviet elite regeneration.) In order to increase the propensity of the general population to get involved in entrepreneurship, it is often recommended that successful entrepreneurs should be promoted as role models.

The final aspect of the enterprise creation process concerns the likelihood of those who are capable of it to become entrepreneurs. This includes the kind of infrastructure that gives an initial helping hand to the aspiring entrepreneurs. Governments establish business advisory bodies offering practical advice on legal and administrative matters related to starting new ventures. (Examples of such institutions include business incubators and business gateways which are quite commonly established by local authorities in the UK. In Uzbekistan, the system is administered by the Chamber of Commerce and Entrepreneurship which has branches all over the country.)

As most of the studies on the obstacles to entrepreneurship, found the financing to be one of the most important obstacles (Sarder 2000, Klapper et al. 2002, Pissarides 1998), SME support programs in almost every country include financial support as an essential ingredient.

Major forms of financial support have been in the form of preferential loans, credits, and grants.

All major international organizations including World Bank, IFC, EBRD and ADB, have SME support programs that extend financial support to SMEs in member countries.

In addition to financial support, support programs offer a wide range of non-financial support which includes management training, entrepreneurship education, technical assistance, marketing help, information, counselling, and infrastructural facilities (Sarder 2000).

## 2.5 Conclusion

In this Chapter we discussed the theories of entrepreneurship. Both the term and concept of entrepreneurship took a long journey from the 15<sup>th</sup> century, when it simply referred to a ‘go-between’, to the modern definition that embraces such multidimensional aspects as innovation, calculated risk taking, hard work and attention to detail, among other things.

However, it is since Schumpeter that entrepreneurship has been at the heart of the development policy agenda. Scholarly discussions thereafter often concentrated on the ways of encouraging entrepreneurial activities and removing any obstacles which might hinder their development.

Recent studies have extended the entrepreneurship theories to overall talent allocation processes and argued that the ultimate development of entrepreneurial activities and hence the development of societies are determined by the overall ‘Rules of the Game’ in every society.

These theories of entrepreneurship, considered against the background in Uzbekistan set out in the first chapter, enable us to suggest the following propositions which will be discussed in the remaining part of the thesis.

**The First Proposition:** Rules of the Game both in the Former USSR and Uzbekistan encouraged rent seeking activities rather than productive entrepreneurship.

**The Second Proposition:** The best of entrepreneurial talent in the former USSR and Uzbekistan chose to enter the rent seeking sector rather than productive sector.

**The Third Proposition:** The resulting system in Uzbekistan resembled the 'grabbing hand' model and therefore most of the problems faced by the entrepreneurs in the country spring from the nature of the system.

## Chapter Three

### Historical Evolution of the Rules of the Game in Uzbekistan

#### 3.1 Introduction

We discussed the theory of entrepreneurship and its role in economic development in the previous chapter. In this chapter, we will discuss entrepreneurship and business in Central Asia in historical perspective in order to establish 'Rules of the Game' that governed the allocation of the talent in the pre-revolution Uzbekistan and construct the evolutionary track of these rules over time.

First we will talk about the history of the region going back to the time of Khanates in early 19<sup>th</sup> century, before the Russian invasion of the region in 1864. The reason for that is that it was the only time when there was a market based system. Although underdeveloped and far from perfect, it was the last experience of the people of Central Asia with markets before the introduction of the planned economy.

The period in question is also important for a number of other reasons. A crucial one is that the decisions made and institutions established during that period had a lasting impact on the development of the region for more than a century to come. It is the time when there started a surge in scholarly interest in the region owing to the intense competition between Russia and Britain for the dominant position in the region (Surucu, 2004). It is also from that time on that one can find any

statistical data about economic activity in the region, good enough for research purposes.

In addition, we will concentrate on the factors that made certain activities and sectors of the economy more attractive for the best talent. We will also discuss the influence of the ‘rules of the game’ in shaping the society and the economy.

This chapter will explore the behaviour of traditional creative entrepreneurship and the striving of the most talented people to get to the top in the wake of major external shocks in the form of foreign invasion and then the Communist Revolution.

### 3.2 Entrepreneurship and Business in the 18<sup>th</sup> Century Central Asia before the Revolution

Defining the boundaries of Central Asia is not as straightforward in economic and political literature as it is in geography. Traditionally, the term was used to refer to the area which included the current territories of Uzbekistan, Turkmenistan, Tajikistan and Kyrgyzstan<sup>6</sup>. Contemporary transition literature tends to add Kazakhstan to the area, mainly because of the historical and cultural heritage that the other countries share with Kazakhstan. The following map shows the boundaries of different definitions of Central Asia.

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<sup>6</sup> Kazakhstan, part of which is geographically located in Europe was not considered to be part of Central Asia according to the official Soviet definition. The exact term used in the Russian literature is *Srednya Asia*, meaning Middle Asia to refer to the former Soviet Republics in Central Asia and *Tsentr'al'naya Azia* meaning Central Asia to refer to general area which included areas outside of the Former USSR however modern literature uses the same term Central Asia for both translations ([www.wikipedia.org](http://www.wikipedia.org))

Considering the similarities in history, cultural and ethnic background, we will include Kazakhstan to the group of other Central Asian countries and thus adopt the common modern definition of Central Asia for the purpose of our study.

Figure 3.2.1 Map of Central Asia



## Historical Perspective

Central Asia has historically been one of the most volatile and dynamic regions of the world. It was invaded by almost every major empire in the past and thus accumulated a very rich mixture of races and cultures over time. The region played a key role in connecting the West with the East as a part of the Silk Road for many centuries. The focus of our study is, however, the period that immediately preceded the Russian invasion of the region in mid-19<sup>th</sup> century.

Since about the 16<sup>th</sup> century, when the last big empire, the Temurid Empire, uniting the whole area collapsed, there existed three independent kingdoms (*khanates*), namely The Khanate of Kokand, The Emirate of

Bukhara and The Khanate of Khiva. All the major cities of those kingdoms, including the capital cities were located within present day Uzbekistan.

Figure 3.2.2 Central Asia prior to the Russian Invasion



Source:Soucek(2000)

The population of Central Asia consisted of nomadic tribes of mainly Kazakhs, Kyrgyz and Turkmen, and the settled population of Tajiks and Uzbeks. The population in Khiva included a large number of Iranian and Russian slaves, while Bukhara had a considerable amount of Jewish population. The ruling royal families in all three kingdoms were from

Uzbek<sup>7</sup> tribes, thus the ruling elite were also dominated by the Uzbeks. As the population of the area was predominantly Muslim, Islamic law prevailed albeit with some peculiarities.

The exact number of population, living in the area around the end of 19<sup>th</sup> century is questionable due to the lack of any reliable records. However, Allworth (1994) estimated it to be in the region of 5 million, quoting some contemporary authors who visited the region immediately after the Russian conquest<sup>8</sup>.

The Head of State and absolute monarch was called the Khan who was ‘nominally absolute master of his realm and the lives and fortunes of his subjects’ (Skrine and Ross, 1899, p379). His prime minister, *Qushbegi*, was the official guardian of the state jewels and the keys of the capital city. He was also responsible for the collection of taxes and customs duties. Next to him in the rank were a large number of executive and court officials.

The regional governors were called the *Begs*. They exercised considerable authority in the areas under their control and were responsible for the collection of revenues and the execution of judicial decrees. But in practice they had much more freedom to run their own domains as they pleased, introducing new taxes, creating their own rules and sentencing their subjects to any punishment they fancied, including death, at will. This degree of discretion in regional government was due to the weak central

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<sup>7</sup> Uzbeks are part of the greater Turkish family. Although the name Uzbek is associated with the name of the King who was first among the Turkish tribes to accept Islam, contemporary Uzbeks represent a wide range different Turkish tribes who settled in the region over centuries.

<sup>8</sup> Francis Skrine, who visited the region in late 18<sup>th</sup> century, estimated the population of Bukhara at 2.5 million



governments and the clan structure of the society typical of Central Asian kingdoms of the time.

### 3.2.1 Agriculture

Economic activity reflected the cultural background of the population, with the nomadic tribes of mainly Kazakhs, Kyrgyz and Turkmen moving around the region breeding their cattle with the settled population of Uzbeks and Tajiks employed in agriculture in more or less the same way they had been doing for centuries.

In theory, all of the land belonged to the state and the head of state was considered its owner. The state derived most of its revenue from land taxes. Much of the uncultivated land was under the communal use of nomads and the cultivated part of the land was divided into several categories for tax purposes. The most common type of land in the cultivated part was the so called *mulk* (property) which was held under some form of private ownership (according to Skrine and Ross, 1899, this category included the land given to successful generals as a gift for the services to the king and to other members of the elite for various favours). This type land was divided into further three categories: the first category (*mulk hurr*) was exempt from tax, the second category (*mulk ushri*) paid a tenth of their harvest in tax and the third category (*mulk khiraj*) paid somewhere between a seventh to half of their harvest in tax. The last category was the land held by non-muslims and according to tradition, inherited from Arabic rules of the 8<sup>th</sup> century, those lands were taxed at higher rates. Another type of land tenure was called *waqf*, which in general

referred to any land owned or used by religious organizations and such lands were completely exempt from taxes.

The general rule was that if anyone cultivated and irrigated an uncultivated, unused piece of land then it could be claimed as private property and would be taxed under the category of *mulk*. According to Matley (1994), about 90% of all irrigated land belonged to the *mulk* category, and therefore were in private hands.

The actual amount of land cultivated compared to the total area of the region was very small. Lyashchenko (1970) reported that the irrigated area amounted to only 2.6 % of the total area at the time of the Russian Invasion. Hence, the proportion of land per household was very small and the price of land was very high.

Agriculture was quite well developed as the following quote from Skrine and Ross suggests:

‘The cultivation of fruits is well understood. The melons have a more delicate aroma than those of any Eastern country. Dried apricots are known in India as the ‘*Alu-i-Bokhara*’; and every variety of fruit familiar to the European palate is to be had in a perfection and at prices which would excite wonder in Covent Gardens.’ (Skrine and Ross, 1899, p363).

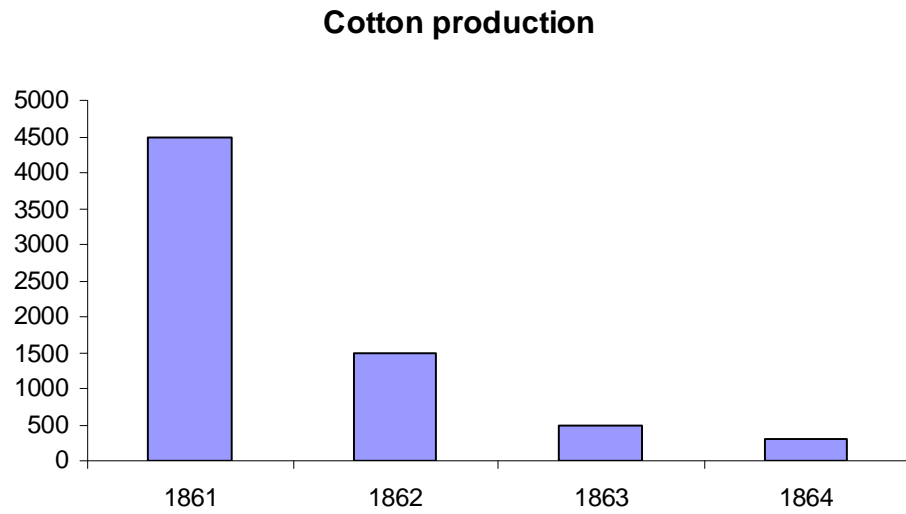
However, nearly all of the fruits and vegetables were produced for local consumption as the transportation problem made it unprofitable to export most of them. The only few agricultural products suitable for transportation over long distances were cotton and dried fruits.

### 3.2.2 Cotton Industry

‘The cultivation of cotton existed in the territory of Central Asia since ancient times, having been introduced there from India. It was mentioned by Herodotus as early as the fifth century B.C. as a crop of the local population. For many centuries the cultivation of cotton in this region was no more than another local industry, since neither the cotton in itself nor its products could find a wide outside market in the face of poor transportation facilities, especially the variety raised there were mostly common local types intended for manufacturing of wadding, and the finished home-woven articles were of poor quality goods’ (Lyashchenko, 1970,p609)

The situation in the world cotton market changed enormously during the 1860s due to the American civil war. The Southern States of America, where most of Europe’s cotton supply came from, reduced production of cotton dramatically. The following figure demonstrates the extent of the fall in cotton production in America during the civil war.

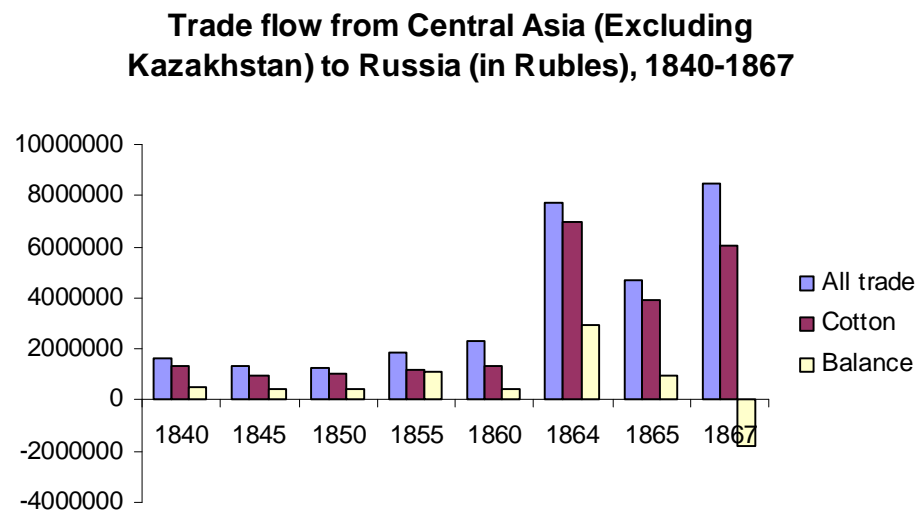
Figure 3.2.3 Cotton production



Source: [www.civilwar.com](http://www.civilwar.com) accesses on February 15, 2006.

As a result textile industries in most European countries, including Russia, suffered badly. This in turn made cotton exports from Central Asia very profitable. The following figure shows the trade flow between Central Asia and Russia during 1840-1867.

Figure 3.2.4 Trade between Russia and Central Asia



Source: Alworth (1994)

### 3.2.3 Other industries

Although the cotton industry dominated the economic scene in Central Asia, there were some other smaller industries flourishing in the region. The nomadic Turkmen tribes were famous for their carpets made of wool, as were the craftsmen of the people of Bukhara and Samarkand for their products.

‘Carpets and rugs of harmonious tone, piles of gaudy shawls and dress pieces, snuff-boxes of polished gourd to hold the pungent green powder affected by the Bokharans, and cutlery and trinkets of every description.’ Skrine and Ross, 1899, p370)

In spite of the fact that the Islamic laws prohibited usury and lending activities, money exchange activities and lending (largely unofficial) were widespread.

‘Money-changers’ stalls are frequent, with tempting heaps of silver and copper discs for exchange against Russian money. ... The Hindu shares with the Jew the immense profits derived from money-lending, which is forbidden to true believers, and they are eager and rapacious traders. The large commerce in tea is in the hands of some wealthy Peshawar Mohammedians’ (Skrine and Ross, 1899, p367)

The main wonder of the Central Asian cities of the time was their bazaars. Having been the central points on the Silk Road for hundreds of years those cities served as main transfer points for European goods going

towards the East and vice versa. After the British conquest of India a large proportion of English goods started coming through Central Asian bazaars to Russia.

The Central Asians, who mastered their intermediary role between Asia and Europe and Middle East for centuries, were controlling most of the trade flow and therefore were considered extremely difficult to compete against by their Russian counterparts.

Especially after they switched from the practice of barter to cash trade in 1830s, the Central Asian merchants caused a considerable flight of gold and silver from Russia to Central Asian markets. Allworth (1994) estimated it to be around 4 million rubles in 1863.

‘Czarist authorities, who had been coveting Central Asia’s natural gold since Peter the Great’s time, felt strong pressure from Russian merchants to ban these exports of money, for the traders believed that such outflows to Bukhara and Khiva represented a single greatest obstacle to the development of Russian trade in that area. These czarist businessmen felt that the greater liquidity acquired with Russian metallic rubles permitted Central Asians to deal actively with Russia’s most feared competition – Iranian and Indian merchants selling English manufactures who demanded cash payments for their wares. In sum, Russian merchants seemed to be unable to succeed in Central Asia’s open market, whereas the Bukharans, Khivans and to a lesser extent Khokandians, so long as Central Asia remained independent, thrived on the rivalry they met in Nizhni Novgorod and other cities’ (Allworth, 1994, p30)

This and the situation in the world cotton market, together with the pressing demands of the 'Great Game'<sup>9</sup> between Russia and Britain for dominance in Central Asia, prompted Russia to invade Central Asian Khanates. The process of systematic conquest which started with the invasion of Oqmachit in 1864 lasted until the 1880s when last groups of Turkmen were defeated. The joint delimitation of the Afghan border with the British finally put an end to the Russian expansion in Central Asia in 1895.

The Russian conquest and subsequent colonization of Central Asia was by all accounts similar to the other colonial expansions of major European powers of the time. In contrast to the earlier expansions of the Russian Empire towards Siberia and the Kazakh steppes, the conquest of Central Asia was not followed by mass migration of civilians and the area remained under military administration even after the final defeat of the local armies.

Clem (1992) defines the typical characteristic of colonial rule in the context of the common practices throughout the other European colonies around the world. According to his observation typical colonial

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<sup>9</sup> The term Great Game was originally coined by British officer Connolly who was sent to Bukhara before the Russian Invasion but was caught and publicly executed. He used the term to refer to the competition between Russia and Britain for dominance in Central Asia. The term later became very popular in the literature on the history of Central Asia and used to describe a wide range of things including the diplomatic and scholarly exchanges that to a considerable extent represented biased views of both sides. To this Great Game we owe much of the scholarly work on Central Asia produced during that time. For an intriguing account of the Great Game politics and the biases reflected in the contemporary literature see Surucu (2004).

arrangements involve a small number of intruders ruling over a large number of indigenous population using superior technology or military power, and they run the occupied country as an economic complementary to the mother country. The control under those arrangements normally exercised through military authorities and the intruders' presence is concentrated in highly segregated urban settlements. The occupied are normally allowed to maintain their own culture and way of life although socioeconomic stratification along ethnic lines prevails (Clem, 1992:25).

In Central Asia, Russians used very similar arrangements. The occupied territories of Kokand Khanate and part of the Bukhara Kingdom up to the town of Katta-Kurgan were annexed. The rest of Bukhara and the Khanate of Khiva became protectorates in 1868 and 1876 respectively. The territory of Kokand including Samarkand included into Governor Generalship of Turkistan which also included part of the Kazakh steppe.

### 3.2.4 Economy and Infrastructure under the Czar's Russia

Due to its landlocked location and desert climate Central Asia presented a formidable challenge in terms of transportation. The following quote from Skrine and Ross (1899), about an earlier Russian raid into Central Asia, helps us to understand the scale of the transportation problem:

'He equipped an army of 3.5 battalions of Orenburg Cossacks, and 22 guns with a rocket train. Transport was effected by nearly 2000 horses and 10000 camels, tended by 2000 Kirghiz, and the utmost care was lavished on every detail of the equipment. ... The



expedition struggled on as far as Ak Bulak, about half-way to the Khivan frontier, and was there fain to retreat, leaving the bones of 10000 men and 8000 camels whitening the pitiless sands.' Skrine and Ross, 1899, p244)

Having learned bitter lessons during their military expeditions, the Russians sought ways to ease this enormous transportation problem as soon as they got the control of the entire area. The advisers to the Tsar considered a few available options:

' A strong party favoured the canalisation of the Amu Darya, and an attempt to divert its stream to its ancient channel, which entered the Caspian at Krasnovodsk. Another faction pointed to the vast results achieved in India by the network of railways, which enables a European military force barely 60,000 strong to dominate 250,000,000 Asiatics; and urged the necessity of providing the means of rapid transport of troops and material between Caucasus and the new strategic bases. (ibid. p307)

Thus, the decision was made in favour of railway construction and by an imperial *ukase* in April, 1884 General Annenkoff was appointed to take charge of the project. The construction of the railway was carried out by the military in such intensity that the distance of 879 miles (including building a bridge over Amudarya) up to Samarkand was completed by May 1888<sup>10</sup>. The railway was extended up to Andijan a few years later and the completion of Tashkent – Orenburg line in 1906 finally connected all the major cities of Central Asia with the rest of the world through Russia.

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<sup>10</sup> Skrine and Ross also point out that the railways built in Central Asia cost almost three times less per mile than the railways built by the British in India (Skrine and Ross 1899, p313)

Although the railway project was planned with military purposes in mind, it was probably the biggest single contribution to the development of the Central Asia by the Russians.

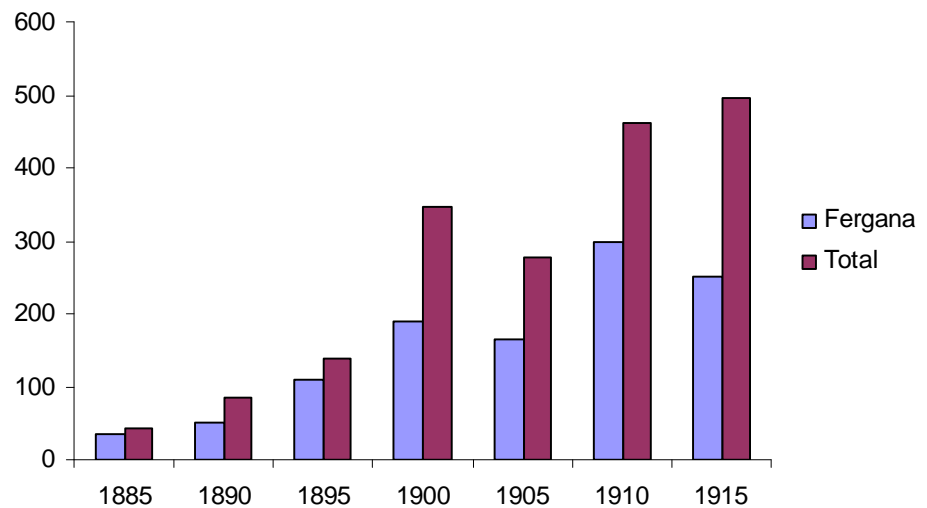
‘The impact of rail transport on the economy was thus considerable. There is a significant correlation between construction of the railroads, the extension of the area sown to cotton, the export of cotton from Central Asia, cotton imports into Russia from abroad, the price of cotton on Central Asian, Moscow, and world markets, and the construction of industrial enterprises for the period 1880-1915.( Matley, 994, p328)

For the first time in the history of Central Asia, the traditional routes of the Silk Road faced real competition from the trade routes coming through by sea up to the Caspian and by the railways thereon.

By 1897 the total exports through railways reached 109,000 tons of which 81,000 tons was raw cotton and 8000 tons was wool. The main import articles included manufactures, sugar, tea, metals, oil and other goods produced in Russia as well as in Western Europe. Tea and spices produced in China and India also found their way through the new trade routes.

But one of the main aims of the Russians in Central Asia was to increase cotton production in order to ease the Empire’s textile industry from reliance on outside supply of cotton. At the time of the invasion, the percentage of land sown to cotton only amounted to about 10% of the total agricultural area. The following table shows the increase in the acreage under cotton before the revolution.

Figure 3.2.5 Increase of the acreage under cotton (in thousand dessyatins)



Source: Lyashchenko (1970)

The local type of cotton was called *g'uza*, which

‘had to be picked in the boll and the bolls had to be labouriously removed by hand – a job mainly performed at home by women. Fiber and seeds were then separated by pair of rough wooden rollers, an inefficient device known as *chighiriq*. In twelve hours only seventy pounds of cotton could be handled by this method. The cotton was then cleaned by being placed on the floor and beaten with sticks.

This badly processed raw material was then packed into large sacks, each of which held about 300 pound, and loaded on the caravans for Russia. By the time the cotton reached its destination the outer layer had been ruined by damp, sand, and dirt, and often some had been stolen by porters. At that time the loss of cotton was said never to be less than 25 percent, often was 50 percent, and averaged about 35 percent’ (Matley, 1994, p309)

Thus if Central Asia was to replace America as the main supplier for the Russian textile industry, some major reforms had to be carried out. The local type of cotton was gradually replaced by the American type which was of a better quality and higher yield.

During the period between 1884 and 1890 the area sown under the American type of cotton increased nearly 200 times to ‘no less than 158992

acres' and by 1990-01, 93.4 percent of the total area of Ferghana oblast grew American cotton. As a result the average yield increased dramatically, from just 160 lbs per acre in 1875 to 1136 lbs per acre in 1915. (Matley, 1994, p275)

Due to the dry nature of the Central Asian climate, irrigation played a major role in the agricultural processes. Sophisticated irrigation systems have existed in the area since the ancient times. Although most of the original system was destroyed during the Mongol invasion, the traces of those irrigation routes were discovered by the Russians even in the unpopulated regions. The administration and maintenance of the irrigation system was very important for the livelihoods of the local people.

The administration of the irrigation system was conducted on a popular basis. The elders of local communities elected water managers called *mirobs* who were in charge of rationing water for irrigation of private plots. Water was generally distributed free of charge and farmers were required to contribute man-power for cleaning and maintenance of the irrigation system.

'In theory, water was distributed evenly to all; for example, those owning land at the head of the canal had no right to use more than they were entitled to, so that those living farther along the canal should not suffer. In practice a well-placed bribe insured supplementary supplies of water, a situation clearly favouring the well-to-do farmer. In addition, landowners at the heads of the canals often diverted more than their fair share of water for the growing of rice.' (ibid., 1994, p280)

The administration of the irrigation system was left in local hands after the invasion by the Russians. However they made it a priority to increase the overall irrigated area in order to increase cotton production. Several new canals were built. Matley (1994) reported that the irrigated area in Central Asia increased from 7.5 million acres to over 13.8 million acres between 1903 and 1814.

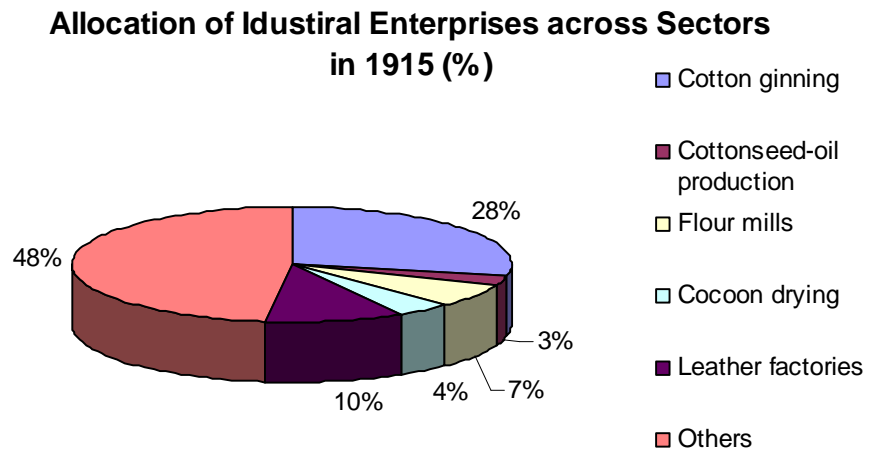
### 3.2.5 Industrial development

The economy became even more dependent on cotton after the trade routes to the East and South were cut by the Russians. Therefore, not surprisingly, industrial development in the region was also closely linked the cotton processing and textile sectors. Industrial production in pre – Russian Central Asia was almost non – existent except for those small craftsmanships and workshops mentioned above. The earlier pockets of industrial production were scattered around the railway stations and along the newly built railways. First workshops were related to the support and maintenance of the railways and the army. As for the cotton processing industry:

‘The first two cotton gins in Central Asia were installed in Khokand by private individuals in 1880 and their number in Ferghana oblast had reached 21 by 1890, increased to 100 by 1901. In 1914 the oblast had 159 ginning plants, which represented the greatest concentration of cotton ginning in pre-1917 Central Asia. In the same year Samarkand oblast ran 33 ginning plants and Sir Darya oblast 28. (Matley in 1994, p319)

The following figures demonstrate the relative share of different sectors in industrial production.

Figure 3.2.6 Allocation of Industrial Enterprises in Central Asia



(Lyashchenko (1970,p615)

Cotton gins along with cottonseed-oil production companies dominated in terms of sheer numbers. The dominance was, however, even more significant in terms of production volume. The cotton industry produced well over 82% of output. Therefore for the local economy of Central Asia it was the first and only industry in its modern sense. The cotton processing companies were considerably larger but relatively less labour intensive than the companies in other industries. They only employed about 45% of the industrial labour force while other more labour intensive industries like cocoon drying employed more people relative to their share in production.

Figure 3.2.7 Industrial Production

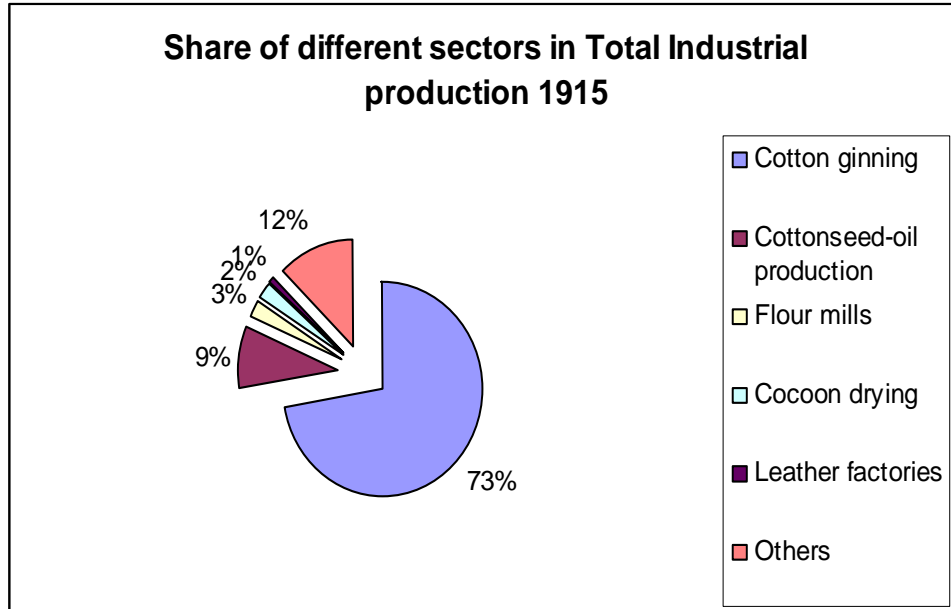
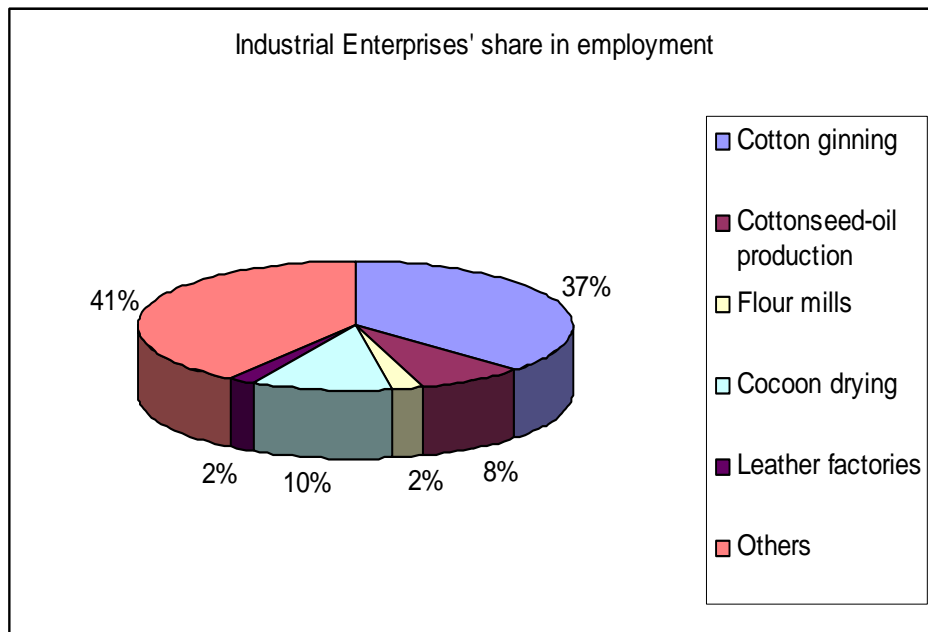


Figure 3.2.8 Industrial Employment



### 3.3 Entrepreneurship and the Rules of the Game under the USSR

#### 3.3.1 Central Asian Enlightenment and Revolution

Employees of the industrial sectors in Central Asia attracted a lot more scholarly attention from Sovietologists and historians than their mere economic importance deserved. The reason for that to some extent was the central role given to the proletariat in the Marxist/Leninist ideology and also the peculiarity of Central Asian proletariat that played an important role during the October Revolution.

The proletariat was the ideological centrepiece in Marx's analysis. He predicted that the industrial workers, oppressed and exploited by the profit maximizing capitalist bosses, would unite and rise up to overthrow the whole social structure made to suit the bourgeois elites.

In the late 19<sup>th</sup> century and early 20<sup>th</sup> century up to the October Revolution, liberal views of all sorts flourished in Russia. Led by the intelligentsia and students, those liberal and socialist movements started attracting a lot of industrial workers whose appalling living and working conditions continued to deteriorate during the political and economic turmoil of the 1990s.

The Russian authorities then had a habit of exiling such trouble makers to remote parts of the Empire, and Central Asia was one of the common dumping grounds for liberal heretics. Many of the activists among students of leading Russian universities as well as activists among workers and even among soldiers ended up being exiled to Central Asia. They continued to do what they were doing now in major cities of Central Asia.



They organized various societies and published liberally minded newsletters in Samarkand and Tashkent.

But the irony of the situation was that the proletariat in Central Asia was far from the oppressed masses described by Marx.

Most of the industrial workers in Central Asia were Russians. Local people were only employed to do low skilled, low paid manual jobs which often were seasonal.

‘In the mining industries where the Central Asians worked all year, 45.6 percent of the personnel were Russians, 34.4 percent Muslims from outside the country (Persian, Afghan, or Tatar), and only 18.9 percent were local labourers. Here again, the Muslims held the most menial jobs at trifling wages. Among the railway employees, who alone represented nearly half the labour pool, for security reasons there were mainly Russians. Finally, certain military railway battalions in charge of guarding the rail lines lived with the employees and not in barracks. These battalions were now filled with Russian students guilty of having liberal views, suspects, and soldiers deemed undesirable in Russia because of ‘poor spirit’. (d’Encausse, 1994, p181)

Thus the proletariat in Central Asia was essentially Russian and was not an oppressed class struggling to survive with long working hours and low wages. In fact, by any standards they were privileged people with better income and better housing. In the eyes of the local population, they were the representatives of the occupying country and therefore did not enjoy any popular support.

