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Republic of Tajikistan Country Economic Memorandum: Executive Summary

Tajikistan's Quest for Growth: Stimulating Private Investment

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EXECUTIVE SUMMARY

TAJIKISTAN'S QUEST FOR GROWTH: STIMULATING PRIVATE INVESTMENT

1. The Tajik government in its Poverty Reduction Strategy Paper for 2010–12 set an ambitious target of doubling gross domestic product (GDP) in a decade.

Tajikistan clearly has the potential to grow at more than 7 percent a year as it has done in the recent past, but it is not going to be easy. The potential for “catch-up” growth from the depths of the recession of the 1990s is largely exhausted, the external environment is now less favorable than it was in the 2000s, and some drivers of past growth are unlikely to be sustained. Nevertheless, efforts by the government to create better conditions for higher private investment, exports, and employment, as well as strong support from the Tajik business community and development partners, could make this target a reality¹.

2. In the 2000s, the Tajik economy recovered from the severe transition-related recession and civil conflict of the 1990s.

Macroeconomic performance improved: inflation fell from 30–40 percent in the late 1990s to 6–7 percent in the mid-2000s, fiscal deficits were lower, and the current account deficit and external debt moved to more manageable levels. Real GDP growth averaged nearly 8 percent a year in 2000–08 (although per capita GDP, despite doubling, is still below pre-transition levels). The poverty headcount fell sharply, from 72 percent in 2003 to 54 percent in 2007 (and 47 percent in 2009), with more than a million people moving out of poverty; during the same period, the share of the extremely poor population fell from 42 percent to 17 percent. Key social indicators (for example, primary and secondary school enrollment rates, infant mortality, maternal mortality, and child malnutrition) also improved.

¹ The government has also shown strong commitment to addressing MDG objectives and donor coordination over the last decade.

3. However, the economy suffered a downturn due to the external shocks of 2007–09.

Tajikistan's terms of trade severely worsened when world prices of cotton and aluminum (in 2007 cotton fiber and other cotton products accounted for 17 percent, and aluminum 63 percent, of total export receipts) declined relative to those of imported food and fuel. Exacerbated by the global economic crisis that hit Tajikistan's trade partners in late 2008, aluminum export revenue fell by 46 percent and the value of cotton sales declined by 28 percent during the two years through end-2009. The global crisis also caused remittance inflows from abroad to contract by more than 30 percent. The government's budget suffered substantial shortfalls in revenue with consequent pressures on public spending. Nonperforming loans in the banking sector rose to record levels. Economic growth slowed to 3.9 percent in 2009, less than half the average annual rate in 2000–08. Even this growth was only possible because better weather conditions contributed to higher agricultural output.

4. Tajikistan's recovery from the recent crisis is under way.

Real GDP is projected to grow by 6.5 percent in 2010, in part because growth in the first half reached 7 percent on higher output in power, construction, and manufacturing, and an increase in remittances and exports. Cotton and aluminum prices have recovered since the crisis and noncotton agricultural exports have risen. Banking performance remains weak due to the overhang of cotton debt and problems with state enterprises; private sector credit has yet to recover. Although government revenue has begun to pick up, the fiscal situation remains fragile with a relatively high public external debt. Without sustained future economic growth, the government will find it difficult to maintain its high rate of public investment.

5. As well as the post-conflict catch-up growth, the strong growth of the 2000s reflected rising domestic demand that was fueled by remittances.

Migration to the Russian Federation grew rapidly from a relatively low base in 2000, with remittance inflows rising to 46 percent of GDP by 2008. This boosted domestic demand for services and goods, especially food and agricultural products. Total investment, dominated by public investment, has hovered at around 20 percent of GDP, while private investment has stagnated at around 5 percent of GDP, the lowest rate in the Europe and Central Asia region.

6. Five factors supported the economic performance.

First, the peace agreement in 1997, which ended the civil war, permitted businesses and households to reengage in the economy. Second, the government was successful in stabilizing the economy, especially in the first five years of recovery, generating substantial dividends. Third, a growing global and regional economy during 2000–07 led to rising prices of Tajik exports, especially aluminum and cotton, and to growing demand for Tajik labor, especially from Russia. Fourth, government efforts at recovery were supported by rising inflows of assistance from donors, including international financial institutions. Fifth, the government carried out reforms, albeit gradually, that permitted existing businesses and households to take advantage of emerging opportunities. (See Box 1.2 for a list of the most important reforms from 2000 to 2010.)

7. The government's reforms covered areas relevant for the country to benefit from a growing global and regional economy.

