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Expert Comment

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The need for soft infrastructure development in Central Asia: Pathway to growth

Ariel Cohen

Central Asia in the global economy

The remarkable transformation of Central Asian economies has been capturing the attention of academics and policymakers around the world for the past 30 years. Having inherited dilapidated extractive Soviet infrastructure and centralised economic planning, the republics of Kazakhstan, Kyrgyzstan, Tajikista, Turkmenistan, and Uzbekistan were challenged to re-orient and liberalise their commodity-based economies for the 21st century. Carefully leveraging their unique geography and rich resource endowments, once isolated and impoverished, the countries of Central Asia are evolving to play a key role as a bridge between the East and the West in the framework of the Belt and Road Initiative (BRI).

Since obtaining independence in 1991, the Central Asian republics (CARs) have been pursuing various economic development strategies. Playing on their competitive strengths, including proximity to a number of large markets, abundant natural resources, educated populations, and openness to proper economic liberalisation policies, the CARs have achieved significant positive results in improving their peoples' standards of living. With up to a nine-fold increase in GDP per capita since the 1990s for select countries, the region has averaged economic growth of 5.5% in 2017 (Organisation for Economic Co-operation and Development [OECD], 2018).

The pace of this economic expansion is, however, slowing. The rapid growth of poorly diversified, resource-driven economies has exposed the CARs to significant systemic risks.

The CARs are highly dependent on volatile fossil fuel and commodities prices and vulnerable to fluctuations in the weakening global economy.

While the neighbouring economic giants – China, Russia, and the European Union – are important strategic partners and investors in the region, deep interconnections with them leave the CARs susceptible to any changes in their domestic politics and foreign and security policy. The instabilities of the Russian economy in the aftermath of the war in the Donbass and the annexation of the Crimea, and the oil price crashes of 2014 and 2016, for instance, significantly affected the countries of Central Asia on multiple levels – from the indirect fallout of the Western economic sanctions imposed on Russia, to heavy reductions in remittance flows, to a substantial weakening of currencies and FDI inflows.

Despite successful development outcomes, the Central Asian economies are still far from realising their full potential. In order to achieve this, the CARs should adopt proactive strategies to develop their 'hard' and 'soft' infrastructure. Indeed, according to the estimates of the Asian Development Bank, the countries of Central Asia will have to invest up to $33 billion in infrastructure development by 2030 to keep up with the growing domestic and international demands (Asian Development Bank [ABD], 2019).

Expanding economic outputs, growing populations, increasing energy needs, rapid urbanisation – all these factors require strong 'hard infrastructure'. Recognising the necessity of filling the 'infrastructure gap', the governments of Central Asia, with encouragement from Beijing, have launched myriad projects aiming to improve geographic connectivity and economic efficiency through transportation, telecommunications, and energy projects.

While the CAR governments work diligently to attract foreign hard-infrastructure investment, all these ambitious projects will not succeed without a solid soft-infrastructure foundation. Like software, soft infrastructure provides the basis on which hard infrastructure operates and develops. Building bridges, highways, airports, and power plants will not suffice to foster development without good governance, rule of law, and pro-business policies. Soft infrastructure is crucial to making these projects profitable. Therefore, to achieve a healthy, functioning, steadily growing economy, the CARs must invest in important components of soft infrastructure like rule of law and effective tax regimes, as well as promote private-sector competition and public-private partnerships.

Critical components of soft infrastructure development

Good governance

Good governance describes the decisive process of how public institutions conduct public affairs and manage public resources in the best interests of the country. Equality and prosperity are impossible without good governance, as well as strong social and economic mechanisms to support growth. Since gaining independence from the Soviet Union, the Central Asian republics have attempted to find sustainable governance models and to place their economies, long-tied to Moscow, on a stable footing.

The degrees of their success differ. The region's governments – with some notable exceptions – continue to struggle to address political and social issues that hinder economic growth and investment. Systemic corruption, a lack of transparency, human rights violations, and high protectionist walls that encumber trade have made it difficult to foster growth and provide the region with necessary infrastructure development. Authoritarianism and Soviet-style censorship across the media landscape stifle institutional development and stunt civil society growth.

Each year, The World Bank issues rankings that examine the quality of governance in countries around the globe, looking at six indicators: voice and accountability; political stability; government effectiveness; regulatory quality; rule of law; and control of corruption (Kaufmann and Kraay, 2019). All five Central Asian countries fall in the bottom 35% of the

World Bank’s governance indicators, pointing at a strong need for governance reform in the region (Organisation for Economic Co-operation and Development [OECD], 2018).

Corruption remains a significant issue throughout the region. Systemic and endemic in nature, it delegitimises and weakens government institutions (see Figure 1: Corruption Perceptions Index, 2018). Properties of good governance like proper regulation and legal frameworks, coupled with a prolonged public education campaign, are essential in combating corruption and distrust within institutions and business environments.

