

KAZAKHSTAN

Enhancing the Fiscal Framework to Support Economic Transformation

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Public Finance Review

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Abbreviations and Acronyms

BEPS	Base erosion and profit shifting	MNE	Ministry of National Economy
BSA	Balance sheet approach	MoF	Ministry of Finance
CBA	Cost-benefit analysis	NAC	National Analytical Center
CIPFA	Chartered Institute of Finance and Accountability	NBK	National Bank of Kazakhstan
CIT	Corporate income tax	NFRK	National Fund of the Republic of Kazakhstan
DEA	Data envelopment analysis	NOD	Nonoil (fiscal) deficit
DSD	Department for sectoral development	NPLs	Nonperforming loans
DSPA	Department of strategic planning and analysis	NPV	Net present value
EAEU	Eurasian Economic Union	OECD	Organisation for Economic Cooperation and Development
EMDEs	Emerging market and developing economies	O&M	Operations and maintenance
ERI	Economic Research Institute	PBB	Program based budgeting
EU	European Union	PFM	Public finance management
FDI	Foreign direct investment	PFR	Public finance review
FSU	Former Soviet Union	PIH	Permanent income hypothesis
FRS	Fiscal risk statement	PISA	Program for International Student Assessment
FX	Foreign currency	PIT	Personal income tax
GCI	Global Competitiveness Index	PLF	Problem Loans Fund
GFS	Government Finance Statistics	PPL	Public procurement law
GoK	Government of Kazakhstan	PPP	Public-private partnership
IFRS	International Financial Reporting Standards	RPVU	Real property valuation unit
IIRC	International Integrated Reporting Council	SAI	Supreme Audit Institution
IPSAS	International Public Sector Accounting Standards	SBD	State Borrowing Department
<IR>	Integrated reporting	SEZs	Special economic zones
ITAS	Integrated Tax Administration System	SK	Samruk-Kazyna, JSC
JERP	Joint Economic Research Program	SMEs	Small and medium-size enterprises
MCI	Monthly calculation index	SOEs	State-owned enterprises
M&E	Monitoring and evaluation	SRC	State Revenue Committee
		SWF	Sovereign wealth fund
		VAT	Value-added tax
		WTO	World Trade Organization

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Executive Summary

Macro-fiscal context and challenges

Kazakhstan benefited from the oil boom of 2000–14 that led to income growth and poverty reduction and helped build a fiscal cushion to stabilize the economy during downturns.

During this period, nominal GDP per capita increased ten-fold, from US\$1,229 in 2000 to US\$12,807 in 2014, mainly due to price effects from currency appreciation that followed an expansion of the oil sector. Income growth led to a substantial decline in the poverty rate, from 77 percent in 2001 to 16 percent in 2014.¹ As oil output more than doubled and the oil price super-cycle emerged, the Government of Kazakhstan (GoK) accumulated substantial fiscal savings in its oil fund, the National Fund of the Republic of Kazakhstan (NFRK).² Fiscal savings in the NFRK peaked at US\$73 billion (33 percent of GDP) at end-2014. A portion of these funds was used for anti-crisis programs in 2007–10, during which time the fiscal stimulus program totaled US\$18 billion (about 15 percent of GDP).³

The oil-price shock since mid-2014 is a structural shift to a "new normal" that requires structural rather than countercyclical fiscal measures. Unlike a temporary crisis that can be managed by a countercyclical response to restore macroeconomic stability, this structural shift—to a new, low oil-price environment—may persist for many years. As such, an overuse of macro-fiscal stimulus measures is likely to be both ineffective and expensive. An attempt to maintain the managed float required the authorities to inject more than US\$30 billion in foreign-currency (FX) interventions in 2014–15, while the current fiscal stimulus package already exceeds US\$20 billion (12 percent of GDP) in 2014–17. As a result, the NFRK balance has fallen from US\$73 billion in 2014 to a projected US\$53 billion by end-2017. The authorities moved to a floating exchange rate regime in the second half of 2015 to stop the leakage of foreign exchange reserves. However, an accompanying fiscal adjustment has not materialized. Some policy makers may still believe that the shock is cyclical and maintain hope that oil prices will recover.

The authorities must urgently adopt and start implementing a fiscal consolidation strategy and refocus macro-fiscal policy on promoting diversified growth and high-quality job creation. The countercyclical fiscal stance adopted in 2014 led to an increase in the nonoil fiscal deficit (NOD), which is too high to ensure medium-term fiscal sustainability and threatens the long-term growth potential of the nonoil tradable economy. Successful fiscal consolidation would require: (i) reducing inefficient expenditure that distorts private incentives while redirecting savings toward productivity-enhancing spending; and (ii) eliminating inefficient tax benefits that result in an uneven playing field for investment. While pursuing a fiscal consolidation effort over the medium term, there are potential benefits to reviewing Kazakhstan's fiscal policy framework and institutions with the goal of strengthening their coherence, credibility, and flexibility.

Policy focus areas and recommendations

This Public Finance Review (PFR) aims to help the authorities identify areas for fiscal consolidation that will bring about fiscal sustainability in the medium term and support economic transformation in the long run. While developing a fiscal consolidation strategy, the authorities should address four policy areas to enhance fiscal sustainability and support economic transformation. These are discussed in the following four policy focus chapters: (i) enhancing the credibility of the fiscal policy framework; (ii) improving public spending efficiency

¹ Using the international poverty measure of US\$5 a day at purchasing power parity.

² Between 2000 and 2014, oil production in Kazakhstan increased from 0.7 to 1.7 million barrel per day. The oil price super-cycle emerged in the mid-2000s with a peak registered during 2011–14, when oil prices exceeded US\$100 per barrel.

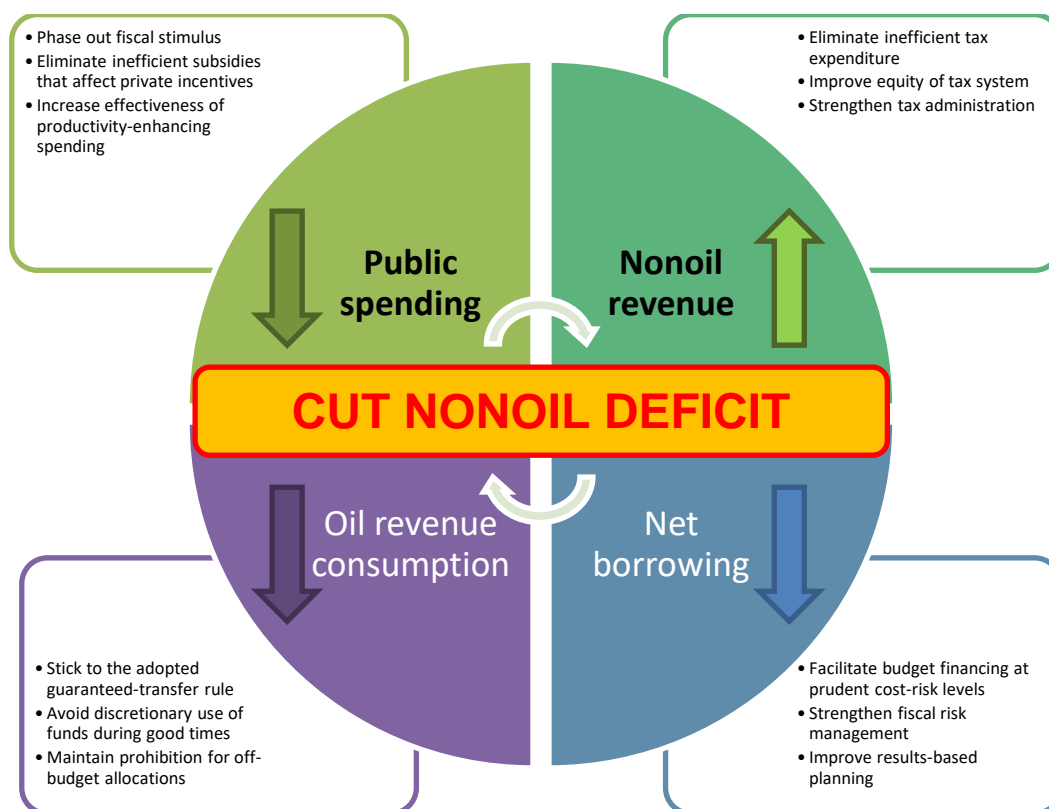
³ The real GDP growth rate slowed substantially, from 10.7 percent in 2006 to 1.2 percent in 2009.

and effectiveness; (iii) mobilizing nonoil revenue and optimizing the tax system; and (iv) strengthening fiscal policy institutions.

Policy focus 1: Enhancing the credibility of the fiscal policy framework

The adoption of a fiscal policy framework with an appropriate fiscal anchor would support a more efficient economy and government sector. This critically-important reform has been suggested by both the WBG and the IMF, but remains unrealized. As a result, Kazakhstan’s fiscal policy framework continues to lack an adequate anchor (particularly, the nonoil balance), while including ambiguous targets and leaving considerable room for discretion in transferring resources from the NFRK to the budget. The purpose of a fiscal policy framework is to help adjust public expenditure and revenue in a way that supports a new growth model based on non-commodity tradables and creates better jobs in a more productive economy. Budget constraints would imply that programs that were inefficient or supported the old economic structure—including state-owned enterprises (SOEs)—would need to be abandoned or phased out. An effective fiscal policy framework would also help the government to increase nonoil revenue by balancing efforts to eliminate inefficient tax expenditures and loopholes, expand the tax base, and raise tax rates.⁴ Such a framework would set out the fiscal policy adjustments needed to support a new growth model, putting Kazakhstan on a path toward a more sustainable nonoil deficit in the medium term (Diagram 1).

Diagram 1: Fiscal policy framework for fiscal consolidation



Reducing the nonoil deficit to a sustainable level will require a significant effort to cut inefficient public spending and, more importantly, increase collection of nonoil revenues in the short to medium term. Table 1 illustrates three possible fiscal adjustment strategies to

⁴ According to government estimates, tax expenditures for CIT and VAT was estimated at almost KZT 3 trillion (about 6 percent of GDP) in 2016.

identify the degree of fiscal consolidation required. Acknowledging the need for fiscal consolidation, the GoK adopted a new rule governing the NFRK in December 2016 that aims at reducing the budget's dependence on oil revenue and cutting the nonoil deficit to 7 percent of GDP by 2020 and 6 percent by 2025. The GoK's baseline strategy will help to bring the fiscal accounts into balance but will lead to an acceleration of debt accumulation and, ultimately, a depletion of GoK net financial assets (that is, NFRK FX assets minus total government debt, including state guarantees). While a delayed adjustment would worsen the net fiscal savings picture—and therefore should be avoided by the GoK—an accelerated adjustment strategy will require a more drastic reduction in core public spending and a sharp increase in nonoil revenue collection. The accelerated scenario is the only one that will allow the GoK to stabilize its net financial assets and improve fiscal sustainability.

Table 1: Three fiscal adjustment strategies for a consolidated budget by 2020 and 2025
(Percent of GDP)

	Actual	Estimate	Delayed adjustment		Baseline strategy		Accelerated adjustment	
	average 2010–13	average 2014–17	2020	2025	2020	2025	2020	2025
Nonoil deficit (NOD)	-8.8	-11.6	-9.0	-8.0	-7.0	-6.0	-6.0	-5.0
Nonoil revenue	12.8	11.7	12.3	12.3	13.0	13.5	13.8	14.5
Expenditure (-)*	21.6	23.3	21.3	20.3	20.0	19.5	19.8	19.5
NOD financing	8.8	11.6	9.0	8.0	7.0	6.0	6.0	5.0
Oil revenue use**	6.2	9.3	4.4	3.5	4.4	3.5	4.4	3.5
Net borrowing	2.5	2.3	4.6	4.5	2.6	2.5	1.6	1.5
Privatization	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
<i>Memorandum items:</i>								
Overall balance	4.0	-5.5	-3.2	-2.8	-1.2	-0.8	-0.2	0.2
Net financial assets***	17.4	15.3	3.8	-9.7	7.7	0.4	9.2	5.7
NFRK FX assets	29.9	33.5	27.9	24.6	27.9	24.6	27.9	24.6
Government debt (-)	12.6	18.2	24.1	34.3	20.2	24.2	18.7	18.9

Source: World Bank staff calculations and projections.

Note: * Expenditure includes off-budget direct disbursements from the NFRK; ** The oil revenue use covers disbursements from the NFRK and customs duty on oil exports; *** Stocks as of end of period.

Policy focus 2: Improving public spending efficiency and effectiveness

While pursuing fiscal consolidation, the GoK can enhance the impact of public spending on growth by fostering the conditions for the sustainable development of the nonoil tradable sector. Doing so will require an improvement in the quality of health and education as well as a reduction and redirection of inefficient public spending away from programs that distort the business environment. Rather than constraining private sector development, public spending and investment should be re-oriented to enhance leverage and catalytic impact, particularly regarding the private sector. High-quality infrastructure projects can play a key role if they are selected transparently and strategically using rigorous criteria that assess their economic viability and their potential to catalyze additional investment. Improvements in the framework for public procurement can also deepen the impact of public spending by reducing the cost and enhancing the quality of publicly-funded projects.

There is room for efficiency gains in public expenditure but—given Kazakhstan's relatively low level of public spending, particularly in health and education—there is little justification for fiscal consolidation that is driven exclusively by cuts to overall public expenditure. Improving the efficiency and effectiveness of spending should be part of any strategy to achieve fiscal sustainability. There is significant scope, for example, to increase the effectiveness of public spending in the education and health sectors where outcomes are less favorable than in countries at similar levels of development. The need to reduce the nonoil deficit implies that, before any significant increase in spending, programs that supported the old structure of the economy, including through SOEs, should be reassessed. Inefficiently used

resources should be channeled to more impactful interventions in support of government objectives, including to improve productivity and promote market-based growth, particularly in the nonoil tradable sector.

Policy focus 3: Mobilizing nonoil revenue and optimizing the tax system

Fiscal consolidation should rely mostly on increasing nonoil tax revenue by balancing efforts to eliminate inefficient tax exemptions and loopholes, expand the tax base, and increase tax rates. The potential for increasing tax collections by eliminating exemptions and closing tax loopholes is significant. According to government estimates, in 2016 the combined revenue cost of tax expenditures for corporate income tax (CIT) and value-added tax (VAT) was almost KZT 3 trillion (6 percent of GDP) (Table 2). Large firms enjoy most of the benefits of these tax exemptions. As such, they are of dubious benefit to the economy overall. They are not cost-effective and should undergo a thorough review. A comparison with Organisation for Economic Cooperation and Development (OECD) countries shows that Kazakhstan’s tax structure is excessively reliant on CIT, which is highly vulnerable to business cycle fluctuations. Furthermore, VAT productivity is low compared to the OECD average. A high level of VAT refund arrears reduces economic efficiency, breaks down the integrity of the VAT system, and acts as an additional tax on and a disincentive to investment. The VAT tax base can be expanded by lowering the VAT registration threshold, bringing large agricultural enterprises under VAT, and revising the list of VAT-exempted goods. Reforms to property tax and personal income tax (PIT) can diversify the tax structure, generate additional revenue, and reduce inequality. Continuous improvements to tax administration through business-process reengineering, strengthened risk management, increased transparency, and modernized IT systems are essential for nonoil revenue mobilization.

Table 2: Budget revenue cost of tax expenditures: 2014–16
(KZT trillion, unless otherwise indicated)

	Number of taxpayers applying for tax benefits			Amounts subject for tax benefits			Budget revenue losses		
	2014	2015	2016	2014	2015	2016	2014	2015	2016
VAT	13,320	13,683	13,467	15.4	13.8	17.1	1.8	1.7	2.1
CIT	43,938	45,544	39,184	3.5	10.3	4.3	0.7	2.1	0.9
Total	57,258	59,227	52,651	18.9	24.0	21.4	2.5	3.7	2.9

Source: World Bank staff calculations based on data provided by the authorities.

Note: Some sums may not add up exactly due to rounding.

Policy focus 4: Strengthening fiscal policy institutions

Fiscal consolidation is a necessary first phase of reform, but broader and continuing reforms of fiscal policy institutions are essential, both to ensure effective fiscal adjustment and to support economic and public sector transformation over the long term. Beyond consolidation, capacity must be built to implement the GoK’s long-term goals of reducing the state’s involvement in directing the enterprise economy while strengthening the management of fiscal risk across the public sector. Current policies target the reduction of Kazakhstan’s extensive state footprint, which is characterized by large SOE holdings created in response to sector-specific crises. However, the fiscal administration lacks the capacity to adequately assess the potential risks associated with SOE contingent liabilities and the coordination of public-sector policy is constrained by the structure of the state property administration.

A detailed action plan for strengthening the GoK fiscal administration should be prepared. Steps have been taken by the GoK to address these issues, both in relation to the implementation of the new NFRK rule and the reduction of the role of the state administration in the economy. This task will involve much closer coordination between the General Government and the management of SOEs as well as the implementation of the SOE privatization program. The PFR

team prepared a draft outline of current arrangements and potential steps toward institutional strengthening. The team recommended that the authorities review this draft (summarized in Table 13), which is very preliminary and requires consideration of major institutional change and restructuring. It is based on the PFR team’s discussions with the main Kazakh organizations involved and is consistent with OECD analysis of the deep changes needed and with prior recommendations made through JERP and continuing work by the IMF. It is recommended that the Kazakh authorities use this table as a starting point to develop a comprehensive, time bound institutional reform program in three phases. First, the program would focus on the urgent task of fiscal consolidation. Second, the ongoing program of establishing accrual basis accounting across the public sector under the International Public Sector Accounting Standards (IPSAS) would be completed and parallel efforts to use accrual and balance sheet data for public-sector risk management and budgeting would be put in place. The final phase would see the full establishment of integrated reporting (<IR>) and results-based budgeting, strengthening Kazakhstan's ability to cope with future structural and cyclical adjustments. It is recognized that <IR> can only be established over the long term, but it is critical that its importance be recognized at the outset, and that initial steps be taken in the near future to begin applying this technique to results-based budgeting and performance reporting in strategically important areas.

Table 3: Summary of key policy recommendations

Policy focus areas	Policy recommendation	
	Short-term	Medium- to long-term
1. Fiscal policy framework	Clarify actions in a credible medium-term plan for fiscal consolidation to bring the nonoil deficit to 6-7 percent of GDP by 2020	Set a target for long-term savings in the NFRK and ensure that the nonoil deficit medium-term targets are consistent with the long-term savings target
	Remove ambiguities in the fiscal framework due to the dual targeting of the nonoil deficit and the guaranteed transfers from the NFRK to the budget	Consider revising the fiscal framework towards a price-based rule for the structural fiscal deficit based on a long-run benchmark for the oil price
	Limit the discretionary resource transfers from the NFRK to the budget beyond the guaranteed amounts	Consider integrating the NFRK into the budget as a financial account to which surplus revenue is transferred and from which withdrawals are made when budgeted resource revenue undershoots projections
	Integrate the extra-budgetary funds into a unified General Government budget account	Introduce an Independent Fiscal Council while effectively ensuring its institutional, functional, and financial independence
2. Public spending efficiency and effectiveness	Phase out the anti-crisis support program starting from 2018	
	Indicate implicit grant associated with below-market-rate lending in budget	
	Include “in-kind” payments, including for housing in compensation for public-sector employees	Formulate and implement multi-year strategy to improve quality of spending on primary and secondary education, with a focus on staffing rationalization, teacher qualifications, training, and competitive remuneration
	Explicitly budget for bonuses for civil servants	
	Review definition of “vulnerable populations” to improve targeting of assistance	

Policy focus areas	Policy recommendation	
	Short-term	Medium- to long-term
	<p>Review estimates of operations and maintenance costs from past project proposals to assess adequacy and draw conclusions for future estimates</p> <p>Extend the Public Procurement Law to all SOEs and tighten requirements for sole-source procurement</p> <p>Require completion reviews for all projects funded from central or local budgets, including comparisons of actual and planned costs</p>	<p>Implement requirement for independent, ex-post evaluation of large and strategic government projects and programs, with lessons learned widely disseminated</p>
3. Nonoil revenue mobilization	<p>Rationalize the tax incentive structure by introducing a simpler system of investment allowances or tax credits, an accelerated depreciation regime and clear and publicly-verifiable eligibility criteria and transparent procedures</p>	<p>Simplify tax administration and modernize IT systems for increased voluntary compliance, improved SRC performance and higher revenue collection</p>
	<p>Estimate the fiscal costs of tax incentives annually and include them in the general budget as an item of tax expenditure</p>	<p>Perform a cost-benefit analysis of tax incentives on a constant basis</p>
	<p>Eliminate inefficient VAT exemptions and bring agriculture under the regular VAT system</p>	<p>Compute sector-wide elasticities to identify sectors where VAT potential is ill-exploited</p>
	<p>Simplify and improve VAT refund procedures</p>	<p>Consider an upward revision of the VAT rate</p>
	<p>Move small businesses toward taxation on a net income basis while putting in place capacity building measures to promote proper bookkeeping on a cash-flow basis</p>	<p>Expanding the property tax base by moving to a market price-based capital valuation of properties instead of an area-based system for property valuation</p>
	<p>Separate social taxes from PIT to determine the effective tax rate on employment income</p>	<p>Introduce a progressive personal income tax structure and tax interest received on bank deposits</p>
4. Fiscal policy institutions	<p>Build capacity to assess and manage the discretionary use of the targeted transfers from the NFRK</p>	<p>Establish comprehensive fiscal risk management and reporting for the public sector</p>
	<p>Initiate a Fiscal Risk Statement covering all public sector fiscal risks as part of budget presentation and approval</p>	
	<p>Review the state property ownership law and institutional responsibilities</p>	<p>Establish an institutional framework for management of all aspects of public sector management, cash and debt management, and development of the securities market</p>
	<p>Review economic statistics the analytical framework for Socio-economic Development Forecasts</p>	<p>Establish a comprehensive results-based management framework for implementation of Socio-economic Development Plans</p>

Policy Focus 1: Enhancing Credibility of the Fiscal Policy Framework

The authorities moved to a floating exchange rate regime in 2015 in the context of the low oil price conditions that began in mid-2014. However, the government has delayed an accompanying fiscal adjustment since then. The countercyclical fiscal stance adopted in 2014 led to an increase in the nonoil fiscal deficit, which is too high to secure medium-term fiscal sustainability and threatens the long-term growth potential of the nonoil tradable economy. A fiscal adjustment to the “new normal” of low oil prices—and providing a longer-term focus for macro-fiscal policy that could form the basis for diversified growth and high quality job creation—must become a priority. Kazakhstan’s fiscal policy framework lacks an adequate anchor (particularly, the nonoil balance), while it includes ambiguous targets and allows for considerable discretion in transferring resources from the oil fund to the budget. This dynamic negatively impacts savings and investor confidence. Successful fiscal consolidation will require: (i) the reduction of inefficient spending that distorts private incentives and the redirection of savings to productivity-enhancing spending; and (ii) the elimination of inefficient tax benefits that distort the investment playing field. While pursuing a fiscal consolidation effort in the medium term, there are potential benefits to reviewing Kazakhstan’s fiscal framework and institutions with the goal of strengthening their coherence, credibility, and flexibility.

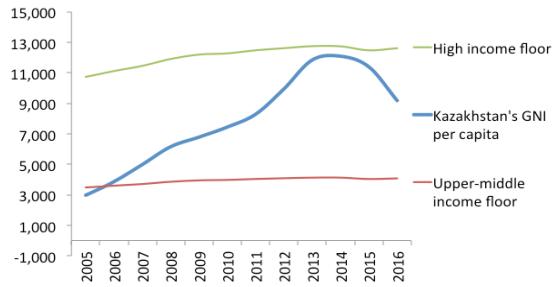
The volatility, uncertainty, and exhaustibility of oil revenue, as well as current institutional arrangements, pose challenges for the design of an appropriate fiscal policy framework in Kazakhstan. Such a framework will need to ensure short-term macroeconomic and fiscal stability, help achieve medium-term fiscal sustainability, and maintain consistency with the government’s long-term development goals. The first section of this chapter discusses the fiscal policy challenges in Kazakhstan since the global financial crisis and how these challenges are evolving. The second section discusses the criteria for the selection of an appropriate anchor for fiscal policy and the potential options for consideration given the experience of other resource-dependent economies. The third section discusses how the current fiscal framework could be reformed to support Kazakhstan’s goals of fiscal consolidation, economic stability, and the structural transformation of the economy in the coming years.

1.1 Fiscal policy challenges in a changing macroeconomic environment

Macroeconomic developments since the global financial crisis

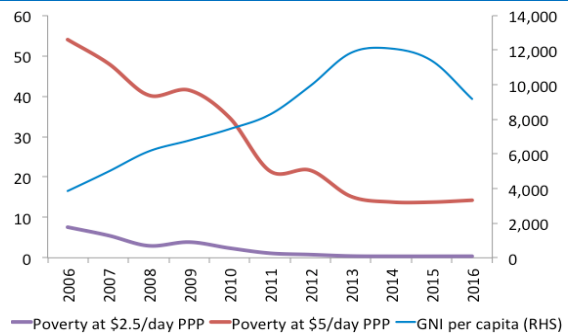
Kazakhstan’s oil-rich economy has experienced rapid income growth with significant poverty reduction. Kazakhstan is one of the world’s 20 top oil producers, with estimated reserves of 30 billion barrels, equivalent to about 2 percent of global oil reserves. The economy remains highly dependent on oil, with oil and gas proceeds currently accounting for two-thirds of exports and one-third of fiscal revenue. The country is also rich in other minerals, has a wide manufacturing base developed with extensive state involvement, and—with the fifth largest amount of arable land in the world—significant agricultural potential. Kazakhstan has prospered thanks to its oil resources and effective economic management. Although Kazakhstan’s GNI per capita exceeded US\$12,000 in 2014—very close to the threshold for joining the group of high-income economies—this trend has reversed in recent years owing to a sharp decline in oil prices (Figure 1). Owing to strong income growth, Kazakhstan’s poverty rate has declined sharply, to stand at 16.1 percent at the US\$5 per day measure (in 2005 purchasing power parity terms) and 0.4 percent at the US\$2.50 per day measure in 2016 (Figure 2), while life expectancy at birth has reached 72 years.

Figure 1: Per capita GDP growth (US\$)



Source: World Bank staff calculations based on data published by the authorities.

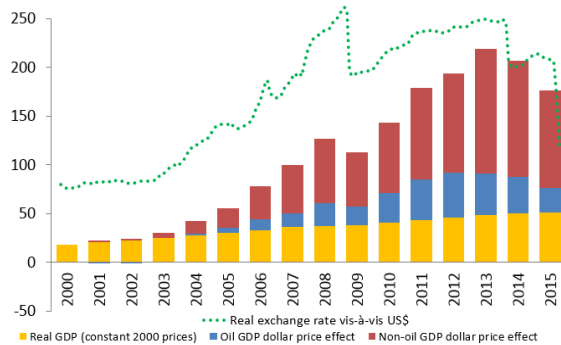
Figure 2: Poverty dynamics (Percent of population; US\$ at current prices)



Source: World Bank staff calculations based on data published by the authorities.

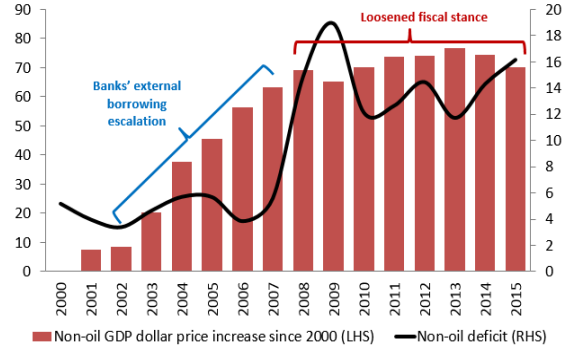
Much of Kazakhstan's economic growth in 2000–15 was the result of a positive oil price effect (on oil GDP) and real exchange rate appreciation (on nonoil GDP). The increase in the dollar price of oil since 2000 raised the value of oil GDP (Figure 3). At the same time, the appreciation of the tenge increased the dollar price of nonoil GDP while also driving an increase in domestic demand. The tenge appreciated because of large capital inflows to the economy reflecting unsterilized oil revenue and sizeable foreign borrowing by the banking sector in 2003–2007. Significantly higher nonoil deficits from 2008 onwards, reflecting an expansionary fiscal stance, also contributed to the real appreciation of the exchange rate up until 2014 (Figure 4).

Figure 3: Real GDP growth and price effects (US\$, billion)



Source: World Bank staff calculations based on data published by the authorities.

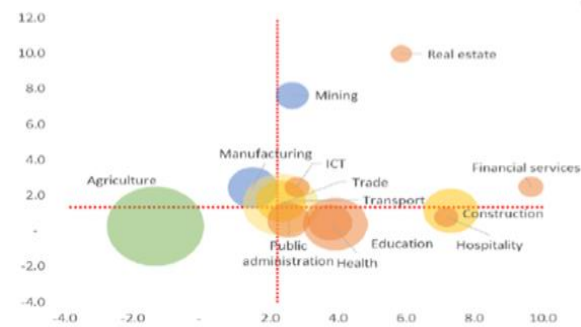
Figure 4: Nonoil GDP price effect and the NOD (Percent of nonoil GDP)



Source: World Bank staff calculations based on data published by the authorities.

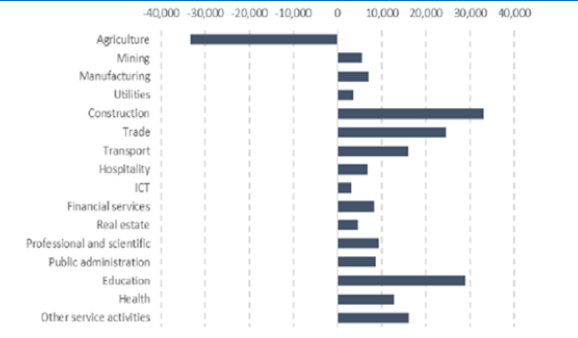
Kazakhstan's exchange rate and fiscal policies have led to economic incentives that favor the development of nontradable services. Growth of nonfinancial services has outpaced that of manufacturing, especially during the years of the high nonoil deficit in 2008–14 (Figure 5). Moreover, the bulk of job creation in 2003–13 was in services, especially in construction, trade, transport, education, and health (Figure 6). Kazakhstan's economic structure has, therefore, on the one hand, become reliant on nonrenewable commodity sectors which are capital intensive and subject to adverse economic shocks while on the other hand, the services sectors that have been developed, though labor intensive, tend to have low productivity growth. While jobs transitioned out of low-productivity agricultural activities, they shifted into service sectors with low productivity profiles. As a result, the country now needs to diversify its economy further, creating new growth engines that will propel productivity and job creation.

Figure 5: Job growth and productivity
(Output per worker; jobs growth)



Source: World Bank staff calculations based on data published by the authorities.
Note: Output per worker is in 2005 U.S. dollars.

Figure 6: Job creation by sector, 2003–2013
(Number of additional people employed)



Source: World Bank staff calculations based on data published by the authorities.

The economy has also become excessively reliant on the state sector. In the 25 years since independence, Kazakhstan has developed a vast SOE sector that manages most of the formal economy. During economic transition, a series of state development institutions were established to support priority sectors, such as textiles, construction, agriculture and food processing, oil and gas machinery, and logistics and transportation. In 2006, all of the key parastatals were merged into three holding companies: Samruk (oil and gas industry, railways and telecom), Kazyna (finance), and KazAgro (agriculture). In 2008, following Kazakhstan’s banking crisis, key SOEs and state development institutions were merged into a giant conglomerate, Samruk-Kazyna (SK). Five years later, in 2013, the state development institutions were separated from SK into the national management holding company, Baiterek. The assets of SK are estimated at 50 percent of GDP; it accounts for about 30 percent of total employment. In parallel, SOEs comprise a significant share of the 300 largest taxpayers.

Kazakhstan faced economic turbulence as a result of the 2009 global financial crisis. Falling oil prices and a banking crisis impaired the country’s ability to provide adequate financing to the nonoil sector. As a result, real GDP growth slowed sharply, from 8.9 percent in 2007 to 3.3 percent in 2008 and 1.2 percent in 2009 (Figure 7). However, Kazakhstan weathered the global financial and economic crises relatively well, thanks to its large foreign exchange reserves cushion, active interventions by the National Bank of Kazakhstan (NBK), and relatively modest exposure to international financial markets. Growth rebounded in 2010 and remained solid through 2013 on the back of high oil prices.

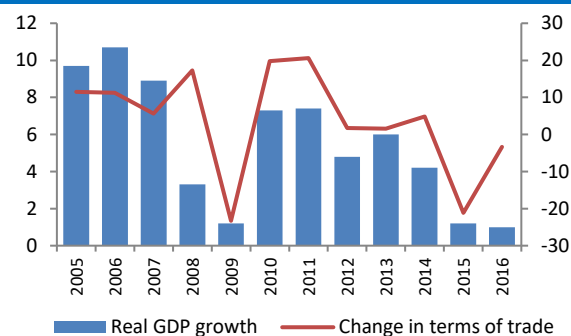
The construction and real estate bubble that preceded the financial crisis left the banking sector heavily burdened by nonperforming loans (NPLs). According to conservative estimates, NPLs currently amount to 30–35 percent of total bank loans.⁵ The issue represents a serious hindrance to private sector growth and deters investment required for the diversification of the economy. Despite substantial expenditure by the GoK to address the overhang of NPLs in the banking system, the issue continues to linger.

Kazakhstan has been facing economic headwinds again since 2014 owing to the sharp decline in the price of oil. Real GDP growth slowed to 4.2 percent in 2014, 1.2 percent in 2015, and 1.1 percent in 2016 (Figure 7). Falling oil prices resulted in a large terms-of-trade shock while, at the same time, economic growth in China slowed further and the Russian Federation’s recession continued, dampening external demand from Kazakhstan’s key trading partners. Lower oil prices reversed the country’s fiscal and external surpluses. Twin deficits were recorded in 2015 for the first time since 2009, with the overall fiscal deficit reaching 8 percent of GDP and the

⁵ Moody’s definition captures retail and corporate loans, based on a survey of 9 banks which come to about 65 of commercial banks’ portfolio.

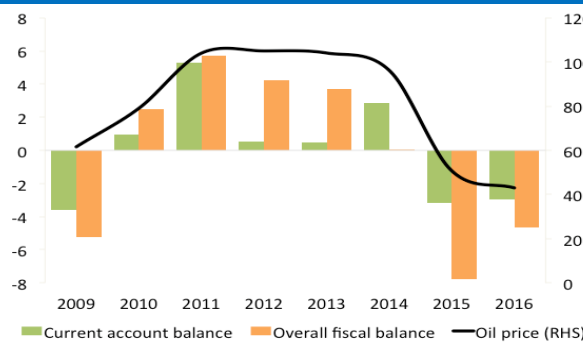
external current account deficit totaling 2.8 percent of GDP in 2015 (Figure 8). The overall fiscal deficit remained high in 2016, at 6.5 percent of GDP, while the external current account deficit widened to 6.2 percent of GDP. The twin deficits put heavy pressure on the currency peg to the US dollar and, as a result, the NBK spent more than US\$30 billion defending the tenge between mid-2014 and mid-2015.

Figure 7: GDP growth and the terms of trade
(Percent; percent)



Source: World Bank staff calculations based on data published by the authorities.

Figure 8: Current account and fiscal balance
(Percent of GDP; US\$ per barrel)



Source: World Bank staff calculations based on data published by the authorities.

The authorities shifted to a floating exchange rate regime in August 2015. This change triggered significant adjustments to the nominal and real exchange rates (which could enhance the price competitiveness of nonoil exports in the long run). After depreciating from 188 KZT/US\$ in mid-August 2015 to 384 KZT/US\$ in mid-January 2016 amid substantial market uncertainty, the nominal exchange rate has stabilized at about 330 KZT/US\$ since end-2016 as oil prices leveled off. The sharp depreciation of the tenge fueled inflation, which rose from an annual rate of 3.8 percent in August 2015 to a peak of 17.7 percent in July 2016. However, inflation receded in the first half of 2017, falling below 8 percent.

With oil prices currently hovering near US\$50 per barrel, Kazakhstan’s shift to a floating exchange rate has spurred a macroeconomic adjustment to adapt the economy to the new normal. Kazakhstan’s economy must now complete this macroeconomic adjustment and build the foundation for a new growth model based on dynamic tradable sectors. This will require: (i) reducing the nonoil deficit and continuing to implement inflation targeting; (ii) addressing the legacy of SOEs and resolving financial sector issues; and (iii) seeking sector-specific public investment and policy changes that encourage investment in the nonoil tradable sectors. Such investments would enable the Kazakhstan nonoil sectors to either directly respond to global and local market signals or indirectly enable producers to plug into global value chains.

Supporting the economy amid falling oil prices

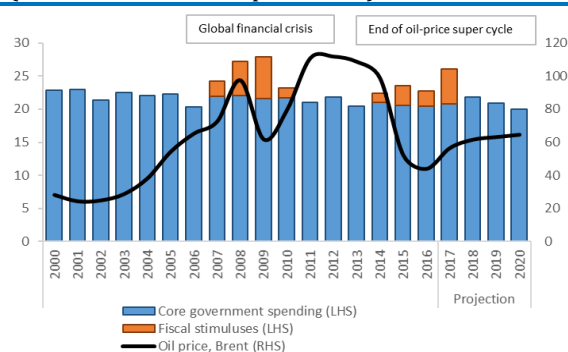
In 2007–10 the authorities reacted promptly and forcefully to the global financial crisis. Kazakhstan used the State budget—as well as the SK conglomerate, Baiterek and KazAgro—as its primary vehicles to implement its anti-crisis program, which totaled about KZT 2.5 trillion (approximately US\$18 billion, or 15 percent of GDP) in 2007–10 (Figure 9).⁶ The stimulus program was one of the largest implemented worldwide in the wake of the global financial crisis. The anti-crisis program was mainly funded off-budget by the NFRK and, secondarily, through an

⁶ The financial sector was the main beneficiary of the 2009 anti-crisis measures, amounting to KZT 761 billion. A significant part of these funds (KZT 308 billion) was allocated for the stabilization of the financial sector through the recapitalization of three banks (BTA, Kazkommertsbank, Halyk Bank). Funds allocated to second-tier banks, for new lending to SMEs but also for the provisioning of NPLs (including mortgage loans), amounted to KZT 384 billion. KazAgro received KZT 120 billion from the NFRK to finance agribusinesses and rural investment projects.

increase in the State budget deficit. The deficit was financed partly by the NFRK and partly by borrowing.

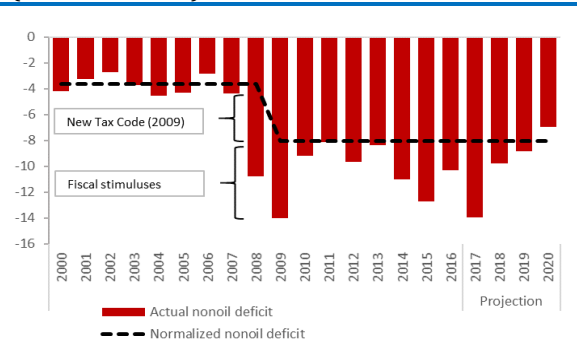
A new Tax Code, which took effect on January 1, 2009, was among the most significant stimulus measures. The new tax code included significant reductions in tax rates, particularly for the non-primary commodity sectors of the economy. The Corporate Income Tax (CIT) was reduced from 30 percent to 20 percent, the VAT from 13 percent to 12 percent, and a unified rate of 11 percent was introduced for the social tax. The cost of these measures was about KZT 500 billion (3.3 percent of GDP) with the CIT rate reduction accounting for the bulk of foregone revenue (about 80 percent). As a result, the nonoil deficit doubled from below 4 percent of GDP (excluding fiscal stimulus) in 2000–07 to about 8 percent of GDP (excluding fiscal stimulus) in the years after (Figure 10).

Figure 9: Fiscal stimuli and price shocks
(Percent of GDP; US\$ per barrel)



Source: World Bank staff calculations.

