



Center for Social and Economic Research

**Economic Transformation in Kazakhstan: Issues of
Macroeconomic policy, External Economic Relations and
Restructuring of the Banking System**

(Final Report of the UNDP Consultative Mission)

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INTRODUCTION (MAREK DABROWSKI)	4
1. MONETARY POLICY (MAREK DABROWSKI)	6
1.1. ANTI-INFLATIONARY POLICY AND ITS IMPACT UPON REAL ECONOMY	6
1.2. MONEY SUPPLY	9
1.3. LOW DEMAND FOR TENGE	10
1.4. THE EXCHANGE RATE POLICY	11
1.5. MONETARY POLICY PROGRAM FOR 1996	13
1.6. CONCLUSIONS AND RECOMMENDATIONS	14
2. BUDGETARY AND FISCAL POLICY IN KAZAKSTAN (JERZY OSIATYNSKI)	19
2.1. IMPLEMENTATION OF THE 1995 BUDGET	19
2.1.1. <i>Macroeconomic Foundations of the 1995 Budget</i>	19
2.1.2. <i>The 1995 Budget Revenues</i>	20
2.1.3. <i>The 1995 Budget Expenditures</i>	20
2.2. THE 1996 BUDGET	21
2.2.1. <i>Macroeconomic Foundations of the 1996 Budget</i>	21
2.2.2. <i>The 1996 Budget Revenues</i>	22
2.2.3. <i>The 1996 Budget Expenditures</i>	24
2.3. TAX POLICY AND TAX ADMINISTRATION	25
2.3.1. <i>Consolidating Budget Revenues in Kazakstan in 1992-5</i>	25
2.3.2. <i>Execution of Main Tax Revenues in 1995 and their Forecast for 1996</i>	27
2.3.3. <i>Some Problems of the Tax System in Kazakstan</i>	29
2.3.4. <i>Problems of Tax Administration in Kazakstan</i>	31
2.3.5. <i>The Problem of Tax Arrears</i>	32
2.4. THE BUDGET SYSTEM	33
2.4.1. <i>Constitutional Foundations of the Budget System</i>	33
2.4.2. <i>Other Legislative Acts</i>	35
2.4.3. <i>Basic Provisions of the Draft Law on the Budget System</i>	35
APPENDIX 1. SOME DETAILED COMMENTS ON THE TAX CODE	41
APPENDIX 2: DETAILED COMMENTS TO THE DRAFT LAW ON THE BUDGET SYSTEM (VERSION OF MID-MARCH 1996).....	41
3. SOCIAL EXPENDITURES IN KAZAKSTAN (HELENA GORALSKA)	44
3.1. WAGES IN THE BUDGETARY SPHERE	44
3.2. THE STATE FUND FOR ASSISTANCE TO EMPLOYMENT (EMPLOYMENT FUND)	45
3.3. THE PENSION FUND	48
<i>The Balance of the Pension Fund</i>	51
<i>Conclusions and Recommendations</i>	51
3.4. THE SOCIAL INSURANCE FUND	52
3.5. ASSISTANCE TO INVALIDS	53
3.6. FAMILY ALLOWANCES	54
3.7. SOCIAL ASSISTANCE	54
3.8. SOCIAL SERVICES	55
3.8.1. <i>Health Care</i>	55
3.8.2. <i>Education</i>	57
3.9. REVENUES AND EXPENDITURES OF EXTRABUDGETARY FUNDS	58
3.10. EXPENDITURES ON SOCIAL PURPOSES IN 1995 AND 1996	59
4. RESTRUCTURING OF THE BANKING SECTOR (WLADYSLAW JERMAKOWICZ)	66
4.1. GENERAL DESCRIPTION OF THE BANKING SYSTEM AND BANKING REFORMS	66
4.2. PRIVATIZATION OF BANKS	67
4.3. PROBLEMS OF RESTRUCTURING «BAD DEBTS» IN THE REPUBLIC OF KAZAKSTAN	70
4.4. MAJOR APPROACHES TO BANKS REHABILITATION AND RESTRUCTURING OF “BAD LOANS”	72
4.4.1. <i>Centralized Approach</i>	72
4.4.2. <i>The Decentralized Approach</i>	72
4.4.3. <i>The laissez-faire Approach</i>	73

4.5. PROPOSED MEASURES FOR CREDIT PORTFOLIOS RESTRUCTURING	73
4.6 THE CONDITIONS NECESSARY FOR INTRODUCTION OF THE PROGRAM	76
4.7. BANKING SUPERVISION	76
4.8. CONCLUSIONS AND RECOMMENDATIONS	77
5. INTER-ENTERPRISE ARREARS IN KAZAKSTAN (WLADYSŁAW JERMAKOWICZ)...	83
5.1 THE CAUSES OF INTER-ENTERPRISE ARREARS	83
5.2. CRITERIA FOR PROPOSED SOLUTIONS	85
5.3. A PACKAGE OF MEASURES	86
5.3.1. <i>Economic Stabilization and Structural Reform Measures</i>	86
5.3.2. <i>Creating of the market in IEA</i>	86
5.3.3. <i>Reform of Payment Systems</i>	88
5.3.4 TAXATION AND THE BUDGET MEASURES	88
5.3.5. THE BANK REHABILITATION MEASURES	89
6. REORIENTATION AND LIBERALIZATION OF KAZAKSTAN'S FOREIGN TRADE (RAFAL ANTCZAK).....	90
6.1. BALANCE OF PAYMENTS	90
6.2. FOREIGN TRADE REGIME	92
6.2.1. <i>Registration of export contracts</i>	93
6.2.2. <i>Barter trade</i>	94
6.2.3. <i>Custom duties and excises</i>	95
6.2.4. <i>Value added tax</i>	96
6.2.5. <i>Currency market</i>	97
6.3. REGIONAL INTEGRATION AND A CUSTOM UNION	97
6.4. RECOMMENDATIONS	99
SUMMARY (MAREK DABROWSKI).....	103

Introduction (Marek Dabrowski)

In the post-communist period, economies of 30 European and Asian countries, including all former Soviet Union (FSU) republics, were undergoing significant transformation. Poland became the first country to enter the way to the development of market economy in late 1989, immediately after the first democratic government had been formed. In 1990-1991, similar orientation was chosen by the rest of Central and Eastern European countries, and starting from 1992 - also by the FSU countries. On the basis of accumulated experience we can identify three major stages of economic transformation:

Stage 1: Break-up of the command economic system

Stage 2: Macroeconomic stabilization and liberalization of economy; creating systemic frameworks for the market system.

Stage 3: Microeconomic and structural reforms.

The first stage proved to be very painful for the majority of former socialist countries, particularly for the FSU republics because of the deep crisis of their economies inherited from the former system.

The great experiment of creating centrally planned economic system, forced industrialization and large-scale collectivization of agriculture, which was started in late twenties in the USSR and then in Central and Eastern European countries in late forties, resulted in a deep crisis and consequently, in political collapse of the world socialist system.

New democratic governments of former socialist countries faced a number of serious economic problems; the following four can be identified as the main ones:

1. Universal (or almost universal) nationalization of economy, a complete prohibition of private entrepreneurial activities or their serious restrictions.
2. Enormous structural distortions based on monopolization of economies, economic autarchy (economies closed for external competition), militarization of economy, administrative regulation of prices, and centralized methods of taking investment decisions.
3. Excessive burden of social expenses compared to the existing level of economic development.
4. Internal and external macroeconomic disbalances which particularly aggravated during last years of communist regimes when the latter lost the ability to control economic and public life (particularly it concerns the USSR in 1989-1991).

As it was already mentioned, post-Soviet countries experienced special difficulties during the break-up of the planned system, first of all, because of accumulation of enormous structural distortions, and delays in launching reforms. During existence of the USSR, no reforms were possible because of political reasons. However, even after disintegration of the Soviet empire, not all post-Soviet countries immediately started radical and consistent economic reforms, as it was in Estonia and Latvia. In this regard it should be noted that large-scale economic reforms started in Kazakstan in late 1994 only. In our view, major reasons of delay in launching economic reforms included the impossibility the independent economic policy under the conditions of common currency (ruble) area which existed until November 1993, as well as certain serious mistakes in monetary and budget policy.

Experience of the majority of post-socialist countries shows that the most efficient method of overcoming negative consequences of the command system is radical and

consistent macroeconomic stabilization, and internal and external liberalization of economy which is a pre-requisite of success of anti-inflation measures. It's necessary to emphasize that only full liberalization allows to free the budget from the burden of subsidies. It's this way that was chosen in Poland in 1989, in Czechoslovakia and Slovenia in 1991, Albania, Estonia and Latvia in 1992, Moldova, Kyrgyzstan and Croatia in 1993. Kazakstan also entered this way in the end of 1994. We can ascertain that during 1995 the second stage of the transformation process was practically completed in Kazakstan.

At present, Kazakstan faces a task of transfer, as soon as possible, to the third stage which includes, apart from further strengthening of monetary and budget policy, such important objectives as microeconomic and structural reforms: large-scale privatization, closing down inefficient enterprises, creating capital and labor markets, attracting foreign capital, reform and development of the banking system, privatization of agriculture, social sphere reforms, etc.

The present report summarizes the preliminary results of nine months work of a group of experts in the framework of the UN Development Programme Project "Advisory Services to the President of Kazakstan on Macroeconomic Issues". The group of experts came from CASE — Center for Social and Economic Research in Poland headed by Professor Leszek Balcerowicz.

The present report includes an assessment of economic situation in 1995, and major areas of economic policy planned for 1996. Topics of the report determined by the project framework include the following issues:

- monetary policy and anti-inflation measures;
- budget and fiscal policies;
- funding social protection and social services;
- restructuring of the banking sector;
- inter-enterprises mutual arrears;
- foreign economic relations.

Every chapter contains both analysis of the situation in the framework of the above topics, and authors' recommendations. A part of this report, especially concerning monetary, budget, fiscal and social policy, is based upon working papers and memoranda prepared earlier by experts under the present project. The authors are grateful for comments received from advisors to the President and members of the Government of Kazakstan who assisted in drafting the present version of the report.

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1. Monetary Policy (Marek Dabrowski)

1.1. Anti-inflationary policy and its impact upon real economy

In 1995 Kazakstan achieved a considerable success in reduction of inflation (see Table 1.1.). Consumer price index gradually decreased from the end of 1994 until the summer of 1995. In the last quarter of 1995, and the beginning of 1996, however, a recurrent increase of inflation rate is observed. In October, a consumer price index increased (comparing to the previous month) by 4.1%, in November- by 4.4%, and in December- by 3.6%. Usually such a tendency is interpreted as a consequence of a gradual rise of administered prices for utilities and transport services. Diagram 1.1 shows that this is only partially truth. The utility prices grew in October. But at the same time food prices also grew quickly in the fourth quarter. It indicates that there were other sources of inflation. The section below confirms that at the end of 1995 the money supply increased due to the budgetary financing requirements and quasi-budgetary operations. Moreover, it is probable that an accumulating inflationary potential may cause damage to ambitious plans to reduce inflation in 1996. The NBK and governmental declarations to reduce the growth of prices over 26-28% from the December of 1995 to the December of 1996 may prove to be unrealistic.

All these mean that the combat with inflation has not been finished yet, and it is too early to declare that macroeconomic stabilization has been accomplished. It is connected not only with the 1995 difficulties to control money supply increase.

The world experience shows that the first phase of the combat with high inflation rates or hyperinflation, technically speaking, is not a difficult problem. It requires only understanding of basic macroeconomical principles, and the presence of a political will and ability to carry out a coordinated policy of the Government and the Central Bank. This exactly happened in Kazakstan at the end of 1994 and in 1995. Due to the coordinated actions of the National Bank and the Government of the Republic of Kazakstan the inflation was relatively quickly reduced from 30-40% per month to 5% per month in spring, and 2-3% per month in summer.

However, further progress, i.e. decrease of inflation rate down to 1-2% per month, and further, as mentioned above, may become rather difficult. This problem concerns not only Kazakstan, but also other countries of Eastern Europe and former USSR. For example, it took the Czechs (whose country was one of the most macroeconomically stable post-communist countries) 4 years to reach a simple number rate of inflation. Poland has been combating with inflation for 7 years, at present this country has an annual inflation rate of 22%. Radically reforming countries like Estonia and Latvia could reach this value in three years.

There are many reasons why it is difficult to reduce inflation down to few percent per year. From the theoretical point of view (see Box 1), inflation rate is determined by money supply and demand for the national currency. The latter is dependent upon the dynamics of the real GDP (the higher the GDP, the higher demand for money); on the other hand, it is determined by the money velocity. The efficient control of money supply is established by elimination of main sources of its growth, primarily, budget deficit (see Section 1.2). Increase of demand for the national currency takes time, especially if the country goes through a long period of very high inflation (this occurred in Kazakstan during a period of 1990-1994), and needs a long-term, well-balanced and consistent policy (see Section 1.3)

Box 1.1: Monetary Source of Inflation

Fisher's equation formula provides for theoretical foundations of the analysis of the sources of inflation, i.e. $PQ=MV$, where P means an average price level, Q is a physical (real) volume of the GDP, M means money supply, and V is a money velocity. The quicker money supply grows (under a given GDP and a rate of money velocity), the quicker the prices grow. Under a given money supply, the higher the money velocity, the lower demand for money is than the higher inflation rate.

Demand for money reflects the readiness of economic entities to keep their assets in a monetary form. The growth of money velocity shows decrease of the demand for money and vice versa.

A successful anti-inflationary measures include two basic courses of action - curbing of the rate of money supply growth and stimulation of demand for money.

A rapid progress in the combat with inflation is critical for the development of the Kazakstan economy. A world wide experience, and the experience of the transition economies shows that without a significant decrease of inflation rate, the conditions for balanced and sound economic growth can not be established. Only those post-communist countries could start a real economic growth, in which an inflation rate does not exceed 30-40% per year (usually, 2 years after they achieved primary stabilization). Besides, a 20-30% inflation rate could be considered only as a temporary achievement. For middle/long-term perspective, such a rate does not provide sufficient stimuli for growth in savings, and does not stimulate foreign investment; it also creates strong inflationary inertia. Therefore, a rapid decrease of inflation to a level comparable to that of the countries with stable market economies (below 5% per year) is inevitable.

Sometimes presented opinion that an antinflationary policy may bring harm to a real economy, and that a strict monetary policy may lead to an excessive fall in production, is not confirmed by the results of actual economic developments in post-communist countries. Those countries which were not afraid to implement strict anti-inflationary measures (and at the same time to radically liberalize their economies) had lowest losses of the GDP. Their economic growth began earlier than in the countries which tried to "protect production" by means of soft monetary and fiscal policies. The amplitude and duration of inflation in these countries resulted in a high differentiation of income and property, and in development of different economic and social pathologies. In general, transformational fall in production reflects a more complicated situation than the one represented by the statistical data (see Box 1.2.) This also concerns the whole economy of Kazakstan, where difficult restructuring processes concern not only industry but also the agriculture sector.

Box 1.2

Fall in production during the post-communist period occurs under the influence of a combination of different macro- and microeconomic factors. This drop at the macroeconomic level is connected with the reduction of a total demand. This reduction is determined by two factors:

- removal of monetary overhang and forced savings after price liberalization, as well as removal of the speculative demand related to a shortage economy;

- removal of excessive demand which in turn results from the lack of macroeconomic equilibrium (such an effect is observed when any stabilization program is carried out, therefore, post-communist countries are not exceptions).

Macroeconomic factors, though evident, are, probably, not so important, as there are more weighty microeconomic factors.

The first group of these factors is connected with the change of a relative demand which has internal and external sources of origin. Disintegration of some significant export markets: first- COMECON (1990-1991), and later - the Soviet interrepublican market (1992-1993),- relates to the external factors.

Liberalization of trade usually leads to the increase of import and export share in the GDP. New import opportunities lead to the decrease in the demand for a part of domestic production, while at the same time new export opportunities provide for increase in production of other goods. However, the elasticity of supply is usually limited (see below), thus a change of relative demand, which appears due to the liberalization of import, results in a temporary reduction of production.

A number of other internal factors determines the change of a relative demand and dramatically affects the activity in certain spheres: demilitarization (a very significant factor for the countries of the former USSR), reduction of investment rate and change of the structure of investment demand, rationalization of interregional relationships, denial of forced substitution, the extension of consumers' freedom of choice as a result of termination of the administered system of resource distribution and privatization of a part of collective consumption (e.g. housing facilities).

The second group of microeconomic factors is connected with a sudden change of the level and structure of prices. Analyzing domestic sources of a price shock in separate industries, we should mention the elimination of direct and indirect subsidies (indirect subsidies usually took a form of lower prices for power and transportation services). In some extreme cases the production was supported, no matter if the value was subtracted instead of being added (in fact, it was a negative value added). Termination of such productions means a real benefit for the national economy, though it leads to the close-down of certain enterprises or entire industries.

Similar problems arise after the external price shock which results partially from the unification of exchange rates (cancellation of indirect subsidies connected with multiple exchange rate regime), and partially from the termination of special rules for trade pricing within the COMECON countries and former USSR.

Finally, the third group of microeconomic factors relates to the motivational and informational issues, namely:

- Collapse of the administrative and economic incentives characteristic for the command economy and its system of stimulation. In most countries this occurred after political liberalization and democratization, and still before economic reform.

- Expectations and motivation formed in the course of privatization, especially a resistance of "red directors" and employees collectives.

- Expectations of support of the state enterprises by the Government and Central Bank ("the Government will never leave the major state enterprises without support"). This belief was based upon the experience of previous reforms. The authors of these reforms were not able to introduce hard budget constraints for the state enterprises. This is the reason why state

enterprises adjust so slowly to the new conditions, and why in Kazakstan and in a number of other countries many enterprises have a large mutual indebtedness. (see Chapter 5).

The transition economy consists of two sectors: the first one (mostly state enterprises of heavy and defense industries, large industrial construction, kolkhozes and state farms) dramatically decreases; the second two (mostly new private and privatized trading and service enterprises) dynamically grows. In the course of reduction of the first sector, labor, power, construction facilities, real estates, and other resources get released, providing opportunities for the second sector to develop. The rate of growth of “a new economy” is dependent primarily upon the real economic freedom (i.e. depth and transparency of the liberalization process), the presence of hard budget constraints, stability of macroeconomic conditions (which is critical for investment climate) and progress of privatization and restructuring of the state enterprises.

1.2. Money Supply

Table 1.2 shows that in 1995 the rate of growth of basic monetary aggregates were very significant. The widest monetary aggregate M3 (cash + demand deposits + time deposits + securities) increased by 106.7% from December 1994 to December 1995, the monetary base of the National Bank increased by 91%, and cash circulation- by 130%. In any case, the presented data does not confirm that the monetary policy was very demanding (comparing to the world standards and taking into account the situation in other post-communist countries.)

Apart from relatively high rates of the monetary aggregates growth, Table 1.2 also shows that their monthly fluctuations were significant. The highest were in March, April, June, July and October. In December 1995, though M3 decreased by 0.1% comparing to November, the monetary base grew quickly, and it may influence M3 in January and February (there is a small usually one month time-lag between the growth of the monetary base and the growth of broad money stock in economy). Together with the fluctuations of the monetary aggregate growth rates, and the above mentioned time-lags, the money multiplier also fluctuated (although at the end of 1995 this did not differ from its value in the end of 1994).

Analysis of the sources of money supply growth (Table 1.3, diagram 1.2) indicates that the role of internal sources of monetary expansion was substantial. It concerns particularly the credit to government which increased by 132.5 % during all 1995. Besides, sharp fluctuations of the rates of this growth were observed especially in April and in the two last months of 1995. At the end of this year there was also a sharp growth of another remarkable type of credit - “clients credits”, i.e. credit issued to the State Procurement Corporation for purchase crops amounting 4,4 billion Tenge . In 1995 the amount of such credits increased more than 10 times (!), but from a very small base. Undoubtedly, this reflects quasi-fiscal operations of the National Bank of Kazakstan (NBK), and in fact, it should be recorded as “a credit to the Government”.

It is remarkable that the growth of net foreign assets of the NBK (gold and foreign exchange reserves) also included quasi-fiscal activity of the central bank. It concerned the purchase of gold from domestic producers in December 1995, The effect of this action was an increase in the value of the NBK gold reserves by over T4 billion¹. As under conditions of modern financial markets, gold does not seem to be an efficient method of accumulating

¹ The NBK Statistical Bulletin, No.12(13), December 1995, p.27.

central bank reserves (low liquidity, storage expenses, absence of revenues from interest rates), such a decision could be considered “an industrial policy” of the NBK.

The growth of credits to government, to the economy, and foreign reserves was partially neutralized by a ten-time fall in credit to commercial banks. Though there were fluctuations here (a sharp growth of credit in August and September), in general, it could be noted that there is a strong tendency to decrease the dependence of liabilities of the commercial banks upon the NBK credits.

This general overview shows that the main problem of the monetary policy is a high demand of the Government for financing fiscal and quasi-fiscal deficit. Here there is threat number one for macroeconomic stability. This problem will be discussed in Chapter 2.

Two remarks should be made here. First, the NBK is not completely independent from the Government. This is confirmed by the readiness of the NBK to credit directly the budget deficit, and to participate in financing quasi-budgetary operations. Secondly, considering the fact that the pressure from the budget does not seem to stop soon, and a new pressure (as in other transition economies) from the balance of payments (growth of central bank foreign reserves) may develop, the NBK should prepare a wide variety of instruments to control liquidity in addition to reserve requirement rates, refinancing credit control (these two instruments will be losing their significance), and issuance of short-term notes. We have in mind the open market operations with using the treasury bonds. The first step in this direction may be the conversion of the part of the existing indebtedness of the state to the NBK into government bonds which could be sold by the NBK to commercial banks and other entities (outright sale).

1.3. Low demand for Tenge

The rate of money velocity (GDP/ broad money in Tenge) in Kazakstan is relatively high. According to Table 1.2, this rate averaged to 11.8 in 1995, despite the tendency of the rate to decrease during the yearly period- from 13.2 in December 1994 to 9.6 in December 1995. A reverse relation, i.e. a ratio of the broad money (M2) to GDP indicates that an average monetarization rate of the Kazakstan economy in 1995 comprised about 8.5%.²

This rate seems to be approximately the same as in Russia, and higher than in the Ukraine. However, these two economies are not examples of macroeconomic stability, and there is no reason to follow them. More stable economies (though still far from the standards of the developed capitalist countries) like Poland, Estonia, Latvia, and Slovenia could obtain about 25%, and this rate may be a target for the monetary policy in Kazakstan for 2-3 years to come.

How could such a rate of monetarization of the Kazakstan be achieved? A key issue will be the confidence in national currency. Despite the fall in money velocity (an effect of the macroeconomic stabilization), this confidence is still not high. Many indications confirm this. The NBK data³ shows that in the Autumn of 1995 the structure of deposits changed sharply, hard currency deposits being preferred. The nominal value of the time deposits in

² On estimating the rate of monetary circulation, drawbacks of the GDP statistics should be taken into consideration.

³ The NBK Statistical Bulletin, No. 11(12), November 1995.

Tenge did not grow from April till November. This tendency existed after the lowest inflation rate in 1995, and within the framework of declared ambitious anti-inflationary plans for 1996.

The proportion of cash in M3 increased from 36.7% in December 1994 to 41.2% in December 1995; the proportion of M1 (cash in circulation + demand deposits) in M3 increased less than M3, i.e. from 87.6% in December 1994 to 89% in December 1995. This is an indirect indication of the lack of confidence both in Tenge and to commercial banks of Kazakstan.

Confidence in currency and in the stabilization policy is determined by many factors, including past experience. The latter does not help to carry out the present monetary policy. The population and economic agents remember destructive effects of the macroeconomic policy of the last years of "perestroika", on the one hand, and three advantageous years of independent existence of Kazakstan, on the other. It will require many years to overcome negative effects of the past imprinted in the people's minds.

Therefore, all available instruments of monetary and fiscal policy should be oriented to decrease inflationary and devaluation expectations.

1.4. The exchange rate policy

In the background of the above discussions, exchange rate, as one of the components of the monetary policy, should be also paid attention to. So far the NBK followed the policy of a floating Tenge exchange rate and smoothing of its short-term fluctuations. It was connected with the NBK's policy of monetary base target. This approach seemed to be reasonable at the first phase of stabilization, when the source of money expansion had to be limited. Also, it was a difficult task to actively control currency exchange rates because of the absence of sufficient currency reserves, the parallel processes of price liberalization and foreign trade liberalization. So, the pre-setting of exchange rates was a very risky endeavor.

Nevertheless, in the early 1996 a different situation developed. On the one hand, prices, especially for tradable goods, were liberalized. A majority of export and import barriers were canceled. The balance of payments is more or less predictable. Present exchange rates can be regarded being in equilibrium. On the other hand, the monetary policy meets with lack of confidence in the national currency. The population and economic entities consider savings in US dollars or other hard currencies to be more reliable and profitable than savings in Tenge. This means that in the nearest months they expect strong devaluation of Tenge (higher than the difference in interest rates between Tenge and foreign currency deposits) or unpredictable fluctuations of the national currency exchange rates.

The transition to the exchange rate target could help to limit unpredictability of the foreign exchange market, and to decrease "risk premium", related to this unpredictability. If such a case, confidence in the national currency could be encouraged, and interest rates could be reduced, comparing to a situation when economic entities are not aware what exchange rates might be.

What does the exchange rate target mean? We propose the preannounced pegging an exchange rate for 6 months to come. Technically it can be done by administered measures, or the NBK declares that it will follow a strict exchange rate path, carrying out its interventions into the currency market. But, as the first variant is connected with the liquidation of the interbank currency market, a second variant is proposed.

A preannounced exchange rate may mean either its nominal stabilization, or a preannounced scenario of crowding devaluation. This will be discussed in the section below.

What benefits could be obtained from the policy of a preannounced an exchange rate scenario?

First, as mentioned above, a preannounced exchange rate could decrease the unpredictability of the exchange rate policy for economic agents. The decrease of risk premium will result in decrease of interest rates on deposits and credits in the national currency, and increase of demand for Tenge, i.e. increase savings in Tenge. The indirect effect could be a quick development of the financial market in Kazakhstan, and easiness of non-inflationary financing of the budgetary deficit, etc.

Secondly, reduction of highly profitable speculative operations in the foreign exchange market could attract the attention to other segments of the financial market (treasury bonds, interbank credits), and could provide the higher level of the banking sector stability. Speculative foreign exchange operations are the main source of the bank risks.

Thirdly, a presented above scenario of an exchange rate policy might help reduce risks of exporters, importers and investors, including foreign investors. Restructuring of the enterprises would be less risky operation in that situation.

Of course, the proposed exchange rate policy will create additional problems.

First of all, it means a reorientation of monetary policy towards protecting the preannounced exchange rate (exchange rate target), and, therefore, it makes the control of monetary base and money stock more difficult. Additional foreign exchange inflow (better situation in the world market, large foreign investments, etc.) requires sterilization of the foreign reserves to prevent an inflationary push. The central bank will need instruments to absorb additional liquidity (see Section 1.2). In opposite situation when the balance of payments worsens there must be sufficient reserves to protect an exchange rate.

The absence of preannounced exchange rate policy theoretically makes it easier for the Central Bank in this respect, that it is possible to use devaluation and revaluation as instruments of intervention in the foreign exchange market. In fact, there are limited opportunities for such interventions. As far as devaluation is concerned, it always results in a direct inflationary push (through export and import prices) and indirect impact (decrease of demand for the national currency). Revaluation (appreciation) is always against the interests of exporters, and therefore, generates a political opposition, especially if the cause of revaluation is beyond the sphere of foreign trade (e.g. an inflow of short-term speculative capital or one-time revenues from a large privatization deal). Devaluations and revaluations, both destabilize other segments of the financial market, including the treasury bonds market which determines non-inflationary financing of the budget deficit.

Secondly, the positive effects of the proposed policy in the form of the growth of demand for the national currency, and the reduction of interest rates in the monetary market, etc. may be expected only when the policy of the Central Bank and the Government is credible for the public. (In our opinion achieving such a credibility is possible in Kazakhstan after the 1995 achievements). Any actions undermining credibility could deprive the NBK of potential benefits resulting from the preannounced exchange rate policy. In fact, the proposed reform in the exchange rate policy will force the Central Bank and the Government to follow more strict financial discipline, avoid sharp changes of monetary and fiscal policy, and require them to plan any action in advance (e.g. managerial contracts and big privatization transactions).

1.5. Monetary policy program for 1996

Apart from the mechanisms of the monetary and exchange rate policy, the NBK and the Government should be able to properly forecast basic macroeconomic parameters, including monetary ones: inflation rate, possible growth of money supply, demand for money, exchange rate, and other. Miscalculations in this sphere may decrease credibility of macroeconomic policy, may have a negative impact upon the quality of budgetary planning, and generate erratic expectations of economic entities.

The adopted maximal consumer price index (CPI) of 26-28% for 1996, (December 1995/December 1996) indicates the governmental intentions to positively resolve the problems with inflation. From this point of view, an accepted by the NBK a 26-28% indicator of a maximal growth of the monetary base seems to be reasonable. The growth of money supply target (M2) is a more "liberal" amounting 36-38 %. It is evident that the difference between the rate of monetary base growth and M2 is based on expectations for decrease of a cash (M0) share in M2 and M3 (it seems to be a regular process), on the one hand, and for decrease of reserve requirement, on the other hand. Under the stable GDP (the 1995 level), this means a further sharp decrease of the rate of money velocity from 9.6 in the fourth quarter of 1995 to about 7.1 by the end of 1996 (and monetarization of the economy at a level of about 14% of the GDP). Theoretically, it is possible, though the task is a very ambitious one (especially if the inflationary potential accumulated by the end of 1995 is taken into account). The accomplishment of this task requires a coordinated and consistent policy of encouragement of demand for the national currency, including stabilization of an exchange rate, as discussed above.

Also, the NBK should develop an additional option, in case when an optimistic variant of the growth of demand for money fails: i.e., a more tough scenario of money supply, or a refusal to reduce reserve requirements.

Unfortunately, the prognosis of an exchange rate (an annual average of T71 per US\$1) approved by the Market Reform Center and the Ministry of Finance does not conform to the above prognosis of inflation and main guidelines of the monetary policy of the NBK. Based on the analysis of the balance of payments, it is difficult to explain a dramatic devaluation of Tenge (practically coinciding with the proposed inflation rates).

Planning a such high rate of devaluation Government wanted probably to meet the interests of exporters. Nevertheless, such an approach does not take into account direct and indirect inflationary consequences of a high rate devaluation (as discussed above). There is a possibility that under these conditions an approved scenario for the 1996 inflation will prove to be unrealistic.

Why there it is not necessary to pursue a strong devaluation of Tenge in 1996?

First, an expected growth of internal prices will relate to the most of all non-tradable goods and services which do not influence production costs, e.g. housing and utilities or transport services.

Secondly, the purchasing power parity (PPP) of Tenge is much lower than the PPP of currencies in the developed countries (according to the IMF it was 36% of the US dollar level⁴ in September 1995); this assumes that Tenge possesses a potential for real appreciation.

⁴ Republic of Kazakstan: Recent Economic Developments, IMF, European II Department, December 22, 1995, p.10.

Thirdly, there still exists a good economic situation in the world market especially on the goods exported from Kazakhstan. A beginning of economic growth in the CIS countries, especially in Russia) will stimulate the growth of the Kazakstani export without devaluation of Tenge.

