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**ROLE OF THE SERVICE SECTOR IN
KAZAKHSTAN'S ECONOMY: AN OVERVIEW**

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EXECUTIVE SUMMARY

1. Kazakhstan is a middle-income country, based on per capita income, with an ambitious goal of entering the top-30 developed countries by 2050. However, its dependence on exports of mineral resources makes it highly vulnerable to external price shocks. Another challenge is the so-called “middle-income trap”, where increased wages impede competing with both low-income and high-income countries. There are also other factors that compel finding alternative growth drivers, such as decline in economic activities in the Russian Federation, Kazakhstan’s key trading partner, or production delays at the Kashagan oil field. To overcome these challenges, the Government is making diversification into services one of the top economic priorities. In particular, tradable services (finance, insurance, real estate, education, and business services) can drive export diversification.
2. The size of the service sector has been rapidly increasing, reaching 54% of GDP and 58% in the number of employed in 2014. The largest contributor is trade, which employs every fourth person working in services, with more than half of workers being self-employed. Trade turnover accounts for 28% of total services output.
3. The service sector in Kazakhstan is dominated by traditional activities: trade, real estate, and transport. Modern services—communication, finance, and professional business services—constitute only about 13% of the economy (for comparison, in the OECD countries, they account for 17%–25%). Mainly modern service activities are tradable internationally; they have higher productivity and better wages as compared to traditional services. Kazakhstan significantly lags behind the advanced economies in services labor productivity, which can be attributed to the dominance of traditional services, which are characterized by a limited productivity upside and a high share of the informal service sector.
4. Kazakhstan is a net importer of services; in 2014, it imported two times more services (\$12bn) than it exported (\$6.3bn). However, the imports-to-exports ratio in services has declined almost twofold in the last ten years.
5. Services drive aggregate productivity, and, in turn, higher growth rates. As a result, it can be claimed that higher share of services leads to higher income per capita. However, such a relationship holds only for service activities that are either a combination of traditional and modern services consumed mainly by households (such as education and health), or modern services, intended for both households and businesses.
6. Share of services value added embodied in manufacturing increases over time. The growing interdependence between services and manufacturing leads to increased service sector value added being embodied in manufacturing.
7. The service sector plays an important role in raising manufacturing productivity and other sectors of the economy. This particularly applies to business services, as they provide key intermediate inputs, such as finance, legal services, human resource recruitment, and marketing and information technology.
8. The main service sector development issues in Kazakhstan include a high presence of traditional services (more than two-thirds of the sector), an unbalanced trade in services (imports are twice higher than exports), and service sector data availability and quality.

9. Low productivity is the most significant barrier for service growth in Kazakhstan, as shown by the empirical analysis. Other factors include the informal sector that decreases services productivity, overall governance issues such as deficiencies in the rule of law and competition, quality of education vis-à-vis market demand, and integration with more developed economies that creates both opportunities and challenges for cultivating modern services that are tradable across borders.

10. Key policy recommendations include measures to increase labor productivity, combatting the informal sector, especially in trade, setting the basis for long-term development of the modern services and promotion of services exports, development of specific sectors, and overall balance between developing manufacturing and services. In addition, general policy recommendations include the strengthening of labor and capital markets, reform of tax regimes, and elimination of burdensome regulations which typically protect incumbent firms, thus stifling competition and innovation.

A. OVERVIEW OF KAZAKHSTAN'S ECONOMY

1. Recent macroeconomic performance

11. Kazakhstan is the world's largest landlocked country and its ninth-largest country in territory with a population of just 17.5 million. With the GDP output of \$232 billion in purchasing power parity (PPP) in 2012, Kazakhstan has the largest economy in Central Asia. Kazakhstan's economy is heavily dependent on mineral resources—oil, gas, uranium, and metals—that combined account for more than two-thirds of exports. Along with the extractables, Kazakhstan is a large exporter of agricultural goods, specifically grain. Based on per capita income, Kazakhstan is considered to be a middle-income country (\$13,610 at PPP in 2013)¹, though most of its wealth is due the abundance of natural resources.

12. After gaining independence from the Soviet Union in 1991, Kazakhstan struggled to adopt a market-based economy. Thanks to large-scale reforms and increased global prices for its main exports, Kazakhstan's economy started to grow by the late 1990s, reaching, between 2000 and 2012, an average rate of over 8% p.a. that, even with two major shocks on the economy (the 2007 banking credit and real-estate crunch and the 2008 global financial crisis followed by a decline in oil prices) was second only to the People's Republic of China (PRC). Mostly due to its extractive sector, Kazakhstan in 2002 became the first country in the former Soviet Union to receive an investment-grade credit rating and enjoyed high inflow of foreign direct investment (FDI); by 2011, the country had cumulatively attracted over \$150 billion investment.²

13. In 2014, Kazakhstan's yearly economic growth rates decelerated from 6% to 4.3%, mostly due to a decline in oil production and decreased Russian and Chinese demand for metals and mining. In addition, in February 2014, the central bank conducted a one-off 20% national currency devaluation against the United States (US) dollar that caused domestic demand to weaken and presumably was aimed at helping enterprises to maintain competitiveness [IMF 2014, p. 4].

¹ World Bank
http://data.worldbank.org/indicator/NY.GDP.PCAP.CD?order=wbapi_data_value_2013+wbapi_data_value+wbapi_data_value-last&sort=asc

² IMF (<https://www.imf.org/external/np/sec/pn/2003/pn0374.htm>).

14. After a decade of mostly favorable global prices on its exports, Kazakhstan has accumulated enough additional funds and foreign exchange reserves as of February 2014³ to promote the ambitious goal of entering the top-30 developed countries by 2050. In order to achieve this, several initiatives have been launched.

15. First, due to the vulnerability of the current economic model that became obvious during the banking and financial crises, the Government announced diversification plans. The 2010–2014 Program of the Accelerated Industrial and Innovative Development (PAIID) was adopted with a total implementation budget of KZT 6.5 trillion and a target of achieving 38% GDP growth through increased productivity in manufacturing, metallurgy, and agriculture. PAIID became a basis for the 2010 Strategic Development Plan for 2011–2020 that set a target for Kazakhstan to enter the top-50 countries with the most favorable business climate by 2020. The new Program for 2015–2019 has been pre-approved with a total implementation budget of KZT 6.6 trillion, and will promote four main sectors: mineral resources extraction, manufacturing, a knowledge economy, and other sectors that will absorb labor resources freed due to increased productivity.

16. Second, Kazakhstan has been actively promoting international trade relations, becoming one of the founding members of the Eurasian Customs Union (CU) in 2010 prior to its evolving into the Eurasian Economic Union (EEU) in 2015. This allowed it to gain access to a market of over 170mn people. Kazakhstan was one of the initiators behind the Western China – Western Europe railroad project. This project allows transportation of goods from the PRC to Europe almost twice as fast as via the sea route. Kazakhstan is also a founding member of the \$100bn Asian Infrastructure Investment Bank that was initiated by the PRC in 2014. In addition, the Government expects that ongoing negotiations to join the World Trade Organization (WTO) will be finalized soon—expected this year as of March 2015—allowing Kazakhstan to fully enter the global market.

17. Third, Kazakhstan has seen gradual improvement in its overall business environment according to the World Bank's Ease of Doing Business indicator. For instance, the time for starting a business since 2004 has decreased from 26 to 10 days, while dealing with construction permits has decreased from 256 to 156 days, and property registration from 52 to 11 days. However, time to export (79 days) and import (67 days) and dealing with construction permits (as noted) remain high [WB 2013, p.3]. The Government is focused on decreasing the post-financial crisis state monopoly in many sectors of the economy, including through the next round of privatization (through the so-called "People's IPO" program). Since 2010, the Samruk-Kazyna National Welfare Fund, which manages state stakes in the economy was estimated to hold around 60% of the country's GDP, including national telecommunications champion KazakhTelecom, national railroads company KazTemirZholy, national electricity grid operator KEGOC, the national oil and gas company KazMunaiGaz, and others [UNECE 2012, p. 3].

18. In response to the changing external environment, i.e., lower global prices on oil and metals and economic slowdown in Russia, the Government has announced counter-cyclical fiscal measures. In 2014, there was a \$5.5bn investment from the National Fund, which provided the banking sector with resources to resume lending following an unsustainable growth in non-performing loans, which now constitute one-third of the banks' portfolio. The situation with lending further worsened after the currency devaluation in 2014, particularly in the only growing segment of retail lending. Another investment from the National Fund is a \$3bn annual transfer to the state budget for infrastructure projects during 2015–2017.

³ National Bank of Kazakhstan. <http://nationalbank.kz/?docid=343&switch=russian>

19. To summarize, the economy of Kazakhstan has faced some serious challenges in 2014–2015, including the drop in prices for its major exporting goods and the economic slowdown and significant currency devaluation of its main trading partner. However, reserves that were accumulated during the earlier years have helped to mitigate these negative effects.

2. Sector performances and trends

i. Overview of the current situation

20. **Agriculture.** Kazakhstan is widely regarded as a key player on world agricultural markets, with considerable wheat, beef, and dairy export potential.

21. Over 80% of the country's total area is classified as agricultural land, including almost 70% occupied by pasture. Arable land constitutes less than 10% of the country's total land area, but its availability per inhabitant (1.5 hectares) is the second-highest in the world after Australia (2.1 hectares).

22. After the dissolution of the Soviet Union, agriculture in Kazakhstan experienced a difficult transition to a market economy. A gradual recovery began in the early 2000s, followed by a rise in Kazakhstan's total trade in agro-food products, when it became one of the world's top grain exporters.

23. Agriculture contributed 4.6% of Kazakhstan's GDP in 2013 and 24% of its employment. Two-thirds of all workers employed in agriculture were informal (in the official statistics sources, the term “self-employed population” is used). Agricultural output reached \$15.5bn in 2013, of which 55% was crops and 45% livestock. Share of services in agriculture has been increasing; however, it still does not exceed 0.5% of total output.

24. Government support to agriculture in Kazakhstan over the 2009–2011 period, measured by the OECD Producer Support Estimate, was KZT 200bn (\$1.36bn) per year. This represents an average of 11% of farmers' gross receipts, which is below the average for OECD economies. Total support for the agricultural sector as a percentage of GDP according to the OECD has declined in Kazakhstan from 1.7% in 1995–1997 to 1.1% in 2010–2012 due to accelerated GDP growth. The share of services in the total agricultural support increased from 11.5% in 1995–1997 to 23.1% in 2010–2012.⁴

25. In Kazakhstan, a clear dominance of large agricultural holdings can be observed, with the 20 largest companies producing about 80% of the grain output. To compare, in Russia, 200 companies control about 25% of the country's grain output [EC 2012, p. 2].

⁴ General Services Support Estimate as a percentage of Total Support Estimate, according to OECD.

Table 1. Dynamics of the production volume and the structure of the agricultural sector in 2000–2013

	in \$bn			in % of Total		
	2000	2005	2013	2000	2005	2013
Total						
Enterprises	0.7	1.3	3.7	25	23	24
Farmers	0.6	1.2	4.8	22	21	31
Households	1.5	3.1	7.0	53	56	45
Total	2.8	5.6	15.5	100	100	100
Crop						
Enterprises	0.6	1.1	2.9	38	36	34
Farmers	0.5	1.0	3.8	35	34	45
Households	0.4	0.9	1.8	27	29	22
Total	1.5	2.9	8.5	100	100	100
Livestock						
Enterprises	0.1	0.2	0.8	8	8	11
Farmers	0.1	0.2	1.0	5	6	14
Households	1.1	2.3	5.2	87	86	75
Total	1.2	2.7	6.9	100	100	100
Services						
Enterprises	0.01	0.03	0.06	100	100	100
Farmers						
Households						
Total	0.01	0.03	0.06	100	100	100

Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2014, p. 13]

26. **Industry.** The industrial sector (including construction) employs one-fifth of the workers in Kazakhstan and produces one-third of the GDP. The industrial sector has been rapidly growing, accompanied by growth in mining which was mainly driven by increased oil production. In 2013, the sector grew moderately by 2.5%, mostly due to mining sector growth (+3.3%).

27. **Oil and gas sector.** Oil production represents about one-fifth of Kazakhstan's GDP and approximately 60% of total merchandise exports. With a production level of about 1.64mn barrels per day in 2013 [EIA 2013, p. 1], Kazakhstan is one the largest oil producers in the world with a 3.5% share of global crude petroleum export in 2012.⁵

28. **Manufacturing.** The manufacturing sector is predominantly oriented around the mining sector, with three-fourths of the output coming from four sectors: metals processing and production (30% of total output in 2013), food production (17%), machinery (15%), and oil processing (14%).

⁵ Refer: http://atlas.media.mit.edu/explore/tree_map/hs/export/show/all/2709/2012/

Table 2. Dynamics of the production volume and the structure of the industrial sector in 2000–2013

	in \$bn			in % of Total for the Industry		
	2000	2005	2013	2000	2005	2013
Industry	5.8	16.9	64.8	100	100	100
Mining	2.3	8.9	35.6	40	53	55
Manufacturing	3.0	6.8	24.9	51	40	38
Utilities	0.5	1.1	4.4	9	7	7
Construction	0.9	4.4	13.9	-	-	-

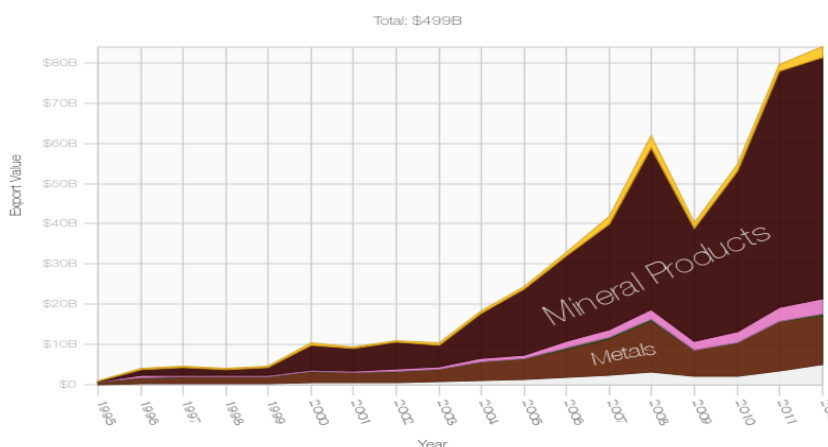
Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2014(1), p. 7]

29. **Construction.** The construction sector has been showing lower growth rates than the economy (on average +3% annual growth in 2010–2013), since showing negative growth after it was hit by the global financial crisis in 2009. However, its 6% share in the 2013 GDP is significantly lower than its pre-crisis level when it was 10% of GDP. Construction employs 8% of all workers in Kazakhstan, with one-third being employed informally.

ii. Industrial Diversification Challenge

30. Lack of economic diversity remains Kazakhstan's biggest challenge. According to the Harvard-MIT Observatory of Economic Complexity in 2012, Kazakhstan's Economic Complexity Index (ECI)⁶ of 0.049 showed high concentration in its exports structure (data is based on exports and not goods produced). The highest score in 2012 was 2.23 for Japan and the lowest was -2.9 for South Sudan.

Figure 1. The dynamics of exports from Kazakhstan by major products types



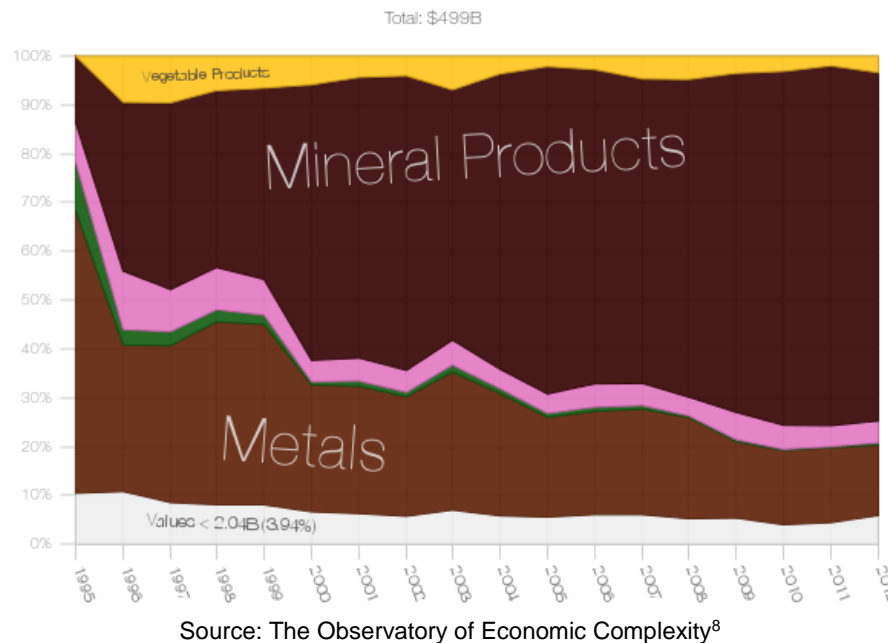
Source: The Observatory of Economic Complexity⁷

⁶ ECI considers information on the diversity of countries and the ubiquity of products, and is able to produce a measure about both the diversity of a country's exports and their sophistication. According to the relevant statistics models, the ECI is a more accurate predictor of GDP per capita growth than traditional measures of governance, competitiveness (World Economic Forum's Global Competitiveness Index), and human capital as measured in terms of educational attainment.

⁷ <http://atlas.media.mit.edu/profile/country/kaz/>

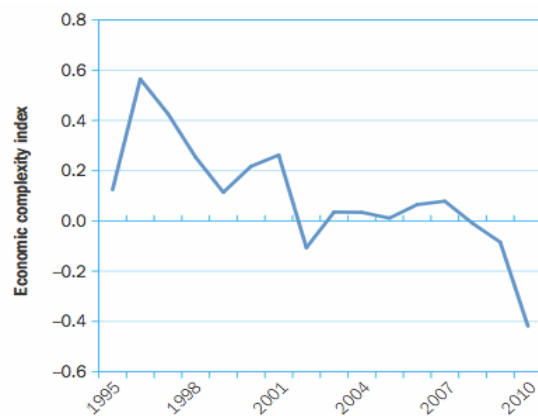
31. Due to its export-oriented mineral-resource-producing structure, the economy of Kazakhstan is highly vulnerable to the external shocks – specifically, to changes in world prices of its main exporting goods (oil, metals and grain). Hence the urge for diversification is one of the top priorities for the current economic policy.

Figure 2. The export structure of Kazakhstan



32. In addition, over the last two decades, the ECI has been steadily declining reflecting the impact of the so-called “Dutch disease” that leads to higher specialization in mineral resources production and exports due to outflow of capital and skilled labor resources from non-mineral sectors.

Figure 3. The Economic Complexity Index of Kazakhstan



⁸ <http://atlas.media.mit.edu/profile/country/kaz/>

33. Kazakhstan still has a scope for expanding its traditional sectors into more downstream complex processing activities, as well as developing more advanced manufacturing and services, with or without Government support. However, as Kazakhstan is the largest landlocked country in the world, one of its main challenges is to overcome high transport costs for manufactured exports (and corresponding import of parts and components) that limit the scale economy for many manufacturing industries.

