Kazakhstan:

A Weakening Fiscal Regime under the New Ownership Structure?

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Biography

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Introduction by Ray Finch, FMSO

States which possess considerable petro-wealth are faced with the challenge of dividing the revenue from these riches fairly among the populace. Don't share enough, and public discontent rises; share too much, and there is the danger of weakening the work ethic. This equitable division and the establishment of fair tax policies have been complicated in post-Soviet Kazakhstan. Some of the formerly state-owned oil industries have been privatized among Kazakh officials and foreign corporations, and, given the weak legal system in the country, determining a fair tax rate to satisfy both owners and citizens has been a challenge for the Kazakh government.

In this detailed study of various tax proposals within the Kazakh minerals industry, Ruoxi Du explores different types of ownership and tax structures. Lacking a tradition of fiscal transparency, she spells out why the Kazakh leadership should adopt more open and reliable accounting procedures (i.e., in order to attract greater foreign and domestic investment into the minerals industry). This is a timely paper, given the growing social protests against what some Kazakhs perceive as an unfair distribution of mineral wealth.

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The nearer building with the arch houses the national oil and gas company of Kazakhstan (KMG), while the huge pyramid-shaped tent (sort of like a giant teepee) in the back is the Khan Shatir (Great Tent) shopping mall. By Ken and Nyetta [CC-BY-2.0 (creativecommons.org/licenses/by/2.0)]

Introduction

Mineral-rich Kazakhstan changed its ownership structure over mineral reserves in 2005, turning the Kazakhstani government elites into direct claimants to the proceeds from mineral wealth; in the past, foreign investors used to serve as the sole direct claimants under the former ownership structure.[1] This shift in ownership structure has great potential to change the way the Kazakhstani government generates and allocates revenue, in particular oil revenue, which accounts for approximately 40 percent of Kazakhstan's total government revenue over the period 2004-2008.[2] A timely evaluation of the performance of Kazakhstan's fiscal regime under the new ownership structure over mineral reserves has important implications on the country's administrative capacity, economic growth, and democratization.[3]

This study assesses whether this newly adopted ownership structure has caused a weakening of the Kazakhstani fiscal regime, i.e., its taxation and expenditure institutions, and how it has been shaping these institutions. First, this paper will clarify the definitions of ownership structure over two key concepts, mineral reserves and fiscal regime. Second, it will assess the

1 Pauline Jones Luong and Erika Weinthal, 11.
2 Silvana Tordo, Brandon S. Tracy, and Noora Arfaa, 56.
3 Ibid, 32.

Kazakhstan map by planiglobe.com [CC-BY-SA-2.5 (creativecommons.org/licenses/by/sa/2.5)]

degree to which Kazakhstan's fiscal regime has been weakened by the change in its ownership structure. Third, the paper will provide theoretical explanations for the problems observed in the developments of the Kazakhstani fiscal regime. Forecasts of the likelihood that Kazakhstan's fiscal regime will remain weak under the current ownership structure and suggested solutions for these problems will be provided in the last two sections.

Key Concepts

Based on the classification developed by Pauline Jones Luong and Erika Weinthal, there are four types of ownership structure over mineral reserves: (1) State ownership with control (S1); (2) State ownership without control (S2); (3) Private domestic ownership (P1); (4) Private foreign ownership (P2). These four forms of ownership structure vary essentially in terms of who owns the rights to develop the majority of petroleum deposits and hold the majority of shares in the petroleum sector (the state, under S1 and S2; private domestic companies, under P1; private foreign companies, under P2). S1 and S2 differ in whether foreign investors' managerial and operational control in the petroleum sector is restricted (S1) or granted (S2) by the state.[4]

4 Ibid, 7.

In 2005 Kazakhstan's Law on Subsoil and Subsoil Use was amended to grant the national oil company KazMunaiGaz (KMG) the status of a contractor and require it to hold at least 50 percent stake in all new oil assets deals.[5] This amendment signifies the transformation of Kazakhstan's ownership structure over its oil and gas reserves from private foreign ownership (P2) to state ownership without control (S2). To be specific, while before 2005 private foreign companies owned the rights to develop the majority of Kazakhstan's petroleum deposits and hold the majority of shares in its petroleum sector, since 2005 the state itself has owned these rights and foreign investors are allowed to participate only through contracts, such as production-sharing agreements (PSAs).[6] Simply put, this shift has made the Kazakhstani government elites, in addition to foreign investors in the country's mineral sector, direct claimants to the proceeds from the country's mineral wealth. Under the former ownership structure, however, foreign investors were the sole direct claimants to these proceeds, while government elites served only as indirect claimants.[7]