Fourthly, the experience of the countries which underwent transformation shows that there are powerful reserves for the growth of export connected with macroeconomic stabilization, liberalization of export, privatization and restructuring of enterprises. Kazakhstan has good prospects for the oil export in the nearest future.

The exchange rate forecast for 1996 included in the state budget may be an independent factor generating devaluation and inflation expectations which can undermine public confidence in the policy of stabilization and the stability of national currency.

1.6. Conclusions and Recommendations

The NBK and the Government have to activate their anti-inflationary measures to halt inflation, which "self-decrease" stopped in the last quarter of 1995. Strict control of the growth rates of the NBK monetary base and money supply should be the basis of such policy. It concerns especially financing of the budget deficit and quasi-budgetary operations. The NBK should refuse to finance directly the budget deficit and to support extra-budgetary state agencies and organizations (e.g. purchasing crops or engaging in sanation of inefficient enterprises), or operations with precious metals in the domestic market. The accrued indebtedness of the Government to the NBK should be converted into treasury securities which can be sold out by the NBK to commercial banks and other entities, if a deeper absorption of liquidity in the money market is required.

The exchange rate policy addressed to decrease of devaluation and inflation expectations and increase of demand for Tenge should be a second basis for a new phase of combat with inflation. A gradual devaluation of a Tenge exchange rate is to be denied for the sake of favorable perspectives for the balance of payments, and a recent exchange rate (T64-65 per US\$1) should be stabilized at least for the period of 1996. It may take a form of a public declaration of the NBK to maintain a narrow band of Tenge exchange rate fluctuations (+/- 2-3%) of an average exchange rate.

A change of monetary policy denotes a necessity to conduct a more active intervention in the money market, and sterilization. Additionally the NBK and the Government must maintain a stricter financial discipline and more stable and predictable policy in all spheres of economy. Refusal to carry out a forecasted devaluation of Tenge will result in the necessity to recalculate some of the 1996 budgetary items, especially the financing of a foreign debt and foreign financing of the budgetary deficit.

Table 1.1: 1995 Consumer Price Index -CPI(% to the previous month)

Month/year	CPI
01.1995	8.9
02.1995	6.7
03.1995	5.1
04.1995	3.2
05.1995	2.7
06.1995	2.3
07.1995	2.9

08.1995	2.1
09.1995	2.4
10.1995	4.1
11.1995	4.4
12.1995	3.6
12.1995/12.1994	60.3

Table 1.2: Basic Monetary Aggregates and Indicators

Month/year	$\Delta M0$ w%	ΔMB w%	$\Delta M3$ w%	GDP:M3	M3:MB	M0:M3 w%	M1:M3 w%
01.1995	-4.0	-11.3	-3.4	13.2	1.87	36.7	87.6
02.1995	1.7	3.0	4.0	13.2	1.88	35.9	87.8
03.1995	12.6	15.6	11.5	12.8	1.82	36.2	86.7
04.1995	27.9	16.9	21.8	11.1	1.89	38.0	88.1
05.1995	-7.5	-3.7	0.6	11.6	1.98	35.0	86.2
06.1995	17.8	17.1	11.5	10.5	1.88	36.9	86.0
07.1995	12.7	16.2	11.4	10.5	1.78	37.8	87.3
08.1995	7.1	0.0	0.3	15.6 ^a	1.79	40.3	89.5
09.1995	1.9	1.1	0.3	15.6 ^a	1.78	41.1	89.3
10.1995	1.7	6.6	15.1	9.6 ^b	1.92	36.3	89.7
11.1995	5.6	-1.8	6.1	9.6 ^b	2.07	36.1	88.3
12.1995	14.1	11.5	-0.1	9.6 ^b	1.86	41.2	89.0
12.95/12.94	130.9	91.0	106.7	11.8 ^c	1.81 ^d	39.9 ^d	89.3 ^d

Source: The National Bank Statistical Bulletin, No.12(13), December 1995, pp.25-32; No.11(12), November 1995, pp.16-20 + the author's estimates

Comments: M0- cash in circulation, MB- monetary base of the NBK, M3- cash in circulation+demand deposits +time deposits, GDP- domestic gross product, GDP:M3- money velocity (monthly GDP x 12), M3: MB money multiplier, Δ - growth rate

^a- a two-month average; ^b- a three-month average; ^c- 1995 nominal GDP; M3- 1995 arithmetic mean; ^d- ratio of arithmetic means

Table 1.3: The rate of growth of factors determining the growth of monetary base (% of the previous month)

Month/year	$\Delta\Sigma C$	ΔC_g	ΔC_e	ΔC_{cb}	ΔEA
01.1995	-1.7	4.3	38.5	-11.0	na
02.1995	1.1	4.4	20.5	-5.9	7.1
03.1995	1.1	2.3	3.9	-1.5	25.6
04.1995	-1.0	11.6	11.3	-28.0	6.0
05.1995	4.6	2.9	48.2	4.2	-1.9
06.1995	-1.3	3.7	17.1	-20.7	9.6
07.1995	-5.3	4.2	-45.9	-32.5 ^a	8.8
08.1995	4.5	1.0	-2.5	28.3 ^a	-6.5
09.1995	15.8	6.1	2.9	66.1 ^a	-2.3
10.1995	-0.8	-4.6	20.3	8.8 ^a	1.0
11.1995	9.5	28.1	-4.1	-3.4 ^a	-8.0
12.1995	27.9	28.3	419.5	-68.6 ^a	6.7
12.95/12.94	63.6	132.5	1088.2	-90.9 ^a	51.2 ^b

Source: The NBK Statistical Bulletin, No.12(13), December 1995, pp.28 and 33; No.11(12), November 1995, pp.18 and 21 + the author's estimates

Comments: $\Delta\Sigma C$ - the growth of a total volume of the NBK credits; ΔC_g - the growth of the volume of the NBK credits to the Government; ΔC_e - the growth of the volume of the NBK credits to economic entities;

ΔC_{cb} - the growth of the volume of the NBK credits to commercial banks;

ΔEA - the growth of the NBK net foreign assets

^a- without the NBK securities in the portfolio of the commercial banks; ^b- ratio of December to January

Figure 1.1: Components of the growth of the Consumer Price Index in 1995 (previous month = 100%)

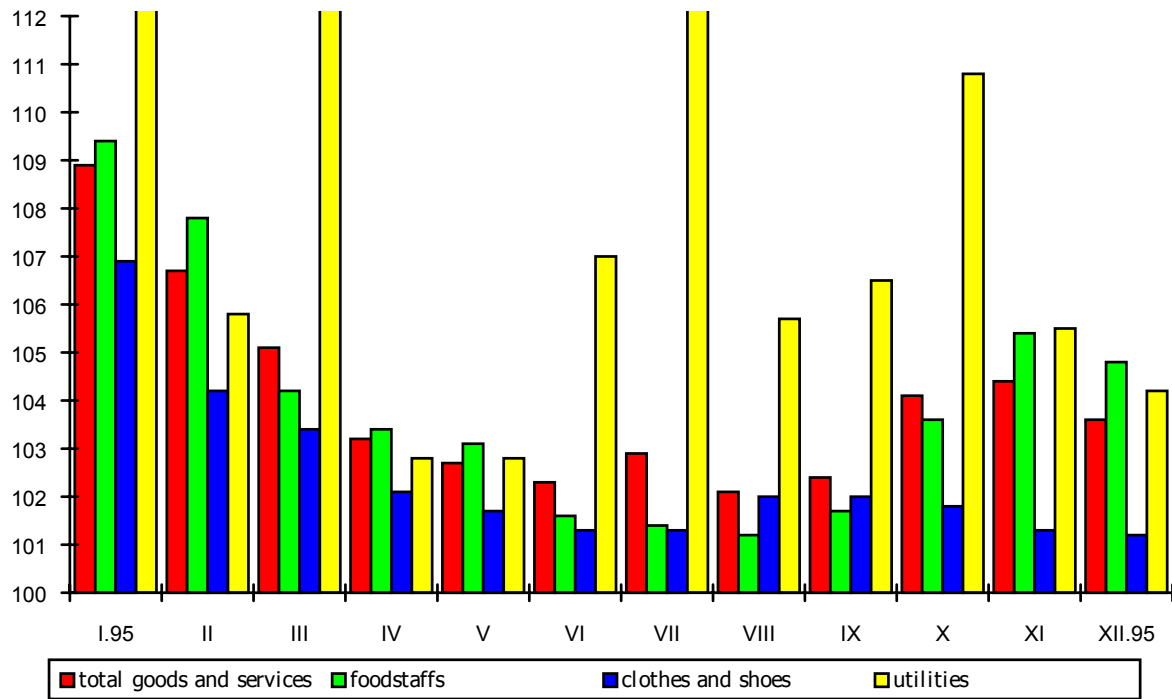
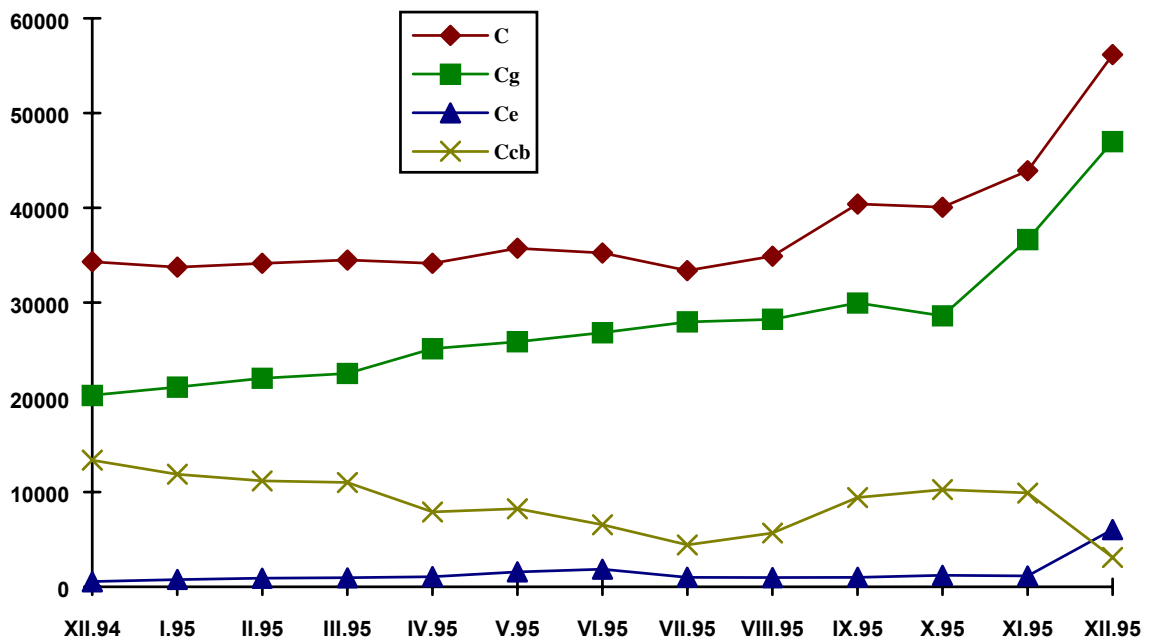


Figure 1.2: The structure of the NBK credits (million Tenge)



Source: The Statistical Bulletin, No. 12(13), December 1995, p.33;

No. 11(12), November 1995, p.21

Comments: C- total amount of the NBK credits; C_g- the NBK credit to the Government; C_e- the NBK credit to economic entities; C_{cb}- the NBK credit to commercial banks.

2. Budgetary and Fiscal Policy in Kazakhstan (Jerzy Osiatynski)

As in other countries in transformation, the public finance crisis in Kazakhstan was contained by drastic cuts in Government spending and attempts to consolidate budget revenues. Such measures have been in the past and will continue to be in future two main determinants of fiscal and budgetary policy in Kazakhstan. They will be discussed in the present chapter which concentrates on the following questions: (i) implementation of the 1995 state budget, (ii) the state budget adopted for 1996, (iii) tax policy and tax administration, and (iv) reform of the budget system in Kazakhstan.

2.1. Implementation of the 1995 Budget

Any budget analysis must deal with the following critical problems: (i) the realism of the budget figures and thus of the macro- and microeconomic assumptions that underlay it; (ii) the evolution of composition of budget revenues and expenditures in time; (iii) the economic policy targets as reflected in the budget figures; (iv) the medium and long term consequences of the present year budget.

Of course, given the constraints of past decisions determining public debt, long term budget commitments towards pensioners, public sector employees, called government guarantees etc., every budget reflects government priorities insofar as it allocates financial resources necessary to implement government programmes. From this point of view any budget is merely a dual part of Government economic programme for a given year. In assessing the feasibility of the budget and its structure one examines in fact the feasibility of this programme and exposes the Government priorities.⁵

2.1.1. Macroeconomic Foundations of the 1995 Budget

To assess the execution of the 1995 state budget, forecast of several macroeconomic indicators assumed when this budget was constructed, and next revised, are necessary. The list of such indicators includes the volume of: (i) industrial output, (ii) employment, (iii) gross domestic product, (iv) export and import, (v) gross capital formation, (vi) consumption, (vii) prices, (viii) household incomes, and (ix) costs, financial accumulation and profits of the business sector. Except for some price indices no such data was available to us, however. Therefore the realism of the 1995 revised budget cannot be evaluated. What can be done instead is the evaluation of the 1995 budget's execution in relation to the pattern of behaviour of the main components of budget revenues and expenditures that had been assumed in the revised 1995 budget.

Before we proceed, it should be noted, however, that a significant rise of the December 1995 to December 1994 prices, by over 50 per cent above the budget target, found apparently very limited reflection in the rise of the 1995 period average price index, by less than 10 per cent above the target assumed in the 1995 budget projection. This may mean that the 'dead-weight' of price rises in the second half of 1994 in Kazakhstan was especially heavy, leaving little room for the impact on the period average price index of the higher than assumed price rises in 1995. If this was indeed the case, it puts into doubt the 1996 budget projected period average inflation index which in the light of the higher than assumed price

⁵ The latter are, of course, subject to political evaluation too - whether they tally with the Government's pre-election or other promises and/or whether that programme meets best social and other aspirations. For obvious reasons, any such assessment is of political nature and goes beyond the subject matter of these comments.

performance throughout all of 1995, and in its last quarter especially, may prove significantly underrated, closer to 40 rather than to 32 per cent assumed in the 1996 budget. Alternatively, the period average 1995 price index may be underreported, which would have direct consequences for the interpretation of budget implementation in 1995. Clearly any combination of both variants is possible. At any rate, the period average price indices - and it is them, and not the end-of-period indices, on which any budget construction must be supported - for both, 1995 and 1996 should be taken with caution.

2.1.2. The 1995 Budget Revenues

The revenue side of the 1995 state budget is examined at greater length in Section 2.3. below. The better than assumed performance of many budget revenues looks much less impressive when the actual price performance is taken into account. Total revenues are then less than 2.8 per cent higher, budget's Part I revenues are 3.7 per cent higher, VAT revenues are 6.4 per cent higher, and personal income tax revenue and excise revenue are lower by 6.4 per cent and 17.4 per cent respectively. Moreover, when it is taken into account that Gross Domestic Product's decline in 1995 was less than expected when the 1995 budget had been constructed (and next revised), and that average wage rate was well above the budgeted targets too, the unsatisfactory performance of tax collection is rather clear.

On the other hand, corporate income tax revenue was in 1995 as much as 10 per cent higher after allowing for higher than planned inflation. We have none more detailed information that would enable us to explain the causes for this result and thus to consider it success or failure. Yet, one should bear in mind that a good budget forecast must not deviate **either way** from the actual performance. Underestimation of budget revenues may lead to unnecessary government borrowing, or unnecessary limiting the government spending, or excessive tax rates. They all could have been avoided had budget revenues been more accurately estimated. It must be noted, however, that in the early stages of transformation any forecasting is difficult because results of economic policies are very uncertain, if at all predictable.

2.1.3. The 1995 Budget Expenditures

With respect to the 1995 consolidated budget expenditures, first of all it must be noted that they increased by one percentage point less than the consolidated budget revenues thus bringing the rate of growth of budget deficit to 4 per cent only. When one looks at the structure of budget expenditures, however, it is immediately seen that there have been large changes between the mid-year revised budget and its actual implementation by the end of the year (see Table 2.2).

Expenditures on both domestic and external debt servicing were higher than planned; those related to domestic debt (payment of called debt guarantees including) were more than fourfold higher. There was also a large rise in expenditure of infra-budgetary (i.e., special purpose) funds, 10 points higher than the rise of those funds' revenue; yet their balance remained strongly positive, at nearly tenge 12 billion (which rises the question of whether the contribution rates to these funds should not be reduced).

That and other additional spending was more than compensated by massive cuts in relative shares in total expenditure throughout all other categories of budget expenditure. Most affected was spending on national economy, whose share fell from 26.2 per cent to 17.2 per cent, and the sector least affected was the expenditure on socio-cultural projects, mainly on account of a rise in spending on education. Other sectors' shares were reduced in a more or less the same proportion.

Across-the-board cuts resulted among other things in mounting arrears of unpaid bills of budgetary units towards suppliers of goods and services and employees. The difference between total volume of these outstanding debts at the end of 1995 and that at the end of 1994 should be added to the 1995 budget deficit (its financing being done by enforced savings of suppliers of goods, services and labour). Since the relevant data is missing, the volume of this additional debt is not estimated here.

Finally, let us make two observations on budget expenditures in Kazakhstan.⁶ On the one hand, only about 35-36 per cent of total budget spending goes for social and cultural projects, of which education and health together take about 30 percentage points. This is much less than in many other countries in transition. (However, when expenditures of the three extrabudgetary funds, i.e. of the Pension Fund, the Employment Fund, and the Social Insurance Fund, which taken together was close to 76 billion tenge in 1995, is added both to the expenditure side of the consolidated state budget and to the expenditure on all social and cultural projects, the relative share of the latter in the former is close to 61 %!). Also the cost of servicing the public debt, although presently rising at high speed, is as yet not very large.

On the other hand, the relative share of government spending on the economy (which used to represent mainly direct and indirect subsidies) sharply fell in 1995. This evidences the progress already achieved in the process of internal and external economic liberalisation, (which allowed in turn to end many subsidies), and in imposing a hard budget constrain in the business sector, which promotes market friendly environment for microeconomic adjustment. At the same time, however, cuts in government expenditure on economic infrastructure and on programmes in support of entrepreneurship do not help to secure the future stable and balanced growth. Experience of many countries, especially the developing countries, points to the significance of infrastructural projects and entrepreneurship supporting programmes for the success of economic development, of the private sector especially.

2.2. The 1996 Budget

2.2.1. Macroeconomic Foundations of the 1996 Budget

The macroeconomic assumptions on which the 1996 consolidated budget of the Republic of Kazakhstan was ultimately founded are not spelled out in the Sbornik no. 1 materialov po gosudarstvennomu budzhetu Respubliki Kazakistan na 1996 god (Almaty, January 1996, Ministry of Finance of the Republic of Kazakhstan). An earlier and rather incomplete version of those assumptions is given in the project of the 1996 budget (Budzheta Respubliki Kazakistan na 1996 god, proiekt, Almaty, November 1995, Government of the Republic of Kazakhstan). From this and other information obtained in the Ministry of Finance it follows that the assumed end-of-period consumer price indexes for 1996 is 26-28 per cent, the period average CPI is 30-33 per cent, and that the rise in money wages in the Government sector, public services including, will be effected at the expense of reduced employment thus leaving the total wage bill unchanged. According to Sbornik no 1, the 1996 GDP will reach Tenge 1312 billion, i.e., 31 per cent above its 1995 volume at current prices, and thus approximately the volume of 1996 GDP at constant prices (using period average CPI as the GDP deflator) will be the same as in 1995.

⁶ The scarce information available to us makes it virtually impossible to determine more exactly which categories of expenditure in the consolidated budget 1995 were preferred by the government and why.

As it was already noted, in the light of last year's performance, the most risky are the assumptions concerning inflation. The end-of-period index, which requires cutting inflation in one year's time by more than half, is very ambitious to say the least, even allowing for the fact that inflation in Kazakhstan is still counted in two digit numbers. The period average index is unfounded in the light of both, the monthly inflation rates in the last quarter of 1995 (see Section 2.1) and the past relations between the end-of-period and period average price indices in Kazakhstan.

Of course, it may be argued that if inflation in 1996 proves higher than assumed in the budget, this will correspondingly augment tax revenues, and since budget spending represents merely upper limits of government financing, while far not all budget expenditures are indexed on inflation, underrating the latter in the budget figures represents a hidden reserve of the budget.

Be it as it may, it should be noted that if cuts in the public sector have already been large in the past and, moreover, if the financial discipline in budgetary units is weak, then higher than planned prices will not necessarily prevent budgetary units, say schools, hospitals, or government administration, to buy material inputs or services. They may instead stop paying for these inputs thus accumulating unpaid checks that ultimately will have to be covered by the budget. If such a situation continues for some time - the government buying out budgetary units in payment arrears - this in turn provides strong stimuli towards foregoing any budgetary discipline throughout the whole system (as it penalises those who observe budgetary discipline against those who do not) and the whole budgetary system may well collapse.

Moreover, commercial banks' and business' price expectations are partly formed on price forecasts of the government, provided, however, that the latter do not significantly deviate from the actual performance. Hence the importance of the government price forecasts for the pattern of price behaviour of economic agents.

In conclusion it may be argued that price indices assumed in the 1996 budget have been underreported with a rather large margin and one may expect deviations between the actual price changes and those assumed large enough to warrant a mid-year budget revision. This in turn will have a negative impact on budget discipline and macroeconomic discipline in general and, moreover, would make the preparation of the 1997 budget much more difficult.

Other macroeconomic assumptions appear more realistic. We believe that after the decline in the rate of fall of the GDP it may indeed be expected that in 1996 the volume of GDP will be the same in real terms as last year. Also the assumption that the wage bill in the public sector will not be affected by wage-rate rises seems difficult to achieve but not implausible. Other assumptions will be examined below together with the 1996 budget's revenues.

2.2.2. The 1996 Budget Revenues

On the assumptions that rates of taxation and tax incidence do not change, the ratio of tax arrears to tax revenues does not increase, and the relation between tax and non-tax revenue does not change, budget revenues should change in proportion with the volume of tax-liable income, i.e. at the same rate as: (i) the volume of sales, (ii) money incomes of population, and (iii) the volume of corporate profits. As the above mentioned assumptions broadly hold for Kazakhstan in 1996, with the proviso that a rise of some taxes on natural

resources is contemplated by the Government and no tax reductions may be expected, the relations (i), (ii) and (iii) should hold as well. Let us therefore examine them at some detail.

At GDP constant in real terms, the volume of sales may be assumed to increase more or less at the same rate as prices.

Money incomes of population depend in turn on money wages both in the enterprise sector and in the public sector, and also on the distributed business' profits and profit related incomes. The average monthly wage rate is assumed to increase in 1996 by 21 per cent and to reach tenge 7124. We do not know, however, the assumptions concerning wage rates in the enterprise sector and in the public sector respectively, or the respective employment numbers. If growth in money wage rates in the enterprise sector were accompanied by a large enough fall in employment there, the rate of growth of money wage bill in that sector could be assumed to be the same as that of consumer prices. This is a strong assumption, however, and rather a rise in the money wage bill in the enterprise sector by 1-2 points above the rate of inflation may be expected.

The average monthly wage rate in the budget sphere in 1996 is not given, nor is that in 1995. However, on account of reduction in employment and what is called 'an optimisation' of the public service network, the wage bill in the public sector is assumed to double in 1996. Hence the rate of growth of money wage rates must have been assumed correspondingly higher.

The rise in distributed profits and profit related incomes of family and small business is assumed in the 1996 budget at 33 per cent which seems realistic.

Thus, all in all, under the above discussed assumptions it is plausible that personal income tax-liable incomes will increase in 1996 at least by 2 per cent in real terms, i.e. by about 34-36 per cent in nominal terms.

With respect to corporate profits we have no information on what was assumed in the budget construction regarding the enterprise profitability. With GDP and the volume of sales unchanged in real terms, unchanged labour costs (increased productivity being offset by a rise in wage rates), and assuming that costs of material inputs change in the same proportion as output prices (and terms of trade in foreign turnover do not change as well) one is tempted to believe that tax-liable enterprise profits should increase at the same rate as prices. However, since it seems safe to assume that labour productivity will rise faster than unit labour costs, corporate undistributed profits may be assumed to increase by 2-3 per cent in real terms.

How the above discussed relationships tally with the 1996 budget revenue figures? A comparison of the 1995 budget implementation with the 1996 budget reveals some puzzling phenomena (see Table 2.1). Total budget revenues in 1996 increase by a mere 15 per cent, less than half the rate of period average inflation, and the budget's Part I revenues, which represent mainly tax incomes, increase by 25 per cent only. The reasons for this huge reduction of tax collection (at unchanged if not in fact increased tax rates) are neither specified, nor understandable.

A closer look at the main components of tax revenue dynamics gives rise to more questions. Except for excise revenue, which is assumed to increase by 50 per cent compared to last year's actual collection (which in turn depends on improved policing of excise administration, an introduction of better secured excise marks, etc.), all other main tax revenues increase at a lesser rate than prices. VAT revenue is to increase by 21 per cent only, when the money value of sales, according to the above, may be expected to increase by 31.5 per cent. Moreover, with the volume of sales augmented by inflation, a rise in numbers of

VAT payees must also be expected. Budget prognosis concerning PIT revenues is underrated too - a 30 per cent increase compared to some 35 per cent increase estimated above. Finally, it is unclear why corporate income tax revenue is expected to rise by a mere 6 per cent.

A reduction in budget's Part II revenue, insofar as it represents a reduction of activity of some infra-budgetary (special purpose) funds, does not give rise to concern. It is noteworthy that budget's Part II expenditure is also reduced and, as in 1995, the overall balance of Part's II income and expenditure is positive.

Regarding export and import tariff revenues they are expected to increase by 66 per cent and 40 per cent respectively. This represents a rise in foreign trade in terms of US Dollar and the Rouble. The 1996 rates of exchange are given (at 71 tenge to one USD,⁷ and 11.80 tenge to 1000 Rouble), but the respective volumes of exports and imports are not. Also no information on the actual and expected effective rates of export and import tariff in 1995 and 1996 are available. Anyhow, in the light of Kazakstan's having entered earlier this year a custom union with Russia, Belarus, and subsequently Kyrgyzstan (see Ch. VI), the 1996 budget figures on tariff revenues most likely need revising.

In conclusion it appears that the Kazakstan Government's estimate of the 1996 budget's revenues is extremely conservative, well below what they could reasonably be expected. If the intention of the Government was to generate in this way incomes that would reduce budget deficit, or allow to reduce some long-term public debt, this should better be clearly spelled out in the budget, by showing more realistic budget estimates. Alternatively, if the presently determined budget revenues are considered satisfactory from the viewpoint of public finance requirement, it would be recommendable to reduce somewhat the tax rates, VAT and corporate income tax rates especially. Then the question arises, however, whether the proposed cuts in Government spending are likely to be accomplished in 1996.

2.2.3. The 1996 Budget Expenditures

The 1996 budget expenditures are planned to increase by 14 per cent, i.e., given the period average rate of inflation, to drop by 8.7 per cent in real terms compared to last year's implementation (see Table 2.1). Expenditure on foreign economic activity and on republican and local government more than double in nominal terms in 1996, the former on account of external debt servicing (a rise by 118 per cent) and the latter (by 136 per cent) possibly in relation to the transfer of capital to Akmola. Expenditure on national economy is nearly stable in real terms compared to last year's performance (a rise by 31 per cent in nominal terms). Other spending follows a rather peculiar pattern: where last year's actual spending was much below the 1995 revised budget's figures, proportionally more is allocated for 1996; where it was overperformed last year, there are large cuts (in nominal terms!) this year.

Total expenditures on socio-cultural projects are to increase in 1996 by 17 per cent, and thus to constitute 36.7 per cent of total consolidated budget spending, compared to last year's 35.7 per cent (see Tables 2.1 and 2.2). Yet, within the group, expenditure on education, which was largely overperformed last year compared to the revised budget's figure, is to decline in nominal terms by 4 per cent. Expenses on culture and mass media, with the emphasis on the latter, will increase their relative share in total spending from 2.2 per cent to 2.9 per cent. Expenses on health, sport, etc. were last year 9 per cent below the revised budget figure; this year they should increase by 31 per cent, thus bringing their relative share from

⁷ This forecast of the tenge/US dollar rate of exchange appears overestimated in the sense that a too high devaluation of the tenge is expected (c.f. Ch. I).

12.2 per cent of total expenditure to 14 per cent. (However, since expenditure on health is planned to fall, does this rise reflect additional expenditure on sport, related to the Olympic Games later this year?)

Spending on social protection was more than 25 per cent below what was planned in 1995; it is supposed to increase this year by 65 per cent (see, however, Section 3.10 below). The same holds for expenditure on science (17 per cent below the plan last year and 63 per cent above last year's performance in 1996), defence (-27 per cent and +62 per cent respectively), and to some extent to public order and safety (-1 per cent and +42 per cent). In general, the composition of budget expenditure at the stage of budget planning in 1995 and 1996 was not much different between one year and another (see Table 2). It is apparently only at the stage of budget implementation that cuts are introduced where least resistance may be expected.

Can the above mentioned cuts in the 1996 budget be executed? The cuts concentrate on servicing the domestic public debt, the volume of which it is relatively easy to calculate, and mainly on education, where special austerity programmes are to be introduced. With respect to the former the answer is in the positive. With respect to education, a reduction of government financing by 27 per cent in real terms is unlikely to be accomplished and one may expect accumulation of unpaid bills in schools and education-related budgetary units in the second half of the year.

Nevertheless the situation in financing education in Kazakhstan in 1996 appears rather exceptional and most other categories of Government spending are assumed to experience a rise in public finance in real terms. This would mean that the budget situation in Kazakhstan in 1996 is unusually favourable. With a very conservative prognosis of budget revenues, that will most likely be some tenge 15 billion higher than anticipated (i.e. total budget revenues will be over 6 per cent higher), and with underestimated public finance requirements in education by about tenge 7.5 billion (austerity programmes in education to provide savings to the value of additional tenge 4.5 billion in 1996), and elsewhere (outside the national economy) by tenge 2.5 billion, tenge 5 billion could be used for financing additional programmes in national economy that would assist better microeconomic adjustment to market environment, or for reduction of budget deficit, or for some other purposes.⁸

2.3. Tax Policy and Tax Administration

2.3.1. Consolidating Budget Revenues in Kazakhstan in 1992-5

First measures aimed at reforming the tax system in Kazakhstan were introduced already in 1992. Yet, the time and outlay necessary to complete the fiscal reform and strengthen tax administration have not been appreciated.

Total revenues of the republican and local Government in 1992 and 1993 in relation to GDP were fairly stable, at a level of 22.9 and 22.5 % respectively. However, 1993 marked already some dangerous trends in tax collection, which declined by 5.9 percentage points of the GDP and which was compensated by a 2.9 GDP points rise in non-tax revenue and by

⁸ However, since our analysis is based on very shaky statistical information, speculating on the use of resources that may well appear illusory must be left aside until the budget statistics are more solid and comprehensive, macroeconomic foundations of the budget including.

additional capital revenues equal to 2.5 GDP points. Apart from the above mentioned, usual factors of decline in tax revenues in the early phase of transition - such as decline in the traditional tax base in the industrial state owned enterprises and the accumulation of inter-enterprise arrears, as well as weakness of tax administration in a new business environment - a major cause of the tax revenue decline was a drop in the VAT collection by 2.5 percentage points of GDP, due to a decline in VAT rate from 28 to 20 %, introduced on January 1, 1993 in all Former Soviet Union (FSU) countries - a move that was not offset by the originally planned reduction of VAT exemptions.

