CHAPTER 1

OVERVIEW AND ASSESSMENT OF FISCAL TRANSITION IN KAZAKSTAN

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INTRODUCTION

In tax reform, Kazakstan has made as much progress as any member of the former Soviet Union (FSU), or more. But in the closely related areas of budgeting and intergovernmental fiscal relations, practice has hardly advanced beyond the Soviet system. This book describes transition—or lack thereof—in these areas and makes recommendations for improvement of the system(s). The recommendations for intergovernmental fiscal relations would improve expenditure assignment and budgeting and provide mechanisms for funding subnational governments that combine greater fiscal discretion with equalization of fiscal capacity. Fiscal transition in Kazakstan can be understood only in the context of the country's overall transition to a market economy. A brief survey of economic and historical background intended to place this book in context precedes a summary of the book's discussion of tax reform and intergovernmental fiscal relations.

Chapter 2 describes the principles and objectives that guided development of the new tax code which was enacted in April 1995, and became effective on 1 July of that year. Chapter 3 describes and analyzes the new tax code. Despite remaining problems, the new tax code is a good one; contrary to the situation in most of the FSU, the need for further tax reform is relatively limited in Kazakstan.[1] Chapter 4 discusses the need for quantitative fiscal analysis.

[1] However, in December 1995, after this book was essentially completed, Presidential Decree No. 2703 unwisely limited deductions for labor costs. Because of the outcry from the governments of the United Kingdom and the United States, this provision was never implemented.

The remainder of this book is devoted to various aspects of intergovernmental fiscal relations in Kazakstan: expenditure assignment, budgeting, tax assignment, and intergovernmental grants. Chapters 5 and 6 discuss the assignment of expenditure functions to various levels of government and budgetary practices.[2] It is logically prior to the discussions of the existing system of tax sharing and subventions in Chapter 7, tax assignment in Chapter 8, and intergovernmental grants in Chapter 9. Chapter 10 proposes a plan for evolution to a new system of financing subnational governments in Kazakstan.

The primary purpose of this discussion is to help the government of Kazakstan think about these issues. It is useful to proceed in a three-stage process. The first stage is conceptual thinking: identification of the conceptually correct solution—the first-best system, assuming administrative feasibility and political realities could be ignored. The second stage is to take account of administrative realities in present-day Kazakstan. In part, because of the legacy of socialism, conceptually attractive solutions may not be feasible. Even so, it is useful to identify them, even if they must be discarded as infeasible. The third stage recognizes political reality. Even if a particular solution is conceptually attractive and might be administratively possible, it might not constitute desirable policy if it would be undermined or distorted by political forces. This point was emphasized repeatedly during the March 1996 follow-up meetings between the government and the leader of the Mission. Although political considerations should not be ignored, they are more appropriately interjected by the government than by the Mission.

Both administrative feasibility and political realities change over time. One of the determinants of what is feasible is the capacity of the bureaucracy to absorb change, for example, in budgeting and tax administration. Augmentation of capacity takes time. Thus, steps that might not be possible now (such as cost-benefit analysis of budgetary alternatives and consumption-based excise taxes), might become possible in the future. Similarly, as the institutions

[2] The government of Kazakstan is unitary, rather than federal. Nonetheless, it is often useful to refer to levels of government as one would in describing a federal system. The Russian term commonly translated into English as "local" encompasses all governmental units below the central government; it does not have the same meaning that "local" has in English. To avoid confusion, this book generally uses the Russian terms for *oblasts* (the second tier of government) and *rayons* (generally the level below the *oblast* level), and generally uses "subnational" for all units below the central level. "Local" is sometimes used in this way.

and practice of democracy develop, it may be possible and appropriate to decentralize government more than would be fitting at the beginning. This suggests that introduction of a decentralized system of government should perhaps be an evolutionary process, rather than follow a big bang approach.[3]

Finally, nothing in this book should be interpreted as contradicting the Kazakstan government's commitment to the stability of its tax code. Stability is so important that it may be necessary to defer some desirable changes to a time when making them would not necessitate opening up the tax code, as it is often difficult to stave off deforms of the tax code masquerading as tax reform.

HISTORICAL AND ECONOMIC CONTEXT OF FISCAL TRANSITION

Kazakstan began its existence as an independent country in December 1991, upon dissolution of the FSU. Before that, it was merely one of the 15 republics that constituted the FSU. As a result, upon gaining independence it lacked the legislative, judicial, and administrative institutions and the legal structure of a national government. It adapted some institutions and laws inherited from the Soviet era to the new reality, created other institutions, and began to enact legislation more appropriate to a market economy.

Historical and Economic Background

With an area of 2.7 million square kilometers (five times that of France), Kazakstan is the second largest republic of the FSU and the ninth largest country on earth.[4, 5] But its population is only about 17 million (about 30 percent that of France), making it one

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[3] One is reminded of the two analogies used to justify the big bang approach to transition to a market economy. Perhaps one can cut the tail off a dog (decentralize government) one centimeter at a time; similarly, perhaps one can leap the chasm of decentralization in several small leaps.

[4] This discussion draws on various sources, including especially World Bank (1993), Pomfret (1995), International Monetary Fund (IMF) (1995 and 1996), and the Economist Intelligence Unit (1995-1996). Most data utilized in preparation of this chapter were taken from publications of international agencies, some of which are not public.

[5] Argentina is 50 thousand square kilometers larger; Sudan, the tenth largest country, is 211 thousand square kilometers smaller.

of the world's least densely populated countries.[6]

Kazakstan shares land borders on the west, north, and northeast with Russia, on the southeast with the People's Republic of China, and on the south with three of the other four Central Asian republics of the FSU.[7] It is also bordered on the west by the Caspian Sea, which in turn is also bordered by Russia, Azerbaijan, Iran, and Turkmenistan; because the Caspian Sea has no outlet to the ocean, Kazakstan is landlocked. This geography has dramatic implications for the future economic development of the country.

Although the ancient silk route crossed Kazakstan, none of the major cities on that famous trade route was located there. (Boukhara and Samarkand are located in Uzbekistan.) Almaty, the capital of Kazakstan, grew to prominence only under the FSU, as the administrative capital of the Kazakstan Soviet Socialist Republic.[8] Until relatively recently, the native people were primarily nomadic, relying primarily on the raising of livestock and minor trading.

Several developments changed this.[9] During the 19th century, Russians began to cultivate the northern part of the country and to exploit its mineral resources. Then, during the 1920s and 1930s, industrialization began and the collectivization of agriculture occurred; this brought large increases in output, but also famine, which is estimated to have cost more than a million lives (Pomfret 1995, 77). During World War II, further industrialization occurred with the relocation of industrial facilities from the western parts of the FSU to Central Asia, to protect them from the Germans. Although much of this relocation was reversed after the war, there was some net transfer of industrial capacity to Kazakstan; moreover, the war years gave some of the previously rural population experience with an industrial and urban way of life.

Also during World War II, Stalin forcefully removed large numbers of persons deemed to be security risks (especially Germans and Koreans, but also Greeks and Tatars) to Kazakstan. Then,

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[6] Of the eight countries that are larger than Kazakstan, only Australia and Canada are less densely populated. Of the other countries that have areas of more than one million square kilometers, several are poor, largely desert, African or Middle Eastern countries that also have extremely low population densities.

[7] Strictly speaking, Kazakstan was not categorized as a Central Asian republic under the FSU; this distinction is ignored in what follows.

[8] Under the FSU, Almaty was known as Alma-Ata; its name was changed in 1993.

[9] For a brief account of these developments, see Pomfret (1995, Chapters 2 and 6). Rumer (1989) is also useful, although it focuses on the other four Central Asian republics.

during the 1950s, the Khrushchev regime undertook to bring the "virgin lands" of Central Asia under cultivation. In addition to increasing agricultural output, and, in the case of Kazakstan, reducing reliance on imported grains, this policy was intended to make the nomadic peoples of Central Asia more sedentary.

As a result of these policies, the percentage of Kazakhs in the population fell to only about 30 percent, before beginning to recover. Even now the country's population is about 36 percent ethnic Russian and 48 percent ethnic Kazakh (Green and Bauer forthcoming).[10] The demographic balance has been shifting in favor of Kazakhs because of their higher birth rate and the emigration of Russians, other Slavs, and Germans following the dissolution of the FSU.[11] The geographic location of the population tends to be split along ethnic lines, with Kazakhs found mostly in the south and southwest and Russians and others found mostly in the north and in Almaty, where they have formed a majority because of their predominance in administrative positions under the FSU.

Industrialization has created several large cities. In 1990, there were six cities with populations in excess of 300,000 (see Table 1.1). It is estimated that 57 percent of the population of the country was urban in 1993 (Economist Intelligence Unit, 1995-1996). Whereas most Kazakhs still live in rural areas, Russians and others live primarily in urban areas.

Table 1.1. Population of Large Cities in Kazakstan

City	Population
Almaty	1,147,000
Karaganda	613,000
Chimkent	410,000
Semipalatinsk	339,000
Pavlodar	337,000
Ust-Kamenogorsk	330,000

[10] The Economist Intelligence Unit (1995-1996, 10) reports that, according to the 1989 census, ethnic Kazakhs were 39.7 percent of the population and Russians were 37.8 percent, with Germans (5.8 percent) and Ukrainians (5.4 percent) being the next largest groups. A 1995 report places the ethnic Kazakh population at 46 percent of the total, with Russians, Ukrainians, and Belarusians comprising 40 percent (down from 44.3 percent in 1989).

[11] It is estimated that there was a net out-migration in excess of one million persons between 1989 and 1995 (Economist Intelligence Unit 1995-1996, 9).

Selected Sectors

It is difficult to determine the relative importance of various productive sectors of the economy of Kazakstan under the FSU because prices did not reflect relative values.[12] As late as 1996, the Economist Intelligence Unit (1995-1996, 13) noted, "Accurate, consistent and timely national accounts for Kazakstan do not exist." Yet it is clear that mining, agriculture, and manufacturing were extremely important. There is a need to reorient these sectors in response to market forces and to deal with the transportation problems that constrain such reorientation.