34. One of the possible solutions for this problem can be development of services such as finance, insurance, real estate, education, and business that can be exported to any part of the world without significant transportation costs. Moreover, such services offer opportunities for diversifying and for implementing indirect industrial policy.

35. One of the sectors with high growth potential could be digital content creation and software-related services. The current state of the ICT infrastructure in Kazakhstan is sufficient to develop such services. There are good examples how some former Soviet member states with comparable education levels (e.g., Russia and Estonia) and sometimes even lower income levels (e.g., Ukraine) have done well as centers for software programming business process outsourcing (BPO), and as hubs for multinationals and global software startups (e.g., Skype, Yandex).

36. As mentioned above, such ICT-enabled export services are not constrained by the high physical transport costs for manufactured products, and can be located in any regional hub that has good ICT infrastructure, becoming a potential source of new employment for the regional hubs and their satellites. In addition, with the rapid growth of digital media, especially mobile applications, Kazakhstan can leverage its Russian-language capability to produce content for the Russian-speaking population at large, in addition to domestic consumption.

37. Comparing Kazakhstan to various former Soviet Union states suggests that it has lagged behind its potential in terms of BPO and digital content services. Indeed, even neighboring Uzbekistan, with lower per capita income and less economic integration with Russia and Belarus, has developed a stronger reputation for such ICT-enabled services. One of the obstacles to ICT in Kazakhstan could be the relatively low priority accorded by the Government to the promotion of high-quality ICT education and digital media services industry [ADB 2014, p. 98].

3. Medium-term prospects and risks for economic growth

38. According to the Government's plan, the GDP per capita in Kazakhstan will grow to \$13,900 in 2015 and \$21,400 in 2019, if the annual growth rates in 2015–2019 hold at 5.0%–6.6%. To reach these ambitious goals, the economy needs to overcome some of the major challenges listed below.

i. Middle-Income Trap

39. Countries fall into the middle-income trap if they are unable to move from a low-cost to a high-value economy due to increased wages, which impede their competing with both low-income and high-income countries. Based on monthly average wage (in PPP), Kazakhstan in 2012 ranked 53rd with \$753, as compared to \$1,215 in Russia, \$959 in Belarus, and \$656 in the PRC.¹⁰

⁹ <http://atlas.media.mit.edu/profile/country/kaz/>

¹⁰ <http://www.statista.com/statistics/226956/average-world-wages-in-purchasing-power-parity-dollars/>

40. Many countries experience a growth slowdown after achieving middle-income status. More than 15 countries globally have been “middle income” for at least 50 years, including three in Asia: Malaysia, the Philippines, and Thailand. According to the World Bank, Kazakhstan in 2013 was an upper-middle income country with GNI (PPP) per capita of \$11,790 comparable to the PRC with \$11,850, while Russia was a high-income country with \$22,880.¹¹

41. One way to avoid the middle-income trap is to diversify the economy and intensify efforts to find new sources for economic growth. This need for industrial diversification is especially relevant for Kazakhstan as explained earlier. It is expected that developing the service sector could become a new source for economic growth in Kazakhstan. Increasing labor productivity through stimulating formal employment, wherein workers get more on-the-job training and development through constant rotation, can be another tool to avoid the middle-income trap.

ii. Structural reforms

42. In 2000, privately owned entities accounted for 76% of GDP. However, by 2013, the Samruk-Kazyna state-run fund owned assets worth \$103bn, accounting for just over half of GDP [ICG 2013, p. 9]. This was mainly driven by the windfall profits accumulated during high oil prices and the active role that the Government played to overcome the global financial crisis in 2009–2010. Despite public management inefficiencies, there is still a resistance to decreasing the directive role of the state, especially during times of stable revenues.

43. According to the International Monetary Fund (IMF), the government’s diversification agenda focuses heavily on top-down industrialization, while progress on broad-based institutional reforms remains slow. Moreover, inefficient and nontransparent public spending may lead to waste and lower long-term growth [IMF 2014, p. 34].

44. Though increasing the state’s role in economic activity may negatively affect Kazakhstan’s prospects of becoming a dynamic emerging market, its focus on broad-based structural reforms, which would include, among others, private sector stimulus packages, education and judiciary system reform, can boost human capital and the country’s institutions. In addition, political commitment to reforms and high efficiency standards in all public spending would facilitate inflow of foreign and local investment.

iii. Recent drop in oil prices and Kashagan oil field

45. The recent plunge in global prices of oil and metals is the single most important external shock affecting Kazakhstan’s economy. The current economic model is built around production and exports of minerals with low value added. The extensive growth of oil production is directly linked with discovering and developing new oil fields, one of which is the giant Kashagan field.

46. With \$50bn invested over the past 17 years, the Kashagan oil field is one of the world’s largest industrial projects and the largest oilfield outside the Middle East. According to some estimates, Kashagan oil production could bring additional 0.3% GDP growth in 2014 and 1% in 2015. It is expected that Kashagan will increase Kazakhstan’s oil production by one-third within five years (from 82mn tons in 2013 to 110mn tons in 2018). Kashagan has already had an impact in terms of bringing foreign investment to the country, with the total amount of local goods, works, and services procured by the operator reaching \$9bn in 2006–2013.¹²

¹¹ <http://data.worldbank.org/about/country-and-lending-groups>

¹² http://www.ncoc.kz/ru/mediacentre/2013/PressRelease-ru_30.06.2013.pdf

47. The Kashagan oil field, which has recoverable reserves of about 13 billion barrels, is considered one of the most technologically challenging in the world due to its offshore nature and the cold climate. The international consortium developing Kashagan includes the industry's largest companies that use technologies specifically designed and produced for the Kashagan field. Consortium members and their respective shares in the project are as follows: KMG Kashagan B.V. (16.87%), AGIP Caspian Sea B.V. (16.81%), CNPC Kazakhstan B.V. (8.3%), Exxon Mobil Kazakhstan Inc. (16.81%), INPEX North Caspian Sea Ltd. (7.56%), Shell Kazakhstan Development B.V. (16.81%), and Total E&P Kazakhstan (16.81%).¹³

48. The official launch, which was postponed several times due to the above-mentioned challenges, finally occurred in September 2013 -- only to be stopped two weeks later due to technical issues. The reason for the production stop was that its onshore pipeline did not meet the quality requirements.

49. As of now, there is no clear date for the project to become operational, with the Ministry of Oil and Gas referring to the first half of 2016 as an optimistic scenario, while the CEO of Total oil company stating that it is more realistic that, due to sanctions on Russia, multinational oil companies will not start production until 2017.¹⁴ It is expected that until then, the Government will have to put more emphasis on onshore fields in order to maintain current levels of production.

iv. Russian economy slowdown and sanctions

50. In 2013, Russia's GDP growth was at 1.3%, despite the oil prices of well over \$100 per barrel. The IMF forecasts even lower growth of 0.2% and 1.0% accordingly in 2014–2015, even with the projected favorable oil prices [IMF 2014(1), p. 36]. The slowdown in the Russian economy is a problem of capacity, with little unused labor (unemployment is at historic low of 6%) or idle production that can be revived by stimulating the economy.

51. Though it is the world's eighth-largest economy according to the World Bank, Russia needs to improve its labor productivity, which is two to three times below that of advanced economies. The extensive growth phase is coming to an end, with the need for intensive growth quickly becoming crucial.

52. In order to return to high growth, Russia needs to reform its economy, though there is a high chance that this could be postponed until the Ukraine crisis resolved and the Western economic sanctions are lifted; most probably, unpopular social reforms will not occur before elections to Duma (Parliament) in late 2016.

53. Due to the above-mentioned reasons, Moody's and Fitch revised the outlook on Russia's sovereign BBB rating from stable to negative, while Standard & Poor's downgraded the foreign-currency credit rating to junk, putting it below investment grade for the first time in a decade.

54. According to the IMF estimates, a 1 percentage point reduction of Russian growth would, through trade and FDI, impact Kazakhstan's growth in the range of 0.1–0.2 percentage points [IMF 2014, p.10].

¹³ <http://www.ncoc.kz/en/ncoc/co-venturers.aspx>

¹⁴ <http://news.nur.kz/333221.html>

55. The impact of an economic slowdown and sanctions on Kazakhstan's economy is expected to be limited, according to President Nazarbayev. However, he expects that some Russian factories might decrease their purchase of goods (mostly mineral goods) from Kazakhstan. On the other hand, Russia is imposing its own sanctions to limit the import of some goods from the EU and the US, which incentivizes food product imports from Kazakhstan.¹⁵ In the meantime, Kazakhstan, along with its Customs Union partner Belarus, may become a re-exporting hub for goods from Russia to the EU, especially non-marked goods like metals and grain.

56. According to the IMF, the impact of Russia-Ukraine tensions has been limited, though may have contributed to weaker investor sentiments and pressures on the tenge [IMF 2014, p. 10]. Nevertheless, further unfavorable developments will have more serious negative consequences. Russia accounts for about 8% of Kazakh exports and for about a third of imports, of which capital and intermediate goods are a significant share. Thus growth may be negatively affected through weaker exports, as well as the higher cost of imports of capital and intermediate goods, especially given the ECU with Russia. Growth could also be impacted through lower investment by a number of Russian companies, mostly in the oil and minerals sector.

57. In the event sanctions persist, a more significant impact can be expected, especially in terms of attracting foreign investment. Increased country risk will raise external loan prices for companies in Kazakhstan. Projects that were planning to attract foreign investment may also be delayed. Also, capital drain may accelerate in the form of dividend payments.

58. The tensions could have much more serious implications in case of spillovers in Europe through disruptions in gas exports via Ukraine. Other potential indirect effects include, on the negative side, lower global growth and increased risk premium; on the positive side, higher oil and grain prices. Finally, in the financial sector, the three Russian-owned banks, that is, Sberbank, Alfa, and VTB, account for about 9% of Kazakhstan's banking system assets; further sanctions could impact their local activities [IMF 2014, p. 10].

61. Despite the 19% devaluation of the tenge in February 2014, the rouble exchange rate dropped 40% by the end of the year. Kazakhstan is putting in place various fiscal, monetary, and administrative measures to minimize the impact, for example, tapping into the National Fund for additional funds (a \$5 billion loan in 2014 and the \$9 billion infrastructure investment-based program Nurly Zhol for 2015–2017). Nevertheless, in 2015, a further slowdown, primarily due to low oil prices and gradual weakening of the currency, can be expected.

v. *Inclusive growth*

59. Non-inclusive growth poses high risks for developing economies, including such social risks as income inequality, with youth, especially from rural areas, being particularly vulnerable. Kazakhstan's economic growth can be assessed as somewhat inclusive based on the official data. The average annual real income in 2000–2013 grew by 9.6%.¹⁶ At the same time, the Gini index that measures income distribution deviation from a perfectly equal norm (index of 0 represents perfect equality, while an index of 1 implies perfect inequality) declined from 0.32 in 1996 to 0.28 in 2013.¹⁷ These official indicators are in noticeable contrast with widely-shared observations of sharply increased income and non-income inequality, the stratification in the Kazakhstan's society, and the rising social tensions. Further efforts, especially in employment creation, are needed to

¹⁵ <http://www.zakon.kz/4648562-sankcii-k-rossii-naprijamuju-kazakhstana.html>

¹⁶ <http://stat.gov.kz/getImage?id=ESTAT086616>

¹⁷ <http://stat.gov.kz/getImage?id=ESTAT086621>

reduce the growing income gaps. Recent efforts to further reduce income inequality by promoting faster employment growth have been relatively weak. Furthermore, despite some progress, rural poverty rates are still relatively high.

60. The unemployment rate has declined rapidly since 2000, but around 30% of the workforce remains vulnerable, being, for example, self-employed or unpaid family workers. Productivity growth in the oil-extracting regions was fueled by large capital investments, while employment creation was limited. Also, the relationship between job creation and growth has been weak, particularly since the global crisis.

61. Macroeconomic stability, human capital, and structural changes are key determinants of inclusive growth in emerging markets, according to the World Bank, with other factors being lower initial income level, trade openness, fixed investment, moderate inflation and output volatility, and a better-educated workforce, as well as FDI [WB 2013(1), p. 6].

62. Another way to conceptualize inclusive growth is through linking underdevelopment with a key institutional weakness, namely that much potentially productive capital in developing countries is outside the system of formal property rights. In developed countries, property rights systems are mature, allowing capital to be leveraged extensively for productive activity; in developing countries, it is often very difficult to establish clear rights to property in the first instance, let alone enjoy the benefits of a formal property rights system. The productive capacity of the economy is thus restricted, and wider participation in the formal economy is hindered, encouraging enclave-like development that only benefits the few [IMF 2012, p. 4]. This is also relevant to Kazakhstan's case with its still high share of informal economy that needs to be addressed.¹⁸

vi. Eurasian Economic Union

63. Since 2010, when the CU was established, Kazakhstan's exports to the member countries have doubled, while for other trading partners, export growth was lower. As a result of deepening economic integration, the number of joint ventures with the CU countries grew, compared to decline in the number of enterprises with other countries. During 2010–2013, Kazakhstan's CU imports have tripled, while those from the PRC have doubled. The main trading partner of the country, Russia, accounts for two-thirds of net imports.

64. Kazakhstan's trade deficit with Russia accounts for 5% of GDP. Due to stronger ties with the Russian economy, the increased trade deficit promotes a devaluing pressure on the tenge. This fact once again became apparent in February 2014 during the devaluation that was mainly caused by the weakening of the Russian currency and in anticipation of economic slowdown.

65. Despite the obvious short-term negative effects from the EEU, there is a set of possible opportunities for Kazakhstan emerging from its membership in the Union. Russia is one of the 10 largest economies in the world,¹⁹ with a market size that is 10 times larger than that of Kazakhstan. Even more important is that the technological difference between companies in Kazakhstan and Russia has not widened as much as with the more developed countries of Europe and Asia and

¹⁸ One possible means of formalizing potentially productive capital is through legalization (of money or assets). This solution, which is especially popular in emerging economies as it can provide immediate results, has been widely used in Kazakhstan. However, the short-term positive effect from the legalization should not be overestimated, as it can undermine more fundamental solutions like ensuring the rule of law and competition, and improving the business climate. Moreover, repeated legalization campaigns give rise to the moral hazard issue, and undermine what little trust the public has in the Government.

¹⁹ <http://data.worldbank.org/country/russian-federation?display=default>

allows for a two-way competition. Thus, through gaining access to the Russian market and integrating with Russian companies, Kazakhstan can increase economies of scale and improve business sophistication.

66. Another opportunity for Kazakhstan in the CU is due to its new members: Armenia, which joined in January 2015, and the Kyrgyz Republic, which is expected to become part of the CU in May 2015. Kazakhstan has strong economic ties with the Kyrgyz Republic and could use this opportunity to increase the export of goods and services to this country.

67. Lastly, Kazakhstan, as a member of the EEU, has a preferable access to the markets of Russia, Belarus, Armenia, and the Kyrgyz Republic, with a combined population of almost 200mn people. Coupled with it being the second-largest economy in the EEU and having an investment grade rating, Kazakhstan can increase its attractiveness for foreign companies that want to invest in producing local goods and services targeted at the EEU market.⁶⁷ To summarize, Kazakhstan is considered a middle-income country with an ambitious goal of entering the top-30 developed countries by 2050. However, its export-oriented mineral-resource-based economy is highly vulnerable to external shocks. Its increasing wages make it difficult to compete with both low-income and high-income countries. There are also several other factors that increase the urge for finding new drivers of economic growth, such as delay in production at Kashagan oil field, recession in Russia, and the plunge in global oil prices.

68. To overcome these challenges, the Government has announced that it will make diversification one of its top priorities for the current economic policy. Service sector development is seen as a possible solution to overcome these challenges. Moreover, tradable services can drive export diversification. The Government's diversification policy, however, supports a top-down approach as opposed to broad-based institutional reforms, rendering the risk of inefficient and nontransparent public spending and ineffective diversification of the economy.

B. THE SERVICE SECTOR IN KAZAKHSTAN

1. A snapshot of the service sector in Kazakhstan

i. Services industry classification in the national statistical system

69. There are several globally used standards for classifying industries and economic activities:

- The International Standard Industrial Classification of All Economic Activities, Revisions 3 and 4 (ISIC) is the United Nations' system for classifying economic data based on predominant activity down to the four-digit level;
- Nomenclature statistique des activités économiques dans la Communauté européenne, Revision 2 (NACE) is the European activity classification derived from ISIC down to the six-digit level;
- The North American Industry Classification System (NAICS) was developed in the mid-1990s to provide common industry definitions for Canada, Mexico, and the US, to facilitate economic analyses of the three North American countries. NAICS is a related, though more detailed, ISIC classification and was developed within a production-oriented conceptual framework and classifies units, not activities. As a result, the structures of ISIC and NAICS are substantially different.

70. The classification system developed in Kazakhstan follows the standards set by Eurostat, the statistical office of the European Union. The service sector classification in Kazakhstan is product-based based on the European Union Classification of Products by Activity, 2008 (CPA 2008).

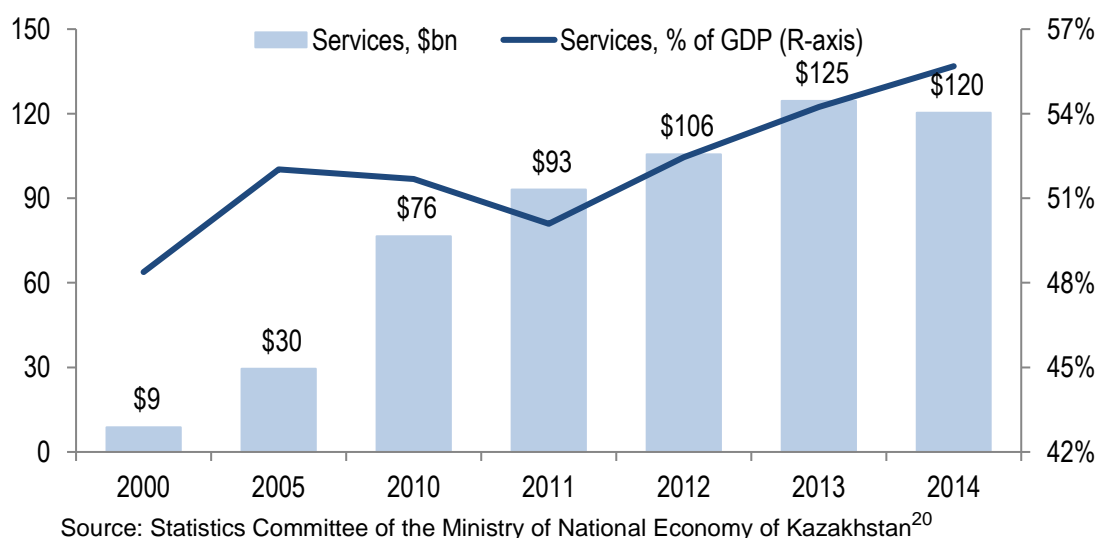
71. The current Kazakhstan services classification, developed and approved in July 2009 by the Committee of Statistics of the Ministry of National Economy of Kazakhstan, has been used since January 2010, with the latest changes implemented in August 2013. Changes to the classification are adopted every five years. The next revision, scheduled for 2014, will widen the activities covered by around 10%.