In the early post-conflict years, the government opened up trade, established the National Bank of Tajikistan as the central bank as well as a commercial banking system, negotiated visa-free access for Tajik workers to go to Russia, and removed taxes on remittance inflows. It

gave an increased role to private businesses and households, privatizing many small and medium enterprises (including cotton ginneries) and reforming agricultural and land institutions. In recent years, it has sought to improve the private investment climate, stimulate competition in air transport, rationalize cotton operations, improve public financial management, and strengthen governance in the central bank and some large state-owned enterprises (SOEs).

8. Nevertheless, Tajikistan still has a significant unfinished reform agenda.

Although the private investment climate has improved, more must be done to enhance, for example, the stability and predictability of property rights by continuous monitoring of enforcement of reforms and limiting arbitrary interventions in businesses and farms for non-business-related reasons. Increased financial viability and transparency of the large SOEs is needed to ensure that government revenue finances infrastructure and social services instead of SOE losses. Similarly, public expenditure must be managed more efficiently and transparently so that government revenue can be used to support growth and reduce poverty. Finally, future revenue from hydropower exports should not be used to finance losses of Barki Tajik, the state-owned power utility.

9. With a less favorable external environment than in the past, the government will need to accelerate reforms to meet its ambitious growth target.

Migration and remittance inflows are expected to grow more slowly, given substantially lower forecast medium-term growth rates for Russia, so, although it is best to limit government interventions in remittances, facilitating migration could be useful. Similarly, efforts to improve productivity in cotton production would be helpful, even if growth prospects for cotton exports (by volume) are limited. Recent growth in noncotton agricultural exports suggests that reform and investment have considerable room to tap the potential for future

growth in agriculture and in agro-processing. If appropriate conditions for implementing hydropower projects can be created, hydropower exports could be a new medium-term growth driver.

10. Tajikistan’s biggest challenge in the coming years will be lifting its low rates of private investment, and this requires a better investment climate.

Existing regulations for starting a business are still too restrictive and past arbitrary government actions have discouraged investors. In addition, poor reliability of electricity supply, difficult tax administration processes, and insufficient storage facilities, among other hindrances, reduce private investment profitability even in the cities.

11. Tajikistan ranks quite low in the perception of investors and others as a place to start and operate a business.

For a country that does not have a big domestic market and is not close to large markets, this is a major deficiency for attracting investment, including foreign investment. The World Bank’s 2011 Doing Business report² ranked Tajikistan 139 of 183 countries (although this was better than 2010’s rank of 152, putting it among the top 10 most improved countries). Elements in the improvement were that the government simplified business regulations, strengthened protection of investments for joint-stock companies, and enhanced shareholder rights.

12. In recent decades, most emerging economies sustained their strong growth by integrating into the world economy.

Tajikistan can endeavor to do the same. Increased private investment and agricultural exports, and diversification into agro-processing and light manufactures, are needed to create jobs. Private investors will invest in export production if they can access competitive connections to neighboring markets from locations in Tajikistan, and if those

² World Bank 2010a.

locations have a sufficiently favorable investment climate. Since the two main cities, Dushanbe and Khujand, have better transport connections to other countries than elsewhere—especially through the north–south corridor—private investments in agriculture could potentially have higher returns if they are made in their hinterlands. The potential for export diversification, too, is highest in those two cities and their hinterlands.

13. Still, the extremely high costs of moving goods within the country and abroad are making Tajikistan uncompetitive in neighboring countries' markets.

The domestic freight rate between Dushanbe and Khujand, for example, exceeds that between Moldova and the United States. Given that Tajikistan is a small landlocked country, efforts to reduce costs and raise profitability of potential private investments will be vital, especially in agriculture and agro-processing.

14. To improve connectivity with neighbors, regional cooperation will be key. .

Tajikistan has to coordinate its efforts with those of neighbors. For example, upgrading roads to the Kyrgyz border will not reduce transport costs unless Kyrgyzstan does the same up to its border with Kazakhstan. Likewise, improving Tajikistan's customs processing will only significantly reduce time taken in crossing borders if Kyrgyzstan and Kazakhstan take similar measures on the north–south corridor. Agreements on customs and transit have to be made among at least three countries.

15. Businesses in the country, including those in Dushanbe and Khujand, complain of power outages and poor supply reliability.