The revolutionary views among the local population were inspired and influenced by the reformist movements of other Muslim minorities of

the Empire, especially by Tatar writers and to some extent by the Turkish reformist movements. Therefore, those new schools of thought developed in Central Asia followed Pan-Islamic and Pan-Turkish routes rather than joining in with the Russian liberal, revolutionary movements. This was partly because of the deliberate Russian policy of excluding local people from modern educational institutions and supporting the existing orthodox social order run by narrow – minded ultra – conservative religious leaders. As a result the growing discontent with the existing order of things turned the new generation of intellectuals not only against the colonial masters but also against the local religious leaders who were desperately clinging on to their fast abating powers.

Those reformist groups, known as *Jadids* because of the new method (*usooli jadid*<sup>11</sup>) of instruction at schools that they pioneered, initially advocated reforms in the education system and criticized the religious leaders for obstructing progress. Although they are generally referred to as a reformist movement or political group, Jadidism was more like an ideology than a political movement. The term is used to refer to the group of well educated young people who represented the middle classes, the kind of people often called the petty bourgeoisie by communist authors. Most of them came from merchant families and therefore travelled extensively between Central Asia, Russia and other European countries. It was during those travels they encountered different ideas and were inspired

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<sup>11</sup> The new method of teaching mentioned here refers to the new way of teaching the old Arabic alphabet that is in use among Muslim population of the Russia Empire. The method was pioneered by a Crimean Tatar called Gasprinsky 1880s. He travelled extensively around the Russian Empire to teach his method and also published a newspaper call Terjuman (Interpreter) which he used to spread his progressive ideas throughout the region.

by the advancements in every area of life in European countries and the desperate state of things in their own country. They saw the root of the problems in inadequate education and corruption of religious leaders. They, like similar reformist movements of other Muslim nations, blamed the ills of society on people not following the teachings of their religion properly rather than criticizing the role of the religion itself. They believe that:

‘the clerics had replaced the dynamic faith of the Prophet with a deceased religion, hostile to any progress, and they had killed the Islamic education that created Bukhara’s glory’ (d’Encausse, 1994, p205).

They also stressed the ideas of freedom to which every person was entitled by birth, universal equality of mankind and continuous progress. Thus the Jadids were at the forefront of the Central Asian enlightenment of late 19<sup>th</sup> and early 20<sup>th</sup> centuries. In addition to their contribution to education and literature, they were also actively involved in politics. They published various newspapers. The first of them, called *Taraqqiy* (progress) was founded in Tashkent in 1906 by Ismael Abidiy. The others called *Khurshid*, *Shohrat* were published later in the same year in Tashkent by Munawwar Qari, who was one of the most prominent Jadids. In Samarkand, Behbudiy published *Ayina* and *Samarkand*, while in Bukhara they established *Turan* and *Bukhara-i-Sharif*, and in Ferghana *Sada-i-Ferghana* . The interests of the local business people were voiced in the newspaper called *Tujjor* (Businessmen or Merchants) established Said Azimbay, one the richest people in Tashkent at that time.

Jadids also established secret societies with thorough and rigorous checks on new members. They discussed ways of achieving freedom for their country and organizing resistance against the colonial masters.

In October 11, 1906, the above mentioned paper 'Kurshid' published

'a genuine program for Jadids of Central Asia, and preached adherence to the Muslim Union (Ittifaq ul-Muslimin), the eventual mainstay of the Constitutional Democratic Party.' (ibid. p191).

This program was signed by Behbudiy, who himself came from a family of influential Muslim clerics, and became one of the fierce critics of established Muslim elite and one of the best known Jadids.

Thus, the revolutionary movements of the local population of Central Asia developed quite independently, of and sometimes in tacit hostility towards, the Russian revolutionary movements of the same region. The Russian revolutionary groups also treated the local intelligentsia with a lot of suspicion if not with open contempt.

As a result the local population did not take any part in both the February and October revolutions and subsequent change of power in the Russian administration of Central Asia following the changes in Moscow. In the aftermath of revolution the Central Government sought to involve all the ethnic groups of the Empire in the revolutionary cause but the idea was rejected by local Russian revolutionaries of Central Asia.

'It is impossible to let the Muslims into the revolutionary government at this time, because the attitude of the local population toward the authority of the Soviets doubtful, and because the indigenous population has no proletarian organizations which the (Bolshevik) group could welcome into the highest organs of the regional government'

(attributed to Kolesov, one of the leaders of Russian communists in Central Asia, quoted in d'Encausse, 1994, p225)

The local activists instead tried to take advantage of the turbulent situation to achieve the independence of the region. There were records of the representative of Jadids approaching the Government of Turkey asking them to invade the region on their behalf and they even approached the British representatives in India about possible military assistance. After being rejected by both sides, they tried to appeal for popular support. In November 1917 they organized a congress in Khokand, the central city in the Ferghana valley at that time, and elected a council of 36 Muslims (mainly Jadids) and 18 Russians. This council then declared autonomy for southern Central Asia and selected the 12-member government to lead the new Autonomous Turkistan. Meanwhile the Russian communists held power in the Russian quarter of Tashkent and claimed to be the legitimate government of Turkistan. The supporters of the Khokand government held public protests against the Russian government in Tashkent but the protests were put down quickly by force. In January, the Khokand government then wrote to Moscow explaining the situation and asking for the support of the central government referring to the resolution, signed by Lenin in the aftermath of the revolution, giving the different nationalities of the Empire the right to determine their own fate. However, to the misfortune of the Khokand government, the person in charge of the Commissariat for Nationalities was a certain Stalin who had different plans for Central Asia. His reply refused to recognize the rival government made up of representatives of 'petty bourgeoisie' reminding them that the legitimacy of

the Tashkent government was based on the popular support of proletariat whom they represented. Without external support, the Khokand government was bound to fail. Their vision for Autonomous Turkistan, independent of colonial masters, was not shared by the majority of the population which remained politically ignorant throughout the whole revolutionary period.

Backed by Stalin's blessing, the Tashkent government asked for military support against the 'counter-revolutionary forces of Khokand' and in February, 1918 the Red Army captured Khokand and practically destroyed most of the city, massacring the inhabitants. However most of the leaders of Jadids, including Mustafa Chuqay, the head of the government, managed to escape.

This bitter experience taught the Central Asian Jadids an important lesson.

'The main political strategy of the Jadids came to focus instead on struggle for participation in the regime and its fledging institutions. 'Knowing that struggle in Turkistan was useless and could lead only to the ruin of the land, ' Choqay wrote in 1923, 'the core of the autonomists remaining after the defeat at Khokand called upon its supporters to work with the existing authorities in order to weaken the hostility directed at the indigenous population by the frontier Soviet regime' (Khalid 1998, p286).

They argued quite successfully that 'in a colonial environment where no conscious and organized proletariat existed, priority be granted to the national struggle rather than to social liberation, and that the local bourgeoisie be given the opportunity to assume leadership of liberation movement' (d'Encausse 1994, p235).

The Central Government, which was already struggling with civil war and internal problems, as these events coincided with the infamous years of war communism, decided to give in trying to stabilize the situation and sent new members for the Communist Government of Central Asia, the Turkic Commission. This new group came with a specific mission of cleansing the local communist party of the remnants of the old regime especially those with an out and out chauvinist and colonial attitude. The Jadids started joining the Communist Party en masse. This new strategy was hugely successful for them, because as they now mastered the communist 'new speak', they were able to push their own agenda much more efficiently. They successfully argued for equal representation of locals in all government bodies and the name of the local branch of the Communist party was changed to 'the Communist Party of Turkic Peoples'. Turor Risqulov, the newly elected head of this party argued, in his speech in front of the Central Committee in Moscow, that 'there were only two basic groups in Turkistan, 'the oppressed and exploited colonial natives and European capital'. (Khalid 1998, p297).

Using this kind of Marxist language he demanded more autonomy and authority for local people including the establishment of a native army subordinated to the autonomous government of Turkistan. Thus for much of the 1920s the Jadids enjoyed a great deal of freedom to express themselves and influence the political and cultural life in Central Asia.

'Fayzullah Khojaev was prime minister of the Bukharan People's Republic and then the President of newly established Uzbekistan, while Fitrat served minister for

education in Bukhara. Cholpan, Qadiri, Hamza, Munawwar Qari, Awlani, Ayni, Ajzi and Haji Muin, to name only a few of the most important figures, were all central figures in the world of letters, arts, and education all through the decade. They saw themselves creating a new civilization – modern, Soviet, Central Asian, Turkic, and Muslim all at once. (Khalid 1998, p299)

### 3.3.2 Economy during the early Soviet years.

This relatively good era in intellectual and cultural development in Central Asia coincided with the period generally known as the ‘NEP’ era, so named because of Lenin’s New Economic Policy. In the aftermath of the Revolution, the Communists were in limbo because Marx had not told them how to build communism.

There was little in Marx’s voluminous writings for his followers to learn about “building” a socialist economy. From his teaching, however, they thought they knew what was wrong with a modern economy, and they had no doubts that it was above all the market mechanism of resource allocation. The market economy was to Marx synonymous with capitalism, it was an exploitative, anarchic and wasteful type of economy, and so his followers were adamant in their resolve to eliminate it. As capitalism and socialism were viewed as antipodes, the latter was supposed to be a market-less, money-less economy. (Gabriel Temkin, 1998, p313)

Because Marx only told what was wrong with capitalism, the communists started to get rid of the things that Marx had said were wrong. Private ownership of any means of production, except in agriculture, had to go, so they nationalized the economy. The supreme Council of National Economy (SCNE) was set up on 15 December 1917 in order to organize the



National Economy. This process of nationalization was as chaotic as the revolution itself as the local revolutionary groups started taking control of the enterprises with their neighbourhoods. The problem of chaotic nationalization was so serious that the SCNE had to issue two consecutive decrees outlawing unauthorized nationalization.

The industrial workers living in cities suffered during the food shortage that followed the revolution and many of them started moving to the countryside where it was easier to survive. In response to this Lenin started applying stricter measures for workers' control, effectively introducing semi-military management of the work force and found himself in opposition to the more liberal communists. It did not, however, deter him from dismissing all the criticism in his enlighteningly titled article 'Left-wing Childishness'.

In it he defended his reforms, asserting the need for strong discipline and one man management system for industrial organizations.

In Central Asia, the local Council of People's Commissars also acted swiftly to confiscate first the cotton mills and soon after other major industrial enterprises. Even the foreign owned companies did not escape the zealous nationalization drive of the proletariat, the Belgian owned 'Tashkent Tram, and the American 'Zinger Company' were taken over by the end of 1918. By the end of the following year more than 700 enterprises in Turkistan were nationalized (Ozerova, 2004).

In agriculture they allowed the peasants to claim the lands they were working on, from landlords. This policy made the communists popular with the rural population initially, but the peasants did not like the idea of giving away their produce in exchange for industrial goods in times of food shortage. Therefore the communists forcefully requisitioned most of the agricultural output. The immediate response of the peasants was to cut the sowing of grain products as the products in excess of their own need would be taken away from them anyway. This reduction in sowings combined with the severe draught resulted in unprecedented famine in most parts of the country.

‘The 1920 grain harvest, only 54 per cent of the 1909-1913 average, was bad enough. In 1921 the harvest was only 37.6 million tons, only 43 per cent of the pre-war average overall, but far worse in affected areas. Uncounted millions died.’ (Nove, 1992, p81)

In Central Asia, the crisis started even earlier and lasted longer than it did in European parts of Russia as the peoples of colonies were given lower priority and hardly any relief effort was directed at them. The civil war that broke out in the immediate aftermath of the revolution cut the railway links between Central Asia and other parts of Russia towards the end of 1917. As a result undelivered cotton piled up and the supply of grain on which the population Central Asia had relied was seized. Hence, the food crisis in Central Asia started even before the War Communism measures of forceful requisitioning began and people started supplanting cotton fields with grain. Later the requisitioning and looting forced the

peasants to cut even further the sowings that were already well short of pre-Revolutionary levels due to extensive damages to the irrigation systems because of civil war.

‘... by 1921 cotton covered only 200,000 acres (80,000 hectares) compared with the 1,058,000 acres (423500 hectares) in 1913. In spite of these belated attempts to substitute food crops for cotton, southern Central Asia experienced severe famines from 1919 to 1923, well over a million people died. Such starvation, along with the general chaos prevailing in the region, reduced the agrarian economy to a state of collapse’ (Matley, 1994, p286)

Under the new arrangements trade and the market also had to go, so they abolished money, banned trade and introduced central distribution. As a result black markets flourished in spite of harsh punishments up to instant execution by shooting for anyone caught engaged in illegal trade. Nove (1992) reported that as much as 60% of consumption in cities went through the black market.

Overall, War Communism as a system failed miserably, popular discontent with the new government was reaching boiling point. The economy was on the verge of collapse and the protests of outraged peasants threatened to turn into a countrywide revolt. Under real danger of losing power Lenin decided to reverse the course of his reforms and introduced what later became known as the ‘New Economic Policy (NEP).

From 1921, requisitioning was replaced with a proportional tax on the output that was in excess of consumption needs. Smaller enterprises

were denationalized and trade and markets were legalized again. After two devaluations, a more – or – less stable currency was introduced in 1923.

The results were very impressive. The economy started to recover at a great pace and by 1926, the peak year under NEP, most production returned to pre-Revolutionary levels. A new class of traders, called ‘*Nepmen*’, emerged to fill the gaps that existed between large scale state owned production and retail markets. Unfortunately, by that time Lenin was already gone and struggle for political power among his followers was heating up. Lenin’s speeches and articles regarding the future direction of economic reforms left them with more questions than answers. Although the NEP was successful in restoring the economy, the communists believed that they should be working towards building a socialist economy somewhat reflecting their Marxist ideology.

‘They were bound to regard the ultimate achievement of socialism as the one possible justification for their being in power. But when was the advance to be resumed? At what speed? In what directions? Above all, what was to be done to convert or transform the peasant majority of the population, and how was the industrialization of Russia to be pursued after the period of reconstruction had come to an end?’ (Nove (1992), p117)

Thus the real core of the problem was the fact that the Communists came to power under the flag of Marxism and were now trying to establish ‘the dictatorship of proletariat’ in an overwhelmingly peasant country.

For most of them, the NEP represented a necessary set back in the face of the hardship of civil war and they saw irreconcilable class enemies in both *Nepmen* and wealthier peasants whom they called *kulaks*. The most

ideologically committed of them joined together in the united left wing opposition led by Leon Trotsky, firmly opposed to all the concessions given to private traders and peasants during NEP. They wanted to see a full scale industrialization led by the state. Nikolai Bukharin, one of the most prominent Marxists and leaders of the Revolution, was also part of the left opposition but he was won over by the successes of NEP and became a strong defender of the new arrangements<sup>12</sup>. He argued for a balanced, harmonious growth with investments in both industrial and agricultural development. Preobrazhensky, an outspoken member of the left wing, proposed an unbalanced growth strategy in favour of industry. He

‘... took up where Marxian expanded reproduction left off, arguing that it was necessary to focus on investment goods to support rapid industrialization. Thus he argued against half measures and for a ‘big push’, a position supported by several considerations.’ (Gregory and Stuart, 1998, p65)

Stalin first aligned himself with the right wing and launched a ruthless purge against the left opposition. All of them were expelled from the party and either arrested or left the country. After eliminating the left wing opposition he turned against the moderates. Bukharin and his so called followers, the ‘Bukharinites’ were turned into villains towards the end of 1928. Stalin then adopted an industrialization strategy that was even more ambitious than anything the pro-big – push leftists ever dreamt about.

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<sup>12</sup> Bukharin was impressed by the contribution of the private sector to the economic recovery during the NEP so much that he became convinced that ‘... greater prosperity among peasants, more commercial production, was not only essential but also not dangerous. In the process of time these peasants too would ‘grow into socialism’. Following his own logic, he launched in April 1925 the slogan get rich.’ (Nove 1992, p119)

‘The first Five Year Plan adopted in 1928 and formally approved in 1929 staggered the imagination of even the superindustrialists. The Soviet capital stock was to double in five years, and even light industry was to expand by 70 percent’. (ibid., p67)

So the decision was made to establish a command economy that would exploit peasants by making them work in collective farms in order to achieve socialist accumulation. Private traders vanished gradually. The share of the private sector in trade and national income decreased from 42.3% and 54.1% in 1925-26 to 5.5% and 27.8% in 1930 respectively. By 1932, the share of the private sector in National Income stood at mere 9.3% (Nove, 1992).

### 3.3.3 The Making of Uzbekistan

As mentioned above, Stalin always had his suspicions regarding the loyalty of Central Asians towards the Soviet regime and as soon as he took over power after Lenin’s death he initiated the reorganization of Central Asia. Applying the principle of divide and rule he decided to separate the Turkic populations of the region into arbitrarily defined republics creating Uzbek, Kazakh, Kirgыз, and Tajik Soviet Socialist Republics (SSRs), in 1924. The Jadids, however, still remained actively involved in the process with Fayzullah Khujayev, the leader of ‘Young Bukharans’ becoming the first President of the Uzbek SSR. The territory of the Uzbek SSR, on which we will be concentrating from here on, stayed largely unchanged until 1963 when a large piece of Kazakh SSR was transferred to Uzbek SSR and some

part of it taken back in 1971. The final result was and still is an area of approximately 447.4 thousand square kilometres which is bigger than the UK, Republic of Ireland and Iceland put together.

The territory of Uzbek SSR included some strategically important areas of Central Asia. It covered most of the cotton growing lands and the capitals of all three khanates that existed before Russian invasion. In addition, this area was more densely populated than any other new Central Asian SSRs. Because of these important factors Uzbek SSR was treated as the regional centre and all the regional headquarters of party, economic and military authorities were located in Uzbek SSR.

After Stalin took over power, he continued the colonial policies with great intensity. As the Czarist regime had intended, he decided that Central Asia should remain as a resource base for the rest of the Empire.

‘Study of the revival in agriculture of settled areas in Central Asia up to 1927 has shown clearly that the Soviet authorities in the 1920s pursued exactly the same agricultural policy as had the czarist administration. The southern part of Central Asia became still more firmly tied to Russia as a one-crop colony. (Matley, 1994, p288)

Stalin was determined not only to achieve what the Czarist authorities had failed to achieve i.e. cotton independence, he was planning to turn the country into a net exporter of cotton in order to finance his industrialization plans. Thus soon after the territorial reorganization another wave of social and economic upheaval started with a mass collectivization drive. In Central Asia, people saw collectivization as an

attempt by the Russian invaders to take away the lands that belonged to them and armed resistance broke out throughout the region.

The local politicians were caught between the two fires. On the one hand they knew all too well that any resistance to Stalin's campaigns would not only be futile but also could have fatal consequences. On the other hand, they could not possibly convince the local population, who were largely unaware of Marxist ideology and therefore did not realize they were being freed from exploitation, that collectivization was the best way forward.

Besides, given their Jadidist background, the Central Asian leaders had completely different dreams for their homeland. While the certain degree of freedom they enjoyed during the NEP years had given them some hope for their future within the Soviet Union, Stalin's reforms, especially the style and pace at which they were carried out, shattered their dreams. Any attempts to mediate between Moscow and local insurgents were bound to fail.

In a recent interview with the radio 'Voice of America' historian Qahramon Rajabov quoted a short conversation that took place between Akmal Ikromov, who was one of the leaders of Central Asian Communists and a prominent Jadidist himself. They were attending a meeting of the Russian Communist Party in Moscow in 1923, where Stalin strongly criticized Central Asian leaders. In response to the criticism Ikromov tried to suggest, as diplomatically as possible given the sensitivity of the issue and occasion, that some of the Soviet policies could have been more successful had they taken into account the local peculiarities. Stalin's reply



summed up his stance towards the local leadership and the Central Asia as a whole. He said: So you are saying that at the moment, the Soviet government is pursuing the wrong policy and the insurgents are doing the right thing. Then why don't you go and join them?'<sup>13</sup> This also demonstrates the amount of trust Stalin had in the local leadership, which was almost entirely wiped out during the series of purges that followed. They were replaced with the so called class of '38, the new generation of 'yes' men with predominantly working class and peasant background and very little education except for what they got from the new Soviet propaganda schools established after the Revolution (Khalid 1998).

After collectivization was finalized in mid '30s and the all independent minded local leadership eliminated, the production of cotton was given a big push and reached new highs in the years preceding the Second World War. The area sown under cotton in 1940 was 75% larger compared to the level in 1928 and the amount of cotton produced reached 1648800 metric tons, a 331% increase over 1928's crop. This was achieved partly by extensive use of mineral fertilizers, the production of which increased 8.75 times between 1932 and 1937.

The other significant factor in this expansion in cotton production was the new irrigation projects.

'During the first Five Year Plan, work began on extending irrigation of such areas as the Farghana Valley and Mirzachol Sahra, and land along the Zarafshan, Surkhan Darya, Chirchiq, and Ahangaran rivers. In all, about 500,000 acres (200,000 hectares) of

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<sup>13</sup> Reported on [www.voanews.com](http://www.voanews.com), accessed on 15.10.2006, Author's translation.

new land was irrigated between 1929 and 1932. The Second Five Year Plan made little progress in extending the irrigated area, and not until 1939 did the first large scale irrigation projects since the pre-1917 period begin.

The first of these was the construction of the 19-mile long Lagan Canal in the Farghana Valley, which was said to have been built in seventeen days by 14000 labourers. In the spring of 1939 forty-five more canals were built, all of them by 'people's construction', in other words the traditional Central Asian system of using unpaid labourers. The greatest such feat of this period was the digging of the Great Farghana Canal (Katta Farghana Kanali) in the summer of 1939 by 160000 Uzbeks, 20000 Tajiks, and about 1000 supervising engineering and technicians, presumably Russian, who finished the construction of this 168-mile-long canal in forty-five days. (Matley, 1994, p295)

Thus the foundations for the new Soviet economic system were set and the role given to Uzbekistan within that system was that of an agricultural 'one crop colony' specializing in production of raw cotton.

This pattern was only disturbed by the German Invasion of the Soviet Union in 1941 when most of the Industrial base, as well as wheat growing fields, located in the European part of the country were destroyed. In order to save what they could of that industrial base the Soviet government started evacuating the equipment from those factories away from the war zone and to Central Asia and Siberia.

'The equipment from more than 100 industrial plants (in toto or in part) was shipped to Uzbekistan alone: metallurgy, coal industry, machine building and others. In Uzbekistan, this equipment provided the basis for 47 new industrial enterprises established during the war, more than half of which were located in Tashkent or its environs. (Rumer, 1989, p54)

This resulted in a great surge in industrial production which grew by 11.1% during the 5-year period following the end of the war. On the other hand, the sharp reduction in the supply of wheat from war damaged regions meant that a bigger proportion of land in Uzbekistan had to be sown under wheat and thus freed from cotton. Cotton production fell from the pre-war level of 1.65 million tons in 1940 to just 0.83 in 1943. So it was only after the war when the Soviet economy took the shape that was later known as the 'classic soviet type' economy and started functioning as it was intended by design.

Ideological foundations aside, one of the main features of the Soviet economy, for the purpose of our analysis, was the government ownership of the means of production. The roots of such organization for the Soviet economy can be found in the writings of Marx and Engels. Their view of capitalist production was based on the labour theory of value. Hence, they maintained that the capitalists used the 'forces' of production (which included labour) to produce goods in order to make profit. Since labour was the only source generating value, the capitalist would try to increase the productivity of labour by innovation and mechanization.

The capitalist does not, however, do it by his own free will. He is dictated to by the 'sanctions' i.e. the rules and norms of the society, the incentives and penalties offered by the social and economic system. In order to keep up with competition the capitalist has to make a profit and accumulate it into Capital, which is the overarching driving force and therefore 'the source of all evils' in the capitalist society. (Marx and

Engels, 'The Communist Manifesto' , in Angernon Lee, Essentials of Marx, New York, Rand School, 1946). The Capital or rather competition to accumulate it, restricts the producer from being truly adventurous.

'The abolition of capitalism and the profit motive removes these restrictions on the creative energies of the people, and entrepreneurship should be expected to flourish under socialism at a higher level than had been possible under the increasingly restrictive regime of capitalism' (Berliner, 1983, p191)

The idea was that, if entrepreneurs did not have to bear the risk of failure (which would have been the punishment for not being profitable) and the costs associated with it, they would have been more willing to enterprise and innovate. Bringing the means of production under public ownership should therefore have encouraged entrepreneurial activity as those risks would be taken by the state.

As we discussed earlier, Communists had far from ideal conditions to start with and Marx's theory, which was developed in the context of Western European capitalism, was not directly applicable in the largely agrarian, backward country that Russia was then.

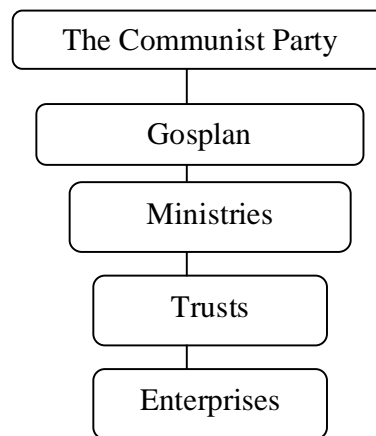
The system they built instead incorporated some key features of Marx's theory such as the abolition of private ownership of businesses, dictatorship of proletariat. But more than that, it was a system that best suited the local conditions. The excessively centralized nature of the system and planning were more driven by the backwardness of the country and the necessities of the war than ideological considerations. When Stalin came to power he decided to industrialize the country fast in order to catch up with

the rest of major developed countries. To do that, he needed to mobilize the population and resources en masse and with military discipline. The system he built was designed for that purpose and it did deliver impressive results albeit with enormous human and material costs. National income rose from 24.4 billion rubles in 1927-8 to 45.5 billion rubles at the end first five year plan in 1932. Gross Industrial Production and Consumer goods increased from 18.3 and 6.0 billions to 43.3 and 23.1 billions respectively for the same period (Nove, 1992, p194).

At the centre of the system was the Communist Party which was in charge of running the country at all levels. At the highest level it decided the policy issues, gave instructions to the planning agency Gosplan and at the regional level the regional head of the party was directly responsible for overseeing the fulfilment of the plan. Thus, at each level economic activity was under the direct control of party officials. Besides, every enterprise had its own primary party unit and the leader of this unit was very influential in running of the enterprise.

The following figure shows the administrative structure of the Soviet economic system. (Adapted from Gregory and Stuart, 1998).

Figure 3.3.1 Soviet economic administration



The production process started with planning. At the initial step, the Politburo, the Governing body of the Party, would decide on the control figures i.e. the targets for the whole economy to work towards. Then Gosplan would work out the details of how those targets could be achieved and allocated the tasks among sectors, committees, trusts, ministries and enterprises. These in turn would give their own estimates of what they could achieve and how much of everything they needed to achieve it. As this was the preliminary stage of planning, there were a lot of bargaining and negotiations between planners and producers as everyone was trying to make the plan as easy as possible for themselves.

After the plan was finalized and approved, they all would have been evaluated on their fulfilment of the plan. Given the sheer scale of planning, it was impossible to get everything perfectly right. Shortages and misallocations of scarce resources were common. Due to the lack of flexibility in the system, managers of enterprises would have to find their own solutions for the shortcomings of the planning.

In addition, one of the most acute problems of the post revolution economic reforms was the lack of skilled specialists and managers. The essence of the problem, termed as the 'Red Expert' in the literature, was that although the Communist Party held the political power those who were key experts and managers of major industries were not loyal to the new regime. Therefore, they generally resisted the reforms introduced by the Communists. This conflict, although it considerably eased during the NEP period due to the concession given to the experts of old regime and private businesses, existed until the late 1930's.

'During the period roughly from the Shakhty trial of 1928 to the Piatkov trial in 1937 the battle continued, but the Party apparatus, with the General Secretary in the lead, had already decided that Soviet Russia would be liberated from the hands of the non-Party specialists who could hoodwink their technically unskilled Communist bosses by a newly created class of Red-experts, who were presumably more loyal to the Soviet regime and who had adequate technical training to deal with the issues of the economy themselves' (Guroff, 1983:202)

Besides, Communists maintained (based on Marx's theory of the perfectly social individual, who would put society's interests ahead of his own personal interests) that these new experts would be more motivated by moral incentives of being part of great Communist project as opposed to their materially minded capitalist predecessors. Apparently this did not turn out to be the case as Stalin himself called for a change of course by

attacking the ‘equality-mongers’ and a whole new system of material incentives was introduced<sup>14</sup> (Berliner, 1983).

The new system allowed for substantial differences in the level of rewards for people depending on their position and profession. The rewards for being part of the Soviet elite consisted of various components.

‘First, the official salary itself was several times higher than the average wage. Second, there were many important fringe benefits, including chauffeurs and automobiles, specialized health treatment, special luxury stores, and summer homes in the countryside. Third, there were large additional, secret sums of money’ (Sherman, 1994, p10).

The data from the early 1970s show that the elite’s share in total income in USSR was even higher than that of some western European countries (Table 3.3.1).

Table 3.3.1 The share of the elite in the total income in selected countries

Countries	Top 10% earner’s share in total income
USSR (urban households, (1972-74))	24.1
UK (1973)	22.7
US (1972)	26.8
Sweden (1972)	20.5

The elite in the Former Soviet Union were not allowed to get rich in the same way as the capitalist entrepreneurs could. However, they lived in relative luxury compared to the rest of the population. They were carefully

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<sup>14</sup> This perceived irony in the Soviet system was famously ridiculed by George Orwell in his ‘Animal Farm’ (1945) as: ‘All Animals are equal but some Animals are more equal than others’



isolated from the rest and given exclusive access to highly subsidized stores, housing, leisure facilities etc. Since those benefits were only available for the elite, the system needed a clear definition of who the elite were and rules defining the criteria for becoming a member of these elite.

The lists of those positions considered to be important were maintained at the Central Committee of the Communist Party, hence the people holding those positions were regarded as members of the Soviet elite often called 'nomenklatura'. The appointments to every one of those positions had to be confirmed by the appropriate party organ.

'All nomenklatura positions, as early as the Stalin era, were divided into 14 ranks. At the highest level was the General Secretary of the CPSU Central Committee, followed by members of the Politburo, candidate Politburo members and the Central Committee Secretaries. The next rank in the hierarchy consisted of the nomenklatura of the Politburo – that is, the list of positions to which appointments were made or approved at Politburo level. This list included the first and (sometimes) second secretaries of republican party organizations, the first secretaries of regional party committees and of largest towns, all-union ministers, the military hierarchy, ambassadors to all the socialist countries and to the largest capitalist countries, directors of the largest military-industrial enterprises, the leading officials of the creative unions, and the editors of central newspapers and journals. The level below this was the nomenklatura of the Central Committee Secretariat, including a more junior list of positions: deputy ministers, the second secretaries of regional party committees, the heads of regional soviet executives, and forth. Then came positions that required the approval of the relevant Central Committee department, and after it positions that required the approval of regional, urban and district party committees, and even (at the lowest level) of local party branches. (Kryshtanovskaya, White, 1996, p715)

Just like any other system of organization and management, the nomenklatura had its own written and unwritten rules for evaluation and promotion. The rules reflected the ideology of Marxism/Leninism/Stalinism and to some extent Russian traditions. As a rule, party leaders had to adhere to communist ideology and had to quote Marx, Engels and Lenin as much as possible, and they had to denounce religion and fight zealously against any rituals, events, and activities deemed to be religious.

The career of a future communist leader would often start from high school where he or she would join the youth wing of the CP, Komsomol. Active involvement in Komsomol organizations not only looked good on the CV, but it also provided valuable experience and access to a social network of party personnel who maintained a close working relationship with Komsomol. Komsomol activists were elected on the basis of merit i.e. achievements in studies, exemplary behaviour etc.

The best of high school graduates would then go to top universities in the capital and continue their work with the Komsomol organization there until they joined the Party. The selection into the membership was on merit basis, where exceptional performers in Party initiatives were nominated for membership.

Once becoming a member, promising youngsters would be sent, after graduating, to a lower level (usually district level party organs) for a few years. Then they could go back to the capital for special party schools, followed by a year or two at the Party headquarters before taking a high level post in the provinces (Kryshtanovskaya, White, 1996).

For Central Asian party leaders, there were additional requirements, such as loyalty to the Russian cause and independence of from local communal influences or even open disapproval of national traditions and culture. Fluency in written and spoken Russian, a degree from a Russian university and imitation of the Russian life style (this often included the hard drinking ‘vodka culture’) were seen as the signs of dedication and loyalty. Allworth (1994) described a typical Central Asian party leader during Soviet times:

... he, usually not she, spoke and wrote Russian fluently and actively promoted the universal employment of that foreign language in Central Asia; he obtained some higher education, if possible at an institute or university in Russia; he enunciated fulsome panegyrics to Russians and CP orally and in writing on state occasions, frequently at other times as well; he strove to maintain for himself a noticeably general, ethically neutral public exterior and avoided any overt expression of localism... (Allworth, 1994, p554)

The results are evident in the fact that, three of the five last leaders of the CP in Central Asian countries had degrees from Russian universities, they all spoke Russian and two of them came from orphanages thus had virtually no ties of kinship with local communities<sup>15</sup>.

Even with the all those strict criteria for promotion, the Soviet authorities did not have enough trust in the Central Asian leadership, as they appointed non-Central Asian second secretaries to the republican and

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<sup>15</sup> In addition, the marriage choices also seem to have had a significant effect on promotion chances. The Presidents of Uzbekistan, Turkmenistan, Kirgizstan and Azerbaijan were married to Russian ladies when they were promoted during Soviet times. It would be interesting to see the effect of foreign wives on the foreign policies of smaller countries considering the fact that the two breakaway members of post Soviet camp the Ukraine and Georgia have American and Dutch first ladies.

regional party organizations. Those second secretaries had authority to direct and countermand the decisions made by the local first secretaries, practically relegating them to ‘superficially prestigious token’ positions (ibid. p553).