In 1994 the budget projection of total revenue of republican and local Government was 21.3 % of GDP and several measures to consolidate the revenue base were applied. They included a simplification of VAT rate structure (with 20 % and 10 % rates, and a reciprocity principle with regard to imposing VAT on imports - not on exports - in relation to turnover with the FSU countries). Excise rates on alcohol and tobacco were increased, and new excise taxes were introduced on gasoline, fuel and other oil products, natural gas, cars, soft drinks luxury consumption goods and household appliances. The number of tax exemptions was reduced and that of products subject to export taxes was increased. The average import duty rate was to increase from 3 % in 1993 to 15 % in 1994 (in practice it increased to 5 % only). Moreover, the Republican Tax Inspectorate was given some extra powers to better enforce taxpayers compliance. Computerisation of the tax and the customs clearance systems has been started.

The revised 1995 consolidated state budget projected total revenues to reach 16 % of GDP, less than the 1994 outcome, due to a decline in non-tax revenues (mainly in central bank's profit transfers). Moreover, the average import duty rate was increased in 1995 to the targeted 15 %, excise taxes on variety of luxury goods were also increased, and the VAT incidence was expected to cover all imports from the non-FSU countries.

The single most important change in 1995, however, was the introduction, as of July 1, the new Tax Code. Apart from simplifying and modernising the tax system in line with the needs of a market economy it also reduced the average consolidated rate of taxation of enterprise profits. Although the new Code is no doubt an important step towards consolidating tax revenues and introducing a modern tax system, some of the Code's new solutions give rise to doubts or are, we believe, incorrect. In what follows our recommendations will be included into the general discussion of the new tax system. Before we proceed, however, let us consider the overall implementation of main tax revenues, as at the end of 1995.

According to the Ministry of Finance, tax revenues were satisfactory. By the end of the year they represented 106.2 per cent of the budgeted tax revenues, of which revenues from the four main taxes, i.e. the value added tax, the corporate income (profit and capital gains) tax, the personal income tax, and excise taxes represented together 111.1 per cent of their planned revenues, while revenues from all other taxes taken together were less than 2/3 of what had been planned for this period (see Table 2.1). Of the four main tax revenues, corporate income tax (CIT) was 20 per cent above the plan, the value added tax (VAT) was 16 per cent above the plan, the personal income tax (PIT) was only 2 per cent above the plan, and excise revenues were some 10 per cent below the plan target.

Also in the opinion of the International Monetary Fund, the revenue collection in 1995 (in its first nine months) was broadly in line with the program target. Indeed, by the end of 1995 total budget revenues (infrabudgetary funds including) amounted to tenge 209.5

billion which at the 1995 GDP estimated at tenge 998 billion represents about 20 per cent of the latter.⁹

2.3.2 Execution of Main Tax Revenues in 1995 and their Forecast for 1996

Have indeed tax revenues been broadly on track and satisfactory?

In what follows we shall examine the above mentioned four main tax sources of budget revenues only, i.e.: (i) the corporate income tax, CIT (tax on profits, and on capital gains including), (ii) the personal income tax, PIT, (iii) the value added tax, VAT, and (iv) excise taxes, and to a lesser degree levies on international trade. Tax on natural resources could become another major source of budget revenues in Kazakhstan, and as the Kazakhstan Government is presently undertaking special measures to achieve this target (amendments in the Tax Code including) this issue shall not be elaborated here.¹⁰

Table 2.1 outlines budget revenues in 1995, planned and achieved, as well as the respective revenues forecast in the 1996 budget, of the four main taxes mentioned above. Let us start with the 1995 revised budget figures and the actual performance.

In VAT collection, revenues were 16 per cent above the revised budget figure. Is this a satisfactory result? It certainly would have been had the actual rate of inflation been what it was assumed in the revised budget. However, the end of period inflation index was over 50 per cent above the target, and the average annual rate of inflation is estimated to have been some 15 percentage points (about 9per cent) above the target. As the volume of the VAT revenue depends on the nominal volume of sales (and thus, indirectly, of the GDP), the success is less spectacular. Moreover, the 1995 harvests were rather poor, which changed the composition of the GDP and sales towards increasing the relative share of goods that are VAT-liable. We are unable to estimate the importance of this factor, however. The significance of new entrants of VAT payers due to higher inflation and therefore volume of sales is also unclear to us.

Corporate income tax performance was even better than that of VAT, 20 per cent above the target. Allowing for the higher inflation rate still leaves plenty of room for profitability improvement and/or better than expected tax collection. Unfortunately, there is no independent information on profitability changes in the business sector. However, taking into account that labour cost significantly increased in 1995 (see below), and that labour costs represent a large proportion of total costs of the enterprise sector, the higher proceeds should probably be attributed to improved tax collection.

In Kazakhstan, of tenge 25.5 billion of the personal income tax collection in 1995 less than tenge 0.4 billion (i.e. about 1.5 per cent) were collected directly by tax offices; the rest was collected by employers and other income payees. Thus PIT revenues depend heavily on wage rates and on the numbers of the employed on the one hand, and on rates of other income (pensions, scholarships, social security allowances, unemployment benefits, etc.) and the

⁹ In contrast to the IMF analysis, the ratios of tax revenues to gross domestic product are not used below because the estimates of the latter do not appear to include corrections for higher than originally forecast inflation rate, higher money wages, etc., and thus as yet they do not appear solid enough for this type of analysis.

¹⁰ Several important macroeconomic indices have not been so far available to us. Therefore some proxy indicators had to be relied on. This may limit the validity of our results although we believe it does not undermine them. At any rate our approach points at some ways of testing the performance of tax collection and of estimating future tax revenues when examining the next year's budget.

respective numbers of beneficiaries on the other hand. Obviously, the single most important source of personal income tax revenue is the tax on wage bill.

The December 1995/December 1994 average wage rate in Kazakhstan increased by nearly 30 per cent. What is needed for our analysis, however, is the period-average rate of growth of wage rates. Unfortunately, this index is not available. Yet, the monthly wage rates in 1994 and 1995 are available. Thus, as a proxy we shall use the mid-year index (July 1995/July 1994). As the July 1995 average wage rate was tenge 5185, and the July 1994 was tenge 1726, it may be roughly estimated that in 1995 the average wage rate increased by 200 per cent. The period-average index of total employment in Kazakhstan in 1995 is not available too. Here as a proxy we shall use the ratio of employment in the 3rd quarter of 1995, i.e. 5.38 million, to that in the 3rd quarter of 1994, i.e. 4.456 million; this index amounts to 0.83. Hence the wage bill (i.e., the taxable income of the employed contract labour) increased in 1995 by 0.83 multiplied by 3, i.e. by nearly 2.5 times.

The rate of growth of the average wage rate assumed in the budget for 1996 is 21 per cent. We do not know, however, the assumed therein rate of decline of employment. At any rate, if notwithstanding this huge rise in taxable earned income, the actual index of collected personal income tax is merely 1.02, this points not only to huge wage arrears (as well as arrears in pensions, social benefits and other transfers), but also to some serious problems in wage control in the economy, as well as in personal income taxes administration and collection.

Next, assuming that price hikes above the figures assumed in the revised budget referred to excise goods at least in the same proportion as on the average, excise taxes being paid ad valorem it should be expected that excise tax revenues will be rather some 10 per cent above the budget target, and not 10 per cent below it. However, there are several problems with administration of excise taxes in Kazakhstan, the most important of which relates to administration of excises on alcohol and tobacco. Excise marks that we could inspect are of poor quality and can be easily falsified. Also the system of accounting of these marks is far from watertight.¹¹

Finally, import and export custom duties, which also are paid ad valorem, should 'automatically' rise together with inflation. Thus if the latter was above what it was assumed in the budget, other factors being unchanged, budget proceeds from these duties should be correspondingly higher.

Regarding tax revenues planned for the 1996 budget, first of all it must be noted that except for excises these revenues had been estimated with huge reserves. - see Section 2.2.2.

Quite apart from the underestimation of inflation rates projected in the 1996 budget figures, and especially of the period average rate, the increase of VAT revenues by merely 21 per cent is puzzling. The estimates of additional VAT revenue due to greater tax incidence and improved VAT administration in 1996 are not available; but at any rate one should expect on these two counts alone an additional rise of VAT revenue, compared to its 1995 actual collection, above the 31.5 per cent inflation rate, unless the Ministry of Finance expects some

¹¹ It may be noted in passim that the introduction of excise marks in Poland was delayed by nearly a year precisely in order to avoid their easy fraud; when banderols were eventually introduced, their protection was not inferior to that of money. Also the producer(s) of excise marks were carefully selected and the system of their accounting was patterned on that of money.

additional troubles in VAT collection, in which case these troubles should be defined and their numerical significance estimated.

It is also unclear why corporate income (profit, capital gains, etc.) tax revenue should increase by a mere 6 per cent compared to the last year's revenue when in 1995 it increased by 20 per cent.

On the other hand, a 50 per cent improvement in the performance of the excise taxes is a rather ambitious target, especially bearing in mind that most of these taxes are administered by local (Oblast) authorities and they represent their income. Improvement in excise collection on alcohol and tobacco is usually connected with their much more intense policing and other complex measures that may need longer time to implement.

2.3.3. Some Problems of the Tax System in Kazakstan

As it was already noted above, although the new Tax Code represents a major improvement compared to the earlier tax system in Kazakstan, nevertheless some of the Code's regulations should be reconsidered. (Some more detail comments on the Tax Code are given in Appendix 1.)

Let us start with VAT regulations. In accordance with the Law on the Budget System, Oblast's budgets are allowed to share in VAT proceeds. These shares are not predetermined in the LBS, or some other law, or in any other systemic way, but are decided each year in the Law on the Republican Budget, and they differ between one Oblast' and another. Many Oblasts' share is hundred per cent and the VAT proceeds represent far the bulkiest part of the respective Oblast's budgets. The arbitrary nature of this differentiation and its negative economic consequences are obvious. Since under this arrangement Oblast's Tax Inspectorate collects VAT's revenues and effects VAT credits, this gives rise to problems when tax returns to a large exporter (to a non-FSU country) are equal to or exceed total tax revenues collected in a given oblast'. There are many complaints against long delays in back payment of tax returns in such cases. In short, where intermediate products are shipped from one region to another for further processing, the inter-regional crediting of VAT-payers becomes politically difficult and an administrative nightmare.

The idea behind this sharing device (patterned on the Russian VAT system) was apparently the conviction that if the Oblasts did not share in the VAT revenues, the Republican Government respective subsidies which the Oblasts should receive would have to be correspondingly greater and, moreover, if Oblasts shared in VAT revenues, collecting them would be also in their interest. In practice, however, in any given Oblast all tax revenues enter the same bank account, and the bank, following a Ministry of Finance predetermined algorithm, divides tax proceeds between the Republican and the Oblast parts. Then the Republican part should be immediately transferred to the Republican budget account.¹² As it has been noted already, the multi-stage nature of the VAT system makes it unsuitable for regional policy implementation. On top of this, the VAT-sharing system effectively blocks exports at the oblast' level.

Moreover, with respect to foreign trade turnovers there exist simultaneously two systems of VAT administration, one for the FSU countries and the second for other countries.

¹² This is far not the case, however, and the local administration is very effective in delaying these transfers, notwithstanding condemnation of such policies by the Republican Tax Inspectorate and Republican Government administration.

Under the former, export is not subject to zero VAT tax rate, and under the latter it is. Apart from ample opportunities which this dual arrangement creates for tax evasion, and the cost and difficulty involved in administration of such a system, the rationale for levying VAT on exports is dubious except that it financially favours the net exporter-country.

It must be noted, however, that in order to implement the standard, destination-based system with zero-rating of exports and taxation immediately upon import, it is important to introduce border controls between the republics. Apart from the necessary outlays, neither Kazakhstan, nor other FSU republics have collective capacity for effective border control at this point, however. At any rate, the financial and other consequences of shifting from the present basis of the VAT system, to a standard destination basis requires detailed analysis and financial calculations.

In conclusion, it is commendable that Oblast and other local government sharing in VAT should be abolished and all VAT proceeds were classified as revenues of the central budget. Moreover, other ambiguous and misleading divisions between the authority of the Republican Government, the Oblasts Governments, and the regional, autonomous territories and local governments concerning tax revenue sharing and tax administration should be also eliminated. If this could not be introduced immediately (bearing in mind that VAT proceeds alone constitute between 50per cent and 65per cent of total Oblast's revenues, the subsidy from the Republican Government including) then VAT sharing should be phased out over a definite period of time. Also the dual VAT system with respect to foreign trade turnover should be reconsidered and unified following the standards of a market economy, according to which every country covers its financial needs by its own population. Financial simulations of both these measures should be prepared by the Ministry of Finance and the Kabmin, as should be the revisions of the respective chapters of the Tax Code.

There is a similar tax-revenue sharing arrangement between the Republican Government and the Oblasts' Governments with respect to excises. This arrangement was probably decided on similar grounds as the VAT-sharing one, it is equally ineffective and should be revised. Excises are a special type of taxes, set arbitrarily by central governments and should therefore constitute only their respective revenue, in Kazakhstan too.

Until recently tax administration and import and export tariff administration have been centralised in the hands of Ministry of Finance. This seems by all means commendable as both types of budget revenues should be collected together and handled by the same administration, among other reasons because both these public services require access to similar data and should use the same communication and information networks. For reasons which were not clear to us they are now separated in Kazakhstan. In our opinion this Government decision merits reconsideration.

With respect to personal income tax, the Government contemplates measures that would make the *consolidated* personal income tax-liable already in 1996. The procedure of personal income consolidation, however, requires much more complicated tax forms than those used at present (even if the new system implied no tax family allowances or other systemic tax reductions), increased capacity of tax administration to process these forms, as well as adequate education and training of tax fillers and tax inspectors. For all these reasons the Government plans are probably premature and I'd recommend instead measures that would improve compliance and collection of taxes by simplifying the processing of tax declarations, and the improvement of their auditing. The Government's decision to introduce

flat tax rates for small and micro firms that operate in trade and services sector is also welcomed.¹³

2.3.4. Problems of Tax Administration in Kazakstan

As many other tax administrations, also that of Kazakstan collects most gladly those taxes that can be collected without leaving their tax offices, by phone and fax. At the same time the work-load of tax administration increased manifold. Thus it is of critical importance that all tax-payers are coded as soon as possible, the number of tax and tariff inspectors increased in proportion with that of tax-fillers, and that these inspectors are well trained and adequately paid. Also a regular inspection of tax inspectors seems highly desirable under the present Kazakstan circumstances. Finally, there must be a fair and easily accessible system of protection of tax- and tariff-payers against abuse.

Moreover, in view of significant changes in the Kazakstan's agriculture, and especially the replacement of the former sovkhozs by hundreds of semi-private and/or semi-co-operative farms, whose legal nature as well as their volume of output and income are hard to establish, it might be sensible to allow local tax administration determine tax-liability of those new agricultural entities and apply some flat-rates of their taxation.

According to anecdotal evidence, cumbersome filling requirements and inefficient collection practices inhibit business development and foreign investment in Kazakstan. On the one hand, calculation of taxable income is still based on accounting standards which, among other things, do not allow for the inclusion of all actually incurred costs; hence occasionally non-existing incomes are also taxed. (The new Law on Accounting should, among other things, better account for the cost of stocks and fixed capital depreciation). On the other hand, transfer pricing is widespread. The Government, aided by foreign experts works on a new Law on Accounting, and the National Bank of Kazakstan on the new accountancy and book-keeping system for commercial banks, yet the urgency of the task does not seem to be fully appreciated.

On top of this, the present book-keeping system, which enterprises are free to choose (between the memorial system and the cash book-keeping system) provided they declare their choice at the beginning of the year in the local treasury office, is an important source of tax avoidance and delays in tax payments. Also, under widespread barter trade and cash operations, the cash book-keeping system provides ample opportunities for tax avoidance.

Moreover, the decline of many state owned companies (SOEs) is accompanied in Kazakstan by re-deployment of capital assets and labour from the distressed SOEs to street and bazaar trading and to small, single-person firms (this tendency is strengthened by some former SOEs paying wages in terms of their produce; the underpaid teachers and other public sector employees are also subject to this re-deployment process). The informal sector of the economy is hardly regulated or taxed anywhere. Yet, bearing in mind that the relative share of this sector in the Kazakstan economy is estimated at anything between 15 to 50 per cent of total output and employment, it is highly commendable that special, simplified forms of taxation and of administering these taxes are developed. Technical assistance of experts from

¹³ Such flat tax-rates have been introduced in the Semipalatynsk Oblast over a year ago and proved very effective in improving tax collection, we were told by the local tax authorities.

a country with similar experience may be desirable, but also more notice should be given to experience sharing between individual Oblasts' approach to this problem.¹⁴

The new Tax Code leaves little room for few tax concessions although there was some last minute pressure for the introduction of preferential profit tax rates hampering equity and revenue collection. Neither the Council of Ministers, nor the Ministry of Finance may grant tax exemptions. Only term of tax-payment may be postponed by tax administration, and provided some clearly specified conditions are met. To reduce the number of such decisions it was decided that from July 1, 1995 tax-postponement decisions may be taken only at the Ministry of Finance level and must be authorized by the minister. A special team to process applications was formed in the Republican Tax Inspectorate, and the number of approved applications since that time has significantly declined. Yet, as shown by the Polish experience and the experience of other countries where special task forces to control tax-postponement decision-making have been set up, this initial decline is a transitory nature only.

2.3.5. The Problem of Tax Arrears

In many countries in transition their Governments, and Finance Ministries especially, see the problem of mounting tax arrears as the single most important problem to be solved. Kazakhstan is no exception to this rule. This is by no means surprising considering that the cumulated tax arrears towards both the Republican and the Oblast' budgets on 1 September 1995 were tenge 26 billion, i.e. nearly 26 per cent of total tax revenues planned in the 1995 budget; on 1 February 1996 total tax arrears were tenge 21.3 billion, and on 1 March 1996 they were tenge 21.8 billion.

Yet, without underrating the significance of measures aimed at containing tax arrears and already contemplated and/or introduced by the Kazakhstan republican and regional authorities, it is important to understand that these measures can only partly accommodate the inherent imbalance of public finance of the early phases of economic transformation. The point is that in Kazakhstan (as elsewhere) the tax base has dramatically collapsed together with the financial performance of the formerly state-owned firms which at present are most often in deep financial distress, with negative profitability, much reduced output, and rising arrears in tax, social security and wage payments. (Thus personal income tax revenue is also eroded.) Hence, even once the new tax system is put into place and tax administration is improved, unless and until these firms restructure, their tax payment ability would not recover. Moreover, solving the problem of tax arrears must be an integral part of a device that would help to clear inter-enterprise indebtedness and solve the problem of bad debts of commercial banks.

It immediately follows that limiting tax arrears to manageable volumes depends critically on the success of transformation of the enterprise sector, and on a genuine privatisation of the formerly state-owned companies (including those turned now into state-owned joint-stock companies in need of post-privatisation restructuring). Clearly, restructuring of the enterprise sector is an extremely complex subject that requires a separate treatment. A summary of some Polish and other experience is outlined in Appendix 1 below. Here we wish to make one observation only.

Unless there is a genuine threat of bankruptcy of the bed-debt ridden company, confirmed by the actual experience of some of the debtors that went bankrupt, no instrument

¹⁴ The 'patent' system developed in the Semipalatynsk Oblast certainly merits attention of both the Republican Tax Administration and tax administration of other Oblasts.

of containing tax and other arrears will deliver the desired results. Although the problem of those arrears is seemingly that of shortage of liquidity in the whole enterprise sector, in fact it is a problem of a few economically non-viable firms which obstruct and block the whole payment system. Without bankrupting them or their successful rehabilitation, injecting additional liquidity into the system will only temporarily alleviate the problem of tax, inter-enterprise and other arrears, yet, at the same time, it will aggravate the danger of increased inflation.¹⁵

2.4. The Budget System

The present budget system in Kazakhstan is practically the system inherited after the former command economy. This is seen in its regulations concerning the process of budget preparation, its implementation and, most of all, in the relations between the republican budget, on the one hand and the oblast and local budgets on the other. Some specific issues of this nature, connected, for instance, with the individualised tax revenue participation rates, have already been discussed in section 2.3. above.

In the last two years, the Government of Kazakhstan, and its Ministry of Finance especially, have launched a reform of the budget system. Serious work is carried out to institutionalise the State treasury and its structures. Gradual reorganisation of the Ministry of Finance and the strengthening of its role in the budgetary planning are under way. A new Law on the Budget System is being drafted. As this law is the core of the budget relations, in what follows attention will be concentrated on the evaluation of the draft currently under discussion.

Needless to say, however, the Law on the Budget System is closely related to other laws of critical economic nature, including the Constitution.

2.4.1. Constitutional Foundations of the Budget System

In a stable democratic state it is the Constitution - not the Law on the Budget System or some other law - that regulates the basic principles of public finance system operation both at the republican and the local level. In particular, the Constitution must answer the following questions:

1. Who approves the budget and how often? Article 53 para. 2 of the Constitution of the Republic of Kazakhstan (CRK) determines that the republican budget is approved by the Parliament at a joint session of the houses, but it isn't said that the budget is approved annually. According to Article 86(4)(1) of the CRK, local budgets are approved by

¹⁵ However, under some well defined conditions unorthodox local initiatives may bring desired results. What we have in mind here is a rather interesting approach to handling tax arrears in the Semipalatynsk Oblast. The essence of the Oblast Government's approach to this problem, after isolating the non-viable firms and either bankrupting them, or saddling them with special recovery programmes, was to inject additional liquidity into the system. The Local Government Bills (quasi-money) could be used for tax-payments as well as for settling accounts against municipal or government-owned suppliers of goods and services. Insofar as we understood the scheme, it comprised of three main elements: (i) fast determination to eliminate bankrupt firms and not to yield to political pressures in this respect; (ii) some pre-arranged mechanism of mutual acceptance of bills as a means of payments; (iii) the predetermined time-horizon of the operation. It must be noted, however, that if that experiment were to spread throughout the country, from the viewpoint of monetary policy it would have give rise to a fall in the demand for national money and to inflationary pressure.

appropriate local maslikhats¹⁶; also in this case it isn't stated that the budgets are approved annually. The same solutions are stipulated by Articles 36 and 40(1) of the Law on Local Representative and Executive Bodies of the Republic of Kazakhstan (RK). Article 36 of this Law emphasises that intervention of higher rank government into the budget approval process of local governments is prohibited.

2. What is the role of each house of Parliament in budget approval ? The CRK recognises equal rights of both houses of Parliament in this respect (Article 53 and 54).

3. What is the role of the Accounting Committee for Control of the Republican Budget's Implementation ? Article 53(2) of the CRK requires that the Accounting Committee prepares a report on budget implementation. With regard to local budgets, the role of the Accounting Committee is performed by maslikhats' auditing commissions (under Article 24 of the Law on Local Representative and Executive Bodies of RK).

4. Who bears the responsibility for budget drafting and submitting the budget to the Parliament ? The CRK Article 66(2) states that the Government drafts and submits to the Parliament the republican budget and the report on its implementation. Local budgets are drafted by local administrations (Article 36 of the Law on Local Representative and Executive Bodies of RK) which submit the draft budgets to maslikhats (Article 40(1)).

5. Who is responsible for budget implementation ? The CRK Article 66(2) determines that the Government is responsible for budget implementation. Implementation of local budgets is carried out by relevant local administrations; interference of higher rank government bodies is prohibited (Article 36 of the Law on Local Representative and Executive Bodies of RK).

6. Who submits the report on budget implementation to the Parliament and the Accounting Committee ? The CRK Article 53(2) states that the Government submits the budget implementation report to the Parliament. However, the Constitution does not stipulate that the Government has to submit the budget implementation report to the Accounting Committee before the report is discussed by the Parliament. (The assignment of the Accounting Committee should be a critical assessment of the Government's budget report). Under Article 40(1) of the Law on Local Representative and Executive Bodies of RK, a local budget implementation report shall be presented by the head of the relevant local administration.

7. Is the approval of budgets for terms of less than one year (i. e., of temporary budget provisions) allowed, and in what cases ? This question is not answered by the CRK.

8. What are the consequences of non-approval of the budget by the Parliament by the beginning of the budget year ? This issue is not addressed by the CRK. It is necessary to mention that the issue is of a double nature. Technically - it is necessary to provide some basis for exercising the budget's income and expenditures until the budget is finally approved. A possible solution is to implement the budget according to the draft prepared and submitted to the Parliament by the Government.¹⁷ Politically - in some countries

¹⁶ local representative bodies.

¹⁷ Such option is practically more useful than the rules proposed in Article 25(11) of the draft Law on the Budget System since seasonal differences between budget incomes and expenditures in the first and the fourth quarter of the year may be rather large.

the President is entitled to dissolve the Parliament if the latter is unable to approve the budget on time.

9. What are the consequences of non-approval of the budget's implementation report by the Parliament. This issue is not addressed by the Constitution. Usually constitutional systems of democratic countries provide for exclusively political consequences of non-approval of the budget implementation report since non-approval of the report can be deemed as a vote of no confidence to the Government.

It follows from the above that the present Constitution of the Republic of Kazakhstan resolves only some of the above questions. With regard to local government and local budgets, they are partially resolved by the Law on Local Representative and Executive Bodies of RK.

Also, the CRK does not include provisions that guarantee balancing of the public finance, such as a cap on budget deficit and on government debt, or a prohibition of crediting of the Government by the National Bank of Kazakhstan.

2.4.2. Other Legislative Acts

Another piece of legislation that needs to be made consistent with the Law on the Budget System is the Law on Budget Control. It must regulate objects and subject of control, its frequency, rights and responsibilities of the controlling and the controlled parties, etc. Since the state budget consists of the republican budget and local budgets, the control system may be regulated by one or by two legal acts.

Since governments usually wish to avail themselves of a system of internal control that would enable them to check financial activities of ministries, state committees and government agencies (irrespective of their control exercised by special agencies that report directly to the President or the Parliament), this internal control system must also have its legislative foundation. Usually, internal governmental control is carried out by the ministry of finance and is introduced by an appropriate law.

The “external environment” of the Law on the Budget System includes also tax legislation. Though taxes are the most important source of budget income, and for this reason are commonly enumerated in the Law on the Budget System, they should be regulated by it but exclusively by tax legislation (the Tax Code).

Other relations between the budget on the one hand, and the individual and legal persons, and the financial institutions (domestic and international) on the other hand, also should not be subject to regulation by the Law on the Budget System. Budget appropriations from them must be regulated either by annual laws on the budget, or by other laws that would regulate the rates of appropriation, as well as standards and methods for their calculation.

2.4.3. Basic Provisions of the Draft Law on the Budget System

Depending upon the “external environment” of the Law on the Budget System the law itself can cover a wider or narrower range of issues. If any problems were not resolved in the “external environment” laws, it is better to resolve them in the Law on the Budget System than to leave them unsolved. Such problems that have not been yet resolved include:

- (i) the frequency of budget approval;
- (ii) the possibility of approving budget for a period shorter than one year (i. e. temporary budget provisions);

(iii) measures taken in cases where the budget was not approved by the beginning of a budget year;

(iv) measures taken in cases where the Parliament (maslikhat) did not approve a budget implementation report.

The Law on the Budget System determines general provisions and procedures for accumulation of financial resources that form the republican budget and local budgets, and for the utilisation of these resources for funding tasks that follow from the functions performed by the republican government and local administrations. This should be the essence of the first article of the Law on the Budget System which is usually regulating the principles of accumulation and distribution of state financial resources.¹⁸ Such an understanding of the essence of the law under consideration determines its structure. It should include the following chapters:

1. General provisions.
2. Principles of financial management.
3. Principles of investment funding.
4. Mechanisms of formulation, consideration and approval of the republican budget.
5. Mechanisms of formulation, consideration and approval of local budgets.
6. Budget implementation.
7. Budget accounting and reporting.
8. Control over budget implementation.
9. Violation of budget discipline and punitive sanctions.

Notwithstanding that the structure of the draft Law on the Budget System differs somewhat from the one proposed above (we do not consider it of a critical nature), it lacks some important provisions. In this regard we propose to add some important revisions to the draft law presently discussed in Kazakhstan.

For instance, in the chapter on principles of financial management of budgetary units it should be clearly stated that the inclusion into the budget of any allocations from definite sources, or any expenses for some specified purposes, does not provide grounds for any claims or suits against any third parties or claims by these parties to the republican or local authorities of the Republic of Kazakhstan. According to this principle, nobody can claim allocations to the budget exclusively because they have been planned by the budget; and nobody can request (through legal suit or any other procedure) subsidies or transfers on the grounds that these have been stipulated in the budget. Both, budgetary allocations and expenses may be claimed in court or through other procedures only provided they are based on other laws.

This provision means that the budget appropriations represent merely their forecast, and that budget allocations determine only the upper limits of expenses for pre-defined purposes, and as such neither budget appropriations nor its allocations create per se any legal obligation of the budget.

¹⁸ The Law on the Budget System does not regulate specific purposes of expending financial resources; these are determined by laws on annual budget.

The chapter on principles of investments funding should determine which data on each and every budget financed investment project must be specified in the central (or local when the project is financed from the local budget) investments inventory, as well as methods of control of budget expenses for these purposes and the agencies that are authorised to perform such controls.

The chapter on budget formulation should clearly state that budget explanation and rationalisation is its indispensable part. In the case of the republican budget, any such explanation must include the following information:

- (i) the expected implementation of the republican budget in the current year;
- (ii) forecast of major macroeconomic indicators in the next year;
- (iii) explanation to each and every draft budget provision;
- (iv) the consolidated balance of the public sector finance;
- (v) the balance of payments;
- (vi) forecast of the balance of state assets (claims) and commitments at the beginning and at the end of the budget year;
- (vii) the evaluation of the republican budget commitments with regard to investment projects under implementation as well as regarding the recognised government guarantees.

The forecast of state assets and claims (vi) and the evaluation of the republican budget commitments with regard to investment outlay and government guarantees (vii), taken together must allow to connect the state budget formulated on the basis of cash principle (i. e., on the current cash flow basis) with the balance of state assets (claims) and commitments. Such a double-check approach is important among other reasons also because the republican (or the consolidated) budget registers only expenses that were actually incurred and took the form of cash flows from bank accounts of budgetary units. If, for instance, a budgetary unit orders and receives goods and services but does not pay for them, no expenses occur from the given year budget's point of view. However, such arrears represent forced crediting and real expenses that must be precisely determined and serviced in the future budgets. The same, of course, refers to investment commitments and state guarantee pledges.

The principles of budget formulation must require that the republican budget includes the financial income and expenditure plan of each infra-budgetary (i.e., special purpose) and extrabudgetary fund. Moreover, in the chapter on the state financial system in the Republic of Kazakhstan it should be requested that each infra- or extrabudgetary fund may be established only by a separate law, and that the financial system of any such fund must not differ from that of budgetary units.

Finally, the chapter on budget implementation should clearly define the following major rules:

- (i) Budget expenses are implemented within the allocation limits determined in the budget, according to their planned purpose and on the basis of their economical and expedient utilisation.
- (ii) Orders for supplies are performed on the basis of choosing the most beneficial proposal.