Ownership structures often have direct influence on the fiscal regimes of mineral-rich states. Is the newly adopted ownership structure in Kazakhstan weakening its fiscal regime? A weak fiscal regime consists of "a tax system that is unstable, based largely, if not exclusively, on the mineral sector" and "a system of expenditures that undermines budgetary stability and transparency."[8]

Thus, in order to identify the impact of the new ownership structure on Kazakhstan's fiscal regimes, this paper investigates the stability and scope of Kazakhstan's taxation system, particularly in regard to its mineral sector. It will also evaluate the stability and transparency of the National Fund of the Republic of Kazakhstan (NFRK) — a special stabilization and savings fund designed to help governments deal with large and variable revenues — and the effectiveness of constraints on government spending.

5 U.S. Energy Information Administration, November, 2010.
6 Ibid, 7.
7 Ibid, 11.
8 Ibid, 12.

> ***“Tax provisions in Kazakhstan, both those in general and those seperate from the mineral sector, can hardly be viewed as stable.”***

Problems in Kazakhstan’s Tax and Expenditure Institutions

Tax provisions in Kazakhstan, both those in general and those separate for the mineral sector, can hardly be viewed as stable, since the country had adopted the P2 ownership structure in the mid-1990s. The 1995 Tax Code served as the main legal act establishing and regulating taxation in Kazakhstan until it was replaced by the 2002 Tax Code. However, numerous amendments were frequently added to the tax codes, making the tax regime fraught with fluctuations. According to a representative from the United States Agency for International Development (USAID), about 250 amendments were introduced to the tax code between 1994 and 2000.[9] In the petroleum sector, despite the fact that foreign oil companies (FOC) were once offered stability assurance by the Kazakhstani government against fluctuations in the general tax code in the 1990s, the terms of the FOCs’ contracts were repeatedly violated, and many of their tax privileges rescinded.[10] The FOCs’ tax obligations became even more unstable after the revisions to the tax code in 2002 allowed for contracts to be amended to adjust the FOCs’ possibly improved position due to changes in the tax law.[11]

Not surprisingly, the Kazakhstani government’s nonstop lawmaking in its tax regime continues under the new ownership structure (S2) adopted in 2005. In 2008, after President Nazarbayev’s announced that Kazakhstan required a new tax code, the Tax Code was adopted in December and came into force on the 1 January 2009. This new tax legislation made Kazakhstan “the only country in the Commonwealth of Independent States (CIS) which has had three tax codes since the declaration of its independence in 1991.”[12] Less than one year after the enactment of the Tax Code, it underwent further changes through the “Tax Code Amendments”

9 Ibid, 273.
10 Ibid, 276.
11 Ibid, 267-268.
12 International Tax Review, April 01, 2010

in December 2009. As summarized by analysts of Ernst & Young, "tax and other rules for doing business can change frequently in Kazakhstan."[13] The new Tax Code also further destabilizes the tax obligations of subsoil users (the mineral sector) by terminating tax stability provisions in all subsoil-use contracts (except for the existing subsoil-use contracts and PSAs), which means that the subsoil users have lost their legal protection that could fix their tax regime to a certain date against any fluctuation in the general tax code.[14]

In terms of the scope of taxation in Kazakhstan, one rule that has remained unchanged in its taxation system, regardless of different tax codes, is that the official tax code does not integrate the mineral sector with other economic sectors. Instead, separate tax provisions are devised for the mineral sector. This has rendered the tax regime narrow in scope, because the exclusion of the mineral sector taxation in the general tax code makes rents accrued from this sector less subject to public oversight.[15] Moreover, since the late 1990s the Kazakhstani government has carried out tax reforms that have increased its budgetary reliance on the mineral sector. For example, the 2002 Tax Code increased the minimum royalty rate in the petroleum sector from 0.5 percent to 2 percent, while at the same time reduced the rates of value-added tax (VAT) from 20 percent to 16 percent and social tax from 26 percent to 21 percent.[16] In addition, the 2004 amendments to the 2002 Tax Code included a new oil export tax, i.e., rent tax, in which the rate of tax increases as world oil prices rise.[17]

