

Republic of Kazakhstan

Country Economic Memorandum

**Getting Competitive, Staying Competitive:
The Challenge of Managing Kazakhstan's Oil Boom***

Background Paper No. 4:
**Elements of A Competitive Environment in
Kazakhstan**

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World Bank Note

ELEMENTS OF A COMPETITIVE ENVIRONMENT IN KAZAKHSTAN

1. The structural reforms initiated over the past decade provide a solid base for further building a competitive economy in fronts other than oil extraction:

- The country's price, trade and currency regimes are relatively liberal, and the private sector drives the bulk of investments and economic activity in both the oil and non-oil sector.
- Banking, pension, and payment systems have been established, which together with a prudent macro and fiscal stance have increased the overall savings rates.
- In infrastructure, reforms have been advanced for the electricity and railways sectors. Rehabilitation is ongoing for a selected set of roads, airports, and irrigation facilities.
- In the institutional area, steps have been taken to introduce stability and professionalism to the civil service, and to modernize the treasury and tax administration.

2. The authorities are aware of Kazakhstan's potential coming from past reform efforts, its large non-oil natural resources (e.g., extensive pasture land and reserves of ferrous and non-ferrous metals), its resourceful people, and its strategic location between the East and West. They also understand the challenges, as the country is behind key trading partners (e.g., Russia¹) in a number of areas governing competitiveness, such as the development of the telecommunications sector and efforts to modernize the education system. Although the overall EBRD/WB business environment indicators for Kazakhstan have improved from 1999 to 2002, when adjusted for its strong macroeconomic performance, the indicators actually worsened.²

1. Ongoing Policy Efforts

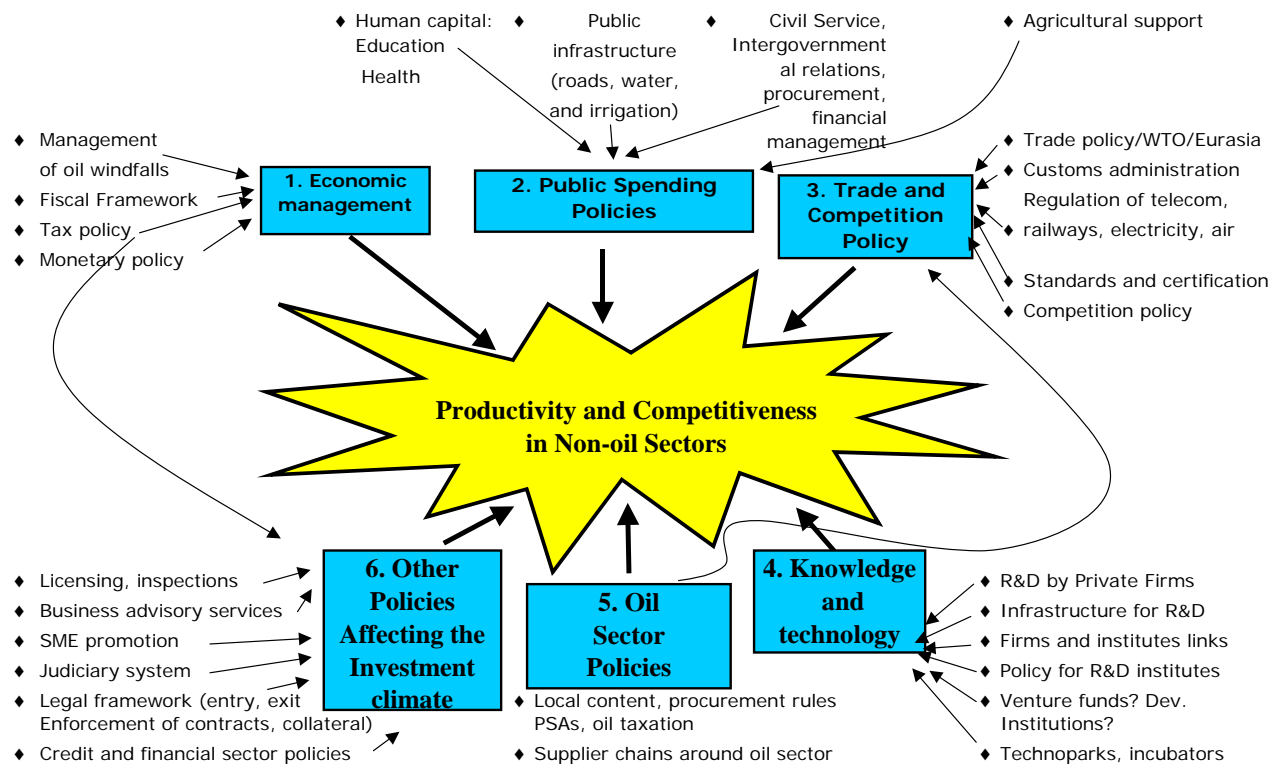
3. The Government of Kazakhstan has laid out objectives for the development of the country over the next 10-15 years, which has been most recently summarized in the Indicative Plan of Social and Economic Development for 2004-2006 (IPSED). These objectives include increasing the competitiveness of its non-oil productive sector, creating jobs, and improving living conditions for the majority of the population.³ To reach these objectives, an ambitious policy agenda is at various stages of design and implementation, which we group in six areas in the diagram below.

