

CHAPTER 3

**THE NEW TAX CODE
OF KAZAKSTAN**

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INTRODUCTION

On 24 April 1995, the President of Kazakhstan, Nursultan Nazarbaev, issued Decree 2235, enacting a new tax code for Kazakhstan.¹ This new tax code was to become effective on 1 July 1995 and was enacted by presidential decree because the parliament had been dissolved following a ruling by the Constitutional Court that the 1994 general election was invalid. In 1995, taxpayers, in effect, had two “short years” of six months each, under the old and new systems. In addition, Decree 2235 on the new tax code was the culmination of a joint effort by officials from MOF, STC, and foreign advisers from several organizations, extending over a period of 15 months.²

¹ The descriptions of the provisions of the new tax code are derived from English translations of Decree 2235, 24 April 1995; the Implementing Instructions for Presidential Decree 2235 issued by STC; Decrees 960 and 974 of the Government, dated 13 and 14 July 1995, giving excise tax rates on imports and local production; Decree 2703 of 21 December 1995, amending the new tax code; Presidential Decree 2701 of 21 December 1995, establishing the Road Fund; Decree 61-1 of 31 December 1996; and Decree 75-1 of 28 February 1997. Given the inevitable ambiguities found in such translations, misinterpretations are quite possible.

² The foreign organizations were the European Union’s program of Technical Assistance to the Commonwealth of Independent States, IMF, the International Tax and Investment Center, OECD, the US Treasury Department, and the US Agency for International Development, through its contractor, the Policy Economics Group of KMPG (Klynveld Peat Marwick Goerdeler, a large, multinational accounting firm since renamed the Barents Group). The start of the tax reform process can be dated from the January 1994 request by Vice President Asanbaev to the International and Tax Investment Center for assistance in preparing a new tax code. It is worth noting that Vice President Asanbaev’s request included the following specific areas: elimination of tax preferences, taxation of natural resources, and intergovernmental fiscal relations. Two of these topics, natural resources and intergovernmental fiscal relations are so large and so complex that they required separate studies.

With that act the Central Asian republic moved to the forefront among the republics of the FSU in the field of tax reform. The new tax code of Kazakhstan is perhaps the most comprehensive, most systematic, most modern, and most investor-friendly of any in the FSU. This chapter summarizes and analyzes the most important features of the new code. It contains no retrospective discussion of the prior tax law.

The new tax code greatly streamlines the tax system of Kazakhstan. The number of taxes has been reduced from most 50 to 11. All laws pertaining to taxation in Kazakhstan, other than customs duties, contributions for social insurance, taxes to finance the Road Fund, and state duties (a set of fees charged for services provided by the government, for example, verification of documents) are contained in the new code, which repeals all laws that are inconsistent with the new code. Indeed, it is now illegal for tax-related provisions not to be included in the tax code. (Nonetheless, a road fund and taxes to finance it were established by presidential decree in December 1995.) Where provisions of the new tax code are inconsistent with those of foreign tax treaties or contracts signed with foreign investors before enactment of the new code, the latter prevail.³ The new tax code covers taxation at all levels of government: central, *oblast*, and local. The most important taxes included in the new code are the income tax on individuals and enterprises, VAT, and excises.⁴ Reform efforts focused on these.

Contrary to the situation in many countries in transition from socialism, Kazakhstan has chosen to rely primarily on market forces to direct the allocation of investment, instead of providing preferential tax treatment of certain industries, new investment, foreign investors, and others. For the most part, the income tax, profits tax, and VAT, as initially enacted, were generally applicable, with relatively few exemptions, special tax rates, or other forms of special treatment. However, income of agricultural enterprises is taxed at a rate of only 10 percent, and Decree 2703 provides a preferential 20 percent income tax rate for enterprises registered and doing business in free economic zones. Moreover, higher excise tax rates are applied to imported alcoholic beverages and tobacco products than to those produced domestically, presumably because

³ The Implementing Instructions extend “grandfathering” to contracts concluded under prior law. Decree 2235 does not. However, Decree 2703 does this for natural resource contracts concluded before 1 July 1995.

⁴ There is now a single income tax on individuals and legal persons, instead of two separate taxes, as in prior law. However, for some purposes the tax is treated as two, for example, in the setting of sharing rates (the percentage of revenues that go to *oblasts*). This book generally follows this practice.

of treaty obligations to other FSU nations. Finally, in a distinct retreat from the initial stance of nonintervention, in early 1997 the government introduced a system of income tax holidays intended to encourage the development of selected industries.

There are five nationwide taxes: the income tax on individuals and legal persons, VAT, excises, the tax on securities transactions, and special taxes and payments by users of mineral resources. Revenues from these “regulating taxes” are shared with the *oblasts* in accordance with annual budget law, as described in the chapter on tax assignment. In addition, the new tax code provides for the following subnational taxes and fees: land tax, property tax, vehicle registration tax, registration fees for legal persons and individuals engaged in business activities, fees to engage in certain activities, and fees on auction sales.⁵ The new code includes details of only the first three of these; the others are to be set forth by the Government. Thus, this book covers only the first three sources of subnational tax revenues in depth.

The tax reform effort that culminated in Decree 2235 concentrated on the income tax, VAT, and excises, plus some forms of taxation that were considered, but ultimately abandoned, such as a gross receipts tax on motor fuels. It did not consider customs duties or the payroll taxes that finance social insurance, and it paid relatively little attention to the structure of minor taxes, including the tax on securities transactions, land tax, property tax, and tax on vehicles. Intergovernmental fiscal relations and the taxation of income from natural resources and other forms of taxation of natural resources, while potentially of substantial importance to the country, were not considered in depth. Intergovernmental fiscal relations are the primary topic of this book, and the taxation of natural resources has been the subject of a special working group.

While far from perfect, the new tax code of Kazakstan, as initially enacted, was a vast improvement over prior law. This was especially true of the income tax, VAT, and excises, upon which reform efforts focused. Because of the enactment of tax holidays in 1997, Kazakstan can no longer claim to have a relatively “clean” income tax. Other taxes also need further improvement.

Comments follow the descriptions of each of the major taxes; these are generally brief, as they provide a general appraisal of the reforms, deal with issues that were not handled adequately in the

⁵ Following the convention adopted for preparation of this book, to avoid confusion, the term “subnational” is used to refer to both *oblast* and lower levels of government; the Russian term is usually translated as “local.”

process of tax reform, or note questions that are addressed in greater detail in the chapter on tax assignment. The taxes on land, property, and registration of vehicles require further attention. Comments made here should be considered only a prelude to a more detailed analysis of these taxes, and not a substitute.

INCOME TAX

There is now a single income tax that applies to both individuals (physical persons) and legal entities. It is, however, convenient to distinguish provisions dealing primarily with the measurement of business income and the taxation of legal persons from those dealing with nonbusiness aspects of the taxation of individuals.

General Provisions

Taxpayers

Individuals and legal persons who have income that is taxable by Kazakhstan are taxpayers. In the case of legal persons (including ordinary partnerships), the taxpayer is the legal entity; it pays tax to the authorities of STC of the *oblast* where the entity is registered. In the case of a nonresident legal entity, registration is in the *oblast* where the entity's permanent establishment is located. The income of simple partnerships and consortia, which are not legal entities, is attributed to, or "flowed through" to, the partners, and included in their calculation of tax liability, instead of being subject to an entity-level tax. Moreover, according to the portion of the new tax code dealing with special taxes and payments on mineral resource users, taxpayers operating under more than one contract for the use of mineral resources cannot consolidate their income or expenditures for the purpose of computing any tax.

Residency

Resident individuals and resident legal entities, including resident subsidiaries of foreign companies, are taxed on worldwide income. By comparison, foreign enterprises and nonresident individuals are taxed only on income from local sources. A legal person is a resident of Kazakhstan if the person is incorporated under the laws of Kazakhstan or has an actual place of management in Kazakhstan. The test of residence for individuals is a standard 183-day rule. If an individual is physically present in Kazakhstan

for 183 or more days in any consecutive 12-month period, the person is considered a resident for the years in which such 12-month period begins and ends.

Source of Income

Income from local sources includes dividends received from resident legal persons; interest received from resident persons or persons having a permanent establishment in Kazakhstan if the payer's indebtedness is related to the payer's permanent establishment or property; royalties;⁶ income from immovable property located in Kazakhstan, including gains on such property; pensions paid by residents of Kazakhstan; premiums for insurance and reinsurance of risks in Kazakhstan; income from telecommunication and transport between Kazakhstan and other countries; business income of a permanent establishment in Kazakhstan; income from the sale of goods in Kazakhstan; and income from management, financial, and insurance services, if the cost of these services is claimed as a deduction by a permanent establishment in Kazakhstan. A permanent establishment is a fixed place of business including one where business is conducted through an agent; a construction, assembly, or collection site and related supervisory activities; an installation, structure, drilling rig, or vessel used in exploration for natural resources and related supervisory activities; and the furnishing of services, including consulting services.

Tax on income derived from investment in foreign legal entities is ordinarily deferred until repatriated. However, income derived from direct investment in legal entities in tax-haven countries is taxed currently. Such countries are those that have tax rates less than one third the rate in Kazakhstan, or that have laws providing confidentiality of financial information or information on companies that provide secrecy concerning the actual owner of property or income.

Filing Requirements

Filing of tax declarations is required of all legal persons and individuals who (i) have income not subject to withholding at

⁶ The tax code defines royalties as payments for the right to exploit natural resources; to use a copyright, software, a patent, a design or model, or a trademark; to use industrial, commercial, or scientific equipment; to use know-how; to use cinematographic and video films, sound recordings, and other recordings; and the provision of technical assistance ancillary to the services thereof.

source; (ii) have engaged in construction or purchases during the year in excess of 1,000 MCIs;⁷ (iii) who have cash in foreign bank accounts; and (iv) who receive income from foreign sources. Because there are few deductions, except for business expenses, and tax on employment income is withheld at source, most individual residents of Kazakhstan will not need to file tax returns.

It is appropriate that individuals will ordinarily not be required to file tax returns, unless they are engaged in business activities. Taxpayers do not have the expertise and experience to file tax returns, and the tax administration does not have the personnel required to cope with universal filing, which had been advocated by some members of the MOF team working on the proposals for tax reform. The loss of equity and neutrality implied by the use of “schedular” taxes on interest, dividends, and wages and salaries is a small price to pay for this simplicity.

Withholding and Advance Payments

Withholding, with reporting to both taxpayers and the tax administration, is required for employment income, pensions, dividends, interest (except when paid to individuals), and payments to foreign persons described above. Claims for deductions for dependents are made to the employer of the taxpayer. Such claims are to be supported by certificates, for example, from the housing maintenance office, other housing bodies, or the local administration. There is no allowance for dependents in the case of employment, except that at the primary place of work. Withholding is to be done on a cumulative basis, by calculating tax due on income earned to date, and subtracting withholding taxes paid to date.

Legal persons and individuals engaged in business activities are required to make monthly payments of tax, based on cumulative financial results for the month. Advance payments are based on the regular tax rates. Payments made in advance can be offset against tax liability for the year, as determined by the filing of a tax return. The requirement of monthly advance payments is understandable, especially during a time of high inflation. Even so, the requirement to calculate income each month may prove to be so onerous that alternatives should be examined.

⁷ At the time Decree 2235 was signed, the terminology used here and in similar rules was “minimum monthly (or annual) wages.” Decree 2703 substituted the concept of “monthly calculation indexes,” defined as “the monthly index which is annually established in the Republican budget to calculate pensions, allowances, and other social payments, as well as fines, taxes, and other payments.”