In spite of such changes that had undermined the potential to broaden the tax base, Kazakhstan's tax reforms under the P2 ownership structure were reportedly aimed at broadening the tax base, and had indeed achieved some success when it came to the collection of indirect taxes outside of the petroleum sector. This is evident in the role of the VAT, which, despite the aforementioned reduction, remained an important main source of government revenue (second largest source in 2005).[18]

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13 Ibid.
14 Vsevolod Markov and Karlygash Bissengalieyva, February, 2009.
15 Pauline Jones Luong and Erika Weinthal, 35.
16 Ibid, 273.
17 Ibid, 273.
18 Ibid, 273.

Under the new ownership structure, where the state's control over oil revenues and its share of tax revenues from the mineral sector has increased, the latest Tax Code, adopted in 2008, indicated a shift of much of the overall tax burden from the non-extractive sectors onto the mineral sector, which corroborated the Kazakhstani government's decreased dedication to expanding the tax base. On the one hand, the new Tax Code introduced to the subsoil users the mineral extraction tax (MET), which ranged from 5% to 18% in 2009, but will range from 6% to 19% in 2013 and from 7% to 20% in 2014, in addition to the excess profit tax (EPT), signature bonus, commercial discovery bonus and rent export tax.[19] On the other hand, the Tax Code and its amendments promoted a gradual reduction of corporate income tax (CIT) from 30% in the previous legislation to 20% in 2009, to 17.5% in 2013 and 15% in 2014. It also included a further reduction of the VAT from 13% to 12%.[20] As a result, the overall tax burden of the oil and gas sector was expected to increase from the previous 49 percent to 62 percent, while the burden for non-extractive sectors is expected to be reduced by 11%.[21]

The Kazakhstani tax system's increasing reliance on the mineral sector and narrowing base are consistent with President Nazarbayev's annual addresses. As Nazarbayev underscored in his 2008 address, for example, "New Tax Code must become the law of direct action and foresee the reduction of tax-burden for non-extractive industries, especially for small and medium sized enterprises, at the expense of greater economic return from extractive sector."[22]

The president of Kazakhstan, Nursultan Nazarbayev by Robert D. Ward [Public domain], via Wikimedia Commons

To summarize, the tax system in Kazakhstan remains unstable, if not becoming even more unstable, under the new ownership structure (S2), and it has been based increasingly on the mineral sector rather than other economic sectors, with no indication that the government would pursue a broad-based

19 Baker & McKenzie, 2011, 46.
20 Vsevolod Markov and Karlygash Bissengalieyva, February, 2009.
21 Baker & McKenzie, 2011, 45.
22 Nursultan Nazarbayev, 2008.

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taxation system. All contribute to a weaker fiscal regime in terms of taxation.

Among the Kazakhstani government’s efforts to improve stability and transparency of expenditures within the mineral sector, the most notable and important is the creation of the NFRK in 2001, because its operation directly affects how much oil revenue is spent (rather than saved), when it is spent, and what it is spent on. The NFRK has been applauded for its outstanding performance in accumulating oil revenues. By 2005 the fund had accumulated $ 8 billion (equivalent to 5% of GDP).[23] At the peak of oil prices in 2006-07, about 60 percent of oil revenues were saved in the NFRK, and it reached $27.5 billion by the end of 2008.[24] In April 2011 the NFRK increased to over $36 billion (approximately equivalent to 25% of the 2010 GDP).[25] This conservative accumulation has enabled the NFRK to better contribute to budgetary predictability.

However, the NFRK has not played an equally effective role in restraining expenditure, largely due to its nontransparent and nondemocratic operational rules. First, since the fund was established by presidential decree instead of an act of parliament, the president has retained exclusive decision-making authority regarding how its assets are used.[26] Second, the lack of oversight mechanisms potentially allows discretionary spending of the fund. Moreover, little information on the operation of the NFRK is available to the public, considering that the tables published monthly on the Finance Ministry’s website include data on inflows and outflows of the NFRK only by major categories.[27]

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23 Pauline Jones Luong and Erika Weinthal, 279.
24 IMF, July, 2010.
25 IMF, June, 2011; The World Bank, September, 2011.
26 Pauline Jones Luong and Erika Weinthal, 280.
27 Matthias Luecke, 2010.