¹ In turn, Russia ranks 70 out of 102 countries in the 2003 Growth Competitiveness Index produced by the World Economic Forum (<http://www.weforum.org>). This ranking comprises sub-ratings in key areas determining overall competitiveness, such as a number of indicators in areas such as technological advance, public institutions and macroeconomic environment.

² See in particular the 2002 EBRD's Transition Report.

³ Key elements of the IPSED include, inter alia, acceding the WTO, bringing about international standards in the financial system, introducing regulatory principles that stimulate the adoption of power- and resource-savings

Diagram 1: A Framework to Study Competitiveness in Kazakhstan



4. Below is a brief account of ongoing efforts and challenges in each of these areas, based on the mission's discussions and the review of several of the recently enacted state programs.

i. Economic Management of Oil Windfalls (current and future oil-related revenues)

5. The authorities understand the fundamental tradeoff that oil management poses to Kazakhstan. On the one hand, excessive public spending may hurt the competitiveness of the non-oil economy through real exchange appreciation, lower efficiency of public spending, and by increasing the likelihood of macroeconomic volatility. On the other hand, if the fiscal stance is too restrictive, it will deprive the economy from basic infrastructure and services, and prevent the current generation from sharing adequately in the country's oil wealth.

6. There appears to be a need to increase the capacity in key economic ministries and agencies to evaluate, on a continuous and systematic basis, this fundamental trade-off. There also appears to be a need to further develop the institutional instruments that define the overall level of public savings and spending (e.g., the National Fund of the Republic of Kazakhstan, and the Medium Term Fiscal

technologies, and improving the economic and social infrastructure at the aul (village) level. In addition, the IPSED also envisages that comprehensive measures will be taken to: (1) implement the Agro Food and the Industrial and Innovation Development Programs; (2) modernize the systems of science, education and professional development of the population; (3) develop industrial and social infrastructure; and (4) foster small businesses development.

Framework). Finally, instruments for setting common goals for monetary and fiscal policy—and for discussing them with key stakeholders—also appear to be in need of strengthening. Part B of this Aide Memoire, below, elaborates on these points.

ii. Public Spending Policies and institutions

7. There appears to be a consensus among key policy makers that public investments in human capital (i.e., health and education spending) are not well geared to build a productive and competitive labor force. A particular pressing issue is that vocational and high education institutions are not preparing the cadre of professionals that is required for a modern productive sector. The problem can be traced back further, to the lack of sustained efforts to reform basic education.

8. Similarly, a debate is emerging about the true operation and maintenance (O&M) needs of the core public infrastructure (e.g., roads, irrigation, drinkable water, and sanitation) and on the best manner to meet these O&M needs as well as to expand the coverage of these various networks (under strict economic rate of return principles).

9. In all the key areas of public spending (education, health, and public infrastructure) a strategic re-assessment is needed, considering both the possible patterns of economic and geographical development, as well as their implications in terms of labor mobility across regions. In addition, there appears to be a need to follow up on the reform and strengthening of key institutions responsible for the efficiency of public spending, including those responsible for the delivery of public services (e.g., the civil service, local governments, line ministries), and institutions that directly or indirectly contribute to the overall efficiency of public spending (e.g., procurement and financial control).

iii. International Trade and Competition Policies

10. Strong competition rather than protection will be the key vehicle to ultimately ensure competitiveness of the domestic economy. In this regard, competition is being promoted through various fronts:

- Anchoring the relatively liberal trade regime to key global institutions (e.g., WTO), which are expected to increase the country's exposure to the standards and institutions required by global trade, and to facilitate the resolution of disputes for key Kazak exports (e.g., metals, grain).
- Securing access to domestic markets and infrastructure of neighboring countries through bilateral as well as regional cooperation agreements. For instance, equal treatment in the use of key common infrastructure (e.g., roads, railways, transmission grids, and possibly oil and gas pipelines) is being discussed, among other issues, under the Eurasia cooperation framework (involving Russia, Ukraine, and Belarus)⁴.