Mining: Mining was an extremely important industry in Kazakstan under the FSU and promises to become even more important. Kazakstan has 90 percent of the FSU's proven reserves of chromium and almost half of its lead, wolfram, copper, and zinc. Kazakstan also accounted for about one fifth of the output of coal of the FSU; some was used to provide electricity to the Ural region of Russia, and some was used in the metallurgical industry around Karaganda and in the Urals.

Although Kazakstan has produced only about 5 percent of the oil of the FSU, its future prospects are for much greater production; proved and provable reserves equal those of western Europe (Pomfret 1995, 35). In 1993, Chevron signed an agreement to form a joint venture (Tengizchevroil) to develop the vast Tengiz oil field in Atyrau, in the western end of the country.[13] British Gas and Agip, having secured exclusive rights to negotiate for the Karachaganak gas field, one of the largest in the world in 1992, has since been joined as a 15 percent partner by Gazprom, the Russian gas giant. Elf-Aquitane has been chosen to develop resources in Aktubinsk. Exploration in the Caspian Sea is being conducted via a joint venture involving the local Kazakstan Caspian Shelf state enterprise and a consortium of western companies (British Petroleum/Statoil, British Gas, Royal Dutch/Shell, Mobil, and Total). The Economist Intelligence Unit (1995-1996, 19) places Kazakstan's oil reserves at 27.3 billion barrels, or just over 10 percent of those of Saudi Arabia.

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[12] On the endemic problems of Soviet statistics, see Schmelev and Popov (1989, Chapter 2). Brukoff (1995) attempts to restate Kazakstan's economic production and trade using more realistic values. See also IMF (1995, Appendix I).

[13] In 1996, Mobil acquired 25 percent of Tengizchevroil from the government of Kazakstan.

Agriculture: Agriculture in the north is dominated by rain-fed cultivation of wheat and other cereals, while in the south it is dominated by the irrigated production of cotton. Kazakstan is the third largest producer of grain in the FSU, after Russia and Ukraine; like Ukraine (and unlike Russia), it is a consistent exporter of grain.

Although Kazakstan is an important producer of agricultural products, its agriculture is, by all accounts, quite inefficient. The World Bank (1993, 130) reports that cereal yields per hectare are only two thirds those of the Canadian provinces. The Economist Intelligence Unit (1995-1996, 11) notes that while Kazakstan contributed 6 percent of the FSU's net material product in agriculture in 1989, it had one fifth of the arable land in the FSU. Pomfret (1995, 81) notes that the virgin lands campaign placed land under cultivation of grain that would have been better left to other uses. The World Bank (1993, 130) suggests that 30 percent of the land brought under cultivation is not suitable for cultivation. Brukoff (1995, 29) places the figure at 20-60 percent. The lack of storage, processing, and distribution facilities have often left crops unprocessed, as in other parts of the FSU (Pomfret 1995, 83).

Manufacturing: Under the FSU, Kazakstan was seen as a provider of natural resources and other unprocessed (or largely unprocessed) materials, especially crude oil, base metals, chemicals, and metallurgical products, and a consumer of final products made in Russia and other parts of the FSU. Half of its consumer goods were imported and three fourths of its exports were raw materials and intermediate goods (IMF 1992, 1). Dienes (1987, 6) refers to the relationship between Central Asia and the European republics of the FSU as that of a "plantation economy." In 1988, an estimated 86 percent of Kazakstan's trade was with other republics of the FSU, much higher than the analogous figure for any of the Canadian provinces. By 1995, trade with the Commonwealth of Independent States (CIS) had fallen to 56 percent (50 percent of which was with Russia).[14] In recent years, Kazakstan has specialized in the processing of minerals, light industry, the manufacture of heavy machinery (including agricultural machinery and washing machines), cement, knitted garments, and steel (Economist Intelligence Unit, 1995-1996, 21).

Transportation: Kazakstan's transportation links reflect the trade pattern just described. Rail lines, power transmission lines, and pipelines run predominantly to and from the rest of the FSU

[14] The figure for 1998 is from IMF data quoted by Pomfret (1995, 37). Those for 1995 are from Economist Intelligence Unit (1995-1996, 26). See also Islamov (1991) and especially World Bank (1993, Annex 2) and Brukoff (1995).

(especially Russia).[15] Transportation within the country is difficult or nonexistent, whether by rail, pipeline, or power line. Thus, the country's two electric power grids are not interconnected. Two of Kazakstan's three oil refineries are located in Pavlodar and Chimkent, in the northeastern and southeastern parts of the country, respectively, far from its oil fields in western Kazakstan; the oil refineries were designed to process Siberian crude, to which they are linked by pipelines. By comparison, the refinery in Atyrau, while located in western Kazakstan, is far too small to process the amount of oil Kazakstan could soon be producing. Moreover, western production is not connected to the population centers in the eastern part of the country. Thus, most oil from western Kazakstan was and will be exported.

The key to the development of Kazakstan's oil reserves, and indeed, to the economic development of the country, is a pipeline that will take the oil to export markets. Under the FSU and even today, oil flows from western Kazakstan to the Russian Black Sea port of Novorossysk. From there it can be loaded on tankers destined for export markets outside the FSU. But the capacity of this pipeline is well below the projected output of Kazakstan oil (700,000 barrels per day from the Tengiz field alone). Moreover, it cannot readily handle the particular type of oil produced in Kazakstan, which is high in mercaptan (a sulfurous compound that corrodes the technically deficient Russian pipeline). As a result of these problems, in 1995, Tengizchevroil was producing only 60,000 barrels per day, compared to its capacity of 90,000 barrels per day, and initial projections of 1995 production of 120,000 barrels per day. Also, Chevron had cut back its investment from the promised $1.5 billion to be spent during the three- to five-year period after signing the contract in 1993, by an estimated 90 percent.

Kazakstan has no good options where the export pipeline is concerned. The route chosen by the Caspian Pipeline Consortium to Novorossysk is probably the best available.[16] It is subject to two

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[15] See, inter alia, Brukoff (1995, 63-4).

[16] Three other routes and their drawbacks are across Iran to the Persian Gulf with political uncertainty and a US veto of funding by international agencies; across the Caucuses and Turkey to the Mediterranean Sea where there are political unrest, civil war, and cost; and across Kazakstan and the PRC with cost and political uncertainty. Any route through an oil-producing state faces a further problem, the reluctance to see Kazakstan's oil reach world markets and suppress the price of oil. For a more complete discussion of these options, see Economist Intelligence Unit (1995-1996, 20). For play-by-play coverage of developments in the efforts to consummate a pipeline deal, see Economist Intelligence Unit (1996, Volume I, 24-6; 1996, Volume II, 26-30; and 1996, Volume III, 24-5). The pipeline contract was finally signed in Moscow on 7 December 1996.

potential drawbacks, besides its enormous cost, estimated at $1.5 billion. First, because the pipeline will pass across Russian soil, Russia will, in effect, have a stranglehold on Kazakstan's ability to export oil. This is reflected in the fact that Russia has been able to obtain 37.75 percent of the equity in the pipeline, compared to only 20.75 percent for Kazakstan, and that the Russian enterprise Transneft will operate the pipeline.[17,18] Second, Turkey has expressed concern over the number of supertankers that will pass through the Bosporous.

Selected Economic Issues

Economic Transition

The pattern of production and trade inherited from the FSU was based on central planning epitomized by specialization as producers and processors of raw materials, economically inefficient production, and transportation links primarily with other republics of the FSU. It left Kazakstan highly dependent on Russia and the FSU, and thus vulnerable to economic disruption of input supplies and export markets when the FSU broke apart. As indicated by the World Bank (1993, 162),

> . . . there was a supranational power planning both trade flows and the pattern of investment and specialization. The central planners [sic] investment preferences, however, only peripherally reflected comparative advantage. . . . Thus it is likely that a very significant portion of the inter-industry trade among the states of the former Soviet Union in manufactures is based on trade diversion which will vanish in the long run without preferential treatment.

While trade within the FSU has fallen precipitously, it has not been replaced by non-CIS trade; nor will it be replaced soon. Lack of direct access to the sea aggravates this problem. Yet trade and production will change, if only slowly, to reflect market forces and competitive advantage.

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[17] Russia's share includes direct ownership of 24 percent by the Russian Federation and indirect ownership of 6.25 percent via the LUKoil/ARCO joint venture and 7.5 percent via Rosneft. The remaining equity ownership is as follows: Government of Kazakstan- 19 percent; Kazakhstanmunalgaz- 1.75 percent; Oman- 7 percent; Chevron- 15 percent; Mobil- 7.5 percent; Agip- 2 percent; British Gas- 2 percent; and Oryx Energy- 1.75 percent (Economist Intelligence Unit 1996, Volume II, 27).

[18] This is from IMF data quoted by Pomfret (1995, 37).

As Kazakstan's economy adjusts to the new market-oriented environment, there will be winners and losers. Brukoff (1995, 28-30) suggests that "moving to world market prices should promote reduced production . . . [of] a wide range of manufactured goods for which there is no demand outside the former Soviet Union." According to her estimates, these include agricultural goods such as wheat, meat, wool, and dairy products, which might seem to be Kazakstan's comparative advantage. But, she notes, ". . . cotton, wheat, and other cereals were probably poor choices for Kazakstan at the outset . . . it [is] unlikely that large-scale production of these commodities will be sustainable." Intensive methods of growing livestock, in lieu of the traditional extensive grazing methods, require irrigated and inefficient production of fodder.

It seems almost certain that in the medium term (if not longer), Kazakstan will suffer from "Dutch disease," the inability to export anything besides oil and gas and perhaps products derived therefrom (World Bank 1993, 29-31). This phenomenon, which has occurred relatively recently in Australia, Mexico, Norway, and United Kingdom, occurs because massive exports of oil cause an appreciation in the real exchange rate that makes most other products uncompetitive in world markets.