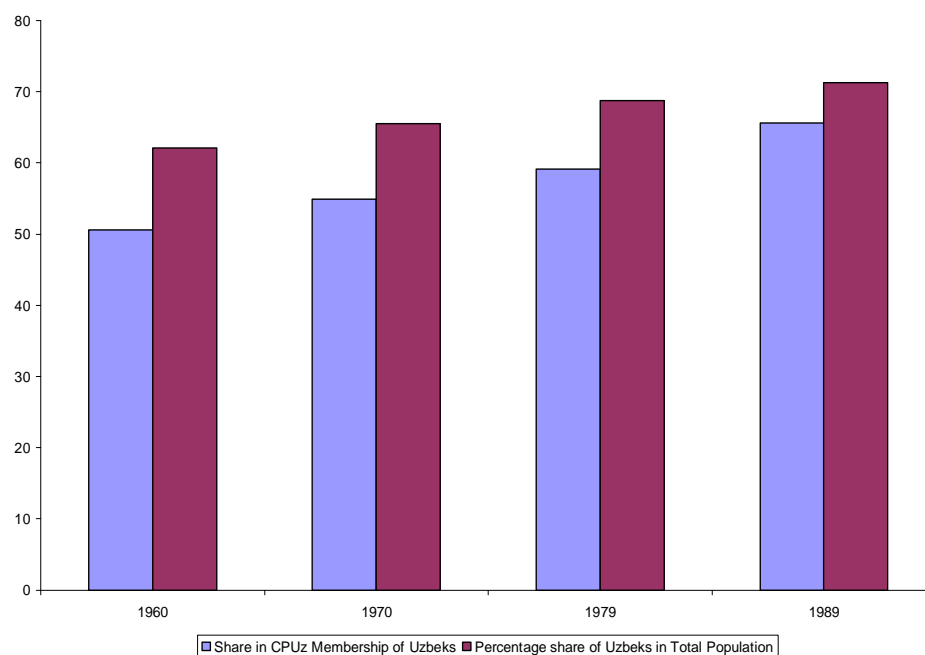
In Uzbekistan, every one of the 13 regions had such Slavic second secretaries. In addition:

‘Members of the nomenklatura, those in position of power, have been more heavily drawn from the non-Central Asian peoples (primarily Russian and Ukrainian) population since World War II. Slavs continue to occupy a disproportionate number of the key positions within the party apparatus, the government structure, the security and armed forces, key economic enterprises. (Lee Schwartz, 1992: 53)

The de facto role assigned to the local cadre was to act as ‘gate keepers’ for their own ethnic groups in order to control mobilization opportunities for political entrepreneurship (Roeder, 1991). In addition, to the ‘second secretaries’ most of the middle level bureaucrats in the party hierarchy were drawn from ethnic Russians:

‘... in most national territories nativization succeeded only at the lowest level, that of the village soviet. The higher the administrative level of the territorial unit, the lower the percentage of nationals allowed in the government agency. While the most prominent functionaries often belonged to the titular nationality, the apparatus would be predominantly Russian.’ (Cohen, 1996: 81)

Figure 3.3.2 Share of ethnic Uzbeks in CPUz membership



Sources: Lee Schwartz (1992) and Robert Kaiser(1992)

Besides, the Soviet Authorities kept the number ethnic Uzbek party members within an unofficially set limit which was just below their proportion in the total population of Uzbek Republic (see the figure above). The limits were enforced by arbitrary quotas and frequent purges of local party members.

Therefore, although a party career offered significant rewards, it was by no means a safe and stable career path with many prominent party leaders falling from grace every time a new wave of purges came along.

The turnover of managerial positions was quite high by any standards as can be seen in the following table<sup>16</sup>.

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<sup>16</sup> Gleason (1991) observed that during Brezhnev years the stability of executive positions improved dramatically as the 'regional officials were offered the expectation of long tenure in office if they avoided political embarrassment to Moscow '(Gleason (1991: 616).

Table 3.3.2: Tenure of kolkhoz chairmen in the USSR (%)

	1953	1956	1959	1965	1971
Less than 3 years	59.4	63.6	43.5	42	34
3 years and longer	40.6	36.4	56.5	58	66

Source: Roy D., and Betty A. Laird (1983)

In the Soviet system as opposed to capitalist system, losing one's executive position meant a lot more than losing a job.

'If a US capitalist loses or gives up an executive job, he or she retains wealth and status. In the Soviet Union, on the other hand, power and wealth adhered to a particular position. If you lost the position, then you lost all your power. If your power was lost, then your income disappeared' (Sherman, 1994: 12)

This unique nature of the system gave the Soviet elite a great incentive to fight for their positions. The system's inbuilt bias towards the physical production targets meant that, in order to keep their position, the party leaders as well as other members of the nomenklatura had to fulfil their share of the plan at any cost. Strategies used by Soviet managers to achieve that ranged from straightforward bargaining and pleas to reduce the plan, all the way to illegal activities like bribing their superiors in order to over report production results.

Those strategies emerged as a response to the combination of rigidity and inefficiency of the planning system. The system was rigid in the sense that the fulfilment of the plan was compulsory and excuses were seen as weakness of the managers. Inefficiency of the system meant that there were significant shortages and wastefulness of resources at the same time. The managers were required to fulfil the plan without adequate supplies of

resources to do so. Whoever managed to secure the supply of those scarce resources could get ahead of other competitors and could over fulfill the plan, thereby paving way for promotion. According to Litwack (1991), almost every Soviet enterprise had a specialist ‘expeditor’ whose job it was to build relationships with important people to secure the supply of scarce resources. The enterprise managers had to set aside a special fund to buy ‘gifts’ for those important people. Roy and Laird (1983) explored the Soviet manager’s dilemma in the context of farm management:

‘Indeed, there may be nowhere else in the world where farm managers in general face a great need to break the rules just to avoid failure as in the Soviet Union. As in Soviet industry, Soviet farm managers who may avoid cheating for personal gain are forced to employ *tolkach* (an expeditor) and *blat* (the practice of manipulation) in order to keep an enterprise going. For example, with chronic shortage of fertilizer, if a farm manager can arrange for a shipment of fertilizer destined for another farm to be diverted to his own, he may be able to increase his yield enough to meet his plan. Or if he can negotiate on the side with a construction brigade to acquire their off-schedule services for constructing a sorely needed storage bin, he may save a large proportion of the farm’s grain from rotting on the ground. Or if he supplies speculators with fruit or vegetables from an overabundance that is spoiling for lack of transportation to the city, he can increase the farm’s income and transfer the badly needed produce to the consumer as well’. (Roy and Laird, 1983:270)

Another one of the common strategies used by the Soviet managers was concealing production capacity. Since the plans were set according the recorded production capacity, unreported extra capacity would certainly help to meet the plan. It was quite normal for agricultural farms for

example to cultivate extra land and conceal it from the authorities (Rumer, 1989). As the bonus payment of every employee depended on the fulfilment and over fulfilment of the plan, it was not in anybody's interest to report the managers over the concealed production capacity.

There is also a lot of evidence of inflated reporting of production figures. As the end products of the state – owned enterprises and collective farms were not directly marketed, it was up to the managers of the state warehouses to verify that the amounts reported were actually delivered. With the plan obligations pressing hard, this situation opened the door for corruption and abuse of power. Kobori and Glantz (1998) reported that an average of 0.5-1 million tons of raw cotton per year was only produced on paper in such a way during the 1970's until 1983, when it was finally exposed.

As a result, thousands of people were expelled from the party and hundreds arrested, not only in Uzbekistan but throughout the Union. The case highlighted a range of serious problems in the Soviet system and was looking to bring far reaching consequences when the Soviet leadership suddenly decided to stop it.

'When leading officials in the Kremlin were to be investigated, the prosecutors were ordered to stop. Some of the prosecutors had political ambitions and were standing for elections. In the end, the investigation, which gave priority to confession, disintegrated completely. (Kobori and Glantz 1998:215)



The people arrested were released (except for those who had already been executed or had committed suicide) and cleared of the charges. The scandal, however, proved the fact that not only was corruption rife and widespread, but is also an integral part of the Soviet system. The root of the problem with such practices lay in the economic policy of the Soviet leadership (Rumer, 1989).

In other words, the set of arrangements that made up the Soviet economic system created an environment which encouraged such behaviour from the Soviet elite. While such kind of practices might have seemed optimal for the individuals operating within the environment, they were disastrously harmful for the system as a whole and have contributed greatly to the eventual downfall of the system.

‘... prolonged attempts to break up the objective laws of economic life, to suppress the age long natural stimuli for human labour, brought about results quite different from what was intended. Today we have an economy characterized by shortage, imbalances, in many respects unmanageable, and, if we were honest, an economy almost unplannable.’ (Shmelev, N., *Novy mir*, N6, 1987, quoted at length in Nove, 1987: 396)

As it became more and more obvious that the economy was already ‘unmanageable and unplannable’, various attempts were made by the Soviet economists and the Party authorities to reform the system. The first of those attempts were made immediately after Stalin’s death by his successor Khrushchev and later by Kosygin. Although those reforms brought about a welcome air of stability and common sense after Stalin’s

tyranny, they still were, at best, variations to the theme, attempts to redecorate a house suffering from serious structural damage.

Hence, when Gorbachev took power in 1985, GDP per worker in USSR was only approximately 37 percent of that in the US (Gregory and Stuart, 1998) and GNP had almost stopped growing at per capita level (Noren and Kurtzweg 1993). It was obvious that much more radical changes were required in order to steer the country out of that deep economic mess. There were, however, some formidable obstacles to the reform initiatives with the system. First of all, the members of the Communist Party were not yet ready to publicly denounce their faith in Marxism, and anything related to markets, capitalism was still considered taboo<sup>17</sup>.

Secondly, members of nomenklatura did not want to give up their positions of privilege and the power to allocate the State's resources.

Besides, the majority of the population was already accustomed to getting the essentials like food, housing and education at subsidized prices and did not approve of the idea of having to pay market prices for those things, the access to which they considered as their rights.

In order to break the resistance and to change the mindset of the population, Gorbachev started the campaign of *glasnost*, calling for open discussion of problems and more freedom of speech (Gorbachev, 1987). His initial economic reforms package, however, was a product of compromise between the urgent need for reform and the stubborn

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<sup>17</sup> Nove (1992) notes that as late as 1990 the Soviet Supreme Council voted, with a big majority, to omit the word 'market' from the name of the economic reform commission appointed by Party's 28<sup>th</sup> Congress.

resistance of the Party machine to changes. In his early years in office he called for rapid industrial re-equipment, acceleration in growth and investment. As this was all financed by the state, the budget deficit increased by approximately 10 times between 1985 and 1989 (Nove, 1992), and foreign debt more than doubled from just over \$25 billion when Gorbachev came to power to \$70 billion in December, 1991 (Aslund, 1993).

By the time the 12<sup>th</sup> and last five year (86-90) plan neared its end it was clear (as can be seen from the table below) that the Soviet economy had failed to recover and very few people now still believed in the viability of socialist system.

Table 3.3.3: Economic Performance of the USSR During Perestroika

	1984-85	1986	1987	1988	1989	1990
GNP Growth	1.1	4.6	1.3	2.1	1.5	-2.4
Industrial Growth	2.3	2.4	3.0	2.7	-0.6	-2.8

Source: Noren and Kurtzweg (1993)

The tipping point, in the shift of attitude towards the reforms and hence the support for them, came as the members of the Nomenklatura (especially the younger members) started to realize the opportunities the changes presented. They formed the backbone of the ‘Komsomol economy’, the group of newly formed commercial enterprises opened under the auspices of the Communist Party’s youth movement.

‘The Komsomol economy’ took its origin from a resolution adopted by the CPSU Central Committee on 25 July 1986 in which it approved a proposal from the Komsomol that it establish a network of scientific and technical centres for the benefit of its members.

The new centres were supposed to operate on commercial principles, basing themselves on agreements with enterprises and providing services that were not otherwise available. ... The scope of the new centres was extended considerably during 1988, allowing them to engage in the manufacturing of consumer goods and to establish economic relations with foreign firms and organizations; they could set their own prices for the goods they imported from abroad, and were relieved of all customs duties. The Law on Cooperatives, adopted in May 1988, was modified as a result of pressure from Komsomol to cover 'other public organizations' and this allowed the new youth centres to broaden the basis for their activity. Complaints soon began to reach government that youth organizations had been buying and reselling video recorders, computers and other forms of technology at inflated prices, and with 'crude violations of the law'; Gorbachev, addressing the 21<sup>st</sup> Komsomol Congress in April 1990, warned that it was not appropriate for the party's youth movement to become involved in 'middleman activity' of this kind. But by then the system was developing under its own momentum; there was already a youth commercial bank, an import – export centre and a network of fashion shops, and by 1990 more than 17000 youth cooperatives were in operation employing about a million staff' (Kryshtanovskaya and White, 1996: 716)

In fact, they were doing what Schumpeter's entrepreneur would be doing under the circumstances. Having realized the great potential for profit for importing consumer electronics and new technologies and taking advantage of their influential position within the Soviet elite they created a monopoly for themselves.

In addition to importing highly demanded goods they also took advantage of preferential loans at symbolic interest rates, benefited from the large amounts of monetary overhang in the economy by obtaining exclusive rights to convert financial assets into cash.

Once they felt ready to take over the state owned enterprises, the new 'entrepreneur turned communists' pushed for more reforms and privatized the Soviet economy for themselves.

### 3.4 Uzbekistan during Perestroika

#### 3.4.1 Uzbekistan's Economic Record under the Soviet Union

Uzbekistan's achievements under the Soviet Union were, at best, a mixed success and scholarly opinion on the matter has subsequently been largely divided. William Mandel published one of the earliest reports on the economic and social progress of the Soviet Central Asia in the early 1940s. His article, (Mandel, 1942), was full of praise for the Soviet authorities' achievements in successfully incorporating the Central Asian people in the background of economic, political and social backwardness, in some cases even pre-feudal, i.e., patriarchal, in character, of civil war and intervention, of mistrust on the part of the native and 'Great –Russian chauvinism on the part of some Soviet authorities as well as their sheer ignorance of the customs and languages of the native peoples.

He highlighted the fact that:

'Seventeen years of Soviet rule in Uzbekistan saw the creation from ground up, of large-scale industry, the value output of which in 1937 was 5.6 times as large as in 1913. The number of tractors employed on its 6500000 acres of sown land was 21500, more than in all of Germany and the acreage under crop had increased 22.5 per cent since 1913.' (Mandel, 1942: 408)

Besides, political and social reforms, including eradication of all religious institutions and emancipation of women, had been completed (albeit at extraordinary human costs<sup>18</sup>) by then.

Medlin and Cave (1964) were also impressed by the role of progress in science and education in Uzbekistan in bringing about such a massive ‘Cultural Revolution’.

It was those dramatic changes in social and cultural aspects of the Central Asian societies that encouraged Spechler (1979) to describe the Soviet policy as ‘Welfare Colonialism’. He compared the results achieved in the Soviet Central Asia with other fellow Central Asians who were not part of the Soviet Union like Afghanistan, Iran, and Pakistan. Those countries, which shared a lot more than just religion and common history with Soviet Central Asia for many centuries prior to the Russian Invasion, still lag behind the Former Soviet Republics in terms of literacy, public health, and women’s rights issues.

Table 3.4.1 Adult literacy ratios (% aged 15 and over, 2002)

	Afghanistan	Pakistan	Iran	Uzbekistan
Male	28.7	41.5	77.1	99.3
Female	14	35.2	70.4	98.9

Source: UNDP (2005), 2003 figures for Afghanistan

Besides, The Central Asian republics enjoyed much higher standards of living than their per capita income afforded under the USSR due to the budgetary subsidies from Moscow<sup>19</sup>. Consequently, Uzbeks

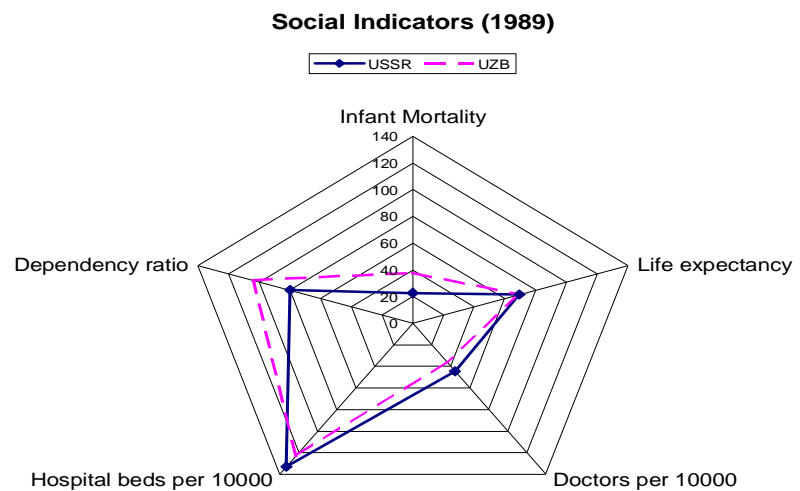
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<sup>18</sup> Of all 6 people who worked as a head of Uzbek branch of the Communist Party at some point before 1937, 5 were executed by firing squad and 1 died in a car accident.

<sup>19</sup> In 1990, the share of such grants in the UzSSR budget was 26.7% (IMF et al., 1991)

achieved the same level of life expectancy as the USSR average, although they had a below – average allocation of doctors and hospital beds. Much higher - than – average population growth, in UzSSR resulted in a much higher - than –average dependency ratio, despite high infant mortality rates.

Figure 3.4.1 Social indicators in Soviet Uzbekistan



Source: Kaufman and Hardt (1993)

However, after seven decades of central planning and distribution, massive gaps still existed between different union republics in terms of economic development. As the table below shows, the per capita Gross National Income in Uzbekistan was only a third of the Russian Republic and consumption was nearly half of that of Estonia.

Table 3.4.2 Some Key Economic Development figures for Soviet Republics (Per capita)

	GNI (89)	Consumption (88)
RSFSR	100	100
Ukraine	71	88
Belarus	89	93
Moldova	66	90
Estonia	103	118
Latvia	103	103
Lithuania	88	103
Georgia	63	94
Armenia	64	76
Azerbaijan	52	64
Kazakhstan	64	80
Uzbekistan	34	68
Kyrgyzstan	45	67
Tajikistan	32	55
Turkmenistan	50	68

Schroeder (1993)

The million-dollar question here is that, given the centrally planned nature of the Soviet system, how such a difference in income distribution had emerged. How can such inequality be explained in a country where every investment decision was taken by the government bureaucrats and every enterprise was allocated according to a carefully considered long term plan?

Soviet specialists pointed to Central Asia's 'legacy of extreme backwardness' and the fast rate of population growth in those republics (Rumer, 1989).

However, there is a long list of Western scholars, who question the validity of those explanations (Hugh Seton-Watson, 1967, Dienes, 1987, Clem, 1992, Schroeder, 1993, Carey and Raciborski, 2004, to name a few).

Hugh Seton-Watson (1967) was one of the earliest scholars to question the role of the Russian and Soviet rule in Central Asia as a



civilising factor. He puts the Central Asian question into a broader context of European colonialism:

‘The conquest of Central Asia by the armies of the Tsars has been retrospectively justified (by the Soviets) as a progressive phenomenon, since it not only preserved the area from the danger of coming under the control of the British Empire, but had the positive merits of expediting the social evolution of its inhabitants from feudalism to socialism, bypassing capitalism, and of bringing them into contact with the advanced culture of the “great Russian people.” This argument is fundamentally the argument for justification of all colonial empires’. (Hugh Seton-Watson, 1967: 158)

He further argues that ‘Russian colonialism had effects only similar to Western colonialism in raising levels of education and health’.

Dienes (1987) also criticized the ‘Quasi-colonial’ nature of the Central Asian economy and labels the region as the ‘plantation province’ specializing in supplying the European parts of the Soviet Union with cheap raw materials.

Rumer (1989) went so far as to call it a ‘tragic experiment’ that turned the whole region into a ‘one crop colony’ where everything else was geared up towards ‘one overarching goal’, which was cotton production. In his 1989 book with a revealing title ‘Tragic Experiment’, he strongly claimed that the deliberate, colonial minded Soviet policy in Central Asia created some serious distortions with enormous economic, environmental and social costs.

One of the aspects of that policy, which attracted a lot of criticism, was Moscow’s investment policy in Central Asia. The investments

allocated to UzSSR were significantly below the all union average on a per capita basis (see the table below).

Table 3.4.3 Per Capita Investment (USSR=100)

	1956-60	1961-5	1966-70	1971-5	1976-80	1981-5
RUSSIA	112	108	110	113	118	119
UZSSR	69	78	89	75	71	68

Source:Liebowitz 1992

Similar to the Czarist regime before, the Soviet government also concentrated most of their industrial investment in Uzbekistan in cotton related sectors. In 1984, 75% of the industry in Uzbekistan was cotton related (Sacks, 1992: 186) and it was a deliberate exercise by the authorities as they did not want any new industries to attack the ‘cotton base of the regional economy’ by creating new large scale employment opportunities<sup>20</sup> (Hodnett, 1974).

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<sup>20</sup> This lack of employment opportunities outside the cotton sector created high unemployment in Uzbekistan. Craumer (1992) reported that about 600 thousand (or 12 % of rural work force) in rural areas were not involved in the state sector in 1987. In an economy wholly owned by the state, it meant that they were either unemployed or were involved in some sort of ‘shadow economy’. Pomfret (2000) argues that, because of that excess labour force, the local authorities in UzSSR actively resisted Moscow’s initiatives of mechanization in cotton harvesting. As a result in spite of large stock of cotton harvesting machines, most of the cotton in UzSSR was harvested by hand. (see the table 3.4.4)

Table 3.4.4 Mechanization of Cotton harvesting in UzSSR

	1960	1965	1970	1975	1980	1986
A	-	23	33	46	63	42
B	48	38	37	36	35	39
C	8300	21800	26100	28700	36600	37900

A - Percentage of Cotton harvested by machines, B – Labour Expenditure per centner of raw cotton in kolkhozes in UzSSR (person-hours) C- Number of Cotton Harvesting Machines Source: Craumer (1992)

This highly concentrated investment policy also resulted in a lack of investment in other areas such as housing and other social projects (Rumer, 1989).

The second important consequence of being a 'one crop colony' was that, due to the dry climate of Central Asia, an increase in the area under cotton required a massive increase in irrigation. The total irrigated area in UzSSR increased from 1361 thousand hectares in 1928 (Matlet, 1994: 288) to 4149 thousand hectares in 1988 (Craumer, 1992: 136). This, combined with an over fourfold increase in population in the same period (Kingkade, 1993), put an enormous strain on the region's water resources. The drying up of the Aral Sea, which is now one of the internationally recognized environmental disasters, was a direct result of this expansion in the irrigated area (Sinnott, 1992). In addition, the extensive use of mineral fertilizers, pesticides and other chemicals resulted in heavy salinization of the soil. In 1986, 61% of all irrigated land in Uzbekistan had a moderate to severe levels of salinization (Craumer, 1992).

Another side effect of the cotton monoculture was the reduction in the production of food and other consumer goods in general. As a result Uzbekistan depended heavily on the rest of the Union republics (in particular on Russia) for supplies of food.

As a result of the unbalanced economic structure, Uzbekistan was running big trade deficits in a number of areas as show in the table below.

Table 3.4.5 Uzbekistan's Interrepublican Trade Balance (In millions of Domestic Rubles)

	1988	1989
Total	-1667	-3504.4
Electric Power	-11	26
Oil and gas	-349	-405.3
Coal & other fuel	-23	-34
Ferrous metals	-541	-544.2
Non-ferrous metals	104	51
Chemicals	-163	-140.3
Machine building	-1949	-2219.5
Wood and paper	-483	-631.6
Building materials	-105	-147.2
Light Industry	1786	1444.6
Food processing	-649	-907.1
Other industry	-133	-185.6
Agriculture	469	289.9
Other material	381	-101.1

Source: IMF et al., (1991)

With the exception only of cotton and related products (i.e. light industry), fresh fruits and vegetables (under agriculture), gold, copper, and uranium (under non-ferrous metals) and electric power, Uzbekistan was importing more of everything else than it was exporting. This dependency coupled with the in built 'followers' mentality' of the Republic's leadership who were trained to follow their masters in Moscow, meant that Uzbekistan stubbornly refused to leave the collapsing Union and stuck with Russia longer than most of the other former republics and followed Russian initiatives rather than 'adopting proactive reforms' (Pomfret and Anderson, 1997)<sup>21</sup>.

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<sup>21</sup> On March 17, 1990, in an independence referendum, in the wake of which government actively campaigned against independence, the population of Uzbekistan voted with a majority of 93% against independence. The country's Parliament declared independence on August 31, 1991, after the Union's collapse became obvious following a failed coupe on 19-21 August of the same year. However, Uzbekistan remained within the 'rouble zone' until November 1993, when Russia introduced its new currency and offer humiliating terms for other republics that wanted to continue to use the roubles (Akramov and Tairov (1998)

### 3.5 Conclusion

In this chapter we looked at the evolution of Uzbek economy and society over three different political systems: the feudal kingdoms, Russian empire, and the Soviet Union. We gave particular attention to the career paths of the elites i.e. the most talented people and the circumstances that determined their career options.

Economy under the feudal system was very backward, compared to Russia and other European countries. Agriculture was the main sector of the economy with cotton being the main crop. The agricultural products were exported to Russia and to the East along the ancient Silk Road. The transportation means were very primitive and inefficient, making the export processes very long and costly. In spite of these difficulties, the cotton export business became very lucrative in the wake of American civil war in the middle of the nineteenth century as the cotton supplies to Russia were disrupted and the prices went up.

Russia decided to invade the region to take control of the cotton producing areas, in order to increase the supplies and reduce the costs. In addition, they wanted to limit the expansion of the British Empire into the region and gain the control the big Central Asian markets.

They occupied the region without much resistance from the weak local kingdoms that had been far inferior to Russia militarily. They established the political control and started implementing the reforms that would increase the supply of the raw materials from the region, stop the

products of other European countries from getting into the local markets, and ultimately strengthen their rule over the region. They also started building a railway connecting the region with the rest of the Empire.

They also brought the American type of cotton which was of a superior quality and gave higher yields. Irrigation system was also improved in order to extend the areas sown under cotton. All these reforms made cotton even more lucrative especially because the railways brought cheap wheat from Russia.

Although the Russian invasion improved the lives of some the poor farmers, it did not change the political and social system of the region very much as the Russians chose to keep the existing elites in power and let them rule the locals in the same way that they were ruling before. In other words they built a system whereby they could extract most of the economic resources without assuming the responsibility for the wellbeing of the citizens and addressing the social tension between the old feudal lords and poor peasants.

Furthermore, annexation of Central Asia, gave the local intelligentsia an opportunity to meet and communicate with the enlightenment movements from other parts of the Empire and Europe. Middle and upper classes could now easily send their children to the educational institutions in Moscow, Saint – Petersburg and in other big European cities. This exposure to new ideas gave birth to the Central Asia's own enlightenment movement which was largely inspired by the similar movements of Muslims in other parts of Russia and Turkey.

These enlightenment movements were independent of the Russian socialist movements like communists and were ideologically opposed to the establishment of the communist government. However, they lost their struggle for the independence of the region and some of them had to join the communist party in order to play a part in the political processes. They later became the victims of Stalin's purges.

Stalin then started a massive project of social engineering in Central Asia, trying to eliminate all of the religious institutions and activists and promoting young, soviet educated people to important posts. He created the system, which later became known as the classic Soviet-type economy. This system also included a set of rules and regulations which determined the aspiring young talents' career paths to the top of the communist party.

In this chapter, we argued that these rules and regulations governing the allocation talent in the Soviet Union encouraged illegal activities and contributed to the downfall of the economy. We also conclude that the main elements of the system remained in place in some of the former republics and played an important part in building the market economies in these republics.

In the next chapter we will discuss the developments in Uzbekistan during the immediate aftermath of the independence and the implications of the initial reforms for the future of the country. We will also look at the main aspects of the new political and economic system focusing on the allocation of entrepreneurship and talent in general.

## Chapter Four

### Uzbekistan's economic performance since independence

#### Introduction

In the previous chapter we discussed Uzbekistan's record under the Soviet Union and its legacy. In this chapter we will discuss Uzbekistan's economic performance after gaining independence. Although Uzbekistan gained its political independence in 1991, it remained dependent on Russia economically for a few more years more. It was since 1994, when the new currency was introduced, that Uzbek government could start the stabilization process in earnest. Uzbekistan made economic and political stability a priority from early on, opting for a slow step by step transition as opposed to a 'shock therapy' which would include wholesale privatization and liberalization.

Uzbekistan's self-sufficiency in energy and specialization in raw materials also helped in re-orienting the directions of trade away from traditional partners and towards the new partners. The pattern of economic reforms started with initial period of accelerated reforms and subsequent period of protectionism in the wake of worsening terms of trade and regional instability.

We will also give special attention to the new system of economic and political administration which included some elements of the Soviet system as well as some new institutions established after independence. The cotton industry will also be the focus a special attention in this chapter,



given the fact that the sector remained to play a central role in the countries economic system.

#### 4.1 Initial Reform and Stabilization

After eventually leaving the 'Rouble Zone' in 1993, Uzbekistan had to speed up market reforms in order to establish a somewhat workable model of a 'market economy'. It was a monumental task given the immediate challenges faced by the Uzbek government. In addition to the usual catalogue of problems associated with post communist transition economies, Uzbekistan had a range of peculiar challenges.

Some of these problems were direct results of being a 'one crop colony' as we discussed above. At the onset of perestroika Uzbekistan had just emerged from the latest of the high profile purges which regularly wiped out the cream of the local political elite and 'condemned people of the area to an indefinite period of elementary self-discovery' (Allworth, 1994). As a result Uzbekistan had virtually no political elite outside its administrative elite at the time of independence (Abdullaev, 2002). As we mentioned earlier, the bulk of the administrative elite was drawn from the Russians and other Slavic nationalities and because those Slavic groups never assimilated into the local communities in any practical sense, they suddenly found themselves in a predicament in the face of the fast changing environment around them. A large number of them started leaving Central Asia while they still qualified for citizenship back in Russia.

The situation presented the Uzbek government with a unique problem similar to the 'Red Expert' problem we discussed earlier. Alimov (1995), for example, noted that as much as 85% of the army officers in Uzbekistan were Russian at the time of independence. The state of affairs in other 'sensitive' sectors was not much better.

Besides, the sudden collapse of the state – imposed ideology left the people of the Soviet Union in general and Uzbekistan in particular deeply demoralized. The freedom afforded during the glasnost campaign often brought radical nationalistic and sometimes religious movements to the forefront of the battle for the hearts and minds of the population (Gleason, 2002, McGlinchey, 2003, Allworth, 1994). Given the number of conflicts that resulted in other countries of the post communist camp from similar movements, the government of Uzbekistan was understandably wary of such movements.

The collapse of the Soviet state also weakened law and order in the years preceding independence and increased the problem of organized crime which was already quite rife before perestroika (Pomfret and Anderson, 1997). Given the fact that the all – powerful Soviet government failed to eradicate organized crime, few believed the new republics could successfully deal with the problem, which was fuelled by the drug trafficking from Afghanistan which produces most of world's heroine.

In addition to the problems mentioned above, Karimov (1998) highlighted the threat of interventionist foreign policy on the part of major world super-powers run by 'chauvinistic' nationalists who treat Central Asia as their 'back yard'. He also criticised the 'regionalist clan politics'

that was prevalent within Uzbekistan. This manifested itself in discrimination by the people in positions of power in favour of their fellow clansmen or people from the same region. At the highest level people formed strong interest groups along those lines and had a potential to mount a serious challenge for leadership (Abdullaev, 2002).

Amid all those mitigating circumstances it was only logical that Uzbekistan would choose an ultra cautious approach to the transition process in order to avoid the possibility of plunging into a political crisis or, even worse, into a civil war like Tajikistan did immediately after gaining independence.

Uzbek government developed a carefully structured gradualist transition plan based on the following five principles (Karimov, 1995):

1. Reforms led by a strong state
2. Priority of economics over politics
3. Strong social security
4. Rule of Law
5. Step by step transformation into a market economy

First, the strong state principle was based on the argument that, given the threat of all the outside influences outlined above, the country needed a strong state to represent the interests of the nation and defend the values that the nation presumably stands for. Towards that end, the government developed a whole new propaganda machine to promote what they called ‘the Ideology of Independence’ to replace Marxism and most importantly to keep out ‘alien’ ideologies like Islamic fundamentalism, Pan-Turkism and Westernisation (March, 2003). In practice, it meant that

all the reforms in sensitive areas like religious institutions, education sector, media and literary and cultural establishments could only be carried out under government supervision and initiative.

In the economy, a strong state meant near total governmental control over key sectors, attracting criticism from various observers dubbing the new system 'Stalinist' (Allworth, 1994) or 'Neo-Stalinist' (Spechler, 2000).

The second principle especially refers to the Soviet past when a lot of big investment decisions were taken without much consideration of their economic viability as long as they met the political aspirations of the leadership. Therefore, the government of independent Uzbekistan made it a priority that politics would be put into the service of economic prosperity of the nation (Karimov, 1992).

Jensen (2003) argued that the transition countries with a large number of their population living near the poverty line would find strong resistance to reforms as the majority of citizens would fear poverty if they lost the subsidies they were getting under the command economy. The argument could be directly relevant to Uzbekistan's case considering the country was one of the poorest Soviet Republics and the living standards in Soviet Uzbekistan were quite high relative to per capita income. Logically, the Uzbek government chose to maintain price control for most necessities in order to avoid popular discontent against sharp rises in living expenses. Although pensions, salaries and other fixed payments fell substantially behind inflation rates over the years following independence, subsidised

prices for energy, housing and some food items somehow lessened the impact of price liberalization.

Although organized crime always played an important role in Soviet society by providing goods and services drawn underground by the restrictive nature of the system (Oleinik, 2002), the collapse of the state during the last years of the Union bred all sorts of organized criminal activity. Some Uzbek criminal groups had also grown to international prominence by the time of independence (Jannings and Sambrook, 2002). The fourth principle in that sense summarises the Uzbek government's 'zero tolerance' policy towards any kind of activity the authorities defined as illegal.

The last principle is the Uzbek government's verdict on the long standing 'shock therapy' versus gradual transition argument and Uzbek press was full of criticism of Russia's chaotic 'shock therapy' during the early years of independence (Akromov and Taipov, 1998).

Based on those clear principles, Uzbekistan's national program for economic transition assumed a three – stage transformation towards a market economy with the first stage involving emergency measures for the initial stabilizing of the economy following the exit of the Soviet economic structure of which the Uzbek economy was an integral part. The first stage, which was planned to last until 1990-91, involved creating the administrative and institutional infrastructures needed to run an independent country. The second stage, lasting between 1992 and 1993, would involve the establishment of the institutional and legal base of the market economy. The third and last stage then would take place during

1994 and 1996, involving fully fledged reforms to finally complete the transition into a market economy (ibid. p35).

Along with adopting a new constitution, establishing diplomatic relationships with most countries of the world, Uzbekistan created a new system of administrative control in 1993, finally officially ending one – party rule by converting the positions of regional party secretaries to the newly formed position of Hokims (Governors) directly appointed by the President. While most of the former party secretaries stayed on in the new role, their job definition and responsibilities changed slightly, taking away from their job description the colourful, highflying words related to the moral high ground the party secretaries were claimed to hold and giving them the administrative tasks that they have been doing in practice.

Gosplan was re-organized into the Ministry of Macroeconomics and Statistics, Gossnab (the state body for distribution of output under USSR) was converted into an Association for Wholesale and Auction trade, Gostsen (the price control body) was abolished and the responsibility for administering price control over the remaining subsidised products was handed over to the Ministry of Finance.

In terms of privatisation, Uzbekistan chose a gradual approach with housing and smaller enterprises being privatised first and then medium and bigger enterprises. The country's first major foreign direct investment project, a joint venture with Korea's Daewoo, was agreed upon in 1992. The following table summarizes major events in Uzbekistan till 1996.

Table 4.1.1 Timeline of major events in Uzbekistan 1991 – 1996

	Laws	Presidential decrees	Cabinet Resolutions	Major events
1991	4	7	2	Two-tier banking system set up, privatization of housing and small enterprises started. Private businesses and cooperatives allowed Independence declared, First Nationwide Presidential election
1992	4	42	11	New constitution, IBRD and EBRD membership, Daewoo plant agreed
1993	12	11	7	Transitional currency introduced, IFC membership
1994	6	22	10	New currency at the rate of 1000:1 introduced, BAT agrees to take over Uzbekistan's Entire Tobacco Industry
1995	7	20	25	ADB membership, Production started at 'Zarafshan-Newmont' Gold Mining JV
1996	13	36	80	Exchange restrictions introduced
Total	96	138	135	

Source: Prepared from the materials selected from Uzbek press.