The Business Environment and Enterprise Performance Survey highlights this as a major constraint for firms' operations, resulting in losses

amounting to nearly 20 percent of annual sales. To ensure continuous production, firms have to install generators, raising investment costs. Exporting firms find it difficult to compete with those in countries that do not have this impediment. The problem arises from less reliable domestic generation of power during the winter (when hydropower falls off due to low water levels in reservoirs), an inadequate transmission and distribution system, and the inability of Barki Tajik to operate profitably and pay cash for purchases of gas or power from neighboring countries.

16. Maintaining macroeconomic stability will be critical for raising private investment for growth, in view of the country's high debt and vulnerability to external shocks.

This will require continued vigilance by the central bank and the finance ministry to address problems facing the country. The room for additional public spending on infrastructure and social sectors is limited and thus public investment needs to be contained and prioritized for growth; in particular, public expenditure management will have to be strengthened to make spending more efficient. Large SOEs and banks require greater transparency and financial discipline, and the government must make more strenuous tax efforts, overhauling the tax regime (consistent with Tax Committee reform discussions with IFIs and as presented by the President to Majlisi Oli in April 2011).

17. The government will have to judiciously use its fiscal space and prioritize public investment.

Upgrading and rehabilitating roads will be important, but they should be selected in a way that maximizes their impact on growth (such as those around Dushanbe and Khujand). In power, although it could finance transmission and distribution and small gas thermal plants, it should see that hydropower projects are financed mainly with nonrecourse debt financing so that their debt service obligations are not a potential charge on the government's general budget. Given its high

debt levels, if it borrows from abroad for public investments it should do so mainly on concessional terms.

18. Investments in noncotton agriculture are adversely affected by farmers' still-limited ability to choose crops or to access finance, inputs, and storage facilities.

Although a “freedom to farm” decree-Resolution 111-has been in effect since 2008 and some progress has been made, farmers’ freedom to select their crops is constrained partly by absence of clear rights to land and partly by interference from local authorities. In addition, farmers’ poor access to working capital and to inputs has affected both cotton and noncotton production. Storage facilities, too, remain inadequate, with most of them built during the Soviet period. Even a region such as Sughd, which has ample facilities, saw its stored fruits and vegetables spoiled due to unreliable power supply, leading farmers to sell all their harvest in summer rather than wait for higher winter prices. Clearly, without good storage facilities in the right places and reliable power supply, exports will remain limited, even as conditions for efficient production improve.

19. Addressing the above issues simultaneously across the country may be the best option, but given limits on capacity and resources initial government efforts may be usefully focused geographically.

Such a focus would mean developing a special export zone in each of the two main cities, with good connections to their agricultural hinterlands. In that event, initial government efforts (to issue land titles; develop better road connections; ease trucking and freight forwarding regulations; ensure farmers’ access to finance, inputs, and storage; ensure power reliability; and provide efficient customs processing) could be targeted at only these zones. The two zones could perhaps focus on agro-processing, dairy or meat, or light manufacturing. Many countries have used this “enclave” approach to jump-start their exports. Similarly in terms of roads, the government could first focus on

connecting the two main cities' hinterlands to the cities themselves and on improving these cities' links to neighboring countries through selective investments in the north–south corridor.

20. Migration and remittance inflows will remain important for growth, even if they are unlikely to grow at pre-crisis rates.

Improvements in the private investment climate and in connectivity with neighbors are likely to encourage recipients of remittances to increasingly allocate their receipts to local investments. A few recipients have recently started to invest in their family farms. So far, the government has not intervened in the recipients' use of their remittance income; this policy has worked well and should be continued. Still, considerable room remains for improving conditions for migrants and potential migrants. A service that provides information on employment opportunities abroad and on migrants' experiences will be useful, as will policies to encourage domestic banks to improve their services to capture a larger proportion of remittances.

21. Tajikistan's energy sector is critical not only for the electricity it provides to all sectors, but also as a potential source of economic growth through hydropower exports.

Domestically, electricity supply has been unreliable for businesses and households due to poor functioning of the transmission and distribution system, shortages in power in winter, and the weak management and financial performance of Barki Tajik. The addition of gas thermal generation capacity (only 5 percent of power generation is thermal) will help in winter. However, crucially, the country has huge potential to develop additional hydropower projects and export power surpluses to South Asia, Russia, and the rest of Central Asia, mainly in summer. If the government can create appropriate investment conditions for such projects, hydropower can be a future source of growth for Tajikistan as it has been for other countries.