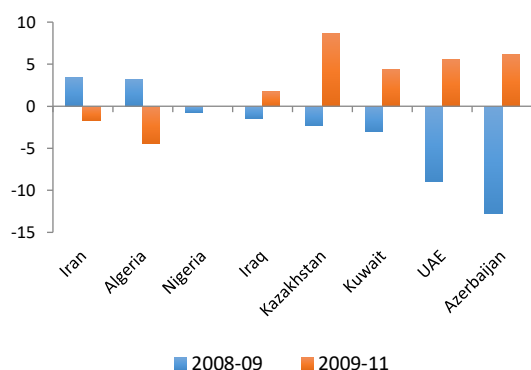
Figure 10: Tax reform and the nonoil deficit
(Percent of GDP)



Source: World Bank staff calculations.

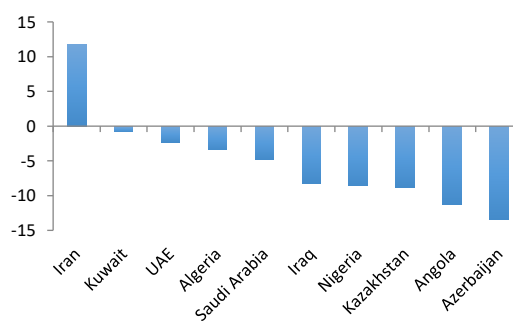
A direct comparison of the anti-crisis programs enacted by Kazakhstan and other oil-producing countries is challenging because of the lack of transparency surrounding spending from sovereign wealth funds. Nonetheless, based on nonoil GDP growth rates, Kazakhstan appears to have weathered the global financial crisis relatively well. Compared to seven other oil-producing countries, Kazakhstan’s nonoil GDP growth declined moderately in 2009, by 2.7 percentage points (Figure 11). However, during the 2010–11 recovery, Kazakhstan saw the largest gains in nonoil GDP compared to the seven other countries. Overall, Kazakhstan’s nonoil GDP registered the strongest growth over the entire crisis and post-crisis periods.

Figure 11: Change in nonoil GDP growth rates, 2008-09 and 2009-11
(Percentage points)



Source: World Bank staff calculations.

Figure 12: Change in nonoil GDP growth rates, 2013-16
(Percentage points)



Source: World Bank staff calculations.

The GoK implemented further stimulus measures in 2014–17 to offset the impact of the most recent fall in oil prices. These economic support programs were financed with exceptional drawdowns from the NFRK and additional foreign borrowing. The One Trillion Tenge program

(totaling about KZT 1.2 trillion, or US\$6.2 billion) was launched in 2014 and included funds for the resolution of NPLs that emerged in the 2007–08 banking crisis and support to the private sector (SMEs and SOEs).⁷ A second support program, launched in early 2015 and running through 2017, was an infrastructure development program, Nurly Zhol (Bright Path). The bulk of financing (about US\$9 billion) for the Nurly Zhol program came from the NFRK plus additional project disbursements from international financial institutions. This program includes significant transport infrastructure investments, investment in utilities, support to social sectors (including housing), and support to the business sector. About one-quarter of these programs channel funds directly to SOEs. In addition to providing economic stimulus, the Nurly Zhol program was meant to help diversify the economy away from the oil sector and toward sectors such as agribusiness, manufacturing, trade and logistics, tourism, information technology, and finance (Box 1). In total, the two stimulus programs implemented since 2014 amounted to KZT 5.7 trillion (equivalent to US\$20 billion, approximately 12 percent of GDP).

Box 1: The Nurly Zhol stimulus program

The Nurly Zhol program targeted the development of seven priority sectors:

1. *Transport and logistics infrastructure.* Main road projects include those linking China to Western Europe and Astana to Almaty. A logistics hub is being created in the east of the country, while port infrastructure is being developed on the Caspian Sea coast.
2. *Industrial and tourism infrastructure.* Projects include the completion of infrastructure in existing special economic zones and the construction of new industrial zones.
3. *Energy infrastructure.* Main projects include the construction of high-voltage lines spanning Ekibastuz, Semey and Ust-Kamenogorsk, and Semey to Aktogay, Taldykorgan and Almaty.
4. *Public utilities infrastructure and water and heat supply networks.* In addition to the funds already budgeted for the modernization of heat and water supply systems, up to US\$540 million annually will be allocated to accelerating the upgrades.
5. *Housing infrastructure.* Social housing will be constructed and made available for long-term rent with the right to buy. Low-interest rate loans will boost housing affordability.
6. *Social infrastructure.* Kindergartens are to receive an additional KZT 20 billion; higher-education institutions will also receive new funding.
7. *Small- and medium-size enterprises and business activities.* Loans totaling US\$837 million will help increase the output of the SME sector to 50 percent of GDP by 2050.

Source: Government of Kazakhstan.

Although smaller than the massive 2007–10 anti-crisis program, the most-recent fiscal stimulus was also sizeable. In contrast to the 2007–10 anti-crisis program, which aimed to ensure financial sector stability, the 2014–15 stimulus targeted the private sector and investment in infrastructure through the Nurly Zhol program. However, like the 2007–10 anti-crisis program, the relative efficiency of the 2014–15 fiscal stimulus is unclear. Nonetheless, it appears that, since the collapse of the price of oil in 2014, Kazakhstan’s nonoil economy has been relatively less

⁷ The economic support program recapitalized the Problem Loans Fund (PLF) in 2014 with KZT 250 billion (equivalent to US\$1.4 billion) in order to reduce NPLs, which constituted about 23.5 percent of total bank loans. Following the delicensing of BTA Bank and the purchase-and-assumption of BTA by Kazkommertsbank in June 2015, the PLF placed its funds as a deposit at Kazkommertsbank to provide liquidity on the condition that the bank reduce its NPL ratio to 10 percent by end-2015. The authorities also extended tax exemptions for NPL write-offs and strengthened prudential regulation through new requirements for calculation of capital adequacy in accordance with Basel III, in effect from January 2015. This is expected to improve banks’ risk management and soundness. Moreover, the banking sector has been buoyed by liquidity injections, to the benefit of specific sectors. Thus, while overall bank lending slowed and then contracted in 2014–16, lending to small and medium-size businesses through the Entrepreneurship Development Fund “Damu” grew, much of it in long-term credits.

resilient than other oil-producing countries. Nonoil GDP growth declined by 8.8 percentage points in the three years from 2013 to 2016, the third largest decline compared to nine other oil-producing economies over the same period (Figure 12).

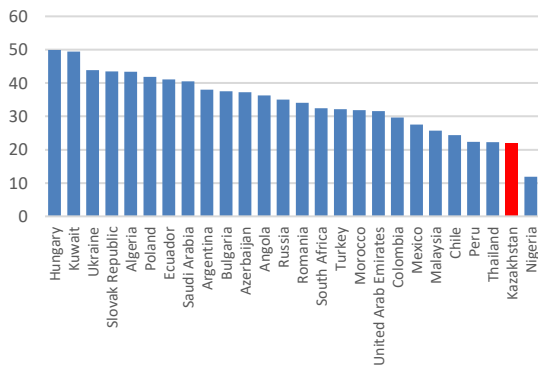
The authorities launched a broad-based institutional reform program— “One Hundred Concrete Steps, a Modern State for All”—in May 2015. The so-called “100 Steps” program includes reforms to public administration, the regulatory framework, public financial management and accountability, the management of the SOE sector, and sectoral and other reforms. The overarching goal of the program was to strengthen governance and reduce the state’s role in the economy. The legislative package containing these reforms was approved in December 2015. A privatization program has also been introduced by the authorities. Both programs are currently being implemented.

The need for a fiscal adjustment to reflect the new normal of oil prices

With oil prices unlikely to return to pre-2014 levels, Kazakhstan should implement medium-term fiscal consolidation to buttress fiscal sustainability. The current nonoil deficit is too high to ensure long-term sustainability in the low oil price environment. The sharp and sustained oil price drop has reduced the value of Kazakhstan’s oil wealth while the stimulus packages enacted since 2009 have increased the nonoil deficit to unsustainable levels. Under a pessimistic scenario of a delayed fiscal adjustment, in which the nonoil deficit remained at about 9 percent of GDP over the next decade despite a projected gradual increase in oil prices to about US\$77 a barrel, Kazakhstan’s net financial assets would decline dramatically. By 2025, this scenario would see NFRK assets drop to 29 percent of GDP (from 34 percent of GDP in 2017) while public debt would increase to 40 percent of GDP (from 20 percent of GDP in 2017). As a result, GoK’s net financial assets would turn negative, falling to -11 percent of GDP by 2025 (Table 1). While the debt-to-GDP ratio would remain relatively manageable, financing costs could rise as markets would expect Kazakhstan to accumulate more financial assets given its oil revenues.

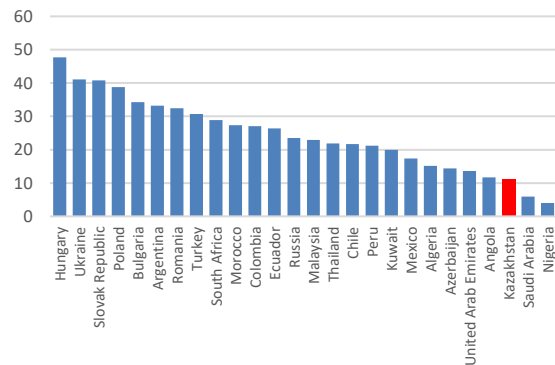
Benchmarking Kazakhstan’s government spending and nonoil revenue as a proportion of GDP provides insights into how fiscal adjustment could proceed. The broad picture that emerges when considering Kazakhstan’s public expenditure and nonoil revenue in comparison to several other upper-middle-income and oil-producing economies is that Kazakhstan *largely underspends while nonoil revenue collection largely underperforms*. Among 26 economies, Kazakhstan has the second-lowest level of total public expenditure as a percent of GDP (Figure 13). Kazakhstan spends more than Nigeria and about the same as Thailand and Peru, but significantly less than all other economies considered. Nonoil revenue is also among the lowest as a percentage of GDP compared to several other oil-producing countries (Figure 14). Nonoil revenue in Kazakhstan is higher than in Saudi Arabia and Nigeria but below collections in Algeria, Angola, Azerbaijan, Kuwait, Russia, and the United Arab Emirates.

Figure 13: General Government total expenditure: average 2014–15 (Percent of GDP)



Source: World Bank staff calculations based on data from the IMF World Economic Outlook.

Figure 14: General Government nonoil revenue: average 2014–15 (Percent of GDP)



Source: World Bank staff calculations based on data from the IMF World Economic Outlook.

It can be argued that these comparisons are distorted by the fact that Kazakhstan executes some expenditure programs—such as the recently-implemented stimulus packages—off-budget. However, off-budget spending has also taken place in other resource-exporting countries. With the exception of implicit subsidies to public consortia through loans at below-market interest rates, Kazakhstan is relatively transparent about off-budget spending.⁸ In 2014–15 off-budget spending was estimated at about 5 percent of GDP, comprising government programs executed by SOEs (3.4 percent of GDP on average), off-budget financing of capital expenses (0.6 percent of GDP on average), and spending by other off-budget funds, for example the Unified Accumulative Pension Fund and the State Social Employment Insurance Fund (1 percent of GDP on average). Adding off-budget spending to General Government on-budget spending would bring Kazakhstan’s total public expenditure to about 27 percent of GDP—a level similar to that of Mexico but significantly below expenditure levels in Algeria, Azerbaijan, and Russia.

Considering Kazakhstan’s relatively low level of public spending, there is little room for fiscal consolidation driven exclusively by cuts to public expenditure. There is, however, room for efficiency gains in public spending; these should be prioritized over any increase in the overall spending envelope. To reduce the nonoil deficit, programs that are inefficient or support the old economic structure, including via SOEs, will need to be eliminated or phased out prior to any significant increase in overall public spending. Redirecting expenditure allocations toward areas that improve the productivity of the nonoil sector and support market-based growth will be critical for establishing the new economic growth model in the years to come. Fiscal consolidation should focus on increasing nonoil tax revenue by balancing efforts to eliminate inefficient tax exemptions and loopholes, expand the tax base and raise tax rates. The potential for boosting tax collections by eliminating exemptions and closing tax loopholes is significant. According to government estimates, the revenue cost of tax expenditures just for the CIT and VAT in 2016 was almost KZT 3 trillion (6 percent of GDP).

1.2 The search for an appropriate fiscal anchor

There are myriad challenges to implementing a coherent fiscal framework in Kazakhstan. The new NFRK rule, adopted in December 2016, emphasizes the need to target the nonoil deficit and to progressively limit the amount of “guaranteed transfers” from the NFRK to the budget

⁸ See the expenditure chapter of the PFR for more information.

(Annex A.2).⁹ Successive reforms of the NFRK rule have aimed to balance economic stabilization with fiscal discipline to generate savings for future generations. However, the new NFRK framework leaves considerable room for discretion in transferring resources from the NFRK beyond the guaranteed amounts; this could have a negative impact on savings over time but also on investor confidence. While pursuing a fiscal consolidation effort over the medium term, there are potential benefits to reviewing the fiscal framework with the goal of strengthening its coherence, credibility, and flexibility. The main attributes of a coherent and credible fiscal framework for a resource-exporting economy and the criteria for choosing the right fiscal anchor are discussed below. In reviewing the successful experience of other countries, the section focuses in particular on the examples of Norway and Chile.

Challenges to the implementation of fiscal policy in Kazakhstan

A review of the evolution of Kazakhstan’s fiscal framework reveals that the GoK already follows elements of a fiscal rule. The fiscal framework values transparency—all oil revenue (except customs duty on oil exports, which goes directly to the budget) accrue to the NFRK, which is the sole conduit for transfers to the national budget. Successive attempts to refine the NFRK rule have aimed to better define the fiscal rule, reflect the desire to balance economic stabilization with fiscal discipline to generate adequate savings for future generations. If the size of fiscal transfers from the NFRK to the national budget is the target variable, the government has clearly made efforts to define a sustainable level of transfers under the various NFRK concepts since 2007. Nonetheless, the NFRK rule leaves room for discretion for one-off transfers for stimulus programs and support to SOEs and other public entities, although there has been a clear trend toward minimizing this discretion over time.

By adopting a target for the nonoil deficit, the authorities added an important anchor to the fiscal framework in 2016. Total guaranteed transfers from the NFRK to the budget are fixed at KZT 2 trillion from 2020. This is below the nonoil deficit target, which is set on a declining trend (from 13 percent of GDP in 2017 to 6 percent of GDP in 2025). The remaining nonoil deficit financing gap will be covered through net borrowing and, as a result, Kazakhstan’s gross public debt (which stood at 20 percent of GDP in 2016) will rise.

Despite the GoK’s efforts to refine the fiscal framework, there remains room for improvement. Key points that merit further attention include the following:

- The new fiscal framework leaves considerable room for discretionary resource transfers from the NFRK beyond the rule-based guaranteed amounts, which could have a negative impact on savings over time. Despite the planned reduction of guaranteed transfers from the NFRK to the budget, targeted transfers totaling KZT 1.5 trillion (3 percent of GDP) were already slated for 2017. These funds will be used to absorb NPLs in the banking system. Unpredictable targeted transfers from the NFRK to the budget could put the credibility of the new fiscal framework at risk, with negative consequences for investor confidence and borrowing costs, both for the GoK and for the economy overall.
- Guaranteed transfers from the NFRK to the state budget are constant over time without any reference to oil revenue developments due to possible changes in oil prices. The sustainability of these transfers could be undermined if oil prices were to decline further or, conversely, discretionary transfers could rise if oil prices were to increase considerably in the future.
- The use of a dual target—for the guaranteed transfers from the NFRK to the budget and for the nonoil deficit—complicates the fiscal policy stance unnecessarily.

⁹ Presidential Decree 825 of December 8, 2016, on the Concept on Formation and Use of the National Fund of the Republic of Kazakhstan.

Actions by the GoK will need to be taken on two fronts to sustain the fiscal consolidation effort over the medium term. The GoK would need to: (i) prioritize spending to support the new economic growth model and generate adequate nonoil budget revenue; and (ii) review the fiscal framework to make it more credible and flexible. The GoK could adopt a fiscal rule based on an explicit target to better anchor fiscal policy for stabilization purposes while generating the desired savings. The GoK could also spell out more clearly the fiscal rules to avoid ambiguities while ensuring that these rules are flexible enough to accommodate changes in the economic environment. The next subsection discusses some options for such a policy reform.

Criteria for a coherent fiscal framework

The volatility, uncertainty, and exhaustibility of oil revenue pose challenges for the design of an appropriate fiscal policy framework in Kazakhstan. A coherent fiscal framework for a resource-exporting economy needs to ensure that it:

- Promotes short-term macroeconomic stability by delinking fiscal policy from the volatility of oil prices;
- Helps to achieve long-term fiscal sustainability by generating sufficient savings for future generations (when the natural resources will be exhausted);
- Allocates sufficient resources to meet development needs and promotes the structural transformation and diversification of the economy.

In response, the fiscal framework should be internally consistent, with clear guidance and communication on the course of fiscal policy over the short- and medium-term. The fiscal framework will need to be underpinned by strong institutional arrangements to bolster policy credibility and investor confidence. In resource-rich economies, there has been increasing attention to how institutional arrangements can reduce volatility and promote fiscal discipline. Such institutional arrangements typically include fiscal rules, sovereign wealth funds, fiscal responsibility laws, and fiscal advisory councils.¹⁰ Norway and Chile stand out among the countries with the most successful fiscal frameworks and institutions to manage natural resource wealth.

Three critical issues have to be addressed when designing an appropriate fiscal policy framework. These issues, which are discussed in detail below, are: (a) the choice of a fiscal anchor (or indicator) around which any fiscal rules or guidelines will be framed; (b) the setting of an appropriate target for the fiscal anchor; and (c) the desired degree of flexibility for achieving the target for the fiscal anchor when unexpected economic developments occur.

a) The choice of an anchor for the fiscal rule

In oil-dependent economies there are two broad options for a fiscal anchor: (i) the nonoil fiscal balance, defined as the difference between public expenditure and nonoil fiscal revenue; and (ii) the structural fiscal balance, the result of a budget formulated using a smooth, benchmarked oil price over time. Such price-based rules are typically coupled with targets for the overall fiscal balance.

The nonoil fiscal balance rule helps to tie short-term fiscal policy to the long-term, sustainable use of oil revenue. The target for the nonoil deficit, in effect, acts as a deficit ceiling that has to be covered in a sustainable way by oil revenue and net borrowing. Moreover, targeting the nonoil fiscal balance can help to delink fiscal policy from oil revenue fluctuations, reducing economic vulnerability. The nonoil fiscal balance also measures the underlying fiscal policy

¹⁰ Sharma and Strauss 2013.

stance, helping policy makers to assess the extent to which government expenditure and taxation boost or dampen domestic demand—loosening or tightening fiscal policy, respectively.

The structural, price-based fiscal balance rule relies on a predetermined benchmark oil price. This approach effectively delinks spending from the price-induced fluctuations of oil revenue, helping to ensure that oil price volatility does not contribute to cyclical fiscal policy swings. The benchmark oil price is usually based on long-term historical and future prices or their combination; in that sense, the rule is defined as a “structural” fiscal balance. In contrast to the nonoil deficit rule, price-based rules have a short- to medium-term focus and can, therefore, provide a near-term anchor for fiscal policy. In principle, exhaustibility issues and changes in oil production are bypassed by this approach, although the target set for the fiscal balance can be calibrated to achieve the desired level of long-term savings.

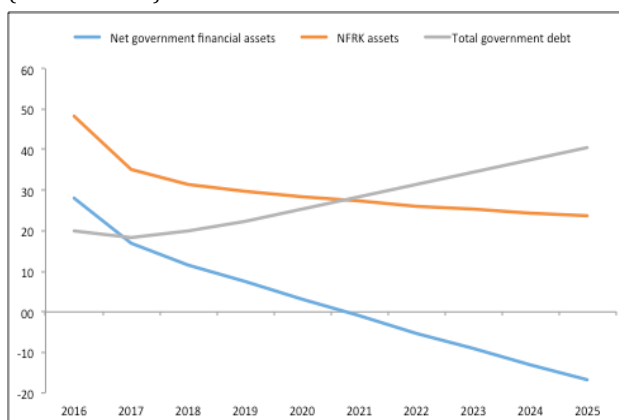
b) Setting an appropriate target for the fiscal anchor

If the nonoil deficit is the anchor of the rule that underpins the fiscal framework, the target should be set using a conservative estimate of annual oil revenue over a long-term horizon.

Under such a rule, the targeted nonoil deficit is financed by an annual transfer from a sovereign wealth fund (SWF). This target is typically set to ensure the desired level of savings for intergenerational equity but also the stability of the transfers over time. The fiscal framework should be underpinned by an appropriate target for long-term savings. If the non-oil deficit in Kazakhstan remained at around 8-9 percent of GDP over the next 10 years, and despite a projected smooth increase in the price of oil to around \$77 over the same period, Kazakhstan’s net worth would be dramatically reduced (Figure 15). By 2025 NFRK assets would decline to 29 percent of GDP, from 48 percent in 2016; public debt would increase to 40 percent of GDP, from 20 percent in 2016, while Government net worth would turn negative, reaching -11 percent of GDP in 2025. While the debt-to-GDP ratio would not be too high, the cost of government market financing could increase, as markets may expect Kazakhstan to accumulate more financial assets given its oil revenues.

Figure 15: Projected NFRK assets, public debt, and Government net worth: 2017-2025

(Percent of GDP)



Source: World Bank staff calculations based on data published by the authorities.

By 2025 NFRK assets would decline to 29 percent of GDP, from 48 percent in 2016; public debt would increase to 40 percent of GDP, from 20 percent in 2016, while Government net worth would turn negative, reaching -11 percent of GDP in 2025. While the debt-to-GDP ratio would not be too high, the cost of government market financing could increase, as markets may expect Kazakhstan to accumulate more financial assets given its oil revenues.

The estimated permanent oil income stream over time usually serves as a reference for setting the nonoil deficit target. The oil income stream under the permanent income hypothesis (PIH) is calculated as the perpetuity value, or the present value of all estimated future oil revenue. Because the projection horizon is long, the estimates are sensitive to changes in critical parameters such as the price of oil, the level of reserves, and the discount rate. If oil prices decline—and are projected to remain low for a long enough time period—the permanent oil income stream and the associated target for the nonoil deficit would have to be lowered. This is currently the case in Kazakhstan. The permanent oil income stream (excluding customs duty on oil exports that are channeled directly to the budget) is projected at between US\$2.5 billion and US\$5.7 billion (2–4 percent of GDP) per year in a baseline scenario (Table 4). If customs duty on oil exports and net borrowing streams are added, the nonoil deficit would be 4–6 percent of GDP.¹¹

¹¹ The GoK has set a target for net borrowing (the State budget deficit) of 1 percent of GDP per year.

Table 4: Permanent income-based annuity value scenarios
(In real 2010 U.S. dollars)

	Oil reserves estimates	Oil price assumption		Annuity transfer at real rate of return	
				1%	2%
Baseline:	4 billion tons	Historical 40-year mean*	\$45	\$2,493	\$4,496
	(30 billion barrels)	Mean + ½ standard deviation	\$60	\$3,165	\$5,674
High case:	5.3 billion tons	Historical 40-year mean*	\$45	\$3,270	\$5,584
	(40 billion barrels)	Mean + ½ standard deviation	\$60	\$4,201	\$7,124

Source: World Bank staff estimates.

Note: * The historical 40-year mean calculation is for the period of 1977–2016. Annuity transfer amounts are expressed in real 2010 U.S. dollars.

A PIH target for the nonoil deficit is more relevant for economies with a relatively short reserve horizon for resources. If the resource horizon is long, the permanent annual oil stream may be relatively small, making the target for the nonoil deficit inadequate for expenditure that promotes long-term development. However, a modified version of the PIH can be designed to accommodate the scaling-up of capital expenditure to allow a more front-loaded spending path which can be offset by lower spending in the future.¹² Such an approach needs a transparent procedure to approve scaled-up capital expenditure if economically justified.

Alternatively, the target for the nonoil deficit could be set at a level equal to the annual income stream derived from the accumulated financial assets of the SWF. This is a “bird-in-hand” approach which is very conservative and places a high premium on the uncertainty of the value of unrecovered oil reserves, essentially providing full insurance against the risk of a shock that would significantly diminish their value. However, since natural resource wealth would likely be greater than accumulated financial wealth (prior to the exhaustion of reserves), the rule would lead to a very restrictive expenditure pattern, postponing spending to the future.¹³ The “bird-in-hand” approach may not be appropriate at this juncture for Kazakhstan. As Kazakhstan is at a relatively early phase of the extraction cycle, the earned investment income is currently relatively low and will keep growing in the future. Moreover, the estimated rate of return on NFRK assets is currently relatively low, at about 1.2 percent. Applying this approach at the current stage of the extraction cycle would unduly constrain the nonoil deficit target

Regardless of the rule used to set the target for the nonoil deficit, a cyclically-adjusted nonoil deficit would be a more accurate measure of the fiscal stance. The economic cycle of the nonoil economy is often not well defined, while it is difficult in oil-dependent economies to disentangle cyclical changes in nonoil tax revenue from changes reflecting the impact of oil prices on the nonoil economy. A cyclically-adjusted nonoil deficit target may, therefore, be challenging to implement. Moreover, given the large fluctuations of total GDP resulting from the volatility of oil revenue, the nonoil fiscal balance should ideally be scaled to nonoil GDP. Otherwise, large declines in oil prices would automatically increase the nonoil deficit in proportion to total GDP. This may trigger unnecessary fiscal adjustment. Conversely, booming oil prices would reduce the nonoil deficit as a proportion of total GDP, possibly leading to unwarranted fiscal policy relaxation. It is critical to use a comprehensive measure of the nonoil deficit as a policy anchor, reflecting General Government operations.

Another option for a coherent fiscal framework is to adopt a price-based rule for the structural budget, based on a long-term price benchmark for the price of oil. Such price-based rules are typically coupled with targets for the overall fiscal balance. They target a certain level of the fiscal balance calculated at a predetermined benchmark oil price. This approach helps

¹² Baunsgaard and others 2012.

¹³ World Bank 2010a.

delink spending from the price-induced fluctuations of oil revenue, thus helping to ensure that oil price volatility does not contribute to cyclical swings of fiscal policy. The benchmark oil price is usually based on long-term historical and future prices or their combination and in that sense the rule defines a “structural” fiscal balance. As opposed to the non-oil fiscal deficit rule, price-based rules have a short- to medium-term focus and can thus provide a near-term anchor for fiscal policy. Exhaustibility issues and changes in oil production are in principle ignored by this approach although the target set for the fiscal balance can be calibrated to achieve the desired level of long-term savings. In a recent analysis of Kazakhstan’s fiscal framework the IMF considered two price-based rules for the structural fiscal balance ([Annex A.3](#)).

Commodity reference prices for the structural fiscal balance when price-based rules are used can be calculated on the basis of various formulas. Price formulas can be a moving average of either past prices or of past spot and futures (market) prices. The choice of the benchmark price involves a trade-off between expenditure stability that the government wishes to achieve and the desired level of financial savings. A long moving average of historical oil prices achieves the greatest degree of expenditure smoothing, but may also lead to insufficient savings if the oil price drops sharply. Conversely, a short moving average of past prices would generate higher spending volatility but also higher savings, thanks to faster adjustment of the price benchmark to the price change. Moreover, the target for the structural budget balance should more appropriately be formulated in terms of the primary balance (that is, the fiscal balance excluding interest payments on the public debt). Targeting the primary budget balance imposes an effective constraint on borrowing needs and thus on the dynamics of public debt.

c) The desired degree of flexibility for fiscal targets, based on the examples of Norway and Chile

The case of Norway provides an example of the successful application of the nonoil fiscal balance rule. Chile is an example of the successful use of a price-based rule for the structural fiscal balance.¹⁴

Norway operates the Government Pension Fund Global (formerly the Petroleum Fund), which receives oil revenue net of the annual transfer to the budget. Serving savings and stabilization purposes, the Government Pension Fund is required to invest its capital abroad to avoid overheating the economy and to shield it from oil price fluctuations.¹⁵ Withdrawals from oil revenues finance the nonoil deficit, determined each year during the annual budget process ([Diagram 2](#)). Since 2001, fiscal policy has been anchored by a structural deficit rule requiring the cyclically-adjusted nonoil deficit to equal the imputed real return on the assets in the pension fund, estimated at 4 percent per year. By constraining government expenditures to cyclically-adjusted government revenues plus the structural balance target, the rule ensures that fiscal policy does not deviate from a sustainable path over time. Because the Norwegian rule targets the cyclically-adjusted nonoil balance, it allows for deficits to exceed the 4 percent target during economic downturns. It also enforces lower deficits during boom periods, reducing pressures on aggregate demand and stabilizing economic activity.

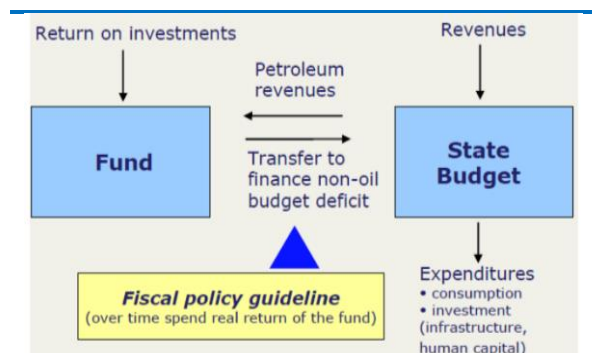
In Chile, fiscal policy is anchored by the requirement of a balanced structural budget, institutionalized in the 2006 Fiscal Responsibility Law. Under the structural balance rule, government expenditures are budgeted so as to match cyclically-adjusted revenues. Those are the revenues that would be realized if the economy were operating at high potential and prices for copper and molybdenum—Chile’s major exports—were at their assumed long-term levels.

¹⁴ World Bank 2013a.

¹⁵ The diversified investment portfolio comprises international equity, fixed-income, and real estate assets, with the aim of maximizing the risk-adjusted rate of return within the investment policy set by the Ministry of Finance. Norway also operates a second SWF, the Government Pension Fund Norway (formerly the National Social Insurance Fund), which is financed from surpluses generated by the social insurance scheme. The two separate SWFs have different funding sources, management arrangements, and investment policies.

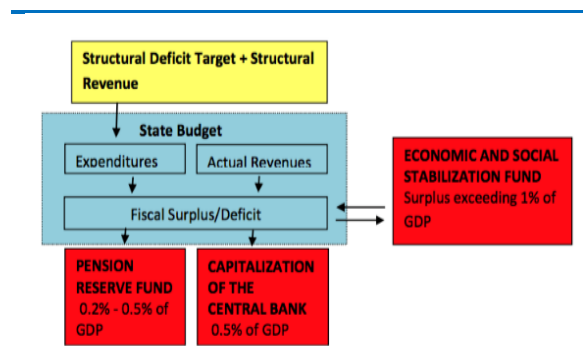
The framework is designed to ensure long-term fiscal sustainability while avoiding cyclical policies and allowing the full operation of automatic stabilizers, mostly on the revenue side. One difference from Norway’s fiscal framework is that in Chile the oil revenue initially accrues to the budget and the fiscal surpluses are then transferred to the two SWFs (Diagram 3).¹⁶ By contrast, in Norway oil revenue accrues to the SWF, which finances the nonoil deficit through a transfer according to the target set by the “bird-in-hand” rule. Kazakhstan’s fiscal framework mimics Norway’s arrangement, the difference being that the amount transferred from the NFRK to the budget is fixed arbitrarily and the recently-introduced target for the nonoil deficit is not clearly linked to a rule ensuring the sustainability of oil revenue over time.

Diagram 2: Fiscal policy and SWF in Norway



Source: Ministry of Finance, Norway.

Diagram 3: Fiscal policy and SWF in Chile



Source: Ministry of Finance, Chile.

As the good practice examples of Norway and Chile show, Sovereign Wealth Funds can be useful tools for macro-fiscal management in resource-rich countries. However, a SWF should not be confused with the fiscal framework; the SWFs’ inflow-outflow rules are not tantamount to fiscal rules. SWFs are best seen as complementary policy tools. The role of the SWF in a sound fiscal framework should be to:¹⁷

- Support the implementation of stable fiscal policies, including by financing countercyclical policies;
- Enhance the transparency of oil and mineral resource revenues and associated savings;
- Maximize the yield of the government’s financial savings.

Therefore, SWFs should be integrated into the budget to ensure its integrity and protect its role as the mechanism to set expenditure priorities and efficiently allocate public financial resources. A SWF could be seen as a financial account linked to the budget to which surplus resource revenue is transferred and from which withdrawals are made when budgeted resource revenue undershoots projections. The example of the Chilean SWF is a good example of this practice. SWFs funds should not have the authority to spend outside the budget.

Establishing an independent fiscal council, as in the case of Chile (Box 2)—to enhance the credibility of the fiscal framework by ensuring an unbiased application of the adopted fiscal rule—would be a promising reform option in Kazakhstan. Fiscal councils are non-

¹⁶ Two sovereign wealth funds support the Chilean fiscal framework. The Pension Reserve Fund accumulates and invests fiscal savings to cover long-term pension liabilities, receiving a minimum annual deposit equal to 0.2 percent of the previous year’s GDP. However, if the effective fiscal surplus exceeds this amount, the contribution can rise to a maximum of 0.5 percent of the previous year’s GDP. The Economic and Social Stabilization Fund is financed from the remainder of the effective fiscal surplus after payments into the pension fund. Withdrawals from the stabilization fund can finance fiscal deficits during periods of weak growth or low copper prices and they can pay down public debt or finance the pension fund. Both funds may invest only in assets abroad and, under current investment policies, are limited to fixed income and money market instruments.

¹⁷ Budina and others 2012.

partisan agencies with a mandate to assess fiscal policies, plans, rules, and performance.¹⁸ Such a council would be particularly helpful if the fiscal rule involves the calculation of either long-term oil price benchmarks (as in the price-based rule for the structural fiscal balance) or a PIH-type of annuity (as in the nonoil deficit rule). Fiscal councils have become more widespread, both among EU member states and emerging and developing economies including Colombia, Uganda, South Africa and, more recently, Peru. The number of fiscal councils worldwide has more than tripled since the global financial crisis; the IMF identified 39 economies that operate fiscal councils at end-2016.¹⁹

Box 2: Chile's independent fiscal advisory bodies

Fiscal policy in Chile has been anchored by a sustained political commitment to prudent policy, the adoption of a fiscal rule, and the enactment of a Fiscal Responsibility Law. Chile's fiscal framework includes two independent advisory bodies—the Advisory Committee on Trend GDP and the Advisory Committee for the Reference Copper Price—that play a role in macroeconomic and budgetary forecasting. Chile's revenue flows depend significantly on trend copper prices while the fiscal rule targets a balanced, cyclically-adjusted budget. The delegation of responsibility for projections of copper prices and trend GDP (which helps to assess the cyclically-adjusted GDP) to non-partisan advisory bodies helps limit potential forecasting bias. Despite the legally-binding projections from the two advisory bodies, the government (Ministry of Finance) is left with substantial leeway to define the overall resource envelope.

There are several ways in which an independent body or fiscal council, with circumscribed responsibilities, can potentially contribute to improved fiscal performance. Fiscal councils can help by limiting political influence over technical aspects of fiscal policy formulation or monitoring. They can be tasked with making independent macroeconomic forecasts or providing assumptions or projections of key variables or parameters on which budget projections can be based. Fiscal councils can also be tasked with making independent revenue and expenditure projections, whether based on current or prospective policies. Fiscal council assessments of long-run fiscal implications of tax and spending initiatives also can contribute to improving the transparency of budgetary decisions. In some instances, fiscal councils can be assigned a key role in monitoring fiscal performance under a politically agreed medium-term fiscal framework. Existing institutions include several of these functions, which combine independent macroeconomic and budgetary projections with a mandate to assess performance relative to prior commitments to a medium-term fiscal framework or a numerical rule. Some institutional steps toward establishing such a body via strengthening audit and reporting to parliament are discussed further in chapter 4.

To effectively deliver on their tasks, an independent fiscal council would need to build and maintain strong institutional credibility. This requires insulation from political interference—a particularly challenging precondition in the case of Kazakhstan. The experience of independent central banks, including of the NBK, can provide important lessons here. Key preconditions include: First, similar to central banks, fiscal councils require institutional independence, separate from other bodies of government.²⁰ They should have broad and timely access to information, particularly detailed budgetary data. Second, fiscal councils should be functionally independent. They should be free to communicate publicly in order to effectively mobilize public opinion and, if necessary, to counteract political incentives for unsound fiscal policies. Third, members of national fiscal councils require personal independence. They should be appointed on

¹⁸ Debrun and others 2013; Hagemann 2011.

¹⁹ For more information about the fiscal councils, see the IMF Fiscal Council Dataset's website at <http://www.imf.org/external/np/fad/council/>.

²⁰ See opening remarks by Benoît Cœuré, Member of the Executive Board of the ECB, at the workshop on "Fiscal councils, central banks and sound public finances", Frankfurt am Main, 27 January 2016 (<https://www.ecb.europa.eu/press/key/date/2016/html/sp160127.en.html>)

the basis of their professional qualifications for a fixed term. They should be relieved of their duties only in exceptional circumstances, for example in cases of serious misconduct. Fourth, fiscal councils require financial independence with sufficient resources to deliver on their mandate. Independent fiscal institutions should be, for example, funded directly by parliament rather than from the government budget.

1.3 A fiscal framework to promote fiscal consolidation and economic transformation

Key challenges for Kazakhstan will be to withdraw the fiscal stimulus, to adjust to the new normal, to ensure fiscal sustainability, and to support economic transformation. The fiscal stimulus should be withdrawn immediately (starting from 2018), consistent with a sustained recovery of the nonoil economy. This process will require an acceleration of structural reforms and an appropriate fiscal policy to bolster nonoil sector growth. With oil prices set to remain low for the foreseeable future, a key fiscal policy challenge is to enable the structural transformation of the economy to a new model where growth is mainly driven by the nonoil tradable sector. This will require action on three at least three critical fronts:

- *Structural reforms.* For Kazakhstan's tradable nonoil sectors to become the engine of a new growth model for the economy, structural reforms will be needed to channel resources to these sectors. A supportive regulatory environment will be needed for this to happen.
- *Adoption of new fiscal framework.* A critical outstanding reform that would support a more efficient economy and government sector is the adoption of a fiscal framework consistent with a new growth strategy that leads to a sustained reduction in the nonoil deficit.
- *Fiscal policy reforms and reallocation of expenditure.* Changes in fiscal policy will be required. Kazakhstan underspends compared to other upper-middle-income emerging economies while, undermined by a broad array of tax exemptions and special tax regimes, revenue mobilization underperforms. To achieve efficiency gains in spending, a reallocation of expenditure toward more productive uses—especially in education, healthcare, and infrastructure—will also be needed.

On the structural front, Kazakhstan needs to implement a series of reforms to restructure the economy. The GoK passed a plethora of laws that aim to strengthen governance and diversify the economy in 2014 and 2015, including the 100 Steps program. Most of the 100 Steps initiatives include legal and institutional reforms intended to professionalize the public administration, increase state transparency and accountability, and enforce the rule of law. The government now faces the arduous task of implementing these reforms. New policies will also be needed to reduce the influence of the SOE conglomerates so that the private sector can operate in a more competitive environment. About 700 SOEs in Kazakhstan are slated for privatization in the next three years. However, despite the importance of the privatization agenda, the government's strategy regarding the SOE sector (and especially the SK) has yet to be clearly articulated.

Other significant structural issues need to be addressed to manage fiscal risks. These structural issues, which could impair growth if not addressed, include: (i) the contingent liabilities of large SOE holdings (in the form of external debt or other obligations); (ii) the spin-off state agencies created for infrastructure or services; (iii) a financial sector that does not fuel growth and could create more fiscal costs; (iv) the risks associated with the continuous substitution of commercial lending with state lending; and (v) management of pension and health insurance obligations. Repairing the banking system to remove acute financing bottlenecks is a key precondition for economic transformation. Doing so will help scale down existing expenditure programs of questionable effectiveness that burden the budget and the NFRK with the aim of supporting private sector financing.