Provisions Relating Primarily to Individuals

Taxable Income of Individuals

Taxable income of individuals includes (i) income from employment, whether in cash or in kind; (ii) business income; and (iii) inflation-adjusted capital gains on property and buildings other than the taxpayer's residence, on securities, on foreign currency, and on precious metals, stones, art, and antiques. Taxable income does not include interest or dividends, which are subject to a 15 percent final withholding tax. Employment income includes (i) the excess of costs over the selling price of items sold to employees at a discount; (ii) reimbursed expenses of employees not related to the business of the enterprise;⁸ (iii) forgiveness of debt of an employee; (iv) premiums for voluntary life and health insurance of employees; and (v) income taxes of the employee withheld by the employer. Reimbursement of travel expenses of employees is exempt, up to inflation-adjusted limits set by the Government.

Tax Exemptions for Individuals

Interest on state securities; state pensions; scholarships; various state benefits, such as those related to pregnancy, disability, and the loss of a breadwinner; alimony; and gifts and inheritances except where received for work are exempt. A deduction equal to one MCI (T300 in late 1995/early 1996; T380 in May 1996; T520 at the end of 1996; and T585 on 1 July 1997) is allowed for the taxpayer and for each dependent family member who has income of less than one MCI. A family is defined as spouses, children, and parents living together and managing the common household affairs.

Income of veterans of World War II (and persons equated to them), disabled of categories I and II,⁹ and the parents of someone disabled since childhood is exempt, up to 480 MCIs. For disabled of category III, the exemption is limited to 240 MCIs.

Despite its surface appeal, the use of income tax exemptions to favor the disabled, veterans, and others deemed to be worthy of special treatment, has clear disadvantages. (This is also relevant in the case of the land tax, property tax, and vehicle registration tax. The issue is not whether such benefits are appropriate; that is a

⁸ Examples given in the Implementing Instructions include educational fees for the children of employees, medical treatment, and the cost of a car or apartment.

⁹ Categories I, II, and III are from Soviet legislation defining such categories.

social decision, not a technical one. The issue is whether to use the tax system to provide benefits, instead of providing them solely through public expenditures.) First, it is an extremely cumbersome way to provide benefits. Those eligible for exemptions must present evidence of eligibility to employers and to bodies involved in tax administration. This creates needless paperwork and clogs the administrative machinery that is already stretched to the breaking point, and diverts administrative efforts from more important tasks.¹⁰ Second, it is not a fair way to provide benefits. If someone who is eligible for tax benefits happens to have a high income, the benefit is worth more than it is to someone with low income (presumably the ordinary case). Moreover, one might wonder why such a person should receive the benefits at all.

The new tax code makes no allowance for the exclusion of benefits paid to expatriate employees to compensate them for additional expenses incurred while working temporarily in Kazakhstan. Such “compensatory” allowances are commonly provided for educational benefits for children being educated elsewhere, expenses of home leave, and cost-of-living allowances for extraordinary expenses incurred while living in Kazakhstan. Besides being questionable on equity grounds, this policy may undermine the country’s efforts at economic development, which are dependent on the expertise of expatriates.

Tax Rates: Individuals

Taxable income of individuals is subject to tax at marginal rates ranging from 5 to 40 percent, according to the marginal rate schedule in Table 3.1.

Design Issues

It is convenient to consider the following design issues together: an increase of the tax threshold, whether that threshold and tax benefits should be created through the use of a deduction or a credit, and the rate structure.

¹⁰ Beyond that, some provisions are either unworkable or of dubious merit. Consider the exemption of property owned by veterans (and certain others), up to 1,000 MCIs. It makes little sense (and is probably not the intent of the law) to provide multiple property tax exemptions, one in each *oblast* in which a veteran owns property. Yet it would be virtually impossible to cross-check property tax rolls of the *oblasts* to determine that multiple exemptions have not been claimed. Beyond that, if such cross-checking were feasible, there would remain the task of determining which *oblast* would be required to exempt property located on its territory.

Table 3.1. Marginal Rate Schedule

Taxable Income (in MCIs)	Marginal Tax Rate (percent)
0-10	5
10-20	10
20-30	15
30-40	20
40-50	30
above 50	40

Source: Decree 2235, 24 April 1995.

Income Tax Threshold. The tax threshold should either be eliminated entirely or increased to a realistic level—one that would eliminate income tax on those below the poverty level. As long as MCI is unrealistically low, it is difficult to achieve the goal of eliminating income tax on those below the poverty level, because the threshold is based on MCI, which is employed for important nontax purposes. It would be anomalous to state the threshold as a multiple (greater than one) of MCI or to give a credit equal to MCI. Both could have devastating revenue consequences if MCI were raised to a realistic level.¹¹ Moreover, there is no conceptual reason for a tax credit equal to MCI, especially if MCI is realistic. All things considered, especially the fact that the threshold has been so low since July 1995, it might not be entirely inappropriate simply to eliminate the threshold.

Deductions versus Credits. If the threshold is to be retained and increased to a reasonable level, then one might ask whether it should be converted from a deduction (which reduces taxable income) to a tax credit (which reduces tax liability by the amount of the credit). Deductions are generally preferable on conceptual grounds, especially where (contrary to the situation in Kazakhstan) deductions are allowed for expenditures that might legitimately be seen to reduce the ability to pay taxes, such as personal expenditures on health care. Because there are (and should be) few deductions in the tax code of Kazakhstan, the choice between credits and deductions is almost irrelevant. It is true that deductions are worth more, the higher one's marginal tax bracket, and that,

¹¹ Given the tax rate of 5 percent applied to income just above the threshold, a credit of T15 provides the same tax saving as a deduction of T300. Given the current rate schedule, a credit equal to MCI would be equivalent to a deduction of 15 MCIs. A credit of T300 would be equivalent to a deduction of T4,500. (Tax on T4,500 would equal 5 percent of T3,000 plus 10 percent of T1,500, or T300.)

for a given rate schedule, credits are more progressive than deductions and result in a greater revenue loss. Also, tax can be removed from low-income households at lower revenue cost by using credits, instead of deductions. But any change in progressivity or revenues achieved by conversion of deductions to credits could be approximated simply by changing the rate schedule.

Credits for Tax Benefits. The clear and potentially important exception to the basic irrelevance of the choice between deductions and credits occurs to the extent that Kazakhstan retains tax preferences for individuals, such as those for veterans of World War II. There is absolutely no reason that these benefits should be provided in the form of deductions. If they are to be continued, they should be converted to credits, so that they will be worth a given amount to all beneficiaries, rather than rising with the marginal tax rate of the taxpayer.

Top Rate. There have been proposals to increase the top marginal tax rate paid by individuals, from 40 percent to as much as 60 percent, or to reduce it to 35 percent. It would be a terrible mistake to raise the top rate. First, together with the very high (32 percent) taxes levied to finance social welfare, the income tax already creates serious disincentives for participation in taxed market activities, instead of black market (or grey market) activities that can escape taxation; raising the top rate further would aggravate the situation. In the present environment in Kazakhstan, where tax evasion is said to be rampant, the income tax is a “tax on honesty.” Higher rates are as likely to generate lower revenues and disrespect for the law as they are to raise more revenue.

Second, high tax rates have an especially adverse effect on the availability or cost of expatriate workers, who have alternatives to work elsewhere, where the after-tax pay would be better. In either event, the economic development of Kazakhstan will suffer; either foreign investors will not be able to get the trained personnel they need or they will be forced to pay them so much that investment is unattractive. A third alternative is renegotiation of contracts with the government to allow coverage of high taxes. In that case, there would be no net benefit to the budget.

Whether Kazakhstan should reduce the top individual tax rate from 40 percent to 35 percent is debatable. Such a change would be consistent with international practice, which has seen substantial reductions in tax rates since about 1980. For example, Colombia and Indonesia reduced their rates to 30 percent and Jamaica chose a rate of 33 1/3 percent. The effects of higher rates described above suggest that perhaps the income tax should be reduced. On the

other hand, it is desirable that the rates of the individual and enterprise income taxes retain roughly their current relationships, in the interest of neutrality and equity. With the enterprise income tax of 30 percent and the 15 percent tax on dividends, enterprise income that is fully distributed would be subject to aggregate (enterprise and individual) taxation of 40.5 percent (30 percent plus 15 percent of 70 percent), roughly equal to the top individual tax rate.

Provisions Relating to Taxation of Business Income

Measurement of Business Income

Unlike the tax laws of many FSU countries, the new tax code of Kazakhstan allows deductions for most important expenses of business, including material and social benefits provided to employees.^{12, 13} There are limits on the deductibility of interest to 150 percent of the refinancing rate set by NBK, motivated by a concern for thin capitalization; reserves for bad debts, with deductions being limited essentially to actual losses, except in the case of banks, which are allowed to deduct additions to reserves for bad debts; and research and development, where an immediate deduction is not allowed for the cost of capital assets. Deduction is allowed for taxes, other than income taxes and the excess-profits tax; for fines and penalties, other than those imposed by the state; and for contributions to state social insurance and to special funds, such as the Road Fund. Charitable contributions by legal persons and individuals engaged in business are deductible, up to 2 percent of taxable income from business activities. When such funds received by charitable organizations are used for unintended purposes, they are subject to tax.

Income of legal entities registered and engaged in business activity in free economic zones is taxed at a rate of 20 percent. For enterprises having land as their main productive asset, income from the utilization of land is taxed at a rate of 10 percent. These

¹² The most important exception, which was introduced in Decree 2703, is that wages are not fully deductible. This provision was never implemented.

¹³ However, deductions are not allowed for personal expenses incurred to earn income from contracts. The Implementing Instructions give the troubling example of disallowance of deduction for the cost of paint and instruments used by a painter in earning income from painting. While it appears that reimbursement of expenses would be excludable if specified in the contract for services, this proviso needlessly restricts the conduct of business.

provisions are equivalent to partial exemption for income from these sources. Interest on loans granted for more than three years for the creation and modernization of fixed assets is exempt. Moreover, Decree 2703, issued on 21 December 1995, provides two extraordinary deductions. The first is for investments in “The New Capital” (an extrabudgetary fund), up to 10 percent of income otherwise subject to tax. The other is for investment in construction of housing in Akmola, the site chosen for the new capital of the country.

Taxable income corresponds much more closely to the concept of economic income than under the old law, which ignored many business expenses and provided numerous tax benefits of dubious merit. This is important because it makes the income tax simpler and more economically neutral, as well as more equitable. Failure to allow deductions for all reasonable expenses could render potentially profitable activities unattractive. Moreover, the allowance of deductions for all major expenses is crucial to the ability of foreign investors, especially those from the US, but also those from Germany and the United Kingdom, to take credits in their home countries for income tax paid to Kazakhstan.¹⁴

Depreciation

Depreciation is particularly simple; except in the case of buildings, depreciation allowances are fixed (maximum) percentages of the remaining book value of assets in pooled asset accounts. Depreciation allowances for buildings are calculated for each structure, using vintage accounts. Unfortunately, there is no requirement that the same rules should be used for tax and financial accounting; the Working Group responsible for revision of financial accounting standards refused to adopt pooled accounts, choosing instead the more conventional use of vintage accounts for all assets. The book value of depreciable assets can be adjusted to reflect the effects of any revaluation of assets prescribed by the Government.

Table 3.2 lists the types of assets falling within each pooled

¹⁴ The introduction of a limit on deductions for wages and salaries in Decree 2703 was, thus, quite troubling. Under substantial pressure from the governments of the United Kingdom and the United States, the Government of Kazakhstan issued letters stating that the offending provision would never be implemented. This was essential to the ratification of the double taxation treaties with both countries at the end of 1996.

asset account and the maximum fractions of the book value of assets in the indicated pool (or of each structure, in the case of buildings) that can be claimed in a given year. Subject to these limits, the taxpayer is free to choose a lower depreciation rate for any pool of assets. Acquisition of depreciable assets under a finance lease is to be treated as a purchase.¹⁵

Expenses of geological exploration and preparatory work for the extraction of natural resources, including expenses of intangible assets incurred in acquiring rights of exploration, development, and exploitation, are depreciated at a rate appropriate to pool 1 in Table 3.2 (25 percent), but are treated as a separate pool. After the first five years, the residual value can be deducted at any time at

Table 3.2. Pooled Asset Accounts

Pool	Rate	Types of Assets (percent)
1	25	Pipelines; equipment used for extraction and processing of natural resources; computers; peripherals and data processing equipment;
2	20	Auto truck machinery to be used on the roads, kits and accessories, special tools;
3	10	Miscellaneous depreciable assets not included in another category;
4	8	Equipment used in rail, sea, and river transportation; machinery and equipment used in generation and transmission of electric power and heating; power transmission lines; communication devices;
5	7	Buildings, facilities, and structures.