Kazakhstan's reluctance to sign the Extractive Industries Transparency Initiative (EITI), which it did only in 2005, and the fact that it is still designated as an EITI Candidate country that is "Close to Compliant" further demonstrate the lack of transparency concerning oil revenues that flow into and out of the NFRK.[28] Under such conditions, the stability and effectiveness of the NFRK is not guaranteed, even thought the change in the rules of the fund in 2006 allegedly integrated the NFRK with the state budget.[29] The 2010 Concept of the NFRK has put an $8 billion limit on annual transfers from the fund to government budget, with the caveat that the NFRK is not allowed to fall below 20 percent of GDP.[30] This policy is expected to increase the proportion of oil revenue to be saved and eliminate the possibility of off-budget use of the NFRK.[31] Nevertheless, due to the lack of reliable data on the implementation of such policies, their contributions to formal limits and transparency in budget execution remain unclear.

In contrast to the persistent characteristics of the NFRK throughout the past ten years, it is outside the mineral sector, where the change of ownership structure has had the most observable impact on Kazakhstan's government expenditure. Specifically, under the P2 ownership structure Kazakhstan had managed to make significant progress in institutionalizing limits on public expenditures.[32] One indicator in support of this statement is that from 1991 to 2005 government spending was cut from approximately 30 percent of to approximately 22 percent of the GDP.[33] In addition, the government succeeded in reducing the size of the public sector and cutting down government spending within the social sphere.[34] These reforms had effectively constrained government expenditures and improved budgetary predictability, thus creating the possibility for the government to make better spending decisions.

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28 EITI, August, 2011.
29 IMF, June, 2006.
30 IMF, June, 2011.
31 IMF, July, 2010.
32 Pauline Jones Luong and Erika Weinthal, 281.
33 Ibid, 281; Economy Watch, December, 2011.
34 Pauline Jones Luong and Erika Weinthal, 282.

Since the country adopted the new form of ownership structure (S2) in 2005, however, many of the former reforms were reversed. According to a 2006 IMF report, "expenditures grew by over 20 percent in real terms, with social spending and civil service salaries increasing even more rapidly."[35] In his 2007 annual address, Nazarbayev promoted a greater role of the government and government spending in the social sphere, and, in particular, emphasized the government's responsibility for improving the pension system.[36]

During the 2007-2009 economic crisis, along with significant increases in budgetary outlays for pensions, public sector wages and social benefits, expenditures aimed at mitigating the impact of the crisis rose sharply.[37] Most of these expenditures were directed through the National Welfare Fund Samruk-Kazyna (SK), a state joint stock holding company created in 2008 by decree of the president, which has enabled the Kazakhstani government to play a greater role in the country's economic sphere.[38] Moreover, since 2009 SK has engaged in significant quasi-fiscal spending, an activity that should be reduced in order to enhance budgetary stability and transparency.[39] Given the continually rising expenditures for development programs, a 2011 IMF report on the fiscal policy of Kazakhstan specifically supported the plans for fiscal consolidation through better tax administration and expenditure restraint.[40]

To sum up, the National Fund, as the quintessential institution for increasing the stability and transparency of expenditures in mineral-rich states, has retained relative stability under different ownership structures in Kazakhstan, but its nontransparent nature persistently undermines its effectiveness. Government spending, on the other hand, has experienced a reverse development, from the successfully imposed institutional limits on public expenditures before 2005 to increased expenditures, with a greater role of the state in the economic spheres.

35 IMF, June, 2006.
36 Nursultan Nazarbayev, 2008.
37 IMF, July, 2010.
38 IMF, October, 2009.
39 IMF, June, 2011; Pauline Jones Luong and Erika Weinthal, 39.
40 IMF, June, 2011.

> ***"...under the new ownership structure, the Kazakhstani government faces a higher barrier to taxing their own population..."***

Explanations for the Weakening of Kazakhstan's Fiscal Regime

The empirical data on Kazakhstan's fiscal regime can be explained within the theoretical framework developed by Jone Luong and Weinthal, where ownership structure over mineral reserves plays a decisive role in shaping states' fiscal regimes. Their theory implies that the particular form of ownership structure determines the level of societal expectations vis-à-vis the state and vis-à-vis foreign investors, which, in turn, influence the way the "owners" of mineral wealth shape the country's fiscal regime. In this way, societal expectations serve as a liaison between ownership structure and fiscal regime.