On the fiscal front, the government should phase out the countercyclical fiscal stimulus program. The expansionary fiscal stance adopted since 2014 has resulted in an increase in the nonoil deficit and a significant increase of transfers from the NFRK for the stimulus program. The nonoil deficit of the consolidated budget (the State budget and the NFRK) increased from 8.4 percent of GDP in 2013 to about 13 percent in 2014–17 (Table 5). At the same time, the annual transfers from the NFRK rose from 5 percent of GDP on average before 2013 to 7.7 percent of GDP on average during 2014–17, far exceeding gross inflows of oil revenue to the NFRK.

Table 5: General Government key fiscal accounts
(Percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017e
Total revenue and grants	27.9	28.9	28.8	26.7	24.5	18.6	19.7	21.1
Oil revenue	11.2	13.9	13.9	12.1	10.3	4.0	4.5	5.7
NFRK gross revenue	11.1	12.2	12.0	10.5	8.3	2.3	3.0	3.9
Customs duty on oil exports	0.1	1.7	2.0	1.6	2.0	1.7	1.5	1.8
Nonoil revenue	16.7	15.0	14.9	14.6	14.3	14.6	15.2	15.4
State budget	13.9	12.9	12.2	12.1	11.4	10.8	12.2	12.3
Other extra-budgetary funds (excluding the NFRK)	2.7	2.1	2.7	2.5	2.9	3.7	3.0	3.1
Expenditure and net lending	23.8	21.5	22.5	21.1	23.0	24.7	24.1	25.8
State budget (excluding NFRK)	16.6	16.8	17.2	15.8	16.3	14.9	15.3	16.5
NFRK consumption	6.5	4.3	4.7	4.6	6.1	8.6	6.8	8.5
Other extra-budgetary funds	0.6	0.5	0.6	0.6	0.6	1.1	1.9	0.8
Overall fiscal balance	4.1	7.4	6.3	5.6	1.5	-6.1	-4.4	-4.6
State budget deficit	-2.6	-2.1	-3.0	-2.1	-2.9	-2.4	-1.7	-2.4
NFRK net fiscal savings	4.6	7.9	7.3	5.9	2.2	-6.3	-3.8	-4.5
Other extra-budgetary funds	2.1	1.6	2.1	1.9	2.2	2.6	1.1	2.3
Nonoil fiscal balance	-7.1	-6.5	-7.6	-6.4	-8.8	-10.1	-8.9	-10.3
State budget and the NFRK	-9.2	-8.1	-9.7	-8.3	-11.0	-12.7	-10.0	-12.6
Other extra-budgetary funds	2.1	1.6	2.1	1.9	2.2	2.6	1.1	2.3
<i>Memorandum items:</i>								
Nominal GDP (KZT trillion)	21.82	28.24	31.02	36.00	39.68	40.88	46.97	52.24
Nominal GDP (US\$ billion)	148.0	192.6	208.0	236.6	221.4	184.4	137.3	160.2

Source: World Bank staff calculations based on data published by the authorities.

Note: Some sums may not add up exactly due to rounding; e=estimate.

With oil prices set to remain low in the medium to long term, the GoK should rebuild its fiscal buffers by consolidating the fiscal accounts over the medium term. The GoK's budget plan for 2018–20 envisages a significant decrease in government spending, including a substantial reduction in the net acquisition of nonfinancial assets, which in practice are primarily cash transfers to SOEs. Meanwhile, under the new NFRK rule, the GoK has prohibited off-budget lending from the NFRK to SOEs. Moreover, the GoK is reviewing potential tax policy reforms and tax administration modernization options to enhance nonoil revenues over the medium term. The government also plans to review the Tax Code. However, these reviews and revisions are still in their early stages, and it is not yet possible to gauge their prospective impact on nonoil revenue.

Despite these positive steps, from a long-run fiscal sustainability perspective, the nonoil deficit is still too high. The World Bank fiscal sustainability analysis suggests that the nonoil deficit needs to be cut by half. However, the method of adjustment of expenditure and revenue is as important as the reduction in the nonoil deficit itself. The purpose of a new fiscal framework should be to help adjust public expenditure and revenue in a way that will support a new growth

model that relies much more on non-commodity tradables and creates better jobs based on a more productive economy.

If the GoK wishes to maintain the nonoil deficit as an anchor of the fiscal rule that underpins the framework, as in the 2016 NFRK rule, the target for the nonoil deficit should act as a strict deficit ceiling. It would be more appropriate, however, to set the target for the nonoil deficit as a percentage of nonoil GDP. The target would also need to be drastically reduced over the coming years to achieve the desired level of savings. It should be set using a conservative estimate of annual oil revenue over a long-time horizon. The targeted nonoil deficit would need to be financed by sufficient transfers from the NFRK to prevent excessive debt accumulation. This target should ensure the sustainability of the NFRK, intergenerational equity and the stability of transfers over time.

The GoK acknowledges that fiscal consolidation is a prerequisite for placing Kazakhstan's economy on a sustainable path. To achieve the desired fiscal consolidation, the GoK should considerably strengthen fiscal management. Under the new the NFRK rule, the fiscal framework has moved closer to a rule anchored by a nonoil deficit target. However, as already argued above, the new fiscal framework includes targeting ambiguities and still leaves considerable room for discretion in transferring resources from the NFRK beyond the guaranteed amounts. This may have a negative impact on savings over time and also dent the credibility of the new fiscal framework, with a negative impact on investor confidence and the cost of borrowing for the GoK and the economy as a whole.

Strengthening the credibility of the fiscal framework is of paramount importance to reduce borrowing costs, attract more foreign investment and promote the economy's new growth model. While pursuing the fiscal consolidation effort in the medium term, the GoK would benefit from further reviewing the fiscal framework with the aim of strengthening its credibility and flexibility. A fiscal framework with a price-based rule for the structural fiscal balance provides an option for a credible fiscal framework with the flexibility needed to stabilize the economy and respond to shocks. The GoK could consider revising the fiscal framework in this direction in the future. Moreover, this fiscal framework provides guidance to the consolidation effort needed over the medium term. The required consolidation effort is estimated at about 6–7 percent of GDP (or 3–4 percent of GDP applied to the pre-crisis level of 9 percent of GDP) and would need to bring the nonoil deficit down to about 5–6 percent of GDP, the minimum required for the adjustment to the new normal (see an accelerated adjustment scenario in [Table 1](#)).²¹

1.4 Policy recommendations

The quality of the fiscal consolidation effort matters as much as its overall size. A fast-paced fiscal adjustment, which would be accomplished in 3–4 years (by 2020), would bolster policy credibility and investor confidence. This would make it possible to reduce Kazakhstan's borrowing costs and attract more foreign investment. A balanced fiscal adjustment would also command more credibility. This would require efforts on two fronts:

- Restructuring public spending by phasing out inefficient subsidy programs and refocusing expenditure toward investment in productive infrastructure, employment and education, while maintaining priority social spending (see the expenditure chapter of the PFR).
- Raising nonoil revenue by broadening the tax base and eliminating inefficient tax expenditure (see the nonoil revenue chapter of the PFR).

²¹ Official baseline targets are to bring the nonoil fiscal deficit down to 7 percent of GDP by 2020 and 6 percent by 2025.

A credible fiscal rule should also be underpinned by reforms to strengthen the fiscal policy institutional framework (see the fiscal policy institutions chapter of the PFR). This would require initiatives on fronts including:

- Transforming the NFRK into a financial account for asset management outside of the budget and phasing out discretionary oil revenue transfers to the budget or off-budget spending of NFRK resources.
- Establishing an independent fiscal council responsible for the monitoring of the implementation of the fiscal rule and setting the long-term benchmark oil price used as a reference for the formulation of the budget.
- Consolidating the expenditures of various extra-budgetary funds, including the Unified Accumulative Pension Fund, the State Social (Employment) Insurance Fund and the Health Insurance Fund (operationalized in mid-2017) into a unified General Government budget account (see further discussion of whole-of-government accounts in chapter 4).
- Estimating and managing implicit contingent liabilities arising from key SOEs.
- Containing external debt accumulation by developing the domestic market for government bonds.

Policy Focus 2: Improving Public Spending Efficiency and Effectiveness

In pursuing fiscal consolidation as part of the macroeconomic adjustment to a new normal, there is scope to enhance the impact of public spending on growth, including by helping to create the conditions for sustainable development of the nonoil tradable sector. This will require improving the quality of, and likely increasing spending on, health and education as well as a reduction and redirection of inefficient public expenditure away from programs that distort the environment for or crowd out private-sector development. Rather than replacing the market, public spending and investment should be re-oriented to enhance leverage and catalytic impact, particularly regarding the private-sector investment. High-quality and strategically-selected infrastructure projects can play such a role if they are transparently selected using rigorous criteria that assess their potential to spur economic activity and catalyze additional investment. Improvements in the framework for public procurement can also enhance the impact of public spending by reducing the cost and enhancing the quality of publicly-funded projects. To be able to undertake the kind of analysis that leads to better outcomes and more efficient resource use will require addressing important data gaps and committing to more systematic analysis of spending and outcomes.

2.1 Kazakhstan's expenditure landscape and pressures

A quick international comparison of Kazakhstan's government spending as a share of GDP suggests that, relatively speaking, Kazakhstan is not a big spender. Total State budget²² expenditure averaged only 22.2 percent of GDP between 2014 and 2016, compared with 34.3 percent for Commonwealth of Independent States (CIS) countries, 30.7 percent for emerging market and developing economies (EMDEs) and 46.8 percent for the European Union (Figure 16).²³

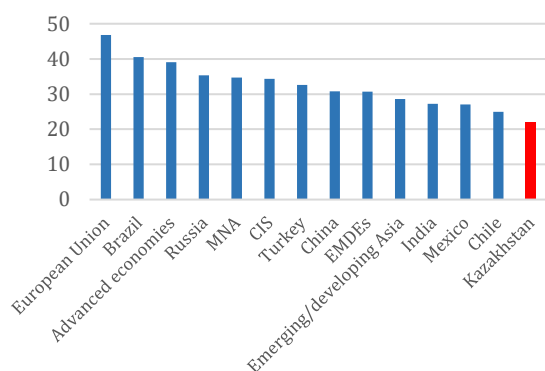
However, these figures, and their comparison to other economies and country groups, should be interpreted with caution. Kazakhstan's fiscal data significantly understates the extent to which the public sector consumes resources. Heavy reliance on off-budget spending and

²² The State budget is comprised of the fiscal accounts of the central and local governments.

²³ For purposes of comparability across countries, fiscal data used are from the IMF's World Economic Outlook (WEO) Database (<https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx>). WEO data are on an accrual basis. This means that items that represent an exchange of assets (that is, "net lending" and "recapitalization of SOEs") are not included in General Government current spending. Kazakhstan's fiscal accounts are on a cash basis and have therefore been adjusted in WEO data. Under cash-based accounting, the purchase of assets (including lending activities) are treated as expenditures in the year that disbursements are made.

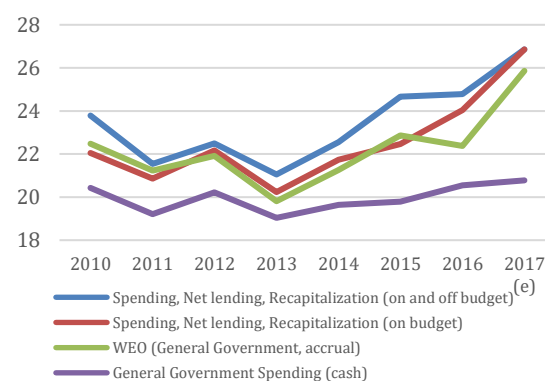
lending in recent years—combined with the characteristics of a cash-based accounting system (which does not distinguish between loans and grants, but treats both as expenditures) and extensive use of subsidized lending to SOEs—mask the extent of state spending in Kazakhstan (Annex A.1). In addition, projections for 2017 point to a significant increase in General Government spending (of more than two percent of GDP) due to one-off support to the banking sector. This suggests that public expenditure in Kazakhstan is higher than indicated by the data and is poised to rise further.

Figure 16: General Government spending in selected countries (accrual): average 2014–16 (Percent of GDP)



Source: World Bank staff calculations based on IMF World Economic Outlook data.

Figure 17: General Government spending in Kazakhstan (Percent of GDP)



Source: IMF World Economic Outlook (April 2017).

An increasing reliance on off-budget spending has understated recent growth in General Government spending. Off-budget spending was estimated to be as high as 3.7 percent of GDP in 2015 (Table 6).²⁴ Annual growth of nominal on-budget General Government spending averaged 12.6 percent between 2010 and 2016; during the same period, off-budget spending rose by an average of 23.4 percent annually.²⁵ Figure 17 compares the level of spending as a share of GDP for the General Government on a cash and accrual basis, with and without off-budget spending.²⁶

Table 6: Off-budget spending²⁷ (Percent of GDP)

	Annual average 2010–13	2014	2015	2016
Total off-budget spending	1.1	1.4	3.7	2.8
NFRK direct loans to SOEs	0.5	0.7	2.6	0.8
Unified Accumulative Pension Fund payments	0.3	0.4	0.8	1.7
Pension payments	0.2	0.3	0.4	0.4
Direct loans to SOEs	0.0	0.0	0.3	1.1
State Social Insurance Fund payments	0.3	0.3	0.3	0.3

Source: World Bank staff calculations based on data published by the authorities.

Note: Some sums may not add up exactly due to rounding.

²⁴ The General Government budget is comprised of the State budget and extra-budgetary funds, including the National Fund of the Republic of Kazakhstan, the Unified Accumulative Pension Fund, the State Social Insurance Fund and the recently-created Social Health Insurance Fund.

²⁵ Excluding interest payments, this figure averaged 13.4 percent per year.

²⁶ As most of the off-budget transactions are loans (on an accrual basis), they are considered changes in the *composition* of assets and are therefore not reflected in changes to the level of expenditures. However, this assumes that lending is at “fair value.” Subsidized lending (which is used extensively) has an implicit grant element which would raise current spending.

²⁷ Includes State Budget expenses, plus extra-budgetary funds less privatization proceeds to the budget.

Composition of Government Spending by Functional Classification

State budget expenses over 2010–16 were relatively stable as a share of GDP. About half of spending was directed to health, education and social security and welfare (Table 7). Components recording the fastest nominal growth included “general public services” (5.8 percent of state spending), interest payments (3.0 percent) and “other” spending (3.0 percent), with education and social security and welfare—the two largest components—increasing slightly faster than the average.²⁸ Health spending did not keep pace with growth in overall spending, resulting in a modest decline in its share of total spending.

Table 7: State budget expenditures: average 2010–16

	Average annual growth	Average share
State budget expenses	13.2	100.0
General public services	17.4	5.8
Defense	12.1	5.3
Public order and safety	8.0	7.9
Education	14.1	17.8
Healthcare	11.1	11.4
Social security and welfare	13.9	20.4
Housing	7.2	6.7
Culture, sports, tourism and information	6.2	3.9
Fuel, energy and sub-surface use	3.9	1.7
Agriculture	12.3	4.5
Industry and construction	8.6	0.5
Transport and communication	11.8	8.1
Other	34.9	3.0
Interest payments	33.0	3.0

Source: World Bank staff calculations based on data published by the authorities.

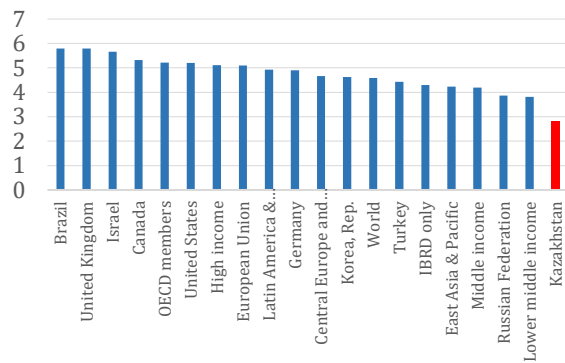
1) Education spending

At less than 3 percent of GDP in 2015, Kazakhstan’s public spending on education is comparatively low.²⁹ In contrast, the global average is 4.6 percent of GDP, the OECD average is 5.2 percent of GDP and the lower-middle-income economy average is 3.8 percent of GDP (Figure 18). As a share of government expenditure, GoK’s public spending on education was also on the low side (below 12 percent), compared to a world average of 14.1 percent and an OECD average of 12.4 percent. Per capita education spending is well below regional comparators (Figure 20); it is half that of Russia (in USD terms) and only about 15 percent of the OECD average. Relatively low spending cuts across levels of education, with Kazakhstan also spending a relatively low share of GDP per capita per student at both secondary and tertiary levels. In Kazakhstan education is largely financed locally, but the current intergovernmental transfer system does not adequately address regional and local disparities between rich and poor regions and rural and urban populations.

²⁸ Assessing trends and emerging spending pressures is challenging given that many government programs and policy objectives are pursued through SOEs. While the GoK has committed to reporting on the consolidated General Government (that is, including spending financed through various GoK funds), there is no similar commitment to report on the consolidated public sector (including SOEs).

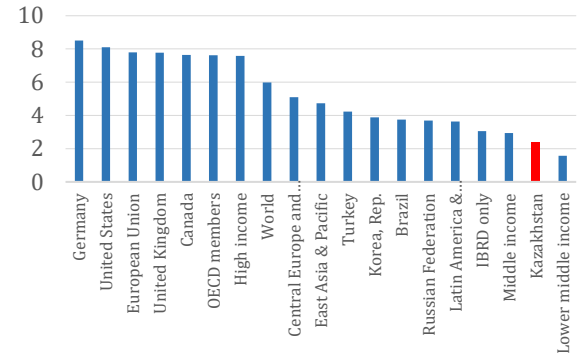
²⁹ Data in this section are from the United Nations Educational, Scientific, and Cultural Organization (UNESCO) Institute for Statistics database (accessed May 26, 2017), <http://uis.unesco.org/>. General Government expenditure on education (current, capital, and transfers) is expressed as a percentage of GDP. It includes expenditure funded by transfers from international sources to the government. General Government usually refers to local, regional, and central governments. Average from 2010 to most recent year available. Data may refer to spending by the Ministry of Education only (excluding spending on educational activities by other ministries).

Figure 18: Government education spending: average 2010–14 (Percent of GDP)



Source: World Development Indicators Database (<http://databank.worldbank.org/wdi>), World Bank.

Figure 19: Government health spending: average 2010–14 (Percent of GDP)

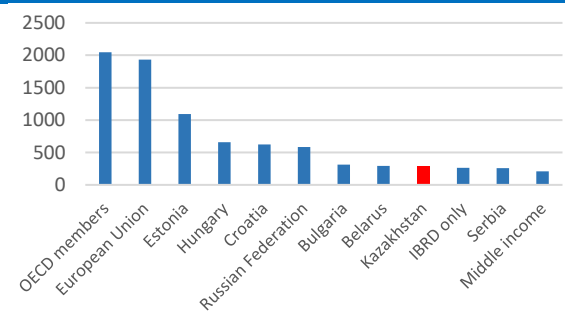


Source: World Development Indicators Database (<http://databank.worldbank.org/wdi>), World Bank.

2) Health spending

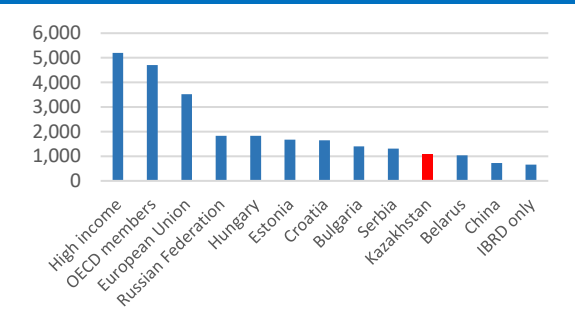
Kazakhstan’s public health spending totals 2.4 percent of GDP, below that of economies at a similar level of development.³⁰ Public health spending is also significantly below the world average of 6.0 percent of GDP, OECD average of 7.6 percent of GDP and average for middle-income economies of 2.9 percent of GDP. Per capita spending (in current USD terms) is also comparatively low (Figure 21). It is only about 60 percent of the level in Russia (and a similar share in PPP terms) and just over 10 percent of the OECD average (and less than one quarter in PPP terms). Just over half (54.9 percent) of total health spending is provided by the public sector in Kazakhstan, compared to a world average of 60.3 percent, an OECD average of 62.4 percent and a middle-income economy average of 51.7 percent (Figure 19). The pattern is similar in terms of health spending as a share of total government spending: Kazakhstan has hovered just below 11 percent since 2011, above the 6.8 percent share in lower-middle-income economies but well below the world average of 15.7 percent and the OECD average of 17.4 percent. As a consequence, the share of “out of pocket” health expenses that Kazaks spend is (at 45.1 percent) more than three times the OECD average.

Figure 20: Government spending on education per capita: 2012–2015 (constant US\$)



Source: World Development Indicators Database (<http://databank.worldbank.org/wdi>), World Bank.

Figure 21: Health expenditure per capita, PPP (constant 2011 international US\$)



Source: World Development Indicators Database (<http://databank.worldbank.org/wdi>), World Bank.

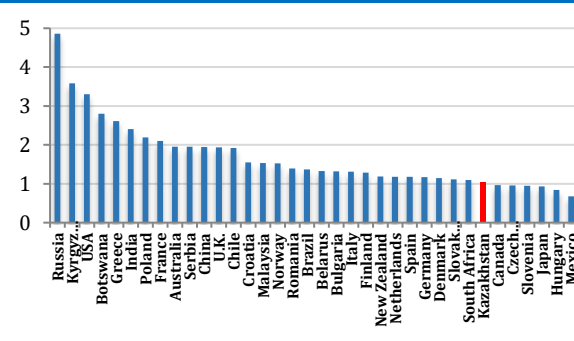
³⁰ Data in this section are from the World Health Organization (WHO) Global Health Expenditure database (accessed August 11, 2017), <http://apps.who.int/nha/>. Public health expenditure consists of recurrent and capital spending from government (central and local) budgets, external borrowings and grants (including donations from international agencies and nongovernmental organizations) and social (or compulsory) health insurance funds.

Low public spending on health and education may reflect—at least in part—low salaries for public servants in these sectors. Teachers in particular, are poorly remunerated which creates challenges in attracting and motivating good staff.³¹ At least until recently, the average public-school teacher made about one-third the average private-sector wage, with starting salaries one-third less than those of health workers. There was some effort to address low public service wages in 2015 when salaries were increased by just under 30 percent. However, this served only to compensate for inflation between 2011 and 2015, prompting a further increase of close to 30 percent in 2016.

3) Military spending

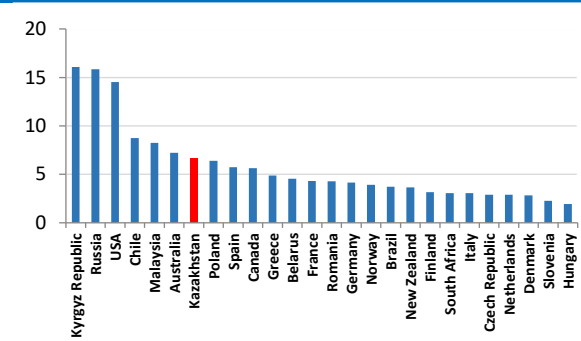
Military spending is low and stable in Kazakhstan at about one percent of GDP. The level of military spending is below the global average of 2.3 percent of GDP, the OECD average of 2.2 percent of GDP and the middle-income economy average of 2.0 percent of GDP. (Figure 22).³² At 6.7 percent in 2015, military spending is somewhat higher in terms of its share of central government expenditure (Figure 23). Military spending as a share of both GDP and state budget expenditure is likely to rise modestly in 2017 following the granting of a 20 percent pay increase for military personnel.

Figure 22: Military spending as share of GDP
(Percent of GDP)



Source: International Peace Research Institute.

Figure 23: Military spending in total spending
(Percent of central government expenditures)



Source: International Peace Research Institute.

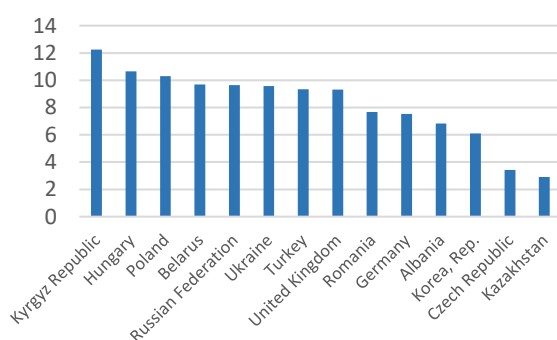
³¹ OECD 2015.

³² SIPRI 2016. Military expenditures data are derived from the NATO definition, which includes all current and capital expenditures on the armed forces, including peacekeeping forces; defense ministries and other government agencies engaged in defense projects; paramilitary forces, if these are judged to be trained and equipped for military operations; and military space activities. Such expenditures include military and civil personnel, including retirement pensions of military personnel and social services for personnel; operation and maintenance; procurement; military research and development; and military aid (in the military expenditures of the donor country).

Composition of Government Spending by Economic Classification

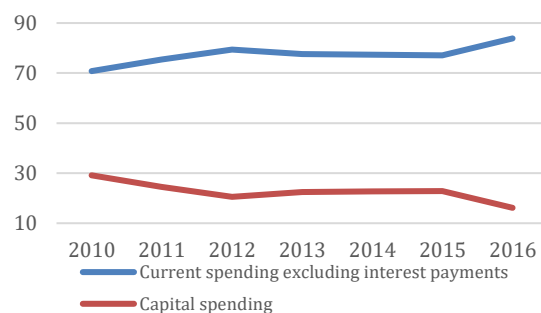
The compensation of public-sector employees in Kazakhstan appears quite low relative to other economies. The reasons underlying low public-sector wages are difficult to untangle given a lack of data on non-monetary compensation as well as on the number and composition of employees in the public and civil service (Figure 24). These data gaps should be addressed to facilitate more rigorous and regular analysis of public sector efficiency. While the wage bill as a share of GDP has been relatively stable over time, there are also important compositional issues concerning public-sector remuneration and wage policy that need to be better understood and analyzed.³³ Comprehensive data on the number of civil and public servants are difficult to obtain as is information on the size and distribution of bonuses (the overall budget for performance bonuses is tied to underspending of non-wage budgets).³⁴ As noted above, data on public-sector remuneration exclude significant non-monetary compensation.³⁵ A very rough estimate of the likely cost of the housing benefit for civil servants would put it between 2.0 and 2.7 percent of GDP in 2016.³⁶

Figure 24: General Government compensation of employees
(Percent of GDP)



Source: World Bank staff calculations.

Figure 25: Current and capital shares of non-interest government spending
(Share of non-interest government spending)



Source: International Peace Research Institute.

Growth in current spending has outpaced growth in capital spending, resulting in a relative increase in current spending both as a share of total spending and of GDP (Figure 25).³⁷ The non-interest current spending share of General Government expenditure was 8.1 percentage points higher in 2016 than the 2010–13 average, mainly due to an increase in spending on subsidies and transfers (Table 8). Interest payments have more than doubled as a share of GDP since 2013. Projections for 2017 suggest a continued decline in capital spending as a share of GDP while total

³³ Significant non-monetary compensation (such as free or subsidized housing and access to special hospitals) is provided to civil servants and other government officials, but is not captured in the budget. The cost is likely significant but challenging to calculate using available data. Government Finance Statistics (GFS) 2001 defines “compensation of employees” to include remuneration in “cash or in kind.” Kazakhstan reports monetary compensation for civil servants but not the value of the significant non-monetary remuneration it provides.

³⁴ Currently, individual ministries, departments, and agencies are allowed to use savings within their administrative budgets to finance performance awards for staff. A July 2015 JERP note on Methodological Approaches and Models for Proposed Public Service Pay Reform called for a cap on the magnitude of administrative savings that could be used to finance performance awards. This was not adopted.

³⁵ Of particular note is the lack of comprehensive data on the volume of free or subsidized housing provided to civil servants, the implicit cost of the benefit and its allocation across beneficiaries. Having a clear picture of the cost of this benefit will become more important with the enactment of Step 8 of the 100 Concrete Steps program, which calls for the “mandatory provision of state housing for civil servants on duty.”

³⁶ This would assume that 60 percent of civil servants received free apartments and that half of these were in Astana (which tends to have higher rents).

³⁷ While difficult to determine given the absence of consolidated public-sector accounts, some of this decline may have been offset by increased capital spending by SOEs, financed off budget.

current spending is expected to continue to rise, driven by increases in interest payments and subsidies and transfers.

Table 8: General Government spending by economic classification
(Percent of GDP)

	2010	2011	2012	2013	2014	2015	2016
Total expenditure and net lending	23.8	21.5	22.5	21.1	23.0	24.7	24.1
<i>Current expenses</i>	<i>17.0</i>	<i>16.3</i>	<i>17.5</i>	<i>16.4</i>	<i>18.1</i>	<i>19.2</i>	<i>20.4</i>
Wage bill	3.4	3.1	3.3	3.1	3.0	3.0	3.1
Goods and services	6.8	6.6	7.7	7.3	7.3	8.0	8.0
Interest payments	0.4	0.4	0.4	0.5	0.6	0.7	1.1
Subsidies and current transfers	6.4	6.1	6.1	5.5	7.2	7.4	8.2
On-budget	5.9	5.7	5.6	5.0	6.0	5.7	6.0
Individuals	3.9	3.9	3.8	3.6	3.8	4.1	4.2
SOEs	1.3	1.3	1.1	0.6	1.3	0.7	0.9
Other private firms	0.7	0.5	0.6	0.7	0.9	0.8	0.9
Off-budget	0.5	0.4	0.6	0.5	1.2	1.7	2.1
Individuals	0.5	0.4	0.6	0.5	0.5	0.7	0.7
SOEs	0.0	0.0	0.0	0.0	0.7	1.0	1.4
<i>Capital expenses and net lending</i>	<i>6.8</i>	<i>5.2</i>	<i>5.0</i>	<i>4.6</i>	<i>5.0</i>	<i>5.5</i>	<i>3.7</i>
Acquisition of fixed assets	0.6	0.7	0.6	0.8	0.9	0.6	0.6
Fixed capital creation and repairs	0.5	0.4	0.5	0.5	0.5	0.3	0.3
Capital expenses for development	4.0	3.5	3.3	2.6	2.8	2.3	1.9
Capital transfers and net lending	1.7	0.5	0.5	0.7	0.8	2.2	0.9
On-budget	0.7	0.5	0.3	0.0	0.3	0.4	0.5
Off-budget	1.0	0.0	0.2	0.7	0.5	1.8	0.4

Source: World Bank staff calculations based on data published by the authorities.

Note: Some sums may not add up exactly due to rounding.

Emerging Spending Pressures

In addition to responding to pressing needs in the health and education sectors, the GoK has also committed to enhancing support to other areas of the economy. Many of the associated initiatives are set out in periodic, and generally ambitious, addresses by the President of Kazakhstan. In 2013, for example, President Nazarbayev committed to increasing state support for agriculture by 4.5 times by 2020,³⁸ implying a more than doubling of state support for agriculture as a share of GDP between 2016 and 2020 (from 0.9 to 1.9 percent of GDP). The GoK has also committed to a 20 percent increase in pension payments for 2.1 million retirees starting in July 2017. Step 8 of the 100 Concrete Steps calls for “mandatory provision of state housing for civil servants on duty” which will also likely have a significant budgetary cost although data is not easily available to assess the likely costs and adapt commitments as needed.

Spending on construction has increased sharply in recent years under various GoK programs, including Nurly Zhol. While spending proposals generally recognize the ongoing costs of operations and maintenance (O&M) for infrastructure, there has been no ex-post assessment of the adequacy of those estimates. At the same time, spending on O&M in local budgets, which account for more than three-quarters of public O&M spending, remains close to its nominal 2010 level. Experience in other economies suggests that a neglect of infrastructure can prove costlier in the long run than ensuring adequate O&M. The GoK may want to consider reviewing O&M estimates from previous projects to determine if there is a systematic bias toward under- or over-estimation of the O&M requirements of approved infrastructure projects. Furthermore, Presidential commitments include improvements and expansion of infrastructure

³⁸ This goal formed part of the Kazakhstan 2050 Strategy.

in transport, power, sport, health and education. The costs associated with many of these initiatives are not clearly articulated nor is rigorous analysis available to ensure affordability.

Contingent liabilities remain a concern, with the interconnectedness of the public, semi-public, and private sectors raising the specter of significant implicit guarantees. Implicit guarantees are a particular concern given that the major holding companies, in their communications to investors, use their links to the GoK as evidence of their credit strength. The Development Bank of Kazakhstan (DBK, part of Baiterek), for example, refers to its “quasi-sovereign status and strong government support” and “access to subsidized funding from the state budget” in its promotion material.³⁹

The expectation of GoK financial support also arises from the use of SOEs to carry out government mandates. Baiterek, for example, serves as the conduit for several programs that provide low-interest loans to entrepreneurs and households. With limited ability to assess credit risk and the articulation of quantitative targets on the number of households and entrepreneurs to be served, the GoK budget is exposed to potentially significant default. Moreover, the Entrepreneurship Development Fund “DAMU” has indicated its intention to make greater use of guarantees in its support of small- and medium-size enterprises and entrepreneurs. DAMU is only required to provision 20 percent of the value of the loan. It will be important that the GoK, as part of its consolidated monitoring of the SOE sector, provide oversight to the use of guarantees and assess the adequacy of associated provisioning.

2.2 Comprehensiveness of the general government fiscal accounts

The budget does not explicitly recognize the grant element implicit in the sizable subsidized lending by the GoK (both on and off budget) to SOEs. The GoK continues to make extensive use of “below-market rate” lending from the Republican Budget (and until 2017, the NFRK) to support government programs, particularly those administered through its holding companies. From the standpoint of fiscal reporting standards (that is, the Government Financial Statistics, or GFS), the purchase of a “below-market rate” bond by the government is treated the same as the purchase of a bond with a market rate. Under Kazakhstan’s cash-based accounting system, the GoK books the face value (purchase price) of the bond as an expense in the year it is purchased by the government; bond payments are recorded as revenue in the year they are received. Under an accrual system (which Kazakhstan is moving toward), purchase of a below-market rate bond is treated as an exchange of assets (cash for the bond), even if one has a lower net present value (NPV). Both the purchase of the “below market rate” bond and its repayment are recorded “below the line” and are included in “net lending”. Regardless of whether cash or accrual principles are followed, the fact that the present value of bond payments is well below the face value of the bond purchased has fiscal implications. It is therefore good practice under GFS principles to at least include a footnote in government accounts noting the implicit grant associated with the purchase of the bond.

The situation is more clear cut from accounting and economic perspectives, where the grant associated with the purchase of a below-market-rate bond should be explicitly quantified. The economic cost is essentially the difference between the net present value of repayments and the face value of the bond, implying that the initial loan has a grant element. International accounting standards, i.e. International Financial Reporting Standards (IFRS), recognize this. Since the holding companies that are the main beneficiaries of subsidized lending from the GoK (Samruk-Kazyna, Baiterek and KazAgro) also borrow on international capital markets, they are required to issue consolidated IFRS-compliant financial statements. The grant element of below-market-rate borrowing is therefore clearly reflected in their financial statements; it is explicitly shown as the difference between the face value of the bond issued and

³⁹ For more information about the company, see DBK’s Presentation to Investors at <http://www.dbk.kz/en/about/investors/prezentatsii-dlya-investorov/>.

its “fair value.”⁴⁰ This difference is treated as a grant from the GoK. Because the grant is being received from the GoK in its capacity as a shareholder, the grant results in an increase in the GoK’s equity in the holding company.

The resource transfers associated with subsidized lending from the GoK are sizeable. These range from 0.7 percent of GDP (US\$1.5 billion) in 2014 to 1.6 percent of GDP (US\$1.9 billion) in 2015 (Table 9). In the first half of 2016, transfers amounted to more than 0.5 percent of GDP, with Baiterek recognizing the equivalent of US\$561 million as a government grant in its accounts.⁴¹

Table 9: Debt securities at below market rates acquired by the GoK, 2014–16
(KZT and US\$ millions, unless otherwise indicated)

Issuer	2014			2015			2016 (end-June)		
	Grant in KZT	US\$ equivalent	% of GDP	Grant in KZT	US\$ equivalent	% of GDP	Grant in KZT	US\$ Equivalent	% of GDP
Baiterek	181,329	994	0.46	219,075	644	0.54	190,088	571	0.42
Samruk-Kazyna	100,000	548	0.25	318,664	937	0.78	44,681	134	0.10
KazAgro	0	0	0.00	105,501	310	0.26	0	0	0.00
Total	281,329	1,542	0.71	643,240	1,892	1.57	234,769	705	0.51

Source: World Bank staff calculations based on financial statements of Baiterek, Samruk-Kazyna and KazAgro.

The holding company is not, in many cases, the ultimate beneficiary of the government grant. Instead, it is passed on through subsidized lending to households or other entities. As part of Nurly Zhol, for example, Baiterek received an implicit grant of KZT 14,470,953 thousand (US\$46.7 million) in 2016 as part of a loan of KZT 19,092,292 thousand (US\$61.6 million) from the Ministry of Investment and Development at an annual interest rate of 0.1 percent over 30 years. The benefit was to be used to support the provision of favorable-term leases to qualified participants in the program. The practice could be made more transparent by making grants more explicit, thereby giving decision makers a clearer sense of the costs of the programs being implemented.

Subsidized lending can crowd out private-sector activity. In addition to the fiscal impact of subsidized lending, many of the activities supported by this kind of lending can crowd out private sector activity by “tilting the playing field” against unsubsidized private-sector entities. Without the benefit of the same artificially-low financing costs, private firms cannot compete with SOEs. Over time, this can hamper the development of the economy’s tax base—or erode the existing tax base—with negative implications for the fiscal balance.

2.3 Public spending for better health and education outcomes

Kazakhstan’s relatively low levels of spending on health and education coincide with relatively poor health and education outcomes. In the World Economic Forum’s Global Competitiveness Index (GCI) 2016–17, which included 138 economies, Kazakhstan ranks 94th on the Health and Primary Education pillar, similar to less-developed Eurasian economies. Despite some progress in recent years, Kazakhstan ranks 88th for Health”, worse than several regional economies with a similar GDP per capita.⁴² The “under 5 years of age” mortality rate (per 1,000

⁴⁰ “Fair value” is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurable date.” See Baiterek National Managing Holding Joint Stock Company. 2015. “Consolidated Financial Statement and Independent Auditors’ Report.” December 31.

⁴¹ See Baiterek National Joint Stock Holding Company. 2016. “Unaudited Consolidated Interim Condensed Financial Statements.” June 20. In addition, Baiterek received subsidized loans from Samruk-Kazyna, another GoK holding company (see Baiterek statement page 53).

⁴² Kazakhstan’s infant mortality rate, for example, has been falling steadily since 2010, declining from 19.3 deaths per 1,000 births to 12.6 (but remaining at a level more than twice the OECD average). The mortality rate for children under

live births), at 14.1, is more than twice the OECD average and is well above both China (at 10.7) and Russia (at 9.6).

Table 10: Health indicators in selected economies

	Belarus	Bulgaria	Croatia	Estonia	New EU Members	Hungary	Kazakhstan	Serbia	Eur-A
Real GDP per capita (thousand US\$)	15.3	16.0	21.0	23.6	21.5	22.0	13.7	11.8	73.0
Life expectancy at birth, males	64.8	70.8	74.0	71.3	72.1	71.7	63.7	72.4	78.7
Life expectancy at birth, females	76.6	77.9	80.7	81.4	79.9	78.8	73.5	77.5	84.0
Infant mortality rate, percent	4.7	7.8	3.6	2.4	5.5	4.9	16.5	6.2	3.6
SDR, cardiovascular disease < 65 years	191.3	148.0	60.8	80.6	88.2	92.9	208.8	84.7	29.9
SDR, cancer <65 years	93.1	85.8	90.6	78.6	91.1	122.4	85.1	103.2	64.2
SDR, cancer of the cervix	5.1	7.3	3.4	7.4	7.7	6.2	8.7	9.3	2.1

Source: World Bank staff calculations based on data from the European Health for All Database (<http://data.euro.who.int/hfad/>), World Health Organization.