72. For more information about services developed in Kazakhstan as compared to international classifications, please refer to a background paper “*Measurement of Service Sector in Kazakhstan: Statistics Issues*” under the overall study.

ii. Role of the service sector in the economy of Kazakhstan

73. Kazakhstan has followed the global services trend and the local sector has clearly been on the rise, whether viewed in terms of output or employment. From about a 48% share of GDP in 2000, services output in 2014 accounted for 54% of GDP. The size of services has been rapidly increasing on the back of overall economic growth in Kazakhstan.

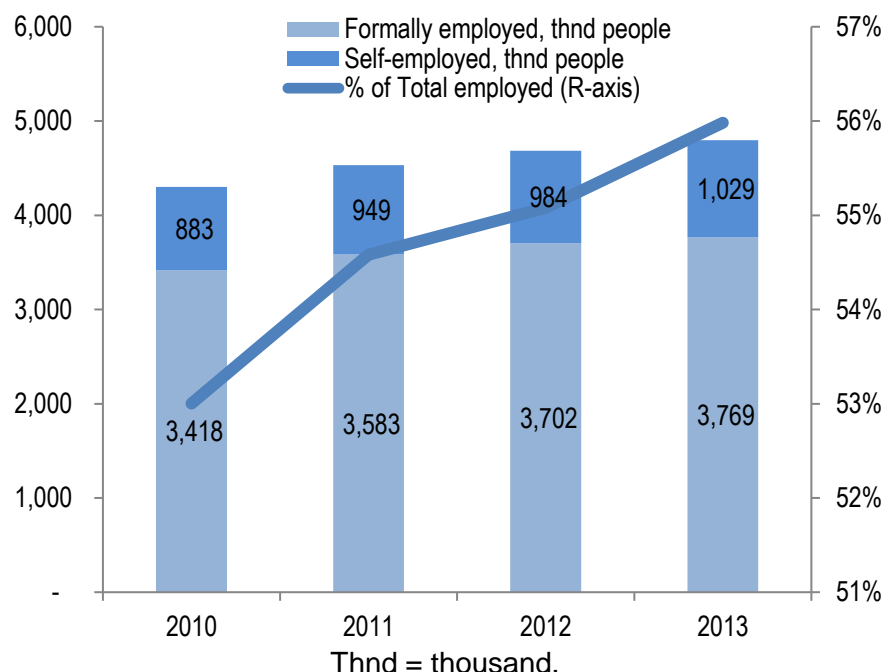
Figure 4. Service sector size (including social services, based on value added) and its share in the GDP of Kazakhstan



74. The service sector has become the source of the majority of Kazakhstan’s jobs. The number of employed in services has reached almost 5mn people and the share of services in total number of employed has been showing steady increase from 53% in 2010 to 58% in 2014.

²⁰ <http://stat.gov.kz/getImg?id=ESTAT084348>

Figure 5. Dynamics of the employed in services in Kazakhstan, including self-employed population in 2010–2013



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2014(2), p. 22]

75. The share of the self-employed population in services has been stable at 21% in 2010–2014, meaning that every fifth worker was self-employed. At the same time, in the overall economy one out of almost every three employed people (31% in 2014) was self-employed, mostly in agriculture. However, it is expected that with the ongoing rapid urbanization, services will capture the inflow of the self-employed population relocating from rural areas (Table 3).

Table 3. Composition of the self-employed sector in Kazakhstan in 2010–2013, in % of total

	2010	2011	2012	2013
Total	100	100	100	100
Agriculture	62	58	56	53
Services	33	35	37	39
incl. Trade	22	22	23	26
Construction	4	5	6	7
Industry	1	1	1	1

Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2014(2), p. 30]

76. Trade is the largest contributor to the sector in Kazakhstan in terms of employment: every fourth person employed in services was engaged in trade activities. In trade services, more than half of workers are self-employed (54% in 2014), which creates significant challenges for the workers due to low social security. However, it also gives opportunities for the trade industry and services to see a quick turnaround with an increase of the organized trade that would lead to the decrease of the share of self-employed population.

Table 4. Employment in the service sector in Kazakhstan including self-employed population in 2010–2013, in thousands of people

	2010	2011	2012	2013
Services total, including:	4,301	4,531	4,686	4,798
Trade	1,224	1,234	1,201	1,257
Hotels and restaurants	105	123	129	139
Transport	512	546	571	569
Communication	109	126	134	133
Financial activities	105	119	139	138
Real estate services	139	136	112	105
Public administration	377	392	386	402
Education	816	852	892	923
Healthcare and social services	370	392	414	425
Other services	544	612	708	707

Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2014(2), p. 23]

77. While Kazakhstan is a net importer of services, with a deficit of \$6.8bn in 2013, the imports-to-exports ratio has declined to 2.3 from 3.6 in 2005. Services exports has shown a higher growth rates (+153% in 2005–2013) compared to services imports (+62%), which can be attributed to the low base effect.

Figure 6. Imports and Exports of services in Kazakhstan in 2005–2014, in \$bn

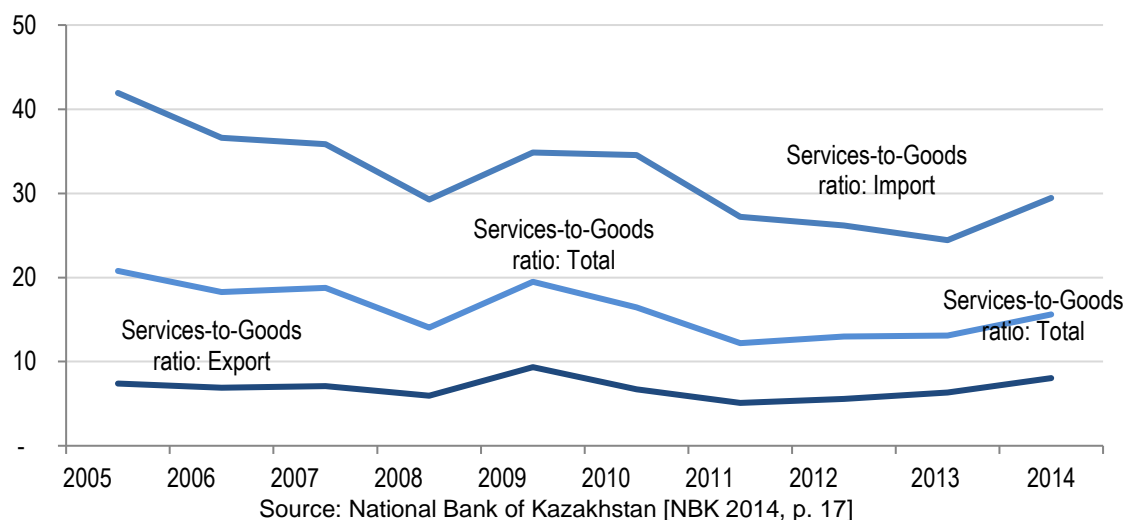


Source: National Bank of Kazakhstan [NBK 2014, p. 19]

78. Analyzing external trade in services as a share of external trade in goods shows that their role has been decreasing. External trade in services in 2013 was at 13% of the goods external trade, down from 21% in 2005. This was mostly due to the goods external trade having grown twice as fast (+188% in 2005–2013) as the services external trade (+88%). However, it is worth

noting that external trade in services is more “sticky”, hence more stable compared to trade in goods; for example, in 2009, after oil prices declined, the turnover in goods fell by 34%, while turnover in services declined only by 9% and exports of services declined only by 4% (compared to 39% decrease in goods exports).

Figure 7. Imports and Exports of services and goods in Kazakhstan in 2005–2013 (%)



2. Extended service sector topology

79. All services can be divided in three groups based on common characteristics and consumer type.

- The first group (sometimes referred to as “group I”) includes *traditional services*: retail and wholesale trade, transport, and storage. In many countries, particularly advanced ones, the share of this group in GDP has fallen noticeably.
- The second group (“group II”) is a hybrid of traditional and modern services and includes *social services*: education; health and social work, and other community, social, and personal services. Their shares rise slowly with time.
- The third group (“group III”) consists of *modern services* consumed by both the household and corporate sectors; this group includes financial intermediation, computer services, business services, communication, and legal and technical services. The share of the third group in GDP has been increasing very rapidly in recent years.

80. There is a positive overall correlation between the service sector’s share of GDP and income per capita. However, this relationship does not hold for all services. For instance, “traditional services” actually have a negative relationship with income per capita; the other two groups show a positive relationship [ADB 2013, p. 3].

81. Local services are those that are consumed upon their creation (like trade and real estate) or their production requires local licensing (such as banking and insurance services). While a major shift toward a larger service sector has occurred in Kazakhstan’s economy, not so much has changed in terms of the composition of services.

82. As in the past in Kazakhstan, traditional services continue to predominate (Table 5). At the other end are modern services which include communication, finance, and professional business services; they constitute only 12.7% of the economy. To compare, in advanced Organisation for Economic Co-operation and Development (OECD) economies such as France, Japan, and the US, as well as in developed Asian economies (Hong Kong, China; the Republic of Korea; and Singapore), they account for about 17%–25% [ADB 2013(1), p. 24].

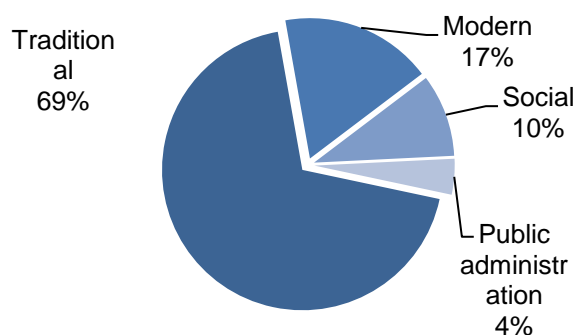
Table 5. Services output in Kazakhstan based on value added in GDP, in \$bn in current prices

	2000	2005	2010	2011	2012	2013	2014
Services total, including:	8.7	29.5	76.5	93.1	105.6	124.6	124.6
Traditional	6.1	21.3	45.2	56.5	65.4	74.8	72.2
Trade	2.2	6.7	19.2	25.7	30.7	35.3	35.0
Real estate services	1.9	8.5	12.8	16.1	17.6	19.7	18.2
Transport	1.8	5.5	11.9	13.1	15.2	17.8	16.9
Hotels and restaurants	0.1	0.5	1.3	1.6	1.8	2.0	2.1
Modern	0.8	3.0	10.0	8.5	9.8	12.7	12.3
Financial activities	0.6	1.8	5.4	3.7	4.3	6.4	6.7
Communication	0.3	1.2	4.6	4.7	5.4	6.2	5.6
Other services	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Social	1.0	2.9	7.3	9.2	9.7	10.5	14.3
Education	0.7	2.0	4.8	6.0	6.3	6.7	6.3
Healthcare and social services	0.4	1.0	2.6	3.2	3.4	3.8	3.7
Public administration	0.4	1.2	3.1	3.7	4.0	4.6	4.3

Source: Author's computations based on data from the Statistics Committee of the Ministry of National Economy of Kazakhstan

83. Only modern service activities are considered tradable internationally and thus offer the opportunity for countries to widen, as well as to diversify, their foreign trade. Advanced economies have shifted towards a larger modern service sector, which tends to have higher productivity and better wages compared to traditional services.

Figure 8. Structure of service sector output in Kazakhstan in 2014

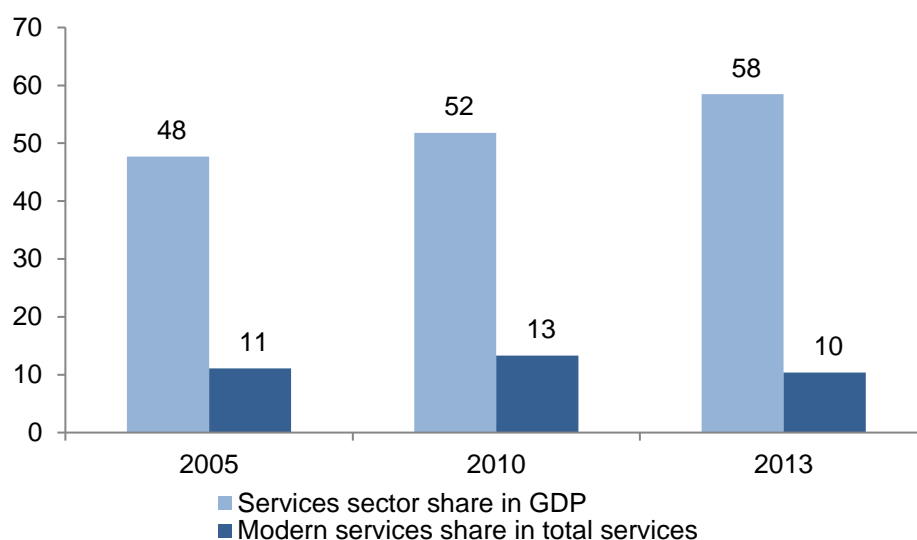


Source: Author's computations based on data from the Statistics Committee of the Ministry of National Economy of Kazakhstan

84. There are two distinct waves of service sector growth and development (the so-called “Two waves of Eichengreen and Gupta”) [NBER 2009, p.8]. In the first wave, the service sector share of output begins to rise at relatively modest incomes, but at a decelerating rate as the economy grows. In the second wave, the share rises again at higher income levels. Importantly, the two waves are populated by different kinds of services. The first wave is characterized by the rise of the traditional services, i.e., lodging, meal preparation, housecleaning, and personal grooming shops, while the second wave is dominated by modern services, i.e., banking, insurance, computing, communication, and business services.

85. Kazakhstan experienced the first wave during 1990s and early 2000s, which was mainly driven by traditional services. The signs of the second wave can be seen in the growth of modern services during 2005–2010 period, which was mostly driven by financial and business sectors. However, there is no clear trend at this stage of service sector development in Kazakhstan, as the share of modern services in total services has been declining in recent years.

Figure 9. Service sector share in GDP is driven by traditional services (%)



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2014(3), p. 14]

86. Services in Kazakhstan are mostly produced by domestic companies that are predominantly private. The size of the enterprise varies between types of services depending on the initial entry barriers (high for telecom and transportation and low for trade).

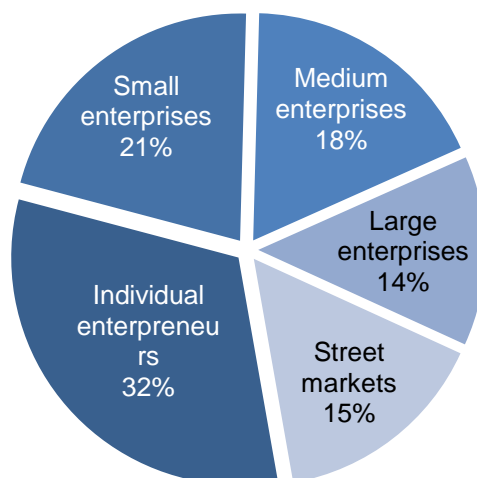
87. To date, the largest sectors of services in Kazakhstan are *Trade, Real estate services, Transport, Financial services* and *Communication*.

88. **Trade Services in Kazakhstan.** Turnover of the trade sector in Kazakhstan represents 28% of the total services output. One-fourth of the trade sector turnover is in retail (\$32bn in 2013), while the rest is in wholesale trade.

89. Retail is predominantly privately owned, with 96% of total retail trade turnover in 2013 carried out by private enterprises. The share of foreign-owned retailers was 4.3%. Four-fifths of the retail trade turnover of foreign companies is concentrated in the two largest cities: Almaty (9.8% of retail trade turnover in the city) and Astana (7.5%).

90. Structure-wise, food products accounted for 35.7% of total retail trade turnover in 2013, with the rest being non-food products. Size-wise, the retail trade is still mostly carried out by small enterprises, with only 31% of all retail trade turnover being done by middle and large enterprises [SC 2014(3), p. 11].

Figure 9. Retail trade turnover volume by the size of enterprises in 2013 (%)



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2014(3), p. 14]

91. In wholesale trade turnover, the share of medium-sized (17% in 2013) and large enterprises (6%) is even lower than in retail trade. The share of foreign enterprises in wholesale trade turnover was 8.5% in 2013, with the rest being domestic private companies.

Photo 1. The “Green Bazaar” in Almaty city

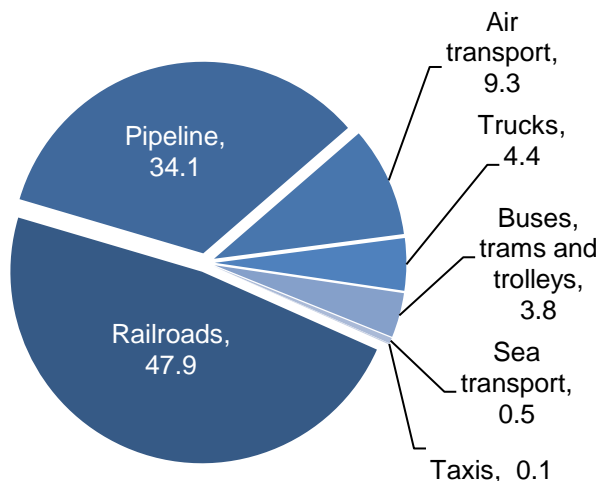


Source: <http://mtdata.ru/u19/photo7821/20964569167-0/huge.jpeg>

92. **Transport Services in Kazakhstan.** Total revenue generated by transportation in Kazakhstan has increased two and a half times since 2006 and reached \$11bn, or 9% of total services and 5% of GDP.

93. Transport services are a reflection of the economic structure of the country: one-third of the total revenue volume in 2013 was generated by oil pipeline transportation and almost one half came from the railroads transportation.

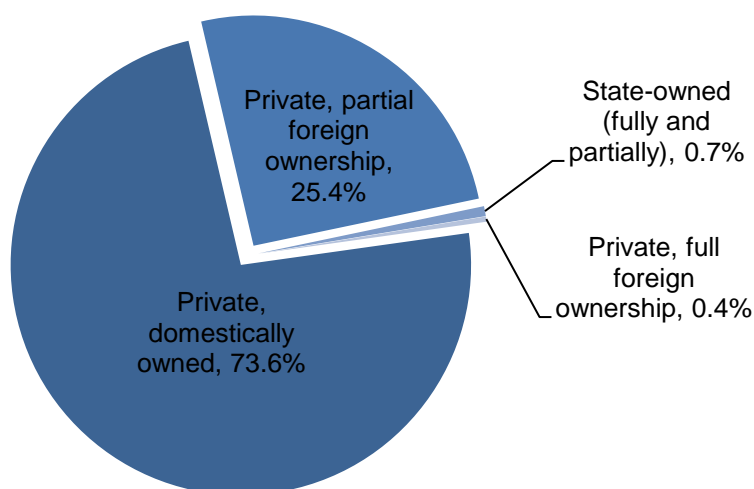
Figure 10. Transport services revenue by means of transportation in 2013 (%)



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan²¹

94. Foreign participation, mostly in the form of joint ventures, is relatively high and accounts for one-quarter of the sector. This is mostly due to the presence of foreign companies in the pipeline transportation and passenger transportation services.