Environmental Factors

As a result of the virgin lands policy, some 90 percent of the water in the Amu Darya and Syrdarya rivers has been diverted from the Aral Sea for use in irrigation. This has had devastating environmental effects.[19] Between 1960 and 1990, the level of the Aral Sea, once the world's fourth largest inland sea, fell by over 45 feet, the surface area of the sea shrunk by some 40-45 percent, and the volume of water in the sea fell by two thirds. The threefold increase in salinity of the Aral Sea has destroyed a once thriving fishing industry. And, because the sea bed is now exposed, surrounding areas are subjected to sandstorms that create health problems and spread salt over agricultural land, reducing its productivity. This has affected primarily the cotton culture of the south, and not the rain-fed, grain-based agriculture of the north. It is estimated that 1.4 million members of the population of Kazakstan are affected. The search for a solution to this problem is stymied

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[19] For further but brief discussions, see Pomfret (1995, 28-30) and World Bank (1993, 154) or, for a more detailed discussion that focuses on the other four Central Asian republics, Rumer (1989, Chapter 5).

because the cotton culture of Turkmenistan relies heavily on water diverted from the Aral Sea.

Kazakstan has also experienced another man-made environmental disaster. Because of its large and relatively unoccupied land area, it was chosen for the sites of both Baikonur, the launching ground for the FSU space program, and the nuclear test ground in Semipalatinsk. Even though the space program was benign (and is now providing some earnings of foreign exchange via long-term lease to Russia), the nuclear testing program, which included some 115 aboveground tests, has left large areas uninhabitable and has led to detectable increases in various types of cancer in the roughly 2 million persons at risk (World Bank 1993, 154).

The tax code of Kazakstan contains special features intended to lighten the tax load on residents of areas subject to environmental disasters. While the desire to help these unfortunate people is understandable, there are better ways of doing it.

Implications for Fiscal Transition

The discussion above suggests some of the factors that must be kept in mind in thinking about fiscal transition in Kazakstan. These are presented in greater detail in the next chapter.

One role of tax policy is to facilitate the transition to a market economy. But it would be a mistake to replace central planning with its functional equivalent, tax incentives intended either to hasten or prevent economic transition. Tax policy should be neutral. It should not be an exercise in picking winners and losers; that is the task the market performs remarkably well.

There will almost certainly be pressures for unwise investment of oil revenues in downstream production (sometimes called resource-based investment) and for tax incentives intended to encourage development of nonoil sectors. International experience suggests that neither of these strategies is likely to be productive.[20]

The north is the industrial heartland of Kazakstan, while the south is primarily agricultural. This is reflected in differences in levels of income, which are much higher in the north. Development of the country's oil reserves will accentuate inequalities in income,

[20] On Dutch disease and resource-based investment, see Gelb and Associates (1988). The Organisation for Economic Co-operation and Development (OECD) (1995); McLure (1997); and the papers in Shah (1995) discuss international experience with tax incentives.

both between households and across regions. Thus, tax policy and intergovernmental fiscal relations must address issues of income distribution and regional imbalance. For reasons noted above, these can take on an ethnic overtone.[21]

Recent Economic Developments

Following the dissolution of the FSU, Kazakstan experienced a severe economic decline. Although statistical problems make it difficult to quantify the decline precisely,[22] it appears that output has fallen by about 50 percent since the end of the Soviet era.[23] There are many reasons for this decline: the loss of markets in the FSU and the inability to replace these markets quickly, because most transport links lead north to Russia, and economic activities established under central planning often fail to reflect comparative advantage; the lack of inputs (capital goods and intermediate goods), especially from the FSU; and the failure of payments mechanisms for trade within the FSU which aggravated the problems created by the first two reasons. On top of this, Kazakstan lost transfers equal to about 10 percent of gross domestic product (GDP) it had traditionally received as a subvention republic within the FSU.

The initial response to these developments was to attempt to protect state-owned enterprises (SOEs) and their employees, rather than to restructure the enterprises, privatize them, or, where appropriate, liquidate them. Nominal employment has remained high, and formal unemployment low, because employees have been forced to take unpaid vacation and other forms of leave, rather than being laid off. Whereas in 1992, total (registered and

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[21] The patterns of overlapping ethnic and economic differences are so great that Dienes (1987, 7) supports "the splitting of Kazakstan between the Siberian and Central Asian realms for the purpose of analysis."

[22] During the Soviet era, attention focused on net material product, a measure of output that excluded output of the service sector, including distribution and trade. Given the recent burgeoning of the service sector, it is thus difficult to compare measures of output from the Soviet era with current measures of GDP. Beyond that, there is little reason to have confidence in data from either period. Similar comments could be made about the data on price levels and inflation cited below. On issues of data and their comparability, see IMF (1995, Appendix I) and also Schmelev and Popov (1989), Chapter 2, and Lipton and Sachs (1990, 78-80, and sources cited there). It is best to concentrate on orders of magnitude, instead of attributing misplaced concreteness to soft statistics.

[23] The Asian Development Bank (ADB) (1995, 1) suggests that GDP in 1994 was 47 percent of its 1990 level. World Bank (1996a, Volume I, 3) states that GDP fell by 50 percent over the period 1991-1995.

hidden) unemployment was 3.9 percent (3.4 percent of which was hidden), this figure was 17 percent in 1994. But of this total, 15.7 percent was hidden; registered unemployment had grown from 0.5 percent to only 1.3 percent. The unemployment problem is especially severe in western and southern Kazakstan and in "company towns" (of which there are about 50), where a single mining or manufacturing facility is the primary employer. Unemployment rates in Atyrau and Semipalatinsk are far above the national average. Where production was formerly for the military of the FSU or contrary to the dictates of comparative advantage, prospects for recovery are especially dim.

Because SOEs continued to operate and pay (or at least promise to pay) employees who were redundant, they built up large debts to other enterprises and the government, as well as wage arrears. Enterprise losses were about 10 percent of GDP in 1992 and 1993.[24] Loss-making SOEs were kept afloat primarily by directed credits from the banking sector.[25] Operations undertaken in 1994 to "clear" the balance sheets of enterprises resulted in the monetization of the credits created by enterprises.

These events have had predictable effects on the budget and other macroeconomic indicators. In 1994, for example, the government budget for "regular" operations was roughly in balance; but there was a deficit of 7 percent of GDP on "quasi-fiscal operations," the netting of interenterprise debt and unanticipated external debt undertaken by SOEs and guaranteed by the government (IMF 1996, 22). Whereas reported inflation (admittedly suppressed by price controls on products that were often not available at the controlled prices) had been under 5 percent in 1990, it rose to just under 100 percent for 1991, and to almost 3,000 percent by the end of 1992; in June 1994, the inflation rate was 46 percent. While some of the early inflation can probably be attributed to the elimination of most price controls (achieved by 1994), the

[24] World Bank (1994, 53) notes the following difficulties in attempting to quantify subsidies: (i) inappropriate accounting practices, for example, reporting of most financial and in-kind payments to workers as a use of profits, instead of as a cost; (ii) insufficient depreciation allowances during a time of inflation; (iii) widespread misreporting of income to evade taxes or engage in rent seeking (selling "out the back door"); (iv) lack of transparent prices (for example, rubles vs. tenge and controlled vs. market exchange rates); and (v) the many implicit taxes and subsidies (such as free use of land).

[25] See World Bank (1994, 54, 58-9), which describes in considerable detail the mechanism by which these transfers to enterprises were implemented. This source estimates the transfer from the household sector to enterprises in 1993 as between 11.9 and 13.5 percent of GDP.

hyperinflation experienced in Kazakstan in 1994 was primarily a monetary phenomenon, related largely to monetization of interenterprise credits (IMF 1996, 8).

Until November 1993, when Kazakstan introduced its own national currency, the tenge, and established its own central bank, the National Bank of Kazakstan (NBK), the country had no real opportunity to control monetary policy; essentially the inflation rate was determined primarily by the monetary policy pursued in Moscow (and in other CIS capitals, to the extent that they had the power to print rubles or issue credits). Finally, during the second half of 1994, the government adopted a more realistic policy stance. For example, in July 1994, banks were told not to make payments on behalf of enterprises with insufficient funds. As a result, the monthly inflation was brought down to about 10 percent by the end of 1994. Progress continued during 1995, and by year-end the annual inflation rate had been reduced to about 60 percent.

The developments reported above have had a devastating effect on real wages and on living standards. It has been estimated that total real income (wages plus social transfer payments) fell by 41 percent between 1991 and 1994. Under one measure, 37 percent of the population was living in poverty in May 1995, compared with 20 percent in 1992. This problem is aggravated by the underdeveloped state of the social safety net, including unemployment compensation, and arrears in the payment of pensions.

Because output (as measured by real GDP) fell by some 50 percent over the four-year period 1992-1995, fiscal resources would have been halved, even if the ratio of tax revenues to GDP could have been maintained. In fact, this ratio fell from 36.8 percent in 1992 to 22.4 percent in 1995. Combining these influences with the loss of transfers from the FSU produced an aggregate drop in real fiscal resources of roughly 75 percent from 1992-1995. Revenues from both direct and indirect taxes fell. While it is anticipated that the tax reform enacted in 1995 laid the groundwork for future growth of revenue, the short-run impact has been a reduction in revenues.[26]

Total current and capital expenditures, including those of extrabudgetary funds, fell from just over 46 percent of GDP in 1992 to just over 25 percent of GDP in 1995. Reductions in spending were initially achieved by sequestration, instead of a more rational process. These reductions in spending were achieved by roughly

[26] See IMF (1996, 23) for the expected impact of tax reform on revenues.

equal reductions in current and capital expenditures, as a percentage of GDP. But while current spending has fallen by about one third, capital spending has been cut by 80 percent, to a mere 2 percent of GDP, well below the figure needed to support economic development. Table 1.2, adapted from a recent World Bank report (1996a), indicates the magnitude of the problem and its growth over time.

Position of Kazakstan in the Former Soviet Union

The system of intergovernmental fiscal relations in the FSU has often been described as the "Russian doll" model. Like a matrushka doll, the relations between the Soviet Union and its 15 constituent union republics (and 20 autonomous republics, most of which were in Russia) were repeated in the relationships between the republics and the first level of local government (*oblasts*, *okrugs* [independent provinces], and *krays* [administrative districts]) and between first and second level local governments. Although the dissolution of the FSU eliminated the outside (union) layer of this multilayered system, lower layers remained essentially intact.