Note: Data are for the last available year. New EU members are members who have joined the European Union since 2014. Eur-A is the weighted average of 27 EU economies: Andorra, Austria, Belgium, Croatia, Cyprus, the Czech Republic, Denmark, Germany, Greece, Finland, France, Iceland, Ireland, Israel, Italy, Luxembourg, Malta, Monaco, the Netherlands, Norway, Portugal, San Marino, Slovenia, Spain, Sweden, Switzerland and the United Kingdom. Fifteen of these countries are included in the list of the 30 top-ranked economies in the 2014–15 Global Competitiveness Report (<http://reports.weforum.org/global-competitiveness-report-2014-2015>). SDR is the standardized death rate).

Despite high educational attainment, Kazakhstan performs poorly on qualitative measures. While enrollment rates are not particularly low for primary education—and are, in fact, quite high for secondary education—the quality of Kazakhstan’s higher education and training pulls down its ranking overall. Kazakhstan is ranked 73rd for its education system despite a relatively high level of internet access in schools (ranked 29th).⁴³ Kazakhstan ranks 70th for the quality of primary education. An international assessment, the Program for International Student Assessment (PISA), conducted in 2012 showed marked improvements and a narrowing of achievement gaps in Kazakhstan compared to 2009. However, Kazakhstani students lagged their peers from economies of similar income levels and scored below the international benchmarks for math and reading by the equivalent of 1.5 and 2.5 years of schooling, respectively. About 45 percent of Kazakhstani students were “low performers” compared to only 23 percent across OECD economies.

To the extent there have been improvements, these have tended to be the result of increased spending rather than the improved impact of existing spending. The efficiency of expenditure in the health and education sectors in Kazakhstan was assessed using Data Envelopment Analysis (DEA).⁴⁴ The original 2005 analysis was updated and extended by World Bank staff; it concluded that outcome indicators in the education sector in Kazakhstan (that is, secondary school enrollment rates and education quality scores) improved between 2005–08 and 2011–14 largely because of increased spending. The efficiency of spending in education, on the other hand, declined (based on an assessment of inputs relative to outputs). This decline reflected an erosion in the quality of education, likely linked to non-transparent governance, limited management capacity, poor teacher remuneration and inadequate teacher training.

age five has also declined steadily, from 21.6 per 1,000 live births in 2010 to 14.1 in 2015 (but remaining at twice the OECD average).

⁴³ Data in this section are from the World Economic Forum’s Global Competitiveness Index. (accessed August 7, 2017), <http://reports.weforum.org/global-competitiveness-report-2015-2016/economies/>.

⁴⁴ Herrera and Gaobo 2005; World Bank staff estimates.

Similarly, improvements in health outcomes appear to derive mainly from spending increases as opposed to improvements in the efficiency and quality of delivery.

There is considerable potential for efficiency gains in the education sector.⁴⁵ However, this will require changes in governance structures, including by strengthening capacity to manage and monitor the use of resources at all levels and increasing regional, local and school autonomy, particularly concerning human resources (both salaries and staffing levels). Efforts will also be needed to better match the skills of teachers with the needs of students, improve the quality of teacher training, and improve the competitiveness of remuneration to attract and retain good teachers.⁴⁶

In Kazakhstan, the primary responsibility for the delivery of public services in education and health care rests with local governments.⁴⁷ But many local governments lack adequate revenue capacity and the system of equalization does not adequately address the differences in access to finance. The GoK's Kazakhstan 2030 strategy provides a framework for economic and societal reforms, the first phase of which will be implemented through the State Program of Education and Science Development 2016–20. This education strategy aims to improve the country's economic competitiveness through improved quality of education at every level by 2020 as a basis for sustainable economic growth.⁴⁸

Given overarching fiscal pressures and the need for fiscal consolidation, significant unmet needs in the health and education sectors highlight the importance of improving the efficiency and targeting of existing health and education spending. To the extent that spending in these sectors may need to be augmented, this should be done (to the extent possible) through reallocations from lower priority areas and sectors. The potential benefits from improving the efficiency of spending in health and education are difficult to quantify, particularly given the limited data available for Kazakhstan.

⁴⁵ OECD 2015.

⁴⁶ For a more comprehensive assessment of progress in improving the quality of teaching, see World Bank. 2013. *Kazakhstan Teachers: SABER Country Report 2013. Systems Approach for Better Education Results (SABER) country report*. Washington, DC: World Bank.

⁴⁷ Local governments finance education with the exception of higher education, specialized types of primary and secondary education (such as military schools and schools for gifted children), and the continuing training of civil servants, which are funded by the Republican budget. In the case of health, local budgets finance general and specialized local hospitals, tuberculosis clinics, diagnostic centers, hospitals, and outpatient clinics for veterans of World War II.

⁴⁸ The World Bank is currently supporting the GoK in its efforts to improve quality and equity in primary and secondary education, particularly in rural and disadvantaged schools, through the Education modernization Project, approved in February 2017. See <http://projects.worldbank.org/P153496?lang=en>.

Box 3: Assessing indicators used to track program performance

Systematic tracking of implementation and impact is key to ensuring that scarce public resources are used effectively and efficiently. Budget programs are expected to include indicators that relate to the achievement of strategic goals and the activities for which the budget funds are allocated, including quantity, quality and effectiveness indicators. Instructional guidelines and rules on the construction and format of strategic plans and budget programs have been adopted. Three state programs were selected—the *State Healthcare Development Program “Densaulyk”* (2016–19), the *Unified Program for Business Support and Development* (Business Road Map 2020) and the *State Program of Education Development (2011–15, 2016–20)*—and their results matrices were reviewed.

Except for the matrix for *Business Support and Development*, all matrices contained baselines against which to assess progress and all three had explicit quantitative annual targets and reported against these targets. While it was not possible to evaluate the quality of the data reported, most targets were outperformed. Consistent with the objective of monitoring the quality of services provided, most health sector indicators were “outcome” indicators, tracking metrics related to the overall health of the population; others focused on capacity measures (such as registered patients per doctor or share of primary healthcare doctors) or usage statistics. Only a few monitored inputs.

In contrast, indicators tracking *Business Support and Development* emphasized inputs, many of which were not clearly related to the desired outcome or impact of the program. There are several indicators, for example, that tracked the number of subsidies given, loans granted or reimbursements made, the number of events organized (lectures, television programs) or entrepreneurs consulted or sent on foreign study tours. Few indicators sought to measure quality or impact, which should be the ultimate measure of program performance.

Like the health indicators, the set of indicators for the *State Program of Education Development* tended to track outcomes, including the extent to which students were taught a particular subject (for example, in science or math). However, given the well-known problems with the quality of education and poor remuneration and retention of qualified teachers, there were surprisingly few indicators intended to assess the effectiveness of the education received. Also, several indicators were vague (for example, the share of schools teaching information and communication technologies). Furthermore, at about 30, the number of indicators was large; this blurred both the focus of the monitoring exercise and its main priorities.

The World Bank report *Next Steps in Implementation of Results-Oriented Budgeting* highlighted several weaknesses that, if addressed, would improve the effectiveness of the assessment system. These include weak links between strategic plans and budget program performance assessments, varying quality of indicators, the resource-intensity of reviews and a lack of adequate analysis of differences between planned and actual performance.

Implementation of a new health strategy and the design and implementation of a social health insurance scheme are currently top priorities for the GoK. The increasing burden of non-communicable diseases and their associated future health care costs prompted the GoK to use its new Health Strategy for 2016–2019 to increase the focus on cost-effective preventive interventions as part of its guaranteed benefits package alongside measures to ensure the long-term sustainability of health care financing.⁴⁹ In addition, there is considerable scope to improve the targeting of public support for health care, rationalize the physical infrastructure, and better tailor services to needs. Currently, for example, certain benefits are made available only to those classified as belonging to “vulnerable populations.” However, the definition of vulnerable populations used is broad and encompasses almost two-thirds of the population. The GoK may also want to review wages in the health sector which are low relative to the private sector and likely have negative implications for productivity and the ability to retain qualified staff.

⁴⁹ The World Bank is also supporting Kazakhstan to improve the accessibility, quality and efficiency of health service delivery and to reduce the financial risks to the population caused by serious health problems through the Social Insurance Health Project, approved in April 2016. See <http://documents.worldbank.org/curated/en/438451467999075986/Kazakhstan-Social-Health-Insurance-Project-Improving-Access-Quality-Efficiency-and-Financial>.

Additionally, there is scope to rationalize the number of hospitals as the health care system moves away from the legacy of extensive (and inefficient) use of inpatient support. Recent efforts to make more routine use of outpatient support is welcome and have helped better tailor health care services to patient needs.

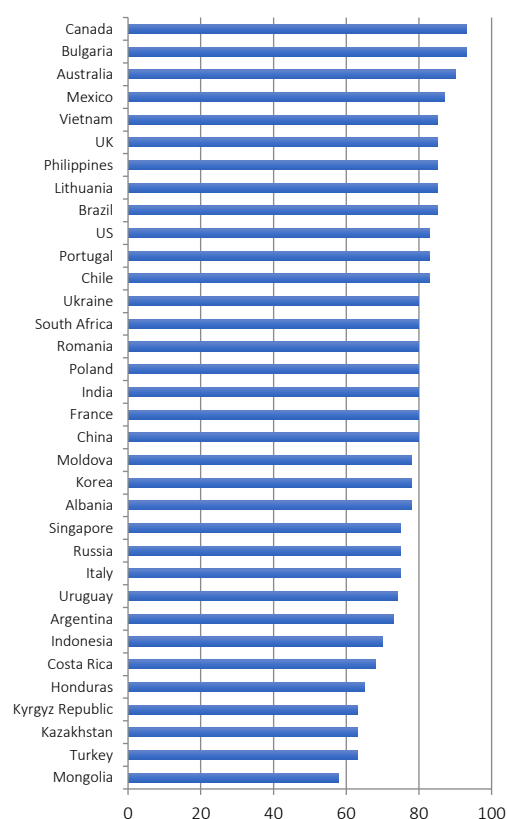
2.4 Effectiveness of public procurement and investment management

The need to improve the efficiency of budget spending in Kazakhstan (including through the holding companies) has been acknowledged at the highest level.⁵⁰ Doing this is a multidimensional task that must accompany any effort to pursue fiscal consolidation and enhance the resilience of the economy. While many of the reforms are sector-specific (and beyond the scope of this section), there are several cross-cutting themes that have been discussed in earlier analytical work by World Bank staff and which have the potential to generate better and less costly results than is currently the case.

Improving the public procurement framework⁵¹

Kazakhstan made real progress in reforming its public procurement system over the last decade. The admission of Kazakhstan as an observer in the Government Procurement Agreement Committee of the World Trade Organization (WTO) constitutes well-deserved international recognition of Kazakhstan’s continued efforts to reform the country’s public procurement systems and to enhance its transparency, efficiency, and effectiveness. However, benchmarking against other countries suggests that there is still room for improvement, particularly if Kazakhstan plans to augment the development impact of its resources through the greater use of public-private partnerships (PPP)⁵² (Figure 26).

Figure 26: Benchmarking public procurement, 2017



Source: Benchmarking Public Procurement Database (<http://bpp.worldbank.org/>), World Bank.

Note: Assessing public procurement systems in 180 economies: Quality of private partner selection process, focus on transparency and fairness of process, bid evaluation criteria, and existence of specific provision. For more information on scores, please refer to "How the *Benchmarking Public Procurement 2017* indicators are scored (PDF)." at <http://bpp.worldbank.org/~media/WBG/BPP/Documents/Reports/BPP17-How-indicators-are-scored.pdf?la=en>

The enhancement of the public procurement system faces several key challenges. These include: (i) increasing the coverage and performance of the public procurement law (PPL) to include SOEs (as recommended by the Accounts Committee); (ii) optimizing the leverage of the public procurement framework to promote socioeconomic and environmental objectives; (iii)

⁵⁰ President Nazarbayev acknowledges the importance of improving budget spending efficiency in his January 2017 address to the nation, entitled The Third Modernization of Kazakhstan: Global Competitiveness.

⁵¹ See World Bank 2014b.

⁵² This is a key element of Kazakhstan’s Socioeconomic Development Forecast for 2018–2022.

enhancing application of electronic government procurement (e-gp); (iv) strengthening capacity building; and (v) reinforcing integrity and citizen engagement in public procurement.

The PPL constitutes the main framework for the conduct of public procurement, ensuring transparency, value for money, predictability, consistency, and accountability in the use of public funds. With limited exceptions, all public procurement activities should be covered by the PPL. In Kazakhstan, however, the PPL excludes national managing holdings, national holdings, national managing companies, and national companies (most SOEs). It is estimated that nearly three-quarters of public procurement expenditure is executed outside the PPL framework. Increasing the coverage of Kazakhstan's PPL and minimizing exemptions to it would ensure greater efficiency, transparency and accountability of the public procurement expenditures with potentially significant budgetary savings and improvements in public-sector productivity. The high volume of sole-source procurement, which reached 49 percent of total procurement in 2013, is a particular concern, as is a lack of appropriate procurement methods such as framework agreements and the absence of an adequate e-catalogue which prevents the government from receiving greater value for money in centralized procurement.

Public procurement has the potential to create synergies between market growth, innovation, and environmental protection. Doing so will require efforts to enhance the leverage of the public procurement framework to promote socioeconomic and environmental objectives. Like in almost every other country in the world, SMEs in Kazakhstan face barriers in making use of public procurement business opportunities given their limited resources and the often-inadequate procurement rules and regulations. Leveraging Kazakhstan's public procurement system to promote access to public procurement could be a key driver of SME-friendly reform.

Professional procurement expertise in Kazakhstan is lagging most countries in Europe and Central Asia. The Center of Electronic Commerce has been providing procurement training, but this has not been able to meet Kazakhstan's needs given numerous amendments to the PPL and implementation guidelines and the rapid pace of technological evolution of the e-GP web portal. Public and private educational institutions have yet to offer procurement or procurement-relevant training. For these reasons, the establishment of an institutionalized and sustainable procurement capacity-building mechanism would represent a major benefit to Kazakhstan and would have a positive impact on the cost of public-sector operations. The Astana Road Map for the professionalization of the public procurement function, which was developed and agreed on by European and Central Asian economies at the 12 PRIMO forum in Astana in May 2016, could guide GoK efforts to strengthen capacity building and achieve effective and sustainable professionalization in public procurement.

The Kazakhstan PPL does not include specific provisions against fraud and corruption in public procurement, nor does it include cross-references to laws and regulations that do contain such provisions. Kazakhstan is ranked 131 of 176 countries in Transparency International's 2016 Corruption Perception Index. Reinforcing integrity in public procurement promotes sound public service delivery and citizens' confidence that public resources are being used efficiently and for their intended purposes. Introducing clear definitions of fraud and corruption in public procurement—with provisions for reporting such cases, mechanisms for their follow-up, and sanctions on guilty parties—should be included in the next update of the PPL.

Strengthening public investment management

Through various Presidential initiatives and reform plans, GoK policy and investment objectives are clear and transparent. The recent decision to have the Accounts Committee review draft Republican budgets to assess alignment with GoK priorities has the potential to enhance alignment further.

However, the process by which individual projects supporting these objectives are selected can lack transparency and rigor, with ambiguity on the specific criteria used.⁵³ An important part of any strategy to improve the process of GoK project selection is to issue general guidelines on project appraisal and appraisal manuals for specific sectors to ensure that the benefits of projects that enter the system outweigh the costs. This can help ensure that scarce resources are not allocated to the preparation of economically-inefficient projects. Some countries (for example, Canada and Chile) undertake pre-feasibility analyses of project investment plans for larger projects to weed out projects for which costs exceed benefits before a more detailed analysis is undertaken. It is also important to ensure that a firm that undertakes a feasibility analysis is not the same firm that eventually implements the project.

Selecting the right projects is critical to the efficient use of scarce public resources. In Kazakhstan, choosing the right projects protects the value of GoK equity in SOEs and the resources of the NFRK. Clear and transparent criteria for project selection and design are needed to promote sustainable and efficient achievement of government priorities and objectives. This may entail selecting projects (and supporting policy reforms) that have a catalytic impact on private-sector economic activity. To be able to screen projects appropriately and at an early stage will require an upgrading of skills for project appraisal, including on the use of rigorous and objective cost-benefit analysis, and including a discussion of alternative approaches in project proposals. There are several tools available for assessing the quality of a country's public investment management, including from the World Bank and IMF. In Kazakhstan, there is also a need to rethink the role of PPP units to avoid conflicts of interest stemming from coincident mandates to review the quality and effectiveness of PPP projects and to carry out the high-level policy objective of increasing the number of PPP projects.

Kazakhstan also needs a credible and independent body to undertake ex-post evaluation and assessment of project and program implementation and impact, with the appropriate dissemination of lessons learned. Completion reviews should be carried out for all projects funded from central or local budgets, including comparisons of actual and planned investment costs, and describing reasons for significant differences. More comprehensive and detailed ex-post project evaluation should be undertaken on a sample of projects, assessing outcomes relative to expectations. Lessons learned should be clearly identified and disseminated widely, including to all entities involved in the project life cycle.

Toward a more efficient, targeted, and market-friendly approach to achieving public policy objectives

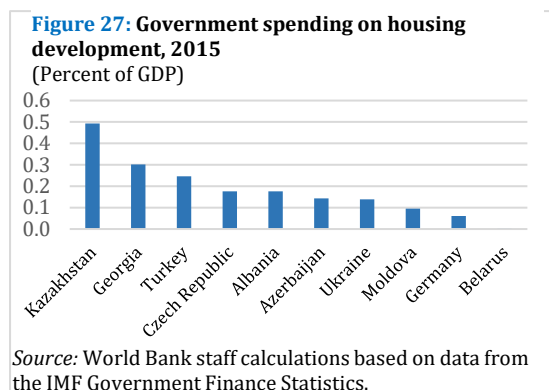
There is a tendency for governments to pursue policy objectives through highly visible, direct provision of the desired output rather than seeking to enhance leverage and act catalytically in pursuing policy objectives. With scarce public resources, decisions on modalities for achieving policy objectives should be preceded by a clear understanding of the underlying market failure or economic distortion that created the problem in the first place. However, many well-meaning governments pursue initiatives that replace the market rather than address the cause of the underlying problem. At best, the results of such efforts are unlikely to be sustained when direct spending or subsidization stops. At worst, they may unintentionally crowd out (or render uncompetitive) private-sector activity in a sector, creating an even greater dependence on public-sector interventions. For this reason, before a decision is made for the public sector to launch a new initiative (including through the provision of subsidized loans or guarantees), policy makers may want to ensure that the private sector is not able to provide the desired output without support. Where this is not the case, public-sector interventions should be

⁵³ This has been noted in earlier work undertaken by the World Bank for the GoK, including *World Bank. 2015. Shadow Economy: Assessment of Public Investment Management. Washington, DC: World Bank*, which drew on international experience to demonstrate the payoff to improved public investment management.

catalytic, focusing on the specific market failure, and explicitly taking into account possible implications (e.g., crowding out) for private-sector activity.

The housing market provides a good example of how this framework can be applied.

Kazakhstan currently spends considerably more on housing development as a proportion of GDP than other countries in the region (Figure 27). Often, this takes the form of the direct provision of housing by the GoK, with the GoK acting as contractor, financier, real estate agent, and landlord.⁵⁴ A more efficient, better-targeted and private-sector-friendly modality for achieving the same development objective may be possible.



For example, under the state housing program, *Nurly Zher*, the GoK subsidizes home mortgage interest rates by up to 7 percentage points for up to 10 years for the purchase of primary housing.⁵⁵ The subsidy is untargeted and available to anyone able to provide a deposit of at least 30 percent of the value of the house.⁵⁶ Under other programs, the GoK directly finances the construction of housing units through a property developer, assuming the full risk associated with selling housing units or allocating them among recipients (including those on waiting lists). The availability of subsidized

housing for large portions of the population (beyond households considered “vulnerable”) has likely contributed to the long waiting lists. At the same time, it has also likely had an adverse impact on private investment in housing as developers (including small, private developers) are unable to compete with the subsidies and easy financing terms provided by the GoK. Significant savings could be achieved if the GoK were to pull back from its role as a *direct* provider and financier of housing, allowing the private sector to build and finance housing projects. The GoK could instead focus on addressing the housing needs of the poor through means testing to provide more targeted, direct subsidies or tax credits. Doing so would be consistent with the longer-term aim of downsizing government support to create space for commercial banks and other private sector entities to address financing needs for all but the poorest and most vulnerable.

Such an approach would be more transparent and avoid the potential abuses associated with waiting lists. If accompanied by appropriate regulation and a supportive investment climate, it could also help stimulate greater private-sector provision of housing (with the added benefit of generating CIT revenue). Similarly, rather than providing housing directly to civil servants and other public employees, the housing benefit could be provided in the form of an allowance for eligible civil servants (based on transparent and objectively applied criteria). Not only would this provide greater clarity on the level of remuneration for civil servants (as well as the overall cost of government), but it would help stimulate private sector activity in the provision of housing and housing services. The GoK’s current stock of housing could be sold off over time with the proceeds used for more targeted housing assistance or returned to the NFRK.

⁵⁴ Under Nurly Zhol, the GoK committed to the construction of 1.4 million square meters of rental housing between 2014 and 2020.

⁵⁵ These subsidies are available for housing loans of up to KZT 20 million in Astana and Almaty and up to KZT 15 million in other regions.

⁵⁶ Kazakhstan faces credit constraints. This is particularly evident with respect to businesses: the country ranks 75th in the World Bank’s 2017 *Doing Business* report for getting credit. Some factors that constrain firm access to credit likely also impact the ability of individuals to secure mortgages. For example, Kazakhstan scores poorly on the indicators measuring the strength of legal rights of borrowers and lenders under collateral and bankruptcy laws. This may create a disincentive for banks to lend to homeowners at lower rates.

2.5 Policy recommendations

Budget Transparency

- Note in the budget the size of the implicit grant associated with below-market-rate lending to holding companies and SOEs.
- As part of a strategy to improve the quality and transparency of data on public-sector remuneration, and consistent with GFS, ensure that compensation for public-sector employees includes “in-kind” payments, including for housing.
- Policies on bonuses for civil servants should be clarified and appropriately budgeted rather than financed from uncapped administrative saving
- Continue move to accrual based accounting

Efficiency of Public Spending

- Wage policies for public servants should be reviewed to ensure that salaries are competitive so that qualified staff are retained.
- Drawing on the extensive analytical work undertaken to date, implement a multi-year strategy to improve the quality of spending on primary and secondary education, with a focus on staffing rationalization, teacher qualifications, training, and competitive remuneration.
- Review the efficiency of government support programs to households and the private sector with a view to improving their targeting to those in greatest need. As part of this effort, review the definition of “vulnerable populations” to improve targeting of assistance. Data limitations should be identified and addressed to permit ongoing monitoring of performance.
- Strengthen the capacity of strategic planning and budget units in line ministries and local governments to set objectives and select appropriate indicators to facilitate the assessment of public spending effectiveness; build on past efforts to introduce results-based budgeting to create stronger links between resource allocation, outputs, and outcomes.
- Reduce the heavy reliance on inpatient care by giving higher priority to primary care services, and specialized ambulatory services to improve allocative efficiency. In addition, expand more cost-effective preventive interventions and increase early detection and health promotion activities that have potential to increase technical efficiency by lowering health care costs and increasing value for money.

Public Investment Management and Procurement

- Review estimates of operations and maintenance costs from past infrastructure project proposals to assess their adequacy and draw conclusions for future estimates.
- Reform the Public Procurement Law and implement reforms consistent with earlier recommendations. As a matter of priority, the PPL should be extended to all SOEs and requirements to permit sole source procurement should be tightened.
- Introduce greater transparency and rigor into the process by which individual projects are adopted, including through clearer and more operational selection criteria and a requirement that net benefits be demonstrated at an early stage.
- Introduce the requirement that completion reviews be undertaken for all projects funded from central or local budgets, including comparisons of actual and planned investment costs, describing the reasons for significant differences.
- Implement a requirement for independent, ex-post evaluation of large and strategic government projects and programs, with lessons learned widely disseminated and integrated into future projects and programs.

Policy Focus 3: Mobilizing Nonoil Revenue and Optimizing the Tax System

Mobilizing nonoil revenue becomes a key priority in the realm of Kazakhstan's new normal. A new tax strategy needs to strike the appropriate balance between long-term fiscal sustainability and growth. The GoK needs to optimize its nonoil tax structure to make it less dependent on corporate income tax (CIT), which is vulnerable to economic fluctuations, and move to a diversified tax base with a larger value-added tax (VAT) base and a greater role for personal income tax (PIT) and property taxes. The introduction of a progressive property tax structure and market-based property valuation tools have the potential to increase revenue collection and the equitable distribution of income. The use of tax benefits to stimulate investment should be reduced to the minimum level possible; revenue losses from these incentives are substantial and the benefits are mostly enjoyed by large firms. Improving tax administration is critical for raising revenue, particularly in a political climate resistant to increasing the tax burden.

The end of the oil price boom means that focus must be shifted to nonoil revenue sources to ensure fiscal sustainability. During the oil price boom of the 2000s, Kazakhstan enjoyed steady and rising oil-sector revenues. Tax revenues from the oil sector grew from just over 3 percent of GDP in 2000 to over 13 percent of GDP in 2011, before falling to below 5 percent in 2016. Given the uncertain oil price outlook, the potential for increasing revenues from this source is also unclear. Moving forward, therefore, it is imperative for Kazakhstan to increase revenue from nonoil sources.

The decline in nonoil revenues which occurred after the 2009 tax reform has continued while tax expenditures have increased. Following the 2009 tax reform—which included significant cuts in tax rates—nonoil sector revenues declined, falling to less than 18 percent of GDP in 2009 from about 23 percent of GDP in 2007 (Table 11). There has been no recovery in recent years. Instead, there has been a further reduction (by about 3 percentage points of GDP) due to the introduction of additional tax exemptions and preferential agreements; currently nonoil revenues hover at about 15 percent of GDP.

Table 11: General Government revenue
(Percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total revenue and grants	32.5	30.3	27.3	27.9	28.9	28.8	26.7	24.5	18.6	19.7
<i>Oil revenue*</i>	9.7	11.9	9.7	11.2	13.9	13.9	12.1	10.3	4.0	4.5
Corporate income tax	5.4	6.4	3.3	3.7	4.2	3.8	3.4	3.3	1.4	0.9
Taxes on natural resources use	2.7	4.2	4.8	6.6	7.7	7.2	6.0	5.4	2.6	1.5
Taxes on international trade	0.0	1.7	0.0	0.1	1.7	1.4	1.6	2.0	1.7	1.5
Nontax revenue	1.6	-0.4	1.6	0.8	0.3	1.6	1.0	-0.4	-1.6	0.6
<i>Nonoil revenue</i>	<i>22.8</i>	<i>18.4</i>	<i>17.6</i>	<i>16.7</i>	<i>15.0</i>	<i>14.9</i>	<i>14.6</i>	<i>14.3</i>	<i>14.6</i>	<i>15.2</i>
Corporate income tax	5.9	5.7	3.8	3.8	3.7	3.4	2.9	2.9	3.0	3.1
Payroll taxes (PIT & Social tax)	4.4	3.6	3.5	3.2	2.9	3.1	3.0	3.0	3.2	3.2
Property taxes	0.6	0.6	0.7	0.7	0.6	0.6	0.5	0.6	0.7	0.6
Value-added tax	4.9	4.0	3.0	3.1	3.1	2.9	3.7	3.0	2.3	3.2
Other taxes on G&S***	1.5	1.2	1.5	1.3	1.3	1.3	1.2	1.1	1.0	1.2
Taxes on international trade	1.2	0.9	0.9	1.6	1.1	1.0	0.8	0.7	0.5	0.6
Pension contributions****	1.8	1.7	1.8	1.5	1.5	1.6	1.6	1.7	1.7	1.2
Other tax and nontax revenue	2.5	0.6	2.3	1.3	0.8	1.0	1.0	1.3	2.2	2.2

Source: World Bank staff calculations based on data published by the authorities.

Note: * Oil revenue covers gross oil revenue to the NFRK and customs duty on oil exports; ** Payroll taxes cover PIT and Social tax payments and social contributions to the State Social Insurance Fund; *** G&S = goods and services; **** Pension contributions to the Accumulative Pension System were included as part of General Government revenue, due to the use of pension savings to finance public investments by SOEs.

The recent sharp decline in GDP growth mandates that tax policy reforms must be growth-oriented. GDP growth decelerated from 6 percent in 2013 to 1.1 percent in 2016. The decline in oil prices has clearly impacted Kazakhstan's economic growth potential, both directly and indirectly. As such, tax policy reforms need to be carefully chosen to ensure they do not inhibit investment or economic growth.

The government is conscious of the need to reform the tax structure and is actively considering a comprehensive reform. Following the president's message of January 31, 2017, the government is formulating a new fiscal policy and tax code. By doing so, the government intends to boost Kazakhstan's global competitiveness by improving the business environment, attract more businesses to the formal economy, rationalize the tax incentive structure by removing inefficiencies, abolish inefficient tax breaks, streamline special tax regimes, and expand the tax base.⁵⁷ The tax reform aims to optimize tax treatment on three levels: (i) general taxation; (ii) the patent system for individual entrepreneurs; and (iii) the special tax regime for SMEs and the agricultural sector. In short, the government would like to bring Kazakhstan's tax policy in line with OECD standards. There are also several proposals to improve tax administration by utilizing e-governance in tax administration, simplifying tax procedures, strengthening audit mechanisms, and implementing the OECD's base erosion and profit shifting (BEPS) guidelines. This has been necessitated by Kazakhstan's gradual integration into the world economy and the need to conform to WTO rules.

This section explores the available options for tax policy reforms focusing on the taxation of the nonoil sector. The study takes as given tax reform package that the authorities and stakeholders are designing, but proposes several additional steps to be taken over the next 2–3 years aimed at improving revenue outcomes. The study focuses mainly on tax policy—taxes on labor, capital, and consumption. It starts with a comparison of Kazakhstan's tax structure with that of OECD countries and then discusses corporate income tax, valued-added tax, personal income tax, property taxes, and taxation of small and medium-size enterprises.

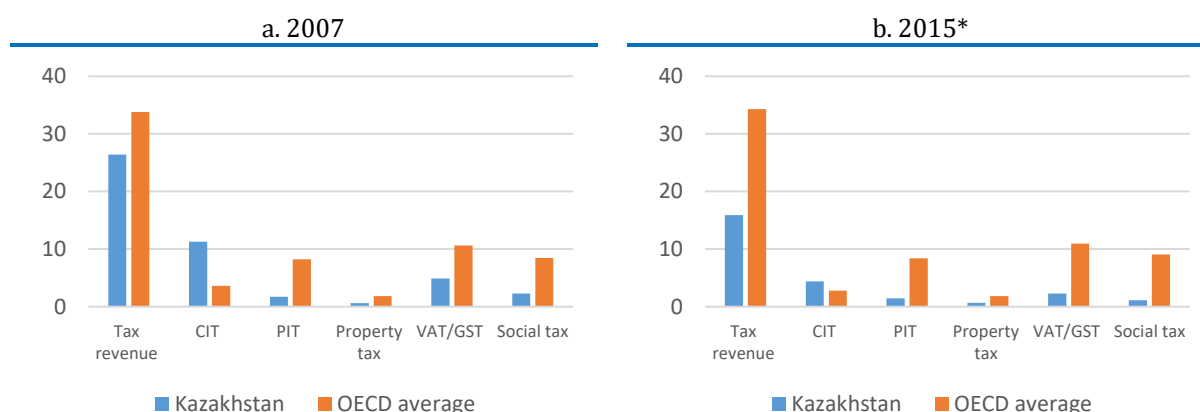
3.1 Kazakhstan tax structure in comparison with the OECD

The overall revenue to GDP ratio for Kazakhstan is below the OECD average. At 32.5 percent in 2007, the overall revenue to GDP ratio for Kazakhstan was below that of the OECD average of 33.8 percent (Figure 28). Following a reduction in tax rates in 2009, the global crisis in 2008 and subsequently the fall in oil prices, Kazakhstan's revenue to GDP ratio declined to 18.6 percent in 2015 while the OECD average stood at 34.3 percent. Looking at different types of taxes, Kazakhstan has higher CIT as a percentage of GDP than the OECD average. On the other hand, as a percentage of GDP, all other taxes (personal income tax, property tax, taxes on goods and services, and social contributions) are much lower than the OECD average. The nonoil revenue⁵⁸ to GDP ratio demonstrates a similar trend, declining sharply following the 2009 tax reform before falling even further in 2012–15 (Table 11). Kazakhstan has scope to improve its nonoil tax to GDP ratio.

⁵⁷ This discussion is based on the concept note on the Republic of Kazakhstan draft Code "On Taxes and Other Compulsory Payments to the Budget" (Tax Code) currently under consideration.

⁵⁸ Nonoil revenue includes CIT, PIT, social tax, property taxes, VAT, other taxes on goods and services, taxes on international trade, social/pension contributions, other tax, and nontax revenue.

Figure 28: Tax to GDP ratio for various taxes, Kazakhstan and OECD
(Percent)

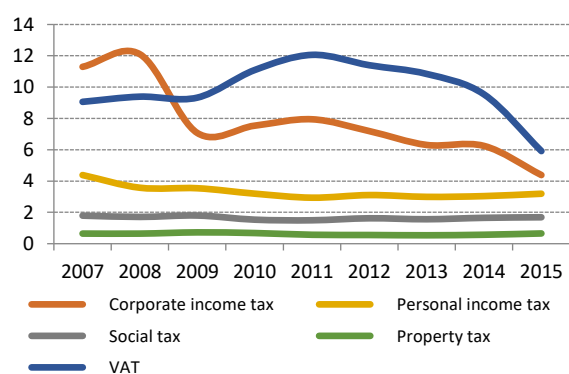


Source: World Bank staff calculations based on data from the World Bank 2016b; OECD Revenue Statistics; IMF World Economic Outlook; and official data published by the authorities.

Note: * designates data for 2014 used (2015 not available); VAT/GST include VAT, other taxes on G&S (excises), and taxes on natural resource use.

Kazakhstan's greater dependence on CIT leaves revenues more vulnerable to economic fluctuations. The evolution of Kazakhstan's tax to GDP ratio for various taxes show the drawbacks of this situation (Figure 29). Collections of CIT tend to be more sensitive to the business cycle. While the sudden drop in CIT revenues in 2009 can be explained by the reduction in the CIT tax rate from 30 to 20 percent, after a short recovery in 2011 both oil and nonoil CIT revenue dropped even further following the decline in oil prices. Even VAT revenue followed a similar trajectory, indicating that its base is narrow. Taken together, this led to the sharp decline in the overall tax to GDP ratio. Personal income tax, property taxes, and social contributions were more stable, but their share in overall revenue is relatively small.

Figure 29: Evolution of Kazakhstan's tax to GDP ratios for various taxes
(Percent of GDP)



Source: World Bank staff calculations based on data from World Bank 2016b; OECD Revenue Statistics; IMF World Economic Outlook; and official data published by the authorities.

Note: VAT refers to taxes on goods and services.

Figure 30: Evolution of Norway's tax to GDP ratios for various taxes
(Percent of GDP)



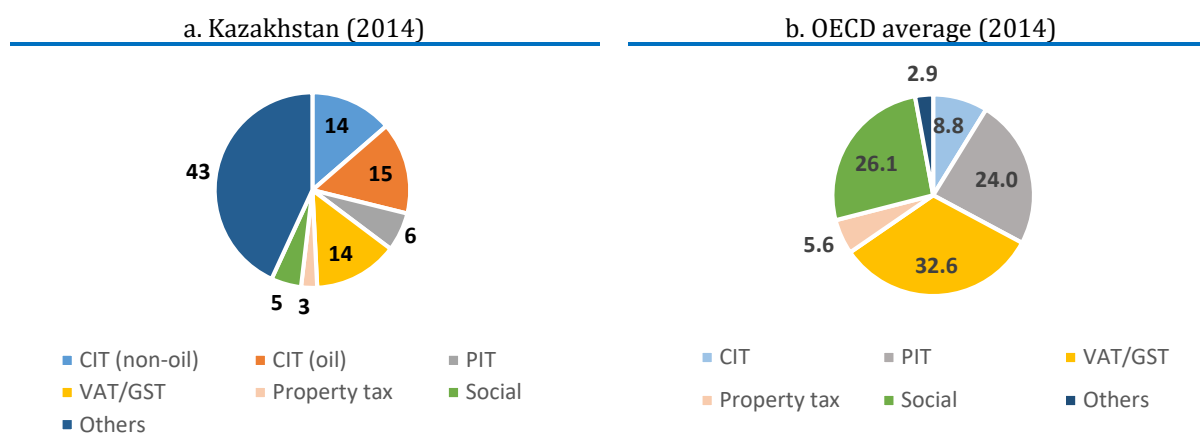
Source: World Bank staff calculations based on data from the OECD Revenue Statistics database.

Kazakhstan needs to lower its dependence on CIT and broaden its VAT tax base. Norway, a major OECD high-income oil exporter, stands in stark contrast to Kazakhstan (Figure 30). While Norway's collections of CIT declined in tandem with oil prices, PIT and VAT revenues remained buoyant and accounted for a much larger chunk of overall revenue. As a result, Norway's overall

tax to GDP ratio remained high and fairly stable (42.1 percent in 2007 compared with 38.1 percent in 2015). The lessons from this are clear.

The transition to a diversified tax base could be gradual or rapid. In the case of Kazakhstan, PIT, VAT and property taxes should play a greater role. For this to happen, the tax structure (that is, the share of various taxes in overall tax revenue) needs to move closer to the OECD average (Figure 31). Kazakhstan’s reliance on other taxes, namely taxes on foreign trade and external transactions and National Fund revenues—which in total accounted for 43 percent of tax revenues in 2014 and 32 percent of tax revenues in 2016—need to be reduced. The options for transition are discussed in greater detail in Annex A.4.

Figure 31: Tax structures in Kazakhstan and OECD average
(Percent of total tax revenue)



Source: World Bank staff calculations based on data from World Bank 2016b; OECD Revenue Statistics; IMF World Economic Outlook and official data published by the authorities.

3.2 The tax system with distortions

Corporate income tax

While the performance of CIT in Kazakhstan has been better than in OECD countries, tax revenues have been unstable. Given the revenue needs of the nonoil sector, the tax base should be strengthened. Kazakhstan’s CIT revenues as a share of total nonoil tax revenues have declined since 2007, falling from 26 percent to 20 percent in 2016, mainly as a result of the reduction in the CIT rate from 30 to 20 percent. However, between 2007 and 2016, the share of CIT revenue fluctuated, rising to 31.4 percent in 2008 and falling to 19.8 percent in 2013. This kind of instability is not surprising because CIT revenues tend to be more sensitive to the business cycle. Keeping in mind the revenue needs of Kazakhstan from the nonoil sectors, however, it is critical that steps are taken to ensure that CIT revenues perform well in the future.

The present CIT structure in Kazakhstan is generally robust. The economic sectors that have contributed the most to CIT revenues in Kazakhstan have been mining and quarrying, manufacturing, construction, wholesale and retail businesses, transportation and warehousing, and, more recently, finance and insurance. SOEs accounted for no more than ten percent of CIT revenues in 2013-2016⁵⁹. The structure of Kazakhstan’s CIT is generally sound and in accordance with international norms. With the one large exception of agriculture, there is virtually no discrimination by sector. Agriculture receives preferential treatment under the CIT structure (as well under the VAT structure). As a result, despite its large share in the economy, revenues from the agriculture sector accounted for less than 2 percent of total nonoil tax revenues in 2016.

⁵⁹ Information from the consolidated financial statements of Samruk-Kazyna, Baiterek and KazAgro holdings for the period 2013-2016.