22. Hydropower projects will require efforts along several dimensions.

First, these projects need feasibility studies to determine their financial viability, at the least to ensure that they can service their debt from projected revenue. One such study is under way for the major Roghun hydropower project at government request. Second, Tajikistan will have to cooperate with other countries in the region both to ensure that those downriver are not affected and to secure power transmission rights over their territory. Third, in view of the high debt, these projects must use nonrecourse debt financing. Fourth, the high costs of these projects suggest that the government may not have the fiscal space to finance them. Thus efforts will have to be made to catalyze foreign private financing, which may be difficult given investor perceptions about the government's limited capacity to fulfill contracts. Fifth, various domestic arrangements will have to be set up (such as hydropower revenue-management rules) to ensure that project revenue helps to support growth and reduce poverty. While these actions appear daunting, other countries (including small, low-income Lao People's Democratic Republic) have implemented such measures for their own hydropower projects, with the support of international financial institutions.

23. A low-income economy like Tajikistan has to ensure that revenue from hydropower exports is additional and thus usable to support growth and reduce poverty.

It therefore cannot relax its revenue-raising reforms. If it does, hydropower revenue will merely substitute for other taxes, benefiting existing taxpayers and not the poor. Similarly, the financial performance of large SOEs, including power utilities, must improve. Otherwise, revenue from hydropower will finance losses of SOEs and not contribute to growth or help to reduce poverty. Strengthening public expenditure management is also important to ensure that such revenue is used efficiently and transparently.

24. The country's social protection, education, and health services need this revenue.

Improving access of the poor in all parts of the country to education and health services will continue to be a priority. Tajikistan's social protection system is ineffective at reducing extreme poverty and vulnerability, partly because it is dominated by old-age and disability pensions. The 2008-09 crisis illustrated that the country had no effective social programs to assist the poor; rather, it had to rely on World Food Program food aid distributed to the most vulnerable. One option to improve the social protection system would be to introduce targeted assistance for achieving higher coverage of the extreme poor and vulnerable while being cognizant that fiscal space is limited.

25. Shortages of skilled labor do not appear to be a major constraint to growth at present.

Indeed, the Tajik population is relatively well educated for a country of its income level. Still, school infrastructure is poor, showing significant inequalities across regions; the quality of education is at risk of deteriorating (in spite of implementing progressive per capita financing mechanism of schools and continuous increase in teachers' salaries shortage of teachers persists); and skill mismatches may become a constraint, as the system is not producing enough people for the specialist and technical professions.

26. Investment in health care, too, is crucial to long-term growth and development.

But Tajikistan fares poorly relative to other countries in the region, due to a combination of low public financing, excessive and outdated hospital infrastructure, underfunded primary health care, and inefficient resource allocation. The cost of health care is a deterrent to accessing care—people have to make out-of-pocket payments, which excludes many of the poor from even the most basic services—although with

improvements in household welfare since 2003, more people now seek health services.

27. Overall, the challenges facing Tajikistan’s quest for sustained growth are many, and the unfinished reform agenda is large.

The country needs to put greater focus on raising private investment and pursuing regional cooperation, as success there will be critical for economic growth. This report’s analysis suggests that the reform agenda can be usefully targeted at the following four sub-objectives. The recommendations under each sub-objective provide a good basis for further discussion. Some of these measures were discussed with the government during the preparation of this report and reflect those discussions. Others are presented here for the first time. Some can be adopted right away, while others may require consultations with other stakeholders.

RECOMMENDATIONS

28. Stimulate private investment, especially in agriculture..

Notwithstanding promising signs in recent years, this has proven difficult to do over the last decade. This is largely because it requires successful actions along several fronts to improve the investment climate, and most importantly a signal to all investors from the highest policymaking level that their property rights are protected. The actions needed from the government are the following:

- Continue to simplify regulations and processes for starting and operating businesses, including those relating to licenses and permits.
- Make special efforts to attract foreign and regional investors with technology and market linkages in agriculture, agro-processed goods, and other relevant areas by increasing transparency and limiting arbitrariness in applying regulations.

- Reduce complexity and nontransparency of tax administration by reducing the number of taxes and the number of tax payments, clarifying tax regulations, and developing a tax manual showing clearly obligations and rights of tax administrators and taxpayers.
- Improve access to reliable supply of electricity year-round, starting with Dushanbe and Khujand and their hinterlands. This is likely to involve some combination of adding gas thermal generation capacity, enhancing the transmission and distribution system, improving power pricing, and strengthening the management and financial performance of Barki Tajik.
- Strengthen banking by implementing the recently adopted strategy and action plan to increase soundness of banks and improve financial services.
- Consider the option of establishing special export/industrial zones in Dushanbe and Khujand, giving businesses streamlined processes for private investment and operation, transparent tax and customs administration, reliable power supply, and other business services.
- Increase efforts at regional cooperation, for improving trade and transport connections to regional markets and trade facilitation at borders, by working closely with neighboring governments.
- Upgrade and rehabilitate a few key legs of the north–south corridor to reduce the transport costs of moving goods to regional markets, and ensure better connections of the two main cities with their hinterlands.
- Continue to foster competition in air transport to expand access and connections within and across borders and strengthen aviation operations.