(iii) Purchases and deliveries of goods and services are carried out in accordance with the Law on state procurement (or in accordance with a similar legislation until such law is adopted).

(iv) In cases of improvident behaviour of a budgetary unit, delays in task implementation, a surplus of financial resources, or a serious violation of principles of budget implementation, allocations committed in the budget may be blocked. There may be different options with respect to who is authorised to make the decision of expense blocking. However, in a budget implementation system that is being established in Kazakhstan, this authority should be vested in the Head of the National Treasury.

Table 2.1. The 1995 and 1996 Consolidated Budgets of Kazakstan (in tenge billions) ^a

Category of budget revenues and expenditures	1995		1996	2/1	3/2
	planned (after revision)	executed	planned		
	(1)	(2)	(3)	(4)	(5)
Total revenue	186.9	209.5	241.8	1.12	1.15
of which: Budget Part I revenue ^b	145.3	164.8	206.2	1.13	1.25
of which:					
CIT	27.70	33.30	35.20	1.20	1.06
PIT	25.10	25.50	33.20	1.02	1.30
VAT	28.00	32.60	39.50	1.16	1.21
Excise	7.80	7.00	10.50	0.90	1.50
Other tax revenues	10.50	6.80		0.65	
of which: Budget Part II revenue ^c	14.1	19.8	5.6	1.40	0.28
of which: Budget Part III revenue ^d	27.5	25.0	30.0	0.91	1.20
of which: export tariff revenue	7.7	9.1	15.1	1.18	1.66
import tariff revenue	2.0	3.0	4.2	1.50	1.40
Total expenditure	226.3	250.5	285.7	1.11	1.14
of which:					
National Economy	59.2	43.2	56.8	0.73	1.31
Domestic debt servicing	3.3	13.7	8.1	4.15	0.59
Foreign economic activity	9.9	15.0	36.7	1.52	2.45
of which: External debt servicing ^e	5.8	10.1	22.0	1.74	2.18
Intergovernmental commitments	-	-	8.1		
Socio-cultural projects	84.3	89.5	104.8	1.06	1.17
of which: Education	34.6	45.6	43.6	1.32	0.96
Culture and mass media	5.4	5.6	8.3	1.04	1.48
Health, sport, etc.	33.7	30.5	40.0	0.91	1.31
Social protection	10.6	7.8	12.9	0.74	1.65
Science	2.3	1.9	3.1	0.83	1.63
Defence	14.7	10.8	17.5	0.73	1.62
Public order and safety	16.0	15.8	22.4	0.99	1.42
Republican and local government	16.4	10.0	23.6	0.61	2.36
Infrabudgetary funds (Budget's part II)	5.2	7.9	4.0	1.52	0.51
Budget deficit	39.4	41.0	43.9	1.04	1.07
Memorandum items					
GDP (in billions tenge)		998.00	1312.00		1.31
Rate of inflation (in per cent)					
average	165.0	180.0	30-33	1.09	0.18
end of period	40.0	60.3	26-28	1.51	0.45
Monthly average money wage rate (tenge)		5877	7124		1.21
Number of the employed		5180.0			
of which in the budget sphere		975.9			
Exports (fob, in USD million)		5198.4			
Imports (fob, in USD million)		5379.0			

Sources: Ministry of Finance of the Republic of Kazakstan, Sbornik no. 1 materialov po gosudarstvennomu budzhetu Respubliki Kazakstan na 1996 god, Almaty, January 1996; Ministry of Finance of the Republic of Kazakstan, Mesiatchnyi otchet ob ispolnieniyi gosudarstvennovo budzheta Respubliki Kazakstan na 1 ianvaria 1996 g., 15 January 1996; Budzheta Respubliki Kazakstan na 1996 god, proiekt, Almaty, November 1995, Government of the Republic of Kazakstan, and other official data.

a - The data includes intertemporal tax and other settlements and follows the Soviet-type budget lay-out which is still in use in the Kazakstan Ministry of Finance budget reporting.

b - Comprises current tax and non-tax revenues.

c - Comprises incomes of infrabudgetary (i.e., special purpose) funds.

d - Comprises revenue from operations with abroad, taxes on international trade including.

e - Includes principle repayments and called external debt guarantees.

Table 2. Composition of Budget Expenditures in 1995 and 1996

Category of budget revenues	1995				1996	
	planned (after revisions)		executed		planned	
	in tenge mln	in %	in tenge mln	in %	in tenge mln	in %
Total expenditure	226.3	100.0	250.5	100.0	285.7	100.0
of which:						
National Economy	59.2	26.2	43.2	17.2	56.8	19.9
Domestic debt servicing	3.3	1.5	13.7	5.5	8.1	2.8
Foreign economic activity	9.9	4.4	15.0	6.0	36.7	12.8
of which: External debt servicing ^e	5.8	2.6	10.1	4.0	22.0	7.7
Intergovernmental commitments	-		-		8.1	2.8
Socio-cultural projects	84.3	37.2	89.5	35.7	104.8	36.7
of which: Education	34.6	15.2	45.6	18.2	43.6	15.3
Culture and mass media	5.4	2.4	5.6	2.2	8.3	2.9
Health, sport, etc.	33.7	14.9	30.5	12.2	40.0	14.0
Social protection	10.6	4.7	7.8	3.1	12.9	4.5
Science	2.3	1.0	1.9	0.8	3.1	1.1
Defence	14.7	6.5	10.8	4.3	17.5	6.1
Public order and safety	16.0	7.1	15.8	6.3	22.4	7.8
Republican and local government	16.4	7.2	10.0	4.0	23.6	8.2
Infrabudgetary funds (Budget's part II)	5.2	2.3	7.9	3.1	4.0	1.4

Appendix 1. Some Detailed Comments on the Tax Code

Article 14 (3): It would be commendable to allow for a possibility of deducting from gross income some expenses involved in obtaining earned income on contract or sub-contract basis (a flat rate allowance, for instance).

Article 19: This article grants research and similar institutes very generous (in practice nearly unlimited) possibilities of cost deduction.

Articles 20 and 42: Depreciation allowances and valuation of cost of stock-keeping should represent genuine costs of capital involved. The presently used methods of these costs estimation underrate them, thus making firms pay taxes for non-existent (merely paper) profits. The rules of allowing for these costs should be fully compatible with market economy standards, and especially with bookkeeping rules.

Article 25(3): This article in its present formulation may in fact discourage enterprises from discontinuing their involvement in incurring costs of maintenance of social infrastructure.

Articles 73 and 151 (1): Too long periods of return of overpaid taxes are provided for; this will unnecessarily increase costs of production and prices.

Article 139: The introduction of Tax Identification Numbers is more complicated than that. For instance, that number (or code) must be 'neutral' in the sense that it must not contain any coded information about the taxpayer, e.g., about his (her) past tax records. It is also recommendable that the corresponding law prohibits combining tax identification numbers in case of enterprise merger, or that codes once in use are given to new taxpayers, etc. In fact the problem of introduction of Tax Identification Numbers is sufficiently complex as to deserve a separate Law, as it was the case in Poland, for instance.

Article 162: As the penalties are rather high, they should be calculated per day rather than per month.

Article 165: Taxpayers complains should be considered by other tax administration than that which considered the case originally.

Article 175: The procedures open to the tax-payer and to be followed in case of breach of secrecy, as well as sanctions against those who violate this secrecy, should be clearly specified.

Appendix 2: Detailed Comments to the Draft Law on the Budget System (Version of mid-March 1996)

Section 1. General provisions

Article 2(4): tirect 3-5 should not be subject of regulation by the Law on the Budget System (LBS).

Article 3(1): paragraphs 2 and 3 are regulated by the Tax Code, not by LBS.

Article 3(3) and (4): We believe that the problem of capital investments is sufficiently important and specific to spare a separate chapter for its discussion. This chapter should clearly determine the cases where investments may be funded from the state budget. The situation where the budget could fund any investments, or - still worse - where an investment fund would be created, must be avoided. A comprehensive list of investment

projects founded from the budget must be approved as an integral part of the Law on annual budget.

Article 3(5): What does the “operation income” mean? Dividends?

Article 5: Its subject matter should not be regulated by the LBS.

Article 6: There is apparently a conceptual tautology in parts (3) and (4) of this article.

Apart from that, Chapter 1 should resolve the issues that were not addressed in the Constitution, i. e. (i) the frequency of budget approval (annual); (ii) conditions of budget approval for a period shorter than one year; (iii) measures taken when the budget has not approved by the beginning of the budget year (either in a way stipulated in Article 25(11), or as it is proposed in section 2.4.1 above; (iv) measures taken when the Parliament (maslikhat) does not approve the budget implementation report.

Chapter 1 should also clearly distinguish between budget incomes that are irrevocable, and financial instruments used for funding budget deficit, such as government bills and bonds and government loans.

Moreover, it would be useful to clearly note in Chapter 1 that the same budget classification applied both to the republican and the local budgets.

Section 2: Budget policy (Articles 7-9)

The subject of this chapter should be considered either in Chapter 4 of the LBS structure suggested above, or in Chapter 7 of the present draft of LBS.

Chapters 3-5 and 7-9: The state budget (Article 10), the republican budget of RK (Articles 11-13), local budgets (Articles 14-16), the mechanism of formulation, consideration and implementation of the state budget (Articles 21-23), the mechanism of formulation, consideration and implementation of the republican budget (Articles 24-28), the formulation, consideration and implementation of local budgets (Articles 29-31).

These six chapters should have been comprised into three: (1) The formulation, consideration and implementation of the republican budget; (2) The formulation, consideration and implementation of local budgets. (3) The formulation, consideration and implementation of the state budget. However, since the state budget represents merely a consolidation of the republican and the local budgets and, moreover, it is not subject to approval by the Parliament, it could be included into a chapter on the republican budget. Then all the problems concerning budget implementation which are in their essence identical at all budget levels could be placed together in a separate chapter. The present Chapter 6, on the state accounts, should then also be included into that chapter.

Articles 11-13: Pursuant to the international budget classification (in compliance with which the Republican Budget for 1996 was formulated) all budget allocations and expenditures related to funding budget deficit should be deleted from the list of income and expenses of the republican budget, including loans and borrowings acquired as well as their repayment; and expenses related to loans granted by the budget, as well as proceeds related to their repayment.

Article 12 (1) para 1-6: Duties are not considered tax-like incomes.

Article 13(1): The present wording of this article seems to promise that the republican budget can fund any expenses if only they are stipulated in a republican or national program.

Since the role of the state in a market economy is significantly lesser, a cap on budget financing of this type of expense is needed (see our comments on budget financed investment projects).

Article 13(1): Mere establishing of a reserve fund is not yet an expenditure; only its utilisation is.

Article 15(2): We recommend that the rates of participation of local budgets in revenues from taxes and duties were more stable and did not change every year; this could secure a more efficient long-term budgetary policy at all levels.

Article 24(7): When currency is readily convertible information on demand for foreign currency purchases is not necessary.

Article 25(8): The present wording allows for any increase in income and expenditure if only budget deficit is unaffected. Such an approach is very dangerous since expenses increased in this way may be of permanent nature (or it may prove difficult to reduce them in future), and the additional revenue may not reappear in following years. Moreover, budget deficit should be determined not as a percentage ratio of GDP, but in nominal terms as any precise GDP evaluation still causes serious methodological problems in Kazakhstan (see also (10) of this Article).

Article 26(2)(1): Such expenses must be funded from the Reserve Fund.

Article 28(3): Total of temporary advances and overdrafts of the National Bank that amounts to 30 per cent of budget revenues actually collected in the previous year seems too high. Moreover, direct funding of budget expenses by the National Bank of Kazakhstan should be prohibited (see Chapter 1 of the present report).

Chapter 6. State Account

It is recommended that the State Account remains in the National Bank of Kazakhstan because the National Bank has a better developed network and more skilled staff than any other bank in Kazakhstan. Moreover, from the point of view of monetary policy, transfer of the State Account to some other bank than the National Bank will produce an additional source of money multiplication.

Chapter 12. Violations and punitive sanctions

We believe that budget discipline violations should be enumerated in this chapter. The most important violations to be listed there include:

(i) Failure to comply or poor compliance with obligations concerning tax collection and transfer of tax revenues to the republican budget (e. g., oblast administrations' withholding of tax revenues that belong to the republican budget).

(ii) Excess spending over the allocations anticipated in the financial plan of a budgetary unit.

(iii) Illegal revisions in the financial plan of a budgetary unit.

(iv) Utilisation of budgeted funds not in accordance with the approved budget.

(v) Payment of wages in budgetary units without payments of their contributions to social insurance funds.

Liability for budget discipline violations should not exclude criminal liability.

3. Social Expenditures in Kazakstan (Helena Goralska)

Social expenditures include expenditures on wages in the budgetary sphere, money expenditures on social payments, expenditures on social services, and various subsidies, especially in the sphere of municipal services.

Regulation of particular expenditures is either based on the former USSR legislation, or was introduced in the recent years (e.g. unemployment benefits and compensation of the price growth). Some resolutions were not subsequently enforced although they are still mandatory formally. This concerns indexation of incomes of population: the Law of 5 June 1991 on indexation of the population's cash incomes according to the growth of prices of consumer goods and services is not being applied. In 1996, some laws, including the Law of 17 June 1991 on the minimum consumer budget and the Law of 17 June 1991 on the minimum wage rate and the state guarantees in the Government sector (i.e. budget sphere), were suspended by the Law on the republican budget (Article 2).

3.1. Wages in the Budgetary Sphere

In Kazakstan, there is no law regulating both the wage rates and the wage bill in the budgetary sphere. The volume of the wage bill depends on the financial means of the state. However, there is a system of basic wage rates composed of 21 groups. The wage rate in every group is determined as the minimum wage rate multiplied by a factor. The factors presently used have not been changed since 1 January 1993, the minimum factor being 2 and the maximum being 13.8. According to the information of the Ministry of Labor, the minimum wage rate was set in such a way that, taking into account the volume of employment in the budgetary sphere, it could "fit" into the planned volume of the wage bill there.

In 1995, the minimum wage was determined by the Law on the republican budget. It was only a benchmark indicator, since the law simultaneously set the minimum limit of wage rate in the budgetary sphere. In 1995, the minimum wage and the minimum limit of wage rate were revised four times; from 1 October 1995 to the end of 1995 the minimum wage was 300 tenge, while the minimum limit of wage rate was 1,050 tenge.

The Law on the republican budget for 1996 does not contain the notions the minimum wage rate and the minimum limit of wage rate. The minimum wage rate was replaced by the reference wage rate, which was 320 tenge in the first quarter of 1996 and will be increased quarterly to the volume of 530 tenge in its the fourth quarter.

Article 12 of the Law on the republican budget for 1996 provides for doubling the annual average wage rates of the employees in budgetary sphere in the course of the year. This article also assigns the Government of the Republic to develop until 1 January 1996 a system of labor pay for the employees of the organizations financed from the state budget.

Moreover, work was carried out in 1995 to revise the system of basic wage rates with the aim to correlate it with the actual minimum wage rate. These changes were to be introduced since January 1, 1996.

The number of those employed in the budgetary sphere is not limited. In the USSR there were norms (personnel quotas) determining, for example, the number of doctors in various types of hospitals, or the number of pupils per teacher. Currently, these norms are no more operative in Kazakstan, and the Ministry of Labor is to develop new ones.

Annual planning of the wage bill in the budgetary sphere is based on the wage bill for the previous year multiplied by the consumer price index. The actual number of the employed is not regulated. For example, there may be a rural hospital with a defined wage bill and an absolutely arbitrary number of staff.

The first directions of the Ministry of Finance on the budget construction for 1996 recommended a reduction of numbers of the employed by 40% on the average. The final version indicates a 20-30% reduction (depending on a sectional branch).

According to the data for July, 1995, the average wage rate in the material production sphere was about 6,000 tenge, whereas the wage rate in the budgetary sphere was approximately 2,800 tenge, that is about 47% of the former. This ratio did not improve in the second half of 1995.

A serious problem is the wage arrears in the budgetary sphere. As of 15 September 1995, the wage arrears of the local budgets were 3,115.8 million tenge.

This means that the indebtedness was somewhat higher than the volume of one month's wage bill. At the beginning of 1996 the wage arrears somewhat reduced. It was 2,870.3 million tenge as of 1 January 1996, 3,651.6 million tenge as of 1 February, and 2,984.2 million tenge as of 1 March .

This means that the average wage arrears in the Republic has not exceeded the volume of 1 month's wage bill in the budget sphere. There were no wage arrears at all in 4 oblasts, which means that in the rest they exceeded the volume of one month' wage bill.

Conclusions and Recommendations

Implementation of a new system of labor pay in the budgetary sphere appears to be a very important step in economic transformation in Kazakhstan. Since a sharp decrease in employment is expected in the budgetary sphere in 1996, this will allow a simultaneous increase in the wage rates of the remaining workers. In this connection, three important recommendations should be borne in mind.

(i) no mechanisms of automatic wage indexation should be introduced. This would intensify the inflationary inertia (see Chapter 1) and would have a negative impact on the state of the budget. Besides, automatic indexation is not conducive to stimulating labor efficiency.

(ii) It is recommended to set the minimum wage rate at a rather low volume. As the experience of many countries shows, a too high wage rates lead to the expansion of a shadow economy and a shadow labor market. A relatively low minimum wage rate also allows to strengthen the stimulating role of labor pay systems.

(iii) It is recommended to settle wage rates and wage disputes in the course of tripartite negotiations at a decentralized level.

3.2. The State Fund for Assistance to Employment (Employment Fund)

The Law on the population's employment of 15 December 1990, came into force on 1 January 1991. Pursuant to this law, the State Fund for Assistance to Employment was set up, as well as the State Employment Service on the republican and local levels. According to the Resolution of the Council of Ministers of April 30 1991, developed on the basis of the Law, the Employment Fund was established at different administrative levels.

The Resolution also decides that the resources of the Employment Fund do not enter the budget, that is the Fund is extrabudgetary. However, in 1993 and 1994 the Fund was included into the budget. That was related to the Fund's good financial position and the possibility to use its surplus resources for the needs of the budget.

In 1995 and 1996 the Employment Fund became extrabudgetary again. Article 21 of the Draft Law on compulsory social insurance (March 1996) says that "Inclusion of the means of the above funds into the budget, as well as their use for other purposes, is prohibited".

The Employment Fund is financed from the following sources: (i) compulsory contributions of employers (the rates of contributions are established annually in the Law on the Budget); (ii) subsidies from the state budget (yet conditions of granting subsidies are not specified); (iii) voluntary contributions.

In 1991, the budgetary units were exempted from contributions into the Employment Fund for one year. According to the information of the Ministry of Labor, the budgetary units actually never paid contributions in subsequent years as well. In 1995-1996, they were exempted from this obligation on the basis of the respective Laws on the Budget.

The regulations on the Employment Fund decide that the rates of contribution is to be not less than 1% of the wage bill, and that 10% of the contributions goes to its centralized part. The Ministry of Labor wants to change this arrangement and differentiate the transfers to the centralized part of the Fund depending on the rates of unemployment in each oblast.

The rate of contributions in 1994-1996 is 2% of the wage bill. The collection rate is estimated at 70-80% depending on a month.

The Employment Fund finances unemployment benefits and allowances for occupational training and re-training, public works, and the creation of jobs for the handicapped.

As the Fund's financial position was good in 1995, it was assigned to carry out financing of activities that were not correlated to the provisions of the Law on the population's employment (e.g., measures to financing connected with migration, financing of the housing sphere, granting credits to bankrupt enterprises, etc.). The Law on the republican budget for 1996 (Article 11) also envisages financing resettlement measures at the expense of the Employment Fund's resources .

The principles of granting unemployment benefits and their volume have changed since 1 September 1995. Until then, a worker that has lost his or her job received the wage from the employer during the following three months provided that he or she was registered in an employment bureau; otherwise he or she received the wage only for 1 month. During the next 26 weeks (36 weeks for workers nearing the pension age and 13 weeks for workers looking for a job for the first time) an unemployed person received benefit determined as a percentage of his (her) former wage rate (starting with 50% but not higher than the average wage rate in the country as a whole). Accordingly, allowances for re-training and occupational training were higher.

Since 1 September 1995, the unemployment benefits were revised and now for persons who have not worked before or persons who have quit their job of their own will the benefits are equal to 3 minimum wage rates (three reference wage rates since 1 January 1996), and for persons who were dismissed the benefit is 6 minimum wage rate (6 reference wage rates).

The upper limit of the benefit is not fixed, which means that it may exceed the formerly received wage. This situation is unlikely to be frequent and may occur only in the budgetary sphere, as the wages in the material production sphere are much higher.

Changing the principles of calculating the benefits resulted in a considerable growth of their volume: the average size of a benefit which was about 500 tenge until 1 September 1995, became about 1500 tenge after that date. As a result of the threefold growth of the average benefit, the Ministry of Labor expected an increase in the number of the unemployed. The staff of oblast employment offices believed that an increase in the number of persons who would claim the status of unemployed was likely but a temporary nature (receiving the benefit is connected with certain commitments including the obligation to visit the employment office).

The numbers of registered unemployment are so far rather low. At the end of August 1995, the number of the registered unemployed was 103,000 of whom 54,000 received unemployment benefits. This means that the rate of unemployment was 1.4% (of the 7.2 million of the professionally active population). According to Ministry of Labor estimates, hidden unemployment at the end of August 1995 comprised about 670,000 people, or about 9% of total employment. In the opinion of the Ministry of Labor, hidden unemployment did not expand in the second half of 1995.

The forecast of the Ministry of Labor of the growth of unemployment proved to be correct, although it is unknown to what degree the unemployment growth was affected by the increase in unemployment benefits and in what by structural changes in the economy. Between January and September 1995, 13,000 to 16,000 people received the status of unemployed every month. In October 1995, there were already 19,000 newly registered unemployed, in November and December about 25,000, and 30,000 in January 1996. In the first half of 1995, there were 2 job vacancies per 1 unemployed, whereas in January 1996 there were 1.8 unemployed persons per 1 vacancy.

The rate of unemployment grew at the end of 1995 and at the beginning of 1996. Except Almaty City and 3 oblasts, the rate of unemployment is higher than 2% and has reached the level of 7.7% in the Kzyl-Orda Oblast.

In connection with the expected bankruptcies of enterprises, the Ministry of Labor anticipates further growth of unemployment in 1996. It is estimated that by the end of 1996 the number of the unemployed will reach 300,000, that is 4,5-5% of the labor force.

In connection with the expected worsening of the situation on the labor market, especially for the youth, the Ministry of Labor in September of 1995 signed an agreement with the Ministry of Education on co-operation in the areas of education and re-training.

A new Employment Law is currently in preparation. The intended changes are to specify certain norms (in particular, the status of an unemployed person and the principles of benefit payments); moreover it is planned to give more prominence to active forms of reducing unemployment. Specifically, it is envisaged to pay a cumulated allowance (say, half a yearly allowance and prior to a preliminary re-training) to persons that want to start their own business. A change of the rates of unemployment benefits is also intended; they will be determined on the basis of the last received wage.

About 3,5000 people work in employment offices, including 100 people at the republican level. In order to improve the performance of the employment service, a loan was taken in the World Bank. It represents a part of a larger credit-line intended to improve the functioning of the social sphere in general. The entire sum of the credit amounts to USD 41.1

million, of which USD 12 million plus USD 6 million from the resources of the Employment Fund have been allocated for the employment service.

The Balance of the Employment Fund

The plan of the Fund for 1995 (see **Table 3.1**) was not fulfilled in its revenue and expenditure parts. The revenues were 66.0% of the planned targets and expenditures were 58.4%. Fulfillment of particular items of expenditures differed from 30% (miscellaneous costs) to 135% (job creation). In the latter case it the increase meant a rise in expenditures from the planned 4 million tenge to 5.4 million tenge.

The question arises as to whether the plan for 1996 was prepared correctly. It stipulates an increase in expenditures by 3.5 times (as compared with the fulfillment in 1995), while unemployment benefits are planned to rise 7.7 times.

Conclusions and Recommendations

(i) The introduction of uniform rates of unemployment benefits must be considered a right measure, since it facilitates the work of the employment offices and permits them to concentrate on the search of jobs for the unemployed. However, the absence of the upper limit of the benefit and the possibility that a benefit may exceed the former wage were results of mistaken decisions which must be rapidly amended.

(ii) Until the end of 1995 the Fund enjoyed a stable financial position. This is likely to continue into 1996, even in the case of unemployment growth, unless the unemployment benefits are considerably increased. In this connection, it would be reasonable to consider reducing the rates of contributions into the Fund, which would be a more sound decision than imposing on it additional tasks that are not connected with implementation of the Law on employment.

(iii) The agreement with the Ministry of Education, particularly of the co-ordination of the required directions of training, should be evaluated most positively. Hopefully, it will allow avoiding difficulties in future employment opportunities.

(iv) Against the background of other countries' experience, my assessment of the use of the loan for the purposes of improving the functioning of the employment service is skeptical. A large part of this credit will be spent on equipping the employment offices with computers, etc., which is gradually happening anyway.

3.3. The Pension Fund

The Law on pensions has been in force since 1 January 1992¹⁹, the pensions for war invalids and combatants being regulated by the same Law but in force since 1 December 1991. The Law served the basis for the establishment of the Pension Fund.

The Pension Fund is extrabudgetary. Since 1993 the Ministry of Social Protection has been in charge of it. The Fund's budget is drafted by the Ministry of Social Protection and submitted to the management of the Fund consisting of representatives of the Ministry of Finance, the National Bank, and the Government's and President's administrations.

In 1994, the Pension Fund (like the Employment Fund) was included into the budget, but in a result of protests it was withdrawn from it four months later. In the opinion of the

¹⁹ As in other countries the pensions of the military are regulated by a separate law.

heads of the Ministry of Social Protection, inclusion of the Fund into the budget resulted in a considerable extension of the term between the collection of money and the payment of benefits. In 1995 and 1996, the Pension Fund was no longer included in the budget.

The revenues of the Pension Fund were formed in 1994 and 1995 from contributions made by enterprises at a rate of 30% of their wage bill (formerly the rate was 37%) for the Pension Fund and the Social Insurance Fund taken together. The Pension Fund received 85% of the collected contributions, while 15% went to the Social Insurance Fund. Since 1 January 1996 the rate of contributions for state social insurance remained at 30% of the wages funds, with 85% of total deductions going to the Pension Fund, and the remaining 15% to the Social Insurance Fund, and to the Medical Insurance Fund. The contribution rate and the norms of resource allocation between the funds are determined by the Law on the republican budget for each year.

According to the Ministry of Finance in 1995 the allocation of resources between the Pension Fund and the Social Insurance Fund should be 90% and 10%, respectively. The Social Insurance Fund could limit its expenses for sanatoria and rehabilitation treatment, whereas the Pension Fund has no similar financial cushion and is therefore under extreme financial strain. According to the obligatory regulations, the Pension Fund may not receive subsidies but can only take loans (which actually happened in 1995).

The collection rate for the Pension Fund makes up, according to different estimates, 60-73%²⁰. This low collection rate is chiefly due to wage arrears and also because sometimes wages are paid to workers in kind (in which case, there are, naturally, no contributions for state social insurance)²¹. In the opinion of the workers of the Ministry of Finance, the low compliance is also connected with the fact that the Pension Fund has no supervising bodies. The tax administration cannot help it because the Fund is extra-budgetary.

The collection of insurance contributions has improved after the Government's Regulation of 5 October 1995 on Bank Control of Collection of Insurance Fees was put into force. The improvement is estimated at anything between 2 and 5 billion tenge per month as compared with September 1995.

The Law on pensions provides for the following allowances: the old-age pensions, work-record pensions, social pensions (paid independently of age), disability pensions (subdivided into three groups), and family allowances.

The pension eligibility age is 60 years for men and 55 years for women, and the necessary minimum length of service is 25 and 20 years, respectively.

The rate of pension depends on the received wages (it is possible to chose a wage for 12 months out of the last 15 years of work) and work record. With the minimum needed work record, a pension is 60% of the received wage; for every year of work over the required minimum work record 1% of wage is added. The base for calculating a pension rate cannot

²⁰ The collection rate of contributions to the Pension Fund and the Fund for Social Insurance is not necessarily the same, since enterprises may have different interests (fees paid to the Social Insurance Fund return to them in the form of sick-leave or pre-/post-natal leave and childbirth allowances); an enterprise may like to register in one of the funds but not in the other, although the enrollment to both is obligatory. Usually, enterprises enroll to the Social Insurance Fund, and try to avoid the Pension Fund enrollment.

²¹ In Kyrgyzstan, for instance, the Social Insurance Fund started collecting in-kind contributions and paying benefits in the same form.

exceed ten minimum wages, and a pension cannot be higher than the calculation base. The minimum pension is equal to the minimum wage.

The rate of disability pension depends on the invalidity group and amounts to 65%, 60% and 40% of the wage, respectively. If an invalid's work record is sufficient for receiving a pension, the amount of his or her allowance is calculated the same way as a pension.

The rate of family allowance makes up 40% of the wage, but not less than 60% of the pension of a deceased person.

The social pension makes up 80% of the minimum pension (actually it is somewhat higher).

The rights to early retirement are extremely wide. Particular instances are indicated in two lists, but there are cases not mentioned in them.

List 1 is narrow enough and concerns persons working in extraordinarily arduous conditions (extracting industry, chemistry, specialization connected with radioactivity, etc.). People working in these occupations can retire at 50 (men) and 45 (women) with 20- and 15-year work records, respectively. List 2 determines the rights of persons working in noxious industries, the list of which is very long. The pension eligibility age is 55 years for men and 50 years for women with work records of 25 and 20 years, respectively.

Many persons not included in the lists also have the right to an early pension. These are agricultural workers: shepherds, milkmaids, tractor operators, etc. The pension eligibility age for these categories is established at 55 and 50 years and work records at 25 and 20 years, respectively.

Doctors and teachers may retire independently of their age, provided they have the necessary work record in the profession: 30 years for doctors (25 years for women) and 25 years for teachers.

Since in some oblasts there are preferential principles of calculating a work record because of the environmental pollution (one calendar year of work is regarded as a work record of a greater duration), people of many occupations in some oblasts may retire on a pension already in the age of 40-42.

The number of the pensioners and persons receiving permanent allowances makes up 2,814,000, that is 16,9% of the overall number of the population (see **Table 3.2**), which is not too high a figure according to the European standards²². However, it is necessary to consider differences in the demographic structure of society.

The number of persons receiving disability pensions makes up 9.5% of the overall number of the pensioners and persons receiving current allowances (36% in Poland). This testifies to a rather healthy structure of the population of the pensioners and persons receiving current allowances.

The number of persons that retired on an early pension was in 1993 about 13% of all persons receiving pensions and about 16% in 1994. Since additional rights to early retirement were introduced on 1 January 1995, it may be expected that the share of these persons has increased in 1995.

²² In Poland the share of pensioners and persons receiving current allowances makes up about 23%.

Pensions and current allowances increase along with the increase of the minimum wage rate (the upper limit of wages taken as a basis for calculating the size of payments increases automatically). Individual recalculation index, determined by the ratio of his or her wages and the average wage in the year of retirement on a pension (the first year of receiving the allowance), is calculated for every pensioner and person in receipt of a current allowance. Recalculation of all pensions used to be done annually in October. In 1995, payments were not recalculated, but all pensions and current allowances were increased as of 1 October by 20%. However, this practice runs counter to the current legislation.