Source: Decree 61-1 (31 December 1996).

the option of the taxpayer. (It is unclear whether the taxpayer has the latitude to postpone these deductions.) Expenses of intangible assets constitute a separate pool, to be depreciated at the rate for pool 3. The value of “technological equipment” used for at least

¹⁵ For this purpose, a lease is determined to be a finance lease if one of the following is true: (i) the term of the lease exceeds 80 percent of the useful life of the asset; (ii) the lessee has the right to purchase the asset at a fixed price or a price determinable at the expiration of the lease; (iii) the residual value of the asset to the lessor at the expiration of the lease is less than 20 percent of its value before the lease; or (iv) the present (discounted) value of payments to be made over the term of the lease exceeds 90 percent of the value of the leased assets.

three years can also be written off at any time. Deductions for the costs of reclamation can be taken over the life of a natural resource project.

Repairs are deductible, up to 10 percent of the book value of each category of depreciable asset in any one year; costs of repair in excess of this amount must be capitalized (added to the book value of assets used in calculating future depreciation).

If the residual book value of any assets in any pool falls below 100 MCIs (40 MCIs, in the case of buildings), the remainder is allowed as a deduction. These same figures are used to determine whether an asset must be capitalized and depreciated or can be deducted immediately. If the amount received from disposal of assets in a given pool exceeds the book value of the assets in the pool, the excess, adjusted for inflation, is treated as income, and the value of the assets in the pool is set at zero. If all assets in a category are sold or otherwise disposed of, the remaining book value of the assets is allowed as a deduction.

Inflation Adjustment

Concern has been expressed that the useful lives implicit in depreciation rates may be unrealistically long. In addition, representatives of some Western companies believe that foreign investors should be allowed to keep books in a “hard” currency, such as the US dollar, to avoid the effects of inflation eroding the value of deductions (including depreciation) that cannot be taken immediately.

This brings up a more general point, whether systematic allowance should be made for the effects of inflation in the calculation of income, as in Chile, Colombia, and now Romania, rather than relying on piecemeal adjustments, for example, of the value of depreciable assets and inventories. This issue deserves continuing attention, especially considering the present lack of inflation adjustment for interest and debt.

The present approach allows full deduction for nominal interest expense. That is, there is no adjustment for inflation in calculating interest deductions. This means that the after-tax real cost of borrowing can be reduced substantially, and it can even be negative, especially at high rates of inflation. To see this, suppose that the real interest rate is 25 percent, the inflation rate is 100 percent, and the nominal interest rate is 150 percent ($1.50 = 2.00 \times 1.25 - 1.00$). With a tax rate of 30 percent, the after-tax nominal cost of borrowing is only 105 percent (70 percent of 150 percent),

and the after-tax real cost is only 5 percent (105-100), not 17.5 percent (70 percent of 25 percent). Suppose alternatively that the inflation rate is 300 percent and the nominal interest rate is 400 percent ($400 = 4.00 \times 1.25 - 1.00$). In this case, the after-tax nominal cost of borrowing is 280 percent (70 percent of 400 percent), and the real after-tax cost of borrowing is minus 20 percent (280 percent minus 300 percent). This incentive for debt finance is undesirable. Inflation adjustment should be extended to interest and/or debt.

Losses

Losses on buildings used in business for more than three years are deductible. Losses on securities cannot be deducted; they can only be used to offset gains on securities. If such losses cannot be offset in the current year, they can be carried forward for up to five years to offset gains in those years. Losses incurred by individuals cannot be deducted nor carried forward; they can only be offset against gains occurring in the same year.

Business losses can be carried forward five years (seven years in the case of the natural resource sector). These carryforward periods may not be long enough to allow tax-free recovery of investments, especially in the all-important petroleum industry; it would be desirable to have different carryforward periods for different sectors, in part because it would be unworkable, it would be desirable to provide a longer carryforward period. Allowing unlimited loss carryforward would be more consistent with international practice. Moreover, because losses are not indexed for inflation, they will rapidly lose value in a period of high inflation. At the least, consideration should be given to allowing inflation adjustment of losses denominated in tenge.

Tax Rates: Legal Entities

Profits of legal entities are subject to taxation at a rate of 30 percent, with the exceptions for agriculture and free economic zones noted earlier, and for firms benefiting from the tax holidays enacted in 1997.

Dividends and interest, whether received by legal entities or by individuals, are subject to a withholding tax of 15 percent. Interest received by individuals and dividends are exempt from further taxation. Enterprises are allowed credit for tax withheld on interest or dividends. A branch profits tax of 15 percent is applied to the after-tax income of branches of foreign enterprises operating

in Kazakhstan. A foreign tax credit, limited to the amount of Kazakhstan tax on the income, is allowed for income taxes paid to foreign countries by residents of Kazakhstan (legal entities and individuals).

Table 3.3 shows the withholding tax rates applied to the income of foreign persons.

**Table 3.3. Withholding Tax Rates on Income
Earned by Foreigners**
(percent)

Dividends and interest	15
Insurance premiums	5
International telecommunications and transport	5
Royalties, consulting, management fees, leasing, and other income (including winnings from gambling) not taxed at the rates applicable to the income of resident individuals	20

Tax Preferences

General Issues: Tax preferences (exemptions and preferential rates, such as those for entities in free economic zones and those enacted in 1997 to spur investment)¹⁶ have several disadvantages. First, tax preferences create an impression of inequity that undermines taxpayer morale.

Second, they violate the principle of economic neutrality. Picking “winners and losers” places faith in bureaucrats and politicians, instead of market forces. Experience under central planning indicates that such faith is not merited.

Third, because tax preferences reduce the tax base, tax rates must be higher than under a comprehensive income tax with no preferential rates. This adversely affects incentives for work, saving, investment, and risk taking, and exaggerates distortions and inequities in the definition of taxable income.

Fourth, tax preferences create complexity and opportunities for abuse. For example, tax preferences for certain sectors or activities create problems of definition of eligible activities and problems of transfer pricing for sales of products between related entities engaged in both taxable and exempt activities.

¹⁶ For a more complete explanation, see McLure (1997).

All-in-all, there is little to recommend this approach to the taxation of business income. There has recently been a worldwide movement to eliminate gaps in the measurement of income, replacing them with lower tax rates.

The provision of tax preferences for investment in Akmola appears to be ill-advised. First, the preferences violate the principle that the tax system should be used to raise revenue, and not to promote special causes. They provide an unfortunate precedent for those who would “break open” the tax code, by providing other tax preferences. It would be far better to use explicit subsidies to encourage investment in housing in Akmola.

Second, these provisions are not carefully designed. For example, there is no indication how long funds must remain invested to qualify for the deductions. Absent such limitations, it might be possible to make an investment in one year and then simultaneously withdraw it and reinvest it in the next, thus receiving tax deductions in both years for a net investment made only in the first year. Similarly, it appears possible to invest borrowed money in both schemes.

Partial Exemption for Agriculture: The existing tax preferences for agriculture are especially problematic. There is no principled reason for such an exemption; it distorts economic decisions and is unfair. Moreover, it creates administrative problems and opens the door for abuse. If the agriculture sector is to receive preferential treatment, it should be through explicit subsidies, and not through tax preferences. At the very least, the exemption for agriculture creates questions of definition: it is necessary to define the activities that are exempt and those that are subject to tax. It would be improper to exempt all activities conducted on farms or by agricultural entities.

There are also important issues in the allocation of expenses between exempt and taxable activities. For example, how should the cost of a new truck and the fuel to run it be divided between taxable and exempt activities? To prevent overallocation of expenses to taxable activities, it would be necessary for STC to monitor such allocations. This would be impossible.

There is another potential problem that is far more troublesome. Entities earning most of their income from land can be expected to “integrate forward,” by undertaking nonagricultural activities, such as processing and packing of agricultural products, transportation of such products, and even marketing. Most of these activities should not be exempt merely because they are conducted by a tax-preferred enterprise. Yet, it would be virtually impossible to prevent

their effective exemption, through the use of fictitious transfer prices for transactions between related entities.

An example will clarify this. Suppose that a state farm establishes related enterprises engaged in processing and packing, transportation, and marketing. An alternative would be for the members of the collective to create these enterprises. Suppose that the market price of a vegetable sold by the farm is 10 tenge and that at this price the farm would earn no profits and the processing and packing enterprise would have profits of one million tenge. By charging a higher price for vegetables sold to the processing and packaging enterprise (perhaps 20 tenge), the enterprises could artificially shift profits from the taxable enterprise to the exempt one. Similar techniques could be employed to shift profits from the transportation and marketing enterprises to the farm.

In principle, these abuses could be prevented by monitoring transfer prices on transactions between related parties. In fact, this would be impossible. The analogous problem in the international sphere is among the most complicated aspects of the implementation of the profits taxes of developed countries. Kazakhstan should not introduce these complexities into its domestic tax system by adopting tax exemptions.

Elimination of the preferential rate for agriculture would probably have little short-run effect, because so little of the agriculture sector is currently showing profits. This suggests that this may be an opportune time to make this change; while it would create relatively little opposition now, it would be fiercely opposed once agriculture becomes profitable.

Tax Exemptions for Businesses Hiring the Handicapped: Tax exemption is provided for various legal entities devoted to providing relief and employment for the disabled and for veterans (except—in an apparent throwback to prereform thinking—for income from trade and intermediation earned by such organizations), and for nonprofit organizations, with respect to their charter activities (but not income from business activity). Enterprises with labor forces consisting of 30 percent or more disabled persons are allowed to deduct twice the costs of remuneration of the disabled, plus contributions for state social insurance and the employment fund of the disabled. While these preferences are attractive at an intuitive level, they must be monitored carefully, as they open the door for fraudulent practices. Benefits are probably better provided in other ways.

Apportionment of Tax among Oblasts

In the cases of a single legal entity operating in more than one *oblast*, total tax payments are to be apportioned among *oblasts* in proportion to the various *oblasts'* shares of receipts, salary, and the cost of main assets of the enterprise. Thus, if an *oblast* accounted for 20 percent of receipts, 30 percent of salaries, and 40 percent of main assets, it would be allocated 30 percent of tax paid by the enterprise. For this purpose, receipts are attributed to the *oblast* where shipments originate, not their destination.

This apportionment formula, provided in instructions issued by the head of STC on 29 January 1996 is a substantial and welcome improvement over the prior practice of allocating all income of an enterprise to the *oblast* where it is registered. (See Chapter 8 for an explanation of the disadvantages of allocating revenues to *oblasts* where enterprises are registered and a discussion of difficulties inherent in the new approach.) The use of an equally weighted three-factor formula is a reasonable choice, provided data for its implementation are available. It will, however, be necessary to provide some technical clarification (essentially precise definitions of the components of the apportionment formula), and to provide different formulas for specific industries such as banking and finance. Moreover, if feasible, it would be desirable to shift from an origin-based measure of receipts to a destination-based measure (see Chapter 8).

Accounting Rules

The tax year is the calendar year for all taxpayers. Taxable income and tax liability are to be calculated in the local currency. Where the taxpayer is involved in transactions in foreign exchange, conversion into tenge is to be made at the exchange rate prevailing on the day of the transaction. If accounting records are kept in a foreign language, STC can require translation into the Kazakh or Russian language.

Accounting for inventories for tax purposes is to be done in conformity with the rules for financial accounting. First-in, first-out; last-in, first-out; and average cost are the acceptable methods of inventory accounting. The taxpayer is not allowed to switch between methods without the permission of STC; in case a switch is allowed, the taxpayer may be required to pay tax based on an adjusted calculation of income. Inflation adjustment is allowed for inventories, but adjustments in excess of that allowed are subject to tax.