During the period leading up to 1996, Uzbekistan adopted 96 new laws and 138 Presidential decrees along with 135 Cabinet Resolutions to facilitate the transition of the economy. Three major investment projects were carried out involving big foreign companies, with Korea's Daewoo investing \$658 million in a car plant, BAT investing \$200 million in the country's tobacco industry, and the in mining company 'Newmont' joining in on the country's already sizeable gold production.

As a result of such a successful reorientation of the economy from being an integral part the ‘USSR Inc.’ to an outward looking, stable economy, coupled with relatively abundant natural resources, the country’s transition crises was much milder compared to its fellow ‘comrades’ (See the Table below).

Table 4.1.2 GDP Growth during the years immediately following the collapse of the USSR (%)

	1992	1993	1994	1995	1996
CIS	-14.1	-9.3	-13.6	-5.0	-3.6
Uzbekistan	-11.1	-2.3	-4.2	-0.9	1.6
Kazakhstan	-5.3	-9.3	-12.6	-8.2	0.5
Russia	-14.8	-8.7	-12.7	-4.0	-3.6

Source: EBRD (2004)

The budget deficit remained moderate too, by transition standards, after a difficult couple of years in the face of losing the subsidies from the collapsed Soviet Government and inflation was also brought down to manageable levels, although seignorage remained high at 8% of the GDP and just under 20% of Budget revenues in 1996 (IMF, WEO 1997).

Table 4.1.3 Budget Deficit and Inflation in Uzbekistan (1992- 96) (%)

	1992	1993	1994	1995	1996
Budget Deficit	-16.0	-16.3	-8.3	-5.8	-5.2
Inflation	645.2	5342	1568.3	304.6	43.1

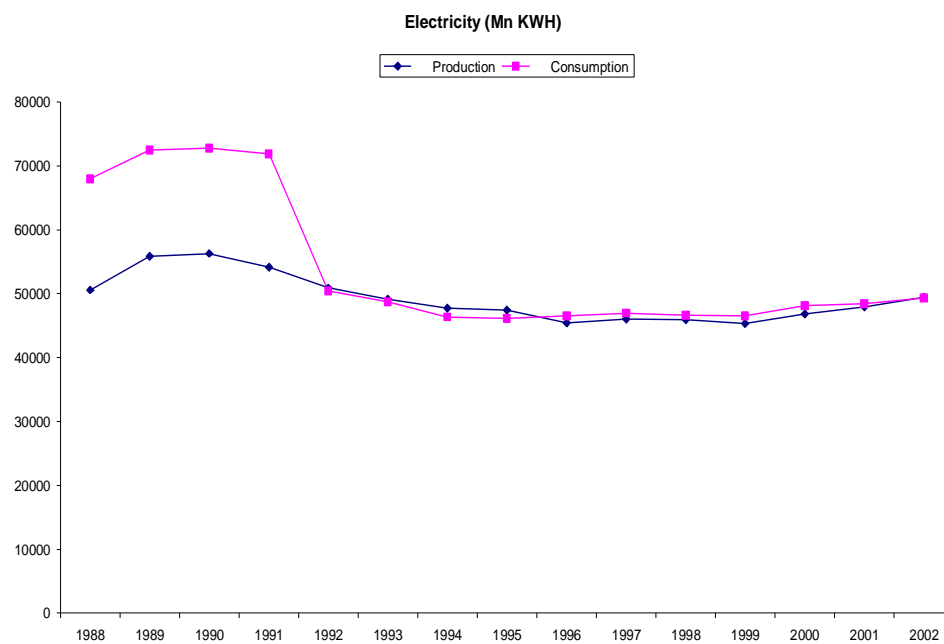
Source: Uzbekistan National Statistics

The main achievements of the initial years were the reduction of the country’s dependence on outside supply of key energy and food item in which Uzbekistan had large trade deficits during the Soviet era. After independence, Uzbekistan managed to reverse the socialist ways of



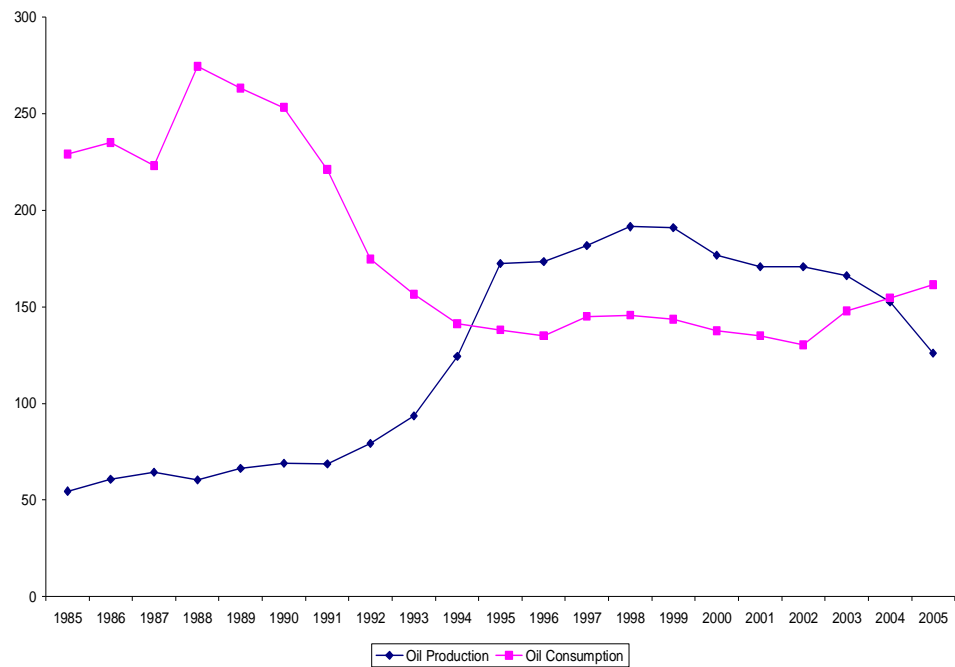
wasteful use of resources and cut the consumption of electricity and oil products to bring them down to the sustainable levels.

Figure 4.1.1 Production and Consumption in Uzbekistan (Mln KWH)



Source: ADB Key Indicators 2006

Figure 4.1.2 Production and Consumption of Oil in Uzbekistan (in thousand barrels)

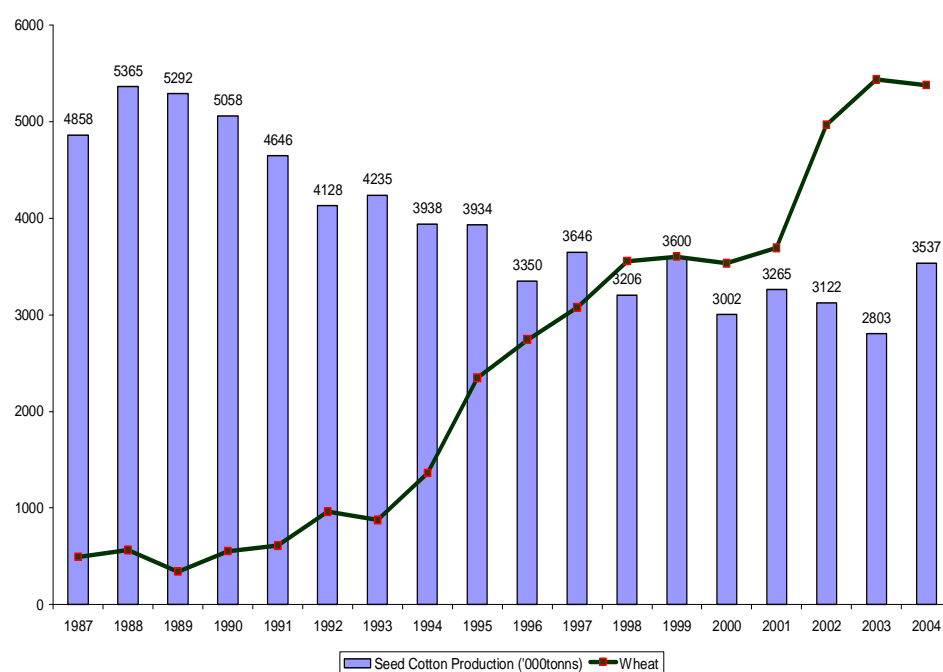


Source: BP World Energy Review 2006

Uzbekistan has increased oil production from 60 thousand barrels per day in 1989 to 172 thousand barrels per day in 1994 and reduced consumption from 274 to 138 thousand barrels per day in the same period in order to achieve energy independence.

In agriculture, the areas sown to cotton was cut back in order to increase food production and as a result the production of wheat increased sharply allowing the country to claim 'wheat independence' by 1996.

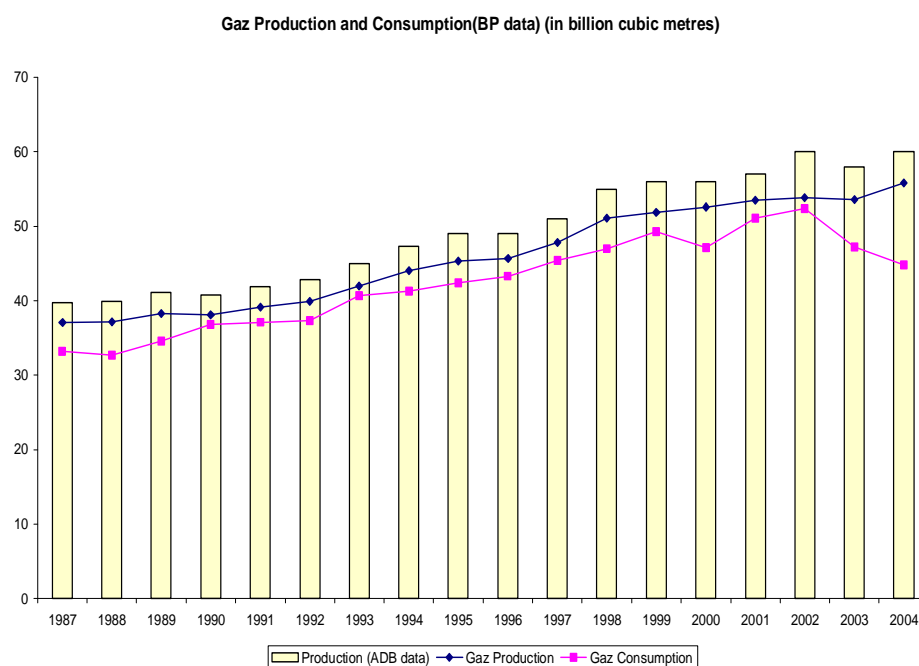
Figure 4.1.3 Production of Cotton and Wheat in Uzbekistan (000 tons)



Source: National Statistics

Domestic consumption of gas remained high and kept on increasing as Uzbekistan produced a lot more gas than was needed for domestic consumption and had only one major pipeline going out of the country, to Siberia through Kazakhstan. Thus export facilities for gas were limited until recently when the government built new facilities for producing liquefied gas for export.

Figure 4.1.4 Production and Consumption of Gas in Uzbekistan



Source: BP World Energy Review 2006 and ADB Key Indicators 2006

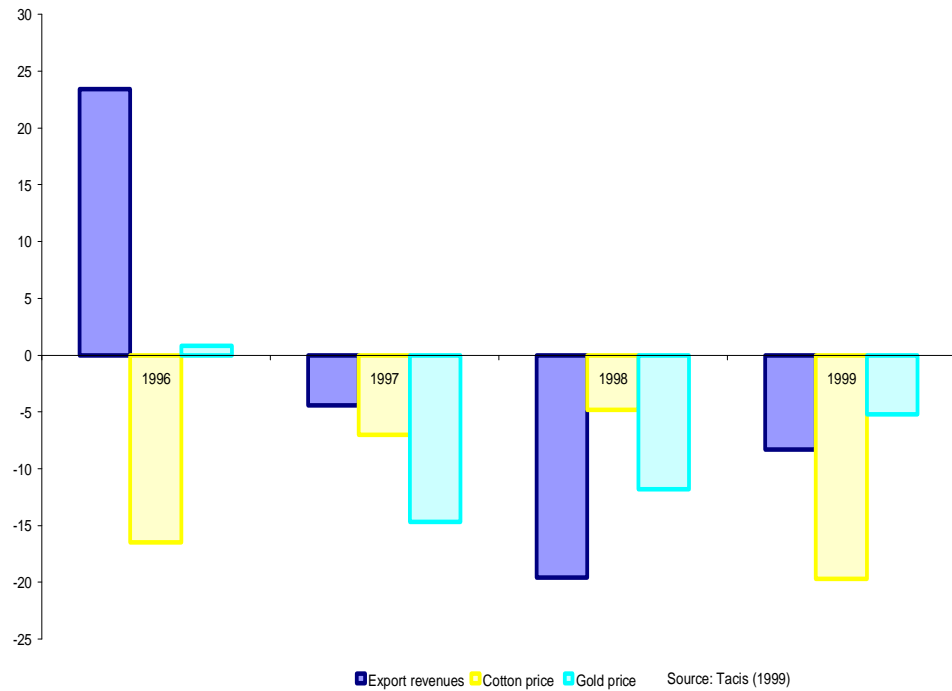
## 4.2 External Shock and Restrictive Policies

As we mentioned earlier, Uzbekistan’s original plan was to have a fully functional market economy by 1996. Instead 1996 became the year when things started go wrong for the country. First, unfavourable weather conditions resulted in a disastrous cotton harvest. The average yield of seeded cotton in 1996 was down to 2.25 from 2.63 tons per hectare in 1995 producing 123 thousand tons less of lint, the main product for export.

Falling commodity prices in international markets worsened Uzbekistan’s terms of trade, putting the country’s precarious trade balance under even more pressure and thereby threatening to derail the Uzbek governments economic policy, which was built on the ‘principle of import substitution and export promotion’. Prices for cotton, which accounted for over 41.5 % of total export revenues, fell by 16.5% in 1996 over 1995. The

price of gold, another major export item, also fell by 14.7 percent in 1997 (see the Figure below).

Figure 4.2.1: Export Revenue, Cotton and Gold prices year on year change 1996-99



Source: TACIS 1999

On the international front, in neighbouring Afghanistan the religious extremist group, the Taliban, which had members of the Islamic Movement of Uzbekistan in their ranks, took the capital Kabul (overthrowing the Afghan government) in September, 1996. The group had ambitious plans for building an Islamic Caliphate that would extend over most of Central Asia including Uzbekistan. Worried about the threat of the Taliban, the Uzbek Government sought to establish closer ties with Russia, despite

having had various differences since independence, mainly over the trade and economic policies of Russian government.

In 1997, Uzbekistan signed an Agreement with Russia on Border Guard cooperation to help protect only non-CIS part of the border, the 137 km border line with troubled Afghanistan.

Domestically, Uzbekistan introduced import restrictions for most import items, with tariffs ranging from 5 to 50%, and imposed mandatory surrender requirements for export revenues (Devereux and Roberts, 1997). Under those arrangements exporters were required to sell their export revenues at the official exchange rate, which was artificially overvalued. (For an elaborate assessment of Uzbekistan's exchange rate regime see Rosenberg and Zeeuw, 2000). The so called 'centralized export' of strategically important items like cotton, gold and the like were subject to 100% surrender requirements. Similarly, strategic imports like important food stuffs and technology items were eligible for hard currency purchases at the official rate. This system of multiple exchange rates and tight trade controls worked as a system of de facto wealth redistribution, taxing the export sector while subsidising importers.

Tarr (1997) suggested a number of plausible explanations for the Uzbek authorities' response to the deterioration of the country's terms of trade and consequently balance of payments.

First of all, as we have discussed above, the design of the Soviet economy did not reflect the true cost of the goods and services supplied to final customers and the population were not only accustomed to, but also heavily dependent on getting the essentials at low prices. Adjusting

domestic prices for the items of essential consumption to international price levels would significantly worsen the living standards of the majority of the population<sup>22</sup>. Therefore subsidising essential items of consumption was one of the main policy objectives of the Uzbek authorities since independence while trying to promote domestic production of those essential import items (an import substitution policy).

Secondly, contrary to the observations of some ‘western scholars’<sup>23</sup>, Uzbekistan had a considerable industrial base inherited from the USSR and actively pursued the preservation and development of industrial base, albeit at the expense of other sectors (especially agriculture). Old Soviet Industrial Enterprises were converted into joint stock companies with the state as the majority shareholder, and they were given access to cheap hard currency for upgrading aging machinery<sup>24</sup>.

Thirdly, the Soviet policy makers’ bias against the production of consumer goods had resulted in a permanent shortage of basic consumer goods and created profitable opportunities for private importers. However, the Uzbek authorities sought to control the imports of ‘frivolous’ goods like

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<sup>22</sup> Jensen (2003) also found that the transition countries ‘with large spans of the population hovering above poverty were less like to achieve high levels of economic reforms’ due to the fear that high adjustment costs might generate a popular discontent.

<sup>23</sup> See for example Zettlemeier (2003) who claimed to have solved a self created ‘Uzbek puzzle’ by suggesting that Uzbekistan’s quick recovery from a milder than average transition recession was the result of ‘low levels of industrialization’. Spechler (2004) on the other hand credited Uzbekistan’s strong resistance of ‘neoliberal policies’ and ‘neo-Stalinist’ approach of Uzbek authorities for achieving better performance during the early years of transition.

<sup>24</sup> Uzbekistan was one of the first Former Soviet Republics to establish major joint ventures with multinational companies, South Korea’s Daewoo Group invested in a \$658 million car factory capable of producing 200 thousand vehicles a year creating thereby over 10000 jobs including during construction, dealerships and local suppliers. In addition, the tobacco company BAT bought the entire tobacco industry of the country in a \$200 million deal in 1995 and increased the production of cigarettes from 2742 million units in 1995 to 10668 million units in 1999 (Takis, 1999).

fizzy drinks, chewing gum and the like in the times of severe hard currency shortages.

The last reason for the introduction of highly restrictive trade and exchange rate policies is directly relevant to our analysis. Tarr (1997) argues that the restrictions were the result of ‘the desire of government officials to either yield power or get rich through extracting rents (bribes)’ (ibid. p10)

As is well documented in the literature, rent – seeking authorities do not take a lot of convincing when it comes to introducing potentially profitable restrictions. In fact, the preferential access to hard currency and lucrative import licences were some of the main activities through which some of the infamous ‘Russian Oligarchs’ accumulated their initial wealth before pushing for a large scale state capture (Kryshchanovskaya and White, 1996). We will discuss the common practices used by rent seekers further in the following chapters.

The following table shows the actual rates of transfer between the export and import sectors.

Table 4.2.1 Transfers between Import and Export sectors 1997-99 (in percent)

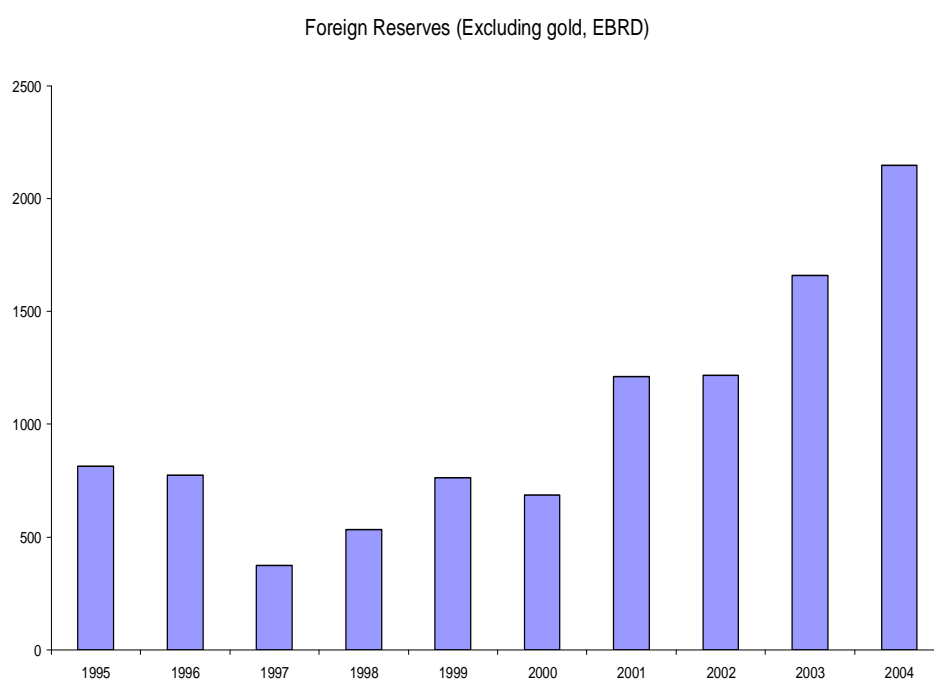
	1997	1998	1999
<b>Implicit Tax Rates:</b>			
Centralized imports	26	37	56
Other imports	5	9	21
<b>Implicit subsidy rates:</b>			
Centralized imports	26	37	56
Other imports	17	30	43

Source: Rosenberg and Zeeuw (2000: 11)



Thus, in 1999, the peak of exchange rate distortions, the rate of implicit tax on centralized exports was 56% and the centralized imports were also subsidised at the same rate. Although in reality the total amount of import subsidies must have been much bigger than the export taxes, as the Central Bank of Uzbekistan lost part of its foreign reserves during the period leading up to 2000, trying to maintain the artificially overvalued exchange rate (see the figure below).

Figure 4.2.2. Foreign reserves (EBRD Transition report various years, in million USD)



Source: EBRD transition reports (various years)

In response to the situation Uzbekistan unified two of the official exchange rates on May 1, 2000, thereby reducing the difference between the official and curb market rates and eliminating part of the indirect taxes

and subsidies. (This may have been partially in response to the fierce criticism from the international community led by the IMF, which closed its country office in Uzbekistan in protest at the exchange rate distortions) However, the overall economic situation in Uzbekistan and its standing in the international community were both far from ideal as Spechler neatly summarized in 2000:

‘The conventional view of Uzbekistan is that it remains unreformed from its Communist past and that it has no transition strategy.’ (Spechler (2000: 296)

Then 2001 was a crucial year for Uzbekistan. First, the prices for cotton and gold started recovering in 2000 and 2001. Then the infamous events of September 2001 in the USA changed the global political and economic conditions dramatically. The uncertainty in financial markets, created by these events, pushed gold prices even higher as investors turned to safer assets.

Even more important for Uzbekistan was the American government’s declaration of war on terror, a global campaign against radical Islamic groups, of which Uzbekistan’s exiled Islamic Movement and troublesome neighbours Taliban were well known representatives.

Uzbekistan’s misfortune of having a ‘war torn’ opium plantation for a neighbour had suddenly changed into a massive blessing, as the US – led coalition invaded Afghanistan, choosing Uzbekistan as the main partner in the region. In March, 2002, only a few months after the 9/11 attacks, Uzbekistan and the USA signed a joint declaration on strategic partnership. Uzbekistan offered the Americans the military facilities built by the USSR

for the original invasion of Afghanistan in 1979. In return, USA brought military and financial aid, and with it came an increased media and scholarly interest in Uzbekistan. Abdullaev (2002) observed

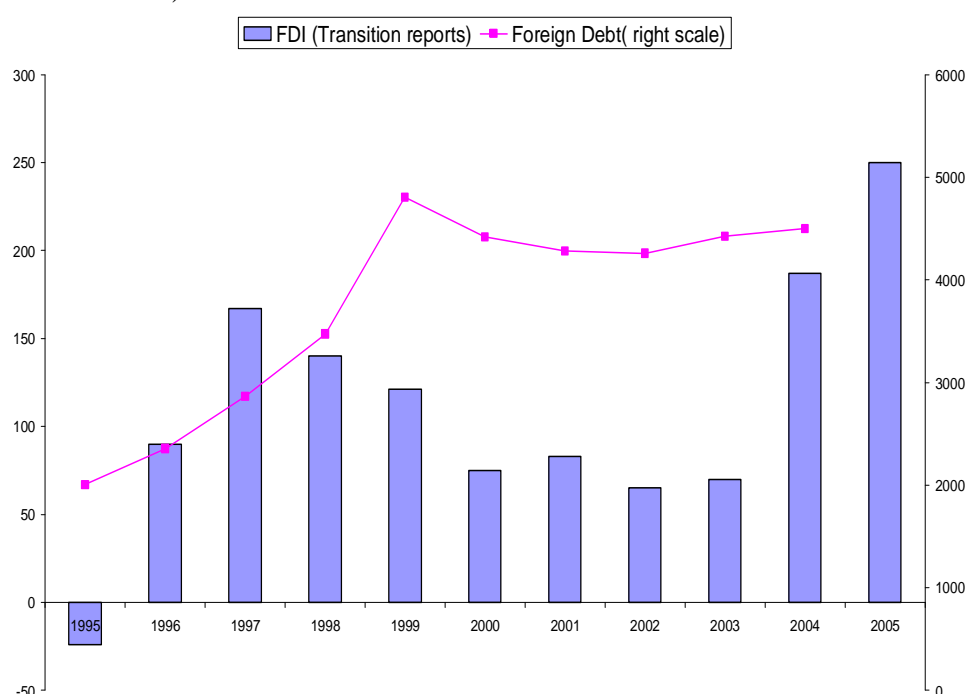
‘juxtaposition of two different types of representation of Uzbekistan: the *apologetic* (which gives an unequivocally positive assessment of the foreign policy of Uzbekistan – viz., as the most reliable regional partner of the United States in its operations in Afghanistan), and the *hypercritical* (which offers an exaggerated portrait of Uzbekistan and seeks to demonstrate the ‘incoherence’ of official Washington in its choice of partners). (Abdullaev (2002: 214, emphasis in original)

Either way, both sides contributed to increasing Uzbekistan’s profile internationally and suddenly a lot of people wanted to do business with Uzbekistan. During the 10 month period following the 9/11 events, 4 delegations of US congressmen visited Uzbekistan to discuss various areas of bilateral cooperation. Military and defence chiefs paid countless visits during the same period, often bringing a significant amount of important equipment for their Uzbek counterparts as gifts, and official military aid was increased from \$60 million in 2001 to \$160 million in 2002 (Plater-Zyberk, 2003).

Military and the related aid funds aside, Uzbekistan failed to cash in on its new – found popularity. The Uzbek government’s reluctance to let go the control of key economic sectors and big state owned enterprises, coupled with trade restrictions, discouraged the kind of FDI flow neighbouring Kazakhstan attracted (Kazakhstan attracted as much 30 times more FDI compared to Uzbekistan in 2001 (EBRD Transition Report 2001). Although much of it was due to oil boom in Kazakhstan, the

country's liberal approach to business and entrepreneurship made it a favourable destination for companies planning to produce their goods for sale in the region). The following figure shows the flow of FDI into to Uzbek economy. Although the figures for 1997-99 are higher, the true FDI amounts are estimated to be lower as the Uzbek national statistics include a part of foreign debt in FDI figures (UNCTAD, 1999).

Figure 4.2.3: FDI flows and foreign debt stock of Uzbekistan (in million USD)



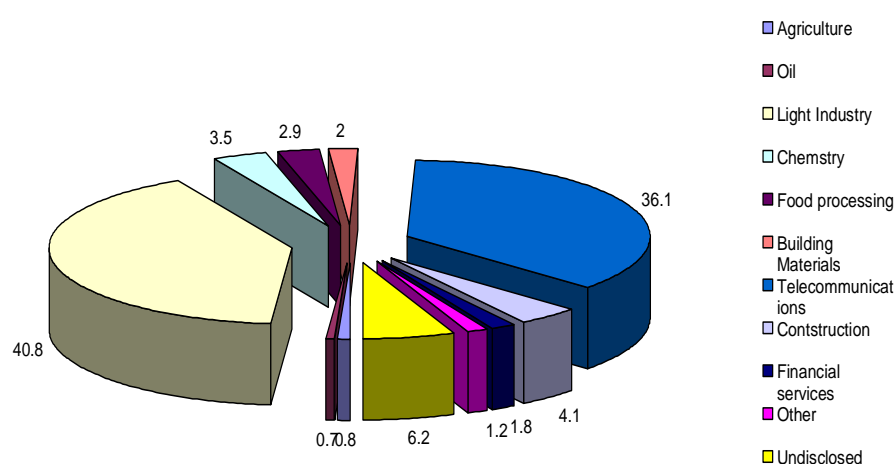
Source: EBRD, Transition Report, various years

The limited amount of FDI that Uzbekistan managed to attract went predominantly into two industries. Light industry, which mainly consists of cottons processing sector, was one the priorities of the Uzbek government. As mentioned in previous chapters, very little of Uzbekistan's cotton was actually processed within the country. Uzbekistan's internal consumption

of cotton doubled since independence and stood at 400 thousand tons in 2005-06 season<sup>25</sup>. This was achieved partially through FDI, 40.8 % of which went into the textile industry (see the figure below).

Figure 4.2.4

Sectoral Distribution of FDI stock 1997 (Percentages)



Source: National Statistics

The second largest piece of Uzbekistan’s FDI pie went into Telecommunications sector (36.1%). The most of those investments were used to build up the country’s mobile communications industry which only took off in the late 1990s and grew very fast. During the period between

<sup>25</sup> Uzbekistan’s internal consumption is set to rise even further as the ‘Program on Attraction of Investments to Textile Industry of Uzbekistan for 2005 – 2008’ adopted on January 2005, envisages further investment of 1.22 billion US dollars in 94 projects. To encourage foreign companies to participate in the program, Uzbekistan introduced a further 5% discount on purchases of cotton fibre on top of the existing 15% discount from the Liverpool Cotton exchange quotes, provided all of the fibre bought for hard currency and processed within Uzbekistan, and at least 80% of the finished product is exported.

2000 and 2006, the number of mobile phone customers per capita increased over ten times (UNDP, 2006).

Despite the important role that the primary sectors like agriculture and energy extraction play in the Uzbek economy, the amounts of FDI attracted into those sectors were at mere 0.8 and 0.7% respectively, largely due to the government's reluctance to open those industries to outsiders<sup>26</sup>.

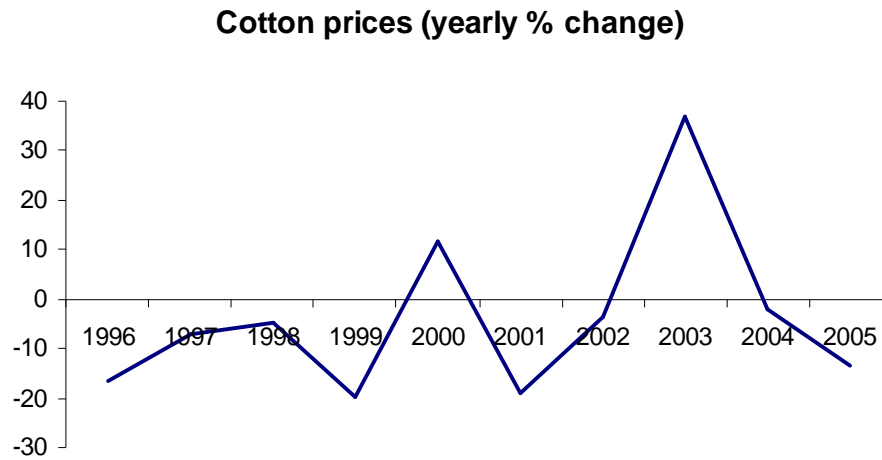
### 4.3 The Cotton Industry since Independence

The World market setting for cotton is a peculiar one. While the demand for cotton has been stable and growing roughly in line with world population growth, the price for cotton has been very volatile, driven by a combination of unstable supply (which depends on weather conditions), and agricultural subsidies by the USA and EU. The figure below shows world consumption and production of cotton (see the figure 4.3.1 below).

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<sup>26</sup> Uzbekistan did attract foreign interest into its other 'strategic' industry i.e. gold. Newmont Mining established a joint venture in 1995. It was reported that the joint venture, in which EBRD also invested, would have a life span of 17 years during which 156 tons of gold would be extracted starting at 14 tons a year and decreasing to 7 tons a year towards the end of its life span. (Levine (1996)

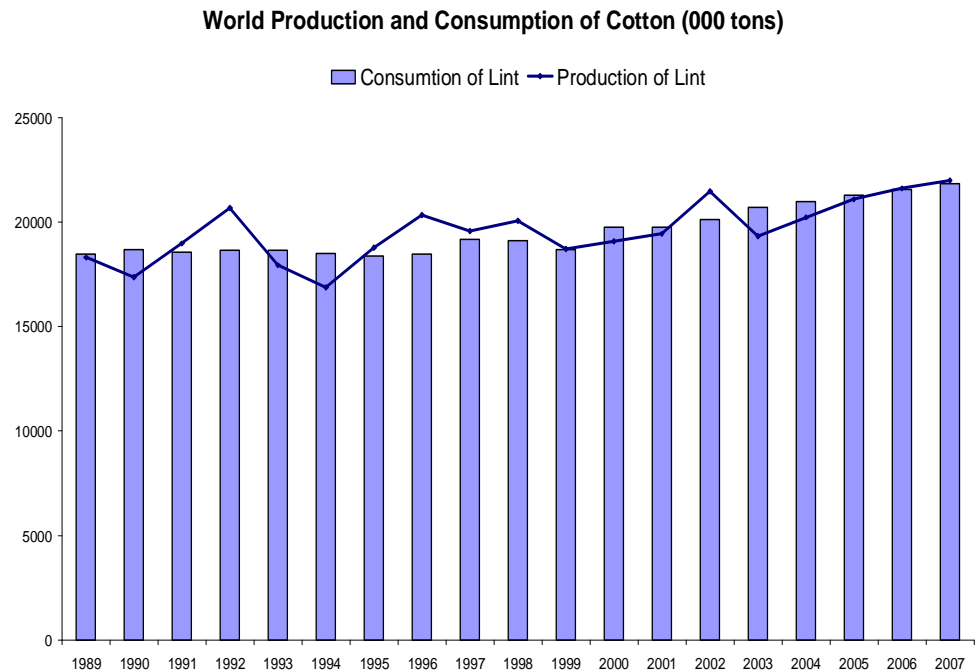
Figure 4.3.1 Cotton price dynamics



Source: TACIS 1999

Although the total world production of cotton is over 20 million tons, most of that amount does not make it onto the export markets. World's biggest producer, China, alone produces around a fifth of the total, but still is a net importer, consuming nearly a third of the world's annual production.