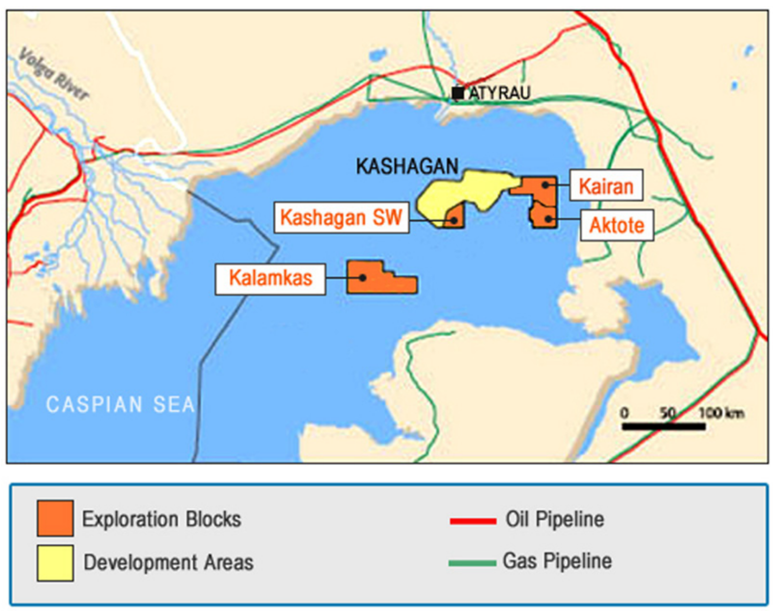
As stated earlier, Kazakhstan changed its ownership structure in 2005 from P2 to S2. According to Jone Luong and Weinthal's theory, such a change is expected to result in a shift in societal expectations vis-à-vis the state, specifically, the role of the state in managing its fiscal regime. Specifically, under P2 ownership structure, since the status of direct claimant to the country's mineral wealth was granted solely to foreign investors rather than the government, societal expectations vis-à-vis the state were low. In contrast, the new S2 ownership structure enables the state to acquire the status of direct claimants to the proceeds from the country's mineral wealth, thus creating significantly enhanced societal expectations vis-à-vis the state's role in the country's fiscal regime.

As a result, the Kazakhstani government became "primarily charged with ensuring that the population receives a share of the proceeds from its mineral wealth through extracting revenue from the foreign investors who are exploiting this wealth."[41] Therefore, under the new ownership structure the Kazakhstani government faces "a higher barrier to taxing their own population," making its taxation system more reliant on the mineral sector and hindering broad-based tax

41 Pauline Jones Luong and Erika Weinthal, 195.

reform.[42] Likewise, in order to at least create the impression that the state is distributing benefits extracted from the mineral sector widely to the population, the Kazakhstani government under the S2 ownership structure is more motivated to expand public and social spending rather than set limits on expenditures. The mechanism of societal expectations, thus, corresponds to the observed reversed policies in Kazakhstan's tax and expenditure institutions. In addition, since the elevated social expectation vis-à-vis the state encourages the government to become increasingly proactive in making extractions from foreign investors in the mineral sector and allocating these revenues, it is no surprise that the tax system remains unstable, while the expenditure processes have not become more transparent.

Given the decisive role of ownership structure in shaping a distinct fiscal regime, it is important to examine the contributing factors to the choice of a certain form of ownership structure. Again, Jone Luong and Weinthal have developed a useful framework for studying this question by emphasizing two domestic-level variables: the degree to which the state leaders can access alternative revenue sources other than mineral wealth, and the level of distributional conflict the state leaders face.[43] According to this theory, state leaders whose access to alternative revenue sources is low and whose level of distributional conflict is high tend to choose the P2 ownership structure, because this ownership structure provides with them immediate access to the funding they need to consolidate their insecure hold on power, for which sake they are willing



As part of the North Caspian Sea PSA, KMG holds a 16.81% participating interest of the Kashagan giant field, 80 km south-east of Atyrau (Kazakhstan), which is believed to be one of the most important discoveries (July 2000) in the world for the past thirty years. Map via ENI.com