The multiple tax incentives and tax preferences in the tax code not only result in revenue losses but also create an uneven investment playing field. While many features of the tax code prior to 2007–08 have since been reformed, two features—offering excessive tax incentives and tax privileges and extending presumptive and simplified tax regimes to specific sectors and businesses—still pose a major challenge. The current tax code also maintains several investment-related tax privileges or tax incentives and tax preferences. Tax preferences are available through various provisions of the tax code.⁶⁰ In fact, any organization that is a non-profit entity or is implementing a priority investment project or social sector project in the areas of medical services, education, and scientific and cultural activities is allowed to reduce its corporate income by 100 percent. Tax preferences often also include exemptions from property and land taxes.

Based on the information from the State Revenue Committee (SRC) for the period 2011–14, a World Bank study concluded that the revenue losses from these incentives are substantial and the benefits are mostly captured by large firms.⁶¹ Although the government does not maintain tax expenditures accounts in a consistent manner, data are available on the granted tax incentives for the period 2014–16 for both CIT and VAT. The following conclusions can be drawn from the findings of the World Bank study and the analysis of the 2014–16 tax expenditure data:

- *Estimate of revenue losses.* In 2014, while the total collection of nonoil CIT revenues was KZT 1.2 trillion, revenue losses due to incentives and concessions amounted to KZT 369.2 billion, or 32 percent of the total. In 2015, the corresponding figures were KZT 1.2 trillion and KZT 627.1 billion, with revenue losses due to incentives and concessions totaling 51 percent of the total. For 2016, these figures were KZT 1.5 trillion and KZT 510.7 billion, respectively, with revenue losses due to incentives and concessions amounting to 36 percent of the total. These revenue losses amounted to about 7, 13, and 8 percent of total nonoil tax revenues in 2014, 2015, and 2016, respectively. The government is losing substantial CIT revenues due to these various tax incentives and tax preferences. Eliminating some of these measures would augment tax revenues considerably. The revenue losses due to the provision of loss carryforwards are excluded from the tax expenditure data as these are not classified as a tax incentive.
- *Benefits by firm size:* The large firms in the economy capture most of the benefits—more than 75 percent—of tax incentives. This is not surprising because they also make the majority of taxable income contributions, generally in the range of 80–85 percent of total income. Data from the SRC on the number of working legal entities as well as legal entities with foreign ownership show that during 2012–16 both figures rose. The total amount of corporate income earned by large firms also increased, but the CIT payable declined marginally during this period.
- *Benefits by sector:* The sectors that benefit the most from tax incentives are finance and insurance, education, healthcare, and the professional, scientific and technical sectors.
- *Benefits by region:* The bulk of tax incentives benefit entities in Almaty (54 percent) and Astana (25 percent); benefits to other regions are minimal.
- *Tax loss under different provisions of the tax code:* The available data show no definitive pattern of tax loss under the various articles of the tax code.

⁶⁰ These include the following articles: Article 99: exclusion of certain types of income from taxable income including dividends, insurance and pension payments and pension funds, income of joint-stock investment funds, income from property trust management, etc.; Article 106: deduction of assessments to reserve funds by banks, reserves by insurance and microfinance organizations; Article 123: deductions for investment-related tax privileges where value of privileged items may be deducted at taxpayer's discretion; Article 133: reduction of taxable income for taxpayers investing in social sectors; Article 134: exemption of not-for-profit organizations and consumer cooperatives; and Article 135: exemption of incomes for organizations in social sectors.

⁶¹ World Bank 2016b. In absence of any recent data on revenue loss due to tax incentives, the data available from 2011–14 has been used.

Special economic zones (SEZs) enjoy a different set of tax benefits for business entities which are excessively generous. Kazakhstan has set up a number of special economic zones (SEZs) to encourage the development of efficient, export-oriented manufacturing, attract investment and introduce new technology. There are currently 10 special economic zones in the country.⁶² According to SRC data, there were 459 participating firms located in Kazakhstan's SEZs in 2015. The tax benefits to firms operating in SEZs generally include a 100 percent reduction of the CIT payable and exemptions from land and property taxes and land use payments. These tax benefits have various expiry dates, ranging from 2017 for the SEZ at Burabay to 2036 for the SEZ at Saryarka. Tax benefits may be claimed by entities that meet certain requirements, and sections 151-1 to 151-10 of the tax code define the different types of business activities that qualify for inclusion in each of these 10 special economic zones and the tax benefits enjoyed by entities in each zone. For the SEZ at Astana-New City, for example, 18 business activities ranging from chemical industries to food production and manufacturing of aircrafts and spaceships are listed. For all of these businesses, land taxes, land use fees, and property taxes are all assessed at 0 percent and the CIT rate is reduced by 100 percent. The tax benefits are very generous at all of Kazakhstan's special economic zones, resulting in significant tax revenue losses. It should be pointed out that tax expenditure data are not available for these zones.

More than two decades of research has shown that outright tax exemptions or tax holidays are not cost-effective instruments. Tax exemptions are opaque instruments in which there is no direct link between incentives and investments and there is no way to evaluate the precise amount of revenues lost.⁶³ The OECD economies invariably use investment tax credits or accelerated depreciation, both of which are well targeted to investment. The experience of developing economies shows that tax incentives and tax holidays do not have a significant impact on investment inflows. However, revenue loss from such incentives is certain and substantial—much of the incentive is captured by investors who do not need it and would invest anyway. It becomes a windfall gain to the investor and a straight revenue loss to the government. Tax holidays are also difficult to control as they encourage transfer pricing within a company or corporate group to shift profits to the tax-free business while shifting costs to the taxable ones. Some developing economies, including those in the Eurasian Economic Union (EAEU) and the Association of Southeast Asian Nations (ASEAN), maintain a variety of incentives. This is primarily due to tax competition between neighbors or the demonstration effect, where one country has to offer incentives because its neighbors do. Studies have also shown that economic and political stability, a well-administered and stable tax system with moderate tax rates, adequate physical and social infrastructure, an untapped but trainable labor force, and the existence of natural resources are the main factors that attract foreign investment. These findings have been further validated by a recent study commissioned by the G-20 countries which concludes that factors other than incentives are more important and that targeted incentives are more effective.⁶⁴

Kazakhstan's legal framework for tax incentives (the entrepreneurial code) is overly generous and grants excessive, mostly open-ended concessions. Kazakhstan's current entrepreneurial code was enacted in January 2016 to promote investment in the country. Under this code all incentives are available to companies incorporated in Kazakhstan regardless of the investor's nationality. It guarantees legal protection to investors in case of requisition of property or nationalization and stipulates full compensation. The law also provides state support to investors by offering investment preferences.⁶⁵ According to official data, in 2015 there were

⁶² The 10 Special Economic Zones in Kazakhstan are the following: Astana-New City, National Industrial Petrochemical Technopark, Innovation Technology Park, Sea Port Aktau, Ontustyk, Burabay, Saryarka, Khorgos-East Gate, Pavlodar, and Chemical Park Taraz.

⁶³ See Howell, Stotsky and Ley 2002; Holland and Vann 1998; Bolnick 2004; Gropp and Kostial 2000; and Byrne 2002.

⁶⁴ For the main findings, see the Executive Summary of World Bank 2015c.

⁶⁵ Article 283 of the law extends the following preferences and special treatments: (i) exemption from customs duties and VAT on imports; (ii) state in-kind grants, including the temporary free use of land or free transfer of ownership

16,339 companies that qualified for VAT-related fiscal incentives (with benefits totaling KZT 26 trillion) while 11,352 companies qualified for CIT-related fiscal incentives (with benefits totaling KZT 3.1 trillion). The number of qualifying firms and the financial benefits derived varies from year to year. These concessions and tax incentives are unusually lavish and are believed to result in huge fiscal revenue losses.

There were 54 tax incentives offered by various government and quasi-government entities in 2015. A World Bank study on the institutional and policy framework for investment attraction and retention found that a total of 54 tax incentive schemes were offered by the central government, sub-national governments and other entities in Kazakhstan.⁶⁶ About 75 percent of these were financial incentives and the rest were tax incentives. Approximately 80 percent of incentives were offered to investors irrespective of any specific location, 17 percent were SEZ-specific and 2 percent were for rural areas and small towns. The extent to which location-specific incentives influenced investment location decisions was unclear.

A thorough examination of the tax incentive system in Kazakhstan is needed. The tax incentive system in Kazakhstan needs to be completely rationalized, linked to the size of investment and better targeted to reducing investment costs, such as accelerated depreciation, investment tax credit rather than opaque and outright tax exemptions. There is a clear tradeoff between giving tax incentives that result in revenue loss and improving the infrastructure by using those foregone tax revenues. Ideally, before offering incentives to investors, Kazakhstan should be doing a CBA and see if it is worthwhile and whether it is even necessary. In doing so, all economic and social costs and benefits should be accounted for. Such an analysis is clearly doable, although it may be a somewhat complex exercise requiring both political will and administrative capacity. Nonetheless, the government should not expand the scope of these incentives further without making a comprehensive assessment of their costs and benefits.

Value-added tax

After CIT, VAT is the second-largest source of revenue and VAT on imports account more than three-quarters of total VAT revenues. Despite a slight increase in 2016, Kazakhstan's ratio of VAT revenue to GDP has been on a declining trend during the past decade. In 2007, VAT revenue stood at 4.9 percent of GDP compared to an OECD average of 10.6 percent; in 2015 it fell to 2.3 percent of GDP compared to 11 percent of GDP in OECD countries. VAT revenue collections in Australia and Canada totaled about 7.5 percent of GDP in 2015. In sync with total tax revenues, VAT revenue in Kazakhstan rose in 2016 although it is unclear whether this was a one-off or the start of a new upward trend. Collections of VAT consist mainly of those on imports; in most of the years between 2007 and 2016, VAT on imports accounted for more than 75 percent of total VAT revenues.

Because Kazakhstan's VAT productivity is low compared to neighboring economies, and because CIT rates are already very high, Kazakhstan must focus on improving VAT collections. Using a measure of GDP productivity to assess VAT revenue performance,⁶⁷

in case of fulfillment of terms of investment, transfer of buildings, machinery and equipment (up to a maximum value of 30 percent of the total investment); and (iii) land and property tax exemptions. Article 290 grants preferences in taxation such as a reduction in corporate income tax by 100 percent and 0 percent tax on land and properties. Article 291 provides for subsidies of up to 30 percent of the actual cost of construction, purchase and installation of equipment for location-specific priority projects meant to promote regional development. In June 2014, Kazakhstan introduced additional measures worth US\$20 million to promote investment projects in priority sectors (primarily manufacturing, not oil and gas). These measures include a 10-year exemption from CIT and land tax, as well as an 8-year exemption from property tax, and state reimbursement for up to 30 percent of capital expenditures after commissioning.

⁶⁶ World Bank 2015a.

⁶⁷ GDP productivity is measured as the ratio of VAT revenues to GDP divided by the standard VAT rate, that is, what percent of GDP is collected for each percentage point of standard VAT rate. Perhaps a better estimate would be

Kazakhstan's GDP productivity was about 0.35 in 2007 before declining to 0.20 in 2015. In contrast, the GDP efficiency in neighboring and other former Soviet Union economies varied between 0.30 (Russia) to about 0.65 (Georgia, the Kyrgyz Republic) in the same year.⁶⁸ The low productivity of the VAT in Kazakhstan is as much caused by poor compliance as poor design of the VAT regime. As is pointed out in the tax administration section below, the State Revenue Committee is making efforts to bridge the compliance gaps through improved enforcement. The use of IT technology also aims to reduce non-compliance.

With the VAT base narrow, it may be worthwhile to analyze the revenue potential of various economic sectors by computing their sector-wise elasticities. The need to boosting VAT collections has taken on new urgency since the sharp decline in oil prices and oil revenues. Kazakhstan needs to lower its dependence on CIT revenue and broaden its VAT base and boost VAT revenues. The sectors that contribute the most VAT revenues are wholesale and retail services (including auto services) followed by construction, manufacturing, and information and communications. It may be worthwhile to do a quick diagnostic of revenue potential by sector and compare it to the actual sector-wise revenue collections over the past 5–10 years, depending on the availability of data. This simple exercise of computing sector-wise tax elasticity should point out the sectors where the potential for additional VAT collection is not being exploited and the reasons for this.

The zero-rating provisions for the Special Economic Zones are overly generous. In addition to the goods and services produced in the SEZs, the goods used to produce those items are also subjected to a zero VAT rate. Articles 242 to 255 of the tax code detail the goods and services that are either zero-rated or exempt from VAT for various reasons. Goods for export, international transportation-related goods and services, and goods produced within the SEZ are included under the zero-rating, which broadly conforms to international norms. The various provisions of article 276 detail the specifics of taxation when exporting, importing and executing works, and providing services within the customs union. These provisions are established on the basis of international agreements concluded between the member states of the customs union and are mostly reciprocal. For the Astana SEZ, however, article 244.3 goes beyond the normal practice of zero-rating goods and services produced and sold through a SEZ. Under the article, zero-rated goods include those used to commission and build a broad range of infrastructure including hospitals, clinics, schools, kindergartens, museums, theatres, secondary and higher education institutions, libraries, playgrounds, sports complexes, administrative and residential complexes.

The extended list of exempt goods makes a strong case for efficiency-enhancing VAT reforms. Such reforms will ensure that any cascading of tax is avoided, distortions in choices of inputs and consumer goods are eliminated, and exports are free from any tax content. VAT exemptions in Kazakhstan include financial services, land and residential building transfers, services offered by non-commercial entities, and services related to culture, science, education, and health care. Article 248 of the tax code provides the full list of VAT exemptions for goods, works, and services consumed within Kazakhstan and article 255 includes the list of imported goods that are exempt from VAT. Both articles include extensive exemptions. The VAT exemption for the housing sector has resulted in particularly significant revenue losses. However, excessive VAT exemptions can create problems beyond revenue loss. First, exemptions can break the VAT chain and create inefficiencies due to cascading. The end product, in effect, absorbs the tax content, resulting in distortions in choices of consumer goods and inputs by producers and rendering exports less competitive (even if those are zero-rated). Second, it increases both the administrative burden and the cost of compliance for taxpayers. An important reform measure

collection or C-efficiency measured as ratio of VAT revenues as a percentage of private consumption divided by the standard rate provided that data on VAT revenues as a percentage of private consumption were readily available.

⁶⁸ Data in this section are from the IMF.

would be to evaluate and remove inefficient exemptions, thereby eliminating various anomalies and rationalizing the VAT base.

Revenue losses due to exemptions and zero-ratings are greater than VAT revenue collections. According to tax expenditure data on VAT, the total loss of revenues under different provisions in 2014, 2015, and 2016 amounted to KZT 1.8 trillion, KZT 1.7 trillion and KZT 2 trillion, respectively. The zero-rating of exports, international transportation, concessions within the customs union, and the exemption of financial services are legitimate exclusions under international good practices. Excluding these categories, the net loss of revenue is KZT 620 billion, KZT 565 billion, and KZT 634 billion in 2014, 2015, and 2016, respectively. These losses amount to about 52 percent, 60 percent, and 42 percent, respectively, of total VAT revenue in these years. Regarding the share of the total tax revenues collected, these losses amounted to about 12 percent of total tax revenues collected in all the three years. Since some of these revenue losses originate from exemptions, there may also be an element of cascading in the revenues collected. These figures, however, indicate the extent of revenue loss due to these overly-generous exemptions and zero-rating policies. Importantly, these losses are recurring; in 2016, total foregone revenue was about KZT 634 billion. VAT tax exemptions cut across all sectors and are not concentrated in one particular area. Combined with CIT exemptions, such revenue losses add up to almost 20 percent of total revenue collections.

The VAT rate is low compared to the OECD norm and the rates in neighboring economies. A positive aspect of the VAT in Kazakhstan is that it is a single rate tax, which reduces administrative problems. However, the VAT rate has fallen over time to a level that is below the OECD average and below rates in neighboring economies (except the Kyrgyz Republic, which has a VAT rate on par with Kazakhstan). In the late 1990s, the VAT stood at 20 percent; it then spiraled down, to 16 percent in 2001–04, 15 percent in 2004–06, 14 percent in 2007, 13 percent in 2008, and 12 percent in 2009, where it has remained since. By comparison, most OECD countries have VAT rates of about 17–18 percent, while most former Soviet Union economies have a VAT of 18–20 percent. The low VAT rate in Kazakhstan is one of the reasons for the low revenue performance of VAT.

The VAT rate was reduced to make investment more attractive and reversing this declining VAT trend may be challenging. As such, the focus should be on rationalizing and broadening the tax base. Typically, the rationale for a low VAT rate lies in a concern for equity—the poor should not be taxed heavily, and with VAT being a consumption tax, it may be mildly regressive. In the case of Kazakhstan, however, the VAT was lowered in an attempt to attract investment to the economy. Before 2007, when oil prices were comparatively high, the GoK used tax rate reductions as an instrument of tax reform and a way of improving the business climate to attract foreign direct investment (FDI). However, as a result of these tax rate reductions—and the impact of the global economic downturn starting in 2008—nonoil tax revenues fell sharply, from 17.3 percent of GDP in 2008 to 12.1 percent of GDP in 2010. Oil revenues also fell, from 12.4 of GDP in 2008 to 11.2 percent of GDP in 2010. Weak petroleum revenues since 2009 have revived the government’s interest in boosting tax revenues from the nonoil sector. The poor performance of both oil prices and nonoil revenues in recent years has complicated the GoK’s agenda of further tax cuts. The government has attempted to compensate for lost revenues by focusing on collections and enforcement efforts. However, it may be the right time to consider an upward revision to the VAT rate. If the rate were to be raised to 15 percent, and assuming 90 percent compliance at the enhanced rate, revenues would rise by an estimated 22.5 percent. With this increase, total VAT collections in 2016 would have totaled KZT 1.8 trillion instead of KZT 1.5 trillion. If Kazakhstan were to adopt a VAT rate of 18 percent (on par with Russia), and assuming a compliance rate of only 80 percent of the previous level, VAT revenues would rise by 40 percent and 2016 VAT collections would have been as high as KZT 2.1 trillion.

The VAT threshold for small traders is high, and there is a case for lowering it in phases. Before 2009, the VAT threshold was a turnover of 15,000 Monthly Calculation Index (MCI);⁶⁹ in 2009, the threshold was raised to 30,000 MCI (about US\$190,000). This is high compared to the international norm of a threshold of below US\$100,000. Indeed, many OECD countries and Kazakhstan's regional neighbors have a lower threshold. The government had previously planned to lower the VAT registration threshold in stages, to 25,000 MCI in 2018 and 15,000 MCI in 2020. However, at the end of 2017, these plans for a gradual reduction of the minimum threshold were abolished.

A high level of VAT refund arrears reduces economic efficiency, breaks down the integrity of the VAT system, and acts as an additional tax on and disincentive to investments. During 2012–16, outstanding VAT refunds have been on the high side. As a percentage of net VAT revenues (that is, the percentage of VAT revenues minus refunds already paid), outstanding VAT refunds during these five years have been at 47, 43, 33, 36 and 22 percent, respectively. Although the remaining refund amounts have declined over time, they remain at a very high level. Refund arrears in Kazakhstan amount to about 2 percent of GDP, unusually high compared to other economies, underscoring the difficulties faced by traders in obtaining their legitimate refunds. The refund is an integral part of a VAT system. A high level of outstanding refunds increases the working capital requirements placed on businesses and acts as an additional tax burden. This is particularly problematic for those traders who are pure exporters and therefore do not have the option of offsetting outstanding refunds against domestic VAT liabilities. Such an unintended but real tax on investment flies in the face of the government's push to attract more investment, including FDI.

The legal provisions for refund procedures should be simplified and improved and a provision for interest payment on late refunds should be considered. Article 273 of the tax code provides the legal framework for the refund of excess VAT paid and states that if the request for refund is presented within the limitation period of five years (per section 46), the tax department has 180 days to issue the refund. There is no distinction between exporters and domestic sellers or a minimum amount of claim that can be paid. However, no information is available on the average time taken to issue refunds to taxpayers. According to the State Revenue Committee, the time taken to issue refunds has been reduced somewhat in recent years. In 2016, for example, the time needed to issue a VAT refund was reduced by five days (from 60 to 55 days) for taxpayers whose turnover on zero-rated goods comprises more than 70 percent of their overall turnover. For other traders, the VAT refund time was cut from 180 to 155 days, a reduction of 25 days. The time to issue a refund is still high and additional efforts should be made to clear claims within three months. In cases when an excess payment is not refunded for some reason, it will be set off against future VAT liabilities. There does not appear to be any provision for interest payments to taxpayers on late refunds. A pre-audit is also not required before making refunds, which is a sound feature of the law. While the law appears to be sound, the VAT refund procedure needs to be examined and streamlined to make sure it does not create disincentives to both domestic and foreign investors.

For the application of VAT, the agriculture sector is divided into four categories, each with their own system of taxation, making the entire structure complex and resulting in both revenue loss and a lack of equity in the tax system.⁷⁰ The agricultural sector is very lightly taxed in Kazakhstan; in some cases, the revenues collected do not cover the cost of their collection. Peasant farmers, who sometimes own thousands of hectares individually, are generally exempted altogether from the VAT, the motor vehicle tax, the PIT, and property tax. Instead, these farmers pay a unified land tax which is supposed to cover the VAT, the PIT, the

⁶⁹ The MCI varies in different years. In 2016, it stood at KZT 2,121.

⁷⁰ World Bank 2016e. The four agricultural categories are agricultural enterprises, peasant farmers, agribusinesses, and subsistence type rural households.

property tax and the land tax. In effect, the only tax paid by peasant farmers is the social tax at a rate of 20 percent of MCI for every employee or adult family member.

The practice of taxing agriculture varies worldwide, but some broad lessons are clear. The practice of applying VAT to agriculture (that is, unprocessed agricultural products) differs around the world. Developed economies—for example, Chile, Denmark, New Zealand, Sweden, and the United Kingdom—tend to treat agriculture like any other sector. Agriculture is subject to normal VAT with the normal threshold (so as to exclude the small farmers). However, developing economies tend to exempt farmers; they do not register for VAT and are not required to issue invoices. To avoid the problem of input tax cascading, under EU rules farmers can add a flat rate on their farm prices to reflect input taxes. This flat rate addition is tax deductible by the purchasers. Both suppliers of inputs and purchasers of outputs are VAT registered, but the farmers are not.

Some unique features of agriculture explain the universal practice of treating agriculture lightly under VAT. First, it is a costly administrative challenge to tax a sector which is largely informal and scattered. Second, compliance costs for small household farmers are high, particularly as they often are not capable of maintaining detailed records. Third, there is a distributional aspect—any tax burden will be shared between the consumers and producers and generally will be regressive in either case, particularly for basic foods. Fourth, taxation of agriculture is a politically sensitive matter, whether in developed or developing economies.

For developing economies, the preferred strategy may be to exempt agriculture within an appropriate threshold. Because of these unique features, in developing economies the best approach may be to bring agriculture into the VAT net just like any other sector, but with an appropriate threshold so that large and wealthy farmers (including cash crop producers) remain under VAT. Agriculture inputs may be either zero-rated or exempt or even fully taxed. Small farmers should be given the option of voluntary registration so that they are not at a disadvantage. Those small farmers who choose to remain VAT-exempt may be allowed to apply a flat rate to their farm prices to reflect the input tax that the buyers can deduct from their VAT liability.

The preferred policy for Kazakhstan would be to bring agriculture under VAT with a threshold of 30,000 MCI applied across the board. The agro-food sector is recognized as a priority sector in the country, but there is no reason that the policy mentioned above should not be applied in Kazakhstan. The normal VAT should be applied to agricultural products and producers, and the small farmers with turnover below 30,000 MCI should remain exempt and should be given the option to register voluntarily. At about \$190,000, the exemption threshold is generous. Exempt farmers should be allowed to charge a flat rate on their prices that is commensurate with the input taxes paid. Such a policy would benefit peasant farmers as well as subsistence-level rural households with average holdings of 0.13 hectares (ha) while at the same time bringing the large farms and agro-businesses into the tax net. It would also be equitable, as it would bring both large individual farms (numbering more than 130,000 with an average size of 77 ha) and agricultural enterprises (numbering more than 180,000 with an average farm size of 8,000 ha) under VAT. The government would not be precluded from exempting peasant and subsistence-level farmers from other types of taxes as deemed appropriate.

Presumptive and simplified tax regimes

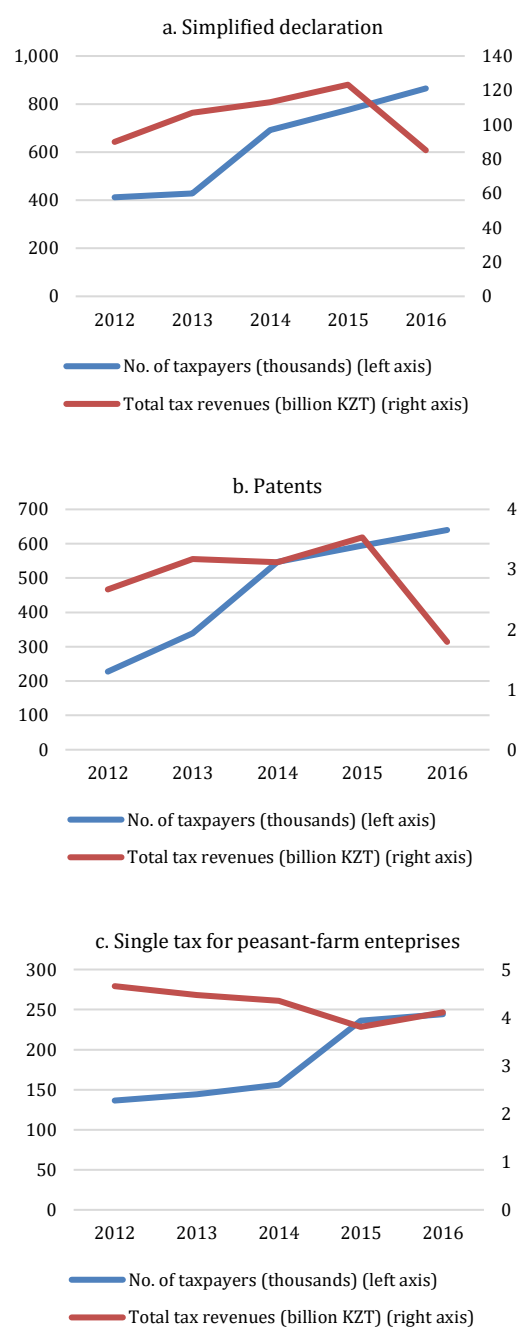
Presumptive and simplified tax regimes for certain sectors and business types have remained unchanged even after several rounds of reform (1995, 2003, and 2009) and, as a result, the number of businesses under these special regimes have increased dramatically while revenues have not increased and even declined for some categories. Kazakhstan's micro and small enterprises are presently covered by patent and simplified tax regimes while peasant farm enterprises are covered by a single tax regime. These regimes act like tax shelter from which businesses do not want to graduate to the normal tax system even when they grow much beyond the stipulated size, thus giving unfair competition to both the domestic and foreign investors in the formal sector.

Without systematic data, it is not feasible to do a trend analysis of the number of businesses or revenue performance of this sector. However, based on SRC data for 2012–16, two observations can be made. First, the number of businesses in each of these three categories has been increasing consistently year on year and the overall increase in the number of firms between 2012 and 2016 has been remarkable. For example, the number of businesses making simplified declarations rose by more than 100 percent, businesses under the patent system went up by 180 percent and those under the single tax regime for peasant farm enterprises went up by 80 percent. Second, the data indicate that revenues did not show a corresponding increase during this period. For some categories, revenues rose until 2015 and then declined substantially in 2016 (it is possible that this is due to incomplete data for 2016). Total revenue for all categories of taxes declined for all special tax regimes from 2012. Excluding 2016, tax revenues under the simplified declarations regime increased by 37 percent while those under the patent system rose by 32 percent; revenues from peasant farm enterprises fell by 18 percent. While the number of businesses under these special regimes has increased substantially, there has been no corresponding increase in revenues. This is clearly another area that needs reform.

The objective of the planned reform in the tax treatment of micro and small business is to address widespread informality and tax avoidance. The current policy has two special regimes based on turnover and operating a single flat tax rate with no sectoral differentiation. This results in several problems:

- The tax base for micro businesses (turnover) is not aligned with the bookkeeping capacity

Figure 32: Number of taxpayers availing simplified schemes



Source: World Bank staff calculations.

- and practice in the micro segment.
- The misalignment of thresholds and tax burdens facilitates abuse and deters growth and graduation between regimes. The simplified tax regime has an unusually high turnover threshold and provides a very generous tax treatment (3 percent on turnover) for high-profit activities.
- Liabilities for business in the simplified regime are not differentiated based on average sector profitability.

The current proposal of the reform committee is to revise the system by limiting the turnover-based tax option to micro entities and moving small businesses toward taxation on a net income basis (Table 12). In addition, a temporary (three-year) expense deduction bonus for newly-established small businesses is being considered, which would be gradually phased out over this three-year period (from 30 percent of declared expenses in the first year to 10 percent in the third year).

Table 12: Current reform proposal

	Threshold	Tax base	Tax rate	Recordkeeping
Micro	< KZT 6.8 million, no employees, only individual entrepreneurs	Turnover	2 percent of revenue + additional benefits	Cash book
Small	> KZT 64 million < KZT 128 million	Net income, some simplification in deduction amounts	10 percent/20 percent + additional benefits	Regular accrual accounting

For micro businesses (a private entrepreneur without employees) the generally-used system threshold is based on business turnover. The appropriate micro regime threshold is typically based on the income-exemption level in the personal income tax law or the subsistence-level income calculation to determine a turnover level. A planned system threshold of KZT 6.8 million (US\$20,200) is in line with international and regional practice. In order to further limit the scope of application of the regime, the additional requirement to operate without hired employees is justifiable. The potential downside of the additional requirement will be that private entrepreneurs may be tempted to use informal employment.

The use of business gross income as the tax base is an issue which may need to be reconsidered regarding the design of the micro-business regime. Experience in other economies has shown that very small businesses either use no bookkeeping at all or have unreliable and incomplete books of account. The most common alternative approach is a calculation of the patent on the basis of a small number (generally one to three) of selected indicators. A single patent fee that replaces income tax, social tax, social contribution and pension contribution could be an option.⁷¹ In this case, the patent amount would be determined based on the type of business activity performed and the business location. Ideally, no more than 10 business types should be defined. Patent revenues are allocated to local governments and, as such, the right to raise or lower the standard patent fees could be granted to the local government.

Any reform will need to be aligned with universal filing obligations by 2020. Any reform of the micro regime will need to be aligned with plans to introduce a universal filing obligation for all individuals and entities in Kazakhstan by 2020. The filing obligation for micro businesses could be limited to the filing requirement under the patent regarding income.

⁷¹ World Bank 2010b.

The proposed reform recognizes that small businesses should be able to calculate their income tax liability on a net income basis. Transparency will be increased by requiring businesses to maintain records and calculate business expenses in addition to calculating gross business income. As the planned SME tax regime is a net income-based regime, there are no major issues with regard to the system threshold or coordination with the VAT regime. The relatively high system threshold can be justified with this approach. However, there is no obvious reason to justify a much higher system threshold to legal persons than for businesses operated by individuals, and this differentiation should be abolished.

The temporary (three-year) expense deduction bonus for newly-established businesses, which is gradually phased out over a three-year period can be justified, provided the right safeguards are put in place. Such an approach, while not unheard of, is not widely used for two reasons. First, new businesses have high start-up costs anyway, which reduces their income tax liability. Second, businesses may, after having used the expense deduction bonus, close the business again and re-open under a new name to benefit repeatedly. Sufficient anti-abuse provisions are needed to counteract such behavior. Businesses should be required, however, to use the three-year timeframe of the expense deduction bonus to build the capacity for proper bookkeeping.

Consideration should be given to administrative simplification and compliance cost reduction. These include income calculation on a cash flow instead of accrual basis. Even in accrual accounting systems, simplifying depreciation rules and offering more favorable depreciation regimes is a common instrument for reducing compliance costs. This consists of either the possibility of an immediate write-off of investment costs or eliminating specific depreciation requirements. Another option is to apply a lump-sum cost deduction approach not for all business expenses, but only for the part of business expenses which are difficult to determine. Penalties can act as a strong deterrent to formalization. For businesses that decide to migrate voluntarily from the informal to the formal economy, it would be appropriate to offer registration without applying retroactive penalties and limiting collection of arrears to unpaid taxes in the preceding tax year.

A range of complementary measures to promote proper bookkeeping should be part of the implementation strategy. In particular, the provision of free bookkeeping software for small businesses (as, for example, was done in Chile) and the organization of bookkeeping seminars and workshops (as in Canada) has proven to be very successful.

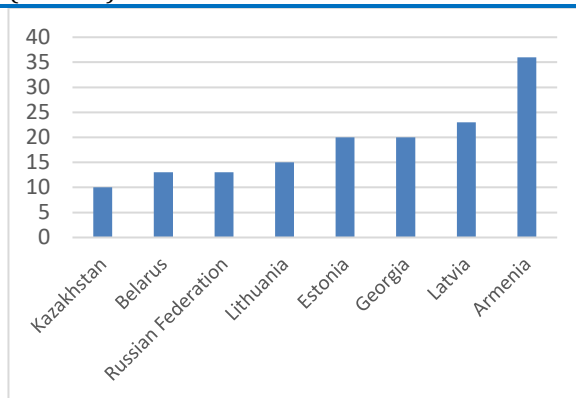
3.3 Equity considerations for labor and property taxes

Labor taxes

The key message on a proposed reform of the personal income tax is that a progressive regime may be considered. The rationale for introducing progressivity in the personal income tax regime is three-fold: (i) it will increase equity; (ii) it will lead to an immediate increase in some revenue areas, with a potential for higher revenues later; and (iii) given the skewed distribution of wage incomes, the suggested reform scores high on grounds of practicality—a small minority of the taxpaying population will be impacted by higher rates, while the vast majority of taxpayers would remain unaffected.

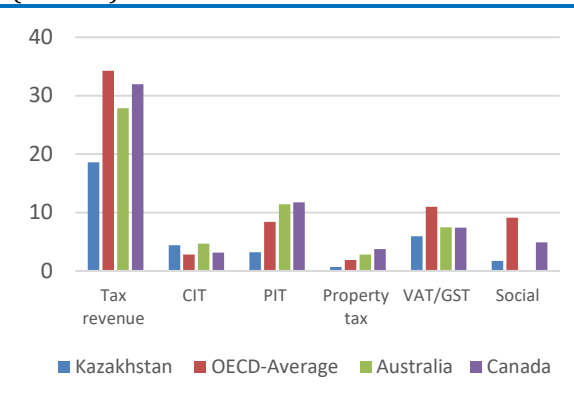
Personal Income Tax is currently levied at a low, flat rate of 10 percent. While a flat rate is common in the economies of the former Soviet Union, Kazakhstan's rate of personal income tax is among the lowest. In addition, passive incomes such as dividends and bank interest are taxed at lower rates of 5 percent and zero percent, respectively.

Figure 33: Personal income tax rates in selected FSU economies, 2017 (Percent)



Source: KPMG Individual Income Tax Rates Table.

Figure 34: Revenue performance of Kazakhstan and OECD countries, 2015 (Percent)



Source: World Bank staff calculations based on data from the OECD and official data published by authorities.

The flat 10 percent personal income tax presents an opportunity to consider moving to a progressive structure to improve both equity and tax revenues. Kazakhstan had a Gini coefficient of 26.35 in 2013 as per World Bank estimates and a net income Gini of about 28 percent as per the F. Solt SWIID Database. A low, flat personal income tax, combined with low taxation of wealth including immovable property, means that there is potential to ensure greater equity through tax policy while raising revenues on a sustainable basis.

A comparison of Kazakhstan’s revenue performance with that of OECD countries shows that the personal income tax and property taxes are the two worst-performing tax instruments. There are opportunities to increase revenue collection from the personal income tax, both by introducing a progressive tax rate structure and by eliminating special tax rates for passive incomes such as dividends and bank interest. Similarly, revenue gains through property taxes are possible.

An analysis of the distribution of wage earners by wage level presents a skewed picture, with higher wages concentrated in a small percentage of the population. An income distribution analysis carried out for the Kazakhstan Tax Strategy Report of 2008⁷² found that about 7-8 percent of the population earn more than twice the average wage, while as much as 70 percent earn less than the average wage. The team was unable to obtain the latest income distribution chart from the Ministry of National Economy (MNE) or the Ministry of Finance (MoF), but a study carried out by the Economic Research Institute (ERI) using December 2015 data shows that income distribution has remained skewed more recently (Figure 35). The average monthly wage in December 2015 was KZT 157,655; this has fallen since, to KZT 136,777 in January 2017.⁷³ Indeed, over 74 percent of the population still earns less than the average wage.

This distributional feature presents an opportunity to introduce a progressive structure in the personal income tax regime, without impacting the vast majority of wage earners. A higher tax rate for taxpayers earning high incomes can be proposed which would lead to higher revenues and also help bring about greater equity in the tax regime.

A three-rate structure is recommended for consideration. The existing rate of 10 percent would continue to be the tax rate for the vast majority of taxpayers. The middle segment would be taxed at 15 percent and the very highest bracket would be taxed at a rate of 20 percent. How

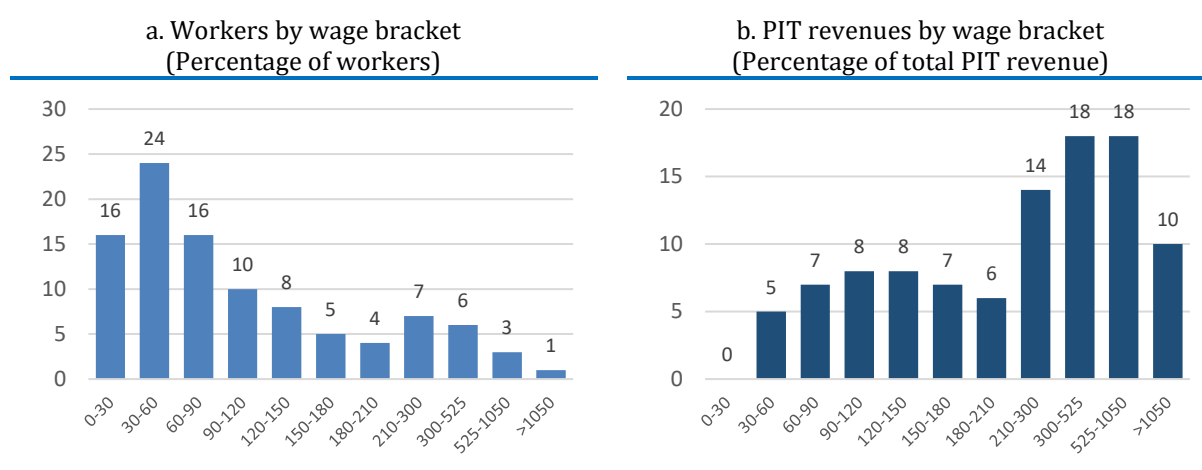
⁷² World Bank 2008.

⁷³ Data in this section are from the Trading Economics database (accessed May 26, 2017), <https://tradingeconomics.com/kazakhstan/wages>.

should these income brackets be defined? There are two options for consideration. Option 1 introduces a personal income tax rate of 15 percent for those earning between KZT 300,000 and KZT 999,999 per month and 20 percent those earning more than KZT 1,000,000 per month. Option 2 has a slightly higher income requirement—between KZT 500,000 and KZT 999,999 per month—for the 15 percent rate while the top rate of 20 percent is applied to those earning more than KZT 1,000,000 per month. It should be noted that the higher tax rate applies only to that part of the income above the respective threshold; incomes below that threshold would continue to be taxed at the lower rate applicable for the bracket.

The choice of income brackets will have an impact on the percentage of the population affected by the higher tax rates but, under either option, that percentage will be relatively small. Given a minimum wage of KZT 136,777 in January 2017, Option 1 implies introducing the higher rate of 15 percent at roughly twice the average wage; Option 2 means introducing the 15 percent rate at roughly three times the average wage. Under Option 1, 9 percent of wage earners would be subject to the 15 percent rate, while under Option 2 only 3 percent would face that rate; the top rate of 20 percent will be applicable to only 1 percent of wage earners under both options (Figure 35).