In the FSU, expenditure needs of the republics were determined by application of expenditure norms. As in the present day system of intergovernmental fiscal relations in Kazakstan, revenues from local taxes were deducted from expenditure needs to determine residual financial requirements of republics to be financed through their shares of regulating taxes and subventions. In 1990 (as in 1989), all five of the Central Asian republics retained 100 percent of the revenues from the turnover tax.[27] Of the other ten republics, only Georgia also retained all revenues from this source; the others retained from 57 to 94 percent. The five central Asian republics also retained all revenues from the personal income tax in 1990 (up from 50 percent in 1989). By comparison, three other republics retained all revenues from this source and the remaining republics retained only 50 percent. The five Central Asian republics, like five other republics, retained only 20 percent of the enterprise profits tax collected from enterprises subordinated to the Union. Although this sharing rate is slightly above the average rate for all republics (brought down to 14 percent by the 12 percent sharing rates for Russia and Ukraine), it was well below the sharing rates of 58 to 84 percent for the three Baltic republics.

What distinguished these Central Asian republics from the

[27] Data in the remainder of this section are from IMF et al. (1991, 279).

remaining republics was the existence of large subventions from the union budget. Fully one fourth of budget revenues of Kazakstan were derived from this source. Turkmenistan, with subventions equal to 30.9 percent of budget revenues, and Uzbekistan (26.7 percent of budget revenues) received somewhat more from this source, and Tadjikistan (15.2 percent) and the Kyrgyz Republic (18.3 percent) somewhat less; Armenia was the only other republic that received revenue from this source (2.9 percent of revenues). While Russia continued to make small transfers to Kazakstan during 1992 and 1993, by 1994 transfers had been eliminated.

Elimination of subventions from the FSU left a large gap in the budget of Kazakstan and in the welfare of its citizens. The figure of 25 percent of budget revenues represented by subventions from the FSU presumably overstates this effect. Kazakstan now has access to 100 percent of revenues from the enterprise profits tax, which under the old system (with its 20 percent sharing rate) constituted 3.3 percent of budget revenues. Based on these figures, the gap created by the dissolution of the Soviet Union would come out to somewhat less than 10 percent of budget revenues (25.0 percent minus 16.5 percent = 3.3 percent/0.20). On the other hand, under the Soviet system, the profits of enterprises subordinated to the republics were allocated solely to the budgets of republics (or to local budgets subject to their subordination). Further complicating matters is the fact that artificially low nominal prices were assigned to Kazakstan's natural resources in the FSU. Had these prices been more realistic, Kazakstan's reported output and tax revenues would have been higher and the need for subventions less (Islamov 1991; Brukoff 1995). Kazakstan's need to finance its own pension system, without assistance from the remainder of the FSU, presumably aggravates this problem (see Table 1.2).

History of Tax Policy

The history of tax policy in Kazakstan reflects the country's history of socialism and central planning. Unlike taxation in market economies, taxation in the FSU did not greatly affect the allocation of resources or the distribution of income; that was determined by the quantities, prices, and wage rates set by the planners. Taxation was part of the relatively unimportant system of monetary balance that was the shadow of the much more important system of real balances that concerned the planners. Macroeconomic stabilization (high employment and price stability) was maintained by fiat (if at all), not by the exercise of monetary and fiscal policy.

Table 1.2. Government Expenditures, Revenues, and Budget Balance, 1985-1995
(percent of GDP)

Year	Expenditures	Revenues			Surplus or Deficit (-)
		Excluding Grants	Grants	Total	
	(a)	(b)	(c)	(d)	(e)
1985	37.8	34.4	4.4	38.8	1.0
1986	35.0	30.0	5.6	35.6	0.6
1987	36.9	30.4	7.3	37.7	0.8
1988	37.3	28.6	10.3	38.9	1.7
1989	39.2	29.0	11.7	40.7	1.5
1990	38.4	27.7	13.6	41.4	2.9
1991	44.1	27.0	8.1	35.1	-9.0
1992[a]	31.9	22.8	1.7	24.6	-7.3
1992[b]	46.2	36.7	2.1	38.9	-7.3
1993	41.0	38.3	1.3	39.6	-1.4
1994	29.4	22.4	0.5	22.9	-6.5
1995	25.3	21.4	0.6	22.0	-3.4

[a] Figures up to and including 1992 are for general government.
[b] Those for 1992 and later include extrabudgetary funds (with expenditures/revenues of 15.8/15.3, 15.6/18/6, 13.0/6.4 and 7.3/7.6 percent of GDP in the four years). Extrabudgetary receipts include those of the privatization fund, which were important only in 1993, at 2.9 percent of GDP.

Sources: World Bank (1994), Tables 2-1, 5-1A, and 5-2; World Bank (1996a, Vol. II), Table 5-2.

In the FSU, most government revenue was derived from turnover taxes and the transfer of enterprise profits to the budget. Turnover taxes were not like the gross receipts taxes that existed in Europe before the advent of VAT. Rather, they consisted of the (positive and negative) differences between prices at the wholesale and retail levels (net of a margin) set by the planners. Because of the large number of prices set by the planners, there were many thousands of implicit turnover tax rates. Transfers of profits flowed to the budget of the government—Union, republic, *oblast*, or other—to which the enterprise was subordinated, regardless of where the enterprise earned its profits. Taxes on the incomes of individuals existed, but they were dwarfed by the taxes implicit in ceilings on wages. Income taxes were levied at progressive rates and were designed primarily to hit (and perhaps discourage the activities of) those who had income other than from employment.

Although changes had begun to be made in the Soviet tax system in 1991, this is essentially the system Kazakstan inherited from the FSU when it became a separate country at the end of 1991. Although further changes were made between then and July 1995, when the new tax code became effective, the prereform tax code was woefully inadequate for a market economy. The defects of the tax code, in general terms, may be described as follows.[28]

Enterprise Profits Tax. Beginning in July 1991, enterprises operating in Kazakstan were subject only to the profits tax of Kazakstan. There was a standard rate of 35 percent, instead of the standard rate of 45 percent (and graduated rates that could go as high as 90 percent) under the FSU. Banks and insurance companies paid a rate of 55 percent, and some sectors paid lower rates, including the 10 percent levied on agriculture. A presidential decree "Concerning Taxation of the Profits and Income of Enterprises," issued in February 1994 just after formal work began on the tax reform process, reduced the standard tax rate to 30 percent, and the rate on banks and insurance companies to 45 percent. Dividends and interest were subject to a withholding tax of 15 percent if paid to enterprises, but not if paid to individuals; receipt of such income was exempt for both enterprises and individuals.

The definition of the profits tax base reflected the thinking and methodology of central planning, rather than Western accounting concepts. Thus, even the 1994 decree defined the tax base in the following manner: "The balance sheet profit, which is the financial result of enterprises' activities and which represents the sum of income reduced by the amount of expenditures, shall be the taxable base." It provided no further elaboration of key terms in this definition, except that "All receipts (in monetary form, in-kind, and any other expression) of enterprises from activities in the reporting period shall represent income. . . . Costs (in monetary form, in-kind, and any other expression) which are incurred by an enterprise in the reporting period shall represent expenditures." This vague language is clearly not adequate to provide investors the clarity and certainty they need.

Some aspects of the definition of income inherent in the fundamental concept of "balance sheet profits" were different from those followed by other countries. Thus, for example, only interest on short-term debt was deductible; that on long-term debt was not; yet repayment of loans was deductible if budget funds had not been allocated for investment. This, and other provisions relating to depreciation allowances (immediate deduction of investments made from own-funds of enterprises, rather than from capital grants

[28] The description of the 1991 law that follows may be unclear, or even inaccurate, in places. This is not surprising because it is based on secondary sources and translations may not have been accurate. The primary message of the description is that this inherited system was badly in need of reform, no matter what its exact peculiarities.

from the state or from accumulated depreciation allowances), apparently reflected a presumption that the state would provide long-term funding for investment in depreciable assets.

There was also initially a large number of exclusions, exemptions, and other preferences, including provisions for tax holidays; thus, planning had shifted from explicit direction to tax-based incentives. There was no allowance for loss carryforward, which would have been more appropriate and more effective as a stimulus to investment. Even worse, the law allowed subnational governments to provide additional tax preferences, essentially with revenues that would otherwise flow at least in part to the central government. The 1994 amendments eliminated most of these preferences and introduced a three-year loss carryforward.

Individual Income Tax. The income tax on individuals, although revised in 1991, remained similar to that under the FSU. It was a "schedular"[29] tax levied on various types of income (including income in-kind), instead of a "global" tax levied on the sum of income from all sources. Rates were relatively low; the top marginal rate was 30 percent, except in a few cases. Much of the tax was collected at source on income from employment; in most cases it was not necessary for taxpayers to complete tax declarations. Perhaps the most glaring defect was the existence of numerous exclusions, exemptions, and other forms of tax preferences. While some of these are defensible, for example, deductions for charitable contributions, others, such as the most generous of those for veterans, are not, even though similar provisions are found in the tax laws of many countries. Tax liabilities were cut in half for individuals with three or more dependents and for single mothers with two or more children under 16. One anomaly of the system, noted above, is the exemption of interest from taxation. Particularly weak (unclear) were the provisions relating to the deduction of business expenses of individual entrepreneurs. Use of presumptive assessments seemed not to have been anticipated.

A second presidential decree issued in February 1994, "Concerning the Taxation of Income of Physical Persons," substituted a global income tax for the previous "schedular" tax and eliminated many of the tax preferences provided in the earlier law. The top personal rate was set at 60 percent in the decree, but was reduced to 40 percent in the budget law enacted in July 1994, following

[29] In a "schedular" system, each type of income is taxed separately, perhaps under a separate rate schedule, with no effort to combine income from all sources into an aggregate figure, as under a "global" income tax.

outcries from many sources, including governments of the home countries of foreign investors.