Figure 11. Transport services revenue by ownership type in 2013 (%)



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan²²

²¹ <http://stat.gov.kz/getImg?id=ESTAT082201>

²² <http://stat.gov.kz/getImg?id=ESTAT083770>

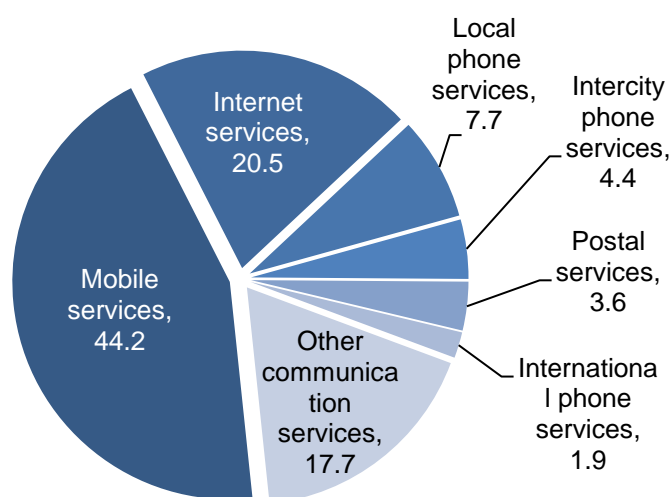
Photo 2. Freight transportation using railroads in Kazakhstan



Source: http://www.railwaygazette.com/uploads/pics/tn_kz-ktz-te33a-containers-ktz.jpg

95. **Communication Services in Kazakhstan.** The volume of communication services provided in Kazakhstan in 2013 reached \$4.3bn, or 3.5% of total services and 1.9% of GDP. The sector is following the global trend of clustering around mobile and internet services. Services are mostly provided by large enterprises (83% of total volume provided in 2013), followed by medium-sized (10%) and small enterprises (7%).

Figure 12. The volume of communication services provided by types of communication in 2013 (%)

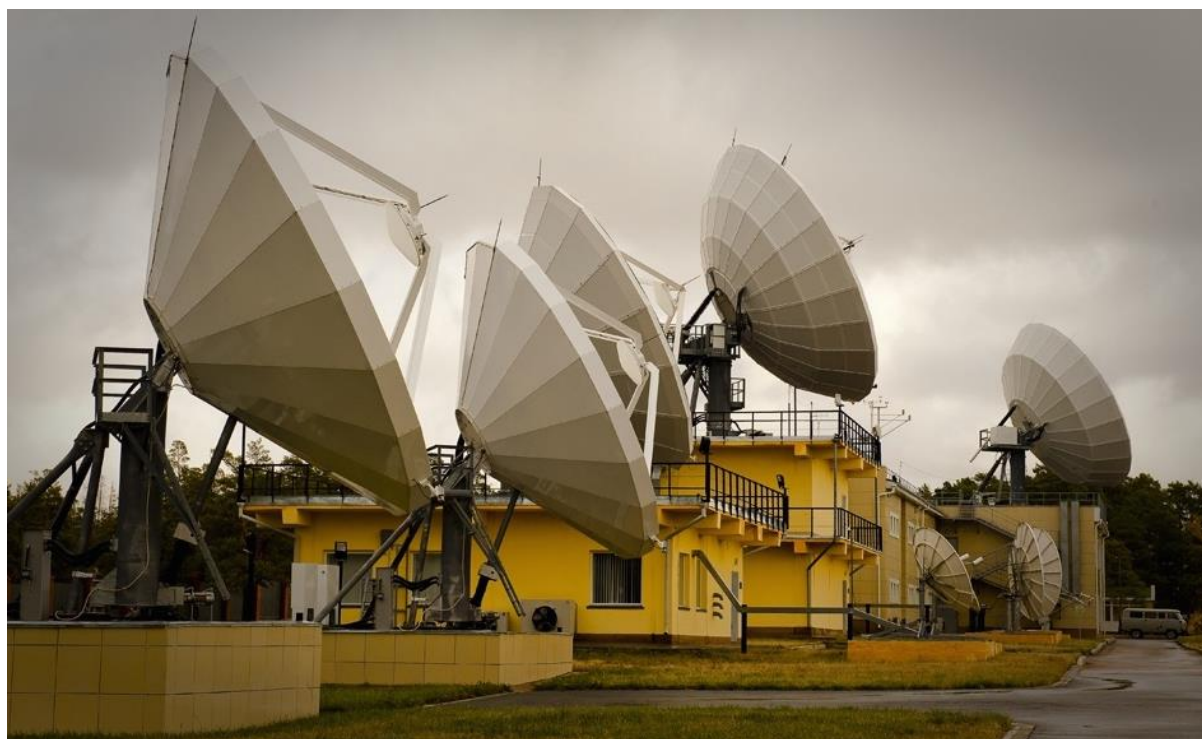


Source: Statistics Committee of the Ministry of National Economy of Kazakhstan²³

²³ <http://stat.gov.kz/getImg?id=ESTAT081367>

96. The number of internet subscribers in 2013 jumped 23% from 1.5mn to 2mn people, almost all of whom had a broadband connection. The number of cell phone subscribers in Kazakhstan in 2013 was at 30mn, of which 9.3mn had a mobile broadband connection. Foreign multinational companies play a key role in communication services and in 2013 accounted for 98% of the total volume of mobile phone services and 38% of internet services.

Photo 3. Communication equipment at Baikonur: the world's first and largest operational space launch facility



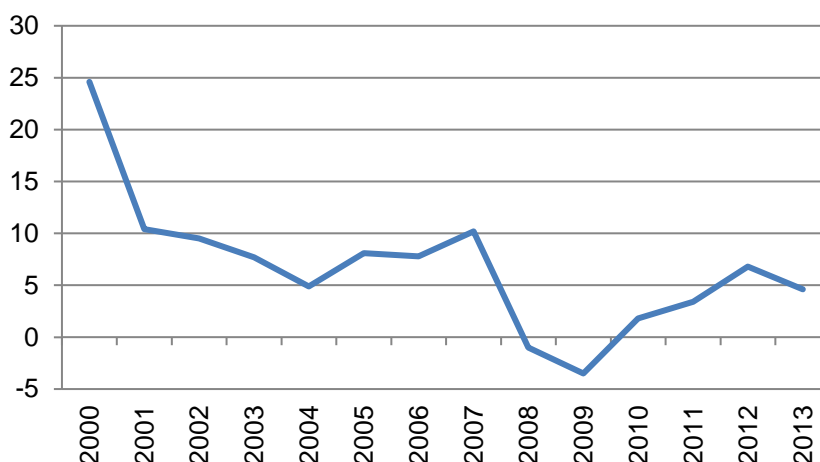
Source: <http://www.voxpopuli.kz/post/view/id/636>

3. Labor productivity in the service sector

i. Labor productivity in different services

97. The data on labor productivity in Kazakhstan is produced by the Statistics Committee of the Ministry of National Economy. The Labor Productivity Index (LPI) is calculated as a ratio of gross value added to the employment (including the self-employed) growth index. LPIs are estimated quarterly for the economy as a whole, and for production of goods and services. More information on the LPI can be found in the “National Accounts” section of the background paper on statistics of service sector under the overall study.

Figure 13. Service sector labor productivity in Kazakhstan in 2000–2013



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan²⁴

98. Table 6 shows that services productivity has increased at the same rate as the whole economy in 10 years. Major drivers of services productivity were transport, communication and financial services, while the lowest performers were real estate services and social services, along with public administration.

Table 6. The dynamics of the productivity (2000 = 100)

	2001	2005	2009
Economy	106	142	168
Goods	101	137	167
Services	110	148	168
Transport and communication	119	172	209
Finance	102	164	206
Hotels and restaurants	127	169	186
Trade	110	153	169
Household social and personal services	116	138	159
Public administration	113	138	142
Healthcare and social services	109	115	122
Education	108	119	122
Real estate	117	125	114

Source: Statistics Committee of the Ministry of National Economy of Kazakhstan²⁵

99. Productivity of different industries in absolute terms is shown in Table 7. The highest productivity in the economy is oil production, which drives the mining sector. Communication and transport have the highest productivity within services and they also demonstrate the highest growth rates comparable with oil production. These services have higher productivity than manufacturing. Within transportation services, land and air transportation are the top performers.

²⁴ <http://stat.gov.kz/getImage?id=ESTAT083099>

²⁵ <http://stat.gov.kz/getImage?id=ESTAT084736>

Wholesale trade, which is comparable with manufacturing, has higher productivity than the retail trade, which is stagnant and has changed little since 2009.

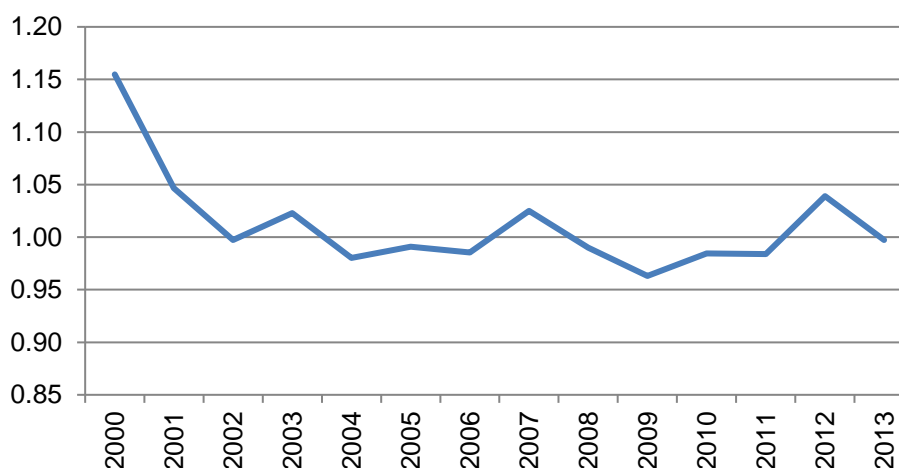
Table 7. Productivity in major industries, in \$ '000 (output per worker)

	2008	2009	2010	2011	2012
Mining	162	150	189	193	211
Oil production	354	438	704	675	777
Manufacturing	39	30	40	51	62
Construction	17	21	36	27	17
Communication	-	28	19	24	82
Transport	35	56	66	94	78
Land	92	88	96	128	166
Sea	18	30	35	35	41
Air	84	84	76	89	73
Warehouse	40	41	-	-	-
Trade	30	23	26	36	41
Cars and motorcycles	38	21	20	29	51
Wholesale trade	38	26	35	50	60
Retail trade	16	20	17	21	21
Postal services	35	4	3	4	16

Source: Statistics Committee of the Ministry of National Economy of Kazakhstan²⁶

100. Figure 14 shows relative labor productivity of services, which is calculated by dividing the services labor productivity by aggregate labor productivity. If it is greater (less) than 1, it is higher (lower) than aggregate labor productivity: in other words, the index gauges whether the services workers are more or less productive than workers in the economy as a whole. Relative labor productivity in services in Kazakhstan has not changed much since early 2000s and is in line with the aggregate labor productivity.

Figure 14. Relative labor productivity in services in 2000–2013



Source: Author's computations based on data from the Statistics Committee of the Ministry of National Economy of Kazakhstan

²⁶ <http://stat.gov.kz/getImage?id=ESTAT083099>

101. Kazakhstan still lags behind the advanced economies in services labor productivity. While much remains to be done to transform the sector, this implies that there is plenty of room for productivity growth in services, and thus for services to contribute to future economic growth.

102. Low services productivity in Kazakhstan can be mainly attributed to the dominance of traditional services, which has a limited productivity upside. Moreover, the high share of the informal sector in services does not promote productivity growth and causes lower worker skill levels, especially in trade services.

ii. Education as a tool to drive labor productivity

103. Service sector productivity is a key driver of aggregate growth differences across developed economies. Increased services competition and the higher levels of service provision have a positive impact on manufacturing and leads to export increases [ADB 2013, p. 3]. A more productive service sector has a positive spillover effect on manufacturing and the rest of the economy. For example, efficient ICT and transportation can promote productivity across the entire economy. A strong modern service sector, in particular business services such as design, prototyping, and marketing, can help Kazakhstan move up the value chain and thus escape the middle-income trap.

104. The development of business services in the country can indicate service sector sophistication. Since the sector is skill-intensive, countries that are relatively skill-abundant typically have larger (as a share of the labor force) and more productive business services. For example, relatively low levels of educational attainment in developing countries are undoubtedly a prime contributor to the low level of business service sector development. On the other hand, most of the developed countries have been very skill-abundant, especially compared with more populous developing countries. Though it is difficult to prove definitively, it is logical to assume that the skill endowment has played an important role in shaping the size, sophistication, and productivity of the business service sectors across countries [ADB 2013, p. 5].

105. Income inequality could become an obstacle to services productivity and might require expanding social spending. It is expected that public services, which enhance low-income groups' productivity through education, training, and re-training and thus improve equality of opportunity, could contribute to solving this problem. For instance, vocational education and training output in Kazakhstan plummeted after gaining independence. In 1989, 42% of the Kazakh population aged 14 to 18 was enrolled in vocational training and technical education; by 2000, the share had dropped to just 24% [ILO 2008, p.32].

4. Services in the informal sector of the economy

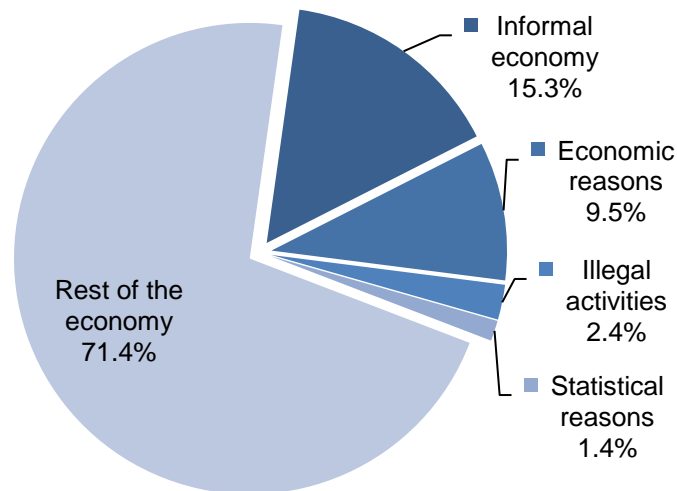
i. Description of services in the informal sector

106. The informal sector is a part of a larger social phenomenon called the unobserved economy (UOE). Currently, UOE accounts for a large part of Kazakhstan's economy; in 2013, it was more than 28.6% of GDP according to official data by the Statistics Committee of the Ministry of National Economy of Kazakhstan.

107. The constituents of the UOE according to Statistics Committee of the Ministry of National Economy of Kazakhstan include:

- Informal economy – production of goods and services in households;
- Economic reasons – false reporting by enterprises;
- Illegal activities – include drugs, prostitution, illegal production of alcohol and contraband;
- Statistical reasons – enterprises that are not included in observations or do not provide reporting.

Figure 15. GDP composition (2013)



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan²⁷

108. The share of the UOE that includes the informal economy, illegal activities, and statistical reasons has been relatively stable since 2005 at around 19% of GDP. In developed countries, UOE is in the range of 7% in the US to 13% in Germany. Sector-wise, the largest Kazakhstan UOE contributors are trade (23%), transport (14%), real estate services (12%), and agriculture (15%).

109. The informal sector is often dominated by services, due to the entry barriers in terms of skills and capital requirement being relatively low compared to manufacturing. Examples of such services in the informal sector include: taxi drivers without registration, real estate rental services by owners, and informal trade on the street markets (bazaars).

110. There is a clear link between the growth of services, the informal sector, and urbanization. Many urban migrants settle for informal sector work because of low skills and limited education. It is easier for poor urban migrants to find work in simple service sector jobs, such as street vendor and small shop assistant, unlike in manufacturing where a minimum level of skill is required to become a machine operator or a production line worker.

111. For the service sector, when counting its informal part, urbanization can be a major driver of growth. At the same time, urbanization, especially at the early stages, tends to generate more informal activities which in turn are also associated with services.

112. Rising urbanization is associated with higher incomes which in turn raises the demand for a wide array of services. Thus, both traditional and modern services thrive in urban locations. There is a tendency for services industries to locate in urban areas to enable proximity to both clients and

²⁷ <http://newskaz.ru/economy/20140818/6844813.html>

suppliers. Face-to-face interaction with clients is important for many service industries such as retailing, education, health, and other community and personal services, so the presence of a large concentration of people in urban locations is favorable for services development.

113. Services industries also often cater to varying business activities, so they will locate in areas with dense and diverse business settings. The research indicates that more urbanized economies have larger services output and employment shares [ADB 2013(1), p. 37].

114. The share of agriculture in Kazakhstan's GDP was 4.6% in 2013, while rural residents accounted for 24% of the total number of employed and 45% of the total population.²⁸ It is logical to assume that growth in other industries will require some of this rural population to move to the cities. Expected higher rates of urbanization will drive services as a source of growth and jobs.

115. As mentioned above, currently, informal trade is a major contributor to the informal sector in services in Kazakhstan. In 2013, informal trade accounted for 4.4% of GDP, or one-fifth of the total UOE. Even more important is that almost one-third of the trade sector is classified as unobservable. Therefore, mitigating informal trade is seen as the "low-hanging fruit" in the mission of decreasing the UOE. One of the most efficient ways to achieve this is to move from unorganized to organized trade and to move from cash to cashless payments.

Box 1. Campaign on Point-of-Sale Terminals in Kazakhstan

In order to increase the use of cashless payments, the Government has planned to require all merchants to install the relevant equipment. However, this initiative has been postponed several times since its first introduction in 2012 due to the high price for small merchants and low level of usage of bank cards by the population.

The number of point-of-sale (POS) terminals has increased from 31,000 in 2013 to 48,000 in June 2014, with half of these terminals being installed in two major cities: Almaty (35%) and Astana (15%), according to the National Bank of Kazakhstan. In 2012, there were 12,000 firms working in trade, with an average trading floor of 370 sq. m., in consideration of which we can assume that most of them have already installed POS terminals, some more than one. However, there were another 218,000 merchants working as individual entrepreneurs with the average trading floor of 25 sq. m. [SC 2014(3), p. 11]. It is reasonable to assume that the current penetration of POS terminals among merchants working as individuals does not exceed 15%. Hence this group of merchants is the main target of the obligatory installation campaign.