The ratio of the rate of pensions and current allowances to the average wage rate is not high and has been declining since 1993 (see **Table 3.3**). In July of 1995, the average pension and current allowance made up 28.5% of the average wage²³. After increasing pensions and current allowances on 1 October 1995, the average pension and current allowance is 1,760 tenge, which is higher than the unemployment benefit (1,500 tenge) by 17%.

Pensioners may continue to work without any restrictions. About 9-10% of pensioners works currently. The Ministry of Social Protection tries to limit the right of pensioners to work and receive a full pension at the same time. It is suggested that payment of pensions be stopped in the case when a pensioner's earnings exceed 15 minimum wages and a reduced pension be paid with lower earnings. These restrictions would concern only the pensioners.

Kazakhstan has concluded an extremely favorable agreement from the financial point of view concerning the transfer of pensions and current allowances to the CIS countries (agreement of March 1992). The so-called territorial principle decides that pensions and current allowances are paid by the country on whose territory the pensioner lives. Since net migration in Kazakhstan is negative, this principle is advantageous from the viewpoint of the Pension Fund's balance.

The Republic's Government is aware that the rights to an early retirement are too liberal and that the pension eligibility age is too low by the international standards. In this connection, amendments to the Law on pension provision of citizens have been drafted. It is suggested there that starting with 1996 the pension eligibility age is increased annually by half a year so that by 2001 the pension age for men be 63 years and for women 58 years, and that the rights to pensions on preferential terms are revised.

The Balance of the Pension Fund

Table 3.4 shows the balance of the Pension Fund for 1995-1996. In 1995, the Fund had met with difficulties and received a budgetary loan, as well as bank credit. Possibly in part those difficulties were of temporary nature connected with a delay in the receipt of contributions.

Conclusions and Recommendations

The relative equilibrium of the Pension Fund's balance could be maintained so far only due to the operation of two factors: (i) high inflation which devalued the pension allowances and a delay in their indexation (and sometimes their partial indexation only); (ii) a favorable situation in the labor market (absence of unemployment). For many people, early or disability

²³ In Poland the minimum pension rate is set at 39% of the average wage rate, and the ratio of the average pension and current allowance rates for workers makes up about 2/3 of the average wage rate. These relative ratios are extremely high as compared with other countries. They are the cause of Poland's serious budgetary problems.

pensions were not needed and had no financial advantage. In the situation of growing unemployment, the interest in getting any type of pension may sharply rise (especially in the branches that provide for an early retirement). A decrease in inflation will inevitably lead to leveling of the average pension rate and the average wage rate. The opportunity to manipulate by choosing the base for calculation of a pension allowance at retirement will therefore increase.

The current pension system is not stable financially in the long-term because of a low pension eligibility age, the numerous pension privileges (opportunity of getting an early pension, special coefficients, etc.), and a short term for which the pension base is calculated. In this situation it is necessary: (i) to continue the elimination of groundless privileges, (ii) to start the planned raising of the pension eligibility age, (iii) to increase the number of years constituting the basis for granting a pension, (iv) to introduce control and supervision mechanisms for contribution compliance.

All these measures must be introduced immediately, before the unbalanced labor market starts to exert a drastic pressure on the pension system and the number of pensioners grows sharply. Should this happen, any amendments of the pension system will become politically much more difficult.

From this perspective, the draft law that envisages increasing the pension age and eliminate part of the rights of a preferential retirement is the right and welcomed step to take. Once this is done, the largest part of the problems concerning pension provision will be resolved.

3.4. The Social Insurance Fund

Till the end of 1995 the Social Insurance Fund operated on the basis of the former USSR's legislation of 1933, and the principles of its functioning, as well as payment of allowances, remained unchanged.²⁴ This was an extrabudgetary fund subordinated to the trade unions. The financial plan of the Fund until 1995 was endorsed by the management of the Fund and the Presidium of the Trade Unions Federation.

As of 1 January 1996, the Social Insurance Fund, like the Pension Fund, is subordinated to the Ministry of Social Protection.

The revenues of the Social Insurance Fund are cut out from enterprise contributions to the Pension Fund and Social Insurance Fund taken together. In 1993-1995, the Social Insurance Fund received 15% of the total sum of those contributions. As of 1 January 1996, the Fund will receive 5% of them.

The collection rate of contributions to the Social Insurance Fund made up about 66%. Some private enterprises that had no trade union organizations, after consultations with the management of the Fund, paid their contributions directly into the accounts of trade union oblast administrative bodies.

The connection between the necessity of making contributions and payment of allowances is not determined in the legislation; even if an enterprise does not pay its contributions, allowances must be paid. The same is stipulated in the draft law on compulsory

²⁴ Funeral allowances for pensioners are paid out of the Pension Fund. The situation is exactly the same in Ukraine and Russia, until recently it used to be such in Kyrgyzstan too.

social insurance. Its article 18 says: *"Non-payment or delayed payment of insurance contributions by employers does not deprive the workers of the right to receive allowances"*.

The Social Insurance Fund met no difficulties in payment of allowances; however, it cut down its expenditures on sanatorium treatment and holiday facilities for children and young people: in 1994 and 1995 these items made up about 20% of Fund's total expenditures.

The Social Insurance Fund covers expenditures on its administration which according to the legal norms must not exceed 2% of total expenditures of the Fund. In a sense, these costs of administration are underestimated, as part of administrative functions is done by enterprises. The position of the Social Insurance Fund in this respect is different from that of the Pension Fund whose all administrative costs are covered by the budget.

The Social Insurance Fund finances various short-term social payments that substitute for labor incomes, such as temporary disability allowances, pre- and post-natal leave allowances, as well as lump sum allowances (childbirth and funeral²⁵). A considerable part of Fund's expenditures comprised those on sanatoria and holiday centers. Unlike allowances that should be paid in the amounts established by law and within strictly fixed terms, expenditures on medical treatment are flexible.

The rate of allowances is pegged to the wage rate received in a particular period and is determined as its specified percentage rate.

It is planned to reduce expenditures of the Social Insurance Fund (see **Table 3.5**) in 1996. This can be done at the expense of sanatorium-and-resort treatment costs (which are flexible). The possibilities to reduce expenditures on the allowances are less clear: reduction of temporary disability allowances can be achieved with a decrease in employment and on increased work discipline of the employed. Demographic prospects for reducing the expenditures for pre- and post-natal leave allowances, as well as for the childbirth allowance, are not known either.

3. 5. Assistance to Invalids

At the end of 1994, the number of invalids receiving pensions or allowances was 416,000 (i.e. about 2,5% of the population), of whom 266,000 received disability allowances.

The special rights of invalids are regulated by the Law of 22 September 1994 on social protection of invalids. This law provides for granting them numerous privileges to invalids: transport, telephone, fuel, and other allowances. The Law also speaks about the necessity to remove obstacles of architectural nature, adjust urban communication to the needs of invalids, as well as to create jobs for them.

Part of tax privileges stipulated by the law was canceled after the introduction of the new tax regulations on 1 July 1995.

The budget for 1995 (both republican and local) envisaged privileges in payment for public transport and communication services, as well as in purchases of fuel. It planned to allocate 930.4 million tenge on these purposes from the republican budget. The local budgets allocated 21,210.5 million tenge, but this sum also included benefits for other categories of allowance recipients (mothers of many children, low-income families, etc.). At the same time the 1995 budget did not provide for other kinds of help to invalids.

²⁵ Funeral allowances for pensioners are paid out of the Pension Fund, however.

3.6. Family Allowances

In Kazakhstan, there are eight kinds of family allowances established by the resolution of 24 July 1992 on allocation and payment of family allowances. The rate of all family allowances is set as a definite proportion of the minimum wage (the reference wage rate since 1 January 1996), that is the allowances increase with its growth.

The main kind of family allowances, making up about 75% of all expenditures on allowances, is child benefits. Granting them is connected with a family's income level: an allowance is granted if the income per family member in the previous quarter of the year did not exceed two minimum wages. (Although granting all other allowances is not linked family's income, they are provided when there is a high probability that they will be received only by poor families).

The monthly allowance per each child in a family was 130% of the minimum wage rate in 1995 (for children under 6 years of age) and 135% for children up to 18. In 1996, allowance of 135% of the reference wage rate is received already by children over 3 years of age. This means that the expenditures on family allowances in the local budgets will increase.

Other family allowances include: allowances for single mothers or widows and widowers rearing a child under age; allowances for children of the military in active service; allowances for children whose parents evade from paying alimony; allowances for non-working mothers rearing at least four children in the age up to 7 years; allowances for mothers of handicapped children, as well as allowance for children infected with Aids (one recipient). These allowances range from 100 to 135% of the minimum wages (reference wage rate).

The allowances are paid from the funds of local budgets. In 1995, it was planned to allocate 4,302.4 million tenge for these purposes.

3.7. Social Assistance

Apart from family allowances for children which have a character of targeted help (depending on incomes), there are other forms of targeted social assistance. They include compensations the price growth, paid to non-working and low-income pensioners, and introduced in 1994. The amount of this compensation is linked to the minimum wage rate and makes up (depending on the kind of pension/current allowance) between 75 to 115% of the monthly minimum wage rate.

According to the Ministry of Finance, 63,000 persons were covered by this form of assistance in 1994. Compensations for the price growth are paid out of the funds of local budgets.²⁶

The republican budget allotted 500 million tenge for subsidies to milk kitchens providing low-income families with food products for children.

The republican budget for 1995 also envisaged allocation of 1,221.4 million tenge for regional charitable funds. These funds were set up on the basis of the President's decree of 15 July 1994. The precondition for granting a subsidy from the budget is accumulation in the regional fund of a sum equal to the amount of the expected subsidy. No regional fund received a subsidy as of the end of July 1995.

²⁶ The authors have no data about the volume of expenditures on this type of assistance.

Conclusions and Recommendations

Formally, no comprehensive system of social assistance exists in Kazakhstan; there are no agencies engaged in helping low-income citizens, assessing their situation not only in terms of the current family incomes, but also taking into account other factors determining its financial position. Considering that wages, pensions and other incomes are really low, numerous groups of the population are granted benefits or allowances. Obviously, it is necessary to create a system of targeted social assistance: it will be more effective and possibly cheaper than the measures currently in use.

3.8. Social Services

3.8.1. Health Care

Until the end of 1995 health care was financed from the republican and local budgets. In the consolidated budget for 1995 the planned expenditures for health care amounted to 33,144.3 million tenge²⁷ (6,069.8 million tenge in the republican budget and 27,074.5 million tenge in the local budgets), which made 14.7% of the total state budget expenditures.

Clinics, research institutes, medical academies and hospitals of national significance are financed from the republican budget. In 1995 expenses of the republican budget made up 18.3% of the total expenditures on health care and 4% of the total expenditures of the republican budget.

In 1996, the planned expenditures of the republican budget decreased due to the introduction of medical insurance and the establishment of the Medical Insurance Fund. The expenditures of the republican health budget are planned at 5,660.5 million tenge, that is 2.9% of all expenditures of the republican budget.

All main types of medical services were financed in 1995 from local budgets (almost 80% of health care expenditures) in which they constituted 27.5% of all expenditures .

The local budgets financed 1,507 hospitals.²⁸ The Ministry of Public Health, the Ministry of Finance and local authorities are of a unanimous opinion that the network of medical institutions is excessively swollen. In 1992-1994, 157 hospitals and a number of other medical establishments were closed. At present, the hospital network is being examined with the view of further reducing the number of health care facilities and stopping their budgetary financing already in 1996.

An decision on the closing (opening) of a hospital, starting with 1991, is made independently by the local authorities that finance it, whereas decisions concerning hospital or health care centers financed from the oblast budgets are to be made in co-ordination with the Ministry of Public Health (until 1991, decisions concerning all hospitals needed co-ordination).

It is widely believed that the number of doctors, which was 60,900 at the end of 1994 (one doctor per 273 population), is excessively high. This indicator is not only higher than in Poland (one per 451 persons in 1993), but also exceeds the corresponding figures for Sweden (one per 394 persons in 1990) or Switzerland (one per 317 persons in 1989). However, it

²⁷ Wages and salaries in health care including.

²⁸ There are about 650 hospitals in Poland whose population is almost twice as large

should be emphasized that the number of practicing doctors has diminished by 3,500 as compared with 1993.

Until 1990, the financial plan of the health sector was developed according to uniform norms whole in the USSR. The necessary expenses were determined on the basis of norms indexed to one hospital bed or the number of staff. The norms were not used in 1992-1995, and the budget was formed on the basis of that of the previous year increased by the inflation index.

The medical establishments were debtors, the growth of their indebtedness for utilities (heating, electricity, etc.) being the main factor. In the first 9 months of 1995, the indebtedness of local budgets towards medical establishments made up in turn about 2 billion tenge, that is about 7% of planned expenditures, and the indebtedness of the republican budget was about 60 million tenge, or about 1%.

The population pays the full price of medicines, except for those used for certain disease treatment (for example, tuberculosis) or by some population groups (invalids, etc.).

Local authorities have the full right to introduce paid medical services. The scale of use this authority is unknown, however. For instance, dentists' services became charged onto the population in one oblast (they remained free for the poorest groups of the population). According to some estimates, the receipts from paid services were to cover about 10% of expenditures on health care in 1995.

Health care is financed not only from the state budget but also directly by the population (paid services being introduced by the local administration) and by enterprises that finance their consultation and ambulatory clinics.

Encumbering enterprises with social service infrastructure, including medical facilities, presents a serious problem also because their maintenance is on average more costly than that of regular facilities run by specialized services. To resolve this problem a credit was taken in the World Bank for financing an experiment (in two oblasts) on a transfer of kindergartens and health care centers to local authorities. For these purposes, USD 29 million were allocated (out of the total 41 million loan). Fulfillment of the project is to take five years during which the cost of maintenance of the infrastructure transferred to the local authorities is to be financed out of the loan (with gradual reduction). The object of this experiment is to decrease maintenance costs and eliminate unrequired establishments.

Today, the main task in the social sphere in general, and in health care in particular, is the rationalization and optimization of the service network. This task is set forth in the republican budget for 1996, of which Article 12 says: *"With the view to use budgetary allocations effectively and considering the changes of labor payment terms, the Government of the Republic of Kazakstan in the 1st quarter of 1996 is to effect optimizing the network of budgetary organizations, and rationalizing the norms and conditions of their activity."*

The health care system will be undergoing through large changes as a result of introduction of the system of medical insurance on 1 January 1996 (see the Decree of the President of the Republic of Kazakstan of 15 June 1995). The Medical Insurance Fund established in connection with this decree will receive 10% of the total contributions for state social insurance.

It is impossible so far to assess how much the system of medical insurance will improve the financial situation in the health care system. It is difficult also to evaluate the technical preparation of the medical insurance system. What can be said with great confidence, however, is that unless the network of the facilities is rationalized and optimized,

there will be no way to finance it, regardless of the source of financing (budgetary or extra-budgetary).

Conclusions and Recommendations

It is necessary to continue the already pursued policy in the area of health care, that is to close redundant facilities, reduce employment, introduce some paid medical services, and continue eliminating medical facilities kept by enterprises. Only these measures will enable to put the thus saved financial resources into improved quality and standards of health services and better pay for those who work there.

3.8.2. Education

Education is financed from the republican budget and from local budgets. The planned expenditures on education in the consolidated budget for 1995 amounted to 34,610.0 million tenge²⁹ (8,848.9 million from the republican budget and 25,761.1 million from the local budgets), that is 15.3% of expenditures of the state budget.

The share of expenditures on education in the republican budget made up 5.9% in 1995. In the republican budget for 1996, expenditures on education were planned in the amount of 11,037.1 million tenge, that is 5,7% of total expenditures of the republican budget.

In 1995 expenditures of the republican budget made up 25.6% of all expenditures on education, and those of local budgets 74.4%.

According to the information of the Ministry of Finance, schools in military garrisons are financed from the budget of the Ministry of Defense, as the Ministry of Education refuses to finance them.

According to the Ministry of Finance, there are 8,256 (primary and secondary) school establishments (excluding kindergartens, special schools, boarding schools, etc.) in Kazakhstan. The schools have 335,992 classes where 2,914,693 pupils study. This means there are 8.67 pupils per class. The teachers' work-load depending on the type of school, is 14-16 hours per week (18-24 hours formerly). This is an extremely low indicator. Therefore, the teachers usually have 1,5 - 2 work-loads.

The education budget is determined on the basis of expenditures in the previous year multiplied by the inflation index.

Private schools exist but they do not receive any financial support from the budget.

In accordance with Article 27 of the Law on the republican budget for 1995 of 1 September 1995, the plan of enrollment was reduced by 5%. The budget for 1996 envisages reduction of enrollment of students into state higher educational establishments by 20%, into special secondary educational establishments by 30%, and into vocational technical schools by 25% (Article 14 of the Law on the republican budget for 1996).

Local authorities have the right to introduce tuition in schools. It is most often done in schools having some specialization (for example, an extended program in a foreign language). The scale of this phenomenon is not known.

According to Article 12 of the Law on the republican budget for 1996, the network of school establishments is to be rationalized and optimized this year.

²⁹ Expenditures for wages and salaries including.

3.9. Revenues and Expenditures of Extrabudgetary Funds

The three funds discussed above are extrabudgetary, that is they do not enter the structure of the budget and are not approved together with it. Financial plans of the funds are endorsed by their management only. The law on the budget for each year determines the rate of contributions for the state social insurance. This means that the financial resources of the extrabudgetary funds are very weakly controlled. At the same time, they operate with considerable financial means.

Overall expenditures of the three funds in 1995 were to make up 62,731 million tenge, that is 27.7% of the consolidated expenditures of the state budget (see **Table 3.6**). In fact, they totaled 75,903 million tenge, that is 30.3% of the expenditures of the state budget. Since the missing data for 1994, it is impossible to say whether the sum of expenditures of the three funds taken together, increased or decreased. However, they are relatively lower than in 1993, when contributions to the Pension Fund and the Social Insurance Fund taken together were 7 percentage points higher.

The total expenditures of the three extrabudgetary funds planned for 1996 amount to 128,027 million tenge, that is 69% more than in 1995, the growth rate of expenditures of every fund being different. The Social Insurance Fund is planned to reduce its expenditures both through cutting expenditures on sanatorium and resort treatment and on allowances.

The expenditures of the three extrabudgetary funds make up 44.8% of the scheduled state budget expenditures which are planned at 285,736 million tenge, that is 14% more than in 1995. It should be noted, however, that the state budget expenditures for 1996 were reduced in comparison with 1995 because of the reduction of budgetary financing of health care.

The expenditures of the three funds are to be supplemented with the expenditures of the Medical Insurance Fund. If we take them to be equal to the receipts from fees (twice the amount of the receipts from insurance fees into the Social Insurance Fund, that is 10,500 million tenge), the expenditures of the four funds will be 138 527 million tenge, that is 48.5% of the state budget expenditures.

In 1994-1995, the burden on the total wage bill resulting from the contributions to the extrabudgetary funds was 32% (see **Table 3.7**), which is much lower than in Poland (where it is 48.2%). In 1996, the overall rate of contributions for state social insurance will not change, although a new fund has been established: the contributions to the Medical Insurance Fund will be made at the expense of contributions to the Social Insurance Fund.

The administrative costs of the Employment Fund and the Social Insurance Fund are covered at the expense of contributions, while the administrative costs of the Pension Fund are paid by the budget (see **Table 3.8**)

Conclusions and Recommendations

(i) It would be expedient to consider lowering contributions to the Employment Fund already now, since this fund finances expenditures not stipulated by the Law on employment; the decision certainly depends on the growth of unemployment in 1996.

(ii) If the rights to an early retirement were limited and the plans to increase the pension eligibility age realized, it would be possible to consider reducing contributions to the Pension Fund after an analysis of demographic trends.

(iii) In spite of the fact that pensions are relatively low, it would be unreasonable to increase them; it would make more sense to establish non-government pension funds instead.

3.10. Expenditures on Social Purposes in 1995 and 1996³⁰

According to the plan, the budgetary expenditures on social targets in 1995 totaled 106,800.6 million tenge, that is 47,2 % of the expenditures of the consolidated budget (226,275.0 million tenge). The expenditures on social purposes in the local budgets (84,218.1 million tenge) made up 85.7% of these budgets (see **Table 3.9**).

The planned budgetary expenditures for 1995 must be supplemented with expenditures of the extrabudgetary funds to the amount of 62,731 million tenge, which are not included into the consolidated budget. Hence, the cumulative expenditures on social purposes amounts to 170,462.0 million tenge.

Since the corresponding data about local budgets for 1996 was not available, we can show only changes in expenditures on social purposes in the republican budget. Moreover, the data for 1995 and 1996 are not quite comparable due to the introduction of medical insurance. The establishment of Medical Insurance Fund would assist reduction of budgetary expenditures on health care any way.

³⁰ Due to numerous methodological factors the computations may contain mistakes. Nonetheless, we believe that basically they reflect the actual picture in this sphere.

Table 3.1. Balance of the State Fund for Assistance to Employment in 1995 and 1996

Items of balance	1995			1996	
	Plan		Fulfillment	Plan	
	million tenge	in %	million tenge	million tenge	in %
Revenues of the Fund, total	3250,0	100,0	2136,5	6362,5	100,0
Expenditures of the Fund, total	3132,1	100,0	1829,5	6362,5	100,0
including:					
1. Payment of unemployment benefits	1000,2	31,9	416,9	3234,9	50,9
2. Occupational training and re-training of the unemployed	730,1	23,3	526,4	1189,4	18,7
including:					
expenditures on re-training	408,1	13,0	227,9	1179,4	18,5
expenditures on maintenance and development of ÓİÖ in Turgen	322,0	10,3	298,5	10,0	0,2
3. Payment for public works	33,0	1,1	12,7	341,5	5,4
4. Compensation of costs of acquisition of equipment and instruments for invalids	5,6	0,2	2,7	50,0	0,8
5. Compensation of costs to converted enterprises for re-training of redundant workers	79,9	2,6	36,6	26,6	0,4
6. Job creation	4,0	0,1	5,4	130,0	2,0
7. Costs of severance pay to enterprises' workers	165,0	5,3	141,3	114,1	1,8
8. Maintenance of the employment service	380,7	12,2	369,1	564,0	8,9
9. Others (compensations beyond severance pay, banking services)	48,6	1,6	14,8	29,1	0,5
10. Expenditures on resettling of migrants	250,0	8,0	110,9	250,0	3,9
11. Financing of the housing sphere	435,0	13,9	192,5	416,5	6,5
12. Paying interest on the IBRD credit				16,3	0,2

Source: Data of the Ministry of Labour

Table 3.2. Number of Pensioners and Persons Receiving Current Allowances (End of Year)

Number of pensioners	1993	1994	
		in 1,000	in %
Number of the population		16607	̄
pensioners and persons living on current allowances	2829	2814	100,0
Including:			
pensioners		2142	76,1
persons receiving disability pensions		266	9,5
receiving family allowances		246	8,7
pensioners receiving special pensions		20	0,7
pensioners receiving social pensions		134	4,8
invalids of war		6	0,2
working pensioners and persons receiving current allowances	309	265	9,4

Source: Main Indicators of Work of the Bodies of Social Protection of the Population of the Republic of Kazakhstan, Ministry of Social Protection, Almaty, 1995.

Table 3.3. Sizes of Pensions and Current Allowances

Year/ Quarter	Average wage	Average size of pension and current allowance	Ratio between average pension and current allowance and average wage
	in tenge		in %
1993	126,4	46,79	37,0
1994	1742,2	570,74	32,7
1995			
I	3571,0	998,0	27,9
II	3649,9	998,0	27,3
III	4161,9	1269,8	30,5
IV	4282,4	1270,0	29,7
VII	4800,0	1370,0	28,5

Source: Main Indicators of Work of the Bodies of Social Protection of the Population of the Republic of Kazakhstan, Ministry of Social Protection, Almaty, 1995, as well as information of the Ministry of Labour, the Ministry of Social Security and the Social Insurance Fund.

Table 3.4. Balance of the Pension Fund in 1995 and 1996 (in Million Tenge)

Items of balance	1995 (fulfilment)		1996 (plan)	
	million tenge	in %	million tenge	in %
Revenues total	68 093,8	100,0	116 206,3	100,0
Including:				
1. remainder of money funds	522,2	0,8	1401,9	1,2
2. revenues from insurance fees	51 018,2	74,9	78426,1	67,5
3. credit of the National Bank	1 700,0	2,5	-	
4. costs of preferential and early pensions	133,3	0,2	.	
5. transfers from local budgets	5 280,8	7,7	6 608,6	5,7
6. budgetary loan	2 413,0	3,5	-	
7. others	1 842,3	2,7	4,9	0,0
8. receipt of indebtedness	-		29 764,8	25,0
Expenditures total	66 615,8	100,0	116 206,3	100,0
Including				
1. payment of labour and social pensions	43 224,4	64,8	91 659,6	78,8
2. other pensions	2 058,5	3,1	421,2	0,4
3. payment of indebtedness in pensions for 1995			6 421,7	5,5
4. pensions total	45 282,9	68,0	92 080,0	79,2
5. postal expenses	804,2	1,2	1 970,1	1,7
6. additions to pensions, compensations and allowances	322,3	0,5	3 643,0	3,1
7. sanatorium-resort and material help	85,5	0,1		
8. payment of allowances to families with children	5 481,1	8,2	6 608,6	5,7
9. other allowances	1 404,8	2,1	.	
10. postal expenses	36,9	0,0	.	
11. allowances total	6 922,8	10,4	6 608,6	5,7
12. subsidies to enterprises	938,6	1,4	-	
13. remainder of unused funds on accounts of payment centres	2 210,0	3,3	-	
14. compensation for fuel	4,0	0,0	-	
15. transfers to the Ministry of Social Protection	6 429,4	9,6	-	
indebtedness of the Social Insurance Fund	7,9	0,0	-	
17. return of loan to the National Bank with interest	863,2	1,3	-	
18. funeral allowances	391,6	0,6	659,2	0,6
19. other	53,1	0,1	-	
20. mutual settlement between the Ministries of Finance and Social Protection	2 300,3	3,4		
21. repayment of bank credits with interest			969,3	0,8
22. 22. repayment of the budgetary loan			358,4	0,3
23. indebtedness of payers carried over to the next year			3 495,2	3,0
24. remainder of money at the end of year	1 478,0	2,2	-	

Table 3.5. Balance the Social Insurance Fund in 1994-1996

Item of balance	1994	1995		1996	
	fulfilment	fulfilment		plan	
	million tenge	million tenge	in %	million tenge	in %
Revenues and receipts total	2 176,0	7 688,7	100,0	5 459,3	100,0
1. remainder of funds at the beginning of year		56,1	0,7	-	-
2. insurance fees		7 286,9	94,8	5 250,0	96,2
3. receipts for sanatorium and holiday accommodation		86,3	1,1	31,0	0,6
4. other revenues		188,2	2,5	178,3	3,2
5. receipts		71,2	0,9	-	
Expenditures total	2 206,0	7 458,9	100,0	5 459,3	100,0
1. temporary disability allowances		4 199,8	56,4	3 609,3	66,1
2. pre- and post-natal leave allowances		1 088,4	14,6	1 000,0	18,3
3. childbirth allowances		115,5	1,5	100,0	1,8
4. funeral allowances		48,2	0,6	50,0	0,9
5. sanatorium and resort treatment		1 703,4	22,8	621,0	11,4
6. 6. administrative costs		164,1	2,2	79,0	1,4
7. other expenditures		139,5	1,9	-	-

Note: The data are not quite comparable as payments for sanatorium and resort treatment are not taken into account in the receipts in 1994

Source: Data of the Social Insurance Fund

Table 3.6. Revenues and Expenditures of Non-Budgetary Funds (in Million Tenge)

Fund	1993		1994		1995		1996	
	revenues	expenditures	revenues	expenditures	revenues	expenditures	revenues	expenditures
Employment Fund	included in the budget		included in the budget		2 136	1 829	6 362	6 362
Social Insurance Fund	no data		2 176	2 206	7 689	7 459	5 459	5 459
Pension Fund	1 755	1 713	21 189	20 708	68 094	66 615	116 206	116 206
The three funds total	x	X	x	x	77 919	75 903	128 027	128 027
Medical Insurance Fund (estimate)	x	X	x	x	x	x	10 500	10 500
The four funds total	x	X	x	x	x	x	138 527	138 527

Note: 1993-1995 fulfilment, 1996 plan

Table 3.7. Deductions to Non-Budgetary Funds (as % from Wages Fund)

Fund	1993	1994 è 1995	1996	1995 (% of collection)
Employment Fund	no data	2	2	70-80%
Pension Fund and Social Insurance Fund, total	37	30	30	x
including:				
*Pension Fund	85% (31,45)	85% (25,5)	85%(25,5)	60%-73%
*Social Insurance Fund				
* Medical Insurance Fund	15% (5,55)	15% (4,5)	5%(1,5)	66%
	x	x	10%(3,0)	x

Table 3.8: Administration Costs (as % of Expenditures)

Fund	1994	1995	1996
	fulfilment		plan
Employment Fund	included into the budget	20,2	8,9
Social Insurance Fund	1,7	2,2	1,4

Source: Data of the Ministry of Social Protection, Ministry of Labour and the Social Insurance Fund

Table 3.9: Budgetary Expenditures in 1995 (Plan) for Social Purposes (million tenge)

Expenditures	Republican budget	Local budgets	State budget
expenditures for socio-cultural purposes	19459,5	54338,1	73797,6
including:			
*education	8848,9	25761,1	34610,0
*health care	6069,8	27074,5	33144,3
*culture	939,5	1485,7	2425,2
expenditures for social security	1901,6	8669,5	10571,1
including:	-	4302,4	4302,4
*family allowances			
privileges for public transport, fuel housing subsidies	930,4	21210,5	22140,9
Subsidies to regional charitable funds	1221,4	-	1221,4
Total	23 512,9	84218,1	107 731,0

Table 3.10. Expenditures of the Republican Budget on Social Purposes in 1995 and 1996 (Plan, in million tenge)

Type of expenditure	1995	1996
1. education	8 848,9	11 037,1
2. health care	6 069,8	5 550,5
3. culture and art	939,5	1 199,3
4. social insurance	1 901,6	954,2
5. representation expenses privileges in public transport and communication services	-	1 112,2
Total	17 759,8	18 899,1

4. Restructuring of the Banking Sector (Wladyslaw Jermakowicz)

4.1. General description of the banking system and banking reforms

The banking system of the Republic of Kazakstan consists of two levels: the National Bank of RK which carries out functions of the central bank of the country, and 130 commercial banks including 3 state-owned banks, 1 interstate, 78 joint-stock banks, 31 private, 7 joint and 7 foreign banks.

Of all second tier banks, 69 are located in Almaty (in the same period of last year there were 92 of them). In each of Atyrau, Kyzylorda, Mangystau, Torgai and West Kazakstan Oblasts, one Head Headquarters of the second tier bank is located. In Semipalatinsk Oblast there is no one of the second tier banks registered.

During last fourteen months, the process of reduction of the number of banks has become evident. Significant changes in the number of banks are shown in the Table 4.1. The number of banks reduced by 32% - from 191 to 130. This reduction is more evident with regard to private banks (their number reduced by 43% from 56 to 32), and commercial banks (their number reduced from 16 in September 1994 to 1 in November 1995). The number of joint stock banks reduced by 21%.

Of 130 registered banks, only 48 received licenses for foreign currency banking transactions, and only 37 - general licenses (see Table 4.2). The actual charter capital amounts to US\$ 133.3 million i. e. average of 1 million per bank which is a very small amount under international standards.