Figure 1: Corruption Perceptions Index 2018		
Country	**Rank***	**Score***
Kazakhstan	124	31
Kyrgyz Republic	132	29
Uzbekistan	158	23
Tajikistan	152	25
Turkmenistan	161	20
**rank is position relative to other countries (out of 180).*		
**score is perceived level of public sector corruption (0 – highly corrupt, 100 – very clean).*		
Based on data from the Corruption Perceptions Index by Transparency International.[17]		

In order for Central Asian countries to foster an environment conducive to economic growth, they must advance comprehensive, long-term development initiatives that seek to modernise regulatory frameworks by eliminating over-regulation, enhancing transparency, facilitating policy discourse, and stamping down on corruption.

Fair and effective tax regimes

Taxation is an integral part of a country's development policy that provides the funding required to build and operate infrastructure on which economic development and growth are based. Fair and legal regulatory frameworks provide the foundation for functioning and effective tax systems, offering sustainable business environments, shaping the way government activities are undertaken, and play a central role in domestic resource mobilisation. Transparent and consistent tax laws are also necessary for market predictability, a prerequisite for outside investment.

The Central Asian republics have, in recent years, dedicated themselves to testing reform policies to establish a balance of tax and non-tax revenues that allow for more comprehensive social programming and the amelioration of the business climate to attract foreign investment.

In 2019, Uzbek authorities began to implement "major tax reform designed to simplify taxes, expand the standard corporate tax regime and value-added tax, while reducing the tax burden on private firms and workers" (International Monetary Fund, 2019). Tajikistan has also introduced tax leniency reforms, capitalising upon its mineral resources with vast tax exemptions for mining and mining-related industries. Consequently, approximately 60% of FDI inflows in Tajikistan were dedicated to the expansion of the mining business in 2018 (World Bank Group [WBG], 2018, p. 5).

Some countries still have their tax reform ahead of them. Kyrgyzstan would benefit from measures aimed at equalising the tax burden between large, medium-sized, and small businesses to ensure that SMEs (small and medium-sized enterprises) grow to the point that the share of government revenues from small and medium-sized businesses is at least 50% of the budget's tax revenues, thus reducing the outsized influence of a handful of large enterprises, and building a more stable tax base for future revenues. Pragmatic tax reforms are taking place in Central Asia, a significant step in their path towards development.

Private sector competition

The encouragement of private sector competition in Central Asia is an important mechanism to facilitate economic growth and competitiveness in the global marketplace. Current CAR economic growth models are based on the extraction and production of natural resources and yield mixed results, with high levels of state involvement and income inequality.

Since the turn of the millennium, the CARs have shown rather impressive growth, but this has come at the expense of economic diversification, small and medium-sized business growth, and institutional development. The Soviet legacy and an over-reliance on natural resources have led to the proliferation of large and often state-controlled enterprises to the detriment of the private sector.

The heavy involvement of an often corrupt and inefficient public sector in infrastructure development brings high project and management costs, frequently leading to projects not reaching completion, or the government bearing the burden of significant over-run costs.

According to the Organisation for Economic Co-operation and Development (OECD), “the aggregate gross domestic product (GDP) of Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan grew at an average annual rate of 7% during 2000-16” despite the oil and gas price decline that occurred from 2014-2015 (OECD, 2018). Concerned about the overreliance on natural resources, the CARs have begun – most notably Kazakhstan – to recognise the need for a more diverse economic model.

While the public sector has a pivotal role to play in initiating infrastructure development, large-scale projects cannot be adequately funded or maintained in an environment where the private sector is restricted by over-taxation or kept outside of massive infrastructure projects for the benefit of senior officials, their families, and cronies.

Increasing the share of the private sector within the CARs, including in the building of infrastructure, should yield higher wages and, more importantly, a stable rate of economic growth that isn't reliant on commodity prices.

Turkmenistan, for example, greatly restricts private sector competition and growth, with the private sector making up less than 20% of the country's economy (Export.gov, 2019). Reforms of the legal framework and institutions of the national economy, to encourage a market-based approach and adopt international standards for business operations, would draw private sector participation. Economies in the region heavily controlled by the state must also begin the painful but necessary unbundling of government monopolies, particularly those in the energy sector.

By strengthening the private sector and diversifying their productive industries, Central Asian countries can transition their national economies to more sustainable, modern economic practices. Through reforms that promote private sector growth, the Central Asian countries can improve market competitiveness and diversify their economies with more opportunities in a broader array of sectors. New sectoral growth and higher productivity will boost new infrastructure development in a virtuous cycle, from power generation to telecommunications networks.