Under the Tax Code, as initially enacted, taxpayers could, at their discretion, use either the cash or accrual method of accounting, but must use the same method for all taxes, including income tax and VAT. However, the new accounting law, effective 1 January 1996, provided that all enterprises and individuals engaged in business must use the accrual method. Legislation passed at the end of 1996 eliminates the option to use cash accounting, effective 1 July 1997.

In the case of taxpayers operating mainly with cash or having a limited number of employees, the tax administration can prescribe the use of patents or a simplified system for determining the tax base and accounting for tax purposes. In the case of accounting violations or the destruction or loss of accounting records, the tax administration can use direct and indirect methods such as assets, turnover, or production costs to determine the tax base and tax liability. Where an individual declares an amount of income that is inconsistent with expenses incurred for personal use, including the acquisition of property, the tax administration can determine taxable income and tax liability on the basis of personal expenses incurred by the individual, taking due account of income earned in years before that in question.

When taxpayers engage in transactions with related parties that are not residents of Kazakhstan, or that are enterprises entitled to tax preferences, and such transactions do not occur at arm's length prices, STC can adjust prices and incomes to reflect prices that would prevail in transactions between unrelated parties.

In the case of long-term contracts (those covering work expected to take more than one year to complete), income and deductions are to be based on the portion of the contract performed during the year. For taxpayers accounting on an accrual basis, the percentage completed is determined by comparing costs incurred during the year with total expected costs.

The new tax code might reasonably be faulted as being too complicated, especially for small business. Unfortunately, an income tax in a country in transition from socialism must serve three "constituencies:" large state enterprises, which are accustomed to using Soviet-style accounting systems; large foreign-owned enterprises, including local joint ventures involving such enterprises, which are accustomed to using Western accounting systems not unlike that assumed in framing the new tax code; and private local businesses, including very small ones, that may not be accustomed to using any system of accounting, and, indeed, may not have existed until recently. Perhaps equally troubling, virtually none of the personnel of STC has experience with implementation of a tax

system such as that contained in the new tax code.

The new accounting law required that state enterprises switch to a Western style accounting system, effective 1 January 1996; any difficulties they have will not be limited to tax accounting, and will be temporary, in any event. It is inevitably difficult to create a system that deals adequately with the complex economic and financial situation of foreign investors and yet is not too complicated for small, new local businesses. It is especially troubling that all taxpayers are forced to use the accrual method, something many advanced countries do not require. Finally, there is pressing need for training for the tax administration.

VALUE-ADDED TAX

VAT is essentially a standard consumption-based, credit method tax. That is, credit for tax paid on inputs, including most capital investment, is offset against tax on sales. (But no credit is allowed for tax on buildings and automobiles.) Tax applies to services, as well as goods. This greatly simplifies compliance and administration.

Although VAT is applied to a comprehensive tax base, there are exemptions for the following:

- (i) the lease and sale of land and buildings except for hotels, parking lots, and the first sale of buildings;
- (ii) financial services;
- (iii) postage stamps except for collection;
- (iv) activities of nonprofit organizations in such areas as health, education, welfare of children, the aged, the disabled, culture, physical training, sports, and religious rites;
- (v) funeral services;
- (vi) services provided by the state and subject to state duty;
- (vii) import of currency except for numismatic purposes, and securities;
- (viii) privatization of enterprises;
- (ix) sale of enterprises;
- (x) certain imports that are exempt from excises; and
- (xi) geologic prospecting and exploration.¹⁷

Except for the last, these exemptions are more or less standard.

¹⁷ Article 73 states that (as in the VAT of most countries) in the case of exempt sales, VAT paid to suppliers cannot be claimed as a credit, and article 68 provides for the apportionment of input credits among taxable and exempt sales, in the case of business engaged in both.

Because of agreements with other republics of the CIS, the origin principle is applied to trade with the rest of the CIS; thus, exports to the CIS are fully taxed and imports from the CIS are not taxed. VAT on trade with non-CIS countries is levied on the destination principle. That is, non-CIS imports are subject to tax, and non-CIS exports are zero-rated (which means that no tax is paid on exports, but credit is allowed for tax on inputs).

There is only one rate, 20 percent. The tax rate is a tax-exclusive rate; that is, it applies to sales net of VAT. However, the tax base includes both excises and, in the case of non-FSU imports, customs duties and fees. International transport is subject to a zero rate.

Wages in-kind are subject to VAT. In the case of barter transactions, taxable turnover is to be calculated on the basis of prices charged by the taxpayer at the time, but no lower than actual cost.

Taxpayers are legal persons and individuals engaged in business activities and registered (or required to register) for VAT. Businesses with turnover in excess of 1,000 MCIs in a month are required to register as VAT taxpayers. Those with smaller turnover can register on a voluntary basis. With the permission of STC, subdivisions of legal entities can be treated as separate taxpayers. (This can have important implication for the division of VAT revenues among *oblasts*; see Chapters 7 and 8.) In such a case, subdivisions are consolidated for purposes of determining whether registration is required. According to the portion of the new tax code dealing with special taxes and payments on mineral resource users, those operating under more than one contract for the use of mineral resources cannot consolidate their income or expenditures for the purpose of computing any tax; thus, VAT must presumably be calculated separately for each concession.

Liabilities for VAT are to be settled on a monthly basis, or on a quarterly basis for taxpayers with average monthly turnover of less than 500 MCIs during the quarter. Taxpayers with turnover in excess of 1,000 MCIs are required to make payments of VAT every ten days. VAT on imports is ordinarily to be paid at the time customs duties are paid, that is at the time of importation. However, in the case of imports of raw materials intended for industrial processing, the tax administration has the discretion to allow deferral of tax for three months. If credits for VAT on purchases exceed VAT on sales, the excess is to be refunded within ten days of the receipt of request for refund by the tax administration, or within 90 days in the case of taxpayers engaged in commercial and intermediary activities.

VAT is essentially the standard type used in most advanced Western countries. It thus deserves little comment. The primary problems relate to the treatment of trade with other members of the CIS. Kazakhstan cannot correct these defects acting alone.

A cardinal principle of tax policy is that it is generally inappropriate to levy tax on productive inputs, for example, capital goods, intermediate goods, spare parts, fuels, and office equipment. One exception is where final products are not taxed and inputs are taxed as a surrogate for taxation of final products. For this reason, virtually all VAT systems allow full credit for VAT paid on business inputs and most allow essentially immediate refund where credits for tax on purchases, including imports, exceed liability for VAT on sales. In principle, Kazakhstan follows this practice. But the high rate of inflation in Kazakhstan, combined with delays in allowing credits for taxes on inputs, and particularly the delays in refunding VAT on capital goods, renders the credits and the refunds virtually worthless. Every effort should be made to accelerate credits and refunds. Given inherent limits to this policy and the persistence of inflation, additional steps should be taken to prevent taxation of inputs. Thus, imported capital goods should be exempted from VAT. The net result would be identical to collecting tax and refunding it immediately, as is appropriate. Exemption might be extended to spare parts and to equipment produced domestically. But care must be taken not to exempt goods such as lubricants that could leak into the retail market.

Concern has been expressed that Kazakhstan receives no VAT revenue from exports of natural resources, except those to the CIS, because of zero-rating. While valid, this concern should be addressed in the taxation of mineral resources, for example, by taxing economic rents in the resource sector.

Giving the taxpayer the choice between cash and accrual accounting in the new tax code could be problematic, if requests for credits were based on accrued liabilities of buyers, but collections were based on cash received by sellers. Withdrawal of the option to use cash accounting should eliminate this potential problem.

EXCISES

Kazakhstan levies excise taxes on production and importation, except from the FSU, of a variety of goods commonly subject to such taxes, including alcoholic beverages, tobacco products, motor fuels, passenger automobiles, and of several less important items,

and on gambling and the production of crude oil. Exports, except for crude oil, are exempt, unless destined to other members of the FSU, as are goods imported as humanitarian assistance, for charitable purposes, and by diplomatic missions and their staffs. The Government sets excise tax rates and has the power to exempt imports by individuals from excises. Under current rules an individual can import one car per year if the car is not to be sold within two years.¹⁸

Excises on alcoholic beverages and tobacco products are specific levies. That is, they are stated in European currency units per liter of alcoholic beverage or per 1,000 cigarettes or cigars. Excises on other goods and on gambling are ad valorem levies. The base of goods subject to ad valorem excises excludes the excise and VAT. In the case of imports, it is the value for customs; that is, it excludes customs duties and fees. In the case of goods subject to barter transactions, the basis for tax is the price of the producer's output. In the case of gambling, the tax base is gross turnover, net of winnings paid out. Where goods subject to excise are produced using raw materials owned by another person, tax is due when goods are transferred to the client. Where raw materials have been subject to excise, the excise on the final product can be reduced by the amount of the excise on raw materials. The rate schedule for excises enacted in the amended budget for 1995 is given in Table 3.4.

Excises on alcoholic beverages and tobacco products produced in Kazakstan are due within three days of disposal of the taxed goods. On other goods produced in Kazakstan and on gambling, tax is due every ten days (within three days of the end of the ten-day period). In the case of imports, the payment schedule is the same as for customs duties.

By stating excise tax rates for alcoholic beverages and tobacco products in European currency units, Kazakstan has neatly sidestepped the choice between per unit taxes fixed in the local currency, which are easier to implement but vulnerable to inflation, and ad valorem rates, which are more difficult to monitor and arguably less justified on conceptual grounds. The social cost of consuming alcohol is more likely to be related to the amount consumed than to the value of the beverage.

¹⁸ There is a proposal to allow tax-free importation and sales of cars, if the sale occurs within the customs area.

Table 3.4. Excise Tax Rates

Product or activity	Local ^a	Imports ^b
Alcoholic beverages (tax in ECU per liter)		
Ethyl drinkable alcohol	3.5	3.5
Vodka	0.7	3.5
Liqueurs and vodka products	0.6	3.5
Fortified drinks, fortified juices, and balsam	0.6	3.5
Wine	0.2	0.8
Cognac	0.4	3.5
Champagne	0.3	0.8
Beer	0.05	0.2
Wine-making stuffs	0.2	0.8
Tobacco products (tax in ECU per 1,000)	0.75	2.0
Other goods and activities (tax in percent)		
Sturgeon and salmon and their roe and delicacies made of such fish or roe	100.0	100.0
Processed and unprocessed furs and hides (hides of mole, rabbit, dog, deer, and sheepskin)	50.0	50.0
Wearing apparel made of natural fur (other than apparel made of hides of mole, rabbit, dog, deer, or sheepskin)	50.0	50.0
Coats, short coats, jackets, and capes trimmed with fur (other than mole, rabbit, dog, deer, and sheepskin)	50.0	50.0
Clothes made of natural leather	50.0	50.0
Objects made of crystal; lighting appliances made of crystal	50.0	50.0
Gasoline (other than aviation gasoline)	20.0	20.0
Diesel fuel	5.0	5.0
Passenger automobiles	n/a	25.0
Firearms and gas weapons	40.0	40.0
Gambling	20.0	n/a
Crude Oil	7.0	n/a

Notes: ECU = European current units; n/a = Data not applicable.

^a Local production for export to the Commonwealth of Independent States (CIS) is subject to excises in Kazakhstan; other exports are not excisable.

^b Imports from the CIS are subject to the excise of the producing country, not that of Kazakhstan.

Source: 1995 Amended Budget of Kazakhstan (Ministry of Finance).