The smallest banks possess charter capital of Tenge 1 million (US\$ 16.6 thousand), the largest - over Tenge 130 million (US\$ 2 million). In late 1995, only three banks in the republic (Exim Bank, KRAMDS Bank and ABN AMRO Bank) had charter capital of over US\$ 10 million and 2 banks (Alem Bank and Turan Bank) whose charter capital is between US\$ 5 and 10 million. For comparison, an average bank in Poland, which in its turn lags behind developed Western countries in development of the banking system, has the charter capital 1.5 times larger than the charter capital of three largest banks in Kazakstan. It points the need for further development and consolidation of banking sector in Kazakstan.

The Table 4.3 shows that the majority of second tier banks do not possess sufficiently large charter capital. Limited size of charter capital is hindering the expansion of banking transactions and positive effect of banks for real economy. The Table shows also that during last three months there were no radical changes in the structure of banks' charter capital.

Starting from 15 April 1995, in order to obtain a license for carrying out banking transactions in Tenge, banks must possess charter capital of no less than the equivalent of US\$ 500,000. The amount of US\$ 1.5 million is the minimum charter capital necessary to obtain a license for carrying out foreign currency transactions (except operating cash currency exchange points), licenses for taking money deposits from the population, and authorization to open a branch. In 1995, only 5 banks obtained the license of the National Bank for carrying out banking transactions. The charter capital of the largest of them - the Almaty Trade and Finance Bank - amounted to Tenge 110 million (US\$ 1.8 million); the smallest - subsidiary joint-stock bank "Alfa Bank" - amounted to Tenge 80 million (US\$ 1.2 million).

The number of banks in Kazakstan is undoubtedly too large. For example, Poland which population is 2.5 times more than that of Kazakstan has 90 banks, Hungary - 31, Czech Republic - 18. Consolidation of banks seems necessary. The new amended version of the

Provision on Liquidation of Banks is promoting the process of consolidation. Under the Provision, after the Executive Board of the National Bank makes the decision to liquidate a bank, the oblast department of the National Bank creates a special liquidation commission. It forms the so called liquidated assets and collects claims, and afterwards will be dealing with satisfying claims of creditors - bank depositors and clients - in accordance with the Provision which, as a matter of principle, stipulates priority satisfaction of claims of individual depositors, and only then - those of the state budget and legal entities.

According to the National Bank, at present, 62 banks in Kazakhstan are being liquidated, and for six of them the liquidation process has been completed. The National Bank established a special structural unit to tackle these issues - the Department of Control over Liquidation Process which was separated from the Banking Supervision Department.

The number of branches is changing between 1011 and 1050. The average number of branches is 7.8 per bank. Though the number of banks is too large, the number of branches is apparently insufficient. Let's consider for comparison density of banks in Western countries (according to applicable international standards, the density is determined as a number of population per one bank branch). There are 717 people per branch in Belgium, 835 - in Switzerland, 1000 - in Germany, 1314 - in France, 1331 in UK, 1780 - in Japan. The most "backward" country from the point of view of branch density is the USA which has 2214 per branch (of course, if we do not take into account numerous firms, trade organizations and other companies which allowed by law to carry out some banking transactions). In Russia, population per branch is more than 1.4 times larger than in the USA i. e. 3100³¹. In Kazakhstan the density is 15952 which shows relatively low saturation with banking facilities. Moreover, if we exclude banking structures located in Almaty it will result in still lower banks density indicator in Kazakhstan. Also, branch concentration is excessive. Two banks possess the majority of branches: the People's Bank of Kazakhstan has 28.4% of branches (296) and the Kazagroprom Bank - 22.5% (235). We believe that rules and procedures of obtaining permits to open branches should be liberalized. For example, the required charter capital could be reduced from US\$ 1.5 million to US\$ 1 million. On the other hand, measures are necessary to promote demand for banking services. For example, to simplify the procedure of opening bank accounts or make banking operations mandatory for legal entities.

4.2. Privatization of banks

The Republic of Kazakhstan is continuing privatization of second tier banks whose founders and shareholders are state-owned enterprises and enterprises where the state possesses controlling interest.

There are a number of reasons for privatization on banking sector. At present, in the transitional economy the state property and monopolization prevail which hampers development of full-fledged competition. Distribution of financial resources still keeps administrative character. Because of absence in Kazakhstan of a network of large competitive second tier banks (there are yet only a few of them) the majority of existing banks provide a very limited set (no more than 20) of services though in developed market economy countries banks offer their clients between 300 and 500 kinds of different services. Apart from it, charter capital of second tier banks existing in Kazakhstan is so small that they are not able to compete with large specialized banks.

³¹ "Issues of Economics" No 11, 1995.

Privatization of second tier banks aims also at strengthening their financial stability, preventing uncontrollable watering of state share of their charter capital, creating favorable conditions for future mass privatization of banking sector in Kazakhstan. One of the documents regulating the process is the Resolution of the Cabinet of Ministers No 304 of 20 March 1995 on Measures to Rearrange State Stock in the Second Tier Banks. It defines the list of banks subject to privatization.

In early 1995 there were about 90 banks where part of stock were owned by state enterprises and organizations. Almost all these banks were partially privatized through privatization of state enterprises that possessed their stock, or through watering state shares by uncontrolled emission of new shares to be sold to private organizations. Nevertheless, state shares formed minority, and in some cases - even majority of stock in almost 80 banks by the moment in the middle of 1995 when the government initiated the banks privatization program.

First auctions for sale of state stock in second tier banks were held in the Central Asian Stock Exchange.

The sale was organized by the State Committee on Privatization (GKP) in cooperation with the Ministry of Finance. In September 1995, the GKP was given state stock of 5 banks (see Table 4.3).

In August 1995, the government sold remaining state shares of two large banks: Turan Bank and Credsoc Bank, and also nine medium-size banks which was done, mainly, through the Stock Exchange. Apart from it, licenses of 19 banks with state participation were revoked. All the above activities reduced the number of banks with state participation down 49 by February 1996.

In the mid-April 1995, the State Committee for Privatization committed to sale stock of 46 banks, including four banks where the state had controlling stock: Gasprom, Torg, Tsvetmet and Ak-Zhol, and in 11 banks the formal state share had never been clearly defined. Shares of six banks were sold through auctions and stock exchange; the most prominent of them is the Kazagroprom Bank.

Many banks carried out additional (the second or the third) emission of new shares. For example, the Tsvetmet Bank have already made the fourth emission of shares. The procedure is as follows: the Ministry of Finance gives a bank, on the basis of their prospectus, a permit for emission of new shares. Then the bank transfers the state-owned part of stock to the State Committee for Privatization which offers them for sale at the Central Asian Stock Exchange.

The role of the Securities and Exchange Commission in these transactions is probably minimal. Analysis of some banks' emission prospectuses shows that they are of very formal nature. The prospectuses include only financial reports approved by local auditing companies, and lists of members of Supervisory and Executive Boards with information on their financial participation in charter capital of the banks. There is no information on marketing strategies, on banks' structure, their strengths and weaknesses, good and bad prospects, etc. Standards for preparation of prospectuses established by the Securities and Exchange Commission are not satisfactory for operational full-fledged financial market.

Many banks are owned by industrial enterprises which are at the same time major clients of these banks. They are, in fact, "pocket banks" where founders get benefits in the form of credits in their "own" bank.

In order to resolve this problem, two provisions were adopted.

The first one stipulates that related persons or entities cannot receive credits in the amount exceeding 10% of the bank's equity. The analysis carried out by the National Bank shows that the number of banks that do not comply with this limit is 7.4% of all banks. In other banks, shareholders (related persons and entities) are normally using approximately 5% of equity i. e. half of the limit.

The second provision is concerning banks that are owned by enterprises with more than 50% state participation. The Decree of the President on banking activities of August 1995 prohibited enterprises with large state participation to hold shares of banks. Accordingly, the Ministry of Finance carried out exchange of all such bank shares for treasure bonds and liabilities of such enterprises to the Ministry of Finance. Then the Government decided to sell within several months all its shares of all banks except a few of them (the Exim Bank, Housing Construction, Rehabilitation, People's, Kazagroprom, Alem and the Central Asian Bank of Reconstruction and Development) which provide specialized financial services or whose difficult circumstances require more time for privatization.

The latter provision and its implementation resulted in some actions that did not comply to the full extent with applicable laws.

First, the Regulation of the Cabinet of Ministers of 20 May 1990 No 304, Chapter "Special Terms", paragraph 2.2. states that "*special bonds of the Ministry of Finance issued in exchange for stock of joint-stock banks are registered, not returnable and are not means of payment and cannot serve as collateral*". It means that the Ministry of Finance, in fact, withdrew means from working capital of enterprises and has them at its own disposal. Earlier enterprises owned stock of second tier banks and could sell it any necessary moment, or provide them to a bank as a collateral in order to obtain credit resources, have income in the form of dividends; but after banks' shares had been exchanged for Ministry of Finance bonds, they lost such an opportunity which made the problem of working capital deficiency more acute.

It's necessary to note that time for repayment of special targeted bonds was not defined, income interest rate was not initially stipulated. It violates the Decree of the President of the Republic of Kazakhstan having force of a law On Banks and Banking Activities in the Republic of Kazakhstan where the above exchange of shares for bonds is a form of deposit, and deposit, in its turn, is accepted on the terms of payment, fixed time and liquidity.

Second, conclusion of the above agreement is legally authorized under the applicable laws only with 100% state owned enterprises. Conclusion of agreement between the Ministry of Finance and enterprises with controlling state interest is legally not authorized and violates applicable laws since banks' shares are owned by joint-stock companies, and decisions on sale, exchange and purchase can be made only by the highest body of joint-stock companies - General Meeting of Shareholders.

Third, it's worth discussing the issue of privatizing state stock of second tier banks. Under the Resolution No 304, the Ministry of Finance after exchange of second tier banks' stock is exercising the rights of ownership and possession of state blocks of shares i. e. rights of a shareholder. It has to initiate General Meeting of Shareholders in each bank and decide on sale of state stock. Under the Decree of the President On Economic Partnerships, "*Shareholders of closed joint-stock companies that want to sell their shares are bound to offer other participants of the joint-stock company or the company itself to buy out the shares. If other participants of the joint-stock company or the company itself reject to buy the shares then the shareholder is entitled, with agreement of the company, to sell shares to third*

parties". However, in violation of applicable laws, the Ministry of Finance did not initiate and did not carry out General Meetings of Shareholders in any bank of the Republic. The decisions on sale of state packages of shares of a number of banks: Kazenergoinvest, Gasprom, Kazpost and other banks which are joint-stock companies were made by the Cabinet of Ministers with agreement of the Ministry of Finance and the State Committee for State Property Management in violation of applicable laws, rights of other joint-stock companies and rights of the relevant joint-stock company itself.

Fourth, these state blocks of shares were sold at nominal value though market value of some banks was much higher; consequently, the state budget received much less funds to its income part.

In our opinion, before the end of 1996, complete privatization of all banks should be done except 7 to 10 banks which licenses were revoked.

In order to prevent restoration of state participation, the budget for 1997 should provide means for potential influx to joint-stock capital only to the Exim Bank, Housing Construction Bank and Budget Bank, and also, addition to funding specialized functions for debt resolution in the Rehabilitation Bank.

In the banks that are not committed to privatization in 1996, the state should delegate into their Supervisory Boards not only representatives of different agencies but independent professionals as well.

4.3. Problems of restructuring «bad debts» in the Republic of Kazakhstan

The present state of affairs in the banking sector in Kazakhstan is characterized by on-going tendency of accumulating losses in individual commercial banks, leading to their gradual decapitalization and deteriorating their liquidity. Acute reduction of inflation in the period between the middle of 1994 and the middle of 1995, resulted in increase of irregular loans. Data on 16 largest banks on 1 March 1996 (Table 4.5) shows that irregular loans called there risk assets amount to almost one third of all assets (32.2%). It is much better than in all banking system where bad loans amounted, according to some assessments, about 55-60% of all commercial banks' portfolio.

Financial situation of all banks shown in the consolidated balance of all banks³², is also somewhat mixed. The capital adequacy ratio K1 which characterizes relation between equity and all assets is, on average, 14.3 (27% in 16 largest banks) and such level can be deemed normal. It's necessary to note significant improvement compared to 1994 when this ratio was 7.9% which is less than the minimum limit. It shows positive trends of the system development. Nevertheless, the average share of banks that did not comply with the capital adequacy ratio (K1) during the year was 27%.

Also, the liquidity factor K3 that shows relation of liquid assets to liabilities is 0.52 higher than the required value which is 0.3. However, this limit is violated by 30% of all banks.

³² Annual report for 1995. National Bank Kazakhstan, 1996, page 14-15.

17% of banks violated in 1995 the factor K2 (risk size per one borrower - maximum limit of 25%). Maximum risk per one related borrower (maximum 10%) was violated by 7% of banks.

In 1995 banks started partially to build provisions for lost and doubtful loans from bank profits. In 1994, such provisions did not exist. The total provisions amounted to Tenge 1330 million of which Tenge 45 million were formed for doubtful loans provided to legal entities and individuals. The remaining amount - T 784 million was formed as reserves for covering general bank risk. And yet, total provisions which amount to T 1330 million is far from the necessary level of provisions calculated in accordance with Basel standards. The capital adequacy ratio suggests that provisions must be 8 times larger than actual figures shown in banks' data. Achievement of such proportion however would be very painful especially for small and medium-size banks. For example, in 16 large banks only 12.1% of required reserves were created. One of banks formed only 2.7% of all necessary reserves for irregular loans. It shows the need for stricter bank supervision, and more active measures to reduce the share of irregular loans in the loan portfolio.

Extremely serious character of this problem is in the fact that the banking sector is not capable of independent resolution of its difficulties. In relation to low inflation in Kazakhstan in comparison to Russia, the Russian *laissez-fair* approach to bank rehabilitation is not applicable. It is indispensable to undertake such urgent measures which should put the situation under control and stabilize the affairs, and resolve some of the major problems of the financial sector so that it would be given the possibility by using market instruments to work on their own for its financial strengthening.

Analysis of the consolidated income statement of all banks confirms that the banks are unable to resolve the problem of bad debts. Total returns of all banks increased 1.7 times which is only 0.1% more than inflation. At the same time, costs increased 2.2 times. As a result, all second tier banks obtained profit of Tenge 8.361 million which is 1.1 times more than in 1994. It means worsening from two different points of view. First, reduction of the real value due to inflation. Second, profitability of all banks reduced from 30.7% in 1994 to 19.4% in 1995. This worsening was a result of reduction in interest rates which was to a significant extent caused by significant reduction in inflation rate. It shows also that future possibilities of obtaining high profits are worsening. This profit reduction would be larger if banks had no possibility to invest into securities. It could be said that securities market development could allow banks to get more income from transactions with other securities.

The main factor which leads to accumulation of losses is a significant amount of idle assets on the banks' balance. In its turn, it results in preservation of very low or even negative spreads in some banks and, consequently, makes real profit impossible which creates prerequisites for liquidity crisis in the financial system.

The significant share of loans in irregular situation in banks' portfolio are those given to state enterprises, and also, loans provided in the past under different decisions of the Government which, in their essence are direct liabilities of the state which the state does not recognize. It results in the problem of unclear responsibility since the state blames state banks for bad financial situation, and banks, in their turn, blame the government for bad management of enterprises and failure to fulfill its commitments. The specific aspect of this problem is lack of possibility to significantly improve banks management when they still are partially in non-market environment. All the above requires the government to undertake urgent measures to improve efficiency of state enterprises' operation and implementation by the state of its commitments made on the basis of numerous decisions.

Failure to fulfill obligations of state enterprises or joint-stock companies that are completely controlled by the state to banks was, as a rule, presented in a form of accumulation of bad loans obtained by enterprises in one or several commercial banks and simultaneous obtaining new credits in other banks and service of these loans only. Thus, problems of these enterprises are transferred to one or few leading commercial banks.

Restructuring of “bad debt” in the Republic of Kazakhstan is complicated by spontaneous privatization of state-owned banks. It results in loss of control over these banks by state authorities.

The Rehabilitation Bank established under the World Bank project can concentrate only on large state debtors (until now, only 34 enterprises), and will not be able to deal with many other state enterprises with bad loans. It was necessary to undertake such measures that would urge commercial banks to deal with restructuring of state enterprises that are not covered by the Rehabilitation Bank program.

4.4. Major approaches to banks rehabilitation and restructuring of “bad loans”.

There exist three basic approaches to the bank rehabilitation and bad debt restructuring applied in different economies in transition:

- (1) the centralized approach, applied in the Czech Republic, Hungary, and Slovenia,
- (2) the decentralized approach, applied in Poland, and
- (3) the laissez-faire approach applied in Russia.

The Kazakhstan's solution is, as yet, the closest to the first, centralized one.

4.4.1. Centralized Approach

The centralized approach, is usually strongly supported by the World Bank. It assumes the creation of separate financial institution in the form of the Consolidation Bank (the Czech Republic) or the Rehabilitation Bank (like in Kazakhstan). The first main target of such institution is to take the relevant portion of bad credits from the commercial banks and in this way, on the one hand, help clean bank balance sheets, and on the other, create acceptable conditions for debtors.

In the Czech conditions the Consolidation Bank took over 110 billion crowns (a total 80 percent of non-performing loans of state-owned firms and 50 percent of the credits of cooperative firms). This amount represented about 15.7 percent of all loans in the economy. The main resources for covering the transferred non-performing loans were long-term facilities from the central bank (bonds and long term loans). The advantages and disadvantages of this approach are presented in Table 4.6.

In Kazakhstan thanks to the establishment of the Rehabilitation Bank, it seems that the centralized approach is pursued.

4.4.2. The Decentralized Approach

In the decentralized approach the main responsibility for the bad loan restructuring is placed in the commercial banks. These banks are responsible for separation of the loans classified as substandard or non-performing, set up new organizational units, workout department to manage the bad loan portfolio.

The Ministry of Finance provided the funds for the capitalization of commercial banks. These funds were allowed the banks to create loan-loss provisions - 100 percent for loss category loans, 50 percent for doubtful category loans and 20 percent for substandard category loans. The recapitalization amount is calculated on the ex ante basis, and is set at the sufficient level to ensure that upon creating the necessary provisions, the banks would reach a 12 percent capital adequacy ratio, according to the Basle standards.

In case of Poland the total recapitalization amount for the seven banks recapitalized under the program reached US\$630 million. Since the recapitalized banks possessed sufficient liquidity the government capitalized them with 15-year redeemable treasury bonds denominated in Polish currency and bearing an interest rate close to market rates. From the time of privatization of a recapitalized bank the cost of further servicing and redemption of the portion of the bonds transferred to the bank are to be refinanced to the State Treasury from the Polish Bank Privatization Fund. The strengths and weaknesses of this approach are presented in Table 4.6.

4.4.3 The laissez-faire Approach

Within the laissez-faire approach no action on the part of the government is required. Due to the inflation, the deep erosion of banking sector assets and capital appears, and thus old bad debts virtually disappear. This situation in classical form appeared in Russia. Very liberal licensing policy resulting in the rapid emergence of a huge number of new banks, many being spin-offs of the old state banks creates the situation that old banks with bad loans are dissolved, and appear new commercial banks not burdened by old loans and old management practices. As an effect in Russia more than 2 thousand of new small, entrepreneurial banks were created. The new banks operate mostly on a regional (oblast) basis, with the larger banks handling international transactions for the regional banks. The natural process appears of banks' selection that will survive the competition.

The comparison of all three approaches (See Table 4.6), seems to demonstrate that the Polish decentralized approach is the most effective one. During two last years (from march 1993 until December 1995) the share of the bad loans in the Polish economy declined from 37 percent to 12 percent, and the problem of inter-firm arrears practically does not exit anymore.

The attached proposal for bank rehabilitation and bad loan restructuring for the Kazakstan's economy is, generally speaking, based on this approach.

4.5. Proposed measures for credit portfolios restructuring

The main goal of the proposed measures is the radical resolution of the bad debts problem of the state-owned enterprises through rehabilitation of the credit portfolios of banks and management of these non-performing assets. It requires:

1. Cancellation of the process of transforming the burden from the industrial sector to the financial system and from the financial system to the macroeconomic environment.
2. Partial recapitalization of the banking system.
3. Improving the quality of the National Bank of Kazakstan supervision of the banking sector.
4. Introducing proper regulatory framework.
5. Developing a modern clearing and settlement system.

The fulfillment of all these tasks should lead to the reduction of the risk level and increase of the public confidence in the national financial institutions.

Steps in the program

The banking rehabilitation and enterprises restructuring should go through following steps.

- Step 1. National Bank of Kazakstan (Banks' Supervision Department)) should commission financial portfolio analysis of all commercial banks, which hold in their portfolio loans provided to the state-controlled firms. The audit should be carried out by international auditing firms, according to international auditing standards, and should cover the period until December 31, 1995..
- Step 2. The credit portfolio of commercial banks should be divided into four categories:
 - (a) regular loans,
 - (b) substandard loans,
 - (c) doubtful loans, and
 - (d) lost loans.
- Step 3. The commercial banks should be obliged to separate out the loans classified by auditors as "substandard," "doubtful," and "loss" and should be obliged to set up new organizational units (workout department) to manage the bad loan portfolio, which will operates separate profit centers.
- Step 4. The supervisory boards or general assemblies of shareholders should appoint the workout department managers. They should be selected by tenders from among professionals not previously involved in the credit activities of a particular bank. They should become members of the executive boards.
- Step 5. The workout departments should divide the portfolio into two groups: into a group of debtors of which restructuring is the responsibility of the Rehabilitation Bank, and in to a group of state-controlled debtors which will be restructured by the commercial banks. The workout departments should be made responsible for the preparation of a bad debt restructuring strategy proposal and obliged during one year (for example until the June 1997) to either sell or restructure the loans separated out as "substandard," "doubtful" and "loss". This proposal should be approved by the executive board and accepted by the supervisory board.
- Step 6. In case of loans which restructuring will be the responsibility of the commercial bank this bank will be not allowed to extend new credit to bad debtor unless before the June 1997 deadline one of the following events takes place:

- * the loan will be recovered in its entirety
- * the debtor will regain its credit worthiness which will be proven by at least a three-month record of servicing the debt
- * liquidation of the debtor was initiated leading to the privatization or assets sale
- * the debtor was declared bankrupt by the court
- * the loan will be sold, in the event the banks failed to restructure the debt
- * a conciliation agreement with the bad debtor will be reached.

Step 7. In the case if the conciliation agreement (similar to the American Chapter 11 procedure) the creditors council is created. This council has to be composed of all main creditors holding at least 50 percent of the claims of the debt. This council has to work with management to draw up a financial and restructuring plan (business plan). This plan has to be approved by the creditors council.

Under the restructuring plan the creditors may:

- * reschedule claims (short term loans into long term loans)
- * write-off part of loans
- * convert bad loans into equity of the firm (debt-to-equity swap)
- * sale the loans.

Conciliation agreement becomes binding on all creditors upon being signed by creditors holding at least 50 percent of the claims of the debt. Another limitation should be implemented that only this bank can start conciliation procedure when the enterprises owe to this bank not less than \$100 thousand, and whose outstanding debt held by the bank accounts for not less than 20 percent of the overall amount of the debtor's debt.

Step 8. The Ministry of Finance should order the recapitalization of banks. The following rules should be applied:

- * banks are requested to create loan-loss provisions
 - 100% for "loss" category loans
 - 50% for "doubtful" category loans
 - 20% for "substandard" category loans.
- * the recapitalization amount has to be calculated ex ante on the basis of the credit portfolio analysis carried out at the end of 1995.
- * the recapitalization amount has to be set at the level to ensure that upon creating the necessary provisions, the banks would reach a 12 percent adequacy ratio, according to Basle standards.
- * the recapitalization should be paid in the form of treasury bond transferred to the commercial banks in the fiscal year ending 1997.

The above presented eight steps in the bank rehabilitation and state enterprises restructuring program combine both the decentralized approach (in the part in which banks alone carry out restructuring activities) and centralized approach (in which these activities are carried out by the Rehabilitation Bank).

4.6 The conditions necessary for introduction of the program

The introduction of above presented program will require preparation of the Law on the Financial Restructuring of Banks and Enterprises, in the form of *lex specialis*, which law should:

- a. present steps which should be undertaken by the commercial banks in the bad loans restructuring,
- b. allow banks to start a conciliation agreement when enterprises own not less, for example, than \$100 thousand, and whose outstanding debt held by the account for not less than 20% of the overall amount of the debtors debt,
- c. allow cancellation agreement to become binding to all creditors upon being signed by creditors holding at least 50 percent of the claims of the debtor,
- d. allow banks to convert loans into equity (shares of indebted firms) and hold it for limited time (two years) in their portfolio.
- e. allow for bad debt sale.

4.7. Banking Supervision

Elimination of bad debts in Kazakstani economy requires improvement of control function of banking supervision. The improvement of banking supervision should be aimed at creating favorable conditions for stable performance of the banking system and implementation of its function of a financial intermediary and conductor of signals of monetary policy, and preservation of public trust in banks.

In 1995, regulatory practice was aimed at compliance by the second tier banks with safe conduct standards, creating incentives and conditions for internal reorganization of banks, forming reliable internal auditing systems, sufficient resources, implementation of sound credit and liquidity policy. These efforts showed the real picture of the banks financial situation, but also led to significant improvement. For instance, in early 1995 more than 65% of banks violated economic standards, but by the end of the year this percent reduced down to 52%. Also, in 1995 the Executive Board of the National Bank revoked permits for opening banks and annulled licenses for banking transactions of 45 banks for violation of established banking laws. 62 banks are in the process of liquidation. The liquidation process was completed in 7 banks.

These achievements, though very significant, still require additional measures, for instance, adoption and promulgation of a resolution of the Government or the National Bank on accounting standards, wide introduction of the new accounting system and complete set of accounting standards which will to a large extent correspond to the International Accounting Standards (IAS). It is also necessary to build the system of borrowers registry, their real estate, pledge of their real property and their loans.

In the process of analysis of the results of inspections carried out by the banking supervision it was found that banks and branches commit, as a rule, violations of the following banking law provisions:

- procedures for formation and increase of the charter capital;
- procedures for crediting;

— rules for carrying out foreign currency transactions (e. g. timely sale of export foreign currency proceeds at the currency exchange, contract payments on behalf of third parties and charging commission and penalties in foreign currency);

— time limits for carrying out transactions, rules of cash transactions, use of the balance accounts No 904, 970, 971 and 016.

Introduction of the new accounting system is under way. The system has already been introduced in the National Bank, and in commercial banks it will be established in the second quarter of 1996. The system of mutual settlements (clearing) is being improved, an intermediary system has been completed which will serve as a basis for the long-term payments system. Adoption of international standards for preparing reports on auditing second tier banks will allow to improve the banking supervision.

4.8. Conclusions and recommendations

There is no doubt that in 1995 significant progress was achieved in reforming the banking system of the Republic of Kazakstan. But further improvements are still necessary.

Reform of bank supervision is the most important factor of reforming the system in general. For reforming this system it's necessary to carry out: (a) introduction of international standards, (b) introduction of new equity calculation procedures and standards, (c) real evaluation of banks capitalization level and their susceptibility to risks, (d) presentation by commercial banks to the National Bank of action plans for recapitalization and regular reports on their implementation.

Recapitalization of largest banks where the state owns the largest share of joint stock is necessary. It's unrealistic to expect that the majority of banks that suffer from equity deficit would manage to acquire adequate equity irrespective of governmental assistance. The Ministry of Finance must carry out capital increase (recapitalization) in order to create reserves to cover long-term losses on loans. Recapitalization must be paid in the form of treasury bonds transferred to commercial banks in 1997. Specific approaches of the National Bank to certain banks suffering from capital deficit should be determined in accordance with the charter capital of the latter and the state share in this capital. See detailed proposals in paragraphs 4.5 and 4.6.

It's useful to speed up the process of banks' consolidation. However, consolidation must be initiated by banks themselves, and banking supervision must facilitate it.

Before the end of 1996, privatization of all banks must be completed, with reservations made in the paragraph 4.2.

In order to improve banking system operation in Kazakstan it is also necessary:

a) to create a national system for collecting and keeping information on borrowers and creditors. Such a system would allow to reduce the probability of new bad loans in the banking system through increasing borrowers' responsibility for repayment of loans and credits and creating informational basis for more sound policy of banking structures themselves;

b) to create the banking deposits insurance system. Such a system would work under supervision of the National Bank and could supervise the state of deposits. Funding could be done in the form of allocation to an appropriate fund of certain percent of profit by commercial banks (in Russia commercial banks are allocating 2% of their profit to deposit insurance and bankruptcy funds for more than 2 years). Such system could reduce the probability of "domino" effect;

c) to create a national information center in the area of financial services;

d) to create the system of constant banks monitoring and rating.

We propose also to make changes in the second tier banks system. It concerns division of functions of the Export and Import Bank into the functions of a guarantor of export policy, and functions of a financial and investment agent for attracting external financial resources necessary to implement structural investment policies of the Government. Besides, the Exim Bank needs privatization, and not capitalization through bonds emission aimed at attracting international financial institutions. Privatization of, say, 30% of international share in the charter capital could attract a strategic investor and improve international image of the Exim Bank and Kazakstani economy. The bonds emission cannot resolve anything.

The National Bank of Kazakstan needs further reorganization also. It must stop providing bank services to economic entities of non-financial sector. Treasury system development and creation of the Budget Bank will be connected with taking its branches of its structure.

Table 4.1. Banks in Kazakstan depending upon methods of forming charter capital.

Month/ year	State	Inter- state	Joint stock	Private	Joint	Foreign	Commercial	Joint-stock commercial	Number of branches	Total banks
09.94	1		101	56	5	4	16	8	1035	191
10	2		102	54	6	4	15	7	1011	190
11	2		106	52	6	4	13	7	1016	190
12	3		106	52	6	4	13	7	1022	191
01.95	3		105	49	6	6	10	5	1042	184
02	3		105	49	6	6	10	5		184
03	3		101	47	6	6	9	5	1038	177
04	3		97	47	6	6	9	5	1047	173
05	4	1	94	46	6	6	5	5	1048	167
06	4	1	94	46	6	6	5	5	1048	167
07	4	1	91	41	6	6	6	5	1050	160
08	4	1	83	38	6	6	4	5	1043	147
09	3	1	80	38	7	6	2	5	1037	142
10	3	1	80	34	7	6	1	4	1029	136
11	3	1	79	32	7	6	1	4	1039	133
12	3	1	77	32	7	6	1	3	1036	130

Source: Statistical Bulletin of the National Bank of Kazakstan, No 1 and 11. 1995

Table 4.2: Data on a number of commercial banks in Kazakstan

No	Data on banks	
1	Registered banks	130
	joint-stock	77
	private	32
2.	Number of second tier banks' branches, total	1036
	branches of Kazagroprom Bank	235
	branches of Saving's (Narodny) Bank	296
3.	Number of banks that obtained licenses for foreign currency banking transactions	48
4.	Number of banks that obtained general licenses	37
5.	Charter capital of banks (million Tenge)	8662,43
	banks that obtained domestic licenses	431.891
	banks that obtained general licenses	6543.69
6.	Number of banks whose licenses were revoked, total for 1994	33
	including transformed into branches of other banks	9
	total for January-August 1995	38
	including transformed into branches of other banks	9
7.	Number banks whose licenses were revoked because of violations of banking laws	53
	total in 1994	24
	total for January-August 1995	29

Source: author's computation based on different sources.