Table 8. Point-of-sale terminals per 100,000 adults in different countries in 2009

Country	Point-of-sale terminals per 100,000 adults
Kazakhstan (2009)	173
Kazakhstan (2014)	384
Czech Republic	651
Malaysia	941
Estonia	1,417
Singapore	1,887

²⁸ <http://stat.gov.kz/getImg?id=ESTAT080637>

France	2,153
US	2,156
Canada	2,202

Sources: National Bank of Kazakhstan, Statistics Committee of the Ministry of National Economy of Kazakhstan, World Bank²⁹

The volume of the cashless payments using POS terminals has increased since December 2013 by 17% and reached \$0.4bn, or 6.6% of the total retail trade volume (\$6.5bn) during the month. At the same time, the average monthly transaction using POS terminals per card was only about \$65, meaning that there is a significant unrealized upside to the cashless payments in Kazakhstan.

ii. Pros and cons of the informal service sector

116. The informal sector is usually viewed negatively from the viewpoint of the policy makers. However, some positive factors are also associated with the informal sector that are not obvious at first sight.

117. Negative impacts of the higher share of the informal service sector include the following:

- Participants do not pay taxes, hence have more incentives to establish informal relations with the controlling organizations and participate in corruption schemes.
- Owners and workers do not participate in the mandatory state social security schemes. Since voluntary social security is still not developed, this poses a high risk of increasing long-term burdens on the state budget.
- Without official salaries being paid, it is difficult for workers to establish a credit history and retail and commercial lending prices increase.

118. The positive impact of the significant informal sector in services is not that obvious:

- The informal sector provides employment for a large portion of low-skilled labor in the country. In particular, it helps absorb the rural population inflow to the cities and provides them with the initial set of skills and everyday income that will allow them to move to the formal sector in future.
- Lower tax and administrative burdens stimulate the accumulation of initial capital that can be invested in acquiring new skills and other formal sector enterprises.
- Income from informal services that was not redirected to other sectors through taxes can contribute to consumption of local services.

119. Overall it can be said that the size of the informal sector in the Kazakhstan economy does not pose an immediate threat and can be viewed as a natural reflection of the current expansive stage of the economic development. Though there are certain positive informal sector aspects that are most relevant in the short term period, in the long term, improvements in the rule of law and the business environment should promote a reduction in the informal sector and more intensive use of available resources.

²⁹ <http://data.worldbank.org/indicator/FB.POS.TOTL.P5>

5. Trade in Services

120. Both the production of, and international trade in, services differ from that related to goods. International trade in goods is conducted separately from production; for example, goods may be produced in one economy and subsequently delivered to residents of another economy with these residents not necessarily being known when production occurs. By contrast, the production of a service is linked to an arrangement made in advance between a particular producer in one economy and a particular consumer or group of consumers in another. Thus, international trade in services is closely linked with international production of services, as the production element, and vice versa.

121. Services is the second major category of the current account. Services cover traditional items, such as travel and transportation and items, such as communications, financial and computer services, royalties and license fees, and many types of other business services that are becoming increasingly important in international transactions [IMF 2013, p. 51].

122. The importance of trade in services has been increasing with the advent of globalization. The share of the trade in services in the total global trade grew steadily from 6% in 1975 to 8% in 2000 to 11% in 2010 [WTO 2013, p. 20].

123. With the exception of Germany, most developed economies are net exporters of services. Most of the developing economies are net importers of services due to development of tradable services requiring certain business sophistication of the domestic economy.

124. **Services imports.** Kazakhstan is a net importer of services. In 2013, the country imported services worth \$12bn, which is one-fourth of the amount spent on imported goods. Country-wise, the imported services originated mostly from: Russia (\$2.5bn, or 21% of total services import), UK (\$1.4bn, or 11.4%), US (\$1bn, or 8.8%), Italy (\$1bn, or 8.4%), the PRC (\$0.9bn, or 7.4%), and the Netherlands (\$0.6bn, or 5%) [NBK 2014, p. 58].

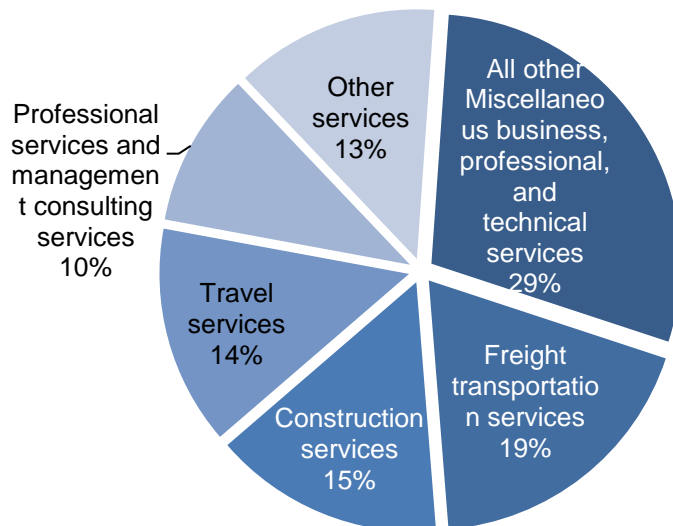
125. The structure of the services imports by types is given in the Figure 16. During 2005–2013, the share of freight services³⁰ in the total services import gradually increased, while the share of construction services³¹ noticeably declined; the share of travel services³² increased slightly [IMF 2013, p.61, 66].

³⁰ *Freight services* include the loading on board or the unloading of goods from carriers if contracts between owners of goods and carriers require that the latter provide that service.

³¹ *Construction services* covers work performed on projects and installations by employees of an enterprise in locations outside its economic territory of the enterprise. Goods imported by the enterprise for use in the projects are included in the value of these services rather than being recorded under goods; expenditures for local supplies, etc. are included under other business services.

³² *Travel* covers primarily the goods and services acquired from an economy by travelers during visits of less than one year in that economy. Excluded is the international carriage of travelers, which is covered in passenger services under transportation. Included is business and personal travels.

Figure 16. Services imports in Kazakhstan by types of services in 2013

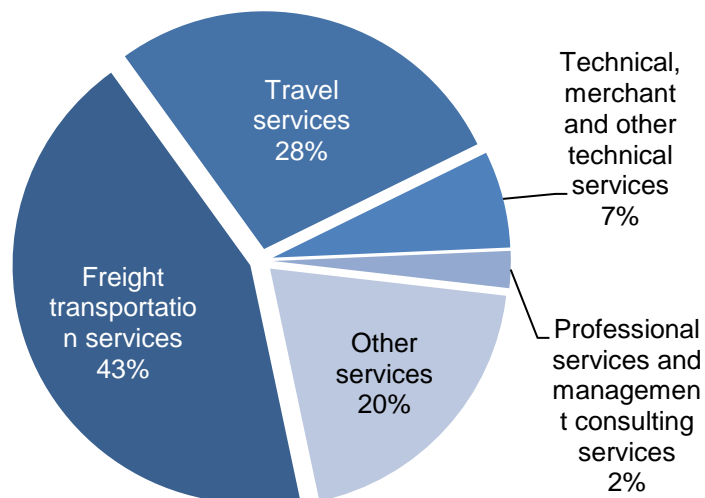


Source: National Bank of Kazakhstan [NBK 2014, p. 23]

126. **Services exports.** Exports of services in Kazakhstan is highly concentrated. Country-wise, the destinations of the exported services were: Russia (\$2bn, or 38% of total services export), the PRC (\$0.7bn, or 14.3%), and Uzbekistan (\$0.4bn, or 8.3%) [IMF 2013, p.64].

127. The share of top-2 items accounts for more than two-thirds of the total services exports. The shares of top-4 items has been stable and did not change significantly during 2005–2013.

Figure 17. Services exports in Kazakhstan by type in 2013



Source: National Bank of Kazakhstan [NBK 2014, p. 22]

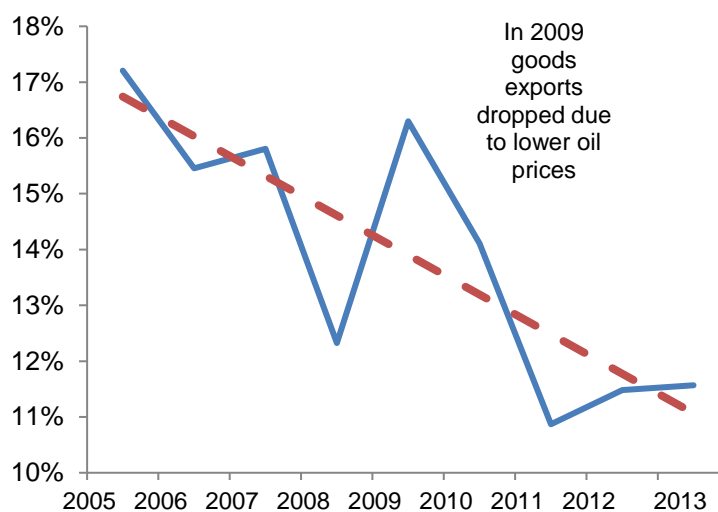
128. **Services imports to services exports ratio** is another way to measure the trade in services. In absolute figures, imports of services shows significant growth that could look alarming.

However, when taking into account the growth in services exports, the situation in external trade in services starts to look more positive. In 2005, services imports was 3.6 times over services exports; however, in 2013 it declined to be only 2.3 times. This positive dynamic is mostly attributed to higher growth rates in services exports (x2.5 times) compared to the growth in services imports (x1.6 times). Freight transportation was the main driver of growth in services exports and grew threefold from \$0.7bn in 2005 to \$2.2bn in 2013. As a result, it accounts for almost half of the services exports. Travel services became another driver of growth that has doubled over the period (\$0.7bn to \$1.5bn) and constitutes 28% of total exports of services.

129. **Trade in services as percent of GDP** is used to show the importance of the tradable service sector in the GDP. The share of services exports and imports in GDP in Kazakhstan has been steadily decreasing from 16.8% in 2005 to 10.5% in 2010 to 7.5% in 2013. Economic development level and the sophistication of local business increases the share of business services in the trade in services. Thus the trade in services as a share of GDP is usually high in developed countries (in 2012 it was 19% in UK, 17% in Germany, 41% in Belgium, and 83% in Singapore) and usually lower in developing countries (8% in Russia and Turkey, 6% in the PRC, 5% in Brazil).³³

130. **Trade in services share in total external trade** tends to increase with economic development. However, this is not the case in Kazakhstan. The share of services trade in total trade turnover has been steadily decreasing since 2005 and has just slightly recovered in 2012–2013. This is a result of the higher growth rates of trade in goods, which has tripled in 2005–2013, while services trade turnover increased only twofold.

Figure 18. Share of services in total trade in Kazakhstan in 2005–2013



Source: National Bank of Kazakhstan [NBK 2014, p.22]

131. **The share of services in imports** in Kazakhstan is significantly larger than that in exports. This is true for most developing countries, with a few exceptions like India, the Philippines, and Pakistan, where some of the business services were developed on the basis of skilled, low-cost, English-speaking labor resources. In developed countries (except Germany) the share of services in exports exceeds or equals its share in imports. Even though the gap between the share of

³³ <http://data.worldbank.org/indicator/BG.GSR.NFSV.GD.ZS/countries>

services in imports and that in exports in Kazakhstan is narrowing over time, it still remains very high at x3.3 times. In other developing economies it is much lower, as shown on Table 9. In developed economies, the average share of services in imports usually does not exceed 20%, whereas the share of services in exports is usually not lower than 20%.

Table 9. Trade in services as % of total trade in different countries

	Kazakhstan			Malaysia	PRC	Chile	France	US
	2005	2010	2013	2010	2010	2010	2010	2010
Service imports as % of Total imports	29.5	25.7	19.6	17.0	12.7	17.6	18.3	17.2
Service exports as % of Total exports	6.9	6.3	5.9	14.1	9.8	13.2	21.9	29.6
Service imports as % of Total imports to Service exports as % of Total exports	4.3	4.1	3.3	1.2	1.3	1.3	0.8	0.6

Source: National Bank of Kazakhstan, Asian Development Bank [ADB 2012, p.19]

6. Services as a potential contributor to export diversification

132. Services can be viewed as one of the potential contributors to the export diversification in Kazakhstan. Traditionally, services exports in Kazakhstan have been clustered around freight (due to increasing transit volumes going through the country), and travel (mostly due to business travels, rather than tourism). However, there are other tradable services with the potential to be exported.

Table 10. Volume of exported services with high-growth dynamics in Kazakhstan, in \$mn

	2005	2010	2013	Ratio of exports in 2013 to 2005
Passenger services	100	231	257	2.6
Telecommunications, computer and IT services	71	94	141	2.0
Professional services and management consulting services	43	103	132	3.0
Insurance and pension services	4	75	37	9.6
Construction services	2	23	36	17.9

Source: National Bank of Kazakhstan³⁴

133. *Passenger services* covers all nonresidents' traveling services from Kazakhstan to other countries or between two foreign economies conducted by resident carriers (export), along with traveling of residents conducted by nonresident carriers (import). This mostly consists of services of international passenger transportation provided by two major passenger carriers: Air Astana and Kazakhstan Temir Zholy railroad company.

³⁴ Refer: http://www.nationalbank.kz/cont/publish344380_25336.xls

134. *Computer and information services* covers resident and nonresident transactions related to hardware consultancy, software implementation, information services (data processing, data base, news agency), and maintenance and repair of computers and related equipment. The growth of the local hardware and software services has resulted in increased nonresident company procurement.

135. *Insurance services* covers the provision of insurance to nonresidents by resident enterprises and vice versa. This item comprises services provided for freight insurance (on goods exported and imported), other types of direct insurance (including life and non-life), and reinsurance [IMF 2013, p.39, 61]. Despite the relative growth, this sector has been decreasing after peaking at \$115mn in 2009 as a result of the overall financial crisis in Kazakhstan. Prospects for growth in this item are more related to the development of the insurance services, especially freight insurance, and to a lesser extent with the pension funds, as these assets are now accumulated in one state fund.

Box 2. Promoting Local Content in Services in Kazakhstan

In order to promote local industries and services, the Government in 2010 created a separate agency subordinated to the Ministry of Investment and Development: the National Agency for Development of Local Content (NADLOC). NADLOC's target is to increase the competitiveness of local producers and to promote the local content.

In 2010–2014, the local content promotion program (hereafter, the Program) was adopted, with the focus on three key areas: goods and services, workforce, and infrastructure. According to the Program, preferences in state procurement are provided for producers that were certified as local. By 2014, most of the targets set in the Program were achieved; the share of local content increased from 48% in 2010 to 63% in 2014. However, the share of services under this program (\$19.2bn in 2013) accounts for only 15% of the total services in the economy (\$124.6bn). Hence the effect of the Program on changing the landscape of the locally produced and consumed services is somewhat limited. More recent data for services is not available on the official website of the NADLOC agency.

Table 11. Indicators of services in local content promotion program in 2013

	Services in local content Program, \$bn	Of which locally produced, %	Target for services localization in 2014
Total	19.2	83	-
Subsoil operators	8.2	74	-
Mining sector companies	1.5	83	74
Oil and gas sector companies	6.7	72	73
National holdings and Samruk-Kazyna	6.8	92	78
State agencies	2.8	84	87
Large private companies	1.5	94	68

Source: NADLOC³⁵

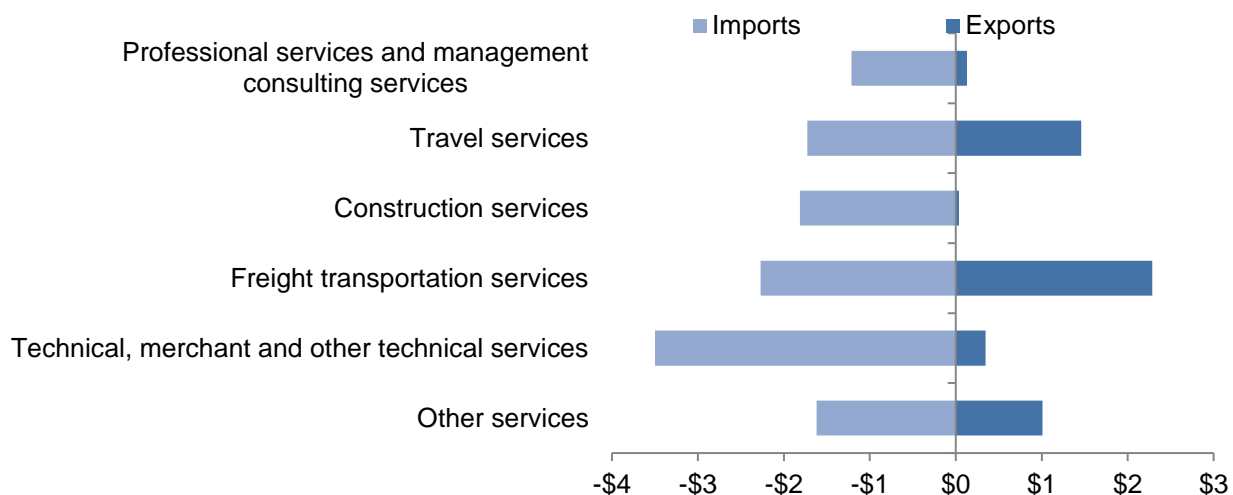
³⁵ <http://www.nadloc.kz/attach/p1157/d1.rar>

To advance its goals, NADLOC has produced the List of 150 most demanded products, which included goods with the highest share in imports that could be produced locally. Unfortunately, there was no such list produced for the most demanded services.

136. Another way to identify tradable services is by analyzing the services that are currently being imported in Kazakhstan. This analysis shows services in demand that could create a strong domestic foothold to support future international expansion. For instance, construction services are in this group: in 2013, Kazakhstan imported construction services worth \$1.8bn, while exporting only \$36mn.³⁶

137. Business services have been in great demand in Kazakhstan as well: in 2013, their imports reached \$4.7bn. Of this amount, \$3.5bn was in technical, merchant, and other technical services (exports of \$0.3bn) and \$1.2bn in professional services and management consulting (\$0.1bn). Travel imports are mostly due to tourism and can be considered as a potential sector where development of local infrastructure and content can lead to the creation of the tradable services.

Figure 19. Top-5 imported services and their respective exports in Kazakhstan in 2013, in \$bn



Source: National Bank of Kazakhstan [NBK 2014, p.22, 23]

138. There are two interesting cases in the current development. The first is related to the growing royalties and license fees for which Kazakhstan spent \$0.8bn in 2005–2013, but earned zero during that whole period. This is a direct result of the weak legislation that does not protect intellectual property (IP) rights in Kazakhstan. Another case is personal, cultural, and recreational services for which the numbers are \$0.3bn and \$8mn, accordingly. We assume that this is mostly driven by the imports of movies to be screened in cinemas. It is well known that local production of movies is not able to meet the local demand or be exported in significant volumes.

³⁶ According to the methodology used by the National Bank of Kazakhstan (NBK), “Construction services” include all services output of foreign construction companies registered in Kazakhstan. Based on the information collected during the meetings with NBK staff, the methodology is expected to be changed next year, so that foreign construction companies that are registered in Kazakhstan will no longer be included in this indicator (in accordance with the BPM6 standards). As local registration is mandatory for foreign construction companies, this would mean that the imports volume for “Construction services” is expected to become zero.