⁴ Kazakhstan has recently granted equal treatment to Kyrgyz enterprises on the use of its railways and roads (implementation mechanism are still to be worked out).

- Negotiating special transportation tariffs with transit countries to improve access to world markets and reduce high transportation costs, which are critical due to Kazakhstan's land-locked position and remoteness from seaports.
- Improving key institutions for trade and competitiveness, such as the customs administration—which has expressed its intention to implement a modernization program conducive to reaching international standards and the Gostandard.
- Improving the institutional and regulatory framework of telecommunications, railways, and electricity, each of which contributes directly and indirectly to the development of the non-oil economy. Among these three, telecommunication is viewed as lagging behind the most.

11. At the same time, the government is searching for ways to accelerate development and modernization of those sectors that are considered vital for Kazakhstan's economy and may be poorly positioned at present to face foreign competition (e.g. agriculture). In this regard, public spending in agriculture has been increased under the umbrella of the Food Security and Rural Development Programs. In addition, the government is debating what stance to take in the WTO negotiations, with respect to export subsidies and tariffs for agriculture (i.e., whether to follow the example of Canada and Australia where there is little subsidization of agriculture, or the example of the US and the European Union). The authorities would also like to explore programs of assistance that are compatible with WTO guidelines, such as competitive grants schemes and assistance to farmers that would help them meet international standards.

iv. Knowledge and Technology

12. There has been an intensive discussion over the past 12 months of the need to foster innovation and technological change at the firm level, both by building on the country's scientific capacity as well as by adopting readily available technologies from elsewhere in the world. This debate has so far centered on the creation of various development institutions (e.g., Investment Fund, Innovation Fund, Export Guarantee Fund) and specific instruments (e.g., Techno parks, industrial clusters, innovation corridors). Discussions on more fundamental issues in this area (e.g., how to increase the commercialization of technologies, how the GOK can play a catalytic role to attract private investments in green field areas) are beginning to take place as the development institutions begin to develop work programs and their memorandums. Rigorous analysis also appear to have been started under the umbrella of the institutions of issues such as constraints on firms' incentives to innovate and adopt existing or new technologies (or to use more actively the scientific and research community), and assessing the core capacities of the research and university communities in Kazakhstan.

v. Oil Sector Policies: Fostering Interaction between Oil and Non-oil firms

13. Large investment projects in the oil and gas sector of Kazakhstan provide a good opportunity to develop the local economy through know-how and technology

transfer, “learning-by-doing” incentives, provided that the right incentives are in place for both international and local companies to associate closely. Concrete investment plans amounting to about US\$7-8 billion dollars are being implemented in various oil and gas fields and its total magnitude could be twice as large by some estimates.

Demand ranges from construction works (e.g., oil platforms, buildings, roads, housing) to a large variety of materials and components (e.g., steel, cement, plastics, chemicals additives, electronics), equipment manufacturing and services (pumps, valves, containers, drilling rigs, transportation vehicles, pressurized vessels). Design, engineering and project management services are also in great demand.

14. Local industries around the oil and gas sector (particularly construction and welding) appears to have been developing at a rapid pace according to experts in the sector, and investments are taking place to develop the capacity of producing key materials locally (e.g., pipes) that are currently supplied mainly by Russian and Ukrainian companies.

15. The challenge is thus to refine the existing framework to increase linkages between oil and oil-related industries and provide fair competition between foreign and local companies (existing or new) bidding for contracts under oil and gas projects. In this context, the authorities are drafting a law on production sharing agreements, and revising the procurement rules that currently apply to foreign oil operators.

vi. Other Policies affecting the Investment Climate

16. There are other areas, which are beginning to receive close attention of the Government of Kazakhstan, including the need to promote small and medium enterprises (SME) development by:

- Reducing the number of required licensing procedures and other bureaucratic regulations
- Increasing assistance programs to improve their access to credit and promoting transparency of their business activities
- Reducing unjustified intervention of regulatory authorities into SME business activities other than those stipulated by the law
- Simplifying the procedure of submitting tax returns to tax authorities;
- Reducing the overall tax burden.