Table 4.3: Charter capital and the number of banks

Charter capital, million Tenge	1.09.1995	1.01.1998
up to 1	20	18
from 1 to 5	30	27
from 5 to 10	10	8
from 10 to 15	4	3
from 15 to 20	10	9
from 20 to 25	2	5
from 25 to 30	6	3
from 30 to 80	18	17
from 80 to 130	19	21
over 130	14	16

Source: Statistical Bulletin of the National Bank of Kazakstan, No 6(7) and 11(12), 1995

Table 4.4: Banks with state participation subject to sale

No	Bank	Decree	Status
1	Kazcreditsoc Bank	No 2/2, of 2 Aug. 1995	sold on 10 August 1995
2	Kazenergoinvest	No 2/3 of 31 Aug. 1995	
3	Ural Bank	No 2/4 of 31 Aug. 1995	
4.	Gasprom Bank	No 2/5 of 31 Aug. 1995	
5.	Turan Bank	No 2/6 of 6 Sent. 1995	sold on 14 Aug. 1995. ³³

³³ The decision about the shares sale was made practically three weeks after the shares were sold.

Table.4.5 The indicators of the financial situation of the sixteen selected banks in the Republic of Kazakhstan (in Thous. Tenge)

№	Risk Assets (RA)	Provisions collected	Provisions needed	Charter Capital		Equity (K)	K1=K1/RA (not less than 0.08)	Maximal risk for one debtor (K2)	Liquid Assets (LA)		Liabilities (L)	K3 = L/LA(not less than 0.3)	Balance Sum
				Real	Registered				no more than 10%				
1	2	3	4	5	6	7	8	9	10	11	12	13	14
1	4197518	37535	1407777	106000	106000	-1899028	-	-	-	783860	2933468	0,27	9788085
6	4849658	410	1258093	520485	1550000	508640	0,11	24,8	-	2781009	4402645	0,63	15188163
7	1485835	40053	298271	150000	150000	441089	0,3	10,3	3,4	170912	942975	0,18	2614777
9	9790739	25960	1831856	400000	400000	2082212	0,21	17	-	2672649	8155103	0,33	21840444
10	5801016	43918	642025	762515	169873	1988374	0,34	13	-	13441480	23109892	0,58	54862760
21	1302446	23831	113188	80199	100000	316877	0,24	21,9	5,7	642865	1477381	0,44	2677950
22	730445	35991	177347	120002	120000	326781	0,45	18,4	-	268468	685831	0,39	1895088
48	4956966	67038	670384	127267	127267	1450032	0,29	23,2	9,9	2019558	6575341	0,31	12661721
53	3317169	13116	894472	200000	200000	237361	0,07	9,82	-	-	-	-	-
66	14655718	10092	4382540	280180	436000	1778054	0,12	10	-	1685827	5087808	0,33	37418478
98	1052324	31257	155589	100471	160000	218538	0,21	15,8	0,5	416152	1094531	0,38	201794
107	1390631	92489	139153	150000	150000	666544	0,48	7,3	5,2	2445230	3025806	0,81	5196988
199	599377	3535	14438	94500	94500	134140	0,22	13,9	-	1252422	1206382	1,04	5601642
225	1286060	3554	3554	603500	597000	787731	0,61	20,7	-	2336638	1795979	1,3	3252646
232	3530276	1624	216054	3204583	3000000	3204359	0,91	6,4	-	379851	335313	1,13	6746277
237	261209	2226	2314	95598	95600	200674	0,77	14,1	-	287026	347521	0,83	839320

K1 - adequacy ratio, K2 - risk ratio, K3 - liquidity ratio

Table 4.6. Advantages and drawbacks of centralized, decentralized and laissez-faire approach to bad debt restructuring.

Centralized Approach	Decentralized Approach	Laissez-faire Approach
<p>- <u>allows</u> for quick separation of bad debts from bank's healthy assets. It is assumed that the old banks, after the bad debt separation can start new commercial activities without the old burdens.</p> <p>-this approach, thanks to the concentration of bad debts in single institution allows for full focus of the new institution on the bad debt restructuring.</p>	<p>- it introduces the mechanism that compels the banks to undertake specific actions with respect to bad debtors</p> <p>- this approach teaches the bank's personnel how to assess credit risk, how to deal with bad debtors and the responsibility for own actions.</p> <p>- because the amount of the recapitalization has to be determined ex ante and not depend on the amount of bad loans to be recovered by the individual banks this creates incentives for the banks to recover as much of the bad debts as possible.</p> <p>-this approach sets clear rules of game to all players and eliminates the risk of political pressures.</p> <p>-this approach indirectly helps firms with excessive amount of bad loan and does not require the establishment of government agency with bad loan working skills.</p>	<p>- this the most market conform approach and the same time the easiest approach to implement. It is easy to perform, because no action on the part of the government is needed, and there is no need for effective supervision.</p> <p>- this is the cheapest approach because no recapitalization of banks by the government is required.</p> <p>- the small size of the banks eliminates any systemic consequences of bank failures.</p>

Disadvantages:

Centralized	Decentralized	Laissez-faire
<p>- it requires the creation of a new agency with loan workout skills. It is difficult to find the highly skilled specialist of bad loan restructuring for state based institution, and there is no guarantee that this agency will vigorously and effectively recover bad debt. The creation of new agency does not answer the question what to do with bed debtors and does not create adequate incentive system that would insure the institution's active approach toward indebted enterprises.</p> <p>- this approach does not teach banks and other debtors responsibility for own actions. It is not sufficient to replace assets and management. It requires to change the whole corporate culture of the banking system. This not address the causes of the problem, which lay primarily in the lack of experience and expertise of the banks in assessing credit risk in the market environment, does not teach banks' personnel the new responsible behavior and responsibility. The danger still exists that the bad loan portfolio will re-emerge in the near future.</p> <p>- the centralized approach does not create adequate incentive system within he banks that would insure the banks; active approach toward indebted enterprises.</p> <p>- the most decisions concerning separation of the loans, and support given to different enterprises is politically based. This creates the danger of political pressures on the credit and restructuring policy toward big debtors.</p>	<p>- there exists danger that banks preoccupied with old debts, would be unable to introduce new standards for their regular credit operations and reorganize banks during the transition period.</p> <p>- there exist the danger that banks will continue to finance the old bad debtors with new loans, without setting any restructuring requirements.</p>	<p>- very easy entry into banking sector creates an excellent opportunity for criminal elements to control the banking system. This is straightened by the very weak banking supervision and poor enforcement of regulations.</p> <p>-due to the high inflation not only bad loans erode, but also banks equities reduces significantly. (For example the largest Russian banks have an equity in the amount of \$100-150 million). This hampers the effective large credit financing, forces for creation of banks consortia, reduced the banks' credit potential.</p> <p>-because of the government's inaction there is no enforcement for restructuring of large bad debtors. The responsibility for large firms restructuring stays at the government agencies (not in the banks) what creates the strong pressure on the government for additional subsidies, and does not create any incentives for firms' restructuring.</p> <p>-erosion of banks equity, and banks deposits undermines the public trust in the banking system, and undermines the normal functioning of economic system.</p>

5. Inter-enterprise arrears in Kazakstan (Wladyslaw Jermakowicz)

In Kazakstan, as in other transitional economies, the problem of inter-enterprise arrears (IEA) which relate to the debts between enterprises which are overdue but not yet paid, has become significant in the early stages of the stabilization and reform program. IEA have grown rapidly in nominal terms since the beginning of 1993. However, in real terms (deflating by the consumer price index) these arrears started to increase significantly in the last months of 1994 and first months of 1995. Between December 1993 and December 1995, IEA in real terms increased by 1163.2% (credit arrears) (See **Table 1**).

By March 1, 1996, overdue debts in Kazakstan were estimated by the Kazakstan National Bank to have reached 405 billion tenge, representing nearly 39.9% of the total GDP for 1995. This constitutes 60,4% of all credits given by banks, budget, and other enterprises.

From the **Table 2** it can be observed that in Kazakstan more than 80 % of credit arrears are concentrated in the enterprises from the most important branches of the economy (industry, agriculture, construction and transportation). Arrears in communication and in trade play a marginal role.

The largest arrears are between enterprises (54%), than to the state budget 14%, the lowest to the banks 8.4%. A percentage of bank credit to enterprises amounts 15.7%. Since there is very little voluntary credit between enterprises and the inherited Soviet transactions system does not seem to provide for such credit, these arrears probably include a significant element that would be normal credit in a market economy. Seen in this light, this ratio is much lower to the ratio of bank lending to the voluntary inter-company credit in western market economies. For example, in the UK in 1990 this ratio was 65%, in Poland 47%. In both economies, however, monetary conditions are relatively loose and interest rate are relatively low. Also risk analysis in the banks of the last two countries seem to be better developed than in Kazakstan.

Apart of this evaluations, the problem of IEA in Kazakstan awakes the serious professional and political discussions and as such requires the comprehensive analysis.

In this document we will discuss the causes of inter-enterprise arrears, criteria for proposed solutions and a package of measures.

5.1 The Causes of Inter-Enterprise Arrears

There are different causes of IEA. Let's discuss some of them.

Firstly, some increase in IEA was to be expected as Kazakstan commenced the transition to a market economy because formal mechanisms to provide trade deficit credit did not exist and enterprises had recourse to arrears. Under the command system, trade credit was practically forbidden - all crediting had to be done through banks. Under market economy, credit provided by a supplier to a customer can be deemed as standard practices and arises no doubts. The present situation in Kazakstan and some other post-soviet countries differs from stable market economies in large scale IEA and larger share of forced crediting (which was not agreed in advance).

Secondly, IEA become particularly attractive to enterprises as a financing mechanism when monetary policy to reduce inflation is tightened. The required

reduction in availability and increase in cost of bank credits brings about a substitution of inter-enterprise credit (bearing lower interest) for potential demand for bank credit. Again, as there are few formal mechanisms for granting trade credit, arrears are incurred and tolerated. These processes have operated explicitly in Kazakhstan since the abolition of the automatic overdraft facilities of some leading banks and their replacement of correspondent accounts and explicit credits. The banks were then immediately unable to increase lending to their clients at the previous rates and the build-up arrears began.

Thirdly, IEA growth is sustained by inaction on the part of creditors. Creditor enterprises do not make as much effort to get paid as they could³⁴, for example, by suspending sales to a defaulting customer, or by initiating bankruptcy proceedings, because creditors expect the customer's situation to improve and/or because they may fear that taking action against its clients may signal to its own creditors that the creditor enterprises itself is in financial difficulties. Additionally some still state controlled enterprises also have relatively little autonomy from the production ministries of government, and they may therefore be subject to pressures from government agencies to continue supplies even if their customers are in arrears. This problem is especially acute for the energy sector because suspension of supply of petroleum products, gas or electricity is likely to cause production to cease quickly in enterprises which are large employers (chemical and metallurgical enterprises), exporters (the agro-industries) or suppliers of consumer goods.

Fourthly, the state budget which does not repay timely its liabilities is an important source of the arrears chain. It is a result of unrealistically too high planned budget expenditures which are not covered by budget income (see Chapter 2).

Fifthly, the growth of IEA in Kazakhstan is exacerbated by various external economic shocks to which the economy can only slowly adapt. These include loss of important foreign markets in the FSU and difficulties in obtaining essential inputs from the FSU, due to the collapse of the Soviet Union and its trade and payments arrangements. The decline in production and sales is not accompanied (at least in the short term) by proportionate reductions in costs, either because of a high fixed cost component or because the enterprises does not wish to shed labor. These problems decrease short term liquidity even for those enterprises and sectors which can find alternative world markets.

Sixthly, during 1992-1994 Kazakhstan liberalized prices and, where these are still administratively determined, embarked on a program of aligning domestic prices of both intermediate inputs and consumption goods to world prices. These changes confront established industries with sharp changes in relative prices (for example prices of crude oil). In the medium term, it is likely that many enterprises in the chemicals, manufacturing and capital goods will prove to be uneconomic at the new prices and will be forced to close while others will adapt; in the short term they are likely to build up further arrears to the suppliers.

A seventh reason for growth of IEA lies in the inadequacies of the payments system maintained by the commercial banks. It is especially by payment delays. The delays appear to result both from the liquidity problems and from technical deficiencies. This may be a small, but nevertheless contributory, factor in the growth of arrears.

³⁴ For example, they could start the procedure of sale of the debtor company or the bankruptcy procedure.

Eightly, different financial regulations on the microlevel add to the IEA increase. For instance, the banking system is not working now in accordance with the rules that oblige enterprises that do not have money excess to use their proceeds, first of all, to pay salaries. The same concerns taxation and accounting rules (see below).

Ninthly, although it is difficult for obvious reason to adduce other than anecdotal evidence, it is likely that corrupt practices have played some part in the growth of arrears. It is reported by enterprise managers, bankers and government officials that some arrears may represent transactions in which individual enterprise staff have been paid in cash for delivery of goods while the enterprises itself is recorded as unpaid creditor. The goods produced, in turn, by the debtor enterprises may once again be illegally appropriated for private sale at home or abroad to generate the cash to keep the illegal cycle going.

Lastly, the growth of IEA in Kazakstan, as in other FSU countries, is encouraged by the initially limited credibility of the stabilization program³⁵. In consequence, enterprises may not believe that the total bank credit will continue to be so tight and may therefore "temporarily" allow their customers to build up arrears. Experience in Kazakstan in the first half of 1994 pointed to hoarding of foreign exchange receipts by enterprises in anticipation of further rapid depreciation of tenge; to build up tenge arrears while holding foreign exchange balances was a rational strategy, until the exchange rate for the tenge was stabilized in December 1994. Liquidation of excess foreign exchange balances appears not to have started in earnest until March 1995. Furthermore, because of uncertainty about future policy enterprises may prefer to maintain the size of their work force (thus avoiding labor conflicts and possible political difficulties) and instead postpone payments to their suppliers. It should be noted that strong rationale existed for such inertial behavior on the microlevel since all attempts of macroeconomic stabilization failed in several years (we mean in the period between 1989 and 1994), and state enterprises (especially large ones) always could expect eventually financial support of the Government or the National Bank. It was not an easy thing to brake this inertia and persuade economic entities that this time attempt of stabilization was serious.

5.2. Criteria for Proposed Solutions

The variety of causes of the growth of arrears and the linkage with other aspects of stabilization, price liberalization and structural change in Kazakstan suggest that there is no single solution to the problem. Rather, it will be more appropriate to set out a package of measures which will both to reduce the current stock of involuntary arrears and discourage future growth of IEA. However, it should be emphasized that IEA are rooted, first of all, in microeconomic behavior of enterprises, and this sphere should be paid special attention.

The criteria to be used in choosing and designing measures to tackle IEA should be:

a) that measure taken do not undermine the monetary and fiscal targets set by the authorities in the context of the program agreed for an IMF Systemic Transformation

³⁵ The quite different situation exists in such countries like the Czech Republic, Slovakia, Poland and Hungary, where the reforms were introduced fast and definitely and where the IEAs never demonstrated the serious problem (from 10 to 30% of the GDP).

Facility; thus the measures should not presume any expansion of public expenditure or increase above target in net credit to enterprises;

b) the measure should aim for a significant "once-and-for-all" reduction in IEA; repeated packages of measures should be avoided because they undermine the credibility of the stabilization effort and introduce moral hazard encouraging the accumulation of further arrears;

c) the measure should, where possible, facilitate market-based reforms and, in particular, the process of privatization

5.3. A package of measures

As written before there is no single solution to the IEA problem. Therefore a package of measures has to contain the systemic reform measures, multilateral netting measures, trade in IEA measures and some measures to reform the payment system, tax system and banking system. Some of them will be discussed in this report.

It is necessary to definitely decline multilateral netting transactions similar to that carried out in spring of 1994. They can only hamper both macroeconomic stabilization (since additional credit emission and increase in money turnover rate are necessary) and microeconomic discipline (enterprises, expectations of future state support). It is perfectly demonstrated not only by Kazakhstan's own experience, but also Russian, Romanian and Ukrainian where similar transactions were carried out quite often.

5.3.1. Economic Stabilization and Structural Reform Measures

In Kazakhstan, as written earlier, similarly as in other transitional economies, the problem of IEA has become significant in the early stages of the stabilization and reform program. The single most important measure in containing the problem is persistence with the program itself. As the credibility of the program improves enterprises will be less willing to supply goods to defaulters. As relative prices are adjusted and privatization proceeds, unviable enterprises will be closed and the resources they use will be re-allocated to more efficient production. In the short run, for successful containing inflation it is necessary to introduce very high real interest rates, which add to the problem of IEA;. Once it becomes clear that the gains in reducing inflation will be sustained it becomes possible to reduce nominal interest rates and it is also feasible for real rates to be reduced (while remaining positive) and thus to boost the cash flow of enterprises.

Effective implementation of the bankruptcy mechanism for inefficient and insolvent enterprises is of cardinal importance for resolving the arrears problem. The Law on Bankruptcy has already been adopted but is not working in our opinion.

5.3.2. Creating of the market in IEA

The market in IEA should allow for trading of IEA at a discount. The inter-enterprise arrears should be traded by the specialized companies (including banks) with the system of systematic and continuous listing of IEA and their actual price at the secondary market.

There are few basic forms of the IEA markets possible.

The **first centralized** one, assumes the creation of the IEA exchange, similar to that existing in the form of stock exchange. At the exchange the arrears of different firms

are listed, and the sale of them is made during weekly sessions. The price for arrears depends on the supply of arrears, demand for them, the financial situation of firms and the prospects of bad debts' repayment in firms, which debts are listed on the exchange.

Every week in a special bulletin it is announced the number of arrears put on the sale and their bid price. Additionally information is given about the price which was paid for the specific firms' debts at the previous session and the size of the transaction. This information is used as a base for price setting for next transactions.

The **decentralized form** of market assumes that there are some firms which are specializing as intermediaries in trade of bad debts. These companies can act either as brokers playing the role of intermediaries between sellers of the debts and their buyers, or as dealers making transaction at the own expense and risk. These firms collect debts, announce in the press their price and organize sales sessions. As intermediaries can function banks, investment funds and other corporations.³⁶

It is also possible, that the creditors announce in the press about their debts sale. Debts are being sold on open auctions.

The buyers purchase IEA in order to :

- a. convert them into the shares of enterprises (debt to equity swap mechanism) and thus accelerating the privatization process,
- b. use them as means of payment in purchasing the products or services of indebted enterprises,
- c. use them as means of payment for paying own debts in the companies, whose arrears they have purchased,
- d. use them for speculative reasons, in hope that the prices of purchased debt will grow in the future,
- e. reduce own taxes obligations through reporting "loses", to increase level of the indebtedness of the company (depends on the accounting system).

Some of the companies are also using the market in IEA to purchase own debts at the discount, to reduce own level of indebtedness.

The creation of a market in IEA has a number of advantages.

Firstly, it accelerates the process of elimination of inter-firm arrears, without the government interventions and influence. The whole process is market conform,

Secondly, it provides the better information about the creditworthiness of enterprises - and thus giving the market signals to managers about their customers - discouraging granting of credit to bad customers and allowing creditors to improve their liquidity.

³⁶ In the USA and Great Britain debt trading is done specialized agencies, called venture capital funds, which invest in liabilities. In Poland its is done by banks on the basis of the Code of Civil Procedures and the Law on financial restructuring (See Chapter 4). The market has developed together with the buyers expertise in setting their own liabilities with the liabilities acquired. In Poland, at present commercial banks organize invited tender sales of debts (financial standing of potential buyers is screened by the banks in order not to undermine bank's reputation). Debts of an enterprise are bought at discount by the third party which next settles its own accounts with this enterprise by means of acquired liabilities. Polish banks prefer this solution in order to avoid expensive and lengthy execution of debts.

Thirdly, it helps in deepening the emerging financial market .

Fourthly, through the debt to equity swap mechanism it helps and accelerates the privatization process. (The introduction of the last advantage would require the change in the Kazakhstan's legislation. According to the Privatization Law the arrears can not be paid with the shares of the privatized firms. The company has to issue new shares in order to cover existing debt).

5.3.3. Reform of Payment Systems

To avoid recurrence of rapid growth of IEA , it is proposed that the payment claim system should be abolished and replaced by the system of payment order in which the debtor (on receipt of a payment order from the creditor) explicitly instructs his bank to debit his current account and transfer the proceeds to the supplier's bank. Under the present system unfulfilled payment claims are filled in "Kartoteka" and wait in a queue until funds become available; priority in payment is given first to wages and second to debts to the budget. This system shifts the responsibility for debt settlement from enterprises to banks and further encourages inaction on the part of managers. Under the proposed system of payment order the bank will function only as an intermediary or agent, with no discretion over which payments to honor and when. The freedom of enterprises to manage own financial resources will be enhanced and bank accounts will function as they do in a market economy.

The change from "payment claim" to "payment order" needs to be accompanied by a change in procedures so that enterprises only deliver to their customers if either (a) they pay in advance , or (b) if voluntary trade credit will avoid an unnecessary collapse of sales. If voluntary trade credit is backed by a system of bank guarantees, procured and paid for by the purchaser, there would be added assurance against growth of new arrears.

To make trade credit function banks need rapidly to develop their ability to discount bills of exchange so that , in effect, enterprises can sell their receivables and improve their cash. It will also expand the trade in IEA. The overall aim, in the context of tight monetary conditions, should be to shift the operations of the banking system toward the financing of transactions rather than overdraft needs of enterprises.

5.3.4 Taxation and the Budget Measures

Enterprise profits tax in Kazakhstan (as far as we understand) is currently levied on a cash basis rather than an accrual basis . In other words it means that tax is payable when payment is received, not when goods are supplied or invoices issued. This system is different from that of market economies and is also a further incentive for enterprises not to pursue creditors as actively as they might. In the long term, the basis of tax payment should be changed on grounds of improving tax administration and efficiency, but the change will also help the IEA problem. In the short run, the cash basis of taxation creates an anomaly which inhibits the netting system. The State tax Authorities (as noted earlier) takes the view that, where netting occurs, each enterprises involved should be regarded as having received in full the payments due to it and thus should be taxed in full. Two changes are necessary. First change is to waive tax payment on the netted out revenues. Second change is to make clear that consistently with a move to an accrual system, future voluntary netting between enterprises will not eliminate any accrued tax liability.

Under the Kartoteka priority is given first to tax arrears and next to pension funds and wage payments. Payments to the banks are at the last place. It is suggested here, as an

transitional measure, wage payments and pension funds payments be removed from the priority list, so that only tax can be directly taken from bank accounts without active decision by the enterprise. Over the next six months, the aim should be to go further towards abolition of the Kartoteka system by negotiating provisional tax payment schedules between the State tax Authorities and the largest taxpaying enterprises. Once these scheduled have been agreed, enterprises would order their banks to make payments to the budget in accordance with the schedules and the existing priority system would be removed with such agreed schedules. In an enterprise than defaults, it should be the responsibility off the State tax Authorities to pursue legal proceedings, including proceedings for bankruptcy of the defaulter. This, however, will require enforcing of the Bankruptcy Law, which is now in place but does not appear to be in operation.

5.3.5. The Bank Rehabilitation Measures

Improvement of the prudential regulation and supervision of banks is necessary so that reduction of IEA does not lead to an increase in debts overdue to banks. A program of improvement in this area is already underway with support from the IMF and World Bank, designed to ensure that banks hold adequate reserves, are suitably capitalized and are encouraged to merge in an effort to develop larger and stronger private sector in Kazakstan. In addition, better credit risk assessment by banks is needed, together with development of a system, by banks themselves and regulators, for evaluation bad loans and the steps to be taken in dealing with them. These problems are discussed more in detail in Chapter 4..

Table 5.1. Kazakstan's Inter Enterprise Arrears (end of the period) in billion Tenge.

	1993		1994		March 1,1996	
	Debit	Credit	Debit	Creidit	Debit	Credit
Total Arrears overdue	20.1	18.8	142.8	148.7	271.0	218.7
Arrears Index (Dec. 1993=100)	100	100	714	790.9	1079.6	1163.2

Table 5.2. The branch and debt structure of the IEA in the Kazakstan's economy

	Arrears to budget	Arrears to other enterprises	Arrears to banks	Total
Industry	33.8	100.4	14.6	194.1
Agriculture	4.8	40.0	14.3	74.7
Transportation	3.6	6.0	0.1	20.2
Communication	0.1	0.2	x	0.6
Construction	11.4	13.7	0.6	35.1
Trade	0.2	3,6	1.1	6.0
Others	3.0	54.8	3.7	74.3
Total	56.9	218.7	34.4	405.0

6. Reorientation and Liberalization of Kazakhstan's Foreign Trade (Rafal Antczak)

Before economic transition started former USSR republics lived in the single currency and trade area separated from the world market competition, technology, and price structure. After a dissolution of the Soviet Union they adopted different strategies of economic adjustment. Some (over)industrialized countries, like Ukraine or Belarus, without rich deposits of natural resources but with energy consuming industry postponed economic reforms and experienced huge and prolonged decline in output. Other countries, like Russia or Kazakhstan, rich in natural resources, decided to implement rather gradual reforms (including foreign trade area). The third group represented by both the Baltic states (especially Estonia and Latvia) and Kyrgyzstan chose radical approach towards macroeconomic stabilization and liberalization. After four years one can see positive results of this third approach — the beginning of economic recovery in 1995 and 1996. What interesting, countries the most determined (and successful) in rapid economic reforms were usually the least supported by natural conditions (mineral resources, climate, geographic location, etc.), and, on the contrary, gradual reformers trusted too much in their natural wealth.

Kazakhstan, after initial phase of gradual reforms, increased their pace in 1995, and unlike Russia, is able to become the first FSU country with the rich natural resources which is introducing reforms effectively and probably will manage to register macroeconomic indicators that are characteristic for the fast reformers in Central and Eastern Europe.

6.1. Balance of Payments

Data on the balance of payments of Kazakhstan are presented in **table 6.1**. This table consists of: consolidated balance of payments, balance of payments with former Soviet Union countries (FSU), and balance of payments with rest of the world countries (ROW)³⁷. Liberalization of the Kazakhstan foreign trade which happened in the end of 1993 and in the first half of 1994 allows to observe, for the first time ever, market driven forces in Kazakhstan foreign trade. Years 1994 and 1995, which are subject to analysis, are especially important, because reveal undistorted differences in structure and quantity of Kazakhstan trade with FSU and ROW countries. Besides, results of the Kazakhstan foreign trade begin to reassemble foreign trade outcomes in successful reformers from Central and Eastern Europe.

Consolidated current account deficit declined significantly in 1995 comparing to 1994. It is connected with lowering trade deficit after faster growth of Kazakhstan export to than import from FSU and especially ROW countries. Balance of trade with FSU is still negative, but deficit in trade declined more than twice in 1995. Export rose by approximately 33% (in US dollars terms) and import by only 14% (**table 6.1**). Even more impressive is a growth in Kazakhstan export to ROW countries _ almost 60% (!), when import went up by less than 13%. Expansion of the Kazakhstan export changed a deficit of

³⁷ Differences in statistics among tables 6.1, 6.2, and 6.3 result from different sources of foreign trade data (for example, National Bank of the Republic of Kazakhstan and Ministry of Industry and Trade). This situation is common to all the transition economies, because of a growth in unregistered activities (together with a "shuttle" trade) or underreporting by enterprises of a real production/trade level.

400 mn US dollars in trade with ROW in 1994 into a surplus of 160 mn US dollars in 1995 (**table 6.1**).

The improvement in Kazakstan export revenues from ROW was achieved by two factors: first, the growth of export volume of ferrous and non-ferrous metals and their products, and second, the growth in world (and interrepublican) prices for exported resources. In 1995 ferrous and non-ferrous metals and products represented 42% (growth from 33.3% in 1994) of total export from Kazakstan (**table 6.2**). Drop in output in Kazakstan and most of FSU countries lowered interrepublican (but not Russian _ see below) demand for ferrous and non-ferrous metals and products. Besides, privatization of management (managerial contracts) in metallurgical sector occurred to be very effective, from the balance of payments point of view. In that situation, Kazakstan enterprises were able to enter the world markets, selling to those who offered the highest price. Liberalization of trade (export) regime through 1993-1995 allowed Kazakstan firms to choose buyers and suppliers, according one criteria _ the best offered price.

Lowering share of highly processed goods (mainly machines and equipment) in Kazakstan export should not be treated as a danger in the short run, taking into account the lack of competitiveness of technologically "advanced" goods from FSU countries on the world markets (except weapons). More important is the structure of import, where the share of Western machines and equipment is growing or at least stable from 1994 (in US dollars and as a percentage of import, see **tables 6.3** and **6.3a**).

Chronic deficit in Kazakstan trade with FSU countries results mainly from the import of energy resources. Unfortunately, the lack of pipelines unables a more advanced exploitation of the rich oil and gas deposits in Kazakstan. Decline in the volume of import of oil and oil products or gas, since 1993, could not balance the growing prices of energy resources from Turkmenistan and Uzbekistan (in both cases - gas) and Russia (oil). Kazakstan trade balance with Russia in 1994 became positive (184 mn US dollars), after a deficit of 450 mn US dollars in 1993 (**tables 6.2a** and **6.3a**). Data on export of Kazakstan to Russia for the first half of 1995 show a rapid growth of Russian demand for ferrous and non-ferrous metals, but also foodstuffs, comparing with 1994. On the other hand, the value of imported Russian manufactured goods to Kazakstan is declining steadily from 1993. During the first half of 1995 import of Russian tools, electric and mechanical equipment, transport vehicles or non-precious metals products declined more than a half. There is also a substantial growth in Kazakstan import from Russia non-processed goods, mostly foodstuffs. What is interesting, trends in import from Russia of some metals (ferrous metals, copper, and lead) are consistent with a growth of Kazakstan export of these products to Russia and ROW countries in 1994-1995 (**table 6.2, 6.2a, 6.3** and **6.3a**). Two possible explanations exist; either Kazakstan reexports Russian resources on ROW markets, or Kazakstan reimports own products sold to Russia earlier. Verification of these hypothesis and possible causes of this situation should be examined more carefully in the next report.

Export of Kazakstan oil to the ROW markets is fully determined by the Russian authorities. This is also the main problem in attracting foreign investments in the most perspective sector of the Kazakstan economy. Russia as a competitor to Kazakstan on the world markets of mineral resources is not interested in an increase of Kazakstan oil, gas, ferrous and non-ferrous metals supply. Beginning from 1994, Russia decided unilaterally to cut Kazakstan access to its pipelines. Ecological explanations of this decision cannot be taken seriously. The export quotas for 1995 and 1996 play a role of an administrative export barrier with respect to Kazakstan oil.

Consolidated capital account shows some improvements in 1995, comparing to 1994, but not all changes are positive. If a decline of capital outflow to FSU, as well to the ROW countries is favorable, then diminishing inflow of foreign (especially Western) investments is alarming (**table 6.1**). Kazakhstan's domestic savings are so far very modest as results of years of high inflation and underdeveloping domestic private sector. Official assistance from the international institutions and Western governments can be seen as the temporary and supplementary source of financing only. Hence, the foreign direct investments (FDI) are the only realistic source of stimulating the economic growth in the medium term. They should play the decisive role in economic recovery, restructuring, and technological reequipping of the Kazakhstan economy.