Figure 35: Distribution of wage earners and PIT revenues by wage bracket, 2015



Source: World Bank staff calculations based on data from the Economic Research Institute.

Note: Data on RK citizens were used as the basis for calculation of pension contributions for December 2015.

Revenue gains are estimated at approximately KZT 80 billion from Option 1 and approximately KZT 43 billion from Option 2. Figures from the same study by the Economic Research Institute show that that PIT revenue collected from the KZT 300,000 to KZT 525,000 income bracket is KZT 92 billion; from the KZT 525,000 to KZT 1,050,000 income bracket is also KZT 92 billion; and, from the greater than KZT 1,050,000 income bracket, PIT revenue is KZT 51 billion. Using this information, Option 1 shows a potential estimated increase in PIT revenue of 28 percent in the KZT 300,000 to KZT 999,999 bracket and a 57 percent increase for the greater than KZT 1,000,000 bracket—an overall increase of KZT 80.5 billion. Using Option 2, it would be possible to boost PIT revenue by 18 percent in the KZT 500,000 to KZT 999,999 bracket and 51 percent in the greater than KZT 1,000,000 bracket—an overall increase of KZT 42.6 billion. Option 1 implies an increase of about 16 percent of current PIT revenues, while Option 2 implies an increase of about 9 percent.

Apart from the personal income tax, other levies on wages include several social taxes. A compulsory employee social health insurance contribution is proposed from July 1, 2017. The rate of contribution is expected to be 2 percent of the employee’s employment income, but it is unclear whether the contribution will be paid by employees before or after tax. In addition, there are a number of tax-deductible payments that an employer must pay in relation to the employment income of its employees. These include:

- (i) Social tax: 6 percent of employment income
- (ii) Social contribution: 5 percent of employment income
- (iii) Employer pension contribution: 5 percent of employee's employment income⁷⁴
- (iv) Additional pension fund contribution for high risk occupations: 5 percent of employee's employment income
- (v) Social health insurance contribution (proposed): 5 percent of employee's employment income

Social taxes should not be characterized as taxes since they are paid in return for an expected future economic benefit. Both types of compulsory employee contributions would entitle employees to future economic benefits in the form of pension income upon retirement and coverage of health care costs. Consequently, these contributions should not be taken into account when determining the effective tax rate on employment income. Consider the examples of two OECD countries, the United States and Germany. The social security component of tax in the United States is about 6.2 percent and the health care component is about 1.6 percent. In Germany, the components are 9.4 and 7.3, respectively, adding more than 16 percent. However, this does not appear to be a contentious issue in those economies because a graduated income tax structure with relatively high tax rates is already in effect.

Individuals who derive only investment income may still have some pension and health care entitlements despite not paying the same contributions as employees. For this reason, it is recommended that those who derive only investment income should be required to make the same contributions as employees. Such contributions can be withheld from dividends and interest in the same way that it is for employment income. This could also factor in the social tax and social contributions made by employers in relation to employment income. The social tax and contributions levied on employers in relation to employment income are tax deductible to the employer.

The special provision that exempts dividends paid on shares held for more than 3 years—and a similar exemption applied to capital gains—should be reviewed. The special provision is intended to act as an incentive to hold shares for investment rather than speculation. Given that capital gains usually have some form of concessional treatment as compared to income, it is not unusual for a minimum holding period to be used as a basis for distinguishing between income and capital gains. It is not clear that both incentives are needed to encourage longer-term investment in shares. The exemption for dividends could be repealed with concessional treatment of capital gains used to encourage longer-term investment in shares.

Another special tax incentive which may be reviewed is the exemption of dividends paid by a company resident on a stock exchange in Kazakhstan. There is also an exemption that applies to capital gains. It is not unusual for economies to provide these exemptions when establishing a local stock exchange to encourage investment in companies listed on the stock exchange. The Kazakhstan Stock Exchange was founded in 1993 with trading in shares in listed companies commencing in 1997. Given that the shares in listed companies have been traded on the Kazakhstan Stock Exchange for nearly 25 years, it is appropriate to review this exemption. In particular, reviewing whether the incentives have been effective in encouraging investment in listed companies and, if it has, whether it is still necessary given the maturity of the Kazakhstan Stock Exchange. Account may need to be taken of the impact that removing the exemption will have on the proposed Astana Financial Centre incentive.

Interest received on bank deposits is not taxed, creating an asymmetry between capital income and debt income. It is proposed that the GoK consider bringing bank interest to tax. The mechanism to collect this tax would be withholding at the source, simplifying the administration

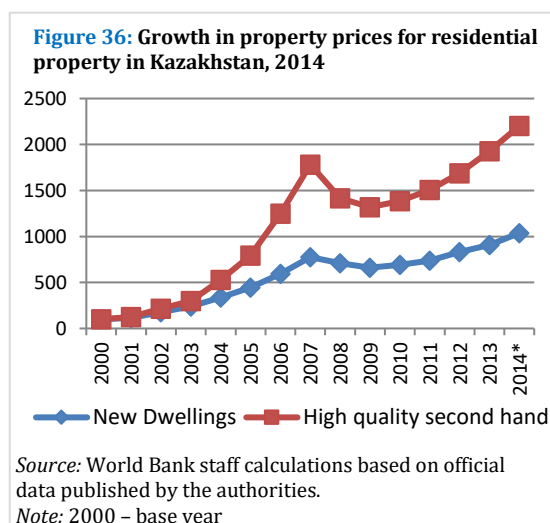
⁷⁴ Starting on January 1, 2018, employers will be required to pay an additional contribution for employees at the rate of 5 percent of the gross employment income to the Unified Accumulative Pension Fund.

of the tax and not adding any additional burden to the tax agency while increasing tax revenues. Bringing interest to tax also ensures that capital income is not unduly exempted.

Property taxes

International experience suggests that property taxes have many advantages, and it is recommended that the GoK consider ways to increase revenue from this source. Local governments are the main beneficiaries of property taxes on immovable property and these revenues help strengthen their public finances. In addition, property taxes are good local taxes as they are levied on an immobile tax base—those who pay the tax also live in the jurisdiction where the local government services are provided and the revenues help fund those services thus following the benefit principle of taxation. According to World Bank estimates, property tax collection is currently less than 1 percent of GDP (about 0.7 percent) and represents an opportunity for additional tax revenue generation. In the OECD countries, property tax collection is above 2 percent of GDP on average; some countries, such as Canada, the United Kingdom and the United States, collect more than 3 percent of GDP from this tax instrument.

Kazakhstan should consider moving to a market price based capital valuation of properties instead of an area-based system for property valuation, like several other former Soviet Union and CIS countries.⁷⁵ Research supports the use of the market-value approach as, in practice, it provides the better tax base. A simple area-based assessment can result in the same tax burden for a person living in a dilapidated house as a person living nearby in a newly-renovated house, assuming similar size houses. Therefore, a value-based assessment tends to better differentiate the tax burden between low-income and high-income households. Property prices show a rising trend in Kazakhstan, which indicates that a market price-based valuation approach could capture additional revenues (Figure 36).

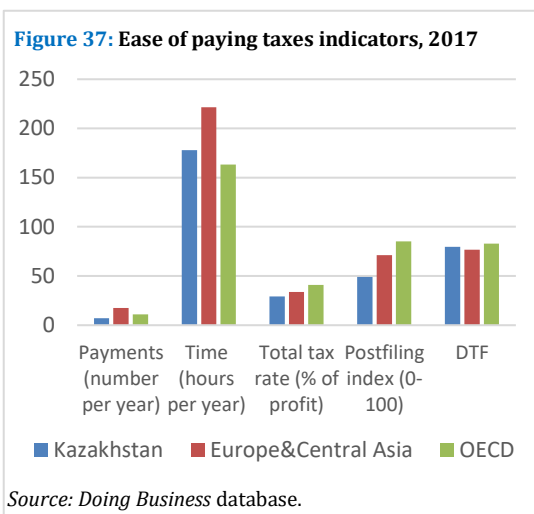


The fundamentals required to support a value-based property tax currently exist in Kazakhstan. Registration and ownership of property is backed by the force of the law. Also, the real estate market is active, particularly for residential and commercial property. The availability of mortgages is developing and should stabilize over time. Finally, having low property transfer costs supports the transparency of declared sale prices. It would be possible to provide valuation services at the Oblast level under the direction of a specially-created valuation center.

⁷⁵ The discussion in these paragraphs is drawn from World Bank 2014c.

3.4 Tax administration reform agenda

Improving tax administration and widening the tax base is critical for raising revenue, particularly where a political decision is made not to increase the tax burden, as in the case of Kazakhstan. For many years, Kazakhstan had been one of the top-ranked economies by the World Bank's *Doing Business* project for the ease of paying taxes in Europe and Central Asia, ranking 18th out of 189 countries worldwide in 2016.⁷⁶ However, in 2016 *Doing Business* introduced post-filing processes into its methodology, resulting in a considerable worsening of Kazakhstan's ranking in 2017, placing it at 60th out of 190 economies.⁷⁷ On the measure for the total number of tax payments, Kazakhstan continues to rank above other economies in Europe and Central Asia as well as the OECD high-income economies (with only 7 annual payments). It also ranked well on time spent by taxpayers (178 hours per year) and total tax rate (29.2 percent). However, Kazakhstan scored 49.1 out of 100 on the post-filing index in 2017 (Figure 37).



Kazakhstan has implemented several reforms to modernize the tax administration. Tax administration efficiency has been a top priority for the revenue authorities for the last decade, supported by the World Bank's Tax Administration Reform Project. As a result, the proportion of firms indicating that tax administration is not a problem has significantly increased, from 28 percent in 2008 to 61 percent in 2013 according to the Business Environment and Enterprise Performance Survey (BEEPS) 2014. In 2015, the government's 100 Steps agenda set out reforms to further improve tax administration. These proposed reforms included the simplification of tax and customs procedures, the integration of tax and customs systems into a "single window" regime, the introduction of universal tax filing by 2020, the introduction of risk management system in tax audits, the improvement of indirect tax administration systems, and the revision of simplified tax regimes. Several legislative and administrative initiatives were implemented to support the proposed reforms.

The introduction of electronic invoices in B2B transactions and the use of cash registers with online data transmission in B2C transactions is an important step toward reducing VAT fraud and tax evasion and improving compliance. In the two years after the voluntary use of electronic invoices was introduced in 2014, the number of e-invoices jumped from 116,304 in 2014 to more than 10 million in 2016. This is partly explained by the introduction of mandatory e-invoices for use by taxpayers importing goods subject to special monitoring following Kazakhstan's accession to the WTO in 2015.^{78,79} In 2018 the use of e-invoices will become mandatory for all VAT payers. E-invoices reduce firms' expenses on paper and postal fees and increase the transparency of operations between market participants. To stimulate the use of

⁷⁶ World Bank 2016c.

⁷⁷ World Bank 2017.

⁷⁸ There are 3,800 goods that are imported into Kazakhstan from non-EAEU WTO members at WTO-negotiated tariff rates below those in EAEU countries. To avoid the spillover of such goods into the territories of the EAEU, Kazakhstan committed to strict monitoring of these goods through the introduction of a "virtual warehouse" module implemented based on the "e-invoices" information system. Goods imported to Kazakhstan at WTO tariff rates are prohibited from being exported to EAEU countries; goods destined for EAEU countries are levied with the Single Customs Tariff and should be accompanied by a customs declaration and a mandatory electronic invoice.

⁷⁹ In accordance with item 2 of Article 263 of the Tax Code of Kazakhstan, starting from January 1, 2018, the issuance of invoices in electronic form will become mandatory for large taxpayers subject to monitoring, and for all VAT payers it will become mandatory from January 1, 2019.

cashless payments, the State Revenue Committee, in cooperation with the National Bank, is working toward the reduction of bank commissions. The mandatory use of cash registers with online data transmission is being introduced in stages by types of goods and services, starting with alcoholic beverages, gas and gambling. There is a concern among small businesses about their ability to perform cashless payments or use cash registers with online data transmission, as these require a financial investment, a secure internet connection and access to electricity at points of sale, which is not always possible. However, there are a number of innovative low-cost options (such as hand-held devices and mobile banking) that can be explored for use by small businesses. End-to-end monitoring of goods (from the time of import or their production in Kazakhstan) to the moment of sale is another measure introduced by the authorities to increase the transparency of market transactions and identify tax evasion schemes. To this end, a virtual warehouse module that uses the e-invoice system to monitor goods in Kazakhstan and track the pricing process of each stage from production to the end user is under development.

The VAT administration is in need of significant improvement, with a focus on the VAT refunds system (where the largest share of fraud occurs). Under Kazakhstan's VAT system, about 90 percent of VAT revenue is collected from 10 percent of registered businesses. Efforts should be concentrated on the expeditious handling of requests for refunds. As explained in the World Bank report *Kazakhstan: An Inquiry into Vat Refunds and Fraud and A Reverse Charge on Imported Capital Goods*, one way to reduce VAT refunds is to expand the scope of the reverse-charge mechanism at the stage of importing capital goods (making the inland purchaser liable for the VAT at import but permitting him to take a credit for the same VAT simultaneously). In addition, comprehensive audits should be performed in conjunction with the business income tax to separate certified (trustworthy) filers from non-certified filers (first filers, businesses without a good tax record). False refund claims cannot be filed without a VAT-registration number, indicating the need to recanvas businesses and weed out those that are not compliant and hence not eligible to claim VAT refunds. This should be supported by a requirement that VAT-registrants (which are generally large firms) appoint a representative from a reputable accounting firm to handle their VAT-related dealings with the tax authorities. Finally, the quarterly filing period should be replaced by a monthly filing period, as in most other economies with a VAT.

Taxpayer services have improved with automation, but IT systems require continuous modernization to keep up with technological innovation and the changing needs of taxpayers. The bulk (70 percent) of Kazakhstan's 52 different tax services are available online through e-gov and the Taxpayer Cabinet portal. Other services are provided through taxpayer service centers, of which 42 are equipped with e-queue systems. A call center and a situational center is established to monitor the quality of tax service provision in the regions in real time and identifying problem zones. Users of Taxpayer Cabinet, however, report regular server interruptions, flaws in IT systems, and insufficient IT equipment in taxpayer service centers.⁸⁰ A World Bank loan is to support SRC in upgrading its IT systems, but its implementation has been delayed for more than two years now. As the introduction of Universal Filing system is approaching, SRC should speed up the development of its Integrated Tax Administration System (ITAS). External communication channels need to be further improved to include feedback on system outages, encourage whistle-blowing of corruption incidences, status reports on resolving reported issues. Continuous training and deployment of tax return filers, related software, taxpayer guides and greater outreach will be needed for the success of the universal filing.

Tax authorities need to continue business-processes reengineering processes and strengthen risk-management systems. Business-processes reengineering initiative is ongoing with a view to simplify, outsource or further automate processes. Its implementation is largely dependent on the well-functioning ITAS. Tax audit procedures are modernized with greater

⁸⁰ Sange 2015.

reliance on risk-based selection, desk audits and simplified procedures. Until recently, significant proportion of tax audits were undertaken at the time of liquidation, causing lengthy liquidation procedures for businesses and heavy backlog pressure on tax officials. There are about 30 to 40 thousand individual entrepreneurs being liquidated each year. Starting January 2015, simplified desk tax audits at liquidation for businesses with income less than 60,000 MCI in the last 5 years were introduced, provided that there are independently audited tax statements. Plans are there to roll over simplified liquidation audits and simplified audits based on audited tax statements to all audits. E-audits are at the initial stage of implementation and require extensive capacity building in regional offices.

3.5 Policy recommendations

Corporate income tax

- *Rationalize the tax incentives structure.* There is a need to rationalize the various incentive schemes (currently there are 54). The special economic zones (SEZs) and regional zones are the most problematic, as it is unclear whether they reflect a coherent industrial policy or are the outcome of a series of lobbying efforts. With no clear transfer pricing regime in place for these zones, there are bound to be leakages. As a result of large loopholes, businesses operating elsewhere in the economy are subject to higher-than-normal tax rates. A review of the entire system should be undertaken to see how it can be rationalized. Even if special incentives for SEZs are left untouched, removing excessive tax incentives and tax preferences in the economy could have saved an estimated KZT 511 billion in revenue in 2016 alone, or 36 percent of total CIT revenues. This is a recurring loss; the government is foregoing similar revenues every year.
- *Simplify the incentive structure to reduce the cost of investment.* Replacing the entire system with a simpler system of investment allowances or tax credits linked to investment size—coupled with an accelerated depreciation regime instead of outright CIT exemptions—would result in a less-distortionary incentive system.
- *Perform a cost-benefit analysis of the existing incentives.* While completing a detailed economic and social cost-benefit assessment may be challenging, a simple fiscal analysis is doable. The cost of financial incentives can be easily estimated using budget expenditure data, while foregone revenue can be valued if the beneficiary companies are required to submit their profit-loss accounts (even if they are not paying taxes). Based on their financial performance, a rough projection of expected future revenues can also be made. In addition, an inventory of how many new investments are made as a result of the geographic and general financial and tax incentives can be readily prepared and updated. This analysis should help assess the effectiveness of the key incentive instruments and whether these are achieving their stated objectives and what, if anything, needs to be adjusted.
- *Estimate the fiscal costs of tax incentives annually* and include them in the general budget as an item of tax expenditure.
- *Define eligibility criteria more clearly.* The eligibility criteria are vague and the procedures followed by various entities are often inconsistent and unclear. The system is poorly designed and, as a result, new firms often receive fewer benefits than large, existing ones. Some firms may even be harmed by enrolling in such a scheme.
- *Award incentives based on publicly-verifiable criteria.* Both the financial and tax incentives should be available automatically to investors if they meet the criteria and there should be no scope for discretion.
- *Make procedures and norms transparent.* There must be a specialized government website that provides comprehensive information on the incentive criteria as well as details of all the investors receiving incentives from different entities, including sub-national levels of government. For this purpose, the government must finalize the inventory of incentives and investors and make this information publicly available in both English and Russian.

The inventory should be regularly updated and should be used to inform policy making and further reforms related to these incentives.

- *Enhance policy alignment with objectives and propose a coherent incentive strategy.* Based on an overall analysis of the existing policies and procedures, the government should come up with a unified strategy that is less costly, reduces the compliance cost for investors, eliminates duplication of efforts, and enhances coordination among different institutions awarding and administering the incentive schemes. This may also require capacity building exercises in the Ministry of Industrial Development, Ministry of Finance and the tax administration.

Value-added tax

- *Broaden the VAT base by eliminating inefficient VAT exemptions.* The loss of revenues as a result of VAT exemptions amounted to 42 percent of total VAT revenue collections in 2016 (following losses of 52 percent and 60 percent of total VAT revenue in 2014 and 2015, respectively). When combined with the CIT tax expenditures, these losses add up to almost 20 percent of total revenue collections.
- *Compute sector wise elasticities.* Scrutinize the revenue potential of various sectors of the economy by computing sector wise elasticities. This simple exercise should point out the sectors where potential is ill-exploited and the reasons for this.
- *Consider an upward revision of the VAT rate.* If the VAT rate were raised to 15 percent (and assuming 90 percent compliance at the new rate), revenues would rise by about 22.5 percent. As such, 2016 VAT collections would be KZT 1.9 trillion instead of KZT 1.5 trillion. If Kazakhstan were to adopt a VAT rate of 18 percent (similar to Russia) and assuming compliance of only 80 percent of the previous level, VAT revenues would rise by 40 percent; 2016 VAT collections would be as high as KZT 2.1 trillion.
- *Reduce the VAT threshold in stages.* The government had previously planned to lower the VAT registration threshold in stages, to 25,000 MCI in 2018 and 15,000 MCI in 2020. However, at the end of 2017, these plans for a gradual reduction of the minimum threshold were abolished.⁸¹ It would be necessary to consider the possibility of returning to the discussion of this issue.
- *Simplify and improve VAT refund procedures.* A provision for interest on late refund payments by the government may also be considered.
- *Bring agriculture under VAT with a threshold of 30,000 MCI applied across the board.* Implementing this change would be challenging, but it is the right approach. For both political and administrative reasons this will not be an easy policy to implement, but it can be done in a phased manner and should not be postponed. The standing policy of special VAT treatment for large farmers and agro-enterprises is not equitable or efficient; it is not tenable by any international norm. Considering the current status of nonoil revenues, VAT can and should be used as the mainstay of taxation and for that it will have to be applied in a more equitable and broad-based manner.

Simplified tax regimes

- Revise the system by limiting the turnover-based tax option to micro enterprises and moving small businesses toward taxation on a net income basis. Consideration should be given to administrative simplification and compliance cost reduction. Changes should include income calculation on a cash flow basis (instead of accrual basis).
- Put in place sufficient anti-abuse provisions for the temporary (three-year) expense deduction bonus for newly-established small businesses.
- Introduce complementary capacity building measures to promote proper bookkeeping.

⁸¹ The relevant amendments, effective from January 1, 2018, are reflected in the draft of the new Tax Code.

Personal income tax

- *Introduce a progressive income tax structure.* A three-rate structure is recommended for consideration: the existing rate of 10 percent for the vast majority of taxpayers, 15 percent for the middle segment, and 20 percent for the highest bracket. The following two options can be considered for the determination of income brackets: (i) Option 1: introduce a tax rate of 15 percent for those earning a monthly income of between KZT 300,000 and KZT 999,999; those earning a monthly income of more than KZT 1,000,000 pay the top rate of 20 percent; (ii) Option 2: introduce a tax rate of 15 percent for those earning a monthly income of between KZT 500,000 and KZT 999,999; those earning a monthly income of more than KZT 1,000,000 pay the top rate of 20 percent.
- *Separate social taxes from PIT to determine the effective tax rate on employment income.* Individuals who derive only investment income should be required to make the same social contributions as employees.
- *Reconsider the exemption of dividends paid by a company resident on a stock exchange in Kazakhstan.* This can be done after analyzing the effectiveness of this measure in encouraging investment in listed companies and an assessment of whether the exemption is still relevant.
- *Introduce a tax on interest received on bank deposits.*

Property taxation

- *Move to a market price-based capital valuation of properties* instead of an area-based system for property valuation. In doing so, the following should be considered:
 - Valuation is an expert function and requires particular skills in the estimation of property values. This capacity should be developed within a central Real Property Valuation Unit (RPVU) within the MoF;
 - The RPVU would have responsibility for determining property values for the entire country and ensuring that such values are uniform and relative, both *within* Oblasts and Rayons and *between* Oblasts and Rayons;
 - The RPVU should have access to actual transaction prices that are currently held by the MoF. Close cooperation with the Kazakh Statistics Agency would also be useful;
 - Centralized valuation departments like the RPVU generally hold valuable data on all real property both in terms of textual data but also in spatial formats. Such data is extremely useful as its potential use is transferable into other areas such as spatial and land use planning, economic development, and as a measure of the real estate wealth base of a jurisdiction.
 - The RPVU should be charged with developing Computer Assisted Mass Appraisal methodologies, relying on transaction evidence drawn from the real estate market.

Tax administration

- Simplify and improve VAT administration and refunds.
- Continue business-processes reengineering.
- Strengthen risk-management systems.
- Modernize IT systems.

Policy Focus 4: Strengthening Fiscal Policy Institutions

Institutional reform and administrative strengthening to support Kazakhstan's consolidation and transformation objectives are essential. A central aim of this PFR is to support the GoK in developing a strategy for fiscal consolidation that facilitates economic growth in an environment of low oil prices. Recent developments in the oil industry and its impact in Kazakhstan have made a medium-term focus on consolidation unavoidable; that task, the main theme of Policy Focus 1, is therefore given priority in the mission's recommendations. However, bold and wide-ranging institutional strengthening will be needed to implement the new NFRK rule and, in the longer term, to continue reforms and transitions already underway. Capacity-building efforts to strengthen fiscal policy management should aim, therefore, to strengthen analysis and oversight of fiscal consolidation under the new NFRK rule. These steps should form a basis for longer-term institutional strengthening—which must be initiated and supported now to ensure implementation of the GoK's broader goals of reducing the state's involvement in directing the enterprise economy while strengthening management of fiscal risk for the whole public sector. Needs for strengthening public spending and revenue administrations are covered under Policy Focus 2 and 3.

4.1 Fiscal and debt management reform needs

Institutional reform must cover the entire public sector. Achieving the GoK's consolidation and transformation aims depends critically on strengthening fiscal control and risk management over the General Government and those SOEs that remain within the public sector. Immediate consolidation efforts should be consistent with and support the broader and longer-term aims of transforming the non-resource sectors of the economy, of freeing economic space for private sector operations, and of ensuring that natural resource revenues are saved to provide an income stream for future generations. As well as responding to the impact of lower oil prices and uncertainty in energy markets, it is vital to recognize the need for a more comprehensive review of fiscal policy and risk management across the entire public sector and look well beyond immediate fiscal constraints.

A public-sector balance sheet approach (BSA) to both fiscal policy and fiscal risk management is a long-term target and is being developed in advanced OECD countries and by international organizations. It is now well recognized in Kazakhstan and internationally that fiscal policy options and their risks must be reviewed much more broadly than through an analysis of annual and medium-term flows of transactions and their implications for debt sustainability. Many risks arise from events determined by global forces; they also arise from outside the General Government through risks stemming from SOE operations or through the financial sector. Standard cash-flow-basis analysis of General Government debt management and debt sustainability continues to provide a valid initial focus for fiscal consolidation efforts. It will become increasingly important, however, to track and assess risks that arise from both asset and liability sides of the public-sector balance sheet; the former risks arise through a potential change in value because of market changes—of obvious relevance to oil reserves and revenues (and other natural resource reserves). Forecasting and assessing this broad range of risks requires both a more-developed public sector accounting and reporting system and a global view of possible economic scenarios.

A sustained and phased approach to institutional development is fundamental to this policy focus. It will first address the issues involved in applying the new rules for managing the NFRK and its transfers to the national budget guided by the nonoil deficit measure. Use of standard practices to assess debt sustainability as well as restructuring the foreign/domestic composition of debt and development of the domestic market are highlighted. The first section will also emphasize the need to look at alternative ways to use proceeds from privatization in terms of compliance both with the new rules applying to NFRK assets and public-sector debt and long-term transformation of the economy.

Many improvements to the present institutional framework are needed. The President's 2017 Address to the Nation gave clear goals for the future, but achieving these goals will take time, careful planning, and execution. First, the technical capacity of the bureaucracy and its links with political decision makers need strengthening, and overall transparency and accountability of fiscal processes must be improved at all levels. We look first at immediately needed modification of the present roles and functions of key fiscal agencies of the public sector to manage fiscal consolidation under the new NFRK rules. As a starting point, [Table 13](#) was prepared following the April 10-14, 2017, PFR discussion of present and proposed institutional arrangements for setting fiscal policy and risk management under the new NFRK rule. In the initial reform phase, institutional reform must focus primarily on building capacity to implement consolidation policies. The subsequent phases will build on the consolidation program to establish, in Phase 2, reforms that will firmly institute accrual basis accounting, budgeting, and risk management practices across the entire transformed public sector. Phase 3 reforms can then use this basis to establish full implementation of results-based budgeting and fiscal management at activity, program, and strategic levels throughout government.

A foundation for long-term reform is already in place. Kazakhstan's now well-established Treasury System provides a sound technical base for effective public finance management (PFM). The treasury system approaches high international standards and, in principle, can be extended beyond General Government to cover the public sector.⁸² Significant progress is also being made in implementing modern accounting and reporting standards that aim to match OECD standards. These are significant achievements that confer a great advantage in achieving its long-term transformation and consolidation objectives—Kazakhstan is a lead reformer in the region in these respects. The Committee for Treasury of the Ministry of Finance is responsible for managing and developing the treasury system, which is being extended to provide access down to the district level. This system, plus recent strengthening of audit legislation, provide a basis for real-time tracking of the fiscal deficit and of the nonoil deficit and for effective fiscal control, management, and accountability.

A detailed action plan needs to be developed to guide immediate and long-term public-sector reforms. [Table 13](#) provides a draft overview of key elements of Kazakhstan's current fiscal administration in relation to the functions and tasks that must be faced over the next decades in tackling the bold transformation advocated in the President's recent addresses and policy directions. It identifies the main agencies of the State that are required to implement the new direction of economic policy and fiscal administration in the coming decades and relates these to the key fiscal policy and management functions that are now recognized as essential for effective policy setting and implementation by advanced economies. Table entries indicate the current and suggested future states of these relationships at four levels that indicate the transformation needed during each of the three phases of reform. Functions designated at level **1** represent the team's understanding of the current status-quo mandate of the listed entities; **2** indicates administrative strengthening actions that would need to be put in place for effective implementation of the priority fiscal consolidation and initial economic transformation now underway in Phase 1; **3** identifies actions needed to implement Phase 2 reforms; and **4** signifies the reforms required to achieve Phase 3 goals. [Table 13](#), it must be emphasized, is a draft; it suggests key actions, but these must be closely examined by the Kazakhstani authorities and developed into a time-bound action plan that can guide Kazakhstan's economic and fiscal transformation over the next decades.

⁸² For an overview of Kazakhstan's Treasury System addressed by the PEMPAL, see the PEMPAL website at https://www.pempal.org/sites/pempal/files/attachments/1-2-treasury-comittee-v3-1_eng.pdf.

	from the NFRK		sector can be integrated with government with respect to operation of the new NFRK rules and public-sector debt management. Privatization and use of privatization proceeds also need to be considered as part of the broad strategy of restructuring the economy and encouraging private sector development.	receipts of NFRK funds for budget financing			
Debt policy and management	1 Debt policy set in line with fiscal projections and debt sustainability			1 Implementation of debt policy is under control of BPD and SBD, with accounting and reporting established by BLD and AAMD; the Committee for Treasury manages the Treasury System	2 Strengthen technical analysis of fiscal options presented to the President	1 Main authority for assessing and approving group SOE external borrowing	1 Oversight and management of borrowing and debt for group members, particularly SME and agricultural financing and support
Asset policy, privatization, and asset management		1 Oversees asset policy development	The leadership of the working group needs to be clearly established (likely under MNE direction) and a program of activities and expected outcomes defined within a short period of time.	1 Asset accounting and methodology incorporated as part of accrual-basis accounting and IPSAS implementation		1 Key agent for privatization preparation and implementation	1 Several prospects for privatization
		2 Clarify authority for policy development for state ownership and governance principles for privatization				2 In consultation with MNE and the WG, redefine the relationship between the SOE sector and General Government for fiscal management and economic transformation; develop a time bound action plan	

Risk assessment and management	3 With DSPA, develop a strengthened framework for fiscal risk analysis and management for the public sector, including monitoring and reporting on outstanding debt and risks related to SOE debt			3 Implement elements of new framework in budget analysis as framework develops	1 Committee for Treasury ensures forecasting of debt service payments and execution of debt service		2 Develop cash and debt forecasting and management, and strengthen local securities market					1 All require standard commercial financial and credit risk assessment procedures to apply to member entities. In principle, these operations could be deepened and provide more comprehensive risk assessment for the elements that remain in the public sector.
Sectoral policy assessment and review	1 With DSD, reviews sectoral policy implementation			1 Debt management strategy reviewed regularly to adjust to macroeconomic changes	1 Sectoral policies are implemented via priority assessment in MTEF				1 Development of major economic enterprise sectors	1 Principal agent to promote SMEs and innovation in non-resource economy	1 Development and support of agricultural enterprises	
Fiscal and financial monitoring and reporting	3 Strengthen oversight of processes of reporting and M&E carried out by DSPA			1 Budget adjustments made to MTEF in line with fiscal policy changes and cash management needs	2-4 Develop accrual budgeting for public sector	2-4 Complete IPSAS-compliant accrual accounting for the public sector**		4 Develop Parliament's capacity for <i>ex ante</i> oversight of fiscal policy and budget—possibly via a Fiscal Council			3 Enterprises remaining in the public sector would integrate reporting practices with General Government reporting to develop consolidated public-sector reports as required by IPSAS	
Results-based management	4 With DSPA, develop			4 Implement integrated budgeting, accounting		4 Audit methodology to		4 Standards of results-based management—including public interest results—to be developed				

	program structure and <IR> methodology for planning, PBB, and strategic analysis of fiscal policy impact				and reporting (<IR>) across the public sector	incorporate performance audit^e		and applied to those SOEs remaining within the public sector
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- a. The Budget Policy Department (MNE) is the principal agency of the General Government responsible for macro-fiscal analysis and setting fiscal policy. As noted, however, other MNE departments, such as the Department of Strategic Planning and Analysis (DSPA) and the Department for Sectoral Development (DSD), play important roles in guiding monitoring and evaluation (M&E) methodology and sectoral policy review, respectively.
- b. The State Liability Management and Financial Sector Development Policy Department (MNE) performs the functions of a secretariat to the NFRK Management Council, mainly dealing with targeted NFRK transfers (and, previously, decisions on off-budget direct lending).
- c. The Committee for State Property and Privatization (MoF) has major responsibilities in these matters and could play a significant role in Working Group deliberations and subsequent implementation. It is the authorized owner of state assets on behalf of the GoK but because shareholder rights are vested in several sector ministries and legally-independent holding companies, ownership is very dispersed. (OECD 2017)
- d. The Committee for Treasury (MoF) plays a vital role in recording budget controls for the annual budget and MTEF in the country-wide Treasury System (covering all transactions with entry down to the Rayon level; it is now being extended to allow direct entry at the district level for General Government ministries, departments and agencies). Work is underway to implement accrual-based accounting fully and to achieve full compliance with IPSAS across the General Government, as well as to use accrual-based accounting for budget analysis and planning. The availability of real-time transaction data against the budget and reconciliation with the Treasury Single Account in the NBK is an essential element of the MoF's cash and debt management system, which is also managed by the Committee. In addition, the Committee maintains a debt management system that records external and local debt, forecasts debt service requirements, and makes payment under the authority of the Minister of Finance.
- e. The Accounts Committee is the supreme audit institution (SAI) for Kazakhstan. It is responsible for internal and external audits as well as the improvement of the use and management of budget funds, state assets, and quasi-public-sector entities (SOEs). The Law on State Audit and Financial Control (of November 12, 2015) requires the Accounts Committee to carry out the full range of audit activities, including financial statement audits, performance audits, and compliance audits. Its scope is broader than similar bodies in some OECD countries, which typically separate internal and external audit functions. Capacity building will be required to fulfill all functions effectively; performance audits, in particular, will be dependent on development of performance data from the planning, budgeting, and accounting systems.

4.2 Phase 1: Toward better state planning and fiscal management administration

Phase 1 of the suggested action plan will build a framework for fiscal consolidation and begin the task of long-term economic transformation. First, it focuses on the application of the new NFRK rules, their possible strengthening, and building administrative capacity to implement policies consistent with these rules. Second, it examines the overall management of public-sector debt, the integration of SOE debt to the public debt management strategy, and the development of the domestic securities market. These activities will set the basis for long-term reform of the SOE component of the public sector, which should aim to develop an integrated management of public assets and liabilities and comprehensive oversight of public-sector fiscal policy.

The Presidential commitment to an economic transformation strategy provides a guide to long-term policies to modernize the Kazakh economy. Tangible steps toward these strategic goals, together with the establishment of effective and transparent rules governing fiscal policy and oil revenue management, will be necessary to free the economy from excessive central direction and to attract foreign investment. Both elements of the vision, however, involve substantial changes and risks. Implementation will require a fundamental re-examination of established institutions, significant efforts to coordinate different elements of the strategy, and a substantial build-up of fiscal administration capacity. The immediate priority for reform, however, is to strengthen the management of the NFRK and the urgent implementation of medium-term fiscal consolidation. A basis must also be established for the long-term transformation of the public and private sectors toward OECD standards.

The NFRK, fiscal rules, and policy implementation

The NFRK and its rules have been strengthened progressively. The NFRK, first established in 2000 and now covering all direct oil revenues, serves two principal functions—a savings function to ensure an income stream for future generations and a stabilization function that smooths the spending of oil revenue flows over time. Savings are invested in foreign assets to avoid exchange rate impact on the non-resource sectors. Sovereign Wealth Funds like the NFRK have been set up in a wide range of economies in recent decades, many of them using the model established by Norway, which created its Government Petroleum Fund in 1990; economies have since tailored their SWFs to their individual circumstances.⁸³ There have been major changes in the oil industry and the global economy since the NFRK was first established and a series of changes have been made to the NFRK management and operational rules in response ([Annex A.2](#)). The 2016 modification of the NFRK rules included additional fiscal controls and transparency requirements. Most importantly, the use of NFRK funds for the off-budget financing of SOEs or other domestic activity was prohibited.

Changes to the global economy and to the outlook for oil and fossil fuels will continue to impact NFRK management objectives. Following the global financial crisis and the more recent collapse of the oil market—as well as rising concerns about the impact of climate change on the future of fossil fuel-based industries—the prospects for future growth in investment and earnings for economies dependent on these industries need to be re-examined. The quantitative savings objectives of the NFRK are critically dependent on the expected flow of resource revenue, as well as the earnings from current savings. Norway, which set up its SWF in a very different global market and at a different stage in its production cycle, has been able to operate using the “bird-in-hand” principle where savings are linked to substantial earnings from foreign assets. That option is not appropriate for Kazakhstan’s position in its production cycle and must be reviewed

⁸³ See Davis, Ossowski and Fedelino (2003) for a discussion of the basic principles and individual country experiences; Ana-Maria Jul (2016) produced a review of recent SWF experience and its relevance to the NFRK as part of JERP support. See also Ossowski 2013.

in line with the present and likely future earnings from its natural resource reserves. Estimation of the permanent income flow from reserves and future production (under the PIH) provides a more realistic (albeit still uncertain) basis for estimating appropriate NFRK targets for savings and transfers to the Republican budget.⁸⁴

Operation of the new NFRK rules should be implemented transparently, and quantitative rules determining the target nonoil deficit investigated further. The new NFRK concept is broadly consistent with price-based fiscal rules. Using a proposed PIH flow as the basis for a target nonoil deficit could easily lead, however, to procyclical policies. The variety of immediate fiscal challenges facing Kazakhstan appear likely to be best served by continuing to use the nonoil deficit as a measure of performance of the nonoil sectors rather than as a binding budgetary target. Institutional capacity to respond transparently and appropriately to cyclical factors and external shocks should be built up as quickly as possible. The possibility of setting structural fiscal balance targets based on an analysis of long-term scenarios should, however, continue to be researched for future modifications to the NFRK rule.

High quality, independent, and transparent advice on targeted budget transfers are essential for the effective operation of NFRK rules. As indicated in [Table 13](#), the MNE Department of the National Fund coordinates advice from the relevant ministries, including the NBK, the MoF, and the Ministry of Energy. The MNE serves as a secretariat to the GoK's Economic Policy Council that makes recommendations to the NFRK Management Council, which is chaired by the President, on targeted transfers from the NFRK to the Republican budget. First, it is recommended that the explanation of the economic impact of proposed targeted transfers from the NFRK include an assessment of short-term risks and possible long-term consequences. Second, all such transfers should be audited by the Accounts Committee and reported to the parliament. The possibility of parliamentary ex-ante involvement, which could strengthen international perceptions of transparency and accountability, should also be considered. Policy Focus 1 recommends taking steps toward establishing an independent fiscal council and discusses some of its key potential functions. Many OECD countries have established fiscal councils or similar bodies; these are typically linked to the legislative branch of government and make their own assessment of the fiscal impact of proposed budgetary measures.

Managing government debt

Outstanding government debt is relatively modest by global standards at about 20 percent of GDP (25 percent of GDP when including NBK debt), and the risk profile is comparatively benign. The mix between domestic and external debt is approximately 50–50 and, because most of the debt is either medium- or long-term, refinancing risks are relatively modest. The average time to maturity is approximately 10 years ([Table 14](#)). Interest rate risk is non-negligible for domestic debt, with 45 percent of the outstanding debt having its interest rate refixed during 1 year (debt maturing and refinanced, and variable interest rate debt). While the risk profile of the debt is relatively sound overall, large currency depreciations in recent years have underscored Kazakhstan's exposure to foreign currency-denominated debt. As discussed below, many of these concerns will change when SOE debt is included as part of total public-sector debt.