Value-added Tax. Like the rest of the FSU, Kazakstan adopted a value-added tax (VAT) at the beginning of 1992. This VAT differed in several important respects from those found in most developed countries (and in most less developed ones, as well). First, the standard credit method, in which tax on purchases is deducted from tax on sales, was not employed in the taxation of commerce. Instead, the subtraction method was employed so that tax was paid on the difference between purchases and sales. Although the two systems are similar in concept and even in operation, under ideal conditions, the subtraction method lends itself to various forms of evasion.

Second, VAT paid on purchases of capital goods was not allowed as a credit against tax on sales. Because it raises the cost of capital, this can be a serious impediment to investment. Finally, the destination principle was not applied to trade within the FSU. That is, whereas a standard VAT is imposed on all imports, but not on exports, and tax paid before the export stage is refunded, under the VAT adopted by the members of the CIS, this treatment was applied only to trade with non-CIS countries. Only the value added after importation from the rest of the CIS was subject to tax, and exports to other CIS countries were taxed. This "restricted origin principle" raises troublesome issues of tax administration and of tax exporting from producing CIS states to consuming states.

Excises. Excises were introduced to complement VAT in replacing the turnover taxes. Like VAT, they were levied on the origin principle in the case of trade with the rest of the CIS.

Number of Taxes. In addition to the important levies discussed above, Kazakstan inherited a number of minor taxes from the FSU (reserved primarily for subnational governments) and enacted a few more during the period before the new tax code was adopted. These included taxes found in many countries, such as those on payrolls (used to finance social security), property, land, securities transactions, motor vehicles, and motor transport; also introduced, inter alia, were taxes on advertising, local auctions and lotteries, pari-mutuel betting, horse racing, entrepreneurial activity, trade in alcoholic beverages, production of films and television shows, parking, resorts, industrial construction in resort areas, dog owners, use of local symbols, logging, natural resources, and use of water. It is difficult to obtain an accurate count of these taxes, in part because it is hard to differentiate between taxes and fees (and between distinct taxes), but it is commonly estimated that almost 50 taxes were in existence in 1994. The plethora of taxes imposed substantial administrative burdens on the tax authorities, as well as unacceptable compliance burdens on taxpayers.

Tax Legislation and Codification. The many taxes levied in Kazakstan were not codified before 1995. Nor was there a standard method of enacting such legislation. Some amendments were enacted by presidential decree and some were included in the annual budget law. Still others were included in nontax legislation. Thus, there was no single place a taxpayer (or a potential investor) could look to learn all the country's tax laws. Even worse, the Ministry of Finance (MOF) and the State Tax Committee (STC)[30] were not always consulted before legislation (including that contained in presidential decrees) was enacted.

Reflecting their genesis, many taxes contained glaring technical flaws. The deficiencies of the taxes on the income and profits of individuals and enterprises were mentioned above. Other taxes had bases similar to (but not identical to) the bases of the income tax; often these alternative bases were defined even less clearly and not in reference to the income tax. For example, the tax on motor transport was based on "income derived from such transport." The Fund for the Transformation of the Economy was financed by an earmarked tax of 5 percent of the production cost of goods produced by profitable enterprises, with no indication (among other things) how to treat enterprises made unprofitable by the tax itself.

TAX REFORM

The new tax code, effective 1 July 1995, is comprehensive, systematic, modern, and investor-friendly. It reduces the number of taxes from almost 50 to 11. It contains all tax laws except customs duties, social insurance contributions, and state duties, and repeals all laws inconsistent with it. It covers taxation at all levels of government: central, *oblast*, and local.

There are six nationwide taxes: income tax on individuals and legal persons, VAT, excises, tax on securities, and taxes and payments by mineral resource users.[31] Reform focused on the first four of these. Taxation of natural resources is the subject of a special working group. *Oblasts* share revenues from the five "regulating taxes."

Kazakstan has chosen to rely on market forces to direct

[30] The name of the tax administration was changed to State Tax Committee at the end of 1996. To avoid confusion, this name is used throughout.

[31] Strictly speaking, there is only one income tax which applies to both individuals and legal persons. Nonetheless, it is convenient to think of this as two taxes.

investment. The income tax, profits tax, and VAT are generally applicable, with only minor instances of preferential tax treatment of selected industries, new investment, foreign investors, and others.

Income Tax

Taxpayers. A single income tax applies to individuals and legal entities. Income of simple partnerships (including consortia) is attributed to the partners, not subject to an entity-level tax. Taxpayers with more than one contract to use mineral resources cannot consolidate operations in computing any tax. Resident individuals and legal entities are taxed on worldwide income. Foreign enterprises and nonresident individuals pay tax only on income from local sources.

Business Income. Deductions exist for most business expenses, with limits on (i) interest expense to prevent thin capitalization; (ii) reserves for bad debts limited to actual losses; (iii) research and development (no expensing for capital assets); and (iv) charitable contributions limited to 2 percent of taxable business income. Deductions for major expenses are crucial if foreign (especially United States [US]) investors are to take credits for Kazakstan's income tax. At the end of 1995, a presidential decree made "excess wages" nondeductible.

Depreciation is calculated by using maximum percentages of the value of pooled asset accounts, except for buildings which are calculated for each structure. Repairs are deductible, up to 10 percent of book value. First-in, first-out (FIFO), last-in, first-out (LIFO), and average cost are acceptable for inventory accounting. Inflation adjustment is allowed for inventories, and, as prescribed by the Cabinet of Ministers, for book values. Accounting for tax purposes must conform with financial accounting for inventories, but not for depreciation. Depreciation rates may be too low. Business losses can be carried forward five years. Five-year loss carryforwards may be inadequate for tax-free recovery of investments. Because losses are not indexed for inflation, they rapidly lose value. Allowance for effects of inflation in the calculation of income deserves further attention. Foreign investors believe that they should be able to keep books in a "hard" currency.

The new tax code is complicated, especially for small businesses. Moreover, virtually none of the personnel of STC has experience implementing such a tax system. There is pressing need for training for the tax administration.

Individual Tax Exemptions. A deduction of one minimum wage is allowed for taxpayers and each dependent family member. Interest on state securities, state pensions, scholarships, alimony, various benefits (such as for pregnancy, disability, and loss of breadwinner), and gifts and inheritances are exempt. Income of veterans of World War II and certain disabled persons is largely exempt. There is no allowance for benefits paid to expatriates to compensate for expenses incurred while working temporarily in Kazakstan, for example, for educational benefits, home leave, and cost of living allowances. Besides being questionable on equity grounds, this may undermine the country's economic development, which is dependent on the expertise of expatriates.

Tax Rates. Taxable income of individuals is taxed at marginal rates of 5 to 40 percent. Profits of legal entities are generally taxed at 30 percent, except in the case of income of agricultural enterprises, which is taxed at a rate of 10 percent. Dividends and interest pay a withholding tax of 15 percent. For individuals this is a final tax. Local enterprises receive credit for taxes withheld on dividends and interest. There is a branch profits tax of 15 percent.

Filing Requirements. Tax returns are required of legal persons and individuals with (i) income not subject to withholding, (ii) construction or purchases in the year exceeding 1,000 minimum calculation indexes (MCIs), (iii) foreign bank accounts, and (iv) foreign source income. With few nonbusiness deductions and withholding on employment income, most individuals will not file returns. This is appropriate; taxpayers lack expertise to file tax returns, and the tax administration lacks personnel to cope with universal filing.

Withholding and Advance Payments. There is withholding on employment income, pensions, dividends, interest, and payments to foreign persons. Claims for deductions for dependents are made to the taxpayer's employer. Legal persons and individuals engaged in business must pay tax monthly. Calculating income each month may prove to be so onerous that alternatives should be examined.

Imputation Methods. The tax administration can use the following methods to impute income: for taxpayers operating mainly with cash or few employees, a simplified system of tax accounting; for accounting violations or destruction or loss of accounting records, direct and indirect methods such as assets, turnover, or production costs; for individuals declaring income inconsistent with expenses incurred for personal use, use of personal expenses.

Value-added Tax

VAT is essentially the consumption-based, credit method, destination-principle type used in most advanced Western countries. Credit for tax on inputs, including most capital investment, is offset against tax on sales. Imports, except from the FSU, are taxed, and exports, except to the FSU, and international transport are zero-rated. No tax is paid on exports, but credit is allowed for tax on inputs. Taxpayers are legal persons, and individuals engaged in business, register for VAT. Businesses with turnover above a minimum must register. Those with smaller turnover can register voluntarily. The VAT base is comprehensive; it includes services, as well as goods, but there are more or less standard exemptions, such as for lease and sale of land and buildings; financial services; activities of nonprofit organizations; funeral services; services provided by the state; and privatization and sale of enterprises. There is only one rate, 20 percent; it applies to sales net of VAT, but is inclusive of excises, customs duties, and fees. The primary VAT problems relate to FSU trade. Kazakstan cannot solve these unilaterally.

Excises

Kazakstan levies excises on production and importation, except from the FSU, of alcoholic beverages, tobacco products, motor fuels, passenger automobiles, gambling, sturgeon and salmon and their roe, furs and hides, apparel made of fur or trimmed with fur, crystal, and firearms. Exports, except to the FSU, are exempt. The Cabinet of Ministers sets excise rates. Excises on alcoholic beverages and tobacco products are stated in European currency units per unit. These imports are taxed more heavily than domestic production. Excises on other goods and on gambling are ad valorem levies. The excise base excludes the excise itself, VAT, and customs duties and fees.

Stating excises in European currency units avoids the choice between per unit taxes fixed in the local currency (easier to implement, but vulnerable to inflation) and ad valorem rates (difficult to monitor and arguably less justified). It would be better to levy uniform excises, providing differentiation through customs duties. As with VAT, the structure of excises on trade with the FSU is problematic.

Securities Transaction Tax

New issues of nongovernment securities are taxed at 0.5 percent of the nominal value. Secondary transactions in securities are taxed at 0.3 percent (0.1 percent for government securities).