- Issue land-use certificates to confirm family farms' land-use rights; implement and confirm the elimination of farmers' old cotton debt; enhance timely access to working capital, irrigation, and inputs especially to farmers with land-use certificates; and expand availability of storage facilities with access to reliable electricity. To ensure maximum impact given capacity and resource limits, make these improvements initially in the agricultural hinterlands of Dushanbe and Khujand.
- Facilitate export diversification by promoting noncotton agribusiness expansion through financing opportunities and regional cooperation.

29. Ensure macroeconomic stability and sound public financial management..

Tajikistan has made significant gains in macroeconomic management. Yet sustaining stability remains challenging, given vulnerability to external shocks, relatively high levels of public external debt and the contingent risks from SOEs, and banks' financial situation. This requires continued vigilance by the Ministry of Finance and the National Bank of Tajikistan. The following actions are needed for sustaining macroeconomic stability in the medium term:

- Contain and prioritize public investment in infrastructure and social sectors, with choice of infrastructure guided by the likely growth impact and later by the impact on expanded access by the poor in all areas, especially those outside Dushanbe and Khujand.
- Subject SOEs and banks to financial discipline and increased transparency through regular external audits, better management, frequent monitoring and reporting by the Ministry of Finance, and reduced access to subsidies from the government, to avoid the quasi-fiscal deficits of Barki Tajik or stemming from cotton financing, which have undermined fiscal stability in the past.

- Improve the tax regime, increase tax efforts through better tax administration and expanded coverage of large taxpayers and ensure tax-payments by SOEs.
- Pursue price stability by putting in place a credible and effective monetary policy framework that requires the central bank to avoid all quasi-fiscal activities.
- Ensure that exchange rate policy remains supportive of exports.

30. Maintain remittance inflows at current or higher levels

Government interventions in migration and use of remittance inflows have been minimal so far, and on most counts this pattern should be continued. The environment in which migrants operate can be improved, however, making it easier on them and their families and increasing the returns per migrant. Recommendations include:

- Continue efforts to seek better treatment of Tajik migrants in host countries.
- Create an information center, consistent with the newly created Migration Service under the Presidency, for migrants and their families. It should offer information on employment opportunities abroad and share migrants' experiences.
- Pursue policies that encourage the financial sector to provide better services to migrants and their families. The aim is to capture a larger share of remittance inflows through banks and to encourage a share of those inflows to remain in banks as deposits.
- Invest in human capital development and ensure better access of the poor to education services (including basic education, specialized skills and language) so that Tajik migrants can earn higher incomes abroad and that returning migrants can contribute more to Tajikistan's economy.

31. Strengthen the electricity sector for reliable domestic supply and larger hydropower exports.

Electricity supply has been unreliable for reasons mentioned above. But given the country's huge potential to develop additional hydropower projects and export power, if the government can create the appropriate investment climate, hydropower can be a source of growth. Recommendations include:

- Reorganize Barki Tajik to transform it into a commercially and technically efficient business-oriented company with management autonomy.
- Eliminate quasi-fiscal deficits in the power sector by reducing technical losses and misuse of the power grid, and by increasing tariffs to cost-recovery levels.
- Focus on enhancing domestic energy supplies while developing energy supplies for export and managing winter availability of power judiciously.
- Undertake feasibility studies to determine the financial viability of proposed hydropower projects to ensure that they can service their debt from project revenue.
- Advance discussions with other countries in the region to ensure that downstream countries are not affected adversely and that other neighbors permit transmission of power exports over their territory.
- Create a climate for attracting foreign private investment in hydropower through public-private partnerships.
- Ensure that revenue from hydropower exports is used to support growth and reduce poverty. To do that, Barki Tajik and other SOEs must improve their financial discipline; also, existing tax efforts

must be maintained, public expenditure management strengthened, and hydropower project revenue-management rules developed. These efforts ought to be built into the design of hydropower projects, as done elsewhere.

- Continue expanding the small-scale hydropower network to reduce power shortages in remote areas through public-private partnerships.
- Complete the techno-economic, environmental, and social safeguards assessments for the Roghun project