The MoF, together with the NBK and with participation of the MNE, is responsible for developing and implementing the medium-term debt management strategy. The MNE is responsible for planning of policies, and the MoF is responsible for debt management strategies, including issuance of government guarantees. On the external side, the borrowing instruments are international bonds and foreign-currency loans from multilateral institutions to finance specific projects. On the domestic side, bonds with different maturities (as usual, between 3 and 10 years) are issued at auctions held by the MoF. The NBK issues bills with maturities of up to 1

⁸⁴ See IMF (2017b), which argues for the development of price-based fiscal rules to anchor short- and medium-term fiscal policy.

year, and has plans to regularly sell from their holdings of medium- and long-term government securities to promote market development.

Table 14: Government debt as of end-2016: selected risk exposure indicators

	External debt	Domestic debt	Total debt
Amount (US\$ billions)	13.7	12.8	26.4
Nominal debt (percent of GDP)	10.0	9.3	19.3
Refinancing risk: ATM (years)	11.6	8.7	10.2
Interest rate risk: Debt refixing in 1 year (percent of total)	19.1	44.6	31.4
FX risk: FX debt (percent of total debt)			51.7

Source: World Bank staff calculations based on data provided by the authorities.

Shifting the government debt portfolio toward domestic debt and the development of the domestic securities market are priorities for the government. Large currency depreciations in recent years have led to a shift in preferences for domestic versus external funding; the current policy is to shift toward domestic funding. A similar change, however, does not appear to have taken place for SOE debt. A move toward increasing domestic government debt will require additional efforts to develop the government securities market. The NBK’s initiative to develop a yield curve starting from the short end is commendable. However, the SBD should play an active role in both the domestic issuance mechanism and process (see below), by leading regular meetings with market participants, and through initiatives to broaden the investor base. Developing a medium-term debt management strategy that is updated and published annually is key to sound debt management and to achieve the preferred overall risk exposure. The strategy will guide all borrowing transactions and debt management activities more broadly. It would initially focus on General Government debt, including estimates of contingent and implicit liabilities, but should be expanded over time to include a more explicit analysis of SOE debt. Annex 5 provides further detailed discussion of fiscal risks and recommendations on SOE borrowing/debt issues.

Several challenges to the development of the domestic securities market need to be addressed. The domestic borrowing plan is developed jointly by the SBD and the MoF Committee for Treasury. The Committee for Treasury plays a key role in deciding the cut-off prices at the auctions. This arrangement suggests potential challenges for domestic securities market development. The Committee for Treasury is responsible for cash forecasting and cash management (these forecasts depend on inputs from the main spending and revenue collecting agencies). While the auction decision is formally a joint decision between the Committee for Treasury and SBD, cash needs play a major role in the decision. As such, domestic borrowing tends to be volatile throughout the year. While this ensures that debt is only issued when needed and when prices are acceptable to the GoK, it is not conducive to market development, where stable and predictable issuance is key. A further potential challenge to preparing and implementing a stable borrowing program is that of monthly transfers from the NFRK; transfers are front-loaded in the first half of each year, affecting the issuance regularity of government securities.

Managing SOE debt in a restructured public sector

Policies to reduce SOE debt and privatize many SOEs are not yet fully developed or well-coordinated with consolidation and long-term fiscal policy development. The President recently ordered the GoK to take “special control” of borrowing by national holdings and companies.⁸⁵ The government has prepared a draft law on issues related to management of SOE

⁸⁵ For more information on debt control, see http://www.kazinform.kz/ru/mery-po-sokrascheniyu-vneshnih-dolgov-nackompaniy-nazval-ministr-finansov-kazahstana_a3027525.

debt, which will cover monitoring and controlling future borrowing by SOEs. Controls will be applied to a selected list of entities, which will require the approval and authorization of the central authorized body on state planning to obtain foreign loans over a certain threshold. Beyond establishing formal control, however, questions surrounding the present level of borrowing by the GoK and the SOE sector relative to NFRK assets (sovereign net debt) must be addressed. The ambitious privatization program and the distribution of the proceeds of privatization must also be clearly administered. The way in which these tasks are tackled—and perceived internationally—will determine the future shape and effectiveness of the new public sector and its relationship to private sector activity.

Although SOE borrowing has slowed in recent years, it remains a major concern. A JERP study in 2012 recorded that, “while the GoK had followed prudent fiscal and debt management policies over the past decade ... major ... SOEs in Kazakhstan have been rapidly building external debt.”⁸⁶ The three main SOEs—SK, Baiterek and KazAgro—are able to raise funds on the international markets, and are the major borrowers of foreign-currency denominated debt. The extent of SOE borrowing and the division of responsibilities to assess risks, authorize borrowing, and monitor outcomes represent major weaknesses in fiscal policy making and management. Action is urgently required to define the policies and guidelines for different components of public-sector debt and to unify GoK authority over this critical area ([Annex A.5](#)).

Table 15: Public-sector debt outstanding as of end-2016

	Domestic		External		Total	
	US\$	% of GDP	US\$	% of GDP	US\$	% of GDP
Central government	12.8	9.3	13.9	10.1	26.6	19.4
Local governments	0.1	0.1	0.0	0.0	0.1	0.1
National Bank of Kazakhstan	7.6	5.5	0.8	0.6	8.3	6.1
Samruk-Kazyna	12.2	8.9	15.6	11.3	27.8	20.2
Baiterek	4.6	3.3	4.6	3.3	9.2	6.7
KazAgro	1.3	0.9	1.7	1.2	3.0	2.2
Total	38.6	28.1	36.6	26.6	75.1	54.7
Debt according to the NFRK rule						35.3

Source: World Bank staff calculations based on data published by the authorities and SOEs.

Note: Some sums may not add up exactly due to rounding.

Fiscal policy coordination in a restructured public sector

Fiscal policy coordination between the MoF and the MNE has significant shortcomings, particularly in relation to SOEs. The current mandates of the MoF and the MNE include the preparation of fiscal forecasts and the Medium-Term Socioeconomic Development Forecast under the broad oversight of the Budget Commission. They are not well coordinated, however, in terms of addressing long-term fiscal reform or conducting comprehensive fiscal risk analysis and management. Their authority over SOE reporting and control of quasi-fiscal activities is very limited. An immediate priority should be to establish clearer organizational responsibilities for the transitional phase, including managing fiscal consolidation under the new NFRK rule and establishing the methodology for managing SOE debt and public-sector debt sustainability analysis. Steps need to be taken now to establish clear mandates regarding SOE borrowing and debt. This work will form the basis for effective risk analysis and debt management for the entire public sector to be achieved over the long term.

Dialogue and coordination among the different SOE entities and the GoK need clear direction and administrative strengthening. As indicated in [Table 13](#), a Working Group

⁸⁶ World Bank 2012, p. 6.

including relevant departments from the MNE, the MoF, and SOE principal holding companies has been set up to examine management of public-sector debt under the new NFRK rules. However, at the time of the PFR team’s visit in April, no clear terms of reference had been prepared or were available to the team. The proposed participating groups expressed differing views on the likely work program and formal operations did not appear to have been initiated other than by general memoranda. The fundamental importance of moving to unified management of fiscal policy, borrowing, and strategic direction for the GoK has been stressed above. As a matter of urgency, clear terms of reference aimed at establishing a time-bound action plan should be drawn up for the Working Group and key sub-groups. The terms of reference should also address the question of how best to utilize the proceeds of privatization to support NFRK savings and stabilization objectives as well as support the long-term development of the economy.

State property ownership laws need fundamental review. Recent work by the OECD makes it clear that the administration must address many fundamental legal and administrative problems to make long-term progress toward the transformation vision outlined in the President’s 2017 Address to the Nation.⁸⁷ A vital step toward establishing a program of economic transformation is a clear definition and restatement of asset ownership policy—preferably, asset ownership should be established in a single ownership entity.⁸⁸ Both the privatization strategy and the need to manage all state assets in line with the fiscal consolidation and economic transformation strategy suggest that there is a need for a fundamental re-examination of the present framework.⁸⁹ The present arrangements involve the separation of a significant part of national wealth and cash flow from budgetary control by incorporation into the SOE sector and outside parliamentary control. These arrangements are distinct from OECD practice and their continuation will make the goals of consolidation and economic transformation very difficult to achieve. Such a review should ensure that the current professional competence within the SOE sector is deployed effectively to support a well-directed privatization program and oversight of the unified public sector. Continuing international assistance will be needed to conduct such a review and help establish an institutional framework for coordinated management of a unified public sector. The review would also set clear directions for long-term institutional reform in Phase 2 and Phase 3 of the suggested action plan, which are outlined below. Much of the implementation of such a review would occur during Phase 2 of the action plan.

Economic statistics and the changing structure of the public sector

Economic statistics and national accounts need to be strengthened to help track changes in economic structure and implementation of the GoK’s modernization program. To track progress in implementing the new NFRK rule, transforming the public sector, and modernizing the economy, major improvements will be required in the collection, reporting, and analysis of economic data. The government’s Socioeconomic Development Forecast for 2017–2021 lists goals and objectives and budget priorities but does not provide a framework for tracking achievements and assessing these against forecasts. It also lacks a means of assessing the success of privatizations or public sector restructuring activities. The task of improving the structure and

⁸⁷ OECD 2017.

⁸⁸ OECD 2017.

⁸⁹ Samruk-Kazyna is characterized in the Presidential Decree of 26 June 2013 as a quasi-public (or Sovereign) Wealth Fund. OECD (2017, 140), indicates key provisions in the Law on Sovereign Wealth Fund that establish the special role of the Samruk-Kazyna fund in managing the economy. Key elements are as follows: (i) neither the government nor other state bodies should interfere with the operations of Samruk-Kazyna or the group companies, unless otherwise stated; (ii) a representative of the Accounts Committee is a permanent member of the “Specialized Committee” of Samruk-Kazyna, with powers to start an external audit of any company of the group. There is a centralized internal audit service within the group; (iii) Samruk-Kazyna and all group companies are required to have ten-year development strategies complemented by five-year development plans; (iv) in the interests of national welfare, Samruk-Kazyna has priority rights to acquire strategic objects, shares of banks and rights to subsoil use; (v) the main principles of interaction between the government and Samruk-Kazyna are included in an agreement on co-operation; (vi) according to the *Law on Sovereign Wealth Fund*, Samruk-Kazyna and the group companies may be required to participate in the realization of “socially significant and innovative industrial projects”.

content of this document could provide a good focus for building the capacity of the GoK's policy agencies and for enhancing its accountability for performance against strategic targets. As noted under Policy Focus 1, current fiscal data does not record all expenditures in accordance with GFS criteria. More work will be required to implement both GFS and IPSAS standards in fiscal reporting. More broadly, economic data should be recorded and reported in a form that allows for the assessment of actual sectoral economic performance against forecasts.

While initiatives for strategic planning and results-oriented budgeting are in place, more work is needed to define strategic goals clearly and to assess their achievement. A clear statement of policy intentions is outlined in both Kazakhstan 2050 and the President's 2017 Address to the Nation. These are broadly reflected in 10-year national development strategies. Mandatory 5-year strategic plans are prepared on a rolling basis at the ministry or agency level. Although existing requirements formally stipulate that agencies must provide performance information against these broad targets, it will require a major long-term program to establish an adequate framework linking strategic planning to performance reporting.

There are weaknesses in statistical coverage and reporting of economic and institutional trends. As noted, the Medium-Term Socioeconomic Development Forecast is the main document used to give the President and the parliament a quantitative overview of the status and forecast impact of policies proposed in the rolling Republican budget. It provides: (i) an outline of major economic and social trends; (ii) an overview of goals and objectives for economic policy during the next 5 years; and (iii) an indication of expected overall economic growth and growth in key economic sectors. The Budget Commission has not yet attempted to incorporate proposed changes to the public sector and between the public and private sectors through the privatization program in the Medium-Term Socioeconomic Development Forecast. It has also not established a framework for monitoring achievements relative to forecasts or to analyze the factors (such as external shocks, price changes, or policy changes) that have resulted in variations between outcomes and forecasts. OECD country frameworks (in particular those for Australia and New Zealand) can provide models for such an approach. However, a major effort will be required to build capacity in the MNE, MNE Committee on Statistics, and the MoF.⁹⁰ Examination of statistics capacity was beyond the scope of this PFR and completing these tasks will require relevant international expertise and support. The PFR team recommends that a major review of institutional statistical capacity and the analytical framework of the Medium-Term Socioeconomic Development Forecast be undertaken at an early stage of the suggested action plan since a strengthened analytical and reporting framework will be essential to effectively implement the national transformation strategy as foreseen by Vision Kazakhstan 2050.

4.3 Phase 2: Accounting and reporting reforms and stronger risk management

Major efforts are needed to establish uniform accounting and reporting rules across the public sector that emerges from the process of economic transformation. As outlined above, for this process to gain substantial momentum, the nature of the new public sector must be clarified in practice and in law. Budget and planning practices will continue to vary between different types of entities, both within General Government and between the General Government and SOEs that remain as part of the public sector because of their significant contribution to public interest (such as public monopolies and social welfare administration). International public-sector accounting standards (IPSAS) and reporting practices being developed and promulgated by the IPSAS Board provide a basis for all units within the public sector to maintain accounts and report in a way that allows a consistent and comprehensive overview of public-sector transactions, their impact on net worth and balance sheet composition, and potential risks.

⁹⁰ The Committee on Statistics is part of the MNE and the Chief Statistician reports to the Minister of National Economy. The activity of the Agency is financed by the Republican budget. For more information about the Committee on Statistics, see the UN website at <https://unstats.un.org/unsd/dnss/docViewer.aspx?docID=602#start>.

These principles are being applied within the General Government in Kazakhstan, but they need to be disseminated more broadly within the public sector that will emerge from Kazakhstan’s economic transformation process.

A sound platform for public-sector accounting, control, and reporting is being put in place. As indicated in [Table 13](#) and in the preceding section, work is already underway to comply with IPSAS throughout the General Government. Full compliance would enable the GoK to meet the IPSAS standard of consolidating the entire government as the “Public Sector” reporting entity, incorporating both the GFS category of General Government and the commercially-operated SOEs remaining within the public sector. Measures are already in place to achieve the reporting goal and to apply accrual-basis accounting to budgeting and planning. Accrual-basis accounting is essential to allow a full balance-sheet approach to fiscal policy and risk analysis and management; these data, in turn, will provide a much stronger base for public-sector budgeting. Accrual-basis reporting under IPSAS is not an end in itself—work on accrual budgeting is also underway and should be continued alongside the program to achieve full IPSAS compliance for financial statements. Support for the introduction of accrual budgeting by the IMF, as well as the recommendations made by in the 2016 World Bank report on the Budget Code, are consistent with a continuing emphasis on using accrual accounting as a basis for accrual budgeting. These efforts should be undertaken simultaneously rather than sequentially.

Accounting and reporting reform—developing a roadmap

A well-defined roadmap for public sector accounting reform is essential to guide modernization of the public sector and the economy. For the most part, PFM reform in emerging economies—whether with the technical guidance of the World Bank, IMF, or bilateral partners—involves a commitment to adopt IPSAS for accounting and reporting. Kazakhstan is strongly committed to such a path and its well-established treasury system provides a strong technical base for applying uniform accounting standards across the public sector.⁹¹ IPSAS includes a requirement for consolidation of the entire public sector, whereas GFS requires only consolidation at the General Government level, and treats SOEs as part of the enterprise sector.⁹² Fiscal policy formulation and management of risks to the fiscal position require policy analysis and intervention from both the General Government and SOEs. An accounting reform roadmap aiming at comprehensive coverage of fiscal policy and risks should, therefore, chart a progression from the present focus on General Government and annual or medium-term transaction flows to a consolidated balance-sheet approach to fiscal policy setting and risk management. Even among OECD countries, few have proceeded very far toward accomplishing these objectives. However, the necessity of applying modern accounting techniques and principles to all entities under public ownership is now generally recognized.⁹³ As outlined earlier, Kazakhstan must first address the fundamental ownership issues in its current government structure. But it is equally essential that compatible accounting and reporting standards be established across the modernized public sector. Furthermore, institutional capacity to use comprehensive public-sector data must be strengthened so that it can be used to formulate fiscal policy, assess and manage fiscal risks, and monitor and evaluate fiscal performance.

⁹¹ Noting that the Treasury System would continue to record ministry, department and agencies’ transactions in real time, while GG entities like pension and social insurance funds would maintain separate accounting systems that would interface with the Treasury System. SOEs, as part of the public sector, would also develop interfaces with the Treasury for purposes of public sector and whole-of-government consolidation and reporting.

⁹² IMF standards for Government Finance Statistics (GFS), though broadly compatible, differ from those of IPSAS regarding accounts consolidation. IMF GFS defines the primary (generally non-commercial) activities of government under the GFSM 2014 “General Government” classification (often divided into central and sub-national levels). State-owned financial and non-financial enterprises are treated separately as sub-sectors more allied to the corporate sector. IPSAS requires consolidation of the entire government-operated sector as the “Public Sector” reporting entity.

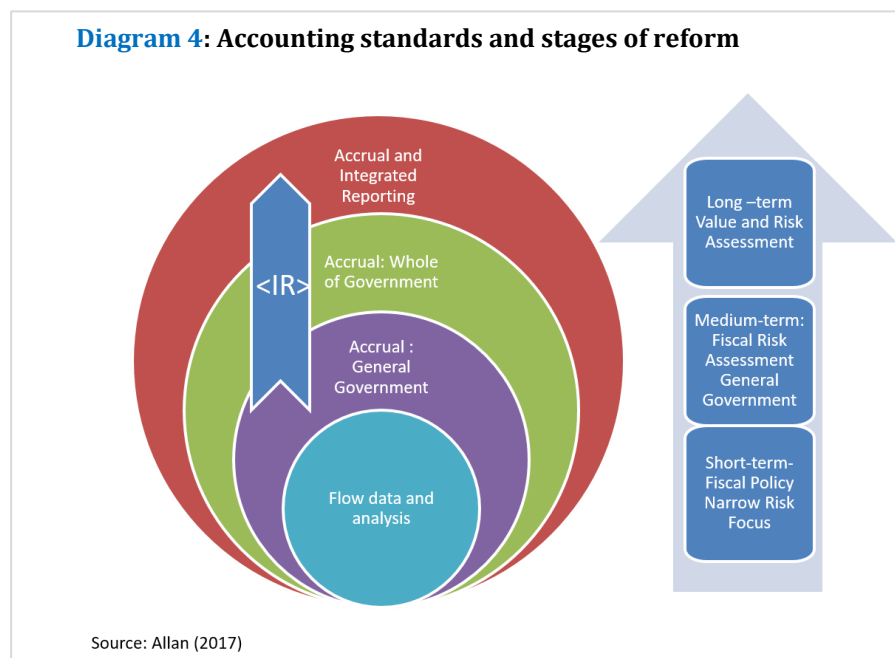
⁹³ The United Kingdom and New Zealand are among the leaders in establishing “whole of government” accounts by applying IPSAS reporting principles to the public sector and linked private entities.

Beyond accounting reform and IPSAS principles, Kazakhstan’s continuing economic modernization requires implementation of effective results-based planning and evaluation. Accrual basis accounting is now widely recognized as a critical tool for public-sector accountability. It is an essential component of reform, but its successful introduction requires a continuing commitment to the kinds of economic transformation outlined in the President’s annual addresses in 2016 and 2017. IPSAS standards should ensure accurate data on transaction flows and stocks of national assets and liabilities. The GoK must focus on building institutions and administrative capacity to use these data for setting fiscal policy and applying a BSA approach to fiscal risk assessment. The President’s 2017 address also emphasized the need for results-based planning and evaluation. Program Based Budgeting (PBB) has been applied widely in OECD countries and is being developed in Kazakhstan as a technique for achieving value for money from government activities. PBB has yet to prove wholly adequate to this task, but new planning techniques are now being applied.⁹⁴

Accounting and reporting techniques are being developed to include measurement of value from non-traditional sources of capital. The concept of integrated reporting (<IR>) has been developed by the International Integrated Reporting Council (IIRC) in cooperation with the Chartered Institute of Finance and Accountability (CIPFA), IPSAS Board, and the World Bank.⁹⁵ <IR> aims to apply much broader social accountability principles to all private and public entities; it is aimed at accounting for all forms of capital and value creation in government and private-sector entities. Practical application of the concept of non-traditional forms of capital (particularly environmental and social) is actively promoted by the IIRC. Many aspects of <IR> need to be developed further, and its application requires a comprehensive accounting and reporting system covering the whole public sector. It is mentioned at this stage because it is being established as an essential part of long-term fiscal management reform; a more detailed discussion of <IR> implementation is given in the final section of the chapter discussing Phase 3 reforms.

The roadmap should encompass all phases of PFM reform. Diagram 4 illustrates the main

accounting and reporting emphasis in each phase of the accounting and reporting reform program. In each phase, the needed technology and standards should be established to set the stage for the following one. The introduction of <IR> is included as an element that needs to be considered early—mainly in relation to PBB techniques, but its full implantation will depend heavily on good progress with the implementation of accrual basis accounting and reporting for the General Government.⁹⁶ Thus, in moving from a traditional focus on flows and short-term policy



⁹⁴ See World Bank 2016d for suggestions on next steps toward RBB.

⁹⁵ See Habhab 2016; Gleeson-White 2014; and Allan 2017.

⁹⁶ However, <IR> should have considerable application in developing PBB reporting and making more effective use of output and outcome information currently considered “non-financial” in accounting reports of spending. An important

analysis to accrual basis accounting, all units of the General Government should be party to plans to adopt the key IPSAS standards and publish a General Government balance sheet. Only when these standards are broadly met can the total set of risks from flows and balance sheet changes be reasonably inferred from the available data. It is well-recognized, however, that many risks emanate not just from the liability and asset risks of the General Government; significant vulnerabilities arise from the operations of other elements of the public sector. In practice, risk analysis is highly dependent on available government accounts and balance sheet data, very often with limited data on public enterprise operations. Comprehensive risk analysis is consequently dependent on improving the quality and availability of accounting data from all public-sector entities, and management capacity needs to be enhanced to meet these challenges as the reform program progresses.

The Budget Code needs to be modified appropriately at each phase of reform to incorporate these principles, and administrative capacity increased sufficiently to ensure implementation. Moving to the broadest stage of public-sector accounting coverage is the ultimate aim of the whole process of improving PFM and risk management. A comprehensive “whole of government” set of accounts on IPSAS/IFRS standards is the aspirational and ultimately necessary goal for providing the full range of data needed to assess public enterprise and government fiscal risks. Principles along these lines should be enshrined in Kazakhstan’s civil code committing governments, ministers, and departmental secretaries to observe the basic principles of fiscal management, accounting, reporting, and public transparency and accountability. Strengthening capacity for risk assessment and management across the entire public sector is vital.

Broadening and strengthening risk assessment and management

Fiscal risk assessment and management is increasingly being based on a public-sector BSA. Fiscal risks arise from deviations from planned and legislated flows and stocks in the annual budget which, in turn, can result from underestimation of macroeconomic impacts or events outside the budget that reduce revenue or add unforeseen costs. Fiscal risk covers calculable risk—variations in outturn that can be estimated by standard probability analysis; uncertainties—where possible outcomes can be identified but insufficient information is available to estimate probability; and ignorance—where policy-makers are unaware of potential risks.⁹⁷ The last of these is, to an extent unavoidable, and can only be overcome as knowledge of the scope of PFM systems and potential threats to it grows. The narrower the focus of government fiscal policy (and associated standards), the greater the impact of ignorance. A program of accounting reform leading to more comprehensive coverage of whole-of-government accounts, as is proposed for Kazakhstan, should therefore significantly reduce the impact of the “ignorance” component of risk analysis.

BSA/risk management conducted in a whole-of-government environment will enable a focus on asset risks as well as liabilities and debt sustainability. This aspect is particularly important for Kazakhstan and the future operations of the NFRK, as discussed in earlier sections. Progress to date on methods to improve fiscal risk management, though focusing mainly on debt sustainability, was recently well covered in an IMF staff paper.⁹⁸ The paper catalogs the main fiscal risks faced by countries and their relative magnitude and proposes a toolkit for their management. Some risks are directly related to operations of government entities either within the General Government or as part of the public sector; others are external. Applying these principles to the broader public sector (including the issuance of guarantees, operations of SOEs,

objective for both advanced and developing economies is to integrate financial and non-financial information to assess the social value of public activities. Some pilot work along these lines could be initiated at any stage of the PFM reform process.

⁹⁷ Petrie 2013.

⁹⁸ IMF 2016a.

subnational governments, and public-private partnership risks) by extending accrual accounting and reporting to the whole of government will enable a more comprehensive overview of fiscal risk and lead to coordinated management of the public sector. Each entity within government should then be subject to similar standards of audit and become increasingly aware of its contribution to risk, as well as its responsibility for risk mitigation.

Current country-level fiscal risk analysis faces difficulties stemming from the diffused authority over SOE operations. Samruk-Kazyna, the main owner and regulator of local SOEs, requires standard commercial risk analysis methods to be applied to all SOEs within the group (and a similar approach is in place at both Baiterek and KazAgro), but these techniques fail to address all potential collective risks to the overall fiscal position. The MNE and the MoF, on the other hand, have the capacity to assess risks that could arise from external macroeconomic shocks stemming from exchange rate, interest rate, and commodity price volatility. But they have limited access to SOE data and lack the authority to develop measures to mitigate risks that may arise from the SOE sector. Improved institutional links—and administrative consolidation—should be put in place to give more comprehensive data coverage and managerial coordination to ensure adequate risk analysis and mitigation measures over the medium to long term.

Important steps toward consolidating fiscal accounts for fiscal policy and risk analysis have already been recommended; these would encourage increased recognition of implicit and formally-accrued liabilities. In 2016, the World Bank mission⁹⁹ strongly supported the authorities' proposal to consolidate its State Social (Employment) Insurance Fund, the Social Health Insurance Fund, and the Unified Accumulative Pension Fund in the budget presentation to give a much clearer view of the GoK's fiscal operations and balances. Measures need to be taken to ensure that IFRS-based reports by these organizations can be consolidated within the General Government financial statements.¹⁰⁰ Potential liabilities that can arise from government policies to support future pension or health payments, though not formalized in law, may give rise to pressures on the fiscal position that cannot be included quantitatively in the budget or financial statements; these are termed *implicit liabilities*. It is not suggested that all such implicit liabilities *should* be explicitly estimated in either the budget or the financial statements; formal estimates could impact the sovereign credit rating—and may indeed overstate the level of fiscal risk. However, these possibilities should be recognized internally and policies aimed at their mitigation highlighted in budget policy statements. The consolidation of social insurance and pension accounts will be a major step toward recognition of the full range of fiscal risks, and consolidation of these accounts—already recognized under GFS as part of General Government—should proceed as soon as is practicable.

A fiscal risk statement (FRS) should be developed for presentation with the budget papers. It can be added that possible bail-outs of failed SOEs or banks, termed indirect liabilities, present similar (and, as noted earlier, often much more severe) risks. Again, these risks must be considered by the administration, and every effort must be made to ensure the best possible data coverage to assess the likelihood of such risks being realized. While it will take some time for all aspects of fiscal risk assessment and management to be developed and applied, this process should be initiated during Phase 1 of institutional reform; the framework for fiscal risk assessment and mitigation should be initiated as early as possible in the reform process.

All relevant agencies must be involved in defining and measuring risks and developing mitigation policies. Defining the elements of fiscal risk and both entity-level and national responsibilities for data provision, risk analysis, and mitigation strategies, will help to define and establish the roles of all agencies involved in this process. The key agencies are broadly identified in [Table 13](#). The Working Group that has been formed for Phase 1 of reform should continue—

⁹⁹ World Bank 2016a.

¹⁰⁰ Noting that IPSAS are based on IFRS, but with modifications to take account of the public dimensions of General Government activities.

appropriately modified for subsequent stages. The Group and its sub-groups should continue development of the new fiscal policy institutional framework around this definition of the nature of fiscal risks. Suggestions along these lines were made by the IMF in a 2014 report on selected issues, including fiscal risk management.¹⁰¹ The IMF team suggested selecting some ministries to pilot the concept and proposed a target date for preparation of an aggregate FRS for the 2017 budget. Much has changed since that time, particularly regarding the much broader and more urgent aims of fiscal risk management that are emerging. However, the objective remains sound and application of FRS principles will provide one important pillar of the Working Group's tasks. It is recommended that the Working Group commence work on establishing an FRS to guide future development of the GoK's fiscal risk assessment and management. International support for this work will be essential; support for many aspects of reform are already underway.

4.4 Phase 3: Improved results-based management of the public sector

Results-based management, while critical to successful modernization and effective fiscal policy over the long term, is methodologically weak. The 2017 President's Address to the Nation rightly emphasized the need to establish results-based management as central to Kazakhstan's modernization goals. The present status of results-based management practices was briefly described under Phase 1 (above), where the need for major capacity building in both economic statistics and the planning framework was recognized. Effective results-based management of the public sector is an extremely challenging goal that has not yet been wholly achieved by even the most advanced OECD countries. At the most general level, no government has yet adequately monitored or accounted for value creation by its agencies: recurrent expenditure is generally valued only at cost, and investment spending, which provides a base for productive private enterprise, is rarely monitored or evaluated for its contribution ex-post. Moreover, while ex-ante appraisals using CBA are conducted by most governments, these do not necessarily determine which projects are given priority in public investment programs; too much public investment is driven by political and region-oriented considerations—and these decisions are very rarely subject to ex-post assessment. The discipline of <IR>, formulated by the IIRC and now being promoted in a wide range of entities, embodies techniques aimed at establishing explicit and accountable reporting on all forms of capital by both public and private agencies.

Integrated reporting redefines the nature of capital and value creation. IIRC/CIPFA (2017)¹⁰² are developing a program to implement <IR> in both the public and private sectors. The basic principles of integrated reporting are illustrated below (Diagram 5). Fundamentally, <IR> recognizes forms of capital and pathways of social value creation or diminution through output/outcome analysis beyond those of standard commercial accounting practice—most notably putting the case that both government and commercial enterprise should account and report on their use of environmental and human capital. As the lower half of Diagram 5 illustrates, these forms of production are, in principle subject to the same kind of value creation (or diminution) processes as are traditional forms of capital. Many of these principles are already applied in traditional CBA but are not systematically incorporated in formal accounting systems. Many of the concepts need to be further refined and codified at entity level to help promote and guide widespread adoption of <IR> practices, as discussed further below. <IR> is applicable to both public and private sector entities, since both make use of all forms of capital, but IIRC/CIPFA are giving priority to establishing the methodology in the public sector, primarily because non-financial capital use is much more central to their objectives and mandate. Country-level implementation will undoubtedly need support from strong standards-setting bodies like IPSASB

¹⁰¹ IMF 2014.

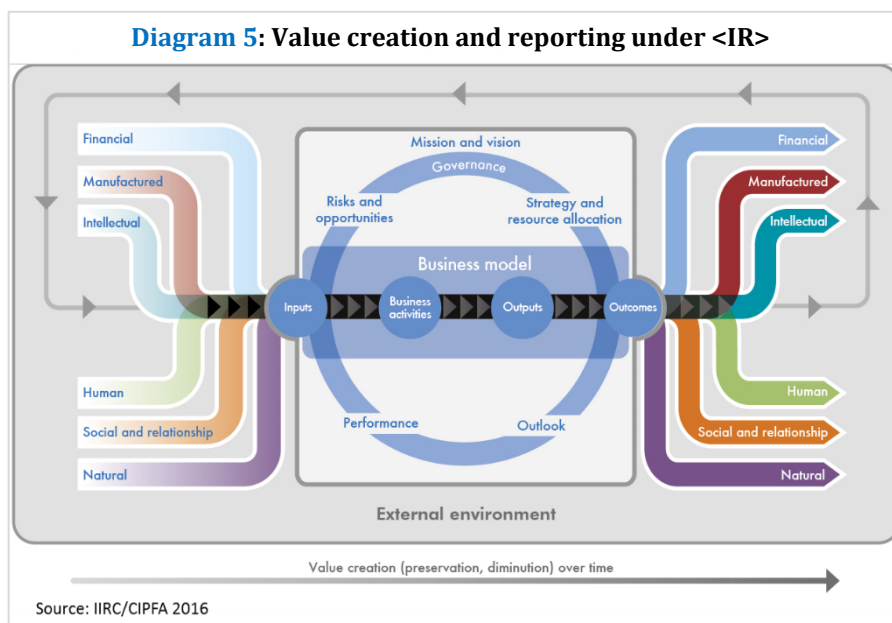
¹⁰² See also Gleeson-White 2014 and Habhab 2016; Allan 2017 links <IR> to general development of accrual basis accounting, budgeting, and risk management; plans for development of <IR> and progress can be followed through the IIRC website: <http://mailchi.mp/theiirc/iirc-newsletter?e=4ac0e9ad50#ACCA>.

and IASB as well as international agencies like the World Bank and IMF, and multilateral and bilateral agencies.

Integrated reporting concepts are particularly important in assessing economic and fiscal strategies in oil-rich economies.

Environmental capital and its use has several social and economic dimensions, many of which can be measured in financial terms. The value of the oil resource itself needs to be estimated as noted earlier, but the use of fossil fuel as

a source of energy also has an impact on the environment through pollution and the climate-change effects of greenhouse gas emissions. In principle, these costs should be factored into a comprehensive <IR> report on entity and national activities to ensure that both commercial and environmental impacts are assessed on a results basis.



Climate-change commitments must also be considered. Kazakhstan is a signatory to the United Nations Framework Convention on Climate Change (UNFCCC) 2015 Paris Agreement on Climate Change. As described in the 2016 OECD Country Study, *Financing Climate Action in Kazakhstan*,¹⁰³ the GoK submitted its intended nationally-determined contribution (INDC) as required by the agreement. It has also adopted laws and policy frameworks to address climate change-linked issues (for example, the Concept for Transition to a Green Economy, the Law on Energy Saving and Energy Efficiency, and the Law on Supporting the Use of Renewable Energy Sources) and is considering establishing a Kazakh Emission Trading Scheme and policies to promote renewable energy. Both the OECD and Climate Tracker,¹⁰⁴ however, suggest that, under present policies, Kazakhstan is unlikely to meet its INDC or an adequate emissions reduction target. An <IR> system would require each entity to monitor and report on total impact against all forms of capital. Environmental impact could be monetized by establishing a carbon price through an emission trading scheme or tax. Oil reserves and fossil fuel-powered industries are of enormous economic significance both in Kazakhstan and globally; a major effort is required to ensure that all uses of resource reserves by public and private sector entities in this sector are adequately monitored, reported, and managed. To this end, it is recommended that the GoK set up a pilot investigation of <IR> applications in this sector as soon as practicable.

Long-term economic transformation will require investment in human capital as well as development spending and privatization. Planning for Kazakhstan's economic future will require careful assessment of likely future global scenarios and the creation of response capacity in both the reformed public sector and a more liberalized private sector. The OECD study referred

¹⁰³ For an overview of global issues addressed by the OECD, see the website at https://www.oecd.org/environment/outreach/Kazakhstan_Financing_Climate_Action.Nov2016.pdf

¹⁰⁴ For more information about climate of Kazakhstan, see Climate Action Tracker (CAT) website <http://climateactiontracker.org/countries/kazakhstan.html>

to above outlines four possible—and radically different—scenarios.¹⁰⁵ It will be important for the MNE, as well as supporting agencies, to develop the capacity track potential global developments in designing the broad thrust of Kazakhstan’s fiscal policies. Likewise, the emerging and expanding private sector should be guided by analysis from the GoK and international organizations of these prospects. Each presents a different challenge; the GoK should build up its internal analytical capacity (requiring a strategic increase in recurrent spending) as well as maintain close links with international organizations. On the positive side, the OECD’s third scenario, reflecting the Chinese-led ‘Belt and Road’ investment aimed at strengthening trade links between Asia and Europe, offers “new opportunities in the non-resource tradeable and non-tradeable sectors” that are key elements of the non-resource economy. As the OECD report suggests, this scenario would require an emphasis on “strengthening the institutional environment for the financial sector and lending.”¹⁰⁶

Non-resource sectors will play an increasingly important role in the economy over the long term. This conclusion follows from the premise of an eventual decline in Kazakhstan’s reliance on resource revenues that is already implicit in the policy framework. The fourth scenario in the OECD outline, termed the “new technology solution” underscores the necessity of prioritizing efforts to improve the institutional framework, including longer-term financial deepening. In this context, it should be recognized that recurrent government spending, in combination with public investment spending, should not be labelled “unproductive.” GoK spending on education and health will be vital to the long-term transition to the non-resource economy. As soon as is practicable, <IR> pilot studies should be initiated within administrative and human resource agencies of government to assess and record impact and value of expenditure in these strategic areas. Major capacity building will be required over the long term to implement <IR> as part of the overall institutional development program. Since these problems are not unique to Kazakhstan, international support is likely to be available and should be sought to undertake such studies.

Integrated reporting principles are relevant to the private sector, the privatization program, and PPPs. The “six capitals” principle of value accounting, reporting, and monitoring apply to all productive entities. While environmental and human capital responsibilities are central to many government activities, virtually all productive activity involves some environmental and human capital impact. Agricultural production and sale of produce inevitably involve packaging and waste at some stage of the production and consumption cycle. These costs are ultimately borne by a government-run—or government-linked—entity, and the widely-acknowledged costs of waste disposal and pollution must be met through some form of taxation. With fossil fuels, a carbon emissions tax has been recognized, at least by economists, as the most efficient way of changing behavior to reduce environmental impact. Similar (Pigovian) principles could be applied more widely to manage a wide range of environmental impacts. It is relatively easier to apply these principles to public-sector entities—when a SOE with significant public interest production responsibilities is privatized or a PPP is created, the new private sector entity or partner should be obliged to take full account of any public interest elements. Current policy in Kazakhstan excludes entities with high social responsibilities from the privatization program—and that element should be strongly protected. Several OECD countries have privatized public technical colleges, childcare and elderly-care centers, and prisons, often with very negative effects on cost of service and delivery of social outcomes. Kazakhstan should aim to avoid similar mistakes. Once integrated reporting principles are well-established in the public sector, they should be promoted vigorously for the private sector.¹⁰⁷

¹⁰⁵ OECD 2017.

¹⁰⁶ OECD 2017.

¹⁰⁷ The concept of ethical investment guidance to corporate investors is complementary to the <IR> approach. Rather than emphasizing corporate obligation to report on all forms of capital, ethical investment advocates—such as members of the Responsible Investment Association Australasia (RIAA) and the Global Sustainable Investment

4.5 Policy recommendations

Immediate consolidation efforts should be consistent with and support the broader and longer-term aims of transforming the non-resource sectors of the economy. A comprehensive review of fiscal policy and fiscal risk management across the entire public sector looking far beyond the immediate future is essential.

A detailed action plan should be developed to guide immediate and long-term public-sector reforms. [Table 13](#) provides a draft overview of Kazakhstan’s current fiscal administration. The team recommends that the authorities review this draft and develop a comprehensive fiscal institutional reform program in three phases.

Phase 1

- Establish capacity for high quality, independent, and transparent advice on targeted budget transfers as required for effective operation of the NFRK rules, including:
 - Major capacity building for the central fiscal policy agencies of the GoK to ensure adequate analysis of the economic impact of, and effective control of, proposed targeted transfers from the NFRK; policy advice should include an assessment of short-term risks and possible long-term consequences.
 - Audit of all such transfers by the Accounts Committee and reporting to Parliament.
- Strengthen public debt management
 - Develop medium-term debt management strategy that is updated annually and published. Gradually expand the scope of the strategy to include SOE borrowing and debt.
 - Move responsibility for domestic issuance to SBD and formulate a plan for market development.
- Strengthen dialogue and coordination among the different SOE entities and the GoK:
 - The Working Group set up to examine management of public-sector debt under the new rules being applied to management of the NFRK should be given clear terms of reference, including a requirement to draw up a time-bound action plan as soon as is practicable. The terms of reference should also address the question of how best to utilize the proceeds of privatization to support NFRK savings and stabilization objectives as well as support the long-term development of the economy.
 - Undertake a review of state property ownership with international assistance. The review would set clear directions for long-term institutional reform in phases 2 and 3 of the action plan.