Figure 4.3.2

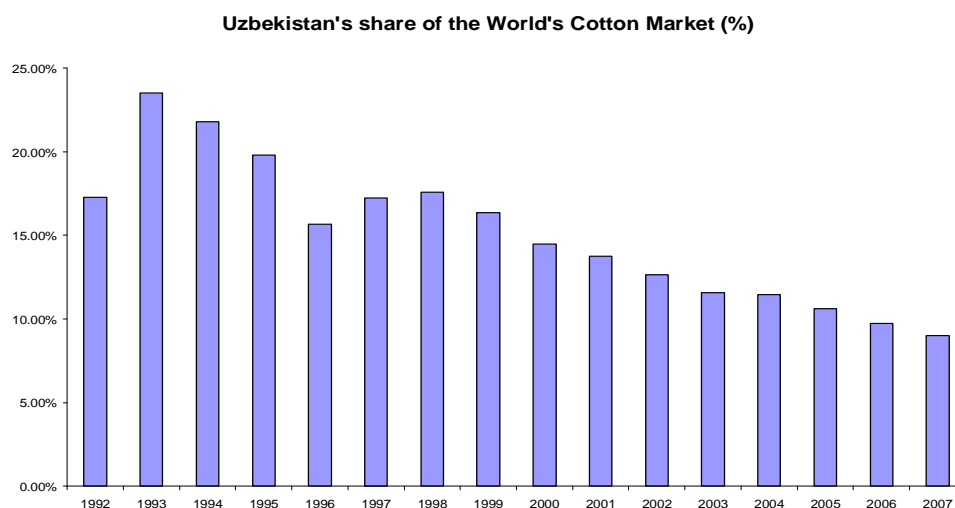


Source: ICAC (2007)

Uzbekistan, the world's 6<sup>th</sup> largest producer, is actually the second biggest exporter of cotton behind the USA. In spite of the fact that Uzbekistan has reduced production of cotton in favour of wheat since independence and encouraging domestic consumption by investing in the textile industry, it still has just below a 10% share of the world's cotton export market. It is a big drop from the early 1990s when Uzbekistan was supplying nearly a quarter of the world's cotton export (see Figure 4.3.3 below).



Figure 4.3.3



Source: ICAC (2007)

The cotton market is also one of the most distorted markets of the world, where 53% of cotton produced in the world is subsidised (ICAC, 2005).

The ICAC secretariat estimated that direct support to cotton production during 1999/00 through 2001/02 averaged about \$5 billion, of which \$3 billion was provided by OECD member countries (the USA and EU).

The USA, the world's biggest exporter, alone spent \$3.3 billion in fiscal year 2002 on its 'upland cotton program' (Townsend, 2006) and as a result producer prices during the 2001/02 season in the USA were 91% higher than world prices (Baffes, 2004). Subsidies in the EU were even higher on a per unit of production basis. With EU subsidies of \$980 million in 2001/02, producer prices in Greece and Spain were 144 and 184 percent higher than world prices.

Those subsidies allow American and European producers comfortably to ignore world market trends and produce to their full capacity, resulting in higher production and lower world prices than those that would have prevailed without subsidies. The situation affects adversely countries like Uzbekistan which depend on cotton revenues.

Uzbekistan's unique procurement system means that Uzbek producers suffer even more from unfair price differentials. As cotton is classified as a strategic export item, producers are not allowed to export directly. They instead sell to the state, represented by Uzpakhtasanoat (formerly Khlopkoprom, the new name is a direct translation from Russian). Uzpakhtasanoat in turn sells it on to three State trading organizations (STOs) which will eventually export it. Uzpakhtasanoat administers and oversees the whole collecting, storing, ginning processes and deals directly with the growers.

Although STOs presumably sell the cotton at or near world prices, they pay much less to Uzpakhtasanoat and hence the producers. Baffes (2004) estimated that Uzbek producers were on average getting only a third of the world prices. The net profit then is transferred to the budget and used to subsidise industry among other things.

The following table shows the amount of taxes and subsidies to the cotton industry in 2004 when the net amount of money taken out of the cotton industry was \$203 million. This amounted to about 31% of the Uzbek farmers' gross income in 2004. Although it represents a big drop from 66% in 2000, it is still considerably high.

Table 4.3.1: Cotton Taxes (+) and Subsidies (-) in 2004 (in million USD)

Irrigation	-161
Debt write-offs	-135
Interest rate credit	-81
Oil price differentials	-28
Fuel (VAT waiver)	-12
Machinery	-12
Fertilizers (VAT waiver)	-11
Ammonium nitrate	-2
Foreign exchange rate control	0
Land tax producers	19
STO commissions	23
Ginning taxes	35
Income tax producers	65
Taxes on crushing	120
VAT fiber	170
Producer price control	213
Net Transfer	203

Source: Guadagni et al (2005: 7)

The existence of such a direct and indirect wealth transfer system away from the cotton industry created a number of distortions in the economy.

First, there is still a widespread waste of important but subsidised inputs. For example, despite the serious water shortages and drying of the Aral Sea, Uzbekistan uses more water per capita than anyone else in the world. Furthermore, Uzbek farmers use 60-80 kg of seeds to plant one hectare of cotton while Australian and American farmers use just 15 kg/ha.

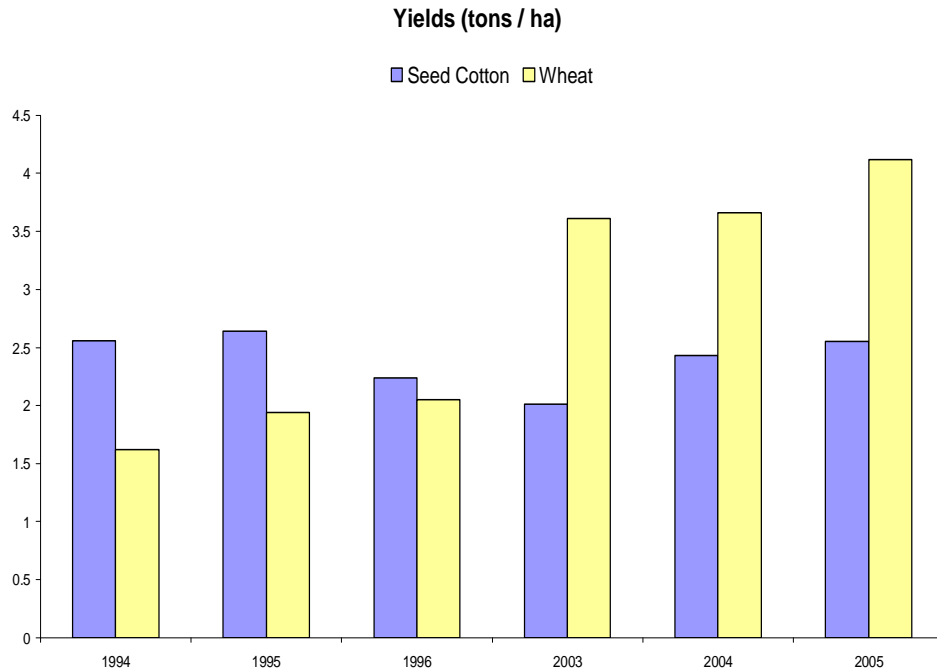
Secondly, excessive taxation left the cotton industry with insufficient funds to invest in infrastructure and technological renovation. Ginning equipment in most of the ginning plants is a lot older than the Republic itself. As a result ginning outturn ratios, the ratios of obtaining exportable cotton lint from seed cotton, have not changed from the early

1960s and stand at about 32% as opposed to 39% and 40% in China and West Africa respectively. In addition the speed of the old machines is much lower by today's international standards, with Uzbek machines ginning 6 bales per hour while American ones handle 25-35 bales/h. Guadagni et al (2005) estimated that Uzbekistan might be losing over \$200 millions a year because of this low outturn ratios.

Thirdly, as 100% of Uzbekistan's cotton is now produced by private farmers, there are serious incentive problems associates with the current system. Farmers see cotton as a burden imposed upon them by the government as a payment for letting them use the rest of their land (just as serfs worked the landlord's land as a payment for their share of plots in feudal times). It would be highly optimistic if not downright naïve for the government to expect farmers to use all of the subsidised fertilizers as intended i.e. for cotton. A simple comparison of average yields for cotton and wheat, the main profitable crop for most farmers, tells a different story.

Wheat yields per hectare have almost tripled since 1994 while cotton yields have virtually not changed (see Figure 4.3.4 below).

Figure 4.3.4 Cotton yields in Uzbekistan (1994-2005)



Source: Annual Statistical Summary for 2005, Uzbek State Committee for Statistics

Even these yield figures are questionable, as there have been allegations of widespread over – reporting in order to fulfil the cotton production plan by desperate farmers (Murodali, 2006). Uzbeks, as well-experienced as they are at over – reporting and plan fixing as we have discussed earlier, now have more incentives than ever before to do so, with all the profits going directly into the private farmers’ pockets.

Fourthly, there is the matter of rent seeking and corruption usually associated with a centralized allocation of highly subsidised goods and handsome revenues accruing from the sale of cotton fibre. As it is an integral part of our main analysis of the workings of the greater

administration system of Uzbekistan, we will discuss this issue in later chapters in greater detail.

The outlook for the cotton industry of Uzbekistan seems to offer some consolation. World prices for cotton might be going up in the future, as the World Trade Organisation ruling in March, 2005 declared US agricultural subsidies illegal. If World Bank economist John Baffes' predictions are anything to go by, world market prices are set to increase by an average of 12.7% over the prices that would have prevailed under the existing system of subsidies over the next 10 years.

In addition, increasing investments in the textile sector in Uzbekistan should also create an internal market for cotton, making it easier for the Uzbek authorities to liberalise should they wish so at some point in future.

#### 4.4 Employment and Population since Independence

Population growth slowed down significantly since independence due to family planning campaigns and general change of attitudes towards life styles and family size under the pressures of the market economy (see Agadjanian and Makarova, 2003, for example full analysis of marriage and fertility dynamics in Post-Soviet Uzbekistan).

The growth of the labour force however remained strong as Uzbekistan's young population started coming of age (Uzbekistan had a

large portion of population under 15 due to fast population growth during Soviet times).

Figure 4.4.1 Growth rate of Population and Labour Force (%)



Source: Annual Statistical Summary for 2005, Uzbek State Committee for Statistics

A fast growing labour force, the exposure of hidden unemployment and underemployment in agriculture by the abolition of kolkhozes, matched equally by the inability of the economy to create new job opportunities, resulted in a massive unemployment problem, especially in rural areas.

The Uzbek authorities persistently belittled the magnitude of the unemployment problem as the official statistics put unemployment at 3.5% for 2005 while EBRD staff estimated it to be 10 times higher<sup>27</sup>.

<sup>27</sup> Reported by Radio Free Europe on the Radio's Uzbek service website accessed on 28/04/06

A lack of employment opportunities at home forced many Uzbeks to travel abroad to seek jobs. The number of labour migrants leaving Uzbekistan nearly doubled in the four years between 2001 and 2004, increasing from 640 thousand to 1050 thousand respectively with Russia (64.0%) and Kazakhstan (28.1%) being the favourite destinations (Ilkhamov, 2006: 4).

Labour migration boosted the country's balance of payments. The net transfers from abroad are estimated to have reached USD 1139 million in 2006 while the revenues from cotton, country's traditional main export earner, stood at USD 1009 million for the same year (ADB Economic Outlook for Asia 2006). The trend is set to continue with the ADB projecting the transfers to double by 2010 (ibid.).

#### 4.5 Conclusion

Uzbekistan's economic performance since independence has been very different from most of the other transition countries.

The country's initial recession was much milder compared to other former 'comrades' and output started recovering much earlier, 'puzzling' some Western observers.

A closer look at the transition process in Uzbekistan reveals an initial phase of accelerated reforms based on clearly defined principles. The now 'famous' five principles called for orderly, gradual, and state directed transition while mitigating the adjustment costs for the most vulnerable members of the society.



Uzbekistan's transition process was soon knocked off track by the country's fragile international terms of trade and peculiar geopolitical location as the commodity prices tumbled and international terrorism threatened the stability in the region.

The Uzbek Government introduced trade restrictions in response to the worsening trade balance and operated multiple exchange rate regimes, forcing exporters to surrender part or in some cases all of their export revenues at an artificially overvalued official exchange rate while selling the proceeds to the importers of selected 'strategic items'.

In fact the multiple exchange rate system, together with the other trade restrictions, was part of government's wealth redistribution scheme which was meant to serve the country's industrialization drive at the expense of the primary sectors such as agriculture and mining. However, the system failed to deliver amid allegations of misuse and corruption.

Becoming the USA's strategic regional partner in the 'war on terror' seemed to have opened a window of opportunity for Uzbekistan to attract significant flow of foreign direct investment and improve trade relations with the West.

Uzbekistan's reluctance to open its economy up to foreign investors and continuing disagreements with international organizations regarding democratic reforms and human rights issues eventually cost the country dear as the major Western countries withdrew their support amidst several reported episodes of internal unrest.

Although the recent economic performance looks solid on paper, especially as commodity prices continue to rise, significant risks remain with the country's political future still unclear.

We will continue to discuss the Uzbek economy in the next chapter, looking at the structure of the economic administration and the implications of the rewards for being involved in the administrative structure in the process of entrepreneurship development.

## Chapter Five

### Entrepreneurship and Talent Allocation in Uzbekistan and the implications for SMEs

#### Introduction

In the previous chapter we discussed the overall performance of the Uzbek Economy since independence. The economic policy pursued during this period created a unique environment for the newly emerging entrepreneurial class to operate in. In addition, the political regime centred on a strong leadership and the so called ‘Ideology of Independence’ created an entirely new set of incentives and punishments for those aspiring to get ahead.

In this Chapter, we will discuss entrepreneurship and business under transition.

As we have done in the previous chapters, we will discuss ‘the Rules of the Game’ that shaped entrepreneurship and the elite generation processes. We will pay special attention to the role of the institutions of higher education as a platform for the development of the future members of the elites.

We will also present the statistical summary of the current state of small businesses in Uzbekistan and discuss the results of the annual surveys on perceived obstacles faced by the Uzbek SMEs.

This chapter will also include a preliminary, general discussion of the main obstacles highlighted in those surveys before we discuss the most important of them in more detail in the next chapter.

## The Entrepreneurship and Small Business in Transition

The importance of entrepreneurship in the transition countries is well documented in the literature ( see for example Kolodko, 2000, Radaev, 2003, Glinkina, 2003, McIntyre, 2003, Kihlgren, 2003, Mitra, Thomakos, and Ulubasoglu, 2002, Kornai, 2001, McMillan and Woodruff, 2002, Berkowitz and DeJong, 2001). Some even go as far as to claim that:

‘... the main purpose for the whole transition exercise is the creation of entrepreneurship’ (Kolodko, 2000: 274).

McMillan and Woodruff (2002) similarly argued that ‘the success or failure of a transition economy could be traced in large part to the performance of its entrepreneurs’ (p154).

The reason for entrepreneurship to get so much attention in transition discussions was related to the perceived ability of entrepreneurs and small businesses to create new jobs, produce much needed goods and services, and spur economic growth. Besides entrepreneurship gained an added importance in transition, because it represented the newly formed private

sector. In addition, transition countries were expected to generate a lot of bright entrepreneurial talent as they had achieved very high levels of educational and scientific development during the years under the command economy.

Initially, as expected, new private start ups got off to a flying start. The number of Cooperatives in the USSR increased from just 15,000 in 1987 to 3,100,000 in 1990 (Kornai, 1992: 440). Small firms were well represented in every sector of the economy.

By the year 2000 the share of SMEs in total GDP in transition countries ranged from 12% in Russia to 75% in Albania.

Many scholars attempted to study the factors behind the differences in the performance of entrepreneurial sectors of different transition countries (Ganev, 2001, Safavian, Graham and Gonzalez – Vega, 2001, Astrakhan and Chepurenko, 2003). Cheikbossian, 2003), for example, argued that the failure to establish ‘The Rule of Law’ resulted in an ‘institutional vacuum’, which in turn allowed economic agents to engage in rent seeking activities.

Sonin (2003) on the other hand argued that it is the rent seeking agents themselves who actively resisted the establishment of property rights because they were best placed to benefit from weak institutions. As a result some economies in transition ‘became stuck in a bad equilibrium with low growth rates, high inequality of income, and wide-spread rent-seeking’.

Stiglitz, also referred to ‘the failure to establish the rule of law and botch privatization’, as the two main reasons for the failure of transition in the former USSR (EBRD, 2006:5).

Oleinik (2002) offered a completely different view on the institutional design of the newly emerging Russian Capitalism. Although the type of ‘rule of law’ prevalent in the Western countries did not materialize in Russia, the business community there had their own unique ‘rules of the game’ based on Soviet time prison subculture<sup>28</sup>.

The Soviet style prisons, still in use in many of the former USSR countries including Russia, had a different system of accommodating inmates. As opposed to the cell system used in many Western countries, the Soviet system used the barracks system, where most of the inmates spend most of their time together with the rest of inmates. Because of the inherent distrust of the authorities, the inmates tend to keep the information about what happens among the inmates secret, making it very difficult for the authorities to intervene in cases of conflict. As a result the inmates develop their own systems for dealing with the internal conflicts and dispute resolution. Oleinik (2002) argues that the subculture, which developed in that environment, is replicated in the Russian business community where people have similar degrees of distrust in the state and the courts.

The main characteristic of that subculture is a clear separation of interest groups defined as ‘us’ and ‘them’.

‘... the two principle conditions necessary to become ‘us’ for the Russian businessman consist either of affiliation with his family in both the direct and figurative (reminiscent of the Peruvian ‘uncles’) senses, or of affiliation with the circle of his close

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<sup>28</sup> This argument supports the earlier claim by Peng (2001) that the entrepreneurial sector in the Soviet Union had close ties with ‘grey individuals’, representing the criminal underworld.

friends. Third, the fact of affiliation with the circle of managers that took shape during the Soviet period (its members were sometimes called the 'Red directors'), requiring that they fulfil particular ethical norms that reduce opportunism *within* this circle (ibid. p21, emphasis in original).

Hence, 'us' is their family, friends and close associates in business (as long as you are not in direct competition) and they are not supposed to steal from them or behave opportunistically towards them. As for 'them', this basically refers to anyone who is not part of 'us'; all of the above is permissible

Most of the loan arrangements (as indeed most other contracts) are informal and interest free.

'... every 'network' lives according to norms that are accepted among 'us', according to the 'understandings' that are specific to it. (ibid. p24)

Anyone who 'fouls his own nest' by breaking those rules will trigger the demise of his own career as a businessman in that market place.

The roots of such practices go back to the Soviet times when all kind of private trade was prohibited and existed only outside the law closely intertwined with the rest of the outlawed activities. Therefore, 'Soviet period entrepreneurs' and most of the Soviet enterprise directors, for that matter, had to rely on informal arrangements to enforce contractual pledges.

Thus, contrary to the prevalent scholarly opinion in the West, the problem with the 'Rule of Law' in transition economies (especially in the

Former USSR) seems to be the existence of the ‘Rule of Alternative Laws’ rather than the lack of the ‘Rule of Law’.

The members of each group operate within those unwritten set of rules, which Oleinik calls ‘understandings’. While the masters of those ‘Alternative Laws’ do not want the formal law enforcement authorities to prevail, they are very careful not to come into an open conflict with them and to maintain the fine balance of power. The high levels of corruption in most of the countries of the former Soviet Union make it easier to maintain that balance.

In that sense, corruption facilitates the redistribution of wealth in favor of well connected and bigger firms. Safavian, Graham and Gonzalez–Vega (2001) found that smaller firms in Russia were more affected by corruption than the bigger firms.

The combination of the ‘lack of legal property rights’, prevalence of informal institutions alongside formal ‘inefficient’ institutions, and widespread corruption of state officials and judiciary, has created a unique environment for the entrepreneurs to operate in.

In order to succeed in that environment, an entrepreneur must affiliate with one of the interest groups and has to watch the balance of powers between the interest groups. He or she should be prepared to switch affiliations in case the group, which he or she is affiliated to, goes down.

The leaders of the interest groups draw their strength from being able to tap into state owned resources, being closely related to the state officials or indeed being part of the government. In order to rise to the top in those circumstances, they must be up for anything, as adherence to strong moral



principles will not take anyone there. Indeed, the 'bad characters' have won the transition battle, because the relatively lawless years in the beginning afforded them to use any 'dirty' tricks they could manage (Ganev, 2001).

The circumstances have made it difficult for genuine 'productive entrepreneurs' to prosper in transition countries. Scase (2003) observed that the big majority of small businesses were proprietorships rather than entrepreneurial companies. The main characteristic of proprietorships is subsistence level trading aimed at consumption of any surplus generated, instead of reinvesting in the company.

Big companies, both state owned and private, are run by well connected elites and they still dominate the economies in the countries of the Former Soviet Union (See Guriev and Rachinsky, 2004) for example).

Surveys on obstacles for business revealed the problems that the system generates for smaller businesses. Pfeffermann and Kisunko (1999) reported the results of a worldwide survey of small businesses on the obstacles they faced. The results for transition countries put tax regulations and high taxes at number one with corruption, unpredictability of the judiciary, policy instability, and crime and theft completing the rest of the top five.

In the next section, we will discuss the entrepreneurial and business landscape in Uzbekistan focusing on the 'Rules of the Game'. We will highlight the aspects of business environment that makes Uzbekistan different from the rest of the transition countries as well as its similarities.

## The State of Small Business in Uzbekistan

As we discussed in the previous chapters, Uzbekistan's approach to transition had been somewhat different to that of the other countries. One of the key aspects of that 'different approach' has been the government's reluctance to let go of the control over the economy. This was reflected in the privatization process too. Unlike most other transition countries that undertook wholesale privatization, Uzbekistan chose a 'bottom up' approach to privatization i.e. privatizing the smallest assets first and then moving to bigger ones gradually. The housing stock was the first to be privatized. Then the small retail and catering outlets were all privatized. Although the agricultural sector was left relatively unreformed in a practical sense, the old kolkhozes (collective farms) have been abolished and their lands were given to private farmers on long term leases creating a large number of agricultural SMEs.

The total number of registered SMEs <sup>29</sup> in Uzbekistan has almost reached the 300 - thousand mark in 2006 (Table 5.3.1), although only 88.9% of them were actually functioning.

Table 5.3.1 SME statistics in Uzbekistan

	01.2005	01.2006
Total Number of Registered SMEs (thousands)	245.3	295.9
Percentage of registered SMEs operating %	83.4	88.9
SMEs' Share in Total Export %	4.6	6.7
SMEs' Share in Total Imports %	29.4	29.7

Source: Uzbekistan National Statistics

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<sup>29</sup> SMEs in Uzbekistan are defined by the number of employees as follows: Micro: up to 10 in industry; 5 in trade, services and other non productive sectors Small: up to 40 in industry; 20 in construction, agriculture and other production sectors; 10 in retail trade and other non-production sectors, Medium sized businesses have up to 300 employees.

The importance of the SME sector in Uzbekistan has been growing steadily during recent years. Their share in the Nominal GDP increased from 33.8% in 2001 to 38.2% in 2005 and their share in total employment increased from 53% to 66% in the same period<sup>30</sup>.

Table 5.3.2. The importance of the SME sector in the Uzbek economy 2001-2005.

	2001	2002	2003	2004	2005
Share in Nominal GDP %	33.8	34.6	35.0	35.6	38.2
Share in Total Employment %	53	55	57	61	66
No of operating legal entities (1000 units)	177.7	215.7	229.6	237.5	268.6

Source: Annual Statistical Summary for 2005, Uzbek State Committee for Statistics

Smaller firms make up the majority of the Uzbek SMEs as 93.5 % of the total SMEs in 2005 were micro firms.

The following table (table 5.3.3) presents the allocation of SMEs in Uzbekistan across different sectors of the economy in 2005. As ever, agriculture dominates the scene, with 53.8% of SMEs operating in agriculture. This is the result of re-organizing the kolkhozes by giving out

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<sup>30</sup> A quick look at the dynamics of those figures reveals an interesting picture. While the total number of SMEs has gone up by 51% during the period, the employment figure has only improved by 25% and the GDP contribution had even smaller change. This either implies that the Uzbek SMEs are getting smaller or they are not reporting part of their production and employment figures. The latter case is quite consistent with Schneider (2004), who estimated the sized Uzbekistan's shadow economy at 34.1 % of GDP in 1999/2000. Considering that the shadow economy mostly consists of smaller participants, the true contribution of SMEs in the economy is probably much bigger. Our own interviews revealed that as much as 75% of businesses conducted by the SMEs were unreported in some cases.

the land for long term leasing. 22.4% of the SMEs were operating in retail and catering, while a further 10% involved in industrial production. Apart from the construction sector, which is accounts for 5.4%, the remaining sectors of the Uzbek economy do not enjoy any significant proportion of SME participation.

Table 5.3.3 Allocation of SMEs across the sectors of the economy (2005, %)

Industry	10
Construction	5.4
Agriculture	53.8
Transport and Communication	1
Retail and Catering	22.4
Other production	3
Other Services	0.8
Health and Sport	1.5
Education	0.4
Culture and Art	0.5
Science	0.3
Other	0.9

Source: Annual Statistical Summary for 2005, Uzbek State Committee for Statistics

This presents us with a general profile of an Uzbek SME, which is normally very small (less than 50 employees) and most likely to be operating in agriculture or retail and catering. This in itself supports Scase's (2000) argument about SMEs in transition being small scale proprietorships operating at self – subsistence level. The implication of Scase's (2000) argument would then be that there is not much of 'truly entrepreneurial' activity happening in Uzbekistan.

However, based on the discussions of the allocation of entrepreneurial talent in the previous chapters, we assume that Uzbekistan, just like any other country, has a stock of such talent among its population of over 26 million. In what follows, we will use Schumpeter's line of reasoning to

identify existing entrepreneurial opportunities and entrepreneurs who were best placed to exploit those opportunities.

But first we will take a general look at the 'Rules of the Game' in the independent Uzbekistan and the factors that shaped those rules i.e. the political system, cultural peculiarities and economic realities.

Assuming that the best of talent in Uzbekistan, just like in any other country, will strive to achieve the highest possible return on their talents, we will first identify the areas and occupations which would enable them to do so.

The literature classifies the top of the pile in every country, termed as the elite, as political, economic, administrative and intellectual elites<sup>31</sup> (Abdullaev, 2002).

In Uzbekistan, the only elite that matters is the administrative elite, as there is no real political elite outside the administrative apparatus, and the economic elites are the extension of the administrative elites.

Constitutionally, Uzbekistan is a democratic country with the President is elected as the head of the state by popular vote. The President is also the head of government.

The president has extensive powers including, but not by any means limited to appointing and dismissing the Prime Minister, his First Deputy, the Deputy Prime Ministers, the members of the Cabinet of Ministers of the Republic of Uzbekistan, the Procurator-General of the Republic of

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<sup>31</sup> The elites are defined as follows: the political elites are the elected politicians and opposition, members of political parties, administrative elites are the members of the bureaucratic apparatus, economic elites in most countries consist of the rich entrepreneurs and other business leaders, while intellectual elites are those who are at the forefront of science, media, culture, art, and literature.

Uzbekistan and his Deputies, with subsequent confirmation by the Parliament; presenting to the Parliament his nominees for the posts of Chairman and members of the Constitutional, Supreme Courts and the Higher Economic Courts, as well as the Chairman of the Board of the Central Bank, and the Chairman of the State Nature Protection Committee; appointing and dismissing judges of regional, district, city and arbitration courts; appointing and dismissing *hokims* (heads of administrations) of regions and the city of Tashkent with subsequent confirmation by relevant Councils of People's Deputies.

The current constitution allows the president to serve a maximum of two seven year terms. However, the current president has been in power since June 1989 when he was appointed by the then head of Soviet Communist Party, Gorbachev as the head of the Uzbek branch of the Communist Party. He was elected as the president by the parliament in March, 1990 and then by a popular vote in December, 1991 (the country's only openly contested election so far). In 1995, a national referendum extended his term till 2000 when he was again re-elected for another seven years. The next elections are due to take place in December, 2007.

The parliament consists of two chambers: the upper house – the Senate and the lower house – the legislative chamber. The Senate has 100 members and 84 of them are elected by the local councils with the rest being appointed by the President. The lower house has 120 members and all of them are elected by popular vote from constituencies across the country. Although there are five different political parties represented in the legislative chamber, they are all pro-government and the government's

position is hardly ever questioned during the parliamentary sessions. The following table shows the composition of the Legislative chamber.

Table 5.3.4 the composition of the Uzbekistan's Legislative chamber

Party	%	Seats
Uzbekistan Liberal Democratic Party ( <i>O'zbekiston Liberal Demokratik Partiyasi</i> )	34.2	41
Uzbekistan People's Democratic Party <sup>32</sup> ( <i>O'zbekiston Xalq Demokratik Partiyasi</i> )	23.3	28
Self-Sacrifice National Democratic Party ( <i>Fidokorlar Milliy Demokratik Partiyasi</i> )	15	18
Uzbekistan National Revival Democratic Party ( <i>O'zbekiston Milliy Tiklanish Demokratik Partiyasi</i> )	9.2	11
Justice Social Democratic Party ( <i>Adolat Sotsial Demokratik Partiyasi</i> )	8.3	10
Non-partisans	11.7	14
Total		<b>120</b>

Source: Uzbek Government website.

The government consists of the Prime Minister, his deputies, and other ministers. The prime minister has 6 deputies and each of them supervise one of the following six areas:

1. Economy and Foreign Economic Relations Sector
2. The construction sector, industry, construction materials, housing and municipal services and transport
3. Machinery, ferrous and non-ferrous metallurgy, oil and gas, geology, energy, chemical production, standardization and metrology, and state and mobilization of resources sectors
4. The communication and Information Technologies sector

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<sup>32</sup> Former Communist Party of UzSSR.

5. The Social Sector, Ministry of higher and secondary special education
6. Women's affairs, the deputy herself is the Chairwoman of the Women's Committee of Uzbekistan

The Prime minister personally supervises the so called 'Agro-Industrial Complex' i.e. cotton production and everything else related to it.

Below the cabinet stand the state committees, agencies and associations. These are the former ministries or big industrial state owned enterprises that were nominally reorganized with the state still remaining as the major shareholder. Their management teams also are directly appointed and dismissed by the president.

Administratively Uzbekistan is divided into 12 regions, called *viloyats*, one autonomous republic, and the capital city Tashkent which stands alone as an administrative unit. Such an administrative system was set up by the Soviet authorities when each region was run by the first secretary of the local branch of the respective communist party.

Since independence Uzbekistan significantly modified the administrative system. The party secretaries were replaced with the newly created and significantly redefined positions of regional mayors called *hokims*.

'In the 1990s, Uzbekistan carried out a general decolonization – a phase common to all the former colonial states once they gained their independence. This period brought accelerated state-building: the growth of the administrative apparatus, the introduction of new symbols, a redistribution of power within the ruling elite, and a renewal of that elite through the infusion of a new generation of administrators. Finally, there has been – naturally, on a new level – a return of the administrative system to that model of



governance and practices that had existed in the pre-colonial period. (Abdullaev, 2002: 221)

At the centre of the new system was the ‘ideology of independence’, the concept which was created

‘to advance a political logic whereby the nature of the political community, the purpose of the state, the unifying political telos and the present regime are fused into a single entity’ (March (2003).

Hence, loyalty to the current regime is synonymous with loyalty to the national cause and vice versa i.e. any opposition to the current regime is seen as the opposition to ‘the constitution of the nation’. The utmost sacred symbol of the nation and the state is the president who ‘bravely led the country to its independence and acts as the guardian of that independence’ in a world where ‘everybody is envious of the achievements of the independent Uzbekistan and plotting against its people’. Therefore, any action taken by the authorities is presented and justified in that context, however heavy-handed they may be.

Just as it was during the Soviet period, an aspiring ‘wannabe member of the elites’ in Uzbekistan has to maintain the official line in any political discourse and zealously demonstrate his or her loyalty to the nation i.e. to the President.

Regional administrations are run by *hokims*, the positions created in 1992 to replace the one party administration. This type of regional

administration has its roots in the pre-colonial administration systems, and was established as a part of decolonization after the independence. The *hokims* serve as heads of the region leading both the representative and executive authorities in their respective regions. They are accountable to the President and respective Councils of People's Deputies.

'Each governor has considerable powers, but they are regularly reminded that these derive from the president. Mr Karimov dismisses several provincial governors every year, often humiliating them in televised sessions of the provincial assemblies. A total of six provincial governors were dismissed in 2004, on charges ranging from nepotism to the poor performance of the agricultural sector and failure to combat smuggling' (EIU, 2005:29).

In reality, the regional mayors wield near absolute power within their realms and their main responsibility remains fulfilling the cotton production plan, the task which changed slightly with the privatization of farming.

In addition, as we mentioned earlier, the former state owned companies were reorganized into listed companies with the state as the majority owner. The senior managers of those companies are also de facto government officials and an integral part of the administrative apparatus.

'During the Soviet era, the interests of solidarity groups were accommodated in designing the local *nomenklatura* elite, promoting personnel, and making appointments to leading posts. The intertwining of clannish interests and rivalry in the struggle for control over Uzbekistan's financial, economic, and administrative resources (privatization, appointments to lucrative posts, career development, educational opportunities for

children, trips abroad, and other benefits) form the background against which the formation and evolution of Uzbek statehood are unfolding today.' (Naumkin, 2006: 132)

The 'solidarity groups' in Uzbekistan are the loosely defined interest groups which have been formed to help compete for economic and political power<sup>33</sup>.

Inogambaev (2006) claimed that in Uzbekistan traditional business models involving the money-goods/markets-money cycle has been modified into a money-power/authority- money form.

At the nucleus of the system is the President, his family and close associates. The economic and political standing of the rest is determined by their closeness to that nucleus and how effectively they exploit that closeness.

A talented entrepreneur, who wants to maximize the return to his or her potential, has to join the administrative apparatus and make powerful allies as fast as he or she can.

The members of the Uzbek administrative elite are allowed to fast-track the careers of their children in ways that the members of the *nomenklatura* were not allowed to during the soviet period. Not only can they afford to send them to the best educational institutions, but they can also get them lucrative appointments at important institutions.

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<sup>33</sup> Some called them clans and others called them lobbyists, the interest groups in Uzbekistan seem to have regional roots rather than clannish per se. The reason for the formation of such interest groups, in our opinion, is the fact that Uzbekistan had been formed in the territory of three different kingdoms which had slightly different cultural, lingual, and social peculiarities. The Soviets had chosen to preserve and use those differences in their divide and rule policy. As a result, there still exist some differences in culture and traditions across the regions and people from the same region tend to support each others in their bids to rise to the top.

For the less privileged ones, the career starts quite differently. The traditional institutions for youth political involvement disappeared with the Soviet Union. They can no longer join any youth party organization as none of the current parties have youth organizations.

The attempt to revive the old *Komsomol* with an all new *Kamolot* youth movement did not prove as effective as the original youth movement was. This is partly because the lack of any clear career advantage from being involvement in the youth movement.

The only option for aspiring young talent then is through the higher educational institutions. Educational institutions had played a very important role in the process of elite regeneration in Uzbekistan. As discussed earlier, religious schools had produced most of the pre-colonial elite, while Russian language schools took over the dominant role after the Russian invasion. During the Soviet time, the traditional route to the top was through institutions of higher education and then specialist Communist party schools.

The collapse of the Communist regime brought down the whole party infrastructure with it and that included the party schools. Hence, the old career trajectory was disturbed.

The Uzbek authorities tried to establish replacement institutions by opening new universities and upgrading the status of the older ones.

As we have mentioned in the earlier chapters, careers in diplomatic services and the foreign trade ministry were the preferred destinations for the children of Soviet nomenklatura members. After independence there were even more lucrative opportunities in those sectors in Uzbekistan.

An all new university, University of World Economy and Diplomacy, was established on the basis of the old party school in 1992 and immediately became one of the most prestigious educational institutions in the country.

The total number of the institutions of higher education (IHE) increased from 57 in 1995 to 64<sup>34</sup> in 2005.