In the case of alcoholic beverages and tobacco products, the current rate schedule differentiates between imports and domestic production, levying higher rates on the former. While unusual by

international standards, this may not be so unreasonable, given the origin-based treatment of intra-CIS trade.¹⁹

The agreement with the other members of the CIS, under which excises on intra-CIS trade are collected by the country where production occurs, reduces Kazakhstan's freedom in the pursuit of excise tax policy. This is perhaps best seen by contrasting the CIS treatment with the destination-based treatment (imposition of excises by the country where consumption occurs, with exports exempt) that is common throughout the rest of the world. In the standard system, a single rate is commonly applied to all consumption of a given product, whether produced locally or imported.²⁰ Similarly, all exports are exempt from excises. Results under the CIS system are quite different, because consumption of products imported from other members of the CIS bear the burden of a tax set elsewhere (by the exporting member, perhaps in agreement with other CIS members). If Kazakhstan were to raise excises on local production, for example, to finance the Road Fund, it could not also raise the excise on imports of, for example, fuels, from the CIS. If excise taxes were to be raised, domestic producers would be placed at a competitive disadvantage, relative to products smuggled into the country without paying tax. This would be particularly problematic in the case of high-value, low-weight, low-bulk products, such as alcoholic beverages and tobacco products, that can easily be smuggled across Kazakhstan's long international borders. Loss of markets to smuggling would result in reduced domestic production, loss of employment, and probably lower revenues. Revenues would be lost from income taxes on individuals and enterprises and from VAT, as well as from excises. Raising excises would thus worsen the competitive position of its producers in both its own market and in the markets of other members of the CIS, vis-a-vis those from other members of the CIS. On the other hand, it is not unreasonable to ask how Kazakhstan's excises compare with those in the rest of the CIS; rough harmonization would be a reasonable goal. Given the differences that exist in the definitions of products subject to excise, this is not easy. Over time, a shift to the international norm of destination-based excises and VAT would be desirable.

¹⁹ Among common explanations for this treatment in other countries are protection of local production and an attempt to equalize the ad valorem equivalent of per unit taxes on goods of different quality. It is generally a mistake—but one made by many other countries—to use excises, rather than customs duties, for this purpose. It is more appropriate (more transparent) to levy uniform excises, providing desired differentiation through customs duties.

²⁰ Explicit imposition of a higher excise on imports would be a violation of the General Agreement on Tariffs and Trade.

In countries throughout the world, excises on electricity are seen to be a reasonable way to raise public revenue, because they can be administered easily and are likely to increase as a fraction of income, as income rises. In Kazakhstan, there is an additional justification: the failure of electricity prices to reflect all costs. To the extent that this is true, a more natural approach would be simply to raise electricity tariffs. However, that might provide additional revenues to the electric utility, and not to governments. On the other hand, a similar result might be achieved, if public subsidies to utilities could be reduced. The policy alternatives in this area deserve closer study.

The approach employed in Russia, taxation only of electricity used by enterprises, violates the principle that productive inputs generally should not be taxed, and thus is inappropriate. The economically rational approach is just the opposite—taxation only of electricity used by households. For both political and administrative reasons it may be best to tax all electricity. Of course, increases in electric rates would impose burdens on low-income families. As in the case of the tax threshold and the bottom rate of income tax, this emphasizes the need to coordinate tax policy with policy regarding the social safety net, such as pensions and unemployment compensation.

SECURITIES TRANSACTION TAX

New issues of nongovernment securities, including stocks and bonds, are subject to a tax of 0.5 percent of the nominal value. Proceeds from secondary transactions in securities are taxed at 0.3 percent (0.1 percent in the case of government securities). Whereas the issuer is liable for the tax on initial issues, the buyer is liable for the tax on secondary transactions.

MINERAL RESOURCES TAX

Statutory Provisions

The tax code foresees the use of bonuses, royalties, and either an excess-profits tax or profit sharing. Details of the calculations of such payments are to be specified in contracts. Thus, neither Decree 2235 nor Decree 61-1, issued at the end of 1996, includes such details.

Taxpayers with more than one contract for the exploitation of mineral resources cannot consolidate income or expenditures in computing liability for any tax. Tax provisions of existing contracts

will be grandfathered. Contracts will be amended if this is necessary to prevent new tax legislation from causing the deterioration of the economic position of either the government or the taxpayer.

The tax code provides for three types of bonuses, in addition to royalties.

- *Subscription bonuses* are one-time payments for the right of geological exploration for resources and/or their extraction. They are paid at the conclusion of a contract with the government.
- A *commercial discovery bonus* is a one-time fixed payment made when a commercial discovery is made.
- An *extraction bonus* is a fixed payment made periodically when certain conditions of resource development or extraction are reached.
- Royalties are payments for the privilege of extracting resources or developing technological formations; they are to be based on the value of resources extracted.

Excess-profits tax will be due if the internal rate of return from a project exceeds 20 percent.²¹ Decree 61-1 requires that tax liabilities should be the same, regardless of whether the tax regime chosen is production sharing or the excess-profits tax.

The rate schedule for the excess-profits tax (and, by implication, for profit sharing) is given in Table 3.5.

Table 3.5. Excess-Profits Tax Rates

Internal Rate of Return	Tax Rate
0-20 percent	0
20-22	4
22-24	8
24-26	12
26-28	18
28-30	24
more than 30	30

²¹ Decree 2235 defined excess profits as “income from operations in relatively better natural conditions or disposing of extracted product in relatively better market conditions.” (This apparently means “better than anticipated at the time contracts are signed.” The words in quotation marks are not included in Decree 2235. They are inferred from the Implementing Instructions.) The Implementing Instructions for Decree 2235 indicate the following sources of unforeseen profits: (i) an increase in world energy prices; (ii) a decrease in capital and operating costs resulting from decreases in the cost of, for example, equipment and know-how; (iii) a decrease in costs resulting from better conditions of extraction than originally expected; and (iv) a decrease in transportation costs.

Liability for bonuses, royalties, and excess-profits taxes is in addition to any other taxes; it does not eliminate liability for such other taxes. All bonuses and royalties are deductible in calculating liability for the income tax or excess-profits tax.

Comments

Structure of Taxation

The government faces the competing objectives of revenue, especially the need for quick revenue, and optimal development of the country's resources. The former suggests the use of signing bonuses and taxes on production. Besides reducing the profitability of investment in exploration and development, taxes on production have the signal disadvantage of discouraging development of marginal fields and encouraging premature abandonment. A tax on economic rents does not have the last effects, because it is levied on the excess of income over all expenses, including the cost of equity capital. Thus, a tax on rents is generally superior to a tax on production, or even to a tax on accounting profits. The sliding scale on royalties, envisaged in Decree 61-1, represents an attempt to meet both objectives.

Box 3.1 is an excerpt from a World Bank study that describes several ways to tax economic rents. It does not strongly make the case for taxing rents instead of production, simply because that case is so well known and is generally accepted among policy analysts. (See also the discussion in Chapter 2.)

Box 3.1. Alternative Forms of Rent Tax

Profits Tax: The profits tax provides a useful starting point in the discussion of taxes on resource rents. Its base is the difference between receipts and expenses in the current year, both calculated on an accrual basis. It differs from an income tax because it provides deductions for the normal return to equity capital (the rate of return that can be earned on alternative investments), as well as for interest expense. Stated differently, an income tax is a combination of a tax on profits and a tax on the normal return to equity capital. The use of accrual concepts implies that accounts receivable are included in receipts, and

depreciation and depletion allowances are used to spread the cost of long-lived assets across time.

Income taxes are plagued by two problems; profits taxes suffer from these problems, plus another. First, in several important cases there is no way of knowing the proper time pattern to use in calculating taxable income; depreciation and depletion are important examples. When timing is not handled satisfactorily, income is not measured accurately and production decisions are distorted. Even where the measurement of income is conceptually straightforward, implementation may be difficult.

Second, in a time of inflation, real income will be mismeasured unless adjustments are made for inflation. Adjustments are needed for depreciable assets, inventories, capital assets that are sold, interest income and expense, and for the imputed cost of equity capital. Inflation adjustment is inevitably complicated; it would be extremely onerous for small enterprises, though perhaps it could be handled by large enterprises. Moreover, it usually is not clear what the rate of inflation has been.

To calculate profits it is necessary to know the normal return to capital. This is inherently impossible; at best an arbitrary assumption must be made. To the extent the assumption used is inaccurate, calculated profits will over or understate economic rents.

Resource Rent Tax: Another form of rent tax is what has been called the resource rent tax (RRT). Its base in any year is calculated as the difference between accumulated receipts and expenditures, both measured on a cash flow basis and adjusted by an interest factor to place them on common present value terms (hereafter called “compounded net cash flow”). In making this calculation, financial receipts and expenditures such as interest are not considered. Tax is due when this difference (compounded net cash flow) is positive (when the present value of receipts exceeds the present value of expenditures). Once tax has been paid, the base that has been taxed is eliminated from future calculations.

RRT has the effect of taxing only income in excess of the interest rate used to adjust past receipts and expenditures. If that threshold interest rate exactly equals the rate of return that can be earned on alternative investments, which is the minimum that must be earned to induce investment, the tax base is exactly economic rents.

It is possible to build more than one threshold into the calculation of tax liabilities. Thus, income in excess of the first threshold (intended to be the normal return on investment) might be taxed at one rate, and the excess over a higher rate might be taxed at a higher rate. This makes it possible to vary the tax rate

with the profitability of the enterprise. In this sense, RRT, with more than one threshold, can be seen as a form of graduated excess-profits tax.

Because prior expenditures are simply accumulated with interest, one of the two problems with income taxation identified above, the proper time pattern of allowances for depreciation and depletion, does not exist. Similarly, the neglect of financial payments eliminates the need for inflation adjustment of interest payments. These are major advantages of RRT.

RRT is not without problems. First, it shares with the profits tax the difficulty of knowing the proper rate of return to employ in calculating the tax base. Second, in an inflationary environment it may not be satisfactory simply to add together receipts and expenditures occurring in different years, even if there is an interest adjustment; this is satisfactory only if the interest rate used to convert to present value terms reflects the nominal rate of interest. Alternatively, prior quantities could be adjusted for inflation and then adjusted to present value terms, using a real rate of interest. Uncertainty about the proper choice of inflation rates, nominal interest rates, and/or real interest rates makes this approach problematic. One way to handle this problem in the case of foreign investors is to denominate all receipts and expenditures in the currency of the investor. The same approach could presumably be used for domestic investors, but doing so would be extraordinary.

RRT suffers from another problem, which is aggravated by the use of several threshold rates. If compounded net cash flow goes from positive to negative, and is never offset by positive net cash flow, tax will be paid on an amount in excess of rents. This could be handled by the use of loss carrybacks, a complicated feature that would not otherwise be needed. (An excess of expenditures over receipts in early years would not be a problem—at least if cash flow problems for the enterprise are ignored, because the resulting negative compounded net cash flow would be carried forward to offset future positive cash flow. In a sense, a *de facto* loss carryforward is an inherent part of the scheme.) This is a general problem of tax systems based on annual measures of profitability; it would also arise under standard profits taxes, which would require an explicit allowance for loss carryforward and, to deal with this problem, loss carryback. An analogous problem could arise if the system uses more than one interest rate threshold; receipts bunched into one year might give the appearance—and taxation—of extraordinary profits, despite subsequent years of loss measured on a compounded net cash flow basis using the higher interest rate.

Cash-Flow Tax: A third way to tax rents is to employ a CFT. Under one form of such a tax, expenditures (except financial expenditures) are deducted from receipts on a cash flow basis. This tax is equivalent to RRT, if the threshold rate under the latter is the normal rate of return.

CFT has several advantages over profits taxation and RRT. First, there is no need for inflation adjustment in the measurement of the tax base, because transactions have tax consequences only in the year when they occur. Second, because there is neither a deduction for financial costs nor compounding of earlier receipts and expenditures, there is no need to choose a normal rate of return for the calculation of the tax base, as there is in the other two systems. Timing issues do not arise because of the use of cash flow accounting.

CFT is also not without problems. Losses for tax purposes would be common in early years of operation and might occur anytime there were large investment projects. To avoid overtaxation, it would be necessary to pay refunds based on these losses or to have a system of loss carryforwards that preserved the present value of these losses. (Loss carryback would also require an interest adjustment. This is also true of carrybacks under the profits tax.) A system of loss carryforwards would require a choice of an interest rate analogous to that in the calculation of the tax base under the profits tax or RRT. But the problem seems less important under CFT than under the profits tax and RRT, because this rate would apply only to those enterprises with losses, while it would apply to all enterprises in the other two cases.