17. As in most other countries, SMEs are expected to be the primary engine for generating employment in Kazakhstan—even if economic growth continues to depend on large sectors such as oil and gas and other extractive industries. An ambitious agenda to promote SMEs was laid out in October by the President at the Forum of Entrepreneurs, which include the need to reduce licensing and permits by more than half, continue to reduce inspections, simplify legal infrastructure, improve skills, and promote adoption of international standards. To a large extent, the implementation of this agenda will fall on local governments, who are responsible for SME promotion.

18. Similar, efforts are ongoing to further improve the country’s financial system (Kazakhstan is planning to introduce EU standards into its financial sector by 2007), fully liberalize capital controls by 2007, deepen mortgage and insurance markets, and continue pension reforms. Real estate markets are booming (especially in country’s

largest cities: Almaty, Astana, Atyrau), partly due to increased access of the population to mortgage loans whose framework could be significantly enhanced.

2. Preliminary Assessment: the three legs of non-oil growth in Kazakhstan

19. No attempt was made by the mission to highlight which of the above areas would have greatest payoff in terms of broadening or sustaining non-oil growth. This is an important next step but one that would require considerably more analysis—beyond the scope of the current work.

20. Nonetheless, a framework to evaluate payoffs can be elaborated by dividing ongoing policy efforts into those that are likely to: (1) **prevent** sharp losses in competitiveness that would affect the entire productive sector in Kazakhstan; (2) help **broadening** the base for non-oil growth; and (3) help **sustaining** such non-oil growth over the medium to long term.⁵

21. *The Sine Qua Non: Preventing sharp losses in competitiveness.* While key fundamentals (such as the size of the oil wealth) suggest that the real exchange rate will appreciate, and that the cost of key factors of production (e.g., labor, land) will increase, the pace for these changes (and the volatility) could be exacerbated by fiscal and monetary policies. This issue is the subject of part B of this Aide Memoire.

22. *Broadening the base for non-oil growth: the investment climate.* International experience shows that actions that reduce business costs and promotes competition across all non-oil sectors are most effective in generating efficiency gains and continued productivity grow. In the Kazakhstan context, key among these are likely to be:

- Reducing the administrative burden of the state, starting with institutions affecting the cost of trading (e.g., customs administration, gostandards), or the cost of running a business (reporting, inspections).
- Improving infrastructure provision and regulation, including prompt liberalization of the telecommunication sector and developing strategies for key infrastructure (e.g., irrigation, roads, airports, telecommunications).
- Promoting trade, including through WTO accession and Eurasia agreements, and promoting foreign investment in non-oil sectors.
- Further developing the package of Agricultural Support Policies, and the institutional capacity to implement such policies in a transparent manner.
- Improving the environment for small and medium enterprises.
- Further developing the financial services, especially for SMEs but also for key sectors, such as construction (mortgages)

23. It is important to note that the agenda under each of the above points would need to be further analyzed in order to judge whether the steps that are already being

⁵ The key challenges for the GOK are to broaden and sustain non-oil growth, the second and third points respectively, rather than 'igniting' or 'sparkling' non-oil growth, which is precisely what past structural reform and stabilization measures, and the coming on stream of oil sector projects, have already achieved. In fact, after a lack-luster performance in 1995-99, real GDP growth has averaged over 10 percent each year in 2000-2002. This growth stemmed largely from oil production and exports, but other sectors, notably mining, food processing and services, have made increasingly strong contributions. Thus, importantly, real non-oil GDP grew by a cumulative 33 percent between 1999 and 2002.

taken will be sufficient to promote broader sources of non-oil growth, and to define additional concrete measures where needed.

24. It is also important to note that while some ‘experimenting’ could contribute to broadening the base for non-oil growth (e.g., promoting the emergence of venture capital funds or developing techno parks), such efforts need to avoid distorting investment incentives, promoting soft budget constraints and rent seeking opportunities, or breaking the integrity of the taxation system.

25. *Sustained growth in non-oil sectors: Human Capital.* This is perhaps where the greatest challenge lies for Kazakhstan. Actions in this regard are long-term in nature (i.e., sustained efforts are needed over various years) and could include:

- Upgrading of the entire education system in ways that it serves the demand of a continuously restructuring economy.
- Creating an efficient health care supply and rules and mechanisms for public financing of basic health needs to secure a healthy work force.
- Developing incentive schemes for promoting research and development and a closer link between researchers and universities on the one hand, and enterprises on the other.
- Broader labor market issues (e.g., skill match, lifelong learning opportunities, immigration policies for certain types of skills).