The IHE in Uzbekistan are classified into 4 general categories: academies, universities, institutes, and colleges. The academies have the highest status and mainly offer postgraduate and further education as well as spearheading scientific research in their respective subject areas. The most prestigious one is the Academy for State and Social Construction under the President, set up to play the role of the old party schools i.e. selecting and training the potential leaders. Students are chosen from among the mid-level managers working at different parts of the administrative apparatus. The other academies are: the Academy of Banking and Finance, the Tax Academy, and the Medical Academy.

Most of the universities are generic institutions of higher education, much like the universities in any other country, and offer both undergraduate and postgraduate degrees in various subjects. There are a number of them, however, that are specialized and the status of being a university gives them extra prestige and more funding.

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<sup>34</sup> The number includes the branches of 3 foreign institutions, namely: Westminster University (UK), Plekhanov Academy of Economics (Russia), and Moscow State University (Russia). But it does not include the military colleges and the educational institutions affiliated to security services, police and the fire department. Those institutions have separate application and admissions procedures, different from the national unified system and there is very little information available about them.

There are 24 universities in Uzbekistan and only 6 of them are specialized. All of the 40 institutes in Uzbekistan are specialized in their respective subject areas and offer degree programs in different aspects of the field. Admission to the most IHEs (except for the branches of foreign ones, academies, and performance based ones like arts and sports) are centrally administered by the Republican Test Centre.

Applicants are required to submit their applications to the desired IHE and will have to sit the national test which consists of 36 multiple choice questions in each of three subjects. The subjects vary depending on the degree for which the applicants are being tested, but the number of subjects and questions are the same for everyone. Subjects carry different weights for each specialization. For example, applicants for economics and business degrees are tested in mathematics, one foreign language, and the applicant's native language (which can be Uzbek, Russian, or some of the minority languages) and each question in those subjects, carries 3.1, 2.1, 1.1 points respectively for each correct answer giving the maximum achievable points of 237.6. For every degree program, the number of placements is fixed and the applicants are allowed to apply to only one program. So they all compete for those placements for the degree program they have chosen. At the end, the applicants with highest total points scored are selected for admission. Each degree program admits students on both grant and contract (i.e. payment) bases. Each year, the percentage of grant and non grant placements is announced for each degree program. The allocation of grants is based on the exam results. For example, if a degree program admits 100 students with 40% of them on a grant basis,

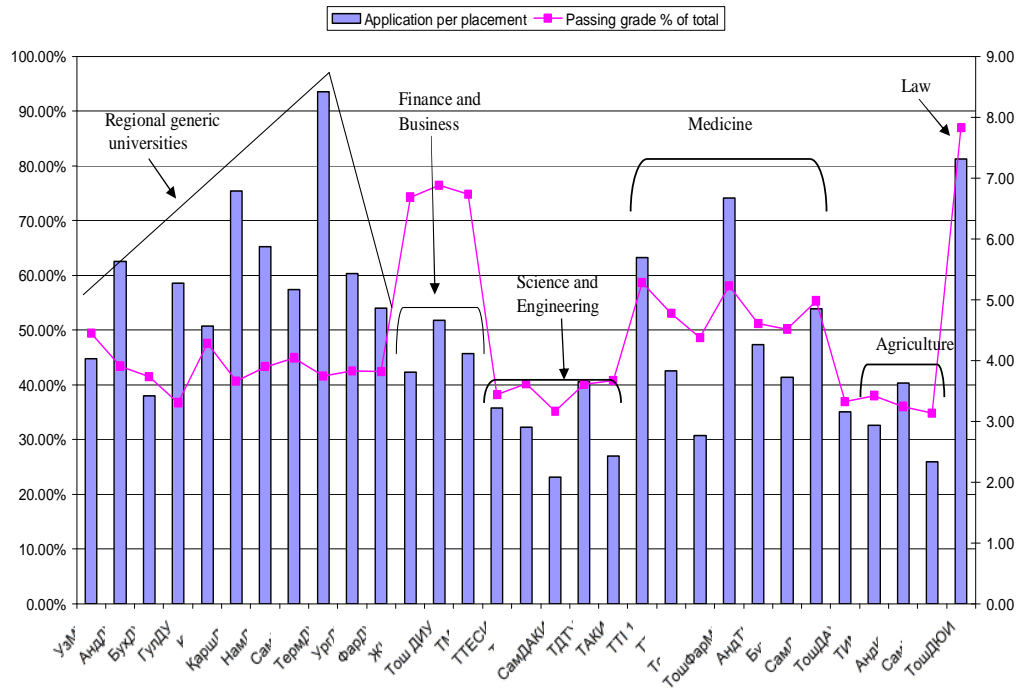
then the applicants within the top 40% scorers in the test are allowed the grants and the rest are required to pay their own fees. Thus, the applicants will not know whether they have to pay for their education until the exam results come out.

The planned total number of placements for the 2006/7 academic year was 57,269 and for the total number of 186,154 applications were received i.e. 3.25 applications per placement.

The test results for the 2006/2007 academic year admissions show some clear trends in both the number of applications and exam results. First, regional generic universities attract a lot of applications with the southernmost university attracting the highest number of applications per placement. This implies that most of the applicants have chosen to go to the closest university rather than going to the ones in the capital, possibly because of increasing living costs. The interesting fact is that, in spite of the high number of applicants, the regional universities have achieved much lower average points in the examinations, implying that the best of talent who are confident enough in their abilities are still choosing to go to the top IHE located in the capital.

Another interesting trend is that degrees in science and engineering, and agriculture, traditionally popular during the Soviet times, have attracted the least number of applications and have achieved lower results in the test. Apart from medical degrees that have always been popular and have attracted a lot bright applicants, the leaders seem to choose the degrees in business, economics and finance, and law.

Figure 5.3.1 Number of applications per placement and passing grades at Uzbek IHEs



Source: National Test Centre Annual Bulletin for 2005-2006 Academic Year

The top 4 IHEs (which all had a minimum admission levels well above the 70% of the maximum points) were the Tashkent State Institute of Law, Tashkent State University of Economics, University of World Economy and Diplomacy, and Tashkent Institute of Finance.

These results are very much in line with the observations of Kryshstanovskaya and White (1996) who claim that the Moscow State Institute of International Relations, Moscow Financial Institute, Law and



Economics Faculties of the Moscow State Universities have become the cradles of elite regeneration in Russia during transition.

Those top four IHEs not only provide good education, but also offer good networking opportunities as they keep close ties with the existing elite.

The national testing system in Uzbekistan is highly organized and strictly monitored by the security services. Although there is nothing to stop the best and brightest to get into any IHE, there have been allegations of corruption allowing the rich to buy their children's way into the institutions of their choice. The prices are alleged to be very high, as much as 20 times per capita GNP (ICG, 2003).

Education is thus becoming increasingly expensive as the population is getting poorer. The aspiring young talents are often supported by the extended group of family and friends throughout the university years and the beginning of their careers. As one of the entrepreneurs we interviewed said:

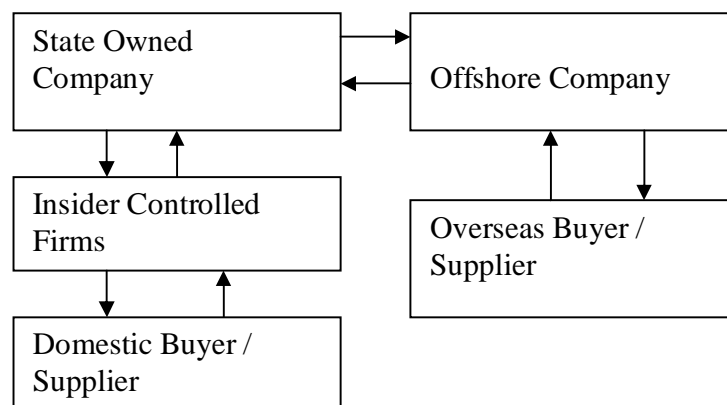
'One does not become a government bureaucrat by himself. He must have the backing of his family and friends behind him and his family understandably expect to benefit from him too. If one of your family members becomes a hokim or a government minister, it is actually better than winning the lottery jackpot. So you have to stand behind them if they have what it takes to get to the top. (Interviewee N8).

As a result whenever a new mayor takes over in a region, the region's business community will undergo a major shake-up. Some businesses (or at least control over the markets) will change hands, while others will change

their allegiance. Those who fail to win new mayor's favour and do not want to sell their businesses to the people related to the mayor face going out of businesses due excessive interference from authorities. In addition, the mayor's control (or influence significantly) the allocation of state contracts and purchase orders in the region, and this enables his people to make easy profits just by standing between the market and the state.

At the national level, the high ranking officials and managers of the big state owned companies have even more lucrative opportunities. They benefit from controlling the purchases and sales of the state owned companies both domestically and internationally (Inogambaev, 2006), as illustrated in the following figure (Figure 5.3.2)

Figure 5.3.2 Common rent seeking transactions involving insider firms



The mayors do not, however, always have everything their way. Every region is a miniature version of Uzbekistan in the sense that, while the mayor is the President's direct representative in the region, every other power group including the security services, police, tax office, procurator's

office has branches in the same region. The heads of those offices also have various degrees of power and they duly seek to convert it into profits.

Thus, the system does not allow for significant economic powers to exist outside the administrative apparatus.

‘This system is self-perpetuating. Bright young people, who may initially be interested in improving the situation in their country, gradually find themselves drawn into the same system of corruption and nepotism as their parents.’ (ICG 2003:13)

The choice in front of young talented people is quite clear. They have to choose between joining the administrative apparatus and hope to get high returns by capturing one of the important posts or loose out on their potential<sup>35</sup>.

Increasing numbers of people are competing for those administrative posts and as predicted by Baumol (1990), the expanding rent seeking sector squeezing the small private sector out. The results are evident in the obstacle reported by entrepreneurs in the business environment surveys which will discuss in the next section.

### Obstacles to Entrepreneurship and Business.

In the previous section we discussed the general state of entrepreneurship and SMEs in Uzbekistan, focusing on the factors that shaped the entrepreneurial landscape in the country.

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<sup>35</sup> The third way seems to be leaving the country in search of employment opportunities abroad. Tens of thousands of young people leave Uzbekistan every year, mainly for Russia and Kazakhstan (Ilkhamov (2006)).

The Rules of the Game that resulted in the independent Uzbekistan discourage traditional forms of entrepreneurship and business and encourage the best talent to seek a career in the administrative apparatus and the government.

The increased expansion of the rent seeking sector is squeezing the traditional forms of entrepreneurial activities to the limits of existence.

The Doing Business report, prepared by the World Bank group, puts Uzbekistan among the most difficult countries to do business in. The report ranks 175 countries in terms the ease of doing business in them. The countries are classified into three categories: easier (1-59), moderate (60-117), difficult (118-175). Uzbekistan, with 151<sup>st</sup> and 147<sup>th</sup> places in 2006 and 2007 respectively, is firmly located in the last group (See the table 5.4.1 below). Having been rated lower than war torn countries like Iraq, West bank and Gaza, Uzbekistan is, by far, the lowest rated transition country in the world.

As we can see from the table, the areas in which Uzbekistan was rated particularly low were related to the restrictive trade policies and excessive regulations in licensing, property registration, paying taxes, and obtaining external financing. The regulations governing export and import operations were rated particularly restrictive as Uzbekistan was declared the most restrictive country for foreign trade in 2006.

Table 5.4.1 Uzbekistan's doing business rankings

Ease of doing the following:	2007 (among 175)	2006 (among 155)
Doing Business	147	151
Starting a Business	70	57
Dealing with Licenses	138	132
Employing Workers	67	66
Registering Property	165	166
Getting Credit	159	160
Protecting Investors	118	114
Paying Taxes	155	154
Trading Across Borders	169	175
Enforcing Contracts	30	31
Closing a Business	112	132

Source: Doing Business Report 2007

The results of the report were supported by the annual surveys of local businesses conducted by International Finance Corporation (See the table 5.4.2 below).

Importing came at the top of the operations that the local business community found the most problematic in both 2004 and 2005. Apart from the obstacles, commonly reported worldwide, like taxation and lack of external finance, SMEs in Uzbekistan continue to struggle with the

regulations and restrictions governing almost every aspect of their business starting from registration, licensing, permits all the way to the liquidation of insolvent ones.

Table: 5.4.2 Top ten operations which the Uzbek SMEs found most problematic to complete during 2003-2005 (IFC Survey results).

2003	2004	2005
Taxation	Importing	Importing
Bank account operations	Obtaining Financing	Liquidation
Obtaining permits	Exporting	Exporting
Inspections	Taxation	Licensing
Registration	Licensing	Standardization
Export and Import operations	Inspections	Obtaining Financing
Licensing	Bank account operations	Taxation
Certification	Standardization	Inspections
Extra operations by banks	Registration	Registration
Currency convertibility	Permits	Permits

Source: IFC Surveys, various years

The problems related to bank account operations, like cash withdrawal restrictions, seem to have improved as they did not appear on the top the obstacles list in 2004 and 2005. We will discuss all these obstacles in greater detail in the next chapter.

## 5.5 Conclusion

In this chapter we discussed entrepreneurship and small businesses in transition countries in general and in Uzbekistan in particular. Entrepreneurship was one of the most discussed and researched topics in the context of transition. Its importance to the transition economies goes well beyond the traditional characteristics of innovation and 'creative

destruction'. The entrepreneurial classes in transition were expected not only to initiate businesses and create jobs but also to spearhead the building process of the market economy.

Although the entrepreneurial class in transition got off to a flying start initially as thousands of new firms were established and thousands more were privatized, the overall performance of entrepreneurs and small businesses, especially in the Former Soviet Republics, was disappointing.

There seems to exist a general consensus in the literature that the one single reason behind such disappointing performance was the lack of clearly established property rights and the Rule of Law. Lack of property rights not only threatens the existing businesses but it also discourages new investment, encourages capital flight and most importantly discourages the brightest talent from getting involved in productive entrepreneurship.

Studies on the Former Soviet Republics have reported that alternatives to property rights and other missing institutions emerged to regulate the business community in those countries. Those alternative institutions and corrupt governments created a unique business environment in which bad characters thrived.

In Uzbekistan too, the Soviet system was modified into an authoritarian regime with strong leadership and a nationalistic ideology. As opposed to most of the other fellow former Soviet Republics, where state property was captured by a few members of the elite, the state in Uzbekistan kept a tight control over the economy while also allowing the private sector to grow alongside the little changed state sector. This in turn opened a whole lot of new opportunities for the few people in charge.

The far reaching powers allotted to administrative bodies not only squeezed the independent private sector but also made administrative jobs the most attractive option for the most talented.

Following the logic used by Baumol (1990), and Murphy, Shleifer, and Vishny (1991) we concluded that the misplaced incentives created an environment which is not very friendly for truly entrepreneurial activity.

Obstacles reported by the business community during various surveys reflected this. Uzbekistan was ranked among the world's most hostile countries to do business in by the World Bank's Doing Business report.

We will discuss those obstacles in even more detail in the next chapter looking at the factors behind them a little more closely.



## Chapter Six

### Obstacles faced by SMEs and their roots

#### 6.1 Introduction

In this chapter we will discuss the obstacles faced by the SMEs in Uzbekistan in more detail. We specifically focus on the ones that persistently made into the top 10 problematic areas reported in IFC Business Climate Surveys during the last few years in Uzbekistan.

We first look at financing options and problems before discussing the taxation issues in more detail. We then will group the remaining areas of concern into one section under 'Rules and Regulations.

While the IFC surveys have reported the obstacles and some of their ramifications for SMEs, they do not go far enough to explore the roots of them. In fact, some people may argue that the situation is much more serious than the IFC surveys suggest judging by a few popular unrests against government regulation in Uzbekistan since independence (ICG, 2006).

We use the findings of those surveys and the findings of our own interviews, conducted during the summer of 2005, when we interviewed 10 entrepreneurs and business managers in various regions of Uzbekistan.

The findings of our survey seem to support the hypothesis we put forward in the chapter two. The main feature of the obstacles encountered by the SMEs in Uzbekistan since independence has been of changing and resilient nature. The Central Government in Uzbekistan, supported by the

international organizations, has tried to address some of those serious problems faced by the SMEs.

However, due to the fact that local authorities depend heavily on rent seeking income to stay in power and progress along the administrative ladders, they have persisted in finding new, innovative ways preserving their power of rent seeking.

## Finance

As we have discussed in the earlier chapters, the financial sector underwent substantial changes during the years immediately following independence. Along with the introduction of a new currency, two tier banking sector, and establishment of the stock market, the financial markets in Uzbekistan saw the emergence of a wide range of new financial institutions like insurance companies, credit unions, and microfinance institutions.

In 2006, the total number of commercial banks in Uzbekistan was 28. Of these, 3 were fully state owned banks, 12 were joint-stock commercial banks with majority of the shares owned by state owned enterprises, 9 were private banks and 4 were banks with foreign participation.

The following table shows the summary statistics of the banks in Uzbekistan at the beginning of the year 2006 (the specialization of the banks is given in parenthesis). The banking system in Uzbekistan is dominated by the top 6 banks shown on this table. They together hold 86%

of all banking assets. The biggest of them, the National Bank of Uzbekistan (NBU), which is a commercial bank, specializes in foreign trade operations. In practice, it mainly handles government guaranteed foreign debt which it lends on to the local firms.

Table 6.2.1 Summary statistics of the Uzbek banks (as of 01.01.06, 000 UZS)

Banks	Assets	Share in assets	Capital
National Bank Uzbekistan (Foreign loans)	2886260093	51.42%	448 305 048
Asaka Bank (Car Industry)	599187537	10.67%	160 090 598
Uzpromstroybank (Industry and Construction)	521529500	9.29%	34 715 145
Pakhta bank (Cotton bank)	357314177	6.37%	63 296 627
Ipoteka (Mortgage bank)	271998319	4.85%	29 795 120
People's bank (Savings, former Sberbank)	191142094	3.41%	14 122 891
ABN AMRO Uzbekistan	103911980	1.85%	12 122 140
Silk Road (universal)	72042658	1.28%	6 196 629
Gallabank (Wheat, agriculture)	71901614	1.28%	17 796 603
Hamkor bank (private, universal commercial)	60876631	1.08%	12 384 175
Uzdeawoo (foreign, commercial)	58214088	1.04%	13 327 629
Microcredit bank (microfinance)	54579228	0.97%	6 184 666
Capitalbank (private, universal commercial)	53382688	0.95%	5 659 975
Savdogar (commercial, foreign participation)	48704255	0.87%	7 168 254
Turonbank (irrigation, commercial)	47257369	0.84%	4 418 449
Credit-Standard (private, universal)	45508273	0.81%	7 614 543
Aloqa bank (communication)	33620273	0.60%	4 794 671
Trustbank (investment, commercial)	30424971	0.54%	3 093 443
Alpjamol (private, universal commercial)	22050281	0.39%	2 637 341
Ravnaq bank (private, universal commercial)	21257243	0.38%	1 371 983
Parvinabank (private, universal commercial)	19549474	0.35%	2 262 892
Uzbek-Turkish bank (JV, commercial)	16825657	0.30%	6 592 254
Saderat (branch of an Iranian bank)	10605618	0.19%	8 594 174
Universalbank (private, commercial)	5114028	0.09%	1 349 393
Uktambank (private, commercial)	3561098	0.06%	1 850 090
Davrbank (private, commercial)	3408713	0.06%	1 317 770
Turkiston (private, commercial)	2226147	0.04%	325 820
Samarkand (private, commercial)	1059417	0.02%	137 461

Source: Annual reports of the banks, press releases, author's calculations.

The others, Asaka bank (automobil industry), Uzpromstroybank (industry, construction, oil and gaz), Pakhta (cotton), Ipoteka (mortgage), and People's (savings) are all specialised (probably slightly less so than the banks were during the Soviet years). Three of those six are directly state-

owned (National bank, Asaka, and Pakhta) and the other three are joint stock companies with state owned enterprises as major shareholders.

Four of them, NBU, Asaka bank, Pakhta bank, and Promstroybank also have 86% of the total deposits and 90% of the total loans (Lamberte and Cordero (2006). Funds for most of the loans come from the government and abroad as foreign credit for the local banks to lend them on. The total amount of loans funded by the banks' own funds made up only 2% of the country's GDP in 2004 (EIU 2005).

Financial intermediation remains very low and the total deposits of the population stood at 493 billion UZS or about 5% of GDP, in 2006. Although this implies an increase of about 50%, it still translates into an average of 19000 sum (approximately \$15) per capita savings in the same year. The monetary policy still remains loose with the broad money growing at a much faster rate than the GDP (See table 6.2.2).

Table 6.2.2 Money supply growth in Uzbekistan

<b>Money supply (M2) growth (in %)</b>	
2002	29.70
2003	27.15
2004	47.77
2005	54.30
2006	35.00

Source: Asian Development Outlook 2007

Central bank's refinance rate was reduced 4 times over the period 2000, to 2005, coming down to 16% p.a. in 2005 from 30% in 2000. The refinance rate has an added importance in Uzbekistan as the government links the rates charged on the directed loans to this rate. Hence, when the

refinancing rate comes down it will reduce the rates charged on directed loans and preferential loans to SMEs.

Of the biggest banks, Pakhta bank (cotton) is the one that makes most loans to SMEs. This is because of its role in financing cotton production which is primarily done by the private farms since the kolkhoz system, of the centralised plan period, was abolished. Although the farming enterprises that replaced the kolkhozes are private, the financing system (as well as the state procurement system) remained largely unchanged from those of the planning era. Hence, the agricultural SMEs (which made up 53.8 % of all SMEs in Uzbekistan in 2005) still have more or less the same kind of soft budget constraint that the Soviet enterprises enjoyed.

The second state owned bank, dealing solely with the SMEs, is the Microcredit bank. Established in 2006, the bank is solely intended to finance small businesses and succeeded in that role Tadbirkor (entrepreneur) bank, inheriting all the assets and the liabilities of it.

The May, 2006 presidential decree, ordering the establishment of Microcredit bank, also set the types, maturities, amounts of the loans as well as setting the maximum rates of interest charged on such loans<sup>36</sup>.

The decree also orders the Ministry of Finance to make annual loans of 10 billion sums a year during the 2007–2010 periods, at 2% per annum, to finance those micro loans to SMEs. In addition, the special employment

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<sup>36</sup> There are three types of loans: 1) privileged micro loan for entrepreneurship for up to 18 months with the amounts not exceeding 200 times of minimum salary (which currently stands at 15525 sum or around \$12) and the maximum rate of interest on this type of loan is 5% per annum. 2) Micro loan for expanding small business and for working capital for periods of up to 24 months. The amounts can be up to 500 times of minimum salary and the interest rate not exceeding the Central Bank's refinancing rate (which currently is 16%) 3) Micro leasing for terms up to 3 years with the amounts up to 2000 times of the minimum salary. The rate for such financing can not exceed 50% of the refinancing rate.

support fund of the Ministry for Social Security will also provide funds for the bank to make loans.

In addition, almost all of the country's small private banks are mainly engaged in SME financing. However, their competitiveness in the market is weakened by the fact that these banks do not get cheap funds from the state and therefore have to mobilise their own financing. Apart from regular lending operations, the banks in Uzbekistan are required to set aside 25% of their profits for lending to SMEs at half the refinancing rate.

During the first half of the year 2007, loans extended to small business entities by commercial banks, funded from their own resources amounted to 374.2 billion sums. The following table summarizes the credit line provided for the local banks by the international financial institutions.

Table 6.2.3 Foreign Credit Lines for SMEs in Uzbekistan

Donor Name	Local bank	Year signed	Amount (000)
EBRD	NBU	1993	EUR 45565
EBRD	Asaka bank	1996	EUR 22745
EBRD	NBU	1996	EUR 41849
EBRD	Uzpromstroybank	1999	EUR 6335
EBRD	Pakhta bank	2000	EUR 8844
Japan-Uzbekistan Small Business Programme (EBRD)	Pakhta bank	2002	EUR 1443
Japan-Uzbekistan Small Business Programme (EBRD)	Hamkor bank	2002	EUR 1519
Japan-Uzbekistan Small Business Programme (EBRD)	Ipoteka	2004	EUR 1519
Japan-Uzbekistan Small Business Programme (EBRD)	Hamkor bank	2004	EUR 2278
Japan-Uzbekistan Small Business Programme (EBRD)	Hamkor bank	2006	EUR 2278
ADB	NBU	1997	USD 50,000
ADB	Asaka bank	1997	USD 15,000
ADB	Asaka bank	2003	USD 7500
IFC	NBU	1999	USD 15,000
IFC	Asaka	1999	USD 10,000
KfW	NBU	1999	EUR 15,000

Source: EBRD, Lamberte and Cordero (2006)

Of the international organizations, the EBRD is the most actively involved in SMEs lending in Uzbekistan providing a total of EUR134,372,000 (27% of its total financial assistance in Uzbekistan) for the local banks to lend on. During the period between April, 2001 and June, 2004, EBRD extended 8092 loans in Uzbekistan amount to a total of \$18,365,617

under the Japan –Uzbekistan Small Business Program (See the table below).

Table 6.2.4 EBRD’s SME lending project (J-USBP) summary for April, 2001 – June, 2004

No. of loans granted	US\$ amount of loans granted	US\$ average loan amount	US\$ amount of loans outstanding	No. of loans outstanding	Arrears % > 30 days	No. of Banks
8,092	18,365,617	2,270	4,755,037	3,385	0.60%	4

Source: EBRD

Those loans were made through four local banks: National Bank of Uzbekistan, Asaka Bank, UzPromstroyBank and Pakhta Bank. The SMEs first apply to their local banks and these banks then present the selected applications to the EBRD staff, which make the final decision. Given the notorious reputation of the Uzbek state banks for bureaucracy and poor service, the process is not always smooth and trouble free<sup>37</sup>.

In addition to the EBRD, Asian Development Bank (ADB), the International Finance Corporation (IFC), and Kreditanstalt für Wiederaufbau (KfW) have all provided SME credit lines for the local banks.

Another source of finance for SMEs in Uzbekistan is credit unions. Since the Law on Credit Unions was adopted in 2002, the credit unions in Uzbekistan developed fast. As of December 31, 2006 there are 35 credit unions licensed and registered by the Central Bank of Uzbekistan, which

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<sup>37</sup> Since 2004, EBRD started working more closely with local private banks. However, the biggest private and a successful partner of EBRD, the Business Bank was closed in 2006 after falling out of favour with the authorities. The biggest current credit line for a private bank was extended to Hamkorbank (EBRD Projects Summary, 2007).



are entitled to receive assistance through the Credit Union Association, which was set up in 2005. The unions have 51,532 members in total with female members making up almost 44 % of the total membership. Total assets of all credit unions taken together in 2006 was US\$ 15.9 million, and for the capital of US\$ 2.1 million. Total savings with the credit unions amounted to US\$ 11.5 million and from which US\$ 10.9 million worth of loans were made. The amount of loans has nearly doubled since 2006 to exceed the \$20 million mark. The following table summarizes the state of the aggregate loan portfolio of the Credit Unions in Uzbekistan as at 31.07.2007.

Table 6.2.5 Breakdown of Credit unions' total loan portfolio as of 31.07.07

Loan Purpose	# of Loans	% of Number of Loans	Volume of Loans	% of Volume of Loans
Agriculture	998	7.2%	\$1,672,964	8.1%
Consumer/Personal	6,312	45.4%	\$6,082,469	29.6%
Micro enterprises	6,580	47.4%	\$12,773,648	62.2%
TOTAL	13,890	100%	\$20,529,081	100%

Source: World Council of Credit Unions.

The loan portfolio of credit unions reflects the reality of the Uzbek SME sector more accurately than the portfolios of other financial institutions, as the majority of their loans have been given to micro enterprises that make up the majority of SMEs in Uzbekistan.

In addition, there are microfinance NGOs that also offer micro loans for individuals and micro enterprises. There were about 64 of those NGOs (six of them international) in 2004, but only three of them accounted for 91% of nearly 9000 active clients and 83% of outstanding loans of about \$1.2 million as at end-January 2004 (Lambarte and Cordero, 2006).

Although still much smaller compared to the rest of the financial market, Uzbekistan's leasing market has seen a considerable upturn since the 'Law on leasing' was adopted in 2002, giving the leasing activities similar privileges to those the other credit institutions enjoy. The total volume of leasing operations more than doubled since 2002 reaching \$107.6 million in 2006 (See the table 6.2.5 below).

Banks' direct involvements in the leasing activities have grown dramatically in recent years, up from \$1.7 million in 2002 to \$46.4 million in 2006.

Table 6.2.6. Leasing Market Players Breakdown, \$ million

	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Leasing companies	39.2	30.5	33.1	59.3	57.3
Banks	1.7	6.7	10.2	19.2	46.4
Others	0.5	0.7	0.1	3.0	3.9
<b>Total</b>	<b>41.4</b>	<b>37.9</b>	<b>43.4</b>	<b>81.5</b>	<b>107.6</b>

Source: Leasing in Uzbekistan, IFC 2006

The majority of the leasing operations served the agricultural sector as the agricultural machinery remains at the top of the list of the leased assets (Table 6.2.7).

Table 6.2.7 Leased Assets in Uzbekistan

Types of assets	2004		2005		2006	
	Number of leases	Value, \$ million	Number of leases	Value, \$ million	Number of leases	Value, \$ million
Equipment for light industry	26	540	4	2,152	38	5,626
Food processing equipment	46	3,438	34	4,003	27	2,624
Printing	5	940	9	3,301	30	3,619
Construction	16	1,178	62	10,596	49	5,924
Other manufacturing equipment	30	866	53	2,824	5	181
Trade	22	27	125	169	10	575
Medical	10	243	10	947	27	889
Computers and office equipment	52	756	36	1,307	28	953
Agricultural machinery	2,493	30,527	3,422	4,6157	5,022	61,337
Trucks	2	221	10	888	24	1,700
Passenger vehicles	80	1,552	242	5,489	274	7,019
Real estate	16	2,702	38	2,352	49	8,917
Other	12	426	33	1,356	47	8,222
<b>Total</b>	<b>2,810</b>	<b>43,416</b>	<b>4,078</b>	<b>81,541</b>	<b>5,630</b>	<b>107,587</b>

Source: Leasing in Uzbekistan, IFC 2006

The financing for most of the leasing operations come from the banks (4 of the 13 leasing companies in operation in 2006 were affiliated to banks), except for 'Uzselkhomashleasing'<sup>38</sup>, which is the biggest player in the market owning 38% of the leasing assets in 2006. Uzselkhomashleasing is directly financed from a special Fund under the Ministry of Finance. The rest of the finance for the leasing companies comes from their shareholders' loans and their own funds.

<sup>38</sup> The name of which, rather predictably, translates as the Uzbek Agricultural Machinery Leasing Company (Author's translation).

Although there is ‘substantial evidence of a vibrant informal sector’ in SME finance (according to Lamberte and Cordero, 2006), there is still no reliable data available on the size and dynamics of the informal lending market in Uzbekistan.

Kandiyoti (2003) reported on the stigma attached to being an informal money lender in rural Uzbekistan, as the money lenders earn a bad reputation by enforcing their loan repayment through unconventional means.

In addition to the private lenders who charge rates as high as 20% per month, entrepreneurs in Uzbekistan rely on interest free loans from family and friends (ibid.)

Overall, the importance of informal financial sector still remains very small with only 2% of the SMEs surveyed by the IFC in 2002 used such form of finance and the number fell even lower to 0.13% in 2005.

On the demand side, the IFC surveys continue to show that Uzbek SMEs predominantly rely on their own savings and other internal sources for their investment projects (Table 6.2.7). Bank loans made up only 2.4% of all sources in 2005 (down from 5% in 2004).

Table 6.2.8 Sources of finance for investment for Uzbek SMEs (%).

	Personal savings	Internal funds	Non-bank loans	Bank loans
2004	59	36	11	5
2005	64	23	10	2.4

Source: Business Climate in Uzbekistan, IFC report 2005

Only 36% of the firms surveyed by IFC said that they need external finance and 21% of those who needed external finance, applied for a bank loan and nearly half of them were successful in their application.

Surveys conducted by the World Bank in 2002 and 2005 also confirmed these observations (Table 6.2.8). According to the 2005 survey, the share of the internal finance reached 95.21% (up from 86.23% in 2002), while the share of bank finance was estimated at 4.66 % in 2005. This figure for bank finance, although higher the figure in IFC survey for the same year, is much lower compared to both regional (region here is defined as the transition countries in Europe and Central Asia) and total sample averages.

Table 6.2.9 Summary of the sources of finance used by SMEs in different countries in 2002 and 2005.

<b>Finance in 2002</b>	<b>Uzbekistan Region All countries</b>		
Internal finance for investment (%)	86.23	70.6	65.87
Bank finance for investment (%)	1.86	10.26	14.78
Informal finance for investment (%)	2.09	4.74	4.79
Supplier credit financing (%)	7.1	6.21	9.01
Value of collateral needed for a loan (% of the loan amount)	115.11	146.62	140.85
Loans requiring collateral (%)	81.37	82.98	80.58
<b>Finance in 2005</b>	<b>Uzbekistan Region All countries</b>		
Internal finance for investment (%)	95.21	70.6	65.87
Bank finance for investment (%)	4.66	10.26	14.78
Informal finance for investment (%)	0.13	4.74	4.79
Supplier credit financing (%)	0.67	6.21	9.01
Value of collateral needed for a loan (% of the loan amount)	122.45	146.62	140.85
Loans requiring collateral (%)	72.55	82.98	80.58

Source: World Bank Investment Climate Surveys 2002 and 2005, the region is Eastern Europe and Central Asia

Such low share of bank finance is paradoxical considering the fact that bank financing in Uzbekistan has lower collateral requirements and is

cheaper rate of interest due to the large amount of subsidized finance available to the banks from government sources.

The answer lies in the unique monetary policy conducted by the Central Bank which maintained loose monetary policy based on offering subsidized loans to the economy while trying to limit the velocity of money by administrative methods. The decision to extend privileged loans comes from outside of the bank in the form of Presidential decree or the Resolution of Cabinet<sup>39</sup>. The banks are obliged to carry out the instruction. However, they try to mitigate the resulting inflationary pressures generated by the process. The situation is further complicated by the fact that a large part of economic activities are carried out using cash, outside of the formal financial system, meaning that, once the cash is issued the Central Bank has very little control over it. Therefore the Central Bank keeps very tight control over the cash it puts out into the circulation using administrative controls similar to the ones used during the Soviet times.

These administrative controls include imposition of strict restrictions on cash withdrawals from both individual and corporate bank accounts as well as limiting the commercial banks' access to their correspondent accounts, at the central bank<sup>40</sup>. The restrictions give rise to various distortions that add to the already hostile business climate.

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<sup>39</sup> For example Cabinet Resolution of February 10, 2006, signed by the President, ordered the Central Bank and Ministry of Finance to plan and organize the establishment of Microfinance bank, with branches in every region, offering a wide range of subsidized finance products and it was duly delivered with in the time frame.

<sup>40</sup> Gemayel and Grigorian (2005) reported that 66% of the SMEs, surveyed in the capital city Tashkent, said they had limited or no access to their cash. The figure in the regions was between 80-85%.