CFT lacks the possibility of making the tax rate depend on the rate of return, as under RRT. To add such a feature to either the profits tax or CFT would require a measure of investment against which to compare rents in calculating the rate of return. The difficulty of calculating investment (aggregating investments occurring in different years on a comparable and meaningful basis) is one of the stumbling blocks of such taxation. RRT achieves this objective, but not without difficulties.

A potential complicating consideration in the use of cash-flow taxation is whether capital-exporting countries that tax worldwide income and allow credits for taxes paid to host countries, especially the US, would allow a foreign tax credit for such taxes. It is generally important that taxes be eligible for foreign tax credits, to avoid the disincentive effects of double taxation.

Source: McLure (1994).

Uncertainty

The Government of Kazakstan, particularly MOF and STC, deserves considerable praise for emphasis on maintaining a stable tax code. Yet stability is not an end in itself; it is desirable primarily because it simplifies tax administration and compliance and because it provides certainty for potential investors. In the case of the taxation of mineral resources, certainty is the key issue. Multinational corporations can tolerate complexity, although they do not like it, but they cannot tolerate uncertainty and will not invest where it abounds. Decree 61-1 does not provide certainty for potential investors.

Royalties: Reflecting provisions found in the tax code, Decree 61-1 provides for three types of bonuses and for royalties. But it does not specify how these bonuses or royalties are to be determined. It does not even provide guidelines for determining royalty rates. Because the law provides no guidance, potential investors will need to enter into negotiations merely to determine what royalties they will be expected to pay, and under what circumstances. Because this is, at best, a long and tortuous process and one that creates the risk of rampant corruption, many investors may simply choose to avoid Kazakstan. Rules for determination of royalties must be stated clearly and explicitly in the tax code.

Excess-profits Tax: Provisions pertaining to excess-profits tax also fail to provide certainty. The calculation of profits and their division among years requires at least as many detailed rules as the definition of taxable income under the enterprise income tax. How much income is earned, and when? What expenses are deductible, and when? These are important and difficult issues. They may or may not be answered identically under the income tax and the excess-profits tax. Even if they are, so that income tax rules can be incorporated by reference, the law must so state. Beyond that, the calculation of the internal rate of return also requires the measurement of capital investments. (How much investment is made, and when? Again, these are complex issues.) Because such rules are not required for the income tax, they cannot simply be incorporated by reference. Until these rules are specified, no potential investor can be expected to place millions of dollars of investments on the line, risking the possibility that much of revenue could be classified as excess profits and taxed at a rate as high as 30 percent, in addition to the regular income tax.

Other Problems²²

Lack of Consolidation: The failure to allow consolidation of contracts for income tax purposes is inconsistent with both economic theory and international practice. There is no principled reason that Kazakstan should expect to share in the profits from productive ventures, but not in the losses from unproductive ones. Besides being unfair, this treatment can be expected to discourage investment. Conventional economic analysis stresses that, even if tax rates are lower, to compensate for this asymmetric treatment, the failure to allow “loss offset” will, on average, discourage investment. The concern that previous contracts were negotiated on the assumption that each contract would be taxed separately can be addressed by providing separate, unconsolidated taxation of contracts concluded before a certain date (a kind of “reverse grandfathering”). There is no reason to let that precedent lead to undesirable and unjustified methods of taxing future contracts.

Dollar Accounting: The lack of systematic adjustment for inflation in the measurement of taxable income is a major problem in the new tax code. It is particularly troublesome in the natural resource area. While there is generally no easy answer to this problem, there is an easy answer in the natural resource area: use of accounting in dollars (or whatever is the “functional currency” of the investor) in this sector, at least in the case of foreign investors and joint ventures.

LOCAL TAXES

In addition to the national taxes described above, there are six local taxes. This section describes three of these; the Tax Code contains no details on the others.

Land Tax

Land is to be subject to an annual tax, whether held by individuals or enterprises. Tax rates depend on the use, quality, and location of land. Land is differentiated according to the following uses: (i) agriculture; (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. Revenues accrue to where the land is located.

²² See also comments on loss offset under the income tax.

Decree 2235 presumes the existence and accuracy of an annual cadastre. Where analysis of soil quality is lacking, expert evaluation of the quality of land is to be made by a commission consisting of a representative of the local authority, a representative of the regional committee for land relations and land management, a soil expert from the regional division of the state scientific center for land resources and land management, and the land owner or representative of the occupant of the land. There are two basic types of agricultural land, each of which is divided into 101 groups according to quality (fertility) of the soil.²³ Given the general description of the two types and the maximum tax rates applied to the second of them (less than one fourth of the maximum for the first), it appears that the two types could be characterized loosely as arable and nonarable.²⁴ Tax rates per hectare vary from T0.25 to T105 for the first category and from T0.25 to T6 for the second. Land otherwise falling within another category, but used for agriculture is subject to these rates. Local authorities have the power to increase or decrease these rates by as much as 20 percent, depending on the location of a plot and the adequacy of its water supply. It is apparently not intended that this provision be employed to reduce the tax rate applied to all land in a particular location. Up to one-quarter hectare of land (including area devoted to buildings) utilized by individuals for subsidiary plots, gardens, and dachas is exempt.

Land in inhabited localities is subject to different rates of taxation, depending on its use and location. In the case of land associated with residential buildings located in towns, including towns of *oblast* significance (and towns of *rayon* significance in Almaty Oblast), the tax rate is T0.2 per square meter. In towns of *rayon* significance (except in Almaty Oblast [T0.1]), settlements (T0.07), and villages or *auls* (T0.05), the rates are lower, as indicated by the rates per square meter in parentheses. For land in towns associated with other types of construction, the tax rates vary by

²³ Decree 2235 specifies only 11 grades of land, with ranges of tax rates within each grade. The Implementing Instructions provide the further breakdown into 101 grades, with a tax rate for each.

²⁴ The first zone is steppe and dry steppe lands in flat areas with ordinary and southern black soils, dark and dark brown soils, and foothill areas with dark grey and brown soil and foothill black soil. The second zone is semidesert, desert, and foothill-desert areas with light brown, brown, and grey soils, and also mountain areas with mountain-steppe land, mountain meadow steppe, and mountain alpine and subalpine soils.

oblast (from T3.00 to T5.00 per square meter, except in Almaty City, where it is T15.00). Rates in towns of *oblast* and *rayon* significance are 85 percent and 75 percent, respectively, of the rates in the center (again with the exception of Almaty Oblast, where the rates are T4.00 and T3.50 per square meter). In settlements and villages, the rates per square meter are T0.5 and T0.25, respectively. Local authorities have the power to increase or decrease these rates by as much as 20 percent, depending on such factors as access to transport, and aesthetic, environmental, social, cultural, and sanitary considerations.²⁵

Land used for industry, transportation, communications, defense, and other nonagricultural purposes located outside inhabited localities is subject to tax rates per hectare that vary from T25 to T3,000, depending on which of the 11 quality categories it falls into. (Land located within inhabited localities that is used for these purposes is taxed at the same rates if it is located outside the area allocated to buildings.)²⁶ Local authorities have the power to increase or decrease these rates by as much as 20 percent, depending on such factors as location and access to communications.

Land of the Forestry Fund and the Water Fund is exempt, except when devoted to agriculture, lumbering, or the structures of organizations devoted to forestry or water-related businesses. Land devoted to forestry is subject to tax equal to 5 percent of the value of timber cut. Also exempt is land of nature protection reserves, land having cultural or historical value, land used for health care and recreation purposes, and the common areas of inhabited localities. In addition, NBK and organizations and individuals benefiting from tax preferences under the income tax, such as organizations of the disabled, organizations hiring the disabled, and veterans of World War II, are also exempt from land tax.²⁷

²⁵ However, for reasons that are unclear, the Implementing Instructions provide that local authorities can increase or decrease tax rates by as much as 50 percent.

²⁶ The Implementing Instructions indicate that such land is to be taxed at the same rates as agricultural land (at rates given in Annex 2 in the tax code). This is presumably a mistake, because the Instructions also say that all land of this type is to be taxed according to Annex 2 (agricultural land) instead of Annex 3, which refers explicitly to industrial and other nonagricultural land located in uninhabited areas.

²⁷ The Implementing Instructions contain a long digression that summarizes the provisions of a Presidential Decree issued on 28 April 1995, "On privileges and social protection of participants and invalids of the Great Patriotic War and persons equated."

The structure of the land tax appears to be quite sophisticated. One wonders, however, whether it can be implemented. It requires the existence of an accurate and up-to-date cadastre. Moreover, it appears to place extraordinary demands on STC, which is called on to administer the tax. This is one area where independent, local legislation and administration would probably be desirable. Similar comments apply to the administration of the property tax. There is little reason it could not be administered locally or that tax rates should not be set locally (see Chapter 8 on tax assignment).

Property Tax

Business assets, other than vehicles subject to the vehicle registration tax, are taxed annually at a rate of 0.5 percent,²⁸ while buildings and structures (“dwellings, dachas, garages, and other buildings and premises”) owned by individuals bear annual tax at a rate of 0.1 percent. Valuation is to be made by “municipal organs, departments for evaluation and registration of immovable property,” which are to supply such information to the local tax administration.²⁹ Revenues from the property tax go to the budget of the *oblast* where property is located. The tax is deductible in calculating taxable income.³⁰

Table 3.6. Vehicle Registration Tax

Type of Vehicle	Percentage of MCI
Passenger cars and buses	8
Motorcycles and motor scooters	1
Launches, boats, tugboats, barges, and motorized sleighs	4
Trucks and other self-propelled machines, except those on caterpillar tracks	4

Notes: MCI = minimum calculation index.

^aWhile Decree 2235 states this rate to be 4 percent, the Implementing Instructions state it as 2 percent.

²⁸ To be subject to tax, an asset must have an annual service value of more than 40 MCIs.

²⁹ The Implementing Instructions list boards of horticulturist partnerships as the only type of body responsible for supplying such information to the tax authorities.

³⁰ The Implementing Instructions state that the property tax is allowed as a credit against income tax. This is presumably an error in translation. Presumably it is allowed as a deduction in calculating taxable income.

Nonprofit and budgetary organizations are exempt. But property of nonprofit organizations used for business purposes is subject to tax. Also, if an individual leases part of premises that would otherwise be taxed at a rate of 0.1 percent, the leased portion is taxed at a rate of 0.5 percent. Heroes of various designations, disabled persons, and pensioners residing independently are subject to tax only to the extent that the value of their property exceeds 1,000 MCIs.

Vehicle Registration Tax

Motor vehicles are subject to annual fees that depend on the type of vehicle and the size of the engine. Table 3.6 shows the tax each kilowatt of power attracts, expressed as a percentage of MCI.

This tax must be paid before the vehicle can be registered. It is deductible in determining taxable income for purpose of the income tax. Revenues from the tax go to the budget of the *oblast* where vehicles are registered.

Exemptions are provided for specialized agricultural equipment, large dump trucks used in mining, motorized wheelchairs and motor vehicles owned by the disabled, and for NBK and organizations and individuals benefiting from tax preferences under the income tax, such as organizations of the disabled, organizations hiring the disabled, and veterans of World War II.

This form of taxation is generally a reasonable way to add to the progressivity of the tax system. Moreover, registration tax can provide badly needed revenue for subnational governments. But registration taxes generally should not be applied to vehicles used for legitimate business purposes, as this distorts decisions on production techniques and discourages economic development. On the other hand, despite the theoretical case for exempting automobiles used in business, given the latitude for abuse, it makes sense to tax all automobiles. Beyond that, great care should be taken so that the system of tax rates is appropriate.

TAXES FOR SPECIAL FUNDS

There are several taxes that finance extrabudgetary funds; these are not included in the tax code.