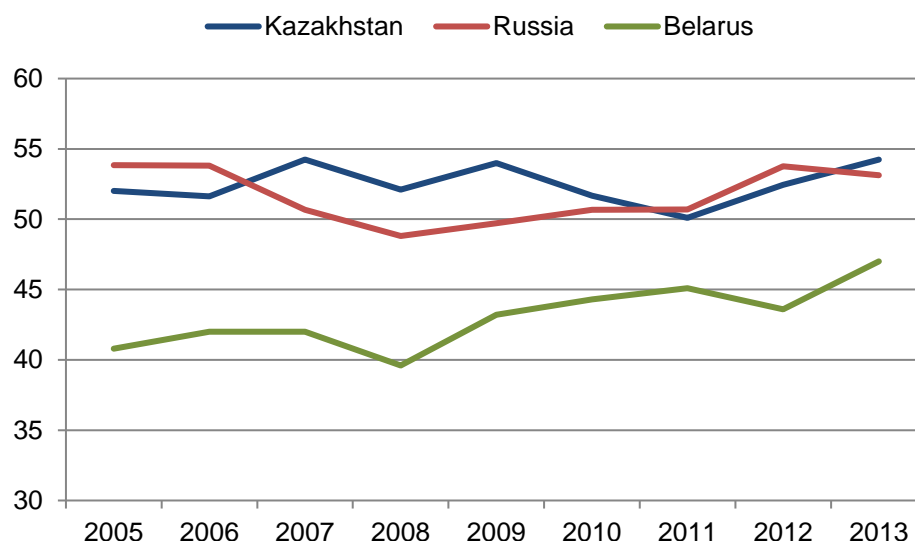
139. The biggest risk to the trade in services in Kazakhstan in our view is related to the upcoming WTO membership that would liberalize the entry for foreign services providers. For Kazakhstan, it is crucial to identify the services in which it has comparative advantages so that it could negotiate better conditions accordingly. For example, according to the Minister of Economic Integration, based on requests from the US and EU, the entry barriers for the telecommunications sector are going to be lifted. Currently there is a 49% limit for the foreign ownership in companies that provide long-distance communication. After the grace period of two and a half years from the date of becoming the WTO member, Kazakhstan will open up its telecommunications market. It is expected that this would positively affect the prices and quality of services. However, the limitation on foreign ownership of the national telecommunications champion KazakhTelecom is expected to remain at the current level (49%).³⁷

7. Cross-country analysis: role of the services sector in the EEU member countries

140. According to the EEU treaty signed between Kazakhstan, Russia, and Belarus, the countries agreed to create a common market for certain types of services in 2015; Kyrgyzstan and Armenia also joined the CU in 2015. This poses certain risks for local services producers, as well as provides opportunities for international expansion. Risks are associated with the entry of more competitive providers, especially from Russia due to its market size. On the other hand, with the entrance of services companies from EEU member countries, the variety of services for producers in Kazakhstan will increase.

141. The share of services sector in the economy in Russia is comparable to Kazakhstan, while Belarus is catching up.

Figure 20. Dynamics of the service sector in the EEU member countries in 2005–2013 in % of GDP



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan, Federal Service of State Statistics of Russia, National Statistics Committee of Belarus

³⁷ <http://www.matritca.kz/news/4693-sektor-telekommunikacionnyh-uslug-budet-liberalizovan-posle-vstupleniya-kazahstana-v-vto.html>

142. The government of Belarus has set a target of increasing the share of services to 50% in GDP in 2015, according to the 2011–2015 Program on socio-economic development of Belarus.³⁸

143. Kazakhstan and Russia have the same share of services trade in total external trade, which is mostly explained by having similar economies and a large mineral goods exporting sector. Belarus, on the other hand, has a more balanced structure with a lower share of services imports.

Table 12. Trade in services in the EEU member countries in 2013, in % of total trade

	Kazakhstan	Russia	Belarus
Service imports as % of Total imports	19.6	27	10.3
Service exports as % of Total exports	5.9	12	16.6
Service imports as % of Total imports to Service exports as % of Total exports	3.3	2.3	0.6

Source: Authors' computation based on data from the National Bank of Kazakhstan, Central Bank of Russia and National Bank of Belarus

144. Kazakhstan is a net importer of services and has spent \$12bn on services in 2013, while exporting only \$5.3bn. Kazakhstan is also a net importer of services within the EEU in its trade with Russia and Belarus. However, this was not the case in 2011 (see Table 13) and in 2010, when Kazakhstan had a positive balance in trade in services with Russia and was exporting services worth \$1.6bn while importing \$1.4bn. It is worth noting that the gap with Russia is widening rapidly and the net import has reached \$0.5bn, adding to the overall increase in imports of its goods and services.

145. The main drivers behind the growth of services imports from Russia and the largest contributors to the widening deficit in trade in services were:

- transportation by trucks (imports of \$453mn versus exports of \$91mn in 2013);
- other business services (imports of \$699mn versus exports of \$135mn in 2013);
- technical services related to trade and other business services (imports of \$517mn versus exports of \$104mn in 2013); and
- architectural, engineering, and other technical services (imports of \$438mn versus exports of \$23mn in 2013) [NBK 2014, p. 115].

Table 13. Trade in services of Kazakhstan with the EEU members in 2011–2013, in \$mn

	2011	2012	2013
Exports of Services			
Total	4,473	4,828	5,271
To Russia	1,654	1,903	2,001
To Belarus	33	39	25
Imports of Services			
Total	10,937	12,776	12,147
From Russia	1,472	2,393	2,569
From Belarus	52	72	65

³⁸ <http://economics.basnet.by/files/Analit12.pdf>

Net trade in Services			
Total	-6,464	-7,948	-6,876
with Russia	182	-490	-568
with Belarus	-19	-33	-40

Source: National Bank of Kazakhstan³⁹

146. Russia is a net importer of services and has spent \$128bn on services in 2013, while exporting only \$70bn. However, in trade in services with Kazakhstan, Russia remains a net exporter, with an annual positive balance of around \$1bn. In 2013, Russia accounted for almost one-fifth (18%) of services imports by Kazakhstan. Of all services exported by Kazakhstan in 2013, almost one-fifth (18%) were sold to Russia.

Table 14. Trade in services of Russia with the EEU members in 2011–2013, in \$mn

	2011	2012	2013
Exports of Services			
Total	58,039	62,340	70,122
To Belarus	717	849	1,472
To Kazakhstan	1,969	1,949	2,224
Imports of Services			
Total	91,495	108,926	128,400
From Belarus	1,323	1,693	2,065
From Kazakhstan	854	1,020	969
Net trade in Services			
Total	-33,456	-46,586	-58,277
With Belarus	-606	-844	-594
With Kazakhstan	1,116	929	1,255

Source: Central Bank of Russia⁴⁰

147. Belarus is the only EEU member that is a net exporter of services; in 2013, the country exported services equal to \$7.3bn and imported \$4.7bn worth of services. Despite some discrepancy in the data from the central bank of Russia, the trend and main picture remain the same: Belarus's exports of services to Russia exceeds its imports.

Table 15. Trade in services of Belarus with the EEU members in 2011–2013, in \$mn

	2011	2012	2013
Exports of Services			
Total	5,610	6,336	7,300
To Russia	1,331	1,707	1,993
To Kazakhstan	65	71	98
Imports of Services			
Total	3,352	4,044	4,718
From Russia	732	849	1,052
From Kazakhstan	14	19	27
Net trade in Services			
Total	2,258	2,292	2,581
With Russia	599	858	941

³⁹ http://www.nationalbank.kz/cont/publish772116_22566.pdf

⁴⁰ http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/trade_new_2011.htm&pid=svs&sid=itm_44615

	2011	2012	2013
With Kazakhstan	52	52	71

Source: National Bank of Belarus⁴¹

148. According to the World Bank data on services trade restrictions, Kazakhstan has the most liberal regulations among EEU members.⁴² The overall restriction level in Kazakhstan is half that in Belarus and significantly lower than in Russia. Among all services listed, Belarus has lower trade restrictions in *International Air Passenger* services and *Auditing* services; and Russia has lower trade restrictions in *Auditing* services.

Table 16. Trade in services restrictions in the EEU member countries⁴³

	Kazakhstan	Russia	Belarus	Kyrgyzstan	Armenia
Overall for trade in services	17	26	35	15	11
Financial	22	47	54	8	3
Banking	21	43	46	0	0
Lending by banks	21	43	46	0	0
Acceptance of deposits by banks	21	43	46	0	0
Insurance	23	53	66	22	7
Automobile Insurance	33	55	53	23	10
Life Insurance	33	55	55	23	10
Reinsurance	5	50	90	20	0
Telecommunications	25	50	63	0	0
Fixed-line telecommunications	50	50	100	0	0
Mobile telecommunications	0	50	25	0	0
Retail	0	0	0	0	0
Transportation	16	14	37	46	25
Air Passenger International	60	68	35	68	50
Road Freight Domestic	0	0	0	0	25
Rail Freight Domestic	0	0	100	100	0
Professional	28	32	40	28	32
Accounting and Auditing	35	20	40	35	45
Accounting	20	20	40	20	40
Auditing	50	20	40	50	50
Legal	23	40	40	23	23
Legal Advice Foreign Law	20	20	20	20	20
Legal Advice Domestic Law	25	50	50	25	25
Legal Representation in Court	25	50	50	25	25

Source: World Bank⁴⁴

⁴¹ <http://www.nbrb.by/statistics/BalPayCustomsUnion/>

⁴² <http://iresearch.worldbank.org/servicetrade/default.htm>

⁴³ Greater number indicates higher restriction level. (0 – open without restrictions, 25 – virtually open, 50 - existence of major/non-trivial restrictions, 75 – virtually closed, 100 – completely closed). Refer: http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2012/06/28/000158349_20120628130854/Rendered/PDF/WPS6108.pdf

⁴⁴ <http://iresearch.worldbank.org/servicetrade/default.htm>

149. Kazakhstan has a unique opportunity to leverage its high-growth service sector to increase services exports to EEU countries, especially Russia, which has 10 times larger annual services imports. At the same time, the services trade restrictions in new members of the EEU are more liberal; that could allow local companies to enter these markets as well.

150. In summary, the size of the service sector has been rapidly increasing: in 2014, the sector accounted for 54% of GDP and 58% in the number of employed. Trade is the largest contributor in terms of employment, and trade turnover accounts for 28% of the total services output.

151. The service sector in Kazakhstan is dominated by traditional activities: trade, real estate and transport. Modern services comprise only about 12.7% of the economy, whereas in the OECD countries they account for 17%–25%. Only modern service activities are tradable internationally and have higher productivity and better wages compared to traditional services. Kazakhstan significantly lags behind the advanced economies in services labor productivity. This can be attributed to the dominance of traditional services, which has a limited productivity upside, and a high share of the informal services sector.

152. Kazakhstan is a net importer of services: in 2014, the country has imported two times more services (\$12bn) than it has exported (\$6.3bn). However, the imports-to-exports ratio in services has declined almost twice in the last 10 years.

C. ROLE OF THE SERVICE SECTOR IN KAZAKHSTAN

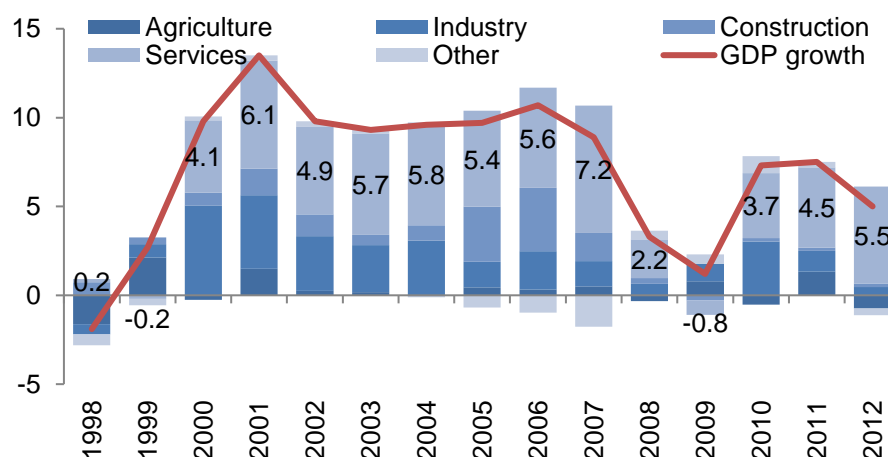
1. Contribution to economic development

153. Studies that examined the links between services and other sectors broadly indicate their critical role in lifting economy-wide productivity and standards of living. The main takeaways from the major studies in the field are the following:

- **Services drive aggregate productivity in the economy, and result in higher growth rates.** Studies that describe the impact of services on the rest of the economy indicate their importance in raising aggregate productivity, as well as in explaining differences in those levels and in growth rates across countries [Joseph and Hoekman 2010, p. 14].
- **Share of services leads to higher income per capita.** Studies find a positive correlation between output share of services and income per capita. However, such a relationship holds only for service activities that are either a combination of traditional and modern services consumed mainly by households (such as education and health), or modern services, intended for both households and businesses. Modern services not only have the highest productivity growth among the services industries, but their share in output tends to rise rapidly at high income levels [Eichengreen and Gupta, p. 17].
- **Share of services value added embodied in manufacturing goods** increases over time. The growing interdependence between services and manufacturing leads to increased service sector value added being embodied in manufacturing [Pilat and Wölfl 2005, p.12].

154. Not only is the service sector a large part of the Kazakhstan economy that employs most of its labor resources, but it has also been an important contributor to overall growth. In 2000–2010, the service sector accounted for more than one-half of GDP growth in Kazakhstan (Figure 21). Calculations were based on the share of different sectors in the GDP and their relevant growth rates. The share of the services sector is also confirmed by the previous estimations [ADB 2013(1), p. 20].

Figure 21. Dynamics of the contribution of different sectors to the GDP growth in Kazakhstan in 1998–2012 in percentage points of GDP growth



Source: Authors' computation based on the data from the Statistics Committee of the Ministry of National Economy of Kazakhstan

155. Trade, transport, real estate and finance have the highest share in total services output. This is a result of the growth in services driven by the influx of petrodollars and external borrowings by the banking and corporate sectors. Trade has been growing as a result of the increased average income level of population. Transport is driven by increased mineral resources exports and imports of finished goods and industrial equipment. Real estate as a function of housing demand is also seen as an investment tool in a country with limited investment options, namely an underdeveloped stock market. Financial services have been rapidly growing due to the favorable macroeconomic situation that allowed for cheap borrowing from external markets.

156. The change in service sector dynamics is highly correlated with economic growth, with the service sector having the highest correlation score with GDP among all the sectors of economy.

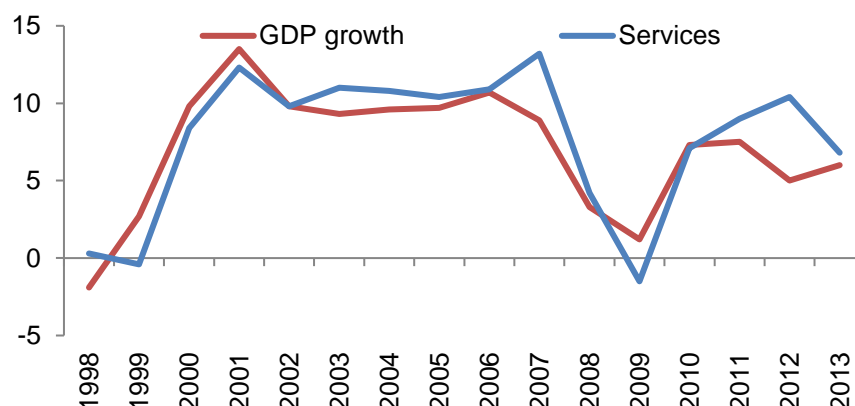
Table 17. Correlation matrix for the growth rates of GDP and main sectors in Kazakhstan in 1998–2013

	GDP	Agriculture	Industry	Construction	Services
GDP	1.00				
Agriculture	0.29	1.00			
Industry	0.81	0.13	1.00		
Construction	0.57	0.09	0.31	1.00	
Services	0.88	0.03	0.55	0.49	1.00

Source: Authors' computation based on the data from the Statistics Committee of the Ministry of National Economy of Kazakhstan

157. Empirical results show that service sector productivity growth can drive economic growth. Faster services productivity growth can spillover to other sectors through inter-industry input-output linkages, factor movements, and consumption and investment dynamics; cross-border spillovers include trade and financial linkages. However, if services labor productivity growth is lower than that of industry, increased sector size with deindustrialization can harm overall output growth [Lee and McKibbin 2014, p.3].

Figure 22. Dynamics of the growth rates of GDP and services in Kazakhstan in 1998–2013, in %



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan⁴⁵

⁴⁵ Refer: <http://stat.gov.kz/getlmg?id=ESTAT084348>

158. According to the model of “unbalanced growth”, higher productivity in the “progressive” (manufacturing) sector, as compared to the “stagnant” (service) sector, causes shifts of labor from manufacturing to services and shows that aggregate output growth slows down over time as the sector with the lower productivity expands [Baumol 1967, p.416].

159. Productivity changes in services are highly correlated with those in manufacturing. The service sector plays an important role in raising the productivity of manufacturing and other sectors of the economy. This particularly applies to business services, as they provide key intermediate inputs such as finance, legal services, human resource recruitment, marketing and information technology to manufacturing, and other sectors. Rather than handling tasks related to business services internally, manufacturing firms may find it more cost-efficient to outsource these tasks. This situation can be seen in Kazakhstan’s services import dynamics—the imports of business consulting and management services has doubled in just three years—from \$466mn in 2011 to \$974mn in 2013, while marketing services in the same period have quadrupled from \$22mn to \$87mn [NBK 2014, p. 56].

160. Increasing business process fragmentation and the corresponding growth of global BPO indicate how service function outsourcing, including offshoring, has become an integral part of running a viable and competitive business. By unloading some tasks to specialized service providers, manufacturing companies can concentrate on their core activities, and on improving production and undertaking innovation and technological upgrade. The synergies between services and industry become more apparent as economies develop, produce more differentiated goods, and require more efficient business systems [ADB 2013(1), p. 18].⁴⁶

161. Also noteworthy is that the service sector in general is considered to be “greener” or environmentally friendly compared to the rest of the economy. Relative to agriculture and manufacturing, the service sector tends to be less resource-intensive and places less strain on the environment. For example, food and beverage manufacturing uses inputs such as agricultural products, land, water, fuel, and electricity, in addition to labor. By contrast, an ICT firm is dependent only on labor and electricity. Furthermore, ICT exports can be sent through the internet and so will require less transport and energy costs than manufacturing exports [ADB 2013(1), p. 35].

2. Determinants of service sector labor productivity growth

162. The empirical analysis is intended to identify the most important determinants of labor productivity in services in Kazakhstan and the extent of their influence. This model has its certain limitations, first, due to the short time period (13 points) on which it is built, and second, due to the data quality issue that concerns both the explained variable and its determinants.