The most visible of these distortions probably is the existence of the difference, in value, between cash money and the money held in the current accounts. The difference arises from the willingness of desperate businesses to pay an extra premium for withdrawing their own money from the bank accounts. The premiums are reported to be in the region of 10-15% and the operations are carried out by an increasing number of often closely connected bogus companies specifically set up for such illegal operations (ICG 2003).

Paying an extra premium just to get hold of your own cash also increases the cost of borrowing from the formal financial institutions, where the loans are paid into the bank accounts of the borrowers.

Of the people we interviewed only three had borrowed from banks (excluding directed lending for agricultural SMEs). The first of them, a property developer in the capital, borrowed \$4000 from the bank where his friend was a branch manager. He had to list his car as collateral and spent around \$100 to prepare the necessary documents for the application. Although the interest rate charged on the loan was just under 10% (well below the inflation rate) the idea of obtaining a so called 'privileged' loan was counter productive for him.

'Although I had the full backing of the bank manager and went through the loan application process quite smoothly, the problems started after the funds appeared in my bank account. I never thought that spending money would be so troublesome. The prices for everything are quoted 15-20% higher if you tell them you want to pay by bank transfer. When I eventually managed to buy some supplies through a firm, I was called to prosecutor's office to answer questions

about '*obnalichka*' (converting non-cash into cash through illegal schemes). In the end, the loan cost me a lot more than I expected' (Interviewee N1).

The second borrower, a restaurant owner, had a lot more problems during the loan application process and had to spend a lot more money even before he obtained his loan.

'Literally every step of the application process was full of problems for me: the valuation of collateral, submitting my business plan, negotiating with the bank manager, everything. I even had to pay 10% in advance, in unofficial payments, and that is on top of the interest that I will have to pay on the loan. (Interviewee N3)'

The third borrower, a construction business owner, also had to pay those unofficial payments and went through the same to get his loan. But he was more positive about it.

'Yes, it cost me more to complete the application process than the interest payment on the loan. However, I think it is meant to work that way by the authorities. The overall cost of the loan for me was about 30% of which less than 10% was official interest and the rest went to the officials involved in the process. That is still around the rate of inflation in my estimates. I know the guys at the bank quite well and I know how much they get in salaries and how much they have to spend to keep their positions. So as I said overall it is just about fair. My real complaint, however, is the amount of time it takes to do it all and the restriction on spending the money you borrow. I only borrowed once from the bank, but I regularly have to borrow from informal lender just because of the speed of the process. Although the interest rates are really high, the way things change in my line of business, sometimes you are desperate for quick cash and there is no alternative to the informal lenders in that respect.(Interviewee N2)'



The bank manager we interviewed also echoed some of these views.

‘People talk about the difficulties faced by small businesses and individual entrepreneurs and tend to portray banks as villains that make life difficult for them. The reality is that the difficulties faced by SMEs are nothing compared to the interferences into the day to day running of a bank by various authorities. I would not be exaggerating if I say that nearly 90-95% of the bank managers’ time is spent dealing with outside interventions. In fact the main function of the banks in Uzbekistan is to act as an intermediary between the government and the customers, not the intermediary between the savers and borrowers. We collect taxes for the government and lend on the money where they want us to, we control the cash circulation for the central bank, collect information for various other government bodies.

The rules and regulations are so complex and intrusive that you cannot go a single day without breaking or bending some of them. Therefore, as a bank manager, I have to keep good relationships not only with the head office but also with the local mayor, prosecutor’s office, police and other security services, tax officials etc. Because, I know they can always find something on me or on one of my staff whenever they want to. I have seen a few bank managers jailed for the things that most of us do to some extent. A friend of mine, also a fellow branch manager, had a heart attack before the age of 30, all because of the pressures of the job.

In Uzbekistan, the boundaries between the legal, quasi legal and downright illegal are blurred and we, the banks, are at the centre of it all because of what we are required to do by the government.

Every year before major public holidays, the mayor calls for a meeting and tells the bank managers to present the list of corporate customers together with the bank balance. He then tells the managers of those companies how much to

donate for the celebrations and similar events. In addition, if the mayor (or any of the heads of major state offices for that matter) tells to give a loan to somebody you will have to arrange it no matter what the applicant's papers look like. Some customers complain that we give their confidential information to various authorities. Well, you try to stand up against the system as a bank manager. You may not only loose your job but even head to jail.' (Interviewee N5)

## Taxation

The tax system in Uzbekistan, like in most of the other transition countries, was established for the first time after independence. The system was initially administered by a special department under the Cabinet of Ministers. The main law 'On the State Tax Service' was adopted on August 29, 1997 and a new, separate Tax Committee was established later that year. In January, 1998, a new tax code came into force. Along with the law and tax code, decrees of President, resolutions of the Cabinet of Ministers and various normative acts of the Tax Committee govern the tax system.

The initial tax arrangements included different tax rates for companies in different sectors, as well as offering many tax holidays and exemptions for new start ups and foreign companies. Later the tax rates were unified and reduced to make it simpler and many of the tax exemptions were abolished to broaden the tax base (Stepanyan, 2003).

The main types of taxes are the same as in other countries, although the relative importance of each type and their contribution to the budget may be different. The unique characteristic of the system, however, is the existence of various tax privileges given to certain sectors at certain times and the confiscator nature of its collection processes.

The following table (Table 6.3.1) shows the composition of the Central budget revenues as a percentage of GDP.

Table 6.3.1 Central Government revenues (as a percentage of GDP)

	2000	2001	2002	2003	2004	2005
Revenues:	28.5	26.0	25.2	24.2	22.5	22.6
a) Direct taxes:	7.5	7.4	6.8	6.4	6.0	6.1
1) Enterprise income tax	3.7	2.9	2.3	2.2	1.8	1.9
2) Fixed entrepreneur tax	0.5	0.6	0.5	0.3	0.3	0.3
b) Indirect taxes:	16.0	13.5	13.8	14.0	12.6	10.5
1) VAT	7.6	6.6	6.1	5.5	5.4	5.4
2) Excise	7.7	6.3	6.7	7.2	6.1	4.0

Source: CEEP 2006

The overall tax burden, measured as a percentage of GDP, has come down from 28.5% in 2000 to 22.6% 2005. This is not very high by international standards, considering the fact that the tax burden for the 25 members of the European Union ranged from 29% Latvia to 51% in Sweden in 2003.

Indirect taxes make up most of the budget revenues in Uzbekistan, while the direct taxes have consistently provided just over a quarter of the budget revenues.

Most of the indirect tax revenues come from Value Added Tax (VAT) and Excise taxes. VAT was introduced in Uzbekistan in 1992 at

25% (except for essential food items) but it was later reduced to 20% (this time it was extended to the food items too at 15%). The excise taxes are levied on a number of items and range between 20-35% and the Cabinet of Ministers periodically updates the list of goods subject to excise tax and the rates of them.

Corporate Income Tax was initially set at 35% in the 1990s. However, the rate has been reduced dramatically since then and in 2006, it stood at a mere 12% which is one of the lowest in the region.

One of the most troublesome taxes for SMEs in Uzbekistan probably is the payroll tax, which was instituted in 1994 at 40% and was later reduced to 35%. However, since it is calculated as a percentage of the total wage bill and paid by employers, it constitutes a major burden on smaller companies and causing many companies to conceal the amount of money they pay to their employees.

In addition, there are a number of taxes that are levied on the turnover. The Road Fund tax at 1.5%, while the Pension Fund receives a further 0.7% and the School Development Fund another 1%. After that there is the Infrastructure Development Tax, levied at 8% of the net income.

SMEs in Uzbekistan have an option to use the general tax system as described above or use a special unified tax system where they would have to pay only 10% of their revenues (or 25% of the mark up for trading companies). Certain small companies and all of the individual entrepreneurs qualify to pay a fixed tax (set as a multiple of monthly

minimum wage). Enterprises using this system are also exempt from the VAT.

Although the tax burden in Uzbekistan appears to be not very heavy by international standards, various surveys have continuously put taxation among the top problems<sup>41</sup>. Part of the problem seems to be the frequency of the changes in the tax legislation as in 2003 alone there over 40 normative acts adopted introducing over 90 changes to the tax legislation (IFC, 2004).

Rosenberg et al (1999) also pointed out that it was the ‘confiscatory nature’ of Uzbekistan’s tax system that was causing much of the problems<sup>42</sup>.

The World Bank’s ‘Doing Business’ Report in 2006 put Uzbekistan at 155 among 169 countries in terms of the difficulties related to taxation. They counted a total of 130 different payments which companies have to pay during the year and that would have cost them 122.3% of their profits.

Most of the entrepreneurs we spoke to found taxation problematic. They complained both about the rate of the taxes and the procedures. For example, the owner of an IT company, complained about the payroll tax.

‘If you pay UZS100 in wages, you will have to pay UZS35 in payroll tax. Then say if they pay another 40% in income tax he will end up with only UZS60. In other words, if my employee asks for UZS60 salary, I will have to pay UZS135 of which UZS75 will go to the state. That is why almost every business that I

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<sup>41</sup> IFC Business Climate Surveys put taxation at the top of the problematic areas list in 2001, 2002, 2003. They also claimed that the current tax system was driving businesses underground as the businesses try to avoid prohibitive tax by underreporting their activities.

<sup>42</sup> Uzbekistan still uses the Soviet style *kartoteka* system where any claims by the state are filed into the company information held by the banks and as soon as the funds come in the account will be automatically debited for the amount owed to the state budget without the permission of the account holders.

know around here pays their employees off the books. They only show minimum amount of people on payroll and pay them minimum amounts to minimize tax bill' (Interviewee N4).

The construction company is paying the unified tax and still finding it too much at times.

'I am paying the unified rate which is around 13% of the revenues. The trouble with it is that it does not matter how profitable your business is. For example, if your profit margin is 26% of your revenues then your will be paying half of your profits in corporate profit tax (Interviewee N2) '.

The shopkeeper we interviewed said he had trouble to keep up with the changes in the tax legislation.

'The tax legislation changes so often that it is virtually impossible to keep up. As a result, when you face the tax men you are never 100% sure that you have done your taxes right (Interviewee N6) '.

While the restaurant owner complained about the costs of the official interventions.

'Official taxes do not bother me much, to be perfectly honest I do not even know exactly how much I am paying in official taxes. That is something my accountant takes care of. But the problem is the unofficial payments that I have to make nearly at every step of the projects I am doing. We are already used to the mayor's requests to pay all sorts of donation and all sorts of favors for free. Last month my accountant was called to the National Security Service (successor to the KGB) office and was told to pay the officer's mobile phone bill. What can you do about that?' (Interviewee N3).

## Regulations and Licensing

Following Baumol's (1990) logic we should expect to observe some obstacles resulting from the actions of expanding bureaucracy which attracted the best of talent in the country.

Some of the most obvious means of bureaucratic interventions in business activities are licensing, issuing permits and certificates, inspections to ensure compliance. In addition, the procedures during the registration and closing of enterprises are subject to significant bureaucratic influences.

The list of the major obstacles reported in the IFC business Climate Surveys is dominated by the problems related to the rules and regulations (Table 6.4.1). (Indeed, the only other obstacles included in the list each year from 2001 to 2005 were financing and taxation).

Table 6.4.1 Top 10 obstacles reported in the IFC business climate surveys in Uzbekistan (2002-2005)

2002	2003	2004	2005
Permits	Taxation	Importing	Importing
Taxation	Bank account operations	Obtaining Financing	Liquidation
Registration	Obtaining permits	Exporting	Exporting
Inspections	Inspections	Taxation	Licensing
Bank account operations	Registration	Licensing	Standardization
Convertibility	Export and Import operations	Inspections	Obtaining Financing
Financing	Licensing	Bank account operations	Taxation
Licensing	Certification	Standardization	Inspections
Certification and Standardization	Extra operations by banks	Registration	Registration
Export – Import operations	Currency convertibility	Permits	Permits

Source: IFC Business Climate Surveys, various years.

relating to starting an enterprise, like registration and obtaining permits to start operations were perceived most problematic initially. However, a series of reforms and the introduction of ‘one window’ registration system in 2001 started to finally work as those obstacles slipped down the list.

The World Bank Doing Business report (2007) also reported a slight improvement in the registration process as the number of procedures decline from 9 to 8 and the number of days to start a business was reduced from 35 to 29 in 2007 (Table 6.4.2). The costs, however, increased from 20.2 % of the per capita income in 2006, to 24.7% in 2007.



Table 6.4.2 Summary Starting Business figures of WB Doing Business report.

Starting Business	2004	2005	2006	2007
Number of Procedures	9	9	9	8
Time (days)	33	35	35	29
Cost (% of per capita income)	64.3	21.9	20.2	24.7

Source: World Bank Doing Business Reports, various years.

In 2001 and 2002, obtaining permits were reported among the top obstacles. The reforms in 2001, however, made the starting up procedures easier, abolishing a number of permits required upon registration. Those permits still remerged or were replaced by similar ones but they were now required later on in the life of the enterprise. The percentage of surveyed enterprises requiring additional permits after registration has grown from 81% in 2002 to 86.6% in 2003 and on to 97% in 2004. There were 130 different types of permits in all in the country in 2004. The main problem with the permits is the fact that they are not subject to any specific laws and wide range of organizations can issue new permits. While, unlike the permits, licenses are regulated by the law 'On Licensing of Selected Activities' and certain Resolutions of the Cabinet of Ministers, and various other normative acts.

Gafurov et al (2002) found that the problem with the licensing system was the fact that the licenses were used as a source of revenue with the price of licenses exceeding the costs associated with running of the system that is managed by the monopolistic state bodies that often do not have offices in the applicants' regions making it a very cumbersome and expensive process for the regional SMEs to obtain the required licenses.

They also found at least 14 licenses which can be abolished without any significant consequences to the national interests.

IFC's Surveys revealed that the most obtained licenses in 2005 were related to medical activities (see the table below).

Table 6.4.3: Most frequently obtained licenses in 2005

Activities	Percentage of total licenses reportedly obtained in 2005 (%)
Medical and Pharmaceutical related	85
Fuel sales and related	17
Tourism and hotels	8
Education	8
Examination of contract and pre-shipment goods	7
Wholesale trade in machines	5
Examination of construction projects	5
Audit services	5

Source: IFC 2006

Those activities include rendering private medical services ranging from diagnostics and treatment to alternative medicines. The category also covers pharmacies and pharmaceutical companies. Given the fact that access to medical drugs (except for intoxicating ones and those that can be used to make explosives) is not strictly regulated, it is a thriving business to be involved in. Private fuel vendors have also mushroomed after government closed down the state fuel distributing body in 2005.

The interesting part of Uzbek licensing is the requirement for licensing in examination of contract and pre-shipment goods (7%), whole trade in machine (5%) and examination of construction projects (5%). Those license requirements are part of the trade restrictions which put

Uzbekistan at the bottom of the World Bank ranking in the ease of importing (169<sup>th</sup> among 169 countries ranked in 2007). The amount of restrictions imposed on import and export operations as well as on the trade inside the country open lucrative opportunities. Hence there emerged special companies dealing with import-export contracts and goods prepared for shipment. Those companies as well as those trading in machines are usually well connected.

The situation with the permits and the licenses improved with the Decree of the President ‘On Reducing the Types of and Simplifying the Permit Issuing Procedures for Conducting Business’ issued on September 21, 2005. The Decree reduced the number of permits issued and established the minimum term for license validity of five years, and approving the list of 13 types of activities licensed for indefinite term.

The new trend in the regulations is the increasing importance of obtaining government standards and certificate of compliance<sup>43</sup>.

The most commonly obtained certificates were the certificates of compliance for goods produced and services rendered (Table 6.4.4.)

Table 6.4.4: Percentage of respondents obtaining the given certificate in 2004-05(%)

	2004	2005
Certificate of compliance for goods produced	92	90
Certificate of compliance for services rendered	4	3
Certificate of quality compliance for medical supplies	2	2
Certificate of compliance for imported goods	3	4

Source: IFC Surveys Figures do not add up to 100% due to rounding up

<sup>43</sup> It climbed up along the top obstacles list from 9<sup>th</sup> top obstacle in 2001 to 5<sup>th</sup> in 2005 (Table 6.4.1.)

According to the law on certification in Uzbekistan there are over 2500 products subject to mandatory certification ‘to ensure product quality to protect the health and safety of the public’. The average number of standards obtained per respondent increased from 1.5 in 2003 to 2.5 in 2005. The Government body in charge of standardization and certification is Uzgosstandard, an agency under the Cabinet of Ministers.

‘The Government exercises obligatory state standardization compliance control. Such compliance controls are conducted by Uzgosstandard inspectors over all commodity and consumer products, including certified consumer goods and commodities that are processed, manufactured, stored, transported, and utilized by all businesses, including individual entrepreneurs. All applicable standards are subject to mandatory compliance requirements by all state authorities, government agencies, and businesses of all forms of ownership’ (IFC 2001:85).

In terms of time spent on application procedures, the most troublesome are the licenses taking on average 15 days to obtain in 2005 (Table 6.4.5), followed by standards at 10, certificates at 6, and permits at 5.7 business days in the same year. In addition, SMEs in Uzbekistan spent on average 2.6 days dealing with inspections.

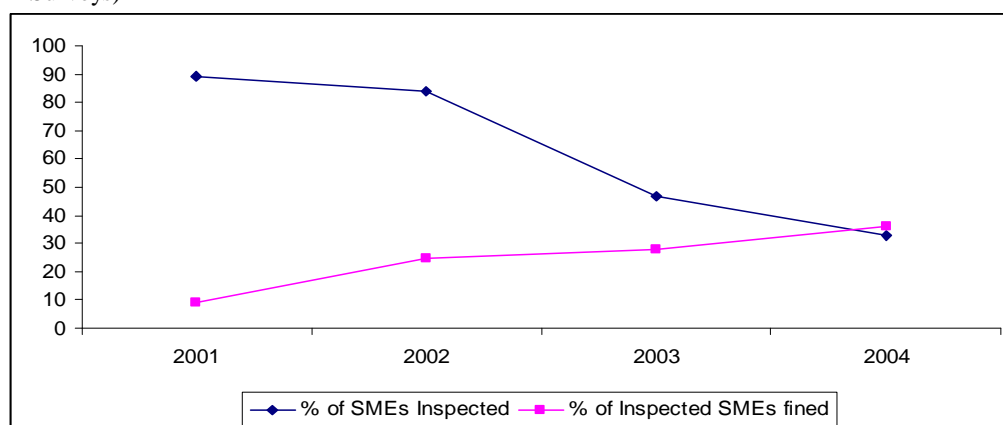
Table 6.4.5: Time spent on dealing with the following (business days)

	2003	2004	2005
Obtaining a License	14	17	15
Obtaining a Standard	9	13	10
Obtaining a Certificate	7	6	6
Obtaining a Permit	5.4	5.6	5.7
Dealing with Inspections	4.7	1.7	2.6

Source: IFC 2005

Another marked trend in the lists of obstacles was the fall reduction of the number of days spent in inspections in the ranks since 2003. This was because of the Government's efforts to limit the number of inspections by various agencies, due to the fact that certain government agencies imposed fines during inspections as a source of funds. However, as a result the proportion of the inspections resulting in fines as well as the amounts of fines increased dramatically following reductions in the number of inspections (See Figure 6.4.1 below).

Figure 6.4.1 Percentage of respondents that were inspected in each year (Source IFC Surveys)



Source: Business Climate in Uzbekistan (IFC Surveys various years)

Tax Inspectorate and Inspectorates for Energy usage are allowed to retain 10% of the fines collected while the Inspectorate for Sanitary-Epidemiological surveillance is allowed to keep all of its revenues from fines; 15% of which is used as staff bonuses.

The most problematic inspections were the tax inspections with 50% of the SMEs surveyed in 2004 found them to be very difficult to deal with, next were the inspections on energy use and on sanitary and epidemiological conditions at 48% and 41% respectively. The inspections from fire department and commercial banks were equally bad for SMEs as 37% of them found those inspections very problematic in 2004.

Of those that were inspected in 2004, 55% had to pay either official or unofficial (sometimes a bit of both) fines. A quarter of those fined only paid the official fines and another quarter paid both official and unofficial fines while the remaining quarter only paid unofficial fines (IFC 2005).

Another 'side effect' of the Central Government's efforts to reduce inspections was the tendency for various agencies to demand that SMEs submit an increasing range of reports. The following table summarizes the number of reports that SMEs are required to submit during a typical year.

Table 6.4.6 Number of reports submitted by SMEs to authorities during a year.		
Reporting frequency	Number of reports can be up to	Total reports submitted per year
Monthly	11	132
Quarterly	8	32
Annual	10	10
Total	29	174

Source:IFC 2005

As the numbers we have seen above suggested the SMEs in Uzbekistan do not see registration as a big problem any more. Our interviews also supported those findings.

‘Registration is not a big deal anymore. If you make a decent effort it takes about 14-15 days to register’ (Interviewee N4).

What we found interesting from our interviews was the fact that while, as a result of concentrated efforts (and in part because of the pressure from international organizations like EBRD and IFC), the interferences into SME activities by some government agencies have been reduced, other agencies have gradually become more intrusive, increasing overall burden on the SMEs.

‘When I started in business during the years immediately after the independence, tax office used to be the most feared of the government offices by the independent business community. But lately other parts of the state apparatus have increased their involvement in the affairs of businesses. The latest menace is the Department for fighting against Currency and Tax Crimes, under the general prosecutor’s office. In the last year and half, 5-6 businesses that I personally knew closed down after inspections by that department staff (Interviewee N2).’

Another important finding was the importance of power relations, which quite often prevail over the existing laws and regulations.

‘Laws and regulations in Uzbekistan do not matter as much as personal relations. That is why you don’t see firms looking for good lawyers. In fact, most of the firms do not use lawyers at all. But everybody would love to employ people with important connections (Interviewee N1).’

The implication of this goes far beyond the apparent limited role that lawyers play in the business community. The power relations also

determine who is allowed to function without much interference as described in the following quote.

‘The number of inspections you get depends on how well related you are to the authorities. For example, nobody would dare to inspect businesses owned the mayor’s family members as long as he remains strong in office (Interviewee N3).’

They also have enabled the authorities to apply seemingly unlimited discretion when enforcing the laws and regulations.

‘Ever changing, complex legislation plays into the hands of the authorities. For every given offence the authorities have various options ranging from completely ignoring to closing your business down altogether’ (Interview N6).

Such level inconsistencies nurtured a culture of distrust by SMEs in the legal system to solve their disputes with the authorities.

‘You can forget about taking the authorities to court. In all those years in business, I have never seen a single court decision against the authorities (Interviewee N8).’

## Conclusion

In this chapter we have discussed the main obstacles reported by the Uzbek SMEs in surveys conducted by IFC annually since 2001. We also made use of the findings from our own detailed interviews, conducted in Uzbekistan during the summer of 2005, with a number of entrepreneurs and SME owners.



The story with obstacles reflects the talent allocation and rent seeking activities in a way that no matter how many laws and decrees the government introduces to curb the rent seeking behaviour of the bureaucrats, they have found new and innovative ways to continue to create alternative rent seeking opportunities.

This manifested itself in the fact that in spite of the government efforts in reducing the specific obstacles, new ones have come to prominence as the bureaucrats seek to find new sources of income.

Therefore the business community in Uzbekistan is more concerned in personnel changes in the government offices than in the changes in the legislation. In the opinion of the local SME community, the best way of securing the future for your business is not to follow the rules and regulation and do everything legally, but to forge very close relationships with the top administrative bodies in the region they work in.

## Chapter Seven

### Conclusions

Experts have listed a large catalogue of factors that are important for the successful transition of a former command economy into a market based one. Entrepreneurship and small business development have consistently figured near the top of the list.

Almost all governments in transition countries have made entrepreneurship a priority in its transition policy. They have poured huge amounts of money into financing, education, and other forms of assistance for the entrepreneurs and small businesses.

Uzbekistan's record on entrepreneurship development has been very disappointing even compared to other fellow transition countries.

At the beginning of this research we had set out to identify the factors that hindered the development of entrepreneurship in Uzbekistan. We looked at the results of the surveys conducted by the IFC and World Bank over the last few years and discussed the main obstacles reported in them. We also conducted our own interviews with owners and managers of the SMES operating in various sectors of the economy.

The IFC surveys have found a wide range of obstacles that most of the Uzbek small business managers and entrepreneurs found problematic. Since 2001 the IFC conducts annual surveys, identify the problem areas and offer recommendations that might help to fix them. Other international

organizations, represented in Uzbekistan have also produced topical research papers to advise the government in improving business climate.

However, their research and subsequent recommendations tend to be very superficial. They seem to highlight symptoms of the problems rather than uncovering the true underlining reasons.

This is partly because their researchers are constrained by the organizations' official policy lines and priorities as well political considerations.

While their surveys and recommendations offer a useful guidance for introducing new legislation or perfecting the existing ones, they do not go far enough to tackle more fundamental issues.

We turned to the academic literature to find the clues for successful entrepreneurship policies and to find explanations for the obstacles so persistently reported by the entrepreneurs in Central Asian countries in general and those in Uzbekistan in particular. As discussed in Chapter Two, entrepreneurship theories, from Schumpeter to more recent contributors, have assumed that all entrepreneurial activities are productive and have looked at creative activities as a positive, driving force moving the economies forward.

Therefore, scholars and policy advisors expected the former communist countries to develop fast once the private entrepreneurship was legalised given the high levels educational and scientific achievements under the command economies.

However, their highly diverse development experiences since the start of transitions in late 1980s and early 1990s have shown that not all creative, entrepreneurial activities necessarily find their way into productive sectors.

We found Baumol's theory on unproductive entrepreneurship and the talent allocation model proposed by Murphy, Shleifer, and Vishny to be most relevant in explaining the development pattern of entrepreneurial sectors in some of the slower progressing transition countries<sup>44</sup>.

Based on the Baumol's theory of unproductive entrepreneurship and the allocation of entrepreneurial resources, we developed the following three propositions in Chapter Two, as the main hypothesis for our study.

**The First Proposition:** Rules of the Game both in the Former USSR and Uzbekistan encouraged rent seeking activities rather than productive entrepreneurship.

**The Second Proposition:** The best of entrepreneurial talent in the former USSR and Uzbekistan chose to enter the rent seeking sector rather than productive sector.

**The Third Proposition:** The resulting system in Uzbekistan resembled the 'grabbing hand' model and therefore most of the problems faced by the entrepreneurs in the country spring from the nature of the system.

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<sup>44</sup> Choi and Zhou (2001) also explored the connection between rent seeking and private entrepreneurs focusing on the bureaucrats' tendency to 'cash in' on their official status. Their offers an intriguing insight into the workings of China's administrative apparatus.

In order to test the validity of our hypotheses, we tried to map out the economic and political landscape in Uzbekistan highlighting the ‘Rules of the Game’, the main driving force in the allocation of entrepreneurial talent.

Uzbekistan’s complex social, political, and cultural traditions could not be adequately explained without looking back through the last century and a half when the Uzbek society went through four distinctly different systems. Being a loosely associated group of backward feudal, agricultural kingdoms, the Uzbek society fell under the occupation of the Russian Empire and underwent a colonial experience very much similar to that of the colonies of the major European powers. Then the October Revolution brought a completely new, experimental system that the world had never seen before. Having lived under the communist regime for over 70 years, the now independent Uzbekistan is now trying to build a fully functioning market economy with democratic institutions.

Some of the questions we tried to find answers for were: how much of the current system did the Uzbek society inherit from the Soviet system and how much of it was down to the uniqueness of the Uzbek society running from the times before the Russian Invasion.

Even more important for the purposes of our study, were the reactions of the entrepreneurial talents to the events during each of those different systems.

The territory, where the current Uzbekistan is, was home to three different kingdoms before the Russian Invasion. Political scene was volatile, built around the monarchs, feudal lords, and the clergy. There was very little upward social mobility if any at all. The economy was

predominantly agricultural with cotton as the main crop. Very little of cotton was actually processed and consumed inside the country and most of it was transported by slow and inefficient means.

Cross country trading was also a major part of the economy because of the region's historic role as a Silk Road trading hub. Cities like Samarqand, Khokand and Bukhara serving the meeting points for merchants from China, India, and Iran with the European traders coming through Russia.

The Russian Invasion in late 19<sup>th</sup> century changed the situation dramatically. The Russians closed all the trading ties that the regions had with the east by closing the borders and improving the transportation facilities to the region from Russia. Thus the region became dependent from Russia for both exports of cotton and imports of manufactured goods and food.

The occupation also opened new opportunities for the talented locals who were not fortunate enough to be born into aristocratic families. They could now learn Russian and cooperate with the occupiers gaining thereby higher status and influence than the people who they were inferior to by birth under the previous system. Some ethnic minorities were also given better opportunities under the occupying regime with the exceptions of the Indian traders most of whom were subjects of the British Empire and therefore treated with suspicion by the Russians.

Old elite were also joining in, by sending their children into the Russian educational institutions as they did not expect their social and economic status to last long under the new regime. A lot of the children of the aristocrats and clergy were educated in Russia and subsequently joined

the Central Asian enlightenment movements and some of them even joined the Communist Party later on.

For the population in general the colonial rule brought mixed joy. On the one hand, for the population that was tired of small inter regional conflicts and political instability, the Russians brought political stability and the newly built railways made cotton exports easier as well as bringing in cheap grain from Russia. On the other hand, the Russians' attempt to enlist the locals into the army and worker battalions caused some popular unrest in the years preceding the October revolution.

In spite of the efforts from the local nationalistic minded intelligentsia and clergy with religious propaganda, and the exiled communist activists with the Marxist ideology, the local population remained virtually oblivious to the big political events happening around them. As a result the fate of the local population was decided by a small group of people with major outside support. Shortly after the October Revolution the Communists took control of Central Asia too.

Lenin's short rein in the beginning of the Soviet experiment was very beneficial for Central Asia. His relatively tolerant attitude to the local intelligentsia brought most of the members of the Jadid into the party structure and the open platform for political discussion encouraged the bright and best to participate in the political process.

The emergence of Stalin, however, was another revolution altogether. He initiated a major reorganization of the region, drawing up border lines between the newly established socialist republics. He also ordered a

wholesale collectivization of the region and eliminated everyone who did not agree with him.

Under his rule, a whole new generation of leaders emerged. This generation of leaders, the so called class of 1938, were drawn from poorer classes and were educated only in the Soviet schools. Thus Stalin created the backbone of the Soviet system of recruitment and promotion. Although the system as a whole did not change much almost until the demise of the USSR, the officials were much less corrupt during the years when Stalin was in power due to the fear of severe punishments.

The system was highly organized, like the rest of the Soviet economy, and straightforward with clear criteria for selection and promotion as well as punishments for failure. The selection procedure for the Uzbek party members were much stricter as the Soviet authorities embarked on an enormous project of social engineering trying to change the local culture and traditions. Anyone hoping for a successful career in the party ranks had to demonstrate his or her commitment to the communist cause and refrain from showing any signs of localism.

As for the rewards, the members of the official administrative and party apparatus were paid, high salaries, discounted housing, holiday facilities, and other consumer goods. However, those rewards were all linked to the positions they held and would be lost with the position. Therefore, the Soviet officials had very strong incentives to use any means, including illegal ones, to fulfil the plan targets to stay in their jobs. Highly ambitious plan targets coupled with an inefficient supply system made their task virtually impossible without resorting to illegal measures. Even the



risk of prosecution and imprisonment did not stop the widespread illegal operations ranging from falsification of the reports to running hidden production facilities, all in order to keep up with plan targets and stay in favour of the party bosses. When the Soviet economy dramatically collapsed causing the Union to dissolve, the newly formed independent republics inherited most of those traditions.

Post independence Uzbekistan preserved the main characteristics of the Soviet system unchanged. The economy is still predominantly agriculture based with cotton remaining as the main crop. Big state owned industries have still not been privatised. Although the old one party rule has been abolished, the command nature of the system has not changed. The new '*Hokim*' (mayor) system is even more authoritative than the party system, giving the regional mayors near absolute power over every aspect of economic, social, and political life.

Just like the Soviet officials, the Uzbek officials do not have high official salaries and their performances are still measured by the fulfilment of the plan targets, mainly for the production of raw cotton. However, they are allowed (unofficially) to get rich and accumulate wealth. Therefore, they have an even better quality of life covered in luxury, by the local standards, than the Soviet officials ever had. On the other hand, they have even lower job security than the Soviet predecessors had. Although there is no comprehensive data available on the tenures of the officials, Economic Intelligence Unit's 2005 country report estimated the tenures at 2-3 years on average.

In order, to make the best of the positions that they hold, they have to extract as much rent as they can get away with, within a short period of time while making sure that the plan targets are met. At the same time they have to build good relationships with the central government officials in the hope that when they leave current positions they leave them for better ones.

Implications of this system of economic management by administrative officials for the development of entrepreneurship and consequently, economic development go far beyond the obvious obstacles seen by the 'naked eye' i.e. those reported in the IFC surveys.

First of all, the official administrative apparatus competes for human resources with the other sectors of the economy and we have seen, in Chapter Five, the evidence of the best young talent trying to get admitted into the degree course leading towards the careers in administrative apparatus. The admission examination results for 2005-2006 academic year showed that the applicants admitted into the selected IHE located in the capital achieved total points as much as 50% above the national average. Attracting talented into the system makes it self – perpetuating with the new comers who have spent so much time and money to get to the top and do not want to change the system when they finally get there.

Furthermore, due to the way extended families support the rise of every top official in the Uzbek society, when an official takes the top job in any given region his or her extended family come to dominate the region during the tenure of that official. They will want to control most of the lucrative business interests in the region, squeezing the rest of the business

community to the margins. It will also make the business climate very volatile given the short tenures of the top officials.

In addition, because the administrative officials of all levels depend on rent seeking activities for their personal incomes, they will use innovative ways to protect their powers to extract rents in spite of the changes in the legislation against their favour.

Cumulatively, the effect of the administrative system in Uzbekistan is on productive entrepreneurship and small businesses, has been highly negative. The obstacles, which are often reported and acted upon by creating numerous new legislations and initiatives, are the symptoms of a much more fundamental problem.

If the current system continues unchanged, it will probably result in one of the scenarios listed below:

- 1) In an optimistic scenario a critical mass of reasonably rich people will emerge and will push for change of the administrative system. The country will gradually move into a normal path of development with open market and efficient institutions.
- 2) Current system will spiral on with increasing income inequality. A small number of super rich will run the country and it will be increasingly difficult for others to break into. The situation will continue to deteriorate until the country will plunge into an economic and political crisis.

On the evidence of the events of the recent years, the latter scenario is looking more likely barring any major external shocks that might bring sweeping changes to the system.

The main recommendation coming out of our research is that in order for productive entrepreneurship to flourish in Uzbekistan, there needs to be a fundamental change of the way the economy is administered. Like in any other country, there is enough creative, talented people in Uzbekistan and they will only choose to channel their talent, energy and resources into productive entrepreneurship when there is a freedom to engage in business and there is a potential for substantial material reward for success in business with firm, proven guarantees for the security of the private property. All of those things are virtually impossible to achieve as long as the administrative apparatus has the power over the allocation decision, and has a freedom and motivation to interfere into the economic activity.

The main contribution of this study, in our opinion, has been the fact that this study is the first one to combine the theory of talent allocation and unproductive entrepreneurship with the empirical studies of the small entrepreneurship and businesses. It is also the first study of entrepreneurship in Uzbekistan looking at the evolution of the economy and talent allocation from a historical perspective. During the period of this study we realised that there was no comprehensive work in the economic history of Uzbekistan.

