

# Postscript

Kazakstan's experience with tax reform, while generally positive, has some negative aspects. There have been missed opportunities, delayed actions and significant counter reforms.

## **POSITIVE ACHIEVEMENTS**

All tax laws in Kazakstan, including those levied by subnational governments, must now be included in the tax code. The number of taxes has been reduced from nearly 50 to about 10. These changes make it much easier for both investors and tax administrators to calculate tax liabilities. The new tax code also specifies that all proposed changes in the code must be vetted by the Ministry of Finance and the State Tax Committee. This should help prevent passage of unwise and counterproductive measures.

The new tax code was initially relatively "clean". There were few exemptions or tax incentives in either the income tax or the value-added tax (VAT). Income for tax purposes generally conforms to the new accounting law, which reflects Western accounting standards. Business interest expense is normally deductible (subject to a thin capitalization rule), and there is no tax on excess wages and no limit on the deduction of wages, despite a 1995 effort to limit such deductions. Losses may be carried forward for five years — or for seven years in the case of natural resource companies.

Kazakstan has reconciled the conceptual case for specific (per unit) excises and inflation's erosion of the value of specific excises denominated in local currency by stating excise tax rates in European Currency Units.

## **NEGATIVE DEVELOPMENTS**

Kazakstan does not immediately refund vat paid on capital goods. One can hardly imagine a worse policy — essentially a tax of 20 percent on the value of investment — for a country that is interested in investment, including that by foreigners. It is appropriate to provide full and immediate credit for all VAT paid

on business purchases, to pay refunds quickly when credits exceed tax on sales, and to exempt investment that could not possibly leak into household consumption (for example, oil-field equipment).

Kazakstan's treatment of expatriate workers is problematic in several respects. Exemptions are not provided for such standard allowances as housing, education of dependents, and travel for home leave. Moreover, there is only a distinction between residents (who pay tax only on Kazakstan-source income) and nonresidents (who pay tax on income from all sources, including investments in their home countries). It is appropriate to have a third category, nonpermanent residents (who would be taxed on income from foreign sources only to the extent remitted to Kazakstan). Failure to provide more realistic tax treatment of expatriate workers could severely damage the investment climate in Kazakstan.

## **MISSED OPPORTUNITIES**

Kazakstan adopted a conventional income tax, instead of considering an alternative that is arguably more appropriate to its economic and political situation, a cash-flow tax. (The flat tax that has recently been debated in the United States is one such tax). A cash-flow tax is simpler and more conducive to saving and investment, and it avoids a crucial problem inherent in income taxation, the mismeasurement of the tax base because of inflation. A cash-flow tax may be particularly appropriate for the taxation of natural resources, as its base is economic rents (the excess of income over the costs of production, including the cost of equity capital). While it is generally assumed that the United States would not allow foreign tax credits for a cash-flow tax, there is a strong economic case that it should.

## **DELAYED ACTIONS**

Kazakstan delayed reform of intergovernmental fiscal relations, including a shift from the present system of filing budgetary gaps of subnational governments to one based on tax assignment. The capacity for subnational governments to set tax rates is generally far more important to subnational fiscal autonomy than the ability of those governments to choose taxes, define tax bases, or administer taxes. Thus, subnational surcharges on taxes chosen, defined, and administered by the central government, combined with grants to offset vertical fiscal imbalance (between the national

and subnational governments) and horizontal fiscal disparities (between subnational governments at a given level), is the appropriate technique of revenue assignment. A system such as that found in the United States, in which the states choose the taxes to impose, define tax bases, and administer the taxes, is totally inappropriate; it is too complex and it involves needless duplication of tax administration and compliance.

## **COUNTER REFORMS**

Kazakstan has recently introduced income tax exemptions and protective import duties for selected industries. Such policies represent a substantial retreat from the principles of uniformity and economic neutrality that gave Kazakstan the only modern tax code in the former Soviet Union: they reflect the bankrupt mentality of central planning and resemble the failed policies followed in Latin America in the 1960s and in Eastern Europe more recently. Rather than offering tax incentives to spur investment, Kazakstan should allow full and immediate refunds of VAT on capital goods, lengthen loss carryforward periods, index losses for inflation, and eliminate the punitive taxation of expatriates. If tax incentives are to be provided, they should be structured as investment incentives (for example, partial expensing), and not as exemptions or holidays, which are much more subject to abuse. Protective import duties should be avoided, because they commonly create high and variable rates of effective protection: low and uniform tariffs are more appropriate.