163. To conduct an empirical analysis, we first defined the determinants of service sector labor productivity growth. Determinants were selected based on their expected role in explaining the changes in services labor productivity in Kazakhstan. In addition to traditional variables such as human capital or FDI, an additional variable for the case of Kazakhstan, i.e., local content dummy was used. Determinants included the following:

- per capita GDP, in current \$ (World Bank)⁴⁷

⁴⁷ Publication of the WB (TBD).

- FDI in services, in \$ millions (National Bank of Kazakhstan) ⁴⁸
- human capital in services, i.e., workers with higher and vocational education as a percentage of total workers (Statistics Committee of the Ministry of National Economy of Kazakhstan)⁴⁹
- share of output in modern services in the output of total services (Statistics Committee of the Ministry of National Economy of Kazakhstan)⁵⁰
- local content, i.e., a dummy variable for the years 2010–2014, when the Program on developing the local content in goods, works and services procured was implemented. The indicator is a proxy for the state policy aimed at promoting the share of locally produced goods, works and services in the procurement of state-owned and private enterprises.⁵¹

164. Service sector labor productivity is not entirely determined by per capita GDP. The more general determinants are examined by adopting a standard empirical growth methodology, with annual data covering the period from 2002 to 2013. The growth rate of labor productivity in the service sector is regressed on a number of explanatory variables. In order to capture lagging effects and to avoid endogeneity problems, we additionally included two explanatory variables' (*FDIS* and *HUMCAPS*) first lags.

165. The empirical model specification is as follows:

$$G_t = c_0 + c_1 \text{LOG}(\text{GDPPC})_t + c_2 \text{LOG}(\text{FDIS})_{t-1} + c_3 \text{LOG}(\text{FDIS})_t + c_4 \text{LOG}(\text{HUMCAPS})_{t-1} + c_5 \text{LOG}(\text{HUMCAPS})_t + c_6 \text{LOG}(\text{MODSERV})_t + c_7 \text{LOCALC}_t$$

G_t	: the growth rate of labor productivity at t
$\text{LOG}(\text{GDPPC})_t$: log per capita income at t
$\text{LOG}(\text{FDIS})_{t-1} (t)$: log foreign direct investment in services at $t-1$ (t)
$\text{LOG}(\text{HUMCAPS})_{t-1} (t)$: log human capital in services (workers with higher and vocational education as a percentage of total workers) at $t-1$ (t)
$\text{LOG}(\text{MODSERV})_t$: log share of output in modern services in the output of total services at t
LOCALC_t	: local content at t (dummy for 2010–2013)

166. The model explains 83% of the labor productivity in the services sector, based on the adjusted R-squared, which is considered a good result based on the data limitation of the model. Logarithmic transformation was used for all determinants (except the dummy variable) to use the growth rates of indicators and make them comparable.

167. Human capital is the most important determinant for labor productivity in Kazakhstan, with the analysis suggesting that its positive impact is greater than that of all other factors combined. We included skilled workers, both with higher and vocational education, since labor productivity is expected to be closely related to human capital. The coefficient of lagged human capital is significant with a large magnitude, meaning that workers newly employed in services need time to adjust before they actually start contributing.

⁴⁸ Publication of the NBK (TBD).

⁴⁹ Publication of the SC MNE (TBD).

⁵⁰ Publication of the SC MNE (TBD).

⁵¹ Program on developing the local content in goods, works and services (TBD).

168. The share of modern services is the second-most important factor that defining services labor productivity in Kazakhstan. The coefficient of share of output in modern services as a percentage of the total services output is positive and significant at 5%, which proves that an increasing share of modern services in the service sector contributes to labor productivity.

169. Services' FDI coefficient at the current period is positive and significant, meaning that the flow of foreign investment has a positive effect on services labor productivity.

170. The coefficient of local content is also positive and significant; however, its impact on labor productivity is limited, and thus these results cannot be used to argue for a more active services localization policy.

171. The coefficient of the per capita GDP is negative and significant, which implies that the lower its level, the higher the subsequent growth rate of services labor productivity. This result is consistent with other studies in the empirical growth literature, with the negative relationship implying that the main challenge in achieving the higher level of labor productivity in services will be to ensure that labor productivity growth would be consistently higher than GDP growth.

172. Services' FDI with the lag of one year is negative and only significant at 10%. This can be explained by the effect of investments in services on labor productivity occurring within the one-year period. Otherwise, the impact of this factor is insignificant taking into account the time series limitation.

173. The human capital coefficient at the current period is negative, but insignificant, and can be ignored.

Table 18. Main parameters of the empirical model

Dependent Variable: GROLAB

Method: Least Squares

Date: 01/07/15 Time: 14:24

Sample (adjusted): 2003 2013

Included observations: 11 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.545470	0.876536	-1.763157	0.1761
LOG(GDPPC)	-0.493362	0.098842	-4.991421	0.0155
LOG(FDIS)	0.253313	0.045385	5.581389	0.0114
LOG(FDIS(-1))	-0.101070	0.033197	-3.044571	0.0557
LOG(HUMCAPS)	-0.543058	0.531762	-1.021243	0.3823
LOG(HUMCAPS(-1))	1.428755	0.556197	2.568794	0.0826
LOG(MODSERV)	0.339807	0.099440	3.417205	0.0419
LOCALC	0.122850	0.040562	3.028706	0.0564
R-squared	0.950844	Mean dependent var		-0.003310
Adjusted R-squared	0.836146	S.D. dependent var		0.042421
S.E. of regression	0.017172	Akaike info criterion		-5.135853
Sum squared resid	0.000885	Schwarz criterion		-4.846474
Log likelihood	36.24719	Hannan-Quinn criter.		-5.318265
F-statistic	8.290005	Durbin-Watson stat		2.820235
Prob(F-statistic)	0.054955			

Source: Authors' computation based on the data from the Statistics Committee of the Ministry of National Economy of Kazakhstan

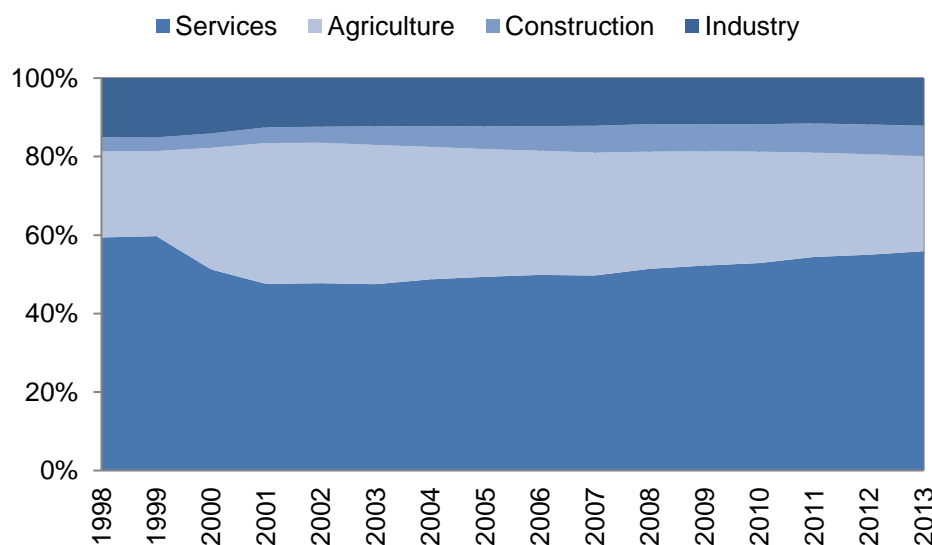
174. The empirical analysis results show that the human capital represented as a share of workers with higher and vocational education is the single most significant factor behind service sector labor productivity in Kazakhstan. It also shows that the impact of human capital improvement usually lags by one year. The share of modern services and the FDI flow also have significant impact on productivity. These results are especially important in terms of promoting Kazakhstan's service sector that will be in more details discussed in the "Policy recommendations" part of the D section of this paper.

3. Service sector development and inclusive growth

175. Though service sector performance may have a significant impact on poverty reduction and inclusive growth, it is difficult to identify its direct impact. Potential channels include the growth of the agricultural, industrial, and service sectors, or the growth of public consumption. High levels of physical and human capital accumulation (particularly with respect to women) may also be associated with rapid and inclusive services growth [ADB 2013(1), p. 29].

176. Two key ingredients of inclusive growth are expanded access to education and productive employment. Services tend to be labor-intensive and generate productive employment, thereby promoting inclusive growth at a broader level by creating jobs. Crucially, these include not only jobs in the modern service industries but also the traditional service industries.

Figure 23. The employment structure in Kazakhstan in main sectors as a percentage of total employment, including the self-employed in 1998–2013⁵²

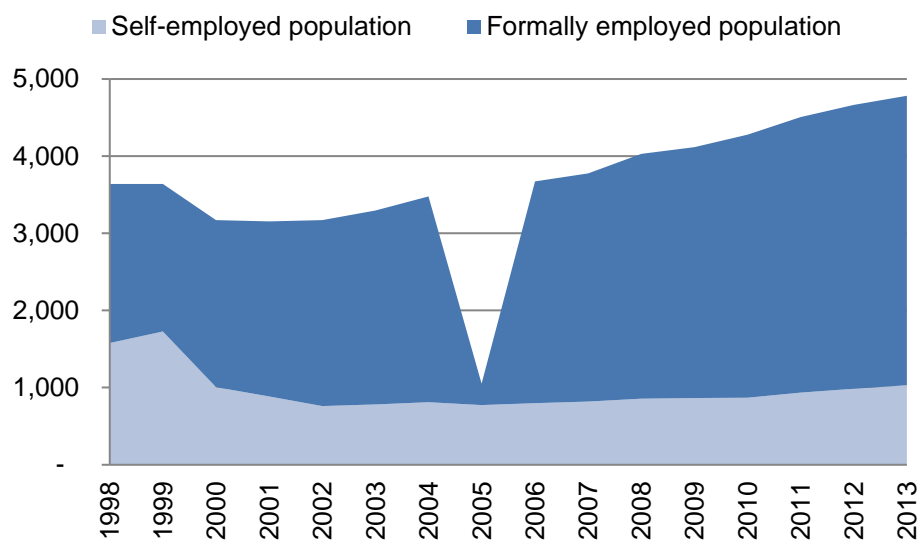


Source: Statistics Committee of the Ministry of National Economy of Kazakhstan

177. The employment in services in Kazakhstan has been steadily growing for the last decade, with growth being evenly distributed among all types of services. Since 2001, the service sector has been the major contributor to creating new workplaces: every three out of four new workplaces in the economy has been created in the services sector, according to the Statistics Committee of the Ministry of National Economy of Kazakhstan.

⁵² Services sector include modern, traditional, social and public administration.

Figure 24. The dynamics of the employment in services sector in Kazakhstan by types of employment in thousands of people in 1998–2013



Source: Statistics Committee of the Ministry of National Economy of Kazakhstan

178. As an economy evolves, service sector growth should be more conducive for female employment since services jobs tend to be less physically demanding than manufacturing jobs, a finding supported by several studies. Development of the service sector can widen employment opportunities for both men and women, but especially for women. Indeed, the 2012 World Development Report shows that across 77 countries, services accounts for a higher proportion of female employment than male employment, with the reverse being true for manufacturing [WB 2011, p. 210]. As such, countries where services account for a higher share of employment have higher female labor force participation rates [ADB 2013(1), p. 34].

179. In 2012, the number of women employed in services (including social services and public administration) in Kazakhstan reached 2.6mn, which accounted for almost one-third of all people employed in the economy. The share of women in the total number of employed in services was 56% and was higher than the share of women in total employment (49% in 2012).

180. Within the service sector, women were mostly employed in trade (17.5% of total employed women in 2012), education (15.6%), healthcare and social services (7.6%), public administration (3.9%), and transportation services and storage (2.9%) [SC 2013, p. 84].

181. Services has been the major provider of jobs for women; in 2012, roughly 63% of all employed women were working in services. In comparison, only 47% of all employed men were working in services.

Table 18. Share of women in total employment in different sectors in Kazakhstan in 2012, in %

	In total employment (including self-employed population)	In self-employed population
Total	48.6	48.4
Agriculture	47.6	51.9
Industry	32.3	49.0
Construction	24.2	23.4
Services	55.8	46.9

Source: Statistics Committee of the Ministry of National Economy of Kazakhstan [SC 2013, p. 84–85]

182. In 2012, of almost half a million unemployed people in Kazakhstan, 60% were women, with one-quarter having a higher education degree and 95% having at least graduated high school. Naturally, the easiest way for these women to enter the labor market would be through services, given the lower entry barriers for skills, gender, and initial capital. Female workers in general cost less than male workers; in 2012, women were paid 70% of the average men's salary.

183. Intuitively, general manufacturing requires a larger stock of physical capital, i.e., factories and machines, than services and is thus more skewed toward the wealthy few, while even the poor are endowed with unskilled labor. A shift in economic structure towards services can thus help to reduce poverty and inequality [ADB 2013(1), p. 43].

184. To summarize, services drive aggregate productivity, resulting in higher growth rates. As a result, it can be claimed that share of services leads to higher income per capita. However, such a relationship holds only for service activities that are either a combination of traditional and modern services consumed mainly by households (such as education and health), or modern services, intended for both households and businesses.

185. Share of services value added embodied in manufacturing goods increases over time. The growing interdependence between services and manufacturing leads to the rising amount of service sector value added being embodied in manufacturing goods.

186. The service sector plays an important role in raising the productivity of manufacturing and other sectors of the economy. This particularly applies to business services, as they provide key intermediate inputs such as finance, legal services, human resource recruitment, marketing and information technology to manufacturing and other sectors.

D. CURRENT ISSUES AND BARRIERS TO SERVICES DEVELOPMENT IN KAZAKHSTAN

1. Current issues relevant to service sector development in Kazakhstan

187. The following are considered to play an important service sector development role and have direct impact on the

i. Data availability and quality

188. One key challenge for Kazakhstan is to improve the quality of service sector data. There is a large need to expand basic data collection efforts as one cannot manage what one cannot measure. Major issues concerning the statistics in services include classifications, registers, adoption of NSA 2008, informal employment measurement, labor productivity in services and BOP statistics.

ii. High share of traditional services

189. With two-thirds of the services sector being traditional services, Kazakhstan needs to diversify the services sector through the prioritizing modern services.

iii. Unbalanced trade in services

190. As a developing country, Kazakhstan still has a very high level of imported services, mostly modern, and a low level of exported services, mostly clustered in traditional services. An additional complication in the case of Kazakhstan is that the mineral resources extraction upon which most of its economy depends is done by multinational corporations, which have set the high requirements that cannot be met by local suppliers.

2. Barriers to development of the services sector as an engine for diversified economic growth in Kazakhstan

191. Most of the barriers to service sector development in Kazakhstan are typical of a developing country and can be directly linked to the current economic model and fundamental issues with the rule of law and education level.

i. Low productivity

192. An abundance of low-skilled labor due to migration to urban areas positively affects the traditional services (mostly trade). However the shortage of skilled labor for modern services is becoming a challenge for the business owners, who sees the problem of “Inadequately educated workforce” comparable to the problem of Inflation and tax rates [WEF 2013, p. 234].

ii. Informal sector

193. The informal sector has a negative effect on the overall productivity of the services sector and its long-term growth rates. On the other hand, it also has a positive effect on providing initial employment during urbanization. It is expected that Government support to services in agriculture could lead to the increased labor productivity in the agricultural sector and creation of new jobs in rural areas.

iii. Overall governance issues

194. A further barrier is systemic governance issues, including rule of law, transparency, competition protection, and effectiveness. Further development of the truly independent and transparent judiciary should enable overcoming this barrier.

iv. Fundamental issues in the education system at various levels

195. Education quality does not allow for the development of modern services that require high-skill labor. Despite the high quantitative achievements, Kazakhstan still lacks a high-quality education system that would produce enough skilled workers to meet market requirements.

v. Integration with more developed economies

196. Integrating with countries that have larger markets, higher income levels, and speak the same language can pose a threat to the providers of local services. This is especially true for tradable services, i.e., modern services that should become the engine of the productivity increase and economy and export diversification. There is a strong deficit of the skilled labor required for modern services. Development of the skills requires time; some nurturing period should also be taken into account. Hence targeted imports of skilled labor may be an option in order to produce modern services domestically, as was the case in Singapore.

3. Current Government policies towards services

197. The diversification of the economy has been the major driver behind numerous Government initiatives to promote the export of more knowledge-intensive goods and services. Mostly these initiatives focused on goods, rather than services. To achieve diversification, a number of state programs have been adopted to develop local production in general and certain prioritized sectors in particular.

198. **Promotion of services sector.** The Government has announced the Program on developing the service sector in Kazakhstan in 2015–2020 (hereinafter, Services program).⁵³ Efforts will be focused on developing nine major sectors selected based on their share in the GDP: trade (15.4% of GDP), transportation and logistics (7.8%), tourism (1.6%), real estate services (8.6%), professional services (4.3%), information and communication (2.7%), financial services and insurance (2.8%), education (2.9%) and healthcare (1.6%). As we can see, modern services are represented only by professional services, informational and communicational services and financial services and insurance, whereas the rest of the services are traditional and social.

199. Success of the Services program will be based on following targets:

- *Increase in services labor productivity by 48% in 2015–2020.* The measurement suggested is nominal and is measured in tenge, with no reference to the inflation or the base year.
- *Share of services sector in GDP should increase from 54% in 2013 to 60% in 2020.* No target is set for the structure and composition of the services sector, hence increasing of the share of modern services within the sector is not emphasized.

⁵³ 2020 Program on developing the services sector in Kazakhstan. Resolution #1378 from 24 December 2014 of the Government of Kazakhstan.

- *Services exports in 2020 should increase twofold compared to 2013* (that is, from \$5.3bn to \$10.6bn). There is no target on the ratio of services export to goods or services imports, which would be a better development indicator.
- *The share of professional services should increase to 4.9% of GDP by 2020.*
- *The share of informational and communicational services should increase to 3.2% of GDP by 2020.*

200. **Informal sector.** The Government has been combatting the informal sector. In 2013, the 2013–2015 Complex Plan (hereinafter, the Plan)⁵⁴ aimed at mitigating the unobservable economy was adopted. According to the Plan, the Government will decrease the cash payments volume and, in strengthening institutions to promote the business climate, decrease corruption and increase public administration efficiency (especially in fiscal and customs administration and state budget procurement areas).

201. Also from 1 September 2014, that would legalize money, stocks, stakes in companies, and local and foreign real estate started that will continue through 2015. Any resident of Kazakhstan is allowed to participate in the 2014–2015 legalization campaign; however, unlike in 2006–2007, only individuals are allowed to participate.⁵⁵ The Government expects that the campaign would result in the legalization of \$12bn (or 5.2% of 2013 GDP) that is now in a grey market. This campaign would compare with that of 2006–2007, which resulted in legalization of assets worth 6.5% of GDP, and 2001, which resulted in legalizing 2.2% of GDP.⁵⁶

202. **Local content.** The 2010–2014 Program on developing local content in goods, works and services is completed. It was planned that as a result of this Program, the share of locally produced services would reach 85% of all procured services for oil and gas companies and 90% for government agencies, SOE's, and large enterprises.⁵⁷ It comes without surprise that the first local content program adopted by the Government was mostly focused on promoting manufacturing rather than services; however, the local content Program can become the basis for shaping future policy towards promotion of local content in services.