Mineral Resources Tax

The tax code foresees the use of bonuses, royalties, and an excess-profits tax. Payment procedures, the level of payments, and other terms are to be specified in contracts. Since 1994, foreign advisors have been working with the Government of Kazakstan to produce provisions for the taxation of natural resources that would reconcile the conflicting objectives of attracting foreign investment and providing revenues for the government. Legislation that clarifies some issues—but leaves some quite unclear—was enacted at the end of 1996.

Land Tax

Land, which is taxed annually at rates that depend on quality, location, and use, is classified as follows: (i) agricultural land; (ii) occupied land in inhabited localities; (iii) land used for industry, transportation, and communication; (iv) land of the Forestry Fund; and (v) land of the Water Fund. To assess land taxes requires an accurate and current cadastre and places great demands on STC. One wonders whether it can be implemented. Independent local legislation and administration of the land and the property taxes might be preferable.

Property Tax

Business assets (except vehicles subject to registration tax) pay an annual tax of 0.5 percent; buildings owned by individuals pay a rate of 0.1 percent. Revenues go to the *oblast* where the property is located. The tax is deductible in calculating taxable income.

Vehicle Registration Tax

Motor vehicles pay annual registration fees that depend on vehicle type and engine size. The tax is deductible in determining taxable income. Revenues go to the *oblast* where vehicles are registered. This tax adds to progressivity and provides revenue for subnational governments. Taxes on vehicles used for legitimate business purposes are not a suitable source of revenue. But, given the latitude for abuse, it makes sense to tax all automobiles. Care is needed to see that tax rates are appropriate.

Administrative Matters

The tax code covers administrative matters, as well as tax structure. Administrative procedures generally apply to all taxes. These include a statute of limitations, appeals procedures, and prohibition of conflicts.

Taxpayers and others making payments taxed at source are to have unique registration numbers, used for all taxes. The tax code gives STC strong collection powers. STC can require banks to assign it priority in collection orders, demand payment from the accounts of the taxpayer's debtors, and prohibit bank transactions by the taxpayer. It can place a lien on the taxpayer's property and sell it at public auction and it can suspend export operations. STC and its employees are to keep taxpayer information confidential, but under treaties, such information can be shared with tax authorities of other countries.

THE SYSTEM OF INTERGOVERNMENTAL FISCAL RELATIONS

Fiscal choice by subnational governments complements transition to a market economy. Just as private markets give consumers expanded choices in the marketplace, decentralization of government allows citizen-voters greater influence over types and levels of public services.

Soviet Legacy

The system of intergovernmental fiscal relations Kazakstan inherited from the FSU, despite significant modifications, is not appropriate for a market economy in which decentralization of government is an important objective.[32] While expenditure assignment is generally sensible, it is not specified by law. The budgetary system deprives *oblast* (and *rayon*) governments of

[32] Preparation of the part of the book and of this chapter dealing with budgetary matters has been extremely difficult. The tax system was reformed in 1995 just before the Mission visited Kazakstan, and has since been subject to only minor changes; the budget system has not been reformed. But numerous drafts of a new organic budget law have been circulated. Moreover, the IMF classification and a new treasury system have been introduced. Rather than trying to rewrite the chapter continually to hit these moving targets, the Mission leader chose to leave the descriptions of needed reforms described in this chapter essentially as originally written, noting changes primarily in parenthetical comments. Chapter 6 reflects a greater effort to be up-to-date.

control over the level and composition of public expenditures affecting their constituents. It is inadequate both as a planning tool and as means of monitoring the integrity of expenditures and evaluating performance.

The system of tax sharing and subventions lacks transparency, simplicity, and logic. Both the division of tax revenues among *oblasts* and the sharing rates set for regulating taxes are essentially irrelevant. If the division of revenues (or sharing rates) were different, sharing rates and perhaps subventions would be different, so expenditure targets could be met. Budgetary officials of both the central government and *oblast* governments are under constant pressure to increase budgetary allocations to lower-level governments on an ad hoc basis. The system seeks to avoid vertical fiscal imbalance and horizontal fiscal disparities through constant tinkering with sharing rates for regulating taxes and subventions, a practice more appropriate for a planned economy than one based on market principles.

Expenditure assignment reflects practice under the Soviet Union. While assignments of responsibilities are generally reasonable, some specific assignments are inappropriate; for example, the funding of social welfare (but perhaps not its administration) should be a responsibility of the central government. Particularly inappropriate is the assignment of all capital expenditures to the central government, even for investment in areas where subnational governments are responsible for operating expenses, including maintenance of facilities.

As state enterprises divest themselves of responsibilities for social services, the assignment of these services to various levels of government will be extremely important, especially because budgetary problems at the subnational level may make it difficult to maintain minimum levels of service. Some services may be provided more effectively through privatization, but others may simply cease to be provided.

Budget practice departs radically from that found in most advanced market economies. It reflects a confusing amalgam of deconcentration (subnational administration of national policies) and devolution (assignment of decision making to subnational governments). The governmental system of Kazakstan is explicitly unitary. Yet, in principle, subnational governments are guaranteed substantial budgetary autonomy. The 1991 Law on the Budgetary System states that subnational budgets are independent of the budget of the central government; it gives subnational governments control over the use of their funds, it forbids interference in the budget process by higher levels of government, and it prohibits recapture of surplus funds of subnational governments. In fact, the system of dual subordination of subnational officials to both the local assembly and to the central government (especially vertical subordination of chief administrative officers of *oblasts* and *oblast* financial officers to the central government), and the process by which budgets are formulated limit subnational control over their budgets.

Local elected assemblies have legal authority to decide on subnational budgets. But the fact that the President appoints the heads of *oblast* administrations limits subnational autonomy. Such dual subordination, which is prevalent throughout the administrative machinery, creates strong vertical links in the decision-making process.

The budget process is one in which information is passed up (from *rayons* to *oblasts* to the central government) and budget allocations are passed down (from the central government to *oblasts* to *rayons*). *Oblast* (*rayon*) budgets can be finalized only after budget allocations from the central (*oblast*) government have been decided.[33]

In recent years, budgets of subnational governments have been calculated by scaling up approved budget allocations from the prior year, primarily to account for inflation.[34] This is done by applying specific scale factors to each component of *oblast* budgets, such as wages, heating, and capital repairs, and summing the results to obtain target expenditures for each sector, and thus for the *oblast* budget as a whole. *Oblast* budgets do not include allocations for capital expenditures, which are provided from the budget of the central government. In recent years these have been small, due to budgetary constraints.

The budget process is not purely mechanical. Both the central government and *oblasts* prepare estimates of expenditure needs and revenues. These commonly differ in expected ways, with *oblasts* presenting higher estimates of expenditure needs and lower

[33] The process of budget formulation and implementation at the *oblast-rayon* level resembles quite closely that at the central-*oblast* level; thus, only the latter is generally described in what follows.

[34] In theory, *oblast* (and *rayon*) budgets are calculated by applying normative expenditure coefficients (for example, costs per hospital bed) to physical "needs" (such as the number of hospital beds in the *oblast*) in the various sectors (health, education, social protection, and so on), as in the prior Soviet system. In fact, this practice has been supplanted by adjusting prior year approved budgets for inflation and increases in wages and pensions.

estimates of revenues. Budget allocations ultimately reflect the outcome of negotiations.

As responsibility for social services shifts from enterprises to the budget, adjustments are made in *oblast* budgets. As this occurs, there will be increasing pressure on *oblast* and *rayon* budgets and service levels. In many cases, enterprises provide higher levels of service than do subnational governments.

Once the budget is approved, *oblast* governments have virtually complete discretion to shift funds between expenditure categories, for example, between health, education, and social protection, and between wages, communal services, and capital repairs. They do not, however, have discretion to deviate from centrally determined schedules for wages and salaries.

An attempt is made to achieve fiscal discipline by prohibiting deficit spending by *oblasts*. Because government accounting is on a cash basis, no more can be disbursed than has been received. This does not, however, imply that *oblasts* and *rayons* cannot incur commitments that exceed receipts. In fact, *oblasts* and *rayons* do make such excessive commitments and some pile up substantial arrears, especially in the form of unpaid wages and accounts payable, for example, to suppliers of energy and communal services. A recently adopted system of obligation accounting based on warrants and subwarrants should help overcome this problem, except in the case of personnel costs. Some *oblasts* attempt to have the central government cover arrears, either by appealing for supplementary allocations of budgetary funds or by carrying arrears forward to future years; the latter ploy does not generally seem to be successful. There is a system of external audit, but it may actually provide little oversight over local budget execution.

Oblast governments have funds that fall outside the normal budget procedures described above. Such extrabudgetary funds exist for a variety of reasons, including circumvention of the normal budget process. (Use of extrabudgetary funds has been curtailed since the Mission visited Kazakstan).

Tax sharing and subventions are different for different *oblasts*. Under the new tax code the four major taxes (enterprise income tax, individual income tax, VAT, and excises) are regulating taxes, as are taxes on natural resources. Although the 1995 tax reform changed the individual income tax from a local tax to a regulating tax of the central government, revenues from this source were assigned entirely to the subnational level in the budget law for 1995. However, in the 1996 budget, the individual income tax was actually used as a regulating tax. Table 1.3 presents sharing rates for major taxes for 1995 and 1996. In 1995, the sharing rates for all four major taxes were 100 percent in 12 of the 20 *oblasts*; all of these *oblasts* also received subventions. *(Oblasts* that receive subventions are commonly called "subvention *oblasts*.")[35] In 1996, 11 *oblasts* received all revenues from both VAT and the individual income tax and also received subventions. All but two of the nonsubvention *oblasts* (Pavlodar and Almaty City) received all revenues from excises, and all but two *oblasts* (Mangystau and Almaty City) received 40 percent of revenue from the enterprise income tax. Five *oblasts* also received revenues from natural resources. *Oblasts* receive revenues from "local" taxes, but these yield little revenue.