Effective public-private partnerships (PPPs)

Public-private partnerships (PPPs) are an important tool for facilitating large-scale infrastructure projects in emerging economies. Using PPPs as a project finance model allows emerging countries to utilise the technology, innovation, and expertise of the private sector while using the government to 'de-risk' projects through guarantees and access to capital (Deep, Kim, Lee, 2019, p.18). Appropriate financial structures, regulatory policies, and incentives can mitigate the risks associated with public-private initiatives. PPP frameworks often provide incentives to the stakeholders financing and managing the project, ensuring a higher-quality project that government agencies may have a hard time achieving.

The Central Asian republics could greatly benefit from PPPs if current legal and regulatory barriers can be addressed. Inadequate protection of property rights, heavy state involvement, corruption, and inconsistent statistical data has deterred competition and prevented PPPs from being implemented more broadly in the region. There is a growing need for infrastructure and investment in Central Asia – with 60% of the investment deficit expected to be met by the private sector and other non-public financial resources (Asian Development Bank Institute [ADBI], 2018).

Some countries are early adopters of this effective economic model. Kazakhstan is a leader in PPP development, adopting a new law in 2015 which created a common legal framework to regulate public-private partnership projects, and Kazakhstan's PPP Center is the only official body in the region that promotes and oversees PPP projects. Uzbekistan has also taken steps to improve its business climate, passing the 'Law On Public-Private Partnership' in May 2019 – signalling a further commitment to address its infrastructure needs (United Nations Development Programme [UNDP], 2019).

Stronger institutions and legal frameworks serve to alleviate investors' fear of corruption and lack of transparency. Availability of reliable and accurate data for stakeholders will result in smarter business decisions and promote investor confidence. Project finance structures that allocate risks appropriately allow for better management and success of high CapEx (capital expenditure) projects. In this vein, development banks must be involved in large-scale infrastructure projects to help mediate any issues between public and private partners and monitor project implementation, thus reducing the risk of delays in the project (Deep, Kim, Lee, 2019, p.54). Governments can also provide subsidies to make infrastructure projects more economically viable and reduce risk and capital requirements for private investors (Deep, Kim, Lee, 2019, p.66).

Plagued by ageing infrastructure, Central Asian governments need assistance from the private sector, international development institutions, and multinational companies to secure financing for the large-scale infrastructure investments required to bolster their economic growth. The indigenous public sector and domestic private sector entities have proven insufficient to provide the risk management structure or to raise and manage sufficient capital. The governments of Central Asia must undertake serious reforms that remove burdensome regulations standing in the way of private sector investment.

Foreign direct investment (FDI)

Foreign investment is a critical component in providing economic development, income growth and employment in developing countries and emerging economies. The Central Asian republics have introduced domestic policies to reform, facilitate, and attract much-needed outside investment in various sectors with varying degrees of success. By 2018, greenfield FDI to Central Asia has reached $113 billion since 2008 (Kazakhstan 70%, Uzbekistan 16%, Turkmenistan 8%, Kyrgyz Republic and Tajikistan combined less than 6%) (Abdimomunova et al., 2018, p.34). The economic and social benefits of FDI are immense and often lead to technological advancement, human capital formation, and growth in international trade. FDI also drives improvements in environmental and social conditions through increased availability of tax revenues and responsible corporate policies.

The regional business climate is not overly hospitable to investors in view of a number of ‘hard’ and ‘soft’ infrastructure factors: high transportation costs due to monopolies and the lack of competition in the transportation and logistics sectors, long distances, extended delays at border crossings due to poor customs and border control management, corruption, flawed legal frameworks, and limited access to the global market. Gradually, reforms have been introduced to create a more favourable climate for investors. In 2010, a customs union was created between Kazakhstan, Russia, and Belarus to reduce barriers and improve efficiency in cross-border trade (Asian Development Bank Institute [ADBI], 2014). In January 2015, Russia, Armenia, Belarus, and Kazakhstan launched the Eurasian Economic Union. Kyrgyzstan joined eight months later. More recently, this economic partnership, linking roughly 183 million people, signed an agreement with China – further connecting the region economically to China's Belt and Road Initiative and to larger trade markets (Remyga, 2018; Dragneva, 2018, p.5).

Figure 2: Ease of doing business

Country	Rank	EODB score	EODB change
Kazakhstan	28	77.89	+0.73
Kyrgyz Republic	70	68.33	+2.57
Uzbekistan	76	67.40	+1.08
Tajikistan	126	57.11	+0.08
Turkmenistan	--	--	--
**rank is position relative to other countries (out of 180).*			
**score is perceived level of public sector corruption (0 – highly corrupt, 100 – very clean).*			
Source: World Bank Doing Business Report 2019[31]			

Regulatory reforms and a legal framework that promote a market-based economy are essential to bringing further investment to the region. A shift towards value-added manufacturing and services can provide a more balanced revenue base and alleviate the reliance on a small number of industries for investment and growth. Significant investment in agriculture, agricultural processing, and food manufacturing will be needed to complement Central Asian countries' current production and export of mainly raw goods and materials. Wheat in Kazakhstan and cotton and vegetables in Uzbekistan are welcome exceptions.