Phase 2

- Continuing international assistance should be sought to establish clear state property ownership and help establish an institutional framework for coordinated management of a unified public sector.
- The PFR team recommends that a major review of institutional statistical capacity and the analytical framework of the Medium-Term Socioeconomic Development Forecast be undertaken at an early stage of the suggested action plan.

Alliance (GSIA)—track corporate performance in relation to a broad range of risk and value indicators (including environmental, social, and governance). The Responsible Investment Benchmark Report (2017), which tracks fund performance, found that funds employing core responsible investment practices “outperformed average large Australian share funds over three-, five-, and 10-year time horizons.” Similar results were recorded for international share funds.

- A fiscal risk statement (FRS) should be developed over phases 1 and 2 as a standard element of the budget papers presented to the President and Parliament.

Phase 3

- The platform provided by the Kazakhstan Treasury System, implementation of accrual basis accounting, and whole-of-government accounting and reporting, should be used to establish full development of integrated reporting (<IR>) and results-based budgeting, both of which would be piloted in earlier phases of the program.
- <IR> principles should be applied to all public-sector entities as well as being promoted in the private sector.

Annexes

A.1 Fiscal data tables

Table A1.1: General Government fiscal accounts
(Percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017e
Total revenue and grants	27.9	28.9	28.8	26.7	24.5	18.6	19.7	21.1
<i>Oil revenue</i>	<i>11.2</i>	<i>13.9</i>	<i>13.9</i>	<i>12.1</i>	<i>10.3</i>	<i>4.0</i>	<i>4.5</i>	<i>5.7</i>
NFRK gross revenue	11.1	12.2	12.0	10.5	8.3	2.3	3.0	3.9
Customs duty on oil exports	0.1	1.7	2.0	1.6	2.0	1.7	1.5	1.8
<i>Nonoil revenue</i>	<i>16.7</i>	<i>15.0</i>	<i>14.9</i>	<i>14.6</i>	<i>14.3</i>	<i>14.6</i>	<i>15.2</i>	<i>15.4</i>
State budget	13.9	12.9	12.2	12.1	11.4	10.8	12.2	12.3
Other extra-budgetary funds	2.7	2.1	2.7	2.5	2.9	3.7	3.0	3.1
Expenditure and net lending	23.8	21.5	22.5	21.1	23.0	24.7	24.1	25.8
<i>State Budget expenses</i>	<i>20.4</i>	<i>19.2</i>	<i>20.2</i>	<i>19.0</i>	<i>19.6</i>	<i>19.8</i>	<i>20.0</i>	<i>19.8</i>
1. General public services	1.0	1.0	1.1	1.1	1.2	1.4	1.3	1.1
2. Defense	1.0	0.9	1.1	1.1	1.1	1.1	0.9	0.8
3. Public order and safety	1.7	1.6	1.8	1.7	1.5	1.4	1.2	1.3
4. Education	3.5	3.5	3.9	3.4	3.4	3.3	3.6	3.5
5. Healthcare	2.5	2.2	2.4	2.2	2.2	2.1	2.2	2.2
6. Social security and welfare	4.1	4.0	4.0	3.8	3.9	4.2	4.2	4.5
7. Housing	1.5	1.4	1.4	1.3	1.4	1.1	1.1	1.2
8. Culture, sports, tourism and inform.	1.0	0.7	0.7	0.7	0.8	0.7	0.7	0.7
9. Fuel, energy and sub-surface use	0.4	0.4	0.4	0.3	0.3	0.3	0.2	0.2
10. Agriculture	0.9	1.0	0.9	0.7	0.9	0.9	0.9	0.9
11. Industry and construction	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1
12. Transport and communication	1.8	1.6	1.6	1.4	1.5	1.7	1.6	1.7
13. Other	0.3	0.3	0.5	0.7	0.7	0.8	0.9	0.6
14. Interest payments	0.4	0.4	0.4	0.5	0.6	0.7	1.1	0.9
<i>Net budget lending</i>	<i>0.1</i>	<i>0.2</i>	<i>0.1</i>	<i>0.1</i>	<i>0.1</i>	<i>0.2</i>	<i>0.5</i>	<i>0.4</i>
<i>Recapitalization of SOEs and IFIs</i>	<i>1.6</i>	<i>1.6</i>	<i>1.3</i>	<i>0.6</i>	<i>1.4</i>	<i>0.9</i>	<i>0.9</i>	<i>4.6</i>
<i>Extra-budgetary funds' expenses</i>	<i>1.7</i>	<i>0.5</i>	<i>0.9</i>	<i>1.3</i>	<i>1.9</i>	<i>3.8</i>	<i>2.7</i>	<i>1.0</i>
NFRK consumption	1.0	0.0	0.3	0.7	1.2	2.6	0.8	0.0
Off-budget direct loans to SOEs	1.0	0.0	0.2	0.7	0.7	2.6	0.7	0.0
Management fee	0.02	0.01	0.02	0.02	0.02	0.03	0.04	0.04
Unified Accumulative Pension Fund	0.4	0.2	0.3	0.4	0.4	0.8	1.6	0.6
Off-budget direct loans to SOEs	0.0	0.0	0.0	0.0	0.0	0.3	1.1	0.0
Pension payments	0.3	0.2	0.3	0.3	0.3	0.4	0.4	0.5
Management fee	0.13	0.09	0.06	0.09	0.10	0.14	0.12	0.14
State Social Insurance Fund	0.3	0.2	0.3	0.2	0.3	0.3	0.3	0.3
Employment insurance payments	0.3	0.2	0.3	0.2	0.3	0.3	0.3	0.3
Management fee	0.003	0.002	0.002	0.003	0.003	0.003	0.003	0.004
Social Health Insurance Fund	-	-	-	-	-	-	-	0.0
Overall fiscal balance	4.1	7.4	6.3	5.6	1.5	-6.1	-4.4	-4.6

Source: World Bank staff calculations based on data published by the authorities.

Note: Some sums may not add up exactly due to rounding; e=estimate.

Table A1.2: General Government expenditures' growth
(Cumulative growth, 2010=100)

	2010	2011	2012	2013	2014	2015	2016	2017e
Expenditures and net lending	100	123	139	147	174	177	208	267
<i>State Budget expenses</i>	100	122	141	154	175	182	211	232
1. General public services	100	132	145	170	215	250	262	255
2. Defense	100	119	154	179	195	205	198	198
3. Public order and safety	100	122	151	165	163	151	158	186
4. Education	100	131	160	164	180	181	221	242
5. Healthcare	100	114	133	144	155	157	189	206
6. Social security and welfare	100	125	137	150	171	189	218	256
7. Housing	100	116	131	141	166	133	152	186
8. Culture, sports, tourism and inform.	100	89	98	114	131	129	144	164
9. Fuel, energy and sub-surface use	100	141	159	150	161	140	126	154
10. Agriculture	100	131	141	125	169	182	200	220
11. Industry and construction	100	88	94	114	151	219	164	94
12. Transport and communication	100	115	123	131	157	174	195	226
13. Other	100	143	211	356	429	455	602	562
14. Interest payments	100	129	138	188	246	314	553	502
<i>Net budget lending</i>	100	311	129	116	195	382	1126	937
<i>Recapitalization of SOEs and IFIs</i>	100	129	117	62	165	110	116	680
<i>Extra-budgetary funds' expenses</i>	100	40	75	134	148	420	353	124
NFRK direct loans to SOEs	100	2	35	117	127	476	165	8
Unified Accumulative Pension Fund	100	86	131	163	177	401	934	337
Pension payments	100	85	164	184	194	303	352	383
State Social Insurance Fund	100	123	153	158	190	227	255	277
Employment insurance payments	100	123	153	158	190	227	255	277
Social Health Insurance Fund	-	-	-	-	-	-	-	-

Source: World Bank staff calculations based on data published by the authorities.

Note: Some sums may not add up exactly due to rounding; e=estimate.

A.2 The National Fund of the Republic of Kazakhstan

The National Fund of the Republic of Kazakhstan (NFRK) was established in 2000. It performs two functions: (i) a stabilization function, to reduce economic volatility from oil revenue inflows by stabilizing the financing of public expenditure; and (ii) a savings function, to address inter-generational equity by accumulating savings from the oil windfall.

As part of the stabilization function, the government had been appropriating US\$8-US\$16 billion annually during 2010-15, while the remaining annual fiscal deficit (implicitly capped at 3 percent of GDP) was financed through domestic and external borrowing. As part of the savings function, the bulk of oil revenue inflows to the NFRK (net of annual appropriations and transfers to the consolidated budget) are invested abroad, while less than 10 percent of total NFRK assets were invested domestically into bonds issued by four SOEs and development institutions. The NFRK rule has been modified several times—in 2007, 2010, 2012 and, most recently, in 2016. Since 2007, the NFRK receives all fiscal revenues from the mineral sectors and makes disbursements to the budget as stipulated by law.

The NBK is in charge of implementation of the NFRK asset investment strategy. The NBK hires private asset management companies and rewards them according to their performance benchmarked against the interest return earned. The NFRK financial accounts are subject to an annual external audit. Monthly and annual reports of the NFRK are publicly available.

The establishment of the NFRK has served Kazakhstan well. During 2000–07, prior to the global financial crisis and the domestic banking crisis, Kazakhstan maintained a prudent macroeconomic policy and avoided pro-cyclicality in fiscal spending. The nonoil deficit averaged 3.7 percent of GDP, even as oil prices and revenues rose for most of the pre-crisis period. Efforts to resist expenditure pressures helped to accumulate significant savings in the NFRK, which reached US\$27 billion (21 percent of GDP) by the end of 2008, and to maintain relatively low inflation for most of this period.

The NFRK helped prevent excessive real appreciation of the exchange rate. The tenge appreciated in real terms by 20 percent in 2000–08, but this was less than in many other resource-exporting countries. This partly reflects the sterilization of a large part of the oil-related inflows through the national oil fund and partly the fact that a significant share of oil profits was expatriated from Kazakhstan during that period. However, real exchange rate appreciation did pick up considerably in 2006–08 because of substantial unsterilized capital inflows, with the tenge appreciating in real terms by 18 percent in 2006–08 compared with only 2 percent in 2000–05.

After utilizing substantial financing from the NFRK for the massive anti-crisis program in 2007–10, a new concept for the management of the NFRK was adopted in April 2010. Under the new concept, the NFRK continued to serve both stabilization and saving functions. However, operational rules, including those for transfers in and out of the fund, were modified. The main features of the 2010 NFRK concept were the following:

- Fixed annual guaranteed transfers to the budget (made in monthly or quarterly installments) of US\$8 billion.
- Minimum NFRK balance of 20 percent of projected GDP at the end of the respective fiscal year. Guaranteed annual transfers would be reduced when the expected balance falls short of this minimum requirement.
- Annual expenditures for public-debt service, however defined, not to exceed 4.5 percent of the imputed fixed investment return on the fund.
- Average cost of service and repayment of public debt over a rolling 10-year period not to exceed 15 percent of total budget receipts including cash transfer from the fund.
- A target nonoil deficit of 3 percent of GDP by 2020.

- No off-budget financing—that is, no guarantees or lending for domestic activity, including to Samruk-Kazyna and KazAgro.

The US\$8 billion rule governing transfers from the NFRK to the budget was consistent with the permanent income approach for the use of oil revenue before the decline in oil prices after 2014. Using historical data for the main parameters, a range of annuity values for Kazakhstan’s oil stock was calculated by the World Bank in line with the permanent income approach.¹⁰⁸ Under the base case estimates for oil reserves, and using the approximate mean Brent crude price over 40 years (1970–2010) and a 3 percent long-run financial rate of return, the implied perpetuity value was estimated at about US\$8.4 billion per year.

The aim of the 2010 NFRK concept was to tighten fiscal discipline by stabilizing transfers from the NFRK to the budget. This was, however, not necessarily consistent with the stabilization objective of the NFRK: stabilizing oil revenue transfers to the budget does not stabilize government revenue or expenditure and may thus result in procyclical fiscal policy. First, stabilizing transfers from the NFRK to the budget does not preclude overspending financed by borrowing, as the provisions to limit debt accumulation were not excessively binding. Second, in Kazakhstan, the correlation between oil revenue and the nonoil revenue of the budget is greater than 0.9. This is because with the current economic structure, the nonoil GDP and, by extension, nonoil fiscal revenue is also profoundly affected by changes in the oil price indicating structural dependence of the nonoil economy on the mineral sector. Therefore, the fixed transfer of oil revenue from the NFRK would result in procyclical responses, which is contrary to the objective of stabilization, as public spending would be reduced during bad years when the nonoil deficit would exceed the amount of the guaranteed transfer from the NFRK.

To address some of these concerns, the government modified the NFRK concept in March 2012 by introducing an allowance for cyclicalities to the fixed nominal transfer from the oil fund to the budget. The annual transfer of funds to the budget was changed from the previously-fixed amount of US\$8 billion to the flexible amount of US\$8 billion plus or minus 15 percent (that is, within a range of US\$6.8–US\$9.2 billion), depending on the cyclical position of the economy. The complementary 2010 provisions to prevent government borrowing from “undoing” the NFRK’s savings remained unchanged.

In December 2016, the government adopted a new concept for the NFRK, which is expected to regulate its operations for the period 2018–30. The new concept reaffirmed the two main objectives of the NFRK, stabilization and savings, and sought to further tighten the rules of fiscal discipline in the use of the NFRK for budget financing. The main features of the 2016 concept are the following:

- From 2020, the guaranteed transfer to the national budget will be fixed in absolute terms in tenge and set in the amount of KZT 2,000 billion (US\$6.3 billion), which is about 20 percent lower than the guaranteed transfer under the previous concept. This amount corresponds to the volume of the guaranteed transfer of income from the oil sector to the NFRK at a price of US\$40 per barrel and investment income with the average indicative yield of 3 percent per year. Funds received by the NFRK at an oil price of more than US\$40 per barrel will be accumulated as savings in the NFRK.
- To smooth the transition to the new lower amount of the guaranteed transfer from the NFRK to the state budget, the guaranteed transfer will be gradually reduced, declining from KZT 2,600 billion in 2018 to KZT 2,300 billion in 2019. The guaranteed transfer will be KZT 2,000 billion in 2020 and remain at that level in subsequent years.
- The flexibility to increase or decrease the guaranteed transfers by 15 percent was removed but the new concept provides for the possibility of targeted transfers from the NFRK. Targeted transfers will be allocated only by decision of the President of the

¹⁰⁸ World Bank 2013a.

Republic of Kazakhstan to finance anti-crisis programs in times of economic recession or growth slowdown, stalled social projects on a national scale, and strategic infrastructure projects in the absence of alternative sources of financing. Targeted transfers to finance anti-crisis programs will be allocated in excess of the guaranteed transfer. In case of non-use or partial use of the targeted transfers in the fiscal year, the unused amount will be returned to the NFRK in the next fiscal year.

- To promote savings of oil revenue by the NFRK, a minimum balance of NFRK resources is set at 30 percent of annual GDP. In the case of non-compliance with this minimum amount of savings, the guaranteed or targeted transfers from the NFRK to the budget will be reduced by a corresponding amount. With a US\$50/barrel price of oil and a KZT 2,000 billion annual transfer to the budget, the gross assets of the NFRK are projected by the government to increase to US\$75.8 billion by 2030, from US\$60 billion in 2016. Under the previous US\$8 billion guaranteed annual transfer, the NFRK's assets were projected to decrease to US\$47 billion by 2030.
- In order to maintain the country's financial stability, the amount of government debt—including state-guaranteed debt and quasi-public sector external debt—should not exceed the amount of FX assets of the NFRK.
- In order to reduce the dependence of the state budget on oil revenues, fiscal policy will be formulated on the basis of a gradual reduction of the nonoil deficit relative to GDP. The rule on the nonoil deficit will be an integral part of fiscal policy and, therefore, the annual budget law will approve the targets for the nonoil deficit. The nonoil deficit will be reduced to 7 percent of GDP in 2020 and to 6 percent of GDP by 2025. The targets for the nonoil deficit during this period are outlined in Table A2.1.

Table A2.1: Government's indicative targets for the nonoil deficit
(In percent of GDP)

	2017	2018	2019	2020	2021	2022	2023	2024	2025
Nonoil deficit targets	13.0*	7.4	7.2	7.0	6.6	6.5	6.4	6.1	6.0

Source: The New Concept on Formation and Use of the National Fund of the Republic of Kazakhstan.

Note: * In 2017, the nonoil deficit target for the year was revised from 9.3 to 13.0 percent of GDP mainly due to a one-off fiscal support to the banking sector.

A.3 Options of an anchor for the fiscal rule in Kazakhstan

There are two broad options for choosing an anchor for a fiscal rule in oil-dependent economies. These are: (a) the *nonoil fiscal balance*, defined as the difference between public expenditure and nonoil fiscal revenue; and, (b) the *structural fiscal balance*, which consist in formulating the budget on the basis of smoothed oil prices over time. Such *price-based rules* are typically coupled with targets for the overall fiscal balance.

a) The nonoil deficit as an anchor of the fiscal rule

The “bird-in-hand” approach, followed by Norway, may not be appropriate at the current juncture for Kazakhstan. As Kazakhstan is at an earlier phase of the extraction cycle than Norway, the earned investment income is currently relatively low and will keep growing in the future. Moreover, the estimated rate of return on NFRK assets is currently relatively low, at about 1.2 percent. Applying this approach at the current stage of the extraction cycle would unduly constrain the nonoil deficit target.

When the nonoil deficit is used as the fiscal anchor, an alternative to the “bird-in-hand” approach is to set the target based on an estimated permanent oil income stream over time. According to IMF estimates, with the post-2014 lower oil prices expected to prevail in the future, Kazakhstan’s oil wealth at end-2016 would be consistent with an annual income perpetuity of 2.2 percent of GDP, which could thus be the target for the nonoil deficit.¹⁰⁹ Under this target, NFRK assets would surpass 200 percent of GDP by 2055, and they would continue growing until the oil resources are exhausted. However, this benchmark could appear to be too tight for an economy with still-considerable social and investment needs. As real GDP grows, future generations are expected to be better off, which would justify the higher use of oil resources by earlier generations.

One option to achieve this would be to delay the adjustment to the nonoil deficit consistent with the PIH perpetuity. For example, a 5-year delay would lead to a marginally lower perpetuity in subsequent years but would also entail slower accumulation of assets to the NFRK. Under this option, the NFRK assets would reach 150 percent of GDP by 2055.¹¹⁰ Other options, with a longer delay of achieving the target of the perpetuity transfer, could be considered but this would be at the expense of lower long-term NFRK assets.

Under the PIH, an alternative to the perpetuity transfer would be an annuity to be withdrawn from the NFRK over a *finite* period to finance the nonoil deficit. An illustrative example of such a rule is an annuity of about 6 percent of GDP over a 50-year period, which could finance a significantly larger nonoil deficit target than under the PIH perpetuity rule.¹¹¹ Such an annuity would be consistent with Kazakhstan’s net wealth as of end-2016. However, under this rule, net wealth—the sum of the financial assets and the value of the remaining oil reserves—would be fully exhausted by the end of the 50-year period. Therefore, although less restrictive, this option would not be consistent with the government’s intention of saving part of Kazakhstan’s oil wealth for future generations.

In summary, the PIH options for setting the nonoil deficit target allow a rigorous assessment of Kazakhstan’s tradeoffs between the restrictiveness of fiscal policy over time and the desired savings for future generations to be achieved in the long run. However, they also present drawbacks as they may create considerable room for discretion and ambiguity in the management of the fiscal framework if an alternative to the strict PIH perpetuity target is implemented.

¹⁰⁹ IMF 2016b.

¹¹⁰ IMF 2016b.

¹¹¹ IMF 2016b.

b) The structural budget as an anchor for price-based fiscal rules

Another option for a coherent fiscal framework is to adopt a price-based rule for the structural budget, based on a long-term price benchmark for the price of oil. Such a rule should be complemented by a target for the overall primary budget balance consistent with the desired level of long-term savings. Contrary to the PIH approach, price-based rules have a short- to medium-term focus and can thus provide an effective near-term anchor for fiscal policy. The choice of the benchmark price involves a trade-off between the government's wish for expenditure stability and the desired level of financial savings. A long moving average of historical oil prices achieves the greatest degree of expenditure smoothing, but may also lead to insufficient savings if the oil price drops sharply. Conversely, a short moving average of past prices would generate higher spending volatility but also higher savings, thanks to faster adjustment of the price benchmark to the price change.

Box A3.1: Main features of a price-based rule for the structural fiscal balance

In this fiscal framework, oil revenue accrues initially to the budget. The primary fiscal balance (PFB) is the sum of the primary nonoil deficit (NOD)—where public expenditure excludes interest payments on public debt—and oil revenue received by the government (OR):

$$\text{PFB} = \text{NOD} + \text{OR} \quad (1)$$

The structural primary fiscal balance (PFB^S) is defined by valuing oil revenue received by the government at a certain long-term oil price benchmark (OR^S):

$$\text{PFB}^{\text{S}} = \text{NOD} + \text{OR}^{\text{S}} \quad (2)$$

Given the amount of budgeted oil revenue, valued at the long-term price benchmark (OR^S), setting a target for the primary structural fiscal balance (PFBST) involves setting a target for the primary nonoil deficit (NOD^T). This target will need to be achieved by managing primary expenditure and nonoil tax revenue accordingly:

$$\text{PFB}^{\text{ST}} = \text{NOD}^{\text{T}} + \text{OR}^{\text{S}} \quad (3)$$

Meeting the target set for the structural fiscal balance involves hitting the target set for the primary nonoil deficit: $\text{NOD} = \text{NOD}^{\text{T}}$. In this case, deviations of the actual primary fiscal balance in (1) from the targeted primary fiscal balance in (3) will reflect deviations of the actual oil revenue (OR) from the budgeted structural oil revenue (OR^S) due to deviations of the actual oil price from the long-term benchmark:

$$\begin{aligned} \text{If } \text{NOD} = \text{NOD}^{\text{T}} \quad \text{then} \quad \text{PFB} - \text{PFB}^{\text{ST}} &= \text{OR} - \text{OR}^{\text{S}} \\ &>0 \text{ if } \text{OR} > \text{OR}^{\text{S}} \quad \text{or} \quad <0 \text{ if } \text{OR} < \text{OR}^{\text{S}} \end{aligned} \quad (4)$$

If the actual oil price turns out to be higher than the long-term oil price benchmark the actual primary fiscal balance will exceed the target and the surplus will be automatically transferred to the Sovereign Wealth Fund (SWF). Conversely, if the actual oil price drops below the long-term benchmark, the actual primary fiscal balance will undershoot the target and a withdrawal from the SWF will become necessary in order to finance the oil revenue shortfall if additional public borrowing is not desirable.

The price-based rule for the structural budget is implicitly based on a nonoil deficit target, which should be consistent with the target for the overall primary structural fiscal balance and the long-term benchmark for the oil price. The way this fiscal framework is configured can be visualized in [Box A3.1](#).

In a recent analysis of Kazakhstan's fiscal framework, the IMF considered two price-based rules for the structural fiscal balance.¹¹²

¹¹² IMF 2016b.

- i. In the first rule, the benchmark oil price is set to an 11-year average of the oil price that includes the past 5 years, the current year, and 5 years of the future price.
- ii. In the second rule, the benchmark price is set *to the lower* of a 10-year historical average and a 3-year historical average of the oil price—a formula followed by Russia. The 10-year average aims to smooth the benchmark price, and therefore government spending, while the 3-year average helps avoid excessive deficits in the event of sustained oil price drop in preceding years.

Regardless of the price rule chosen, the target for the structural balance could be calibrated to generate the desired level of long-term savings, similar to the savings expected under the PIH nonoil deficit benchmarks. According to IMF calculations, a target of a structural primary fiscal balance of zero would be sufficient only to maintain roughly the current level of net financial assets, but would not generate further savings for future generations.¹¹³ However, a targeted surplus of the primary structural fiscal balance of 2.5-3 percent of nonoil GDP could generate significant long-term savings. Under either of the two price rules for the structural budget, this target would generate savings of between 150 and 170 percent of GDP by 2055.

The price-based rules targeting a structural primary surplus of 2-3 percent of nonoil GDP would force a considerable reduction in the nonoil primary deficit in the future, as the benchmark price for the formulation of the budget would adjust, moving forward, to the lower oil price that has prevailed since 2014. Under the 5-1-5 price-based rule, with a 2 percent primary fiscal surplus, the nonoil deficit would have to decline to 8 percent of nonoil GDP (6 percent of GDP) in the short term and would have to further decrease to about 5.5 percent of nonoil GDP (4.1 percent of GDP) by 2025. Under the Russian-type formula for the price-based rule the adjustment would be sharper, with the nonoil deficit decreasing to 4 percent of nonoil GDP (3 percent of GDP) by 2025.¹¹⁴

A price-based rule for the fiscal deficit could be implemented with some flexibility regarding the achievement of the target for the structural primary fiscal surplus. This could be achieved, for example, through a requirement to achieve the target not on an annual basis but over a period of 2-3 years. This would create some leeway for a countercyclical response to shocks. However, such flexibility should be introduced only at a later stage, once the process of fiscal consolidation has progressed and the nonoil deficit has been reduced significantly from its present unsustainable level.

¹¹³ IMF 2016b.

¹¹⁴ IMF 2016b.

A.4 Options for transition to a diversified tax structure

Kazakhstan would do well to move to a diversified tax structure such as that of Canada (Figure A4.1). How can such a transition be carried out? One way could be a quick change, similar to that undertaken by Poland in 1992 (Figure A4.2). It rapidly increased the share of PIT while reducing CIT and other taxes; thereafter, the tax mix remained fairly stable. Another option is one of slow and gradual change as implemented by the Republic of Korea in response to economic changes and demographic shifts (Figure A4.2). During the period of rapid industrialization through the 1970s and 1980s, Korea's reliance on taxes on goods and services was high. From the late 1980s, CIT, PIT and property tax increased their share in overall revenues while the importance of taxes on goods and services declined. In view of an ageing society, social contributions also increased and rose further in the last two decades.

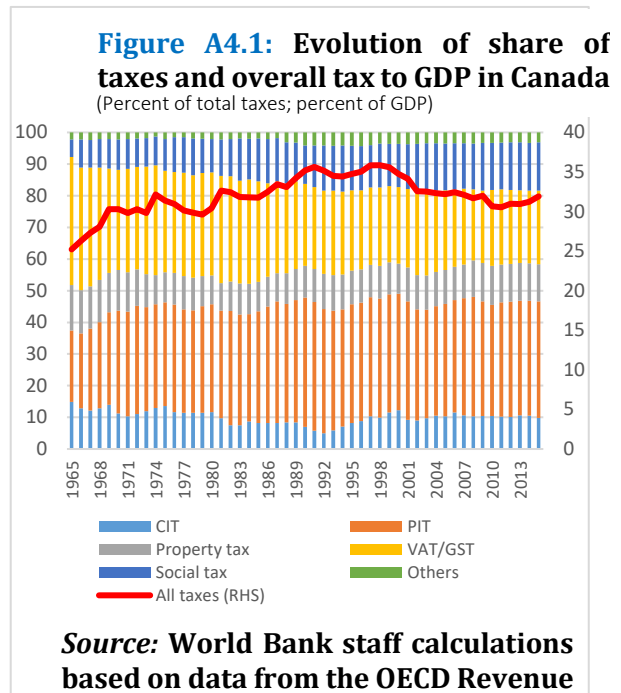
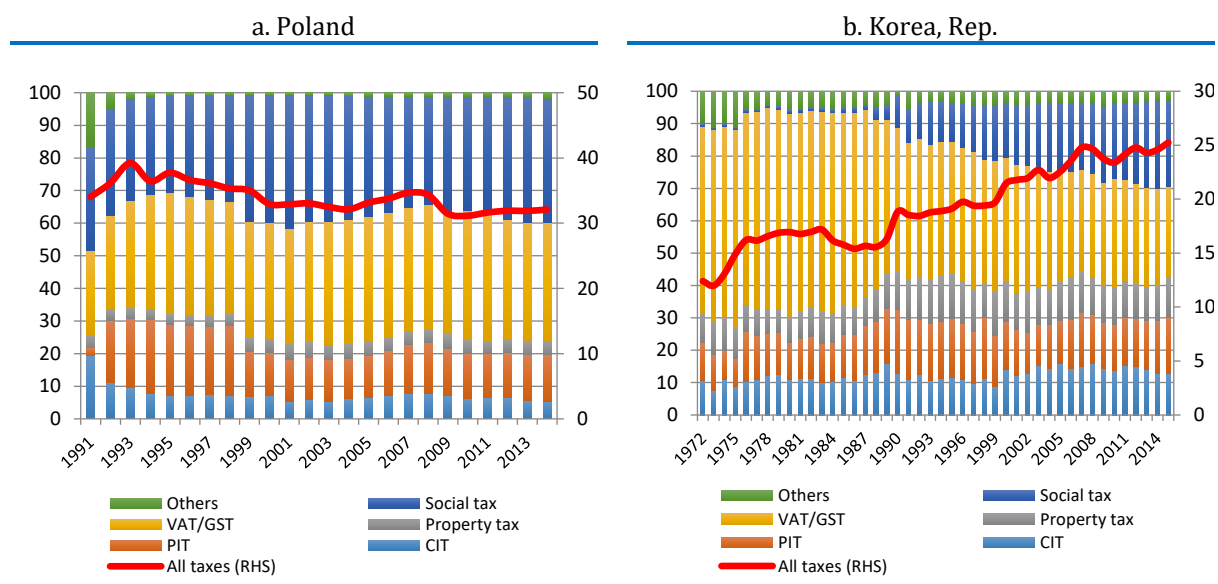


Figure A4.2: Evolution of share of taxes and overall tax to GDP for Poland and Korea
(Percent of total taxes; percent of GDP)



Source: World Bank staff calculations based on data from the OECD Revenue Statistics.

A.5 Options for setting SOE borrowing limits

Background: fiscal risk

Fiscal risk can be broadly defined as deviations of fiscal outcomes from what was expected at the time of the budget or medium-term forecasts. Fiscal risk can arise from both government revenues (assets) and expenditures (liabilities).

The fiscal risk matrix provides insights into the types of risk that potentially can affect the balance sheet and debt level of the central government (Table 16). The matrix moves from the explicit and direct liabilities (primarily government debt) to implicit and indirect liabilities (for example, defaults of SOEs on non-guaranteed debt). In the context of SOE borrowing and indebtedness, a core area of focus in the fiscal risk matrix is the indirect liabilities, guaranteed or non-guaranteed, of SOE debt. If these risks materialize, especially if they are unexpected, they can have severe implications for the size of the government debt and the government's budget that can require unpleasant macroeconomic adjustments.

Table 16: A simplified fiscal risk matrix

	Direct liabilities	Indirect (contingent) liabilities
Explicit liabilities (legal obligation)	<ul style="list-style-type: none"> - Foreign and domestic debt - Budget expenditures 	<ul style="list-style-type: none"> - Guarantees for borrowing and obligations of sub-national governments and SOEs - Deposit insurance - Insurance for private pension returns
Implicit liabilities (political, moral obligation)	<ul style="list-style-type: none"> - Future public pensions if not required by law - Social security schemes 	<ul style="list-style-type: none"> - Defaults of sub-national governments and SOEs on nonguaranteed debt - Commercial bank failures - Environmental disasters

Source: Brixi and Schick 2002.

A common way of controlling fiscal risks is through fiscal rules. A fiscal rule is a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. Examples include limits on the budget deficit, revenue or expenditure rules, and debt limits. It should be noted that fiscal rules can last for many years, but typically are revisited regularly to ensure that they are in line with the current economic environment. Limits can be defined for the central government, the General Government (that is, including local governments) or the public sector (including SOEs), or they can apply to sub-sections of these entities (such as debt limits for central government external debt, limits for debt of SOEs, etc.). Limits can be made at a national level—such as rules formulated through a Fiscal Responsibility Act governing the General Government deficit—or the supranational level, for example, the limits included in the EU Treaty.

A key element of any fiscal rule is enforceability—what sanctions can be taken when a limit is broken. In some economies, such as Poland, for example, the reaction function when the debt limit is approaching is specified in the constitution. The EU Treaty limits provide an example of very clear sanctions that are enforced very irregularly. In contrast, developing economies tend to adjust their debt limits when they are in danger of being breached. Respect for potential sanctions and how they are enforced in practice—as well as limits for deficits and debt—play a central role in implementing sound fiscal policy.

An important reason to set limits on SOE borrowing and debt is to avoid a situation where the central government—through its medium-term debt management strategy—defines its preferred debt composition and the trade-offs between cost and risk, and then the SOE operates in a way that is contradictory to that strategy. For example, the central government debt management strategy may stipulate a preference for domestic debt, but the SOE then chooses to borrow in foreign currency. As per the fiscal risk matrix above, this could lead to the same risks to the government’s balance sheet materializing that the central government is trying to avoid.

Because SOEs can generate fiscal risk, governments should monitor and manage these risks. At the same time, however, it is critical that an appropriate balance is struck between instructing SOEs on what to do and giving them the freedom to make decisions (an important part of the reason that they were formally separated from the government in the first place). The least invasive means of controlling SOE borrowing and indebtedness is through the board of the holding company or SOE, specifically via the member(s) appointed by the central government. Where this is considered insufficient, the challenge is to find the most appropriate way of controlling the borrowings of the SOEs.

Where limits are introduced, it is not clear whether they should cover all SOEs or only the riskiest, or if different types of limits should apply to different types of SOEs. [Box A5.1](#) gives some examples of how other countries have approached this challenge.

Box A5.1: Country examples of SOE borrowing limits

Brazil: Ex ante approval required for foreign borrowing

Canada: Government entity (Treasury Board) review of all SOE corporate borrowing plans

Chile: All borrowing by SOEs requires authorization of Ministry of Finance

France: Government monitors indebtedness (one of three performance indicators)

India: Performance-based system, where higher SOE performance allows more access to borrowing

Spain: State holding company reviews borrowing and business plans

Source: Arrobbio and others 2014.

What are the options for controlling and managing SOE indebtedness in Kazakhstan?

A range of options exist for monitoring and managing the borrowing and debt levels of SOEs. Some potential options are presented below and ranked from weak to strong control; the purpose is to briefly outline the options as opposed to providing a complete and detailed description of each. A framework for monitoring will most likely be a combination of different approaches, and there could be different approaches for various types of SOEs.

Limits for borrowing could be on a net or gross basis, with the latter potentially leading to an implicit preference for long-term borrowing. Similarly, and taking into account the National Fund, limits and debt and risk exposures for the public sector could be on a net or gross basis, and limits for SOE debt could be calculated as debt minus current assets.

The options listed below assume that limits will cover both domestic and foreign currency borrowing and debt.

1. Monitoring of outstanding debt and risks

The central government collects information on outstanding debt and the borrowing plans of SOEs (for example, debt to equity ratios and foreign exchange exposure). The central government then prepares (internal) reports that provide an aggregate view of the risk exposure of the total

public-sector debt. If there are positions or debt levels that are worrisome to the central government (MoF or MNE), they will contact “their” board member and request that the issue be raised at the next board meeting.

This approach can be efficient from a monitoring point of view, especially if one of the data requirements is that the SOEs provide medium-term borrowing plans. However, it restricts the central government’s limited ability to manage the overall public debt size and risk exposure. The management of SOE debt will be expected to be handled by the board of the individual SOEs or holding companies.

2. Guidelines for SOE borrowing

The central government develops guidelines for SOE borrowing based on the current medium-term debt management strategy. It is crucial that the guiding principles for SOE borrowing are directly related to the debt management strategy—the main reason for the guidelines is to ensure that the type of risk that the SOE is undertaking through new borrowing is in line with the risk exposure of the central government debt. The guidelines could outline preferences regarding currency exposure (domestic or foreign), interest rate (fixed or variable), and maturity. Specific guidelines could also provide target ranges for individual indicators.

Guidelines are not strict rules for borrowing. However, SOEs would be expected to follow the guidelines, which could be made public as part of the medium-term debt management strategy of the central government.

3. SOE borrowing plans

The central government requires all or a subset of SOEs to submit borrowing plans for specific time periods (for example, with 2-3 year horizons) and, depending on the individual SOE, requires that the rolling borrowing plan is updated either annually or biannually. The borrowing plans allow the central government to track the plans compared to actual transactions and to ask questions or intervene through its board member whenever the view is that the borrowing plan is not sufficiently in line with the balance sheet of the SOE or the central government’s medium-term debt management strategy.

4. Debt limits for SOEs

A debt limit puts a ceiling on new borrowing and, indirectly, on the debt composition; a high share of external debt would imply exposure to exchange rate changes and would require that the central government or the SOE define a buffer against currency depreciation to avoid breaching the debt limits.

Debt limits can be defined for all SOEs as a whole, as specific limits for subsets of SOEs, or for SOEs on an individual basis. An alternative to debt limits are limits on the annual net borrowing of SOEs.

5. All borrowing transactions pre-approved

The most effective way to control SOE debt levels is to require that all borrowing transactions receive central government approval. Such an approach ensures that the indebtedness and risk exposure of the SOEs can be tightly controlled. However, while effective, it raises some issues regarding governance and the “ownership” of the debt. By definition, SOEs are operating with a substantial degree of freedom to undertake their business. Requiring that borrowing be pre-approved would reduce this freedom. More important, lenders may (rightly) perceive that all SOE borrowing has an implicit government guarantee (that is, since a particular loan has been approved by the central government, creditors will expect that the government will step in if the SOE is unable to cover its debt service).

Recommendations

A precondition for a monitoring framework that ultimately focuses on the risks to the overall government balance sheet is that a medium-term debt management strategy for the central government debt is in place. This strategy provides information on the preferred risk exposure (and therefore debt composition) of the government's debt and will be a foundation for all guidelines and limits that regulate the debt and borrowing of SOEs.

Designing a framework for monitoring and managing SOE indebtedness is a challenging endeavor that seeks to find the right balance between controlling SOE borrowing activity while not impairing its ability to act as a commercial entity. Below is a proposal to address this issue gradually, starting with solid risk management of the central government's direct debt and a framework to monitor SOE borrowing and debt risk. These initial steps could then be supplemented by requirements that SOEs share detailed borrowing plans with the MoF and MNE. Only then, and on the basis of detailed analysis of the existing and expected risk exposure, should limits for SOE borrowing and debt be introduced.

- (i) **Publish and review annually a medium-term government debt management strategy.** The SBD of the MoF is drafting a strategy. The strategy will provide guidance for borrowing and the structure of the central government debt and will be a critical element in efforts to develop an active market for government securities;
- (ii) **Establish a monitoring framework for SOE borrowing and debt.** Data collection and analysis are important elements of a monitoring framework, as is a clear definition of the scope and coverage of SOEs. This includes clear lines of reporting for the relevant SOE, avoiding duplication of reporting, and ensuring that SOEs are only required to report what is needed for effective monitoring. Ideally, information and analysis should be shared and discussed with the SOEs to ensure that the purpose and importance of providing accurate and timely information are understood. Also, having a single unit in the central government that is responsible for data collection and monitoring of SOE borrowing and indebtedness would result in substantial efficiency benefits and avoid duplication.
- (iii) **Decide on means to monitor and control the indebtedness of SOEs.** Depending on the individual holding or SOE—including the extent to which they adhere to international accounting and auditing standards—limits on annual borrowing and outstanding debt can be defined. The limits should be based on the total amount of debt and risk that the public sector is willing to accept, taking into account issues of debt sustainability and target size of the National Fund, and what proportion of that debt and risk should be on the central government's books.

Regardless of how the framework looks in practice, the objective of the government should be to identify and quantify the potential SOE-related fiscal risks, develop appropriate risk and debt management rules, and encourage better SOE performance.

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