The system used to fund intergovernmental fiscal relations in Kazakstan can be described in the following schematic terms:

Target *oblast* (or local) budget
Less : estimated revenues from *oblast* (or local taxes)
Equals : amount to be financed from regulating taxes and subventions
Less : estimated revenues from *oblast* (or local share of regulating taxes)
Equals : subventions required for budgetary balance.

It is useful to employ the diagram in Figure 1.1 to illustrate the current system of tax sharing and subventions from the central government to the *oblasts*. The two boxes represent the target revenues of two *oblasts*, as determined by the application of expenditure norms or inflation adjustment of approved budgets of prior years; one is a subvention *oblast*, and the other is not.

Local taxes account for the small amount of revenue shown at the bottom of each box, leaving the rest of the box to be filled by local shares of regulating taxes, and, if necessary, by subventions. In the case of the nonsubvention *oblast*, tax-sharing rates of less than 100 percent for at least some taxes are adequate to fill the box, so no subvention is needed. In the case of the subvention *oblast*, there is not enough revenue from shared taxes to fill the gap, even with sharing rates of 100 percent for all regulating taxes of the central government; thus a subvention is needed.

[35] Because of its unique situation, Leninsk City is omitted from these comparisons.

Table 1.3. Tax Sharing Rates: 1995, 1996
Oblast Share of Collections of Regulating Taxes
(percent)

Oblast	VAT		Excise		Enterprise Income		Individual Income		Subvention
	1995	1996	1995	1996	1995	1996	1995	1996	
Akmola	50	70	100	100	90.0	40	100	63.7	No
Aktubinsk	50	20	100	100	51.3	40	100	79.6	No
Almaty	100	100	100	100	100.0	40	100	100.0	Yes
Atyrau	10	10	10	100	39.5	40	100	10.1	No
East Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Jambyl	100	100	100	100	100.0	40	100	100.0	Yes
Jezkazgan	100	20	100	100	100.0	40	100	66.2	No
West Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Karaganda	50	50	100	100	54.0	40	100	85.9	No
Kzyl-Orda	100	100	100	100	100.0	40	100	100.0	Yes
Kokshetau	100	100	100	100	100.0	40	100	100.0	Yes
Kostanai	50	50	100	100	29.4	40	100	65.2	No
Mangystau	10	10	10	100	19.7	20	100	36.0	No
Pavlodar	20	10	50	20	26.2	40	100	62.0	No
North Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Semipalatinsk	100	100	100	100	100.0	40	100	100.0	Yes
Taldykorgan	100	100	100	100	100.0	40	100	100.0	Yes
Torgai	100	100	100	100	100.0	40	100	100.0	Yes
South Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Almaty City	20	10	20	20	8.9	20	100	31.5	Yes

Sources: 1995: Amended 1995 Budget (11 July 1995); 1996: Presidential Decree No. 2700, "On the Republican 1996 Budget" (21 December 1995).

Figure 1.1. Illustration of the Present System of Tax Sharing and Subventions

Nonsubvention *Oblast*	Subvention *Oblast*
	Subventions
Shared Taxes < 100%	Shared Taxes=100%
Local Taxes	Local Taxes

Meeting Basic Objectives of Intergovernmental Fiscal Relations

The system just described is not conducive to rational decentralization of governmental decision making. To be satisfactory, a system must attempt to deal simultaneously and satisfactorily with at least the following objectives. Because some objectives may be in conflict, the system should facilitate rational compromises:

- transparency and simplicity;
- logic in assignment of expenditure functions and tax revenues;
- objectivity in the determination of budget allocations and intergovernmental transfers;
- decentralized control over the level and allocation of public spending;
- incentives for subnational governments to make economically efficient decisions;
- a hard budget constraint facing subnational governments;
- control over public funds;
- information needed for informed decisions; and
- satisfactory resolution of the problems of vertical fiscal imbalance (ordinarily manifested in inadequate revenues at the subnational levels of government) and horizontal fiscal disparities (differences in the capacity of subnational governments at a given level to provide public services).

The present system does not deal adequately with any of these. It is not transparent, simple, logical, and objective. Budget allocations to subnational governments are determined by the interplay of expenditure norms, inflation adjustments, and negotiations. It appears that upper-level governments have primary influence over the level of spending by lower-level governments. The system of tax sharing and subventions leaves subnational governments with almost no independent sources of revenue, and thus, little choice in the level of expenditures.

Once budget allocations have been determined, subnational governments are free to spend the allocations as they wish, subject to important restriction on wage rates. Thus, the actual composition of expenditures needs bear little resemblance to the composition of expenditures in the budget submitted to the higher level of government and approved by it. While there is the appearance of substantial decentralization of decision making, the system of dual subordination makes this questionable. At no level is there systematic and objective economic analysis of expenditure alternatives. Finally, the existence of extrabudgetary funds further obscures fiscal decision making.

Level of Public Spending

The system being employed to determine budget allocations (scaling up approved budget figures from the prior year) places undue emphasis on the base-year budget and makes too little allowance for relevant changes that have occurred during the interim, for example, in demographic factors and economic conditions during the transition to a market economy.

Oblast control over the level of public spending is relatively limited. Budget totals for current expenditures (leaving aside extrabudgetary funds) are mandated from above and can be exceeded (except by running arrears) only if unexpected funds become available, primarily because economic conditions or tax administration is better than expected, or if revenue estimates are inaccurate. *Oblast* governments have almost no latitude in determining tax policy, essentially being limited to determining whether or not to levy certain local taxes; they have no latitude in determining the tax rates to be applied to the tax bases attributed to their territory. Within limits, they are able to increase user charges to recoup costs of services; even here, they operate under restrictions imposed from above. For example, free health care is guaranteed in the constitution and a presidential mandate caps cost reimbursement for meals served in kindergartens at 30 percent of costs. *Oblasts* are not allowed to engage in capital spending, except where surplus funds are available, for example, in extrabudgetary funds, or to borrow.

In the current system, revenues from local funds are inframarginal,[36] as seen ex ante; that is, additional expected revenues from local taxes simply reduce the sharing rates for regulating taxes or subventions. This is true even if the *oblast* exerts greater tax effort, for example, by increasing user charges. In theory, it is impossible for them to exert greater administrative effort because STC is responsible for collecting local taxes. Greater effort is impossible, even in the area of individual income tax (which was assigned entirely to subnational governments until 1996), because the central government determines tax rates. The only latitude for greater tax effort is in the area of extrabudgetary funds. Thus, local governments have little incentive or opportunity to exert greater tax effort.

Local fiscal autonomy could be strengthened in a system resembling the present one by eliminating local taxes from the calculation of the budgetary gap to be filled by regulating taxes and subventions and giving subnational governments control over local tax rates. In this way, such taxes could be made an incremental source of revenue for subnational governments, thereby strengthening local fiscal power. In fact, this would not provide much fiscal discretion, given the minor nature of these taxes. A major overhaul of the system is required to give subnational governments meaningful control over fiscal decisions.

Allocation of Public Spending

Oblasts have somewhat more room to determine the allocation of funds once their budgets have been approved. The major obvious exceptions to this statement are (i) that subnational governments must pay wage rates set centrally, and (ii) the central government is responsible for capital expenditures, including those related to services for which *oblasts* are responsible for current costs, including maintenance and repairs.

The latitude allowed *oblast* governments in redirecting

[36] Marginal funds are incremental funds that increase the total amount of revenue available to the *oblast.* Inframarginal funds are not incremental; they simply replace revenues that would have otherwise been derived from shared taxes or subventions.

expenditures is both too great and not great enough. It is not inappropriate that *oblasts* be given only limited discretion in discharging programs that can properly be seen as reflecting policy of the central government (for example, payments to veterans and families with many children), provided funds needed to discharge expenditure mandates are provided by the central government. There should be no mandates without funding. By comparison, *oblasts* should be given greater latitude in determining the wages and salaries they pay their employees. There is no reason these should be centrally mandated.

Subnational governments seem reluctant to depart from the allocation of funds implied by the application of budget norms, despite the legal authority to do so. While it can be argued that this psychological barrier is not inherent in the system of budget formulation, it may be easier to reform the system than to change the mindset of *oblast* financial officers inherited from the FSU.

Capital expenditures by the central government may not coincide with the preferences of *oblast* residents. Once capital investment has been made, the resulting social assets feed into the calculation of budgetary allocations for current expenditures. Repair and maintenance may be neglected, accentuating the waste of resources, either because capital expenditures do not reflect local preferences, or because subnational governments believe that the central government will replace facilities that are deteriorating due to inadequate maintenance and repair. *Oblasts* should be responsible for capital expenditures in the areas assigned them. Separation of capital expenditures from current expenditures deprives *oblasts* of a substantial degree of important fiscal control and distorts the budget process. Only if *oblasts* are responsible for capital expenditures can the problems identified earlier be avoided.

Assignment of responsibility for capital expenditures to *oblasts* implies that *oblasts* must have access to debt finance, because it cannot be assumed that such expenditures are to be financed solely from current revenues. This raises a host of potential problems. Most obviously, if left free of all constraints, subnational governments might borrow so much as to jeopardize the macroeconomic stability of the country. Thus, the central government should have advance knowledge of all debts issued by subnational governments and its approval should be required, at least for important debt issues. It would be useful to have explicit limits on the borrowing capacity of subnational governments. Such limits could be expressed as the percentage of revenues or expenditures devoted to debt service.

It is particularly important that the central government provide no guarantees to lenders, either explicitly or implicitly, that it will be responsible for payment of principal and interest not paid by the borrower; indeed, it must state explicitly and credibly that it will not guarantee such debt. It is difficult to make such statements credible. This is especially true in the case of a major city such as Almaty, which may be thought to be "too big to let fail." It is also important to impose sanctions against government officials who illegally and inaccurately represent that the central government will guarantee subnational debt. Consideration should be given to creation of a financial intermediary that would borrow and on-lend to individual subnational governments.