Social Security Taxes

Social insurance is financed through a 30 percent payroll tax. There is also a 2 percent tax on payrolls earmarked for the employment promotion fund. (See also the discussion of social security in Chapter 5.) These taxes are paid only by employers, and regardless of their legal form of organization.

While these taxes are more or less unexceptionable in principle, they have unfortunate effects. It is undesirable that the tax be levied entirely on employers. Unlike the income tax, these payroll taxes are likely to be essentially invisible to employees. Thus, employees may fail to realize that social security actually costs them something. (Commonly accepted incidence theory agrees that in a market economy payroll taxes are ultimately borne by employees, rather than by employers.) This may lead to excessive demands for social security – demands that are more generous than the economy can support and more generous than would be demanded if employees could choose freely between higher wages and higher social security benefits. Serious consideration should be given to lowering the payroll tax and shifting its legal burden from employers to employees. It is much more common in Western countries that the tax be split between employees and employers.

Road Fund

The Road Fund is an extrabudgetary fund designed to finance the cost of construction, maintenance, and repair of roads and on-road facilities. The Road Fund is to be financed by a combination of turnover taxes, taxes on the retail sales of motor fuels, transportation fees, and toll charges for the use of selected roads. Funds from these sources are to be split between the budgets of the central government and *oblasts*.

A tax of 0.1 percent is to be levied on the turnover of legal entities engaged in wholesale, transit, storage, and retail-operating procurement, sale, and provisory activities. A tax of 0.5 percent is to be levied on the following: gains from services rendered by legal entities in stock exchange activities; gross profit (the excess of premiums over insurance claims) of legal entities in insurance activities; and the aggregate income of legal entities operating banking activities; as well as goods disposed, works executed, and services rendered by legal entities operating activities not listed

Table 3.7. Assignment of Road Fund Revenues
(percent)

Tax or Fee	Central Government	<i>Oblasts</i>
Turnover tax	65	35
Transportation fees	65	35
Motor fuel tax	50	50
Toll charges	Republican roads	<i>Oblast</i> roads

Source: Decree 2701, 21 December 1995.

above. Various charitable organizations, NBK, noncommercial organizations executing their statutory activities, international agencies, production enterprises having at least 50 percent disabled among their employed, and enterprises providing common utility services and transportation (except taxis) are exempt from tax.

The second tax is to be levied on legal entities and individuals operating retail, gasoline, and diesel outlets. The current rate of tax is 3 tenge per liter. Fees (also to be set by the government) are to be levied on the entrance, exit, and transit through the territory of Kazakstan by legal entities and individuals operating international transportation.

Table 3.7 shows the assignment of revenues to the Road Fund of the central government and of the *oblasts*. Despite this assignment, grants can be made from the Road Fund of the central government to the road funds of *oblasts*, to equalize the level of development of roads throughout the country. Conversely, *oblast* administrations can allocate *oblast* resources for development of republican roads.

Establishment of an independent road fund financed by user charges and benefit-related taxes can be consistent with sound budgetary principles. However, the particular funding devices used to finance the Road Fund in Kazakstan are highly questionable. In addition, the government must be diligent to ensure that extrabudgetary funds financed with earmarked taxes are employed only where there is an important and direct link between benefits received and readily administrable taxes or charges. Proliferation of extrabudgetary funds and earmarked taxes is generally to be avoided. First, imposing the turnover tax on legal entities engaged in stock exchange activities, insurance, and banking is highly questionable. Most obviously, these must surely be among the commercial activities that make least use of roads. If so, there is little justification for levying a turnover tax on these activities intended to finance the Road Fund, much less imposition of what

appears to be a penalty rate (0.5 percent compared to 0.1 percent for other activities). The choice to tax these financial activities is doubly questionable, because such activities are essential for development of a market economy.

Second, turnover taxes are generally undesirable, as they encourage vertical integration and cannot readily be collected on imports or rebated on exports. In the case of nonfinancial activities, however, there might be some justification for such a tax earmarked for the finance of the Road Fund. In any event, adverse effects are mitigated by the relatively low rate of tax, but a substantial increase in rates would be worrisome.

Third, the design of the turnover tax seems to be totally independent of, and inconsistent with, the remainder of the tax code. First, one benefit of the new tax code is the creation of a modern tax on value added. Reversion to a turnover tax, besides being archaic, necessitates calculation of an entirely new tax base, together with all the problems of compliance and the administration that implies. In the case of the tax on entities engaged in stock exchange activities, insurance, and banking, there is no indication how the base of this tax relates to the calculation of income for tax purposes. All things considered, it would have been much more efficient simply to designate a portion of general revenues, perhaps from VAT, for support of the Road Fund.

The retail sales tax on gasoline and motor fuel is also an unfortunate development. While this tax is conceptually appealing, there is very little chance that it can be administered effectively, given the nature of retail distribution of motor fuels and administrative resources in Kazakhstan. Except for the agreements with other members of the CIS, it would have been preferable to introduce a small surcharge on the excise tax on motor fuels.

ADMINISTRATIVE MATTERS

The tax code covers administrative matters, as well as tax structure. Administrative procedures apply to all taxes, except where otherwise provided.

Registration

All taxpayers must be assigned a unique registration number, as must all persons who are not taxpayers who make payments that are taxed as source. This registration number is to be used for all taxes. It must be provided to all payers of income, as well as

used on all tax declarations, other tax-related documents, and correspondence with the tax authorities.

Audits

Audits cannot be conducted more frequently than every six months for one tax and annually for “complex audits.” The statute of limitations provides that STC can make or amend a tax assessment and the taxpayer can claim a refund or credit within five years of the tax period.

Appeals

Taxpayers who dispute assessments made by STC can appeal, first to STC in an administrative procedure and then to a higher organ of STC or a court. If appeals are not reviewed within 30 days, the taxpayer can appeal to the next higher organ of STC or to the courts. A notice of assessment must include information on appeals procedures.

The taxpayer is entitled to present documents in evidence of the right to tax preferences; to examine evidence of audits; to offer explanations of the calculation and payment of taxes; to appeal decisions of the tax authorities; and to withhold documents not related to taxation. Communication with taxpayers is to be in writing.

Collection Techniques

The tax code provides STC with strong collection techniques. Banks can be required to assign priority to collection orders from STC.³¹ Where the taxpayer’s bank accounts lack sufficient funds to discharge obligations for taxes, penalties, and interest, STC can demand payment from the accounts of the taxpayer’s debtors. STC can also prohibit all bank transactions by the taxpayer. Banks are liable to strong sanctions for failure to comply with orders from STC (for example, a penalty of 5 percent of banking transactions that have been prohibited).

STC can limit the taxpayer’s right to dispose of property if neither the taxpayer nor debtors has adequate funds in the bank to

³¹ Where the taxpayer lacks sufficient funds in an account denominated in tenge, STC can demand payment from accounts in foreign currency.

discharge obligations to STC. Property seized from taxpayers can be sold at a public auction, with the taxpayer receiving the excess proceeds of the auction, after discharge of tax liabilities. STC is also empowered to suspend the taxpayer's export operations, by seizing exports.

Penalties

Overdue tax payments are subject to a penalty of 150 percent of the refinancing rate of NBK. The same rate applies to late refunds of amounts owed the taxpayer. A monthly fine equal to 5 percent of the amount payable is imposed for late filing of tax returns. A fine of 100 percent of the amount in question is applied to understatement of tax, understatement of monthly advance payments, and unreported disposal of goods.³² There is no indication of whether the same understatement (for example, sales) can trigger two or more fines.

Organization of the State Tax Committee

STC is organized along hierarchical lines. The President appoints the head of STC, who then appoints the directors of the tax inspectorates for *oblasts*, *rayons*, towns, and *rayons* within towns. The tax inspectorates for these jurisdictions are subordinate to the inspectorate immediately above it in the hierarchy. In an important change from prior law, because it reduces the tendency to dual subordination, *oblast* authorities do not have the right to approve appointments of *oblast*-level tax administrators.

Confidentiality of Taxpayer Information

STC and its employees are to keep taxpayer information confidential. They can disclose such information only to other employees of STC, law enforcement agencies, and courts, and only when needed for the discharge of official duties related to determination of taxpayer liability, enforcement of tax laws, and adjudication of disputes regarding taxation. As provided by international treaties, taxpayer information can be shared with tax authorities of other countries.

³² Note that while the first of these involves fines equal to the amounts of understatements of tax, the last apparently involves a fine equal to the understatement of sales (or other disposal).

Conflicts of Interest

To prevent conflicts of interest, members of STC cannot engage in business activity or work for other organizations except for scholarly and teaching activities. Nor can they engage in official duties with respect to taxpayers who are closely related or in which they have or their family has a direct or indirect financial interest.

Comments on Administrative Matters

Codification of administrative issues is a positive development. However, the new tax code contains some questionable features. First, despite statements that charge STC to be evenhanded, it appears that there is the risk of bias against the taxpayer. This is evidenced, for example, in the extremely strong collection measures placed at the disposal of STC, such as suspension of banking transactions and export activities, the capacity to collect unpaid taxes from the taxpayer's debtors, and the sanctions that can be levied against banks that do not satisfactorily discharge their responsibilities in restricting the activities of delinquent taxpayers.

Moreover, the designation of part of the revenues resulting from audits to incentives for personnel of STC (repealed in Decree 2703) has both advantages and disadvantages.³³ While such incentives may be appropriate under carefully controlled conditions, they risk running counter to the legal mandate that STC is to "strictly observe and protect the rights of taxpayers and the interests of the State." They might lead to improved performance and provide a way of combating the problem of dual subordination of the tax administration to *oblast* officials, as well as STC. STC would have an independent source of the funds needed to provide housing, office space, computers, and so on. But the incentive is for *more* revenue, not *accurate assessments*. This risks creation of incentives toward overtaxation. It is notoriously difficult to create incentives for accurate assessment.

It appears that far too little advance preparation went into implementation of the new tax code. This is perhaps the inevitable result of the attempt to implement on 1 July 1995 a law that had only been approved on 24 April of the same year. Before 1 July 1995,

³³ Decree 2235 provided that 30 percent of the additional assessments for tax and penalties resulting from audits be devoted to social development, material and technical support, and financial incentives for STC. While the draft law on taxation of mineral resources would have restored this incentive, decree 61-1, as actually enacted, does not contain this provision.

both taxpayers and tax administrators learned about the new tax code primarily from published accounts in newspapers and other mass publications; there were no information pamphlets for taxpayers, apparently because there was no funding for this purpose, and tax administrators had training seminars beginning only in June, less than a month before the effectivity date of the new code.

There is an urgent need for training in at least the following areas: debt collection, the interface of accounting reform and tax reform, audit of taxpayers transacting business primarily (or heavily) in cash, and audit of taxpayers with computerized accounts. Training for the tax police, the enforcement arm of STC, would also be appropriate.

More generally, it would be appropriate to institutionalize a professional training component within STC. The approach used to disseminate the new tax code, “cascading” lectures in which tax administrators from the *oblasts* are given lectures in Almaty and sent home to reproduce them for their staffs, depends heavily on the motivation and communication skills of those relaying the message. It is not likely to be as effective as a professional training institute using carefully crafted instructional materials.

Increased training will not yield long-range results unless it is accompanied by increased compensation for tax administrators. If pay is not comparable to that in the private sector, those who have been trained at public expense or with foreign technical assistance will simply be hired away by private firms, including local offices of foreign accounting firms.

There appears to be less separation of functions than is commonly found in tax administrations of advanced Western countries. This results in the loss of potential economies of specialization and scale. Particularly problematic is the failure to separate collection from assessment; a given tax administrator is responsible for both functions in dealing with a particular set of taxpayers. This arrangement suffers from several defects. First, the skills needed to assess taxes and to collect taxes are very different. Moreover, the need for the tax administrator to maintain friendly relations with the taxpayer may discourage the use of aggressive collection techniques where they would be appropriate. Second, this arrangement prevents collection effort being devoted to taxpayers where the expected payoff (tax due, multiplied by the probability of collection) is the greatest. Given the enormous amount of tax arrears (more than T20 billion) and its rapid growth from T8 billion in January 1995, this issue deserves urgent attention.