203. **Labor productivity.** The first state program on productivity was adopted in 2011 and mostly targets manufacturing. The goal of the Program is, “to improve the competitiveness of industrial enterprises in the prioritized sectors of the economy through the increased labor productivity”.⁵⁸ However, the list of prioritized sectors of the economy includes some services, such as technical services for oil and gas and mining sectors, transport and storage, and communication services.

204. **Trade services.** Trade sector development program⁵⁹ was adopted in 2010 and sets a target to have at least half of the retail turnover going through the enterprises of the modern trade formats. The main goal of the program is to increase the efficiency of the domestic trade sector and improve the labor productivity in the trade sector. The retail turnover has increased from \$21bn in 2010 to \$30bn in 2013.

⁵⁴ Complex Plan on counteractions for shadow economy in Kazakhstan for 2013–2015. Resolution #190 from 27 February 2013 of the Government of Kazakhstan.

⁵⁵ Refer: <http://www.uchet.kz/news/detail.php?EID=162841&icon=Y>

⁵⁶ Refer: http://forbes.kz/finances/finance/legalizatsiya_vryad_li_vernet_v_kazahstan_vyivedennyie_za_rubej_390_mlrld

⁵⁷ 2010–2014 Program on developing the local content in goods, works and services in Kazakhstan. Resolution #1135 from 29 October 2010 of the Government of Kazakhstan.

⁵⁸ “Productivity 2020” Program. Resolution #254 from 14 March 2011 of the Government of Kazakhstan.

⁵⁹ 2010–2014 Program on developing the trade in Kazakhstan. Resolution #1143 from 30 October 2010 of the Government of Kazakhstan.

205. **Transportation and logistics services.** As stated in the *Kazakhstan 2050 Program* [include a reference], Kazakhstan will emphasize the development of the logistics service sector. This will be supported by the increased goods turnover due developing new routes, such as CU goods transportation with Russia and Belarus, development of the new Western Europe – Western China transport corridor, and a new railroad to the Persian Gulf via Turkmenistan.

206. The state transportation system program⁶⁰ declared the goal of integrating Kazakhstan into the international transport system. One of the main targets set by this program is to increase the volume of the transit cargo twofold: from 17.8mn tons in 2012 to 35.5mn tons in 2020. By 2020, the volume of the transit cargo intended for the PRC to the European Union (EU) should reach 15mn tons, while that intended for Russia to the EU and Central Asia should reach 20mn tons. Total expenses required for this program are estimated at 5.2 trillion tenge (\$33.6bn), mostly funded by the state budget (52%) and the national railroad firm Kazakhstan Temir Zholy (29%).

207. **Telecommunications services.** The Informational Kazakhstan Program⁶¹ is aimed at current challenges related to the lack of an ICT infrastructure in the regions and rural areas.

208. The action points set up by the Government include:

- i. modernization and development of telecommunications network using CDMA technologies;
- ii. introduction of a 3G network wherever the population exceeds 10,000 people;
- iii. introduction of a 4G network in all regional capitals, locations with populations exceeding 50 000 people, and all district centers in Kazakhstan; and
- iv. a decrease in tariffs on internet access and traffic services annually by 10%.

209. One of the targets of the program is to increase the share of the ICT sector to 4% of GDP by 2020. Another target is to increase by 2020 the turnover of local internet stores to 40% of all retail trade turnover paid using cashless payments and up to 10% of total retail trade turnover.

4. Policy Recommendations

210. The results of the empirical analysis presented in this paper suggest that there are two main factors that drive labor productivity in the service sector. First and foremost is human capital. It is important to note that the model shows that workers newly employed in the service sector need time to adjust before they actually start contributing.

211. Second, an increase in share of modern services in the service sector also contributes to the growth of labor productivity. Therefore it is worth considering targeted development of some modern services in order to increase the overall labor productivity.

212. However, the industrial policy approach may not be the most effective way to promote growth in services, and it should not be considered as straightforward as in manufacturing due to services' higher heterogeneity. There were several cases in the world when increased direct government involvement in services through industrial policy and picking winners has had its positive effects; however, in most cases, a broader approach aimed at creating generally favorable business conditions was sufficient for the services market to grow.

⁶⁰ State Program on the development and integration of the infrastructure of transportation system of Kazakhstan till 2020. Decree of the President of Kazakhstan #725 from 13 January 2013.

⁶¹ State Program "Informational Kazakhstan - 2020". Decree of the President of Kazakhstan #464 from 8 January 2013.

213. The Government of Kazakhstan has made a lot of progress in improving the business climate and promoting entrepreneurship in the country. However, there is still much work to be done to ensure the rule of law and to offload the administrative burden, especially from the small enterprises, as well as the protection of competition, significant privatization of the SOEs that crowd out private investments, and deregulation of business activities.

214. The service sector plays an important role in raising the productivity of the manufacturing sector and other sectors of the economy. Business services provide key intermediate inputs such as finance, legal services, human resource recruitment, marketing, and information technology to manufacturing and other sectors. Rather than handling tasks related to business services internally, manufacturing firms may find it more cost-effective to outsource these tasks to firms that specialize in them.

215. Increased fragmentation of business processes and the corresponding growth of the global business process service function outsourcing industry, including offshoring, indicate how it has become an integral part of running a viable and competitive business. By unloading some tasks to specialized service providers, manufacturing companies can concentrate on their core activities, and on improving production and undertaking innovation and technological upgrade. The important synergies between services and industry become more apparent as economies develop, produce more differentiated goods, and require more efficient systems for businesses [ADB 2013(1), p. 42].

216. Some widely anticipated policies that the Government can pursue include the following:

- easing entry to boost competition and increase productivity;
- reducing the regulatory burden;
- improving access to capital, especially for entrepreneurs and small- and medium-sized enterprises;
- reducing taxation on labor, and increasing the flexibility to labor markets more generally; and
- equalizing tax treatment across sectors where manufacturing activities are often treated preferentially.

217. The Government can help lay the foundation for a vibrant service sector through both policy reform and investments in physical infrastructure and human capital, and can take active measures to create a more conducive environment for the service sector, such as investing in physical infrastructure such as telecom and education/human capital. Good infrastructure and adequate supply of human capital are especially important for the modern service industries, such as ICT-BPO [ADB 2013(1), p. 29].

218. Some of the key areas for promotion of services in Kazakhstan include the following items:

i. Increase in labor productivity

219. Labor productivity should become one of the major targets for the state policy. More emphasis should be put on ensuring the quality of the productivity statistics and its usability for international comparison (refer to part 3 of this report for more information).

220. Based on the results of the empirical analysis, education is the most important factor driving services labor productivity. Education is also a key for promoting the modern services that require highly skilled labor. It is expected that the gradual decrease in informal employment will have its positive effect on labor productivity in traditional services.

ii. Focus on addressing the informal sector

221. Informal employment in Kazakhstan is mostly concentrated in three sectors: trade, agriculture, and construction. Hence, state policy should include the mechanism for decreasing the size of the informal sector in trade and absorbing the inflow of workers from rural areas, as urbanization is one of the major factors to define the services development.

222. Informal trade is a “low-hanging fruit”, as almost 50% of the trade is unorganized. As of 2013, only one-third of retail trade was via medium and large enterprises. It is crucial to promote the development of medium and large trade enterprises and national retailers so that they can have a bigger bargaining power and are able to compete with unorganized retailers.

223. Another way to look at the problem is to analyze the concentration level and foreign participation in the trade sector. The share of foreign companies in the retail trade in 2013 was only 6%. Higher concentration levels and increased attractiveness of the trade sector for foreign investors could positively affect the overall transparency and efficiency of the trade sector and could contribute to the decreasing the informal sector in services.

224. Finally, almost all payments outside the large cities are made in cash. Only the two largest cities—Almaty and Astana—accounted for 57% of all cashless payments.⁶² Currently employed measures in the Complex Plan⁶³ are seen as inadequate to change the behavior of merchants and customers. More bold measures are required to change the tradition of using cash in daily life in Kazakhstan, with the most effective being introducing tax incentives for using cashless payment terminals. It is expected that the loss of taxes due to proposed discounts for using cashless payments will be surpassed by the increased tax base.

iii. Primary focus on developing modern services

225. The state policy should set the basis for long-term development of the modern services that can gradually increase its share in services. Statistics of modern services should be broadened in terms of detailing the output, employment, and export/import of the services.

226. The Local Content Program has defined the List of 150 most-imported goods. It is advised for the respective agency of the Government to come up with an analogous list for services. Based on this list, the Government can design further mechanisms to promote these services through providing affordable funding, facilitating technology transfer, and teaching and training of required specialists for the local market. Also, new services need to be developed that are present in economies with similar income levels, but are underdeveloped or non-existent in Kazakhstan.

227. The deficit of skilled modern services labor can be addressed through targeted talent acquisition from other countries, as happened in the cases of Singapore, Canada, and Australia. However, one should understand that importing labor is a short-term solution, while a long-term solution is developing the domestic educational system. In the case of Singapore, importing skills from overseas allowed establishing a regional financial hub in a relatively short period of time; by contrast, in the PRC, the state policy focused on providing training for its own people. At the same time, in the United Arab Emirates, the Government has attracted foreign talents to build a

⁶² <http://nationalbank.kz/?docid=786&switch=russian>

⁶³ Complex Plan on counteractions for shadow economy in Kazakhstan for 2013–2015. Resolution #190 from 27 February 2013 of the Government of Kazakhstan.

successful modern services sector, but later failed to implement the “Emiratization” of the skilled labor.

iv. Promoting export of services

228. A constant analysis of the current state and historic dynamics of modern services development in Kazakhstan will provide precious information for services policy making. Modern services with a high potential for exports (first of all within the EEU) should be promoted through subsidizing loans and using the existing entrepreneurship and export development agencies, such as Damu and Kaznex.

229. One of the goals of the state policy should be to define the comfortable level of the trade balance in services, first of all within the EEU, and also with all other countries. The timing of this task is especially important due to the upcoming membership of Kazakhstan in the WTO and the expected decrease in the entry barriers for foreign companies.

v. Focus on several key areas with the possible highest result

230. It is advisable for the state policy to focus on a limited number of crucial tasks that would allow achieving quick visible results in lieu of larger endeavors.

231. For the process of identifying the crucial tasks, the following process was used:

- 1) Define the challenge.
- 2) Identify the cause.
- 3) Come up with the solution.
- 4) Focus on the 20% of the solution that will ensure 80% of the result.

Table 19. Crucial tasks for the policy considerations for the development of services sector in Kazakhstan

	Challenge	Cause	Solution	Focus
1	Low productivity in services	Low educational level, especially of the rural population that migrates to the urban areas	Decrease informal employment	<ul style="list-style-type: none"> • Focus on trade sector where every second worker is self-employed • Focus on retail trade where productivity is low and stagnant since 2009
			Affordable education, training and re-training	<ul style="list-style-type: none"> • Vocational education and training • Support competition in the services sector and decrease the share of state-owned enterprises through privatization and public-private partnership
2	Low diversification of services exports	Tradable modern services are not competitive or are non-existent	Develop modern services that can be exported	<ul style="list-style-type: none"> • ICT / BPO services targeted at the Russian market • Freight and logistics services • Engineering services (based on strong domestic foothold in oil and gas, mining, agriculture, and transport)
3	Low diversification	“Dutch disease” symptoms:		

	Challenge	Cause	Solution	Focus
	of exports	exports of oil and gas making other exports non-competitive		
4	High import of services, mostly modern services	Domestic modern services are not competitive or are non-existent	Promote local content in services	<ul style="list-style-type: none"> • Focus on oil and gas, mining, engineering, business and professional services that comprise most of the services import • Identify services that will be most affected by the entry to the WTO and support them

vi. ICT-BPO sector development

232. One area where active government intervention can make a big difference is ICT infrastructure, especially broadband. ICT has large spillover effects on services and served as a catalyst in transforming non-tradable services into tradable ones. Telecom liberalization is key in this context. With respect to the efficiency of public services and utilities, privatization has largely fallen out of favor, while fostering more competitive markets remains the more basic challenge [ADB 2013(1), p. 44].

233. The promotion of ICT and BPO services represents a key area for future growth of Kazakhstan's knowledge economy. It is thus critical that the deployment of ICT infrastructure be accelerated as part of the new regional agglomeration strategy. To ensure that this happens, the Government may need to liberalize competition in telecommunications. Also, the development of high quality educational programs in ICT and digital media in selected local universities (preferably one in each of the regional hubs) is also a high priority [ADB 2014, p. 96].

vii. Balanced development of manufacturing and services sectors

234. There are several examples where Governments have been mostly focused on the developing the manufacturing sector (Germany, South Korea) and missed the point vis-à-vis the services sector.

235. On the other hand, some country examples (India, Philippines) are used to justify the so-called "leapfrogging hypothesis", which argues that technological progress allows countries to leapfrog industrialization and move straight into the post-industrial phase. This leads to the wrong conclusion that services-led growth offers a viable alternative development strategy to traditional manufacturing-led growth. The leapfrogging hypothesis is dangerous because it can be used as an excuse for the failures of the manufacturing sector.

236. Analyzing the international experience suggests that viewing growth and development in terms of either manufacturing or services is not very meaningful because it is necessary for a country to have both. Indeed, while the relative importance of the two sectors evolves over time, they both account for a large share of output and employment in most countries, and development is likely to be maximized when they move forward together symbiotically. Hence, while more industries within the service sector in different countries have shown rapid growth rates by improving their tradability, a good balance between services and manufacturing remains the most viable growth strategy for developing countries [ADB 2013(1), p. 41].

237. In addition, there are potentially large synergies between services on the one hand, and manufacturing and the rest of the economy on the other. For example, efficient energy, transportation, and distribution networks boost manufacturing productivity. A strong modern service sector, in particular, business services such as design, prototyping and marketing, can move middle-income countries up the value chain toward higher value-added activities and thus help them escape the much-feared middle-income trap.

viii. Suggested targets for the state policy

238. In order to monitor the state policy's efficiency and be able to introduce timely policy changes, certain targets should be identified. Among such targets, the following can be used:

- Labor productivity by types of services
- Output of the services as percentage of GDP
- Output of the modern services as percentage of GDP
- Number of workers with higher education as percentage of workers by types of services
- Number of self-employed in services as percentage of number of employed in services
- Number of self-employed in services as percentage of number of employed in retail trade
- Value of cashless payments in as percentage of payments in retail trade
- Value of services imports as a ratio to the value of services exports
- Trade in services as percentage of GDP
- Trade in services as percentage of total external trade
- Exports of services as percentage of exports
- Imports of services as percentage of imports
- Exports of modern services as percentage of exports of services
- Imports of modern services as percentage of imports of services

ix. General policy recommendations

239. The overall guiding principle for policymakers when addressing the service sector must be to create a more competitive environment for their industries. The significant gap in productivity between Kazakhstan and developed economies implies a wide range of structural and policy impediments that must be removed to fully unleash the potential of services as an engine of growth and jobs.

240. Internally, these include strengthening of labor and capital markets, reform of tax regimes, and elimination of burdensome regulations, which typically protect incumbent firms, and thus stifle competition and innovation. The international historical experience shows that regulatory reforms often deliver economic benefits, such as higher labor productivity and lower prices. External barriers such as those to trade in services also impede competition in domestic services markets. Reducing such barriers can not only promote services efficiency and productivity, but also contribute directly to exports and growth (e.g., India's well-known success as an ICT-BPO exporter).

241. Kazakhstan must support its service sectors to improve employment opportunities and both internal stability and international relations. Traditional services still dominate in the country, while developing modern services should be seen as an imperative.

242. Because traditional services still account for a large share of the sector, Kazakhstan lags behind advanced economies in terms of efficiency. There remains a great opportunity for further

growth and development. The productivity gap between Kazakhstan and advanced economies strongly suggests the removal of policy and structural constraints to free the service sector to better serve as an engine of employment and growth.

243. The primary focus should be placed on the encouraging competition in the provision of services, which may require removing burdensome regulations. International experience demonstrates that regulatory reforms often deliver significant economic benefits, including increased labor productivity with lower prices. Where services are now provided by public entities, competition can be encouraged through regulatory reforms fostering choice and innovation without necessarily privatizing existing institutions [Noland, Park and Estrada 2013, p.7].

244. Regulatory reform may be necessary for such changes, but it is unlikely to be sufficient. Strengthening capital and labor markets will be a needed complement to regulatory reform to establish and grow new and innovative service providers.

245. To sum up, the main issues in the development of services in Kazakhstan include data availability and quality, high share of traditional services, and unbalanced trade in services.

246. Barriers for the growth in services include low productivity, an informal sector that retards the service sector, overall governance issues such as rule of law and competition, quality of the education and its relevance to the market demand, and integration with more developed economies that creates both opportunities and challenges for the development of modern services that are tradable across borders.

247. Policy recommendations include the following: measures to increase labor productivity; focusing on addressing informal sector, especially in trade; setting the basis for long-term development of the modern services and promotion of services exports; development of specific sectors (ICT-BPO); and overall balance between developing manufacturing and services. In addition, general policy recommendations include the strengthening of labor and capital markets, reform of tax regimes, and elimination of burdensome regulations.

E. CONCLUSIONS

248. The intangible nature of many services takes nothing away from their very real economic effects in employment and broader economic dynamism. Efficient energy, distribution, and transportation networks boost productivity in manufacturing. Strong modern services, especially business services such as design, marketing, and prototyping, can stop Kazakhstan from becoming trapped at the middle-income level and lead them into higher-value-added activities generating higher incomes.

249. The service sector already accounts for a large share of Kazakhstan's employment and output. At the top, service sector growth already contributes to the country's economic growth. It is tempting to directly apply the experience of other fast-growing developing countries (the Republic of Korea, the PRC, Taipei, China) that showed a long period of economic growth while simultaneously increasing the employment and elevating most of their populations from poverty.

250. Kazakhstan has some unique features that do not allow it to follow this recipe, such as a geographic location that increases transportation costs of goods and decreases competitiveness of its exports, abundance of mineral resources that leads to higher concentration of capital-intensive extractive industries, and insufficient savings and investment rates (especially FDI inflows) directed into manufacturing. The service sector, on the other hand, does not require large capital and is not dependent on the proximity to end-markets. Also, labor-intensive services positively influence employment, especially of some social groups, i.e., young people, women, and elderly people.

251. There is no doubt that the development of services will positively affect the economy in general and will increase labor productivity in other sectors, especially in manufacturing. In addition, promoting modern services will positively contribute to diversifying the economy and external trade. Developing the service sector will add to the stability of the economic system that is currently overly dependent on the exports of raw minerals.

252. Because of the Government's top-down approach, there is a high risk of inefficient and nontransparent public spending that can eventually lead to lower long-term growth.

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