Revenue Sharing and Subventions

The revenue side of the budget is also not transparent, logical, objective, nor simple. *Oblast* budgets are financed from three sources: local taxes, local shares of national "regulating" taxes, and subventions; in total the amounts expected from these sources exactly equal the expenditure targets. Revenue from regulating taxes should not be viewed as own-revenues of the *oblasts*, which have no power to choose the base or rate of tax or to administer the taxes; they are merely an unusual form of subvention. Ex ante, shared taxes and subventions are essentially perfect substitutes from a policy point of view; lower estimated revenues from regulating taxes could be offset by higher subventions.[37] Moreover, the methods used to determine the geographic derivation of tax revenues (with the possible exception of the individual income tax) are so anomalous that it seems inappropriate to accord them the legitimacy of calling revenues from regulating taxes own-revenues of subnational governments. It would be far more transparent, more honest, and simpler to replace the system of regulating taxes with a system of uniform sharing rates (even if this required larger subventions), at least during an interim period in which it is not feasible to implement a system based on more rational tax assignment. Thus, despite appearances, the division of tax bases among the *oblasts* and the sharing rates applied to regulating taxes are largely irrelevant ex ante; if they were different,

[37] Because of their dependence on economic conditions, somewhat greater uncertainty may be attached to revenues from shared taxes than to subventions, ignoring the possibility that subventions will not be forthcoming.

there would be compensating differences in the sharing rates for regulating taxes and subventions. Of course, ex post, these choices do matter; see Chapter 7.

As administrative realities allow, sharing of tax revenues from the individual income tax, the enterprise income tax, and excises should be replaced by subnational surcharges on the bases of those taxes; these should be administered by STC. Because the division of tax bases among *oblasts* is largely irrelevant, the current system accommodates allocations of tax revenues to *oblasts* that, in a true system of tax assignment, would be intolerable because revenues would be allocated to the "wrong" *oblasts.* The following are the most egregious examples of inappropriate allocations:

- allocation of enterprise income tax to the *oblast* (and *rayon*) where the enterprise is registered (converted to formula-based apportionment in January 1996);
- allocation of VAT on domestic production to the place where the enterprise is registered;
- allocation of VAT on international trade (with countries outside the CIS) to the point of import or export; and
- allocation of excises to the point where goods subject to excise are produced or imported.

These should be replaced temporarily with the following tax-sharing rules:

- allocation of revenues from the enterprise profits tax among *oblasts* (and *rayon*) on the basis of economic activity (introduced in January 1996);
- allocation of VAT entirely to the central government, with no attempt at derivation-based sharing of revenues; and
- allocation of revenues from excises to the *oblast* where goods subject to excise are consumed, perhaps on the basis of a formula.

These rules would form the basis for evolution to a system of tax assignment based on surcharges.

Vertical Fiscal Imbalance and Horizontal Fiscal Disparities

Introduction of a system of tax assignment will produce vertical fiscal imbalance between the central government and the *oblasts.*

The poorest *oblasts* are likely to remain dependent on subventions from the central government, even if assigned all revenues from taxes where such assignment is logical and administratively feasible. In principle, the more prosperous *oblasts* could be fiscally self-sufficient, but this should be achieved in a sensible manner. Given the administrative capacity of the country and the risk of duplication of effort, tax exporting, and complexity that would result from independent legislation and administration of taxes (fortunately not a widely discussed alternative), only the use of surcharges on taxes legislated and administered by the central government is a viable option. Surcharge rates will need to be limited to levels that avoid unacceptable horizontal disparities and other problems.

It appears that substantial horizontal fiscal disparities among the *oblasts* of Kazakstan are also inevitable under a system of tax assignment based on surcharges. In part this reflects differences in the economic conditions of the various regions; average income levels are higher in the industrial *oblasts* and in those with substantial natural resource bases than in the more agrarian *oblasts*.[38] (Whereas GDP per capita in Mangystau is twice the national average, it is barely half the average in Almaty Oblast and Kyzl-Orda.) Disparities will probably increase substantially with the development of natural resources; this depends on the value and geographic concentration of such resources.

Information and Control

The present budgetary system is inadequate to meet the normal requirements of such a system, including planning, execution, control, and evaluation. Information is not recorded in a fashion that meets these objectives, and reports needed for control are not prepared on a timely basis. Because control was only exercised over disbursements, it was possible and common during the recent period of budgetary stringency for subnational governments to accumulate arrears to employees and suppliers. The growth of arrears threatens to undermine fiscal discipline. The recent method of attacking the problem, through sequestering of funds, is at best a stopgap measure, because it creates distortions in budgetary

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[38] The potential for horizontal disparities would be especially great if tax assignment was to follow the present system, due to the peculiar interpretation given the objective of assigning revenues from certain taxes on a derivation basis. An example is the assignment of revenues from VAT and the enterprise income tax, to *oblasts* where enterprises are registered, and the assignment of revenues from excises to the *oblast* where production or importation occurs. Disparities would be even worse if this method were extended to the *rayon* level. As noted earlier, this is not recommended.

execution. Greater attention should be devoted to containment of deficits. A system of control based on commitments would prevent the growth of arrears. A commitments-based system, combined with multiyear planning for investments, would also help rationalize investment planning and prevent the common phenomenon of uncompleted projects. Completion of installation of a treasury function and the use of warrants and subwarrants to control obligations will help meet these objectives. But to be fully effective, the treasury function and the use of warrants must be extended to subnational governments.

Government accounting, inherited from the Soviet system, does not provide adequate information for most purposes. Being based on large "complexes," data are not sufficiently disaggregated or based on either economic or functional classifications. Thus, it is not adequate for economic analysis and budgetary planning or for evaluation of past performance. Moreover, both contemporaneous and ex post control over budget execution suffer from the lack of adequate data. Use of the budget classifications in the International Monetary Fund's (IMF) *A Manual on Government Finance Statistics* introduced during 1996, will help overcome the problem. The budget should distinguish between current and capital expenditures, and it should indicate for future years, as well as the current year, sources of finance for the latter.

There is currently not an adequate system of controls. Both internal and external audits should be initiated or improved to protect the integrity of the system.

SUMMARY OF RECOMMENDATIONS ON INTERGOVERNMENTAL FISCAL RELATIONS

The book contains many recommendations for rationalizing the system of intergovernmental fiscal relations in Kazakstan. The following are the most important:

Expenditure Assignment

The following are recommended in the area of expenditure assignment:

- Establish a formal assignment of expenditure responsibilities.
- Reassign selected expenditure responsibilities (for example, financing of social welfare).

- Reassign responsibility for capital investment to the level responsible for current expenditures.
- Facilitate financing of capital investment by subnational levels of government.
- Continue efforts to rationalize divestiture by enterprises of responsibility for social expenditures.
- Implement policies that will guarantee minimal levels of crucial public services.
- Initiate sectoral reviews in key areas, including health, education, and social welfare.
- Consider reform of political organizations (dual subordination) governing relations between the central governments and the *oblasts* (and between *oblasts* and lower level governments).

Budgetary Process: Formulation

The process of budgetary formulation should be reformed as follows:

- Restructure budgetary relationships to eliminate negotiation and bring transparency to the process.
- Develop wider and more flexible norms to replace current physical expenditure norms and modify budgetary practices to deal with inflation.
- Include all extrabudgetary activities in the budget, except for pensions and social insurance (essentially done, but with creation of a road fund).
- Include estimates of the costs of fiscal privileges provided through the tax system in the budget.
- Reconsider and reform the relationships between line ministries and subnational governments in budget preparation.
- Place higher priority on containment of budget deficits.
- Improve forecasts of both expenditures and revenues.
- Adopt IMF budget classifications to improve planning and control of the budget and accountability (begun in 1996).
- Adopt a budget format that distinguishes capital investment and current expenditures.
- Adopt a multiyear framework for planning capital investment.

Budgetary Process: Execution

Budgetary execution should be improved in the following ways:

- Extend the treasury function to encompass subnational governments (begun in late 1994).
- Employ IMF budget classification for budget execution (begun in 1996).
- Include personnel decisions in the budget process.
- Institute commitment accounting for investment expenditures.
- Implement better controls of budget deficits at all levels of government.
- Reform the accounting system to record all transactions and produce timely reports.
- Improve the reporting system to provide reports needed for both formulation of policy and management and control.
- Reform procurement practices.

Budgetary Process: Control, Audit, and Evaluation

Budgetary control, audit, and evaluation should be strengthened in the following ways:

- Strengthen ex ante controls.
- Establish rules and regulations for administrative sanctions.
- Establish rules and regulations for management of public funds.
- Establish explicit rules and procedures for internal audit and control.
- Increase effectiveness of State Committee on Financial Control in internal audit.
- Develop capacity for external audit at all levels of government.
- Establish capacity for budget evaluation at all levels of government.

Revenue Assignment

The following changes should be made in the method of revenue assignment to increase subnational control over marginal sources of finance:

- Restore the prior status of the individual income tax as a local tax (Stage 1).
- Rationalize tax-sharing rules that assign revenues to the "wrong" *oblasts* (Stage 1).
  - Eliminate derivation-based, subnational sharing of VAT revenues.
  - Shift sharing of revenues from enterprise income tax from place of registration to place of economic activity (done in January 1996).
  - Replace sharing of revenues from excises with the place of production or importation to sharing based on a formula reflecting the place of consumption.
- Shift from tax sharing to a system of tax surcharges on the individual income tax, the enterprise income tax, and excises (Stage 2).

Intergovernmental Grants

The following are suggested for the design and implementation of a new system of intergovernmental grants:

- Implement a system of grants that allows *oblasts* to finance "typical" expenditures with typical tax rates for local taxes and surcharges.
- As the country gains experience with the system of grants intended to equalize the ability to provide typical levels of services with typical tax rates, explore ways to implement other objectives of grant policy.
- Provide additional funds to subnational governments where needed to discharge expenditure responsibilities mandated by the central government.

Timing

It is proposed that the changes in revenue assignment and grants be implemented in two stages, over a three-year period. Rules for tax sharing would be rationalized in Stage 1, and surcharges would replace tax sharing in Stage 2. This would allow time to digest the changes being made (that is, to reform administrative practices, gather data, and adjust to changes). However, neither the content of the stages nor their timing is sacrosanct. The structure of grants would change, as the rules for revenue assignment change.