PROTECTING THE TAX CODE: RECONCILING STABILITY WITH REVISIONS

The Government of Kazakstan deserves considerable praise for its acceptance of the importance of stability in its tax legislation, and for its adherence to the principle of stability in the face of pressures from both domestic interests and international organizations to make ad hoc changes to the new tax code. The primary exception, and it is an important and unfortunate one, is the limitation on the deductibility of labor costs. The government recognizes that potential investors will be wary of making long-term commitments in a country with an unstable tax system. Moreover, as experience in Eastern Europe has shown, rapid changes in tax laws hinder the ability of both taxpayers and tax administrators to comply with the law. Also, the budget for 1996 was formulated on the basis of the existing law. Finally, stability is important for political reasons to show that the government can deliver on this one important promise. Yet there are several areas in which revisions to the new tax code are needed. This section discusses two types of revisions that can and should be made now without undermining stability, the need to resist “tax deform,” and procedural safeguards that should be put in place to protect stability in the future.

Technical Corrections

Some of the needed revisions involve what might legitimately be called technical corrections, places where the language of the tax code is unclear or the code reaches effects that appear to be different from what was intended. There is probably little disagreement that these issues can be resolved without undermining stability, and should be resolved, as long as revisions do not go beyond correction of technical inaccuracies.

Policy Issues

More important are issues of policy – areas where the tax code reflects bad policy – or at least fails to reflect good policy. The most important of the policy-related defects in the existing code threaten foreign investment every bit as much as legislative instability. Thus, it is imperative that they be corrected at the earliest opportunity. Among the most egregious examples of bad tax policy

are the short limit on the carryforward of losses and the lack of exemptions for allowances of expatriate employees. Far from undermining investor confidence in the stability of the tax system of Kazakstan, correcting these defects at the earliest opportunity will actually enhance the reputation of Kazakstan as a place to do business.

Resisting “Tax Deform”

If revision of the tax code is undertaken to make technical corrections and correct policy defects, there is considerable risk that provisions inconsistent with the concepts underlying the new tax code, for example, the limitation on the deduction of labor payments (enacted in Decree 2703, but never implemented), will also be proposed, given serious consideration, and even enacted. Such proposals for “tax deform” may well include provisions for tax benefits that are overly generous, such as the tax holidays introduced in 1997, as well as provisions that are inimical to investment. These should be resisted in the interest of protecting both tax revenue and the principle of stability.

Safeguarding the Process

Even if technical corrections and needed revisions of policy can be implemented now, without “tax deform,” there will be a continuing problem of protecting the tax code (and thus stability) from ad hoc amendments that would be inconsistent with the concepts underlying the new code. This is especially true, given the apparently universal proclivity of members of legislative and executive bodies around the world to propose amendments without adequate analysis. This tendency is aggravated by the lack of an expert tax policy staff in the Parliament of Kazakstan. It is thus important to establish obligatory procedures whereby MOF and STC act as “gatekeepers” for all proposals to modify the tax code, examining them in detail and making a report, before the changes can become part of a formal recommendation to the government. To minimize the risk of ad hoc amendments, it might also be appropriate to specify that changes to the tax code can only be enacted once a year.

Consideration might be given to including such restrictions in the next set of amendments to the tax code. Being procedural, such restrictions could not be said to undermine stability. Indeed, they would obviously increase stability.

Appendix

Technical Corrections

“Grandfathering” Prior Commitments

Important investments have been made in Kazakhstan, relying for their tax treatment on either contracts with the Government of Kazakhstan or the Foreign Investment Law in effect at the time commitments were made or contracts were signed. A guarantee of tax stability is a key feature of many such contracts. In some cases the new tax code provides tax treatment that is less favorable than anticipated in such prior laws and contracts. The new tax code (in Articles 1 and 2.3) explicitly appears to void all such prior laws and contracts. While Article 179, paragraph 2 (inserted into the code by Decree 2703) “grandfathers” certain contracts concluded before 1 July 1995, Article 94, paragraph 4 may provide compensation in a limited number of cases. They do not solve the problem, in part because they apply only to the natural resource sector, and then only to projects that are profitable. (Many such exploration ventures end in a total loss. Moreover, the government may not retain a large enough share to be able to make the compensation envisaged.) Besides being unfair, this practice of retroactively changing the tax treatment of investment is highly inimical to the development of an investment-friendly climate in Kazakhstan; indeed, it violates the very heart of stability. The law should be amended to protect all tax provisions, including those in the Foreign Investment Law and contracts with the government, under which foreign investors made investments.

Employment Income from Kazakhstan Source

Article 5, paragraph 6, needs to be amended to include a definition and method of calculation of employment income from Kazakhstan source, where the employee is employed by the same employer both inside and outside Kazakhstan during the year. The following definition, which foresees the possibility of employment by more than a single employer during the year, is suggested:

If an employee is employed by a given employer both inside and outside the Republic of Kazakhstan during the year, employment income from Kazakhstan source is calculated by multiplying the employee’s

total taxable income from employment by that employer by a fraction, the numerator of which is the number of days the employee was present in the Republic of Kazakhstan while employed by that employer and the denominator of which is the total number of days during the year the employee was employed by that employer.

Definition of Business Activity

STC has been interpreting the wording of the first paragraph of Article 51 (“Individuals engaged in business activity”) to require advanced payments of tax from individuals working under employment contracts. Article 5 should be amended by adding the following definition:

Individuals involved in business activities are those who employ themselves and control their own business activities.

Clarification of Days in Kazakhstan

A literal reading of the instructions interpreting paragraph 22 of Article 5 could give the following unusual and onerous result: “Suppose an individual who was resident in Kazakhstan in Year 1 left the country on Day 2 of Year 2 and did not return until Day 363 of Year 3 (almost 24 months later) and then became a resident during Year 4. Under the current interpretation, the individual would be deemed to be a resident (and thus subject to tax on worldwide income) for the entire 4-year period, including Years 2 and 3 (during which time he was in the country less than one week).” Paragraph 22 of Article 5 needs to be amended by adding the following:

If an individual is continuously physically absent from the Republic of Kazakhstan for a period of at least 12 months, then the counting of days for residency will begin again; if an individual becomes resident again after being absent continuously for a period of 12 months or more, then the individual will not retroactively be deemed to have been a resident for the previous time spent outside Kazakhstan.

Limitations on Interest Deductions

Article 16 of the new tax code seems to envisage only borrowing in the local currency. To take account of loans in hard currency, Article 16 should be revised as follows:

Article 16:

Interest on credit shall be deductible within the following limits:

On loans in the national currency: 150 percent of the refinancing rate of the National Bank of Kazakhstan on the date the credit is granted;

On loans in hard currency: 150 percent of the London Interbank Offer Rate on the date the credit is granted. (Note that there is still an issue of debt in rubles.)

Withholding on Cost Reimbursement

There should be no withholding tax on payments from a Kazakhstan entity to a foreign entity, where the payment is made only to reimburse the foreign entity for costs incurred in providing services to the entity in Kazakhstan (the payment does not contain a profit component). Also the wording of Articles 33 and 36 should be made consistent. The following insertions to Articles 33 (italicized) and Articles 36 are proposed:

Article 33:

. . . without deduction, *provided the source of income is in the Republic of Kazakhstan* at the following rates:

Article 36:

There will be no withholding tax on payments made solely to reimburse foreign entities for expenses incurred in Kazakhstan.

Withholding on Income of Permanent Establishments

There is some confusion about whether income of permanent establishments is subject to withholding. Article 35 should be amended by adding the following sentence:

Article 35:

This income shall not be subject to withholding at source, regardless of where it is received.

Disallowance of Deductions for Nonbusiness Expenses

Paragraph 3 of Article 48 seems to be much too broad; strictly interpreted, it would appear to deny deductions for wages and salaries (which are income of employees) and for interest income (which is subject to withholding). It would be clearer to substitute the following for the present paragraph:

3. Nonbusiness expenses that are not deductible under Chapter 4 and also dividends.

Nonpermanent Residents

The taxation of expatriates in the new tax code of Kazakhstan differs from common international practice in several important respects. The new tax code recognizes only two types of physical persons, residents, and nonresidents; the distinction is based on a 183-day physical presence rule. While nonresidents pay tax only on Kazakhstan-source income, residents are taxable on their worldwide income from all sources. Besides arguably being unfair, taxing those temporarily working in Kazakhstan on the same basis as permanent residents is likely to engender disrespect for the government and the tax system. Because it will be extremely difficult to implement, it will also foster avoidance and evasion. Finally, administration of foreign tax credit rules with respect to such persons will be a nightmare. Other countries, for example, Brazil, Chile, PRC, and Japan, provide an intermediate status between nonresidents and permanent residents, that of “nonpermanent resident.” Foreign-source income of a nonpermanent resident physical person is not included in taxable income. It is proposed that Kazakhstan follow a similar policy, by adding the following definition to Article 5 (following the current paragraph 22) and revising paragraph 2 of Article 9 to include the italicized words:

Article 5:

a “nonpermanent resident” is an individual who has lived in Kazakhstan for less than five years,

is employed by a foreign enterprise, joint venture, or cooperative joint venture, or wholly foreign-owned enterprise doing business in Kazakhstan, and has no general intention to take up long-term residence in Kazakhstan.

Article 9

The aggregate annual income of a nonresident taxpayer or a *nonpermanent resident physical person* consists of income derived from sources in the Republic of Kazakhstan. Foreign-source income of nonpermanent resident physical persons is included in taxable income only to the extent it is remitted to the Republic of Kazakhstan.

Exemption of Nonresidents in Kazakhstan for a Short Term

At present there is no distinction between someone who has been in Kazakhstan for 182 days and someone who is there only for one day; both must pay tax on Kazakhstan-source income. This is onerous to the tax administration, as well as potential taxpayers, many of whom may not even realize that they have tax liability in Kazakhstan. It would be appropriate to exempt those who are in the country for extremely short periods (say, less than 60 days in the year) from paying income tax to Kazakhstan. This can be accomplished by adding the following sentence to paragraph 1 of Article 6.

Nonresident physical persons who are present in the Republic of Kazakhstan less than 60 days during any 12-month period shall not be payers of income tax.

Taxation of Allowances of Expatriates

The new tax code provides no exemption for allowances received by foreigners working temporarily in Kazakhstan. Such allowances generally do not increase the welfare of the employee; they simply compensate for increased costs of being away from home. Employers must increase compensation enough to reimburse

employees for the income tax on the allowances. This can have one or two effects: either this higher compensation is reflected in the terms of contracts with the government of Kazakhstan or the employer will find Kazakhstan a less attractive place to do business. It is proposed that Kazakhstan, like other countries, exempt such compensation from tax, by adopting the following additions to Articles 13 and 10, paragraph 3:

Article 13:

5. In the case of nonresident and nonpermanent resident physical persons, the following are considered exempt income, within reasonable limits:

- (a) contributions made by the person's employer to the state social and pension funds of the Republic of Kazakhstan;
- (b) allowances for living expenses in the Republic of Kazakhstan;
- (c) compensation for the costs of schooling of children, food, family vacations, and similar purposes;
- (d) compensation for the cost of renting a dwelling and maintenance of a vehicle; and
- (e) business travel expenses.

Article 10, paragraph 3: Add the following sentence:

This limitation shall not apply to business expenses specified in Article 13, paragraph 5.

The application of VAT to services may not be in the best interest of Kazakhstan. (For example, because of this treatment, it is more attractive from the point of view of taxation to seek advice from a foreign firm, instead of one headquartered in Kazakhstan. Moreover, the term "goods" may be overly restrictive. Article 62 should be amended to zero rate exports of works and services, as well as exports of goods, by adding the underlined words:

The export of goods, *works, and services* . . . shall be taxed at a zero rate.