## Limitations of the Study

This study does not do proper justice to the novelty of the main idea behind it due to the limitation from which it suffered during the data collection and subsequent presentation of the results<sup>45</sup>.

The main challenge during this study has been the lack of publicly available data on Uzbekistan due to the restrictive nature of regulations governing the statistical organizations in Uzbekistan. The small amount of data that is available is of not of good quality and collected by methodologically questionably means.

Therefore, we had to conduct our own in depth interviews in order to get reliable, first hand knowledge of the problems faced by entrepreneurs. Understandably, given the limitation of resources we could not have a large sample.

There are still a lot of opportunities for future studies in this area not only in Uzbekistan but also in the wider Central Asian and Eastern European regions where the similar systems, inherited from the Soviet era, are still in place.

The conclusions of this study have to be taken with certain degree of caution due to the limitations with the data collection and sample selection. The secretive nature of the Uzbek public bodies and restrictions on independent researchers within the country severely limited the possibility

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<sup>45</sup> The field trip, planned to collect data in Uzbekistan unfortunately coincided with the infamous 'Andijan event' where according to International Crisis Group a large number of people were killed during the protesters, protesting against the arrest of 23 local entrepreneurs, clashed with security forces (ICG Report 2005).

of obtaining a truly representative sample for our study. This study is an exploratory attempt to understand the nature and causes of the main obstacles to entrepreneurial by analysing the 'Rules of the Game' in the context of a transition economy. Further studies are therefore needed to establish the true extent of the relationship between these 'Rules' and the entrepreneurial development.

## Appendix 1: the study, data collection, and the transcripts of the interviews

By far the most challenging aspect of our research has been the availability and quality of data. At the beginning of our study we had intended to request firm level data from the Uzbek authorities dealing with statistics with the aim of conducting a quantitative analysis. However, as we went through the available scholarly literature, we grew ever less optimistic about the prospects of succeeding in getting the official firm level data which no researcher had been able to obtain. The reason for that is the fact that Uzbekistan has inherited the secretive nature of government agencies from the old Soviet period and the only publicly available statistical data on the Uzbek economy are aggregate economic indicators the accuracy of which had been questioned by a number of international organizations.

Therefore, when we planned our field trip to Uzbekistan during the summer of 2005, we kept our options open and prepared survey questionnaires as well as making arrangements to meet the officials from the State Committee for Statistics, Tax Office, The Chamber of Entrepreneurs and Producers and commercial banks. During these meetings with the officials, who only agreed to meet unofficially and off-the-record, we were advised not to push too far with the official data requests and also not to go around trying to survey entrepreneurs ourselves given the political situation<sup>46</sup>. As a result, we were left with the only option of face-to-face

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<sup>46</sup> Unfortunately, our visit to Uzbekistan coincided with the tense political standoff with the Western countries and Uzbekistan in the aftermath of the Andijan events where a large number of people died during the popular uprising against the arrest of 21 local

interviews with the few local entrepreneurs who agreed to speak to us on the condition of full confidentiality without any audio or video recording. We could only take notes of the answers and had to reconstruct the full scripts afterwards. We managed to interview 10 people representing different sectors and regions including one bank manager, one manager of a multinational logistics company. The transcripts of the interviews are presented below.

- Interviewee N1: a property developer in Tashkent

*Question:* Could you tell us about your educational background?

*Answer:* I graduated the Tashkent State University with a degree in Mathematics during the Soviet times and worked as a teacher at a high school, until it became impossible to live on a school teacher's salary.

*Question:* So you did not have any experience in this business before?

*Answer:* No, not much actually. I started with a friend of mine on a part time basis in the beginning. He had a lot of experience in building and construction. When we started making some money I decided to go full time and quit the school.

*Question:* Did you have any business management training?

*Answer:* No, I had to learn by doing in this business. As I said the only education I ever had was the degree in mathematics and that has been good enough for me so far.

*Question:* How big is your business now?

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entrepreneurs. The government blamed the Western countries for the uprising and started a massive campaign against the representatives of foreign NGOs and research organizations. The officials we met warned us about the suspicion that an independent survey of entrepreneurs might raise under the circumstances.



*Answer:* We are now employing 5 people from outside in addition to me and my partner. In terms of the turnover, we are looking to reach \$20,000 within the next 6 months.

*Question:* Have you ever borrowed from any external sources? If you have, who did you borrow from?

*Answer:* I had to borrow from my family and friends to start up initially and I have already paid that off. In addition, we took a bank loan last year from a local bank.

*Question:* Could you tell me more about the details of the loan?

*Answer:* It was a loan of about \$4000 in local currency at an official interest rate of 8%, I think. It was an interesting experience, though not a very enjoyable one I must admit. Because we have always kept our business unofficial, so-to-speak, and only dealt in cash when buying and selling the properties and buying the supplies for construction. Last year, I spoke to my friend, who is a bank manager and he told me that I could increase my earnings by selling my cash money for non-cash money which I could still use for buying supplies. But for that my business had to be registered. He also told me about cheap loans that were going at a much lower rate of interest than the inflation rate. So, we decided to try it. We got ourselves registered as a small business and applied for a loan. The loan was cheap, interest-wise, but the other costs added up. I mean the costs like registering the collateral and the like. Although I had the full backing of the bank manager and went through the loan application process quite smoothly, the problems started after the funds appeared in my bank account. I never thought that spending money would be so troublesome. The prices for

everything are quoted 15-20% higher if you tell the suppliers that you want to pay by bank transfer. When I eventually managed to buy some supplies through a firm, I was called to the prosecutor's office to answer questions about 'obnalichka' (converting non-cash into cash through illegal schemes). In the end, the loan cost me a lot more than I expected. I was lucky that I knew the bank manager. Otherwise I do not think that anyone can get any benefit from bank loans if they have to pay the bank officials as well.

*Question:* You mentioned the problems with the bank account regulations, what other obstacles are the most serious for your business at the moment?

*Answer:* For my business, the main problems are related to the paperwork during buying and selling properties. There are so many documents are involved and we have to make a lot of unofficial payments to get the paperwork done. We used to have less trouble before we registered officially. We still do not report most of our dealings but for any bit of business we report we get our fair share of intervention from the authorities.

*Question:* How about the taxation, are you happy with the amount of taxes you are paying?

*Answer:* To be really honest, I do not exactly know how much tax my business is paying officially. It is not a very big amount anyway. I have an accountant who takes care of that side of things. My real problem is the amount of unofficial payments.

*Question:* Uzbekistan's business legislation has a lot of provisions against corruption and unofficial payments. Have you ever complained against the unofficial payments?

*Answer:* I know we have the perfect laws on paper. But I also know that you can never win any legal disputes against the authorities. Laws and regulations in Uzbekistan do not matter as much as personal relations. That is why you don't see firms looking for good lawyers. In fact, most of the firms do not use lawyers at all. But everybody would love to employ people with important connections. I would not risk damaging my relationship with the authorities by blowing a whistle on things which everybody knows about anyway.

*Question:* Do you agree with the notion that the smaller businesses need outside protection to operate in a post communist country? If so who do think can offer the best protection in your environment?

*Answer:* I do not think the situation is too bad for small businesses. The problems get much more serious as the business grows bigger. The really small ones can survive by paying the bribes when needed. Protection would certainly be a very big help. In Uzbekistan, the best protection could be only provided by the top officials. Because most of the problems come from the officials, only the top officials can make them go away completely.

*Question:* How optimistic are you about the future of your business and the future of the entrepreneurial sector in Uzbekistan?

*Answer:* The future of my business is looking stable. I do not think I will be expanding my business very much in the near future though. I am far less optimistic for the future of the business sector in general. The business environment is getting very tough.

- Interviewee N2: a construction business owner in Tashkent

*Question:* Can you tell us about your educational and professional background?

*Answer:* I have a degree in architecture and worked at a state construction company for many years before independence.

*Question:* When and how did you start up in business?

*Answer:* I started my own company when a part of the assets of the company I was working for, was privatized in 1991. Since then we have been doing various construction projects for both state and private clients. We do road works, building repairs, and renovations.

*Question:* How big is your business at the moment?

*Answer:* We employ up to 20 people depending on the time of the year. The summer is the peak time of our season and at the moment we have 18 people on our books. They are working on two different sites. One is the refurbishment of a school building and the other one is the road resurfacing project. The projects are worth about 18 million UZS (about \$17000) together.

*Question:* What are the main obstacles to your business in your opinion?

*Answer:* For my business, the main problem is the lack of opportunities. There are not many construction projects in progress except for the state orders. The state orders take a lot of time to materialise because of the bureaucracy involved and the payments take even longer to arrive. We have to spend a lot of time and money to speed up the whole process.

*Question:* The surveys have reported the tax system as one of the main obstacles. How big a problem is it for you?

*Answer:* I am paying the unified rate which is around 13% of the revenues. The trouble with it is that it does not matter how profitable your business is. For example, if your profit margin is 26% of your revenues then you will be paying half of your profits in corporate profit tax. Another problem for us is that we can not hide much of our profits, because a large part of our revenues are coming from the organizations financed from state budget and we are therefore under a lot more scrutiny compared to other similar businesses. However, the amount of taxes we are paying is very small compared to the unofficial payments we have to make during the course of our business. As a result we have to inflate our other costs to recover some of those costs.

*Question:* Have you ever borrowed from external sources? If you have, who did you borrow from?

*Answer:* Yes. We have taken out one bank loan and we have borrowed from informal sources a few times before.

*Question:* Could you give us a few more details about your borrowings?

*Answer:* I borrowed from a bank a few years ago. The amount was UZS 10 million at a very low nominal rate but the paper work cost me even more.

*Question:* Really, did the application process cost you more than the interest you paid on the loan?

*Answer:* Yes, it cost me more to complete the application process than the interest payment on the loan. However, I think it is meant to work that way by the authorities. The overall cost of the loan for me was about 30% of which less than 10% was official interest and the rest went to the officials involved in the process. That makes the final overall rate of interest still within the rate of inflation in my estimates. I know the guys at the bank quite well and I know how much they get in salaries and how much they have to spend to keep their positions. So as I said

overall it is just about fair. My real complaint, however, is the amount of time it takes to do it all and the restriction on spending the money you borrow.

*Question:* How about the informal loans? You said you used informal loans too?

*Answer:* I did borrow from some informal sector lenders a couple of times. In spite of the fact that the informal sector loans are prohibitively expensive with the monthly rates as high as 20% if you need quick liquidity informal finance is the source to go for. I have to borrow from informal lenders just because of the speed of the process. Although the interest rates are really high, the way things change in my line of business, sometimes you are desperate for quick cash and there is no alternative to the informal lenders in that respect.

*Question:* How do you see the role of the authorities in the development of the small businesses in Uzbekistan? Are the official interventions decreasing as a result of new legislations supporting entrepreneurship?

*Answer:* The role of the authorities in general has not changed much but the relative importance of different organizations has changed overtime. When I started in business during the years immediately after the independence, tax office used to be the most feared of the government offices by the independent business community. But lately other parts of the state apparatus have increased their involvement in the affairs of businesses. The latest menace is the Department for fighting against Currency and Tax Crimes, under the general prosecutor's office. In the last year and half, about 5 or 6 businesses that I personally knew closed down after inspections by that department staff.

*Question:* How optimistic are you in the future of your business and the future of entrepreneurship in general?

*Answer:* Not very much, to be honest with you. Things are very uncertain in our country right now. We do not know who is going to be running this country in, say 5 years time and how will the structure of the administration look like than. As you probably know as well as I do, the changes in personnel at the top is more important here than any changes in the legislation.

- Interviewee N3: a restaurant owner in Tashkent

*Question:* Can you tell us about your educational and professional background?

*Answer:* My education did not go any further after high school. I could not get into the university and had to start working as an assistant to a chef. I worked my way up to the position of a head chef at a big restaurant within 6 years and finally had a chance to open my own restaurant with the help of my family and friends. I have been running my own business for the last 5 years.

*Question:* How has your business progressed in this period?

*Answer:* We have done quite well. Customer numbers have steadily increased over the last few years and we also have nearly finished an extension to the restaurant. We are currently employing over 10 people, including serving staff.

*Question:* What are the main problems for your business at the moment?

*Answer:* If I tell you about all the problems we have, we will be sitting here forever. Such is the restaurant business in this country. Unlike other businesses, our business happens out in the open and everybody can see how well you are doing, how busy you are. Therefore, they all want to get a slice of it. I mean, everybody who can make life difficult for us tries to get something off us. Working in cash, we have to hand in a certain amount of cash every period and if you don't you will be called to tax office, prosecutor's office etc.

*Question:* How do you deal with all of them and run your business at the same time?

*Answer:* We can't deal with all of them, so we don't. We keep good relationship with one or two top people around here and they help out when things get really tough. This is important in our line of business. Every restaurant or a retail outlet has to have the support one or two important people, ideally top official or a high level law enforcement officer. The number of inspections you get depends on how well related you are to the authorities. For example, nobody would dare to inspect businesses owned by a very important official's family members as long as he remains in office.

*Question:* Have you ever used external finance?

*Answer:* Yes, I borrowed from family and friends in the beginning and I took a bank loan last year to build an extension to the restaurant.

*Question:* Can you tell us about your experience of applying and obtaining the bank loan?



*Answer:* It was not a very pleasant experience unfortunately. Literally every step of the application process was full of problems for me: the valuation of collateral, submitting my business plan, negotiating with the bank manager, everything. I even had to pay 10% in advance, in unofficial payments, and that is on top of the interest charges.

*Question:* Have you ever used any informal sources of finance apart from your family and friends?

*Answer:* No, I do not use informal money lenders if that's what you mean. The reason is simply because they charge very high interest rates.

*Question:* You mentioned about the banking related problems and interventions into your business, what about the taxation?

*Answer:* Official taxes do not bother me much, to be perfectly honest I do not even know exactly how much I am paying in official taxes. That is something my accountant takes care of. But the problem is the unofficial payments that I have to make nearly at every step of the projects I am doing. We are already used to the mayor's requests to pay all sorts of donation and all sorts of favours for free. Last month my accountant was called to the National Security Service (successor to the KGB) office and was told to pay the officer's mobile phone bill. What can you do about that?

- Interviewee N4: owner of an IT company in an eastern region

*Question:* Can you tell me about your educational and professional background?

*Answer:* I studied Information Technologies at a local college and worked at a small, private company as a computer technician for 3 years. Then I left the company and decided to open my own computer games and internet club. I have expanded the business over the last 2.5 years to cover a wide range of computing, internet and information management services.

*Question:* What are the main problems which your business is facing?

*Answer:* The problems are changing all the time. When I started my business, the registration process used to be quite long and problematic. Registration is not a big deal anymore. If you make a decent effort it takes about 14-15 days to register.

Some of the other things remained as difficult as they have always been. Things like taxation, dealing with the banks, and other officials.

*Question:* What is exactly the problem for you as far as, for example taxation, is concerned? Is it the system itself or the rate of the taxes?

*Answer:* I will give you an example. The biggest tax I have to pay, percentage-wise, is the payroll tax, which is 35% at the moment. If you pay UZS100 in wages, you will have to pay UZS35 in payroll tax. Then say if they pay another 40% in income tax he will end up with only UZS60. In other words, if my employee asks for UZS60 salary, I will have to pay UZS135 of which UZS75 will go to the state. That is why almost every business that I know around here pays their employees off the books. They only show minimum amount of people on payroll and pay them minimum amounts to minimize tax bill.

*Question:* What about the problem of dealing with the officials and the banks?

*Answers:* The problem with the banks has always been the same, the lack of cash money. I do not understand why they still cannot solve this simple problem even though the Central Bank can print as much cash money as it wants. It has been a consistent problem for us the smaller businesses. We have to hand in the cash money we receive from our customers and when we I ask to withdraw from our accounts they put a lot of restrictions on us.

The other recent problem for us has been the intervention from the security services. They have increased the pressure on the firms providing internet access like us, putting restriction on what websites our customers can visit, what kind of information they download and send etc.

*Question:* Have you ever borrowed from any external sources of finance?

*Answer:* No, I have never borrowed from outside sources. When I started, I started with a partner who provided the money for the business and I put all the effort. So that was the agreement, we still own 50% of the business each. We have expanded slowly without much financial investment and therefore did not need to borrow anything.

*Question:* How optimistic are about the future of your business in particular and about the future of the Uzbek entrepreneurship in general?

*Answer:* I am quite optimistic about my own business. Because this is a relatively new sector in this country and has a lot of potential. We are moving into web designing and hosting markets and exploring the prospects of online shopping and the like. So there are many opportunities for us to exploit.

I am not very optimistic about the business sector in this country in general.

I have seen a lot of business going bankrupt due to the things that are

outside their control. Especially the shops selling imported things are having a hard time. People are not confident enough to make big investments with longer term business plans. The businesses are very vulnerable to the interferences from the authorities and the officials change very often. So the entrepreneurs do not know who is going to be in charge of the government offices in the medium to longer term and therefore go for quick profit making opportunities instead of longer term investments.

- Interviewee N5: a bank manager in Tashkent

*Question:* Can you tell us about your educational and professional background?

*Answer:* I graduated from Tashkent Institute of Finance and joined one of the biggest commercial banks in Tashkent. I have been working in the banking sector for more than 10 years and the last 3 years as a branch manager.

*Question:* What is your assessment of the state of the entrepreneurial sector in Uzbekistan and the role of the banking sector in the development of this sector?

*Answer:* People talk about the difficulties faced by small businesses and individual entrepreneurs and tend to portray banks as villains that make life difficult for them.

The reality is that the difficulties faced by the SMEs are nothing compared to the interferences into the day to day running of a bank by various authorities. I would not be exaggerating if I say that nearly 90-95% of bank manager's time is spent dealing with outside interventions. In fact the main function of the banks in Uzbekistan is to act as an intermediary

between the government and the customers, not the intermediary between the savers and borrowers. We collect taxes for the government and lend on the money where they want us to, we control the cash circulation for the central bank, collect information for various other government bodies.

*Question:* What do you think is the main obstacle preventing the banks from providing good services to the businesses?

*Answers:* The rules and regulations are so complex and intrusive that you cannot go a single day without breaking or bending some of them. Therefore, as a bank manager, I have to keep good relationships not only with the head office but also with the local mayor, prosecutor's office, police and other security services, tax officials etc. Because, I know they can always find something on me or on one of my staff whenever they want to. I have seen a few bank managers being jailed for the things that most of us do to some extent. A friend of mine, also a fellow branch manager, had a heart attack before the age of 30, all because of the pressures of the job.

*Question:* Do you think there are a lot of illegal interventions into the activities of the commercial banks by the authorities?

*Answer:* In Uzbekistan, the boundaries between the legal, quasi legal and downright illegal are blurred and we, the banks, are at the centre of it all because of what we are required to do by the government. Every year before the major public holidays, the mayor calls for a meeting and tells the bank managers to present the list of corporate customers together with their respective bank balances. He then tells the managers of those companies how much to donate for the celebrations and similar events.

In addition, if the mayor (or any of the heads of major state offices for that matter) tells to give a loan to somebody you will have to arrange it no matter what the applicant's paper works look like.

A client says to me: You're my bank. You have to keep all my banking operations secret. Then how do the tax authorities, the khokimiyat, and public prosecutor know about them? So what am I supposed to say in reply? I have my instructions and if I don't provide all the information on time, they cannot only fire me; they can bring charges against me too. If a large sum of money appears in your account, you can rest assured that they'll be coming to check up, and you'll be called into the khokimiyat and be made to finance some public construction project or something or other of that.

- Interviewee N6 a shopkeeper

*Question:* Can you tell you us about your educational and professional background?

*Answer:* I have a degree in education and worked at school for over 10 years teaching the Uzbek language and literature. I started in business with importing clothing and footwear in small amounts from Turkey and Emirates and selling them in the bazaars. Later I saved up enough money to buy this place for my shop. I have been increasing my turnover gradually but there is only so much you can do with one shop.

*Question:* Do you have plans to open new shops in the future then?

*Answer:* No, I do not think I will open any new shops in the near future. It is too risky to put all your investment in one business in Uzbekistan at the

moment. I might look for other opportunities in other sectors, possibly in property development or something like that.

*Question:* Why do you think it is riskier to expand within the same sector compared to expanding across sectors?

*Answer:* Simply because, with our authorities you never know when they are going to be decided to put restrictions on certain sectors. If one sector goes down you will not go down with it. That is what everybody is doing. We have seen that within the retail sector a few times already. The government closed markets, borders, introduced prohibitive restrictions that put a lot of people out of business overnight.

*Question:* What are the main problems for the businesses like yours at the moment in Uzbekistan?

*Answer:* There are plenty of problems. The most important probably is the unpredictability of the legislation. The tax legislation for example, changes so often that it is virtually impossible to keep up. As a result, when you face the tax men you are never 100% sure that you have done your taxes right. Ever changing, complex legislation plays into the hands of the authorities. For every given offence the authorities have various options ranging from completely ignoring to closing your business down altogether. Ever changing, complex legislation plays into the hands of the authorities. For every given offence the authorities have various options ranging from completely ignoring to closing your business down altogether.

*Question:* What other problems do you face apart from the changeable legislation and tax rules?

*Answer:* Well, there is the ongoing problem with banks and cash plans. We have grown tired talking about those problems. We try to minimize our dealings with the banks but you cannot really avoid them.

*Question:* What kind of reforms would make real difference in improving the business environment for smaller businesses like yours, in your opinion?

*Answers:* This may sound very pessimistic, but I do not think any reform kind make much difference under current circumstances. I have seen a few initiatives and reforms in my time so far but almost every one of them made the situation worse. I am sceptical of any new reforms now. I think the officials use the reforms to increase their power and influence and therefore we end up being the main losers after every wave of reforms.

*Question:* How optimistic are you about the future of your business and the entrepreneurial sector in general?

*Answer:* I do not know. I have mixed feeling about the future prospects for my business or for the future of the private business community in general. A lot of things depend on the things that we have no control over: things like foreign relations, politics etc. The recent improvements in the relationships with Russia and other close neighbours are encouraging, because those the important markets for us. On the other hand, I am not sure what is our political environment is going to be like in say 10 years time. I think therefore most of the people in this country are working with shorter term outlook.



- Interviewee N7 a farmer in a southern region

*Question:* Can you tell us about your educational and professional background?

*Answer:* I had graduated from the institute of agriculture before the independence and started my career at a sovkhos (state farm) as an agronomist. I worked there right until the state farm was abolished and its lands were allowed to be given to private farmers for long term lease. Then I established my own farm. That is what I have been doing ever since.

*Question:* How big is your business now and what kind of crop do you specialize in?

*Answer:* The land I am currently leasing is nearly 20 hectares. We also have some cattle too but that is not the major part of the business. The major crop has always been the cotton, because it is compulsory. Although cotton is not very profitable, we need to do it in order to keep the land. The other major crops are wheat and vegetables.

*Question:* What are the main problems for your business?

*Answer:* My main problem is the cotton. It occupies most of the land, requires a lot more work than our other crops and costs more to grow. However, the profits from it are much less compared to other crops. We have to buy the seeds, the fertilisers, and the fuel at market prices but get paid for our cotton at state prices. We have plan targets for wheat too but those are much more realistic and so are the prices for wheat. Besides we can sell the remaining part of the wheat crop in the open market quite easily, unlike cotton.

*Question:* Is it just the pricing of cotton the main problem or are any other issues about it?

*Answer:* The pricing is at the centre of it. We would not complain if we were paid well, would we? Since we are not paid well for cotton, we do not want to do it. So they have to make it compulsory to grow cotton. Initially they only imposed the plan targets i.e. the amount of cotton we had to deliver. But private farmers would rather bribe the officials at the collection point rather than growing the required amount. Then they introduced the quotas for land saying that certain proportion of your land had to be sown under cotton. But we still do not strictly follow those requirements, simply because you can always negotiate with the people who come to inspect your land. It just increased our costs further.

*Question:* What kind of reforms would you like to see introduced in order to solve your problems?

*Answer:* I would like to see our authorities to acknowledge the problems openly and admit that the current system is not working first of all. Then introduce a system which increases the accountability of our local authorities. Because we have some very good laws on paper but the local authorities often ignore them.

*Question:* How optimistic are you about the future of your business and about the future of the entrepreneurship in general?

*Answer:* To be honest, I am quite optimistic about the future in spite of these problems. I think with the energy and mineral prices going up our government may find itself less and less dependent on tax income and

might even give us more freedom and support. Hopefully, that will give us a big push towards achieving a vibrant private sector.

- Interviewee N8 a farmer in a central region

*Question:* Can you tell us about your educational and professional background?

*Answer:* I grew up in village working in the cotton fields and looking after cattle and sheep. I only finished high school and served in the army. After coming back from the army I was not sure what to do and decided to apply to become a private farmer. But unfortunately my application was turned down as I did not have the support of the local officials. Then I decided to write to the top officials in the capital and complain about it. After a few months there was an inspection into the land allocation in the region and the inspection team asked to meet me to find out about the details of my complaint. As a result I was allocated 3 hectares of land to start my private farm. I have later managed to increase it to over 10 hectares.

*Question:* What are the main problems for your business?

*Answer:* The main problem is the lack of freedom in terms of what to do with the land we are using. We have an agreement with the government and we pay the taxes but still cannot choose what we want to grow. For example, if growing wheat is the most profitable for me than growing cotton I should be able to grow cotton as long as I pay my fair share of the taxes. But we do not have that freedom. We do not even have freedom to spend our own money in our bank accounts; they tell us what we can spend it on.

*Question:* What kind of reforms would you like to see introduced in order to solve your problems?

*Answer:* I do not know which reform would do it, but I would like to see the state order system abolished and more freedom given to us to grow what we want and to sell them to whoever we want to sell them.

*Question:* How optimistic are you about the future of your business and about the future of the entrepreneurship in general?

*Answer:* As you might guess, I am not very optimistic about the current system. I think we will keep going down the same road until there is a big crisis happens. I hope I am wrong but I do not see any positive changes happening in the near future.

- Interviewee N9 a farmer in an eastern region

*Question:* Can you tell us about your educational and professional background?

*Answer:* I only graduated from high school and worked for the local kolkhoz all my life. I applied to become a farmer about 7 years ago and since then I have been running my own private farm.

*Question:* What are your main crops and how big is your business now?

*Answer:* The main crop is cotton. We also grow wheat, carrots, onions and some other vegetables for the markets of the nearby towns. Last year, we had a large order from a ketchup making company for tomatoes, so we grew a lot of tomatoes. The land, we are currently using, is just over 13 hectares with well over half of which is under cotton.

*Question:* What are the main problems for your business?

*Answer:* We have many problems around here. But the main ones would be the amount of intervention in our businesses. It is getting worse every year. The problems with the cotton are well known. They tell us what to plant, when to plant, and when to harvest. They have now started sending the police to monitor the harvesting of wheat to make sure that we are not concealing any of the harvest.

*Question:* There are a lot of laws and regulations in Uzbekistan to protect entrepreneurs like you? Have you ever considered complaining about the interventions or taking the officials to court?

*Answer:* I have heard about a few farms who failed to deliver according to the plans and protested about the system. They had their lease agreements terminated and the lands taken away. You can forget about taking the authorities to court. In all these years in business, I have never seen a single court decision against the authorities.

*Question:* What kind of reforms would you like to see introduced in order to solve your problems?

*Answer:* I would like us the farmers to have access to the outside markets more easily, so we could get fairer prices for our products. I also would like see the powers of the local authorities limited so they do not interfere with the businesses too often.

*Question:* How optimistic are you about the future of your business and about the future of the entrepreneurship in general?

*Answer:* I do not know. I hope things will get better. We have a very patient nation which endured some very tough time in the past. I believe that our nation is capable of achieving great economic prosperity and I hope our

government will also start believing and give us a little more freedom to achieve that.

- Interviewee N10: the regional manager (for Central Asia) of an international transport company<sup>47</sup>

*Question:* What are the main destinations of goods that you handle for the Uzbek companies? (In and out of Uzbekistan)

*Answer:* Our main transit region in/out of Uzbekistan is the Middle East, Turkey and the European ports. We do transportation to and from places all over the world, mainly working via Bandar Abbas, Mersin, Poti, Novorossiysk, Riga, Klaypeda ports as transit points. As you know our country is double land locked and for any export or import of goods we need to pass through these ports. Additionally there are Ukrainian ports that we use rarely due to high cost of rail way to reach ports of Odessa and Illichevsk from Uzbekistan.

*Question:* Who are the main players in you line of business (i.e. main players in the transportation business in Uzbekistan, is it dominated by big state owned companies)?

*Answer:* The main operators on rail way you mean? Rail ways belong to the government as it is normal for whole of the CIS and same is in the EU. The operators are various, our Uzbek rail way has own daughter companies such as Uzzheldorexpediciya and Uzzheldorcontainer. However, we don't

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<sup>47</sup> This interview was done over email and the interviewee answered the question in English. Therefore, we presented the answers word for word, without editing.

work with them. Our company is working with the Russian rail way operators due to low charges and very good service. For the road transportation - there is no monopoly. Central Asia Trans by being a State Company is handling mostly government orders. We use our own our partners' vehicles and so far no problem.

*Question:* How much does it cost to transport a single container (for example to Moscow and to a Western European city like Paris or London)? What are the standard sizes of containers? Do the sending or receiving parties have to buy the containers?

*Answer:* The freight cost from FOR Chukursay (Tashkent), (definition Free on Rail means cleared and loaded on rail way station and none of those charges are included) to FOR Novorossiysk (Russia) is USD 2000/40' container. To Paris it can be EUR 5600 per 40' container. From Paris to Tashkent EUR 10,000 per container.

From Uzbekistan to Europe we deliver mostly by carrier's own container that means no need for Consignee to purchase. But Uzbek carrier needs to sell container in Europe as 2nd hand. Hence, there is also margin for Transport Company. However from Europe to Uzbekistan comes mostly by Shipper's own container and the price of container is already included in cost of goods basis CIP Tashkent. The Consignee/importer is selling container at double less price. Here is loss.

*Question:* What is the main mean transportation for your company (by road, sea & rail, Sea road, or a combination of them)?

*Answer:* Mostly by railway, as rail way is more convenient and organized. There is no winter season or holiday for rail ways and you don't need to go

after driver's visa and pay extra charges for demurrage. However (it) depends on (customer's) wish and situation. If cargo delayed then client (may) order by road.

*Question:* Do prices differ for different kind of goods? Is the delivery time same for all goods?

*Answer:* Of course, (the timing) is various and depends on goods description. Rail way tariff is depending on goods and distance. The separate issue is dangerous goods and oversized/ heavy lift cargoes. In road transportation dangerous goods and high valued (expensive) goods are charged more, because all is coming from expenses on routes for escort, etc. Same is for airfreight. For the regular and big volume every transport company gives special tariff to secure the shipment. Transit time is for all cargoes the same, excluding oversized and heavy lift cargoes. Because such a special project cargoes are transported by low speed and special instructions. See attached file how to know that cargo is oversized for CIS rail ways.

*Question:* Do any of the Uzbek Companies have special discounts (i.e. priority export goods producers, like cotton industry, gold, other precious metals, minerals for agriculture, or Neftegaz, NGMK etc)?

*Answer:* For the prestige you can give special tariff for UN or Government organization, however usually all these clients are paying more than any other client but your service should be high level. We never worked for Gold or cotton in Uzbekistan. However Uzelkhoz mash Holding and all companies in this holding are our clients (TTZ, Uzcasemash, Tashselmash, etc).



*Question:* What are the main components of your cost per delivery?

*Answer:* The cost of transportation is consists from different charges: fuel, border charges, documentation fee, customs fee for transit, visa for drivers, etc.

## Appendix 2

- Questionnaire

### Section One: General Information

#### 1.1 Educational background of the interviewee:

- High School
- College
- Undergraduate degree
- Postgraduate degree

#### 1.2 Did you have a prior experience in the sector that your business is operating in?

- Yes
- No
- If yes, in what capacity:
  - Professional
  - Managerial
- And how long:
  - Less that a year
  - 1-5 years
  - More than 5 years

#### 1.3 Have you been a member of the nomenclature (i.e. were you a member of the Communist party or did you hold any administrative/managerial position during the Soviet years)?

- Yes
- No

#### 1.4 Have you had any training in business management?

- Yes
- No
- If yes to which level:
  - Short courses
  - College degree
  - University degree
  - Postgraduate level

#### 1.5 What was the main reason that made you start your own business?

- Recognized a great business opportunity

- Lost employment
- Needed an extra source of income
- Other (Please specify \_\_\_\_\_ )

1.6 General info about your business:

Industry:

- Agriculture
- Manufacturing
- Services
- Other

Number of employees:

- Less than 50
- 50-250
- More than 250

Age:

- Less than a year
- 1-5 years
- 5-15 years
- More than 15 years

Ownership structure:

- Joint venture
- Privately owned
- Limited Liability Company (LLC)
- LLC with government share
- Other (please specify \_\_\_\_\_ )

Section Two

This section will deal with general obstacles faced by the Businesses. The issues that are covered in the section include the nature of obstacles, their relative importance etc.

2.1 What is the biggest obstacle that your business is facing? (Please grade the following perceived obstacles in order of importance to your businesses with 1 being the biggest problem)

- Excessive regulations
- High taxes
- Financing
- Corruption
- Street crime
- Other (please specify \_\_\_\_\_ )

2.2 Does the local government hinder, have no influence on, or help small business?

- Hinder
- Has no influence
- Helps

2.3 Who do you trust to resolve a business related dispute?

- Government agencies
- Courts
- Private mediators

Other

2.4 Do you think one needs a 'roof' to operate a business in Uzbekistan?

Yes

No

2.5 What is an estimated cost of unofficial payments to keep your business running (as a percentage of total costs)

None

Less than 10%

10-25%

25-50%

More than 50%

2.6 What percentage of business activity in a typical company in your industry goes unregistered?

None

Up to 25%

25-50%

50-75%

More than 75%

### Section Three

This section is about the obstacles related to financial services and financing. The main purpose of this section is to find out the importance of financial institutions to small businesses.

3.1 Do you have a bank account?

Yes

No

3.2 How long have you had your account at your current bank?

Less than a year

1-5 years

More than 5 years

3.3 Have ever applied for a loan from a financial institution?

Yes

No

3.4 (If you said yes to 3.3) Which institution(s) did you apply to?

The same institution where I keep my bank account

Different commercial bank

Government agency

International Financial Institution ( \_\_\_\_\_ )

Credit Bureau

Other ( \_\_\_\_\_ )

3.5 Was your application successful?

Yes

No

3.6 (If yes to 3.5) What was the term of the loan?

Short (less than a year long)

Medium (1-3 years)

Long (longer than 3 years)

3.7 (If no to 3.5) Why was your application rejected?

Lack of collateral

Lack of track record

Did not want to pay the informal fees

My business plan was not convincing

Other

3.8 (If said no to 3.3) Why not?

No need for external finance

High interest rates

High collateral requirements

high informal payments

Other (\_\_\_\_\_)

3.9 What is your preferred source of finance?

Own savings

Friends and family

Banks

Government SME funds

IFIs

Informal loans

Other (\_\_\_\_\_)

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