However, each country should not walk along this path alone. Regional cooperation among Central Asian countries with cohesive economic and regulatory policies will help to further facilitate investment (Abdimomunova et al., 2018, p.6).

Kazakhstan has been the leader in the pursuit of economic evolution from the status of a low-income to a high/middle-income country. Following social and economic reforms, Kazakhstan attracted $4.7 billion of FDI inflows in 2017 and is ranked 28th in the World Bank's *Doing Business Report* 2019, and first in terms of 'Protecting Minority Investors' (Index of Economic Freedom, 2019; World Bank Group [WBG], 2019). The government must now maintain proper supervision over the red-tape-ridden bureaucracies and uphold the business environment to sustain the inflow of FDI that will support a modern infrastructure environment (Williams, 2018).

Uzbekistan has greatly benefited from foreign investment, receiving 70 loans amounting to $7.4 billion since joining the Asian Development Bank (ADB) in 1995 (Asian Development Bank [ADB], 2019). These loans have contributed to sustainable economic growth in the country and the region, with the ADB continuing to explore opportunities for direct investment via public-private partnerships and private sector projects (Asian Development Bank [ADB], 2019).

If Central Asian governments address the issues slowing down investment, the region is well-positioned for further FDI and for growth, sitting between prominent economies such as China, Russia, and India, while also being a critical transportation and raw materials component of the BRI. With the proper implementation of investment-friendly policies and an improved legal and regulatory framework, the region will succeed in attracting investment for much needed projects that will bring technology, infrastructure, growth, and economic diversification.

Soft infrastructure takes root

Across Central Asia, the pillars of 'soft' infrastructure – good governance, effective tax regimes, private sector competition, Public-Private Partnership, and foreign investment inflows – are strengthening. Though hampered by a shared Soviet legacy, mismanagement, corruption, resource-extraction-driven economies, and poor societal and institutional development, the region is well positioned for sustained future growth through comprehensive, multi-pronged, and sustained reforms. The Central Asian republics boast a strategic location relative to important markets (South Asia, East Asia, Russia, Europe), young and growing populations, significant human capital, a wealth of natural resources, and enjoy relative peace and stability – despite the proximity to Afghanistan.

However, Central Asia is no monolith, and this holds true with regard to the existing policies and institutions which form the 'soft' infrastructure of each Central Asian republic. Clear stratifications exist. Kazakhstan – the region's largest economy – sits far ahead of its neighbours thanks to the country's bold leadership, forward-looking development strategies, and natural resource endowments. Kazakhstan's GDP per capita is more than ten times higher than that of Tajikistan. Deliberate efforts to increase connectivity across the country via road, rail, dry ports, airports, and digital infrastructure, combined with pro-business policies, expanded PPP engagement, aggressive anti-corruption campaigns, and intentional economic diversification strategies make Kazakhstan a far more attractive destination for investment relative to the other CARs. Indeed, the country ranks 28th in the World Bank's 2019 *Ease of Doing Business* index, whereas Kyrgyzstan is nearest in 70th position, a long way behind.

That said, natural resource extraction still accounts for more than 70% of Kazakhstan's total FDI stock (OECD, 2018, p.1), meaning that FDI attractiveness is still very much a function of commodity prices – a common feature among the countries of Central Asia. This is going to change when – and if – Kazakhstan shows the way to diversify away from the raw-materials economy and into added value in finance, advanced manufacturing, sophisticated agriculture, engineering, services, etc. Other CARs would then follow suit.

The remaining CARs have shown mixed success in the pursuit of soft infrastructure development. Democratic reforms in Uzbekistan and Kyrgyzstan are helping to bolster the pillars of good governance, including increasing transparency and making positive legal changes to their regulatory regimes, though Uzbekistan has consistently been the smallest recipient of FDI. Turkmenistan, which enjoys the second highest FDI inflows in the region thanks to its massive natural gas sector, and Tajikistan, a mining-focused economy with electricity export potential, have been slower to develop their critical pillars.

Corruption, a lack of transparency, and heavy government involvement in the economy remain consistent obstacles to investment across the region. The long-term success of the Central Asia republics will be contingent on their willingness and ability to provide leadership and to embrace and implement the necessary reforms. Those which choose to invest in the development of their soft infrastructure – improving governance, boosting the rule of law, enhancing transparency, developing legislative and regulatory institutions, and levelling the playing field for market competition – will be far more prepared to attract investment and achieve growth and integration into the global economy.

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