42 Ibid, 194.
43 Ibid, 300.

to sacrifice some degree of sovereignty.[44] In contrast, state leaders whose access to alternative revenue and level of distributional conflict are both low are most likely to adopt the S2 ownership structure, because it allows them to reap as many immediate benefits as they can while at the same time retaining a relatively high degree of sovereignty.[45]

In the case of Kazakhstan, due to the state's lack of agricultural or manufactured goods that can serve as alternative sources of revenue and the high level of distributional conflict the state leaders confronted in the 1990s, including the Russian and Kazakh nationalist movements, the state leaders first adopted the P2 ownership structure to consolidate their power.[46] By the mid-2000s, however, the significantly lower level of distributional conflict allowed the Kazakhstani leaders to increase sovereignty without undermining their power by choosing the S2 ownership structure. And so they did.

Forecasts

It has been made clear by the analysis above that the problems in Kazakhstan's tax and expenditure institutions should, to a large degree, be attributed to the government's choice of changing its ownership structure over mineral reserves. This choice hinges upon two domestic factors: access to alternative revenue sources and level of distributional conflict. Since the availability of alternative revenue sources tends to remain at a stable level over time, the stability in Kazakhstan's ownership structure is primarily dependent on the level of distributional conflict in the country.

Given Kazakhstan's fairly satisfactory economic development compared to that of other post-Soviet states, the potential of separatism in northern Kazakhstan has been significantly reduced. In addition, the Kazakhstani central government's strategy to distribute certain power to the political elites from the oil-rich western part of the country has also contributed to better stability

44 Ibid, 305.
45 Ibid, 306.
46 Ibid, 306.

in Kazakhstan's domestic politics. President Nazarbayev seems to have gained popularity among Kazakhstani people, as well as greater capability to marginalize his political opponents. There is no sign of an imminent end to his 20-year rule over the state, as long as his health remains good. The lowered level of distributional conflict in Kazakhstan and the subsequent change in its ownership structure, thus, are not accidental events, but results of continued political and economic developments in the country. Therefore, the level of distributional conflict will very likely remain low.

As long as both the access to alternative revenue sources and the level of distributional conflict remain low, Kazakhstan's current ownership structure will most likely stay in place. This paper therefore forecasts the following about the performance of Kazakhstan's fiscal regime in the short term: Kazakhstan's tax system will remain unstable and become increasingly reliant on the mineral sector instead of becoming broad-based; Kazakhstan's expenditure system, in particular the NFRK, will continue to lack transparency; and it will be difficult to effectively constrain government spending in the social sector. As a whole, the possibility of a weakening of Kazakhstan's fiscal regime is high in the foreseeable future.

Suggested Solutions

In theory, in order to prevent a failing fiscal regime, the government is supposed to initiate broad-based tax reform and institutionalize limits on public expenditures, as well as promote their transparency. However, in practice these policies might be difficult to implement, given the lack of incentives for the political elites to reform from within. Under such circumstances, this paper proposes two suggestions concerning the roles of foreign investors, international nongovernmental organizations, and international financial institutions.

First, a unified front formed by foreign investors might be helpful in restraining the Kazakhstani government's ability to enforce arbitrary changes to its tax system. A stable and broad-based tax system in Kazakhstan is by all means in the interests of foreign investors, whose benefits have been eroding by the current unstable system, which has significantly increased their tax burden. If foreign investors can unify and thus maximize their leverage vis-à-vis the Kazakhstani government, they would have a better chance to improve their investment environment, and at the same time contribute to strengthening Kazakhstan's tax system.

Second, greater assistance from international financial institutions and greater pressure from international nongovernmental organizations would be conducive to better decisions in government spending and its transparency. No matter which form of ownership structure Kazakhstan adopts, its mineral sector exists and operates in an international context and, to a certain extent, needs to comply with international norms. International financial institutions, such as the IMF and World Bank, and international nongovernmental organizations, including EITI, Global Witness, and the Open Society Institute, have played active roles in assisting and monitoring the development of Kazakhstan's mineral sector. To support a fiscal regime in Kazakhstan that can effectively constrain and enable the state, it is important that these international actors continue to exert and increase their positive influences.

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