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Understanding tax reform in the Central Asian Republics☆

Manouchehr Mokhtari [a,*], Mamak Ashtari [b]

[a] University of Maryland – College Park, 1142 SPH, College Park, MD 20742, United States
[b] 1142 SPH, College Park, MD 20742, United States

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ABSTRACT

Two decades of tax system reforms in the Central Asian Republics (CARs) show that, in addition to political commitment, understanding reformers' incentive structure and a roadmap are necessary if full reform equilibrium is to be reached. Borrowed laws and institutions that are based on international best practice are useful, but are not effective in catapulting the CARs' tax systems to their western level aspirations. Persistence of the Soviet legacy, legal origin, and the gradual piecemeal approach to tax reform have entrenched the vested interests (early winners and losers of reform) who oppose sustainable commitment to tax system modernization in the CARs.

'The best tax policy in the world is worth little if it cannot be implemented effectively.'

Richard M. Bird (2003)

1. Introduction

Neglecting tax reform has been one of the most painful lessons of the transition of the former Soviet states to a market system. Cyclical and unpredictable economic downturns coupled with inadequate fiscal institutions often cause a country in transition to face financial responsibilities with an empty government coffer. While, in 1989 the Soviet Union's boasted government revenue that was similar to its western counterparts (around 41% of GDP), by 1995 this had fallen by almost half

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* Corresponding author. Tel.: +1 301 405 3672; fax: +1 425 871 7769.
E-mail addresses: mokhtari@umd.edu (M. Mokhtari), ashtarim@yahoo.com (M. Ashtari).

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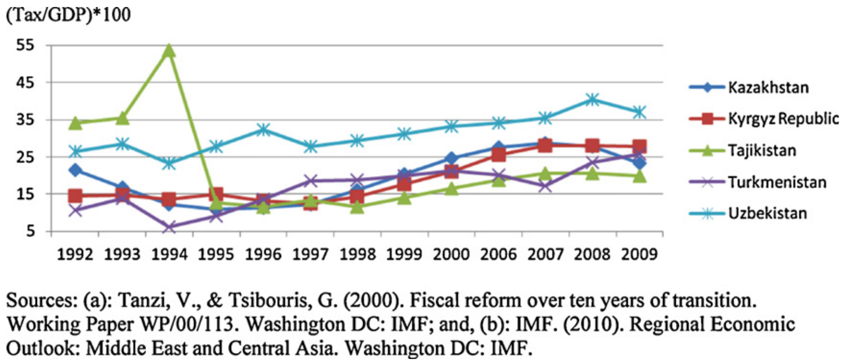

Fig. 1. Tax/GDP ratios of the Central Asian Republics, 1992–2009.
Sources: (a) Tanzi and Tsibouris (2000); and (b) IMF (2010).

Table 1
Tax/GDP ratios in the Central Asian Republics.

	Average 2000–2005	2006	2007	2008	2009	2010
Kazakhstan	24.6	27.5	28.8	27.9	23.4	24.7
Kyrgyz Republic	21.1	25.6	28.1	28	27.7	27.3
Tajikistan	16.5	18.9	20.5	20.5	20	20.2
Turkmenistan	21.2	20.2	17.3	23.6	25.8	21.7
Uzbekistan	33.1	34.1	35.4	40.5	37.1	36.9

Source: IMF (2010).

(to 25% of GDP). This suggests that a market-oriented transition is a revenue losing proposition for the government, while a revenue gaining proposition for others, including those instigating reform. Nonetheless, the fact remains that the citizens of countries in transition stand to suffer prolonged hardship if proper institutions are not established in time.

Fig. 1 depicts the dynamics of tax/GDP ratios in the Central Asian Republics (CARs) during the 1992–2009 period. While the first decade of transition shows declining tax/GDP ratios, the second decade depicts a remarkable recovery (Table 1). Given that, decentralization of trade in the former soviet states (FSU) led to a 4% drop in the trade-related levies relative to GDP (from an original rate of 6%), then the sharp contraction of government revenues cannot be explained by the revenue from trade among the CIS countries. However, this reflects the reformers' choice within the confinement of their constraints.

While there is no established theoretical framework (roadmap) for moving from a socialist economic system to a market economy, the experience of the CARs in establishing the required institutions to ensure proper tax revenue provides us with the underlying elements of success and failure during the transition to a modern tax system.[1] However, establishing proper institutions is not an easy task. Przeworski (1991) and Hellman (1998) provide competing theories that both lead only to partial reform in the postcommunist economies in transition. Przeworski contends that early negative distributional consequences of reform lead to backlash (by the losers) against reform. Hellman, on the other hand, argues that early gains from reform by the reformers provide incentives to stall the economy in a partial reform equilibrium, where, their concentrated rent is protected. In this paper, we provide a simple model of a reformer's incentive structure to aid our understanding of tax reform in the former soviet states (FSU). History and varying degrees of tax system reforms in the five Central Asian Republics (CARs) of Kazakhstan, the Kyrgyz Republic, Uzbekistan, Tajikistan, and Turkmenistan indicate partial reform relative to the international best practice.

Section 2 provides a brief introduction into the soviet legacy and the common features of the CARs. Section 3 presents a theoretical framework. Section 4 reviews the reform during the transition years. Sections 5 and 6 discuss tax policy and tax administration reform in the CARs, respectively. Section 7 provides conclusion.

2. Soviet legacy and common features of the CARs

2.1. Soviet command and tax system legacy

Prior to 1991, the Soviet Central Asian economy was marked by: (a) the absence of private property rights; and, (b) the full government ownership. By controlling production, cost structure, prices, and distribution, the Soviet command found economies of scale to be a solution to its data-intensive problem. Thus, a small number of large state owned enterprises (SOEs) were producing all major goods in the economy. Private sector contribution to the official GDP was negligible. The

[1] In the case North Korea, Noland (2000) offers an extensive analysis of potential reforms in the Korean peninsula.