Almost all foreign direct investments in Kazakhstan are concentrated in the oil and gas sectors, in spite of problems with transport via the Russian pipelines. Foreign investors' obligations on the long-term investments in Kazakhstan reached an astonishing amount of 46 billion US dollars, however in practice the sum of money really invested in Kazakhstan is only a fraction of that amount. Such substantial investment obligations prove the foreign corporations' interest, but only in access to mineral (energy) resources, and what is more important - in the long-run. The most popular form of attracting foreign investments in the mining sector of Kazakhstan's economy - contracts on management by enterprises with foreign companies - can only be successful in the longer term if the managing firms obtain reliable guarantees (in theory by law, and in practice by facts) of a possibility to acquire these enterprises. Otherwise, management firms will be only interested in exploitation of ex-state firms without investing in their development and profitability in the future. Drop of FDI in 1995 either means the beginning of this stage or existence of artificial, administrative barriers for investors.

Capital account improvements during 1994-1995 also resulted from declining trend in outflow of capital from Kazakhstan. Net others investment (**table 6.1**) indicates 142 mn USD capital flight in 1995, mostly in private sector. Comparing with 337 mn USD in 1994 it is a substantial improvement. Data on net others investment in FSU and ROW in 1994-1995 reveal declining capital outflow from Kazakhstan to FSU and capital inflow from ROW.

Overall balance of payments of Kazakhstan in 1994 and 1995 became negative amounting 469 mn USD and 440 mn USD, respectively. The small improvement in the balance of payments with ROW in 1995 did not compensate deterioration in the balance of payments with FSU countries (**table 6.1**). This deterioration partly resulted from 5-times drop in the position "errors and omissions" in the overall balance of payments, from 1423 mn USD in 1994 to 286 mn USD in 1995 (with respect to FSU). These data in "errors and omissions" for 1994-1995 indicate a decline in unclassified capital inflow from Russia and capital outflow to ROW countries. The scale of unclassified trade and/or capital movements is declining, together with a progress in foreign trade statistics and diminishing influence of administrative barriers in foreign trade in Kazakhstan. Liberal free markets, with clear and simple regulations act against illegal trade activities, making them unnecessary.

6.2. Foreign trade regime

Liberalization of the foreign trade regime in Kazakhstan had truly begun since the mid of 1993 when Kazakhstan government reached an agreement with IMF on STF. According to this agreement, foreign trade barriers were to be lowered and finally

eliminated. The amount of goods, which were subject to export quotas declined from 34 in December 1993 to 25 in February 1994, and 7 in May 1994. Import quotas have been cancelled in the end of 1993. The amount of goods which required export licenses lowered from 55 in the end of 1993 to 34 in May 1994. In May 1994 the list of goods which import was subject to licensing shortened to 8 products. Import taxes were ranging between 0.5% and 21%.

The decline in the value of interrepublican trade in 1993-1994 resulted in natural collapse of administrative trade arrangements descended from former Soviet Union. In the end of 1993 the amount of interrepublican trade sharply lowered, and the system of state orders (*goszakazy*), providing the fulfilment of the intergovernmental agreements, was replaced by a system of state needs (*gosnuzhdy*), which correspond more to market conditions and was based on contractual prices. However, at the same time, export taxes (varying from 1% to 30%) were imposed on 145 goods, of which domestic prices were lower than the world ones. Export taxes was to be paid in foreign currencies. In 1994, as domestic prices approached the world level, the average rate of export taxes was lowered to 7%, and tax was to be paid in tenge. Also, all exemptions from export and import taxes were removed. Foreign trade regime in Kazakhstan in the end of 1993 and in 1994 was more transparent, however not fully.

6.2.1. Registration of export contracts

In 1995 (third quarter) Kazakhstan government further liberalized foreign trade regime: all export quotas were cancelled; export and import licenses were required for 8 and 9 groups of goods, respectively³⁸ (Resolution of the Cabinet of Ministers from 20 July 1995 No. 1002); the monopoly on the export of strategic goods (which was in force since the mid of 1993, after the establishment of 13 state branch monopolies) was cancelled³⁹; the export of manufactured and agricultural products through the commodity exchange was expanding. However, together with further steps towards external trade liberalization, the Kazakhstan government introduced typical administrative barrier in trade _ registration of export contracts for some types of goods (19 groups of goods). The list of these goods can change reflecting preferences of some groups of producers or consumers, and every particular decision taken by bureaucrats has an immediate influence on economic situation of Kazakhstan firms. Besides, foreign investors managing former state enterprises in Kazakhstan are exempted from licensing and register regime, what is, of course, a method of attracting of foreign capital, but this is also a discriminatory practice towards Kazakhstan (state and private) firms.

The most typical indicator of administrative intervention in CEE and FSU economies is a protection of the agricultural sector _ a very influential group of interests, very effective in lobbying. In the beginning, import of chemicals for plants protection was not restricted by import licensing regime in Kazakhstan, but was incorporated to the document (Resolution of the Cabinet of Ministers from 20 July 1995, No. 1002) after few

³⁸ These lists were composed on the basis of national security (including armaments, explosives, radioactive materials, etc.), personal security (guns), and health (narcotics, medicines).

³⁹ At least in theory, because practice is somehow different. It is possible, that even after the influence of state branch monopolies was diminished, they still occupy a dominant positions in trade, because of their information superiority acquired in the past years. On the other hand, these informal barriers for small and big exporters, if exist, should be cancelled.

months as a supplement (Resolution of the Cabinet of Ministers from 13 September 1995, No. 1256). All around the world producers for and from agricultural sector try to restrict foreign competition, but in most market economies their power is diminishing together with the liberalization of markets.

6.2.2. Barter trade

Growing amount of barter contracts is not only a concern of Kazakstan government, but also many FSU countries. The beginnings of barter trade in all post-communist countries derive from the system of intergovernmental trade arrangements. The collapse of the Soviet Union and CMEA left state enterprises in post-communist countries cut from the network of mutual interdependence from supply as well demand sides. Additionally, persistent high inflation (steady depreciation of financial resources of enterprises) and obligatory surrender of (all or part) foreign currencies earnings for exporters in most FSU countries hindered currency payments in interrepublican and ROW trade. Barter trade soon became the easiest method of tax evasion and capital flight from FSU countries, including Kazakstan. It is worth to underline, that the reasons which determined the growth in barter trade lay in a lack of macroeconomic stabilization and liberalization of external trade in all FSU countries, also in Kazakstan.

The administrative ban on barter transactions is the quickest way to cancel this trade. Resolutions of the Cabinet of Ministers No.: 984 (from 17 July 1995) and 1015 (from 20 July) put a ban on barter in export as well import in Kazakstan. However, the enforcement of these resolutions was weakened very soon by the exception to these rules for barter operations related to agricultural production (Resolution of the Cabinet of Ministers from 1 August 1995, No. 1060), which imply a special attention of government for agricultural sector. Another example of the law dilution in Kazakstan is a Resolution No. 1200, from 29 August 1995, which add one more exception to the ban of barter trade _ Kazakstan producers were allowed to export their production to FSU countries and import an input from FSU countries for the process of their production.

This last exemption, again introduces differences in Kazakstan trade with FSU and ROW countries. It does not assist Kazakstan state and private enterprises in transition from the old system to a market economy in the long run. Under any circumstances, all over the world, firms always decide to choose the easiest way of trade. In that case, Kazakstan firms can choose the old, well-known partners from FSU countries, instead of more difficult in the beginning, but also more promising world network of cooperation. Reorientation of Kazakstan export, as well import from one dominant Russian market (or markets of FSU countries) to ROW markets consolidates, from economic point of view, the independence of the country⁴⁰. Kazakstan geographical position is similar to the Polish one, between two powerful states Russia and China (Poland is situated between Russia and Germany). Additionally Kazakstan is close to the fast growing markets of Arabs states, India and Pakistan. Stable political situation in Kazakstan, macroeconomic stabilization will promote foreign trade and foreign investments.

⁴⁰ All Central and Eastern European countries managed to switch their trade from FSU to ROW, mostly Western European countries. For example, in Poland, in 1995, less than 10% of trade turnovers were with FSU countries, comparing with more than 35% in 1989 [GUS, Foreign Trade of Poland, 1995]. Similar reorientation happened in the Czech Republic, Hungary, and Baltic countries.

6.2.3. Custom duties and excises

The system of custom duties in Kazakhstan is determined by political and economic agreements reached with Russia in 1994 and 1995 (see, Resolutions of the Cabinet of Ministers from 15 August 1995, No. 1124 and No. 1125).

In the third quarter of 1995 the system of custom duties in Kazakhstan consists of import duties, excises, and export duties. Import regime in Kazakhstan (Resolution of the Cabinet of Ministers from 15 August 1995, No. 1125) introduces import tariffs on 96 groups of goods _ from animals, agricultural produce, or foodstuffs, through light industry products, ferrous and non-ferrous metals and products, to electric and electronic equipment. The list of these goods is very detailed and import tariffs varied from 0% to even 30%(!) of custom value of goods within one group, what implies state trade protectionism towards not only branches of industry, but also particular enterprises and products.

There is a general tendency in Kazakhstan (opposite to CEE countries) to rise import tariffs of agricultural products and foodstuffs - on average by 5 percentage points, comparing to import tariffs from the beginning of 1995 (Resolution of the Cabinet of Ministers from 3 January 1995, No. 2011). Also, tariffs for means of transport were risen to a level of even 30-40% for cars and small buses, but the lowest import tariffs (5-10%) were levied on tractors for agricultural purposes. The positive factor is a generally low level of import tariffs on machines and equipment (5-15%), what allows replacement of used and old, energy consuming equipment of state, private, or privatized enterprises.

The level of excises in Kazakhstan on imported goods was, in the end of 1995, under negotiations with Russia. There is a broad understanding among Kazakhstan officials of the necessity and importance of low excises, especially on means of transport (cars, trucks, buses) or other non-Russian industry goods, which quality and prices are highly competitive with the Russian ones (and there are no domestic substitutes). If excises rise, Kazakhstan domestic consumers (individuals and firms) will pay more than their foreign competitors, or would be forced to buy products from Russia, Belarus, or other FSU countries. It should be mentioned here, that a free choice and equal access to all suppliers and buyers is a basic rule in a market economy. The economic premises are against rising excises, but the decisions are made by the politicians.

Export duties were levied on 23 groups of goods (Resolution of the Cabinet of Ministers from 15 August 1995, No. 1124), from agricultural produce and foodstuffs, mineral resources and products (e.g. ferrous and non-ferrous metals, oil), to cotton. The idea of export duties was rejected by all developing countries in Asia (from the very beginning of economic reforms), South America (economic collapse put an end of the idea of protectionism in late eighties), Western Europe and Central and East European countries under transition. In all these groups of countries, export-led growth was a cause of a fast recovery and growth in output (the latest successful examples: Poland, Czechia, Albania, and Estonia).

Any barriers on export of "strategic" or any other goods will not provide sufficient supply of these goods on domestic markets in the longer term, because producers of export-protected goods are reluctant to sell these goods on domestic markets at usually lower prices than the world ones. They often monopolistic position on domestic markets allow them to rise the prices without improvements in efficiency (if prices are flexible, without administrative constraints), or to demand budget subsidies (if prices are fixed by the authorities) in any, but finally always financial form (again without any changes in

efficiency). In both cases consumers (individuals and firms) loose as well as the whole economy of a country.

Kazakstan is a good example. State enterprises⁴¹ are not allowed to export the most marketable goods, because of administrative constraints. The demand on domestic markets, because of output decline, is rather weak, and domestic prices are lower than the world ones (like on other markets of FSU countries). The only possibility for enterprises to receive financial resources is selling on the world markets. However, these markets are less profitable because of export duties, which first, rise the prices of Kazakstan products, and second, lower incomes of Kazakstan enterprises (much less efficient than their competitors in developed countries). Lower incomes of firms mean lower level (or not as high as possible) of budget revenues (taxes), and export duties, in practice, do not compensate that. Besides, state enterprises are losing time, not being restructured.

The supporters of export duties often use an argument of anti-dumping procedures in developed countries. It is true, but these charges are effective only towards the state enterprises from post-communist countries, where one can easily find indirect state subsidies for exporters. After these enterprises were become private, all arguments vanished (cases of steel producers in Poland, or Czechia). On the contrary the Ukrainian (still) state exporters of ferrous products are under the anti-dumping investigation in European Union and USA.

6.2.4. Value added tax

The value added tax in Kazakstan is levied on import of all goods except ones from FSU countries. Also investment goods imported by foreign investors are exempted from VAT (first, investors pay VAT, and then Ministry of Finance return this tax back). In that respect the administrative regulations indirectly force state enterprises to trade with the firms from FSU countries. The dissolution of the former Soviet Union and natural collapse of economic ties among FSU countries is the best time for Kazakstan enterprises to turn to the world markets. Any artificial support by tax exemptions delay or diminish this chance, which will not last forever.

Fiscal aspects of the VAT collection and the dangerous practice of its decentralization were described in the chapter 2.

The process of formation of a custom union between Kazakstan, Russia, and Belarus, which begun on 20 January 1995 and is speeding up together with a political fight in Russia before the presidential elections has a serious consequences with respect to taxation in foreign trade. According the sign agreements (see below) VAT (but also excises) will be collected on the external borders of the countries belonging to a custom union. For Kazakstan, which is separated from European and Asian markets by Belarus and Russia, respectively, it means that VAT and excises levied on goods to Kazakstan will go to the budgets of these countries, and after some time should be transferred to Kazakstan central budget. Two problems arise. **First**, the proper distinguishing of the countries-recipients of VAT revenues takes time which in inflationary environment existing in FSU countries is very important and has its own price. Besides, central budget problems in Belarus or Russia may be the first barrier for due to Kazakstan taxes. The old

⁴¹ Privatized firms, sold to foreign investors or under their management, operate under free market conditions, selling their production on the world markets.

Soviet system was also known with the low efficiency of the bureaucratic central administration. **Second** problem is connected with a convertibility of a custom union countries' currencies. Since VAT is paid in local, internally convertible currencies (at least in Russia, Kazakstan, and Kyrgyzstan), they should be exchanged using real market rates. The methods and places (e.g. currency exchange markets) of doing it were not specified in the agreement.

6.2.5. Currency market

Beginning from 1 January 1994, half of export earnings of Kazakstan enterprises was subject to obligatory surrender to the National Bank of Kazakstan (NBK) at the auction rate of the Kazakstan Interbank Currency and Stock Exchange (KICSE). Establishment of KICSE and introduction of market determined auction rate was a very important step in removing hidden taxation of export by artificially appreciated exchange rate of Kazakstan currency. Together with macroeconomic stabilization it allows to expect growing confidence to national currency unit (reverse of dollarization of Kazakstan economy) and higher level of repatriation of export earnings (higher supply of foreign currencies on domestic market) by the Kazakstan enterprises (state as well private ones) resulted in a natural appreciation of tenge. Besides, higher confidence in the stable exchange rate of tenge will increase monetization of Kazakstan economy (see - chapter 1).

Proper functioning of the independent KICSE is of great interest of Kazakstan economy (see above). Law fundamentals of KICSE (closed stock company, free access to the currency market for domestic and foreign banks, arbitrage commission, and possibility to operate abroad through corresponding accounts) are transparent and equal for all participants. Turnover at KICSE is still not significant (about 8 mn US dollars per day in the third quarter of 1995), however this amount represents about 70% of total foreign currencies turnover in Kazakstan (according to KICSE officials) what is an achievement taking into account rather short period of independent existence of KICSE (from the end of 1993). The rest (about 30%) of foreign currencies turnover in Kazakstan has place in the interbank currency market. Foreign investors are allowed to sell currencies either on interbank or KICSE market, making a choice between slightly better exchange rate (about few percentage points) and reliability of transactions. As practice shows most of them decide to choose the last possibility.

Foreign trade liberalization in Kazakstan should result in a bigger supply of foreign currencies in the domestic market, unless future changes in currency regime or trade with FSU countries disturb that (see above). Payments in trade with FSU countries, after introduction of the administrative ban on barter transactions (see above), should be done in foreign or national currencies at market determined exchange rates. Any return to intergovernmental trade agreements in direct (e.g., by signing, in fact, barter contracts on governmental level) or indirect way (e.g., by introducing tax relief in FSU trade) will undermine the Kazakstan currency market, which could be the biggest currency and stock exchange market in Central Asia, taking into account economic potential of the Republic of Kazakstan and its location.

6.3. Regional integration and a custom union

On 20 January 1995 Kazakstan entered a Custom Union Agreement with Russia and Belarus. One year earlier, on 10 and 16 January 1994, Kazakstan signed an agreement on the Unified Economic Zone (Edinaya Ekonomicheskaya Zona) with Uzbekistan and

Kyrgyzstan, respectively. This last document was left on a paper, in spite of the establishment of common intergovernmental institutions like, Interstate Council of the Republic of Kazakhstan, Kyrgyz Republic and the Republic of Uzbekistan, or Central Asian Bank for Cooperation and Development.

The formation of a Custom Union has different political and especially economic consequences for all countries involved. There are two stages in implementations of a Custom Union: first stage - harmonization of tariff regulations between member countries, and second stage - establishment of a common tariff wall for trade with ROW countries.

Summing up, the functioning of the Custom Union is connected, from the perspective of Kazakhstan, with three main problems:

1. Belarus, Russia, Kazakhstan, and Kyrgyzstan are very different with respect to pace and depth of economic reforms. Kazakhstan, in 1995, made a serious step ahead in economic transformation, whereas Russia stopped, because of political fight. Kyrgyzstan is reforming very fast since 1993, on the contrary to Belarus, where real reforms never happened. The pace of reforms in Kazakhstan should and must not slow down in the nearest years to reach a break-through point and begin recovery and growth of GDP. For that purpose, Kazakhstan need an open and free trade relations with all the countries, especially developed ones in Europe, Asia, and America. Custom Union will halt these free choices for Kazakhstan producers and consumers⁴². There is a real danger that Russia (with a support from Belarus) will force its own preferences in trade structure and directions. Practice of Russian trade policy shows that liberalization of export barriers is replaced by import constraints which are also against (like export barriers earlier) GATT/WTO rules. As a consequence, Custom Union countries can be excluded from the world trade relations, as it was during the old Soviet times.
2. Custom Union, possesses common external borders, what means the erection of a common tariff wall around the members of the union. The tax revenues (VAT and excises) will be collected on the borders of the member states and transferred to other countries (see above). Countries of the European Union were implementing such a system by 20 years, because of proper organization and coordination of tax and custom services. Kazakhstan (and Kyrgyzstan) being geographically isolated from European and North American markets can expect a lost of central budget revenues from taxes (VAT and excises) after implementation of the Union.
3. Kazakhstan comparative advantage neither has yet been established, nor is very different from the Russian one (at least in some important fields). Kazakhstan is a competitor to Russia on the world markets of resources (oil, gas, ferrous and non-ferrous metals). Example with a halt on export of Kazakhstan oil is a serious sign. Additionally, Russian manufactured goods (highly processed goods) were and are being push out from the world markets. Custom Union with its import barriers creates a favorable environment for the Russian exporters. The idea of financial-industry (or rather industry-financial) groups is strongly related to that. Hence, Kazakhstan national interests differ from the Russian ones.

⁴² The dispute between Kazakhstan and Russia on excises on cars in 1995 is an example of the different preferences.

Kazakstan can (and should) develop regional cooperation with Uzbekistan, Kyrgyzstan, Russia, and Tadjikistan, based on microeconomic needs and relations, but not administrative decisions.

6.4. Recommendations

Kazakstan begun liberalization of foreign trade regime later than Russia, however in the end of 1995 Kazakstan trade seems to be more liberal than Russian ones. But comparing with the world standards (GATT/WTO member states) is it much to be done. The most important are:

1. Kazakstan still need a simple and transparent trade regime. It is necessary to cancel export taxes and other administrative export barriers (licenses, registration). Import taxes should not be higher than 20%, and transparent within one group of goods.
2. There should be no exceptions from the trade regime for "strategic" enterprises or branches in economy, neither because of the ownership structure (state, privatized, or newly private), nor direction of trade relations (FSU versus ROW countries). All foreign trade subjects should be equal.
3. Foreign trade payments should be made in fully convertible currencies, or national currencies using market determined exchange rates. Kazakstan government should promote market (horizontal) system of foreign trade transactions and payments, instead of system based on intergovernmental agreements.
4. Barter trade should be banned without any exceptions, either permanent or temporal (for example, because of harvests).
5. The development of Kazakstan trade with ROW countries (see — **table 6.1** and **6.4**) denies the myth of a structural dependence of FSU countries (enterprises) towards Russia (enterprises). The transition period is the best time to reorganize and reorient Kazakstan trade. It is possible, as Poland, Czechia, Hungary, and the Baltic states example show.
6. The Kazakstan government should not play a role of a guarantor of foreign trade transactions. This is commercial banks business. States, especially poorer ones, should only facilitate movement of goods, capitals, and labor.
7. Temporary problems with a separations from developed markets do not change the fact, that Kazakstan is situated in a favorable geographic location. The undeveloped infrastructures, because of the lack of investments in the past created a transport barrier. But this can be reversed, especially in a situation of very rich mineral resources in Kazakstan.

Table 6.1: Balance of Payments of Kazakstan, 1994-1995 (in mn US dollars)

Item	All		FSU		ROW	
	1994	1995*	1994	1995*	1994	1995*
Current account	-904.76	-360.69	-348.20	-167.50	-556.56	-193.19
Balance of trade	-919.60	-58.80	-517.70	-218.80	-401.90	160.00
Export	3285.30	4719.00	1958.40	2610.20	1326.90	2108.80
Import	-4204.90	-4777.80	-2476.10	-2829.00	-1728.80	-1948.80
Services. net	-82.36	-142.50	168.50	48.90	-250.86	-191.40
Transfers	92.70	23.20	1.00	0.60	96.20	22.60
Capital account	-754.91	-364.98	-1674.10	-777.30	919.19	412.32
Capital transfers	-1065.4	-732.3	-791.1	-431.7	-274.3	-300.6
Net foreign investment	635.00	478.90	3.00	2.80	632.00	476.10
Net short-term investment	12.60	30.00	-2.40	0.00	15.00	30.00
Net others investment	-337.11	-141.58	-883.60	-348.40	546.49	206.82
Errors and omissions	1190.72	285.38	1422.80	285.80	-232.08	-0.42
Balance of Payments	-468.95	-440.29	-599.50	-659.00	130.55	218.71

*Forecast for the whole year 1995 based on data after nine months of 1995

Sources: National Bank of the Republic of Kazakstan

Table 6.2: Structure of export from Kazakstan, 1994-1995 in mn US dollars and as a percentage share)

Group of products	1994	%	1995*	%
Export	3375.30	100.00	4650.00	100.00
Oil	788.90	23.30	1274.00	27.40
Benzine	22.10	0.60	27.90	0.60
Diesel fuel	51.70	1.50	69.00	1.50
Mazut	29.40	0.90	41.00	0.90
Copper	387.60	11.50	614.00	13.20
Zinc	95.30	2.80	140.00	3.00
Lead	30.70	0.90	41.00	0.90
Ferrous alloys	215.30	6.40	440.00	9.60
Ferrous metals rolling	319.30	9.40	590.00	13.10
Chrome ore	77.10	2.30	93.00	2.30
Phosphorus	29.70	0.90	23.00	0.50
Fertilisers	19.40	0.60	27.00	0.60
Electric energy	146.90	4.30	116.00	2.50
Others	1161.90	34.60	1154.10	23.90

*Forecast for the whole year 1995 based on data after nine months of 1995

Sources: Ministry of Industry and Trade, Ministry of Economy

Table 6.2a: Structure of export from Kazakstan to Russia in 1994 and the first half of 1995
(in mn US dollars)

Group of products	1994	%	1995 1 half	%
Export	1582.90	100.00	829.90	100.00
Foodstuffs and produce	101.20	6.40	123.10	14.80
Grain	29.40	1.90	56.10	6.80
Energy resources	578.10	36.50	244.40	29.40
Oil and oil products	492.80	31.10	187.90	22.60
Chemical products	223.50	14.10	103.60	12.50
Light industry products	18.80	1.20	8.00	1.00
Skins	4.80	0.30	2.10	0.30
Wool	3.40	0.20	0.80	0.10
Cotton	4.90	0.30	4.30	0.50
Chemical fibbers	2.50	0.20	1.30	0.20
Metals	386.10	24.40	257.80	31.10
Ferrous metals	267.20	16.90	154.70	18.60
Copper	82.30	5.20	67.80	8.20
Zinc	18.10	1.10	19.70	2.40
Lead	16.20	1.00	9.20	1.10
Machines, installations, and electric equipment	69.40	4.40	25.40	3.10
Transport means	20.20	1.30	7.50	0.90
Electric energy	146.60	9.30	86.40	10.40

Sources: Ministry of Economy

Table 6.3: Structure of import to Kazakstan, 1994-1995

Group of products	1994	%	1995*	%
Import	3805.60	100.00	3150.00	100.00
Gas	440.00	11.60	275.00	16.80
Machines and installations	445.70	11.70	529.00	16.80
Electric equipment	329.00	8.60	297.00	9.40
Chemical products	348.90	9.20	312.00	9.90
Foodstuffs	358.80	9.40	391.00	12.40
Energy resources	273.50	7.10	271.00	8.60
Electric energy	582.60	15.30	244.00	7.70
Transport vehicles	271.70	7.10	246.00	7.80
Light industry products	256.90	6.70	180.00	5.60
Others	498.50	14.00	405.00	13.10

*Forecast for the whole year 1995 based on data after nine months of 1995

Sources: Ministry of Industry and Trade, Ministry of Economy

Table 6.3a: Structure of import to Kazakstan from Russia

Item	1994	%	1995 1 half	%
Import	1399.20	100.00	648.50	100.00
Foodstuffs	44.30	2.30	36.50	5.70
Sugar	9.40	0.70	11.70	1.80
Milk and products	5.30	0.40	2.50	0.40
Fat and Butter	3.50	0.20	3.20	0.50
Alcoholic and non-alcoholic beverages	2.60	0.20	2.80	0.40
Oil and oil products	232.70	16.60	178.70	27.50
Electric energy	290.40	20.80	134.90	20.80
Gas	8.30	0.60	6.10	0.90
Chemical products	55.90	4.00	42.60	6.50
Rubber	32.60	2.30	17.90	2.80
Explosives	5.90	0.40	6.40	2.80
Wood and paper products	61.70	4.40	36.80	5.60
Stones and gypsum products	1.40	0.10	3.80	0.60
Glass products	5.50	0.40	4.00	0.60
Ferrous metals	146.70	10.50	72.00	11.10
Copper	2.40	0.20	1.50	0.20
Aluminium	7.40	0.50	3.30	0.50
Lead	1.00	0.10	4.80	0.70
Tin	4.80	0.30	5.10	0.80
Tools	9.10	0.70	1.70	0.30
Non-precious metals products	20.00	1.40	2.50	0.40
Electric and mechanical installations	214.30	15.30	87.80	13.60
Transport vehicles	166.70	11.90	59.00	9.10

Sources: Ministry of Economy

Table 6.4: Main ten trade partners of Kazakstan in the first half of 1995 (in mln US dollars)

Country	Trade turnover	Export		Import	
		Total	Barter	Total	Barter
Total	4416.5	2554.4	661.3	1862.1	303.7
Russia	1822.7	1037.0	351.8	785.7	202.5
the Netherlands	289.5	270.5	24.2	19.1	0.0
Germany	225.2	93.5	36.8	131.8	3.0
Switzerland	174.8	126.1	122.6	48.7	2.5
China	174.7	151.3	80.7	23.4	17.3
Turkmenistan	167.0	34.9	4.2	132.1	0.3
Uzbekistan	164.7	95.3	19.6	69.3	17.3
Great Britain	126.5	73.4	1.5	53.1	1.0
Turkey	105.6	37.4	14.5	68.2	4.9
Ukraine	97.2	46.8	8.1	50.4	15.1

Sources: Ministry of Economy

Summary (Marek Dabrowski)

Kazakhstan initiated market economic reforms with some delay compared to the Baltic states, Moldova, Kyrgyzstan, and, with regard to some parameters, later than Russia. However, starting from late 1994 the process of market transition speeded up greatly, and significant progress was achieved practically in all spheres of economic reforms. At present, Kazakhstan may be considered one of the leaders among CIS countries that are carrying out economic reforms. It concerns, first of all, the achieved level of macroeconomic stabilization and liberalization of the economy.

At the same time, it's necessary to bear in mind that only the first stage of transition has been completed, and many processes are still under way e.g. privatization, speed and results of which will determine possibilities for efficiency growth at the micro level; positive structural changes in the Kazakhstan's economy; and alleviation of enterprises' pressure to monetary and fiscal policy. It is the agriculture where privatization is a crucial pre-requisite for restructuring and introduction of market rules into economic behavior. However, both technical and social characteristics of the sector, and political conditions (influential kolkhoz lobby) are making quick privatization more difficult.

Since privatization was the subject of a separate UNDP project with participation of an expert team under the guidance of Professor Leszek Balcerowicz, this report had no intention of comprehensive analysis and recommendations on the progress of privatization in the Republic of Kazakhstan.

Privatization and related industrial restructuring are not the only component of necessary macroeconomic policy reforms. Among the wide range of needed activities the following should be noted:

1. Creating favorable climate for private investments (domestic and foreign) and private entrepreneurship which could in future absorb excessive workforce disengaged as a result of closing inefficient enterprises, excessive employment reduction in many companies, and "optimization" of the cultural and social services networks and other budgetary sphere facilities. In order to create good business climate, especially for foreign investors, a number of measures and activities are necessary in different spheres of regulating the economy and public life, including:

- a. introduction of simplified procedures for registration of economic activities without obtaining any required authorizations;
- b. stable, transparent and concrete taxation rules which are more important than special tax benefits; in Chapter 2 we proposed specific mechanisms for improvement of the tax system in order to make it more favorable for private business development;
- c. abolition of many unclear administrative instructions and practices that pave the way for administrative arbitrariness and corruption (e. g. export contracts registration, traffic police posts in the roads, registration requirements for foreigners and many others);
- d. adoption of the national treatment regime for foreign investors;
- e. simplification of regulatory procedures concerning construction law, territory planning rules, social, sanitary and fire safety law, etc.;
- f. simplification of border and customs control for people and goods' movement.

Further task in implementation of this UNDP project is to carry out separate expertise on the issue of favorable foreign investment attraction policy.

2. Financial sector and capital market restructuring and development. It affects not only amount of future savings and opportunities for efficient utilization of existing investment resources, but also chances to attract larger amounts of foreign investment. In Chapter 4 of this report we discussed more detailly situation in the banking system of Kazakhstan and prospects of its sanitation and privatization. The problems related to commercial insurance and securities market development need separate expertise.

3. Free migration of workforce between enterprises, industries, professions and regions are a major factor that determines speed of economic transition in Kazakhstan, its growth prospects, and possibilities to resolve such painful social problems as poverty and unemployment. Creation of a flexible labor market requires quick revision of labor and social law (from the perspective of removing labor mobility barriers), improvement of the housing market, solving the problem of social assets belonging to the state-owned enterprises and budgetary sphere institutions, creation of a modern educational and labor retraining system.

Though during recent 1.5 years Kazakhstan achieved significant success in inflation rate reduction, the macroeconomic stabilization task has not been completed. It's necessary to note that macroeconomic stabilization cannot be achieved once and forever. In case of Kazakhstan, the way to relative stability (i. e. one-digit inflation rate) is still very long. The most important barrier in this way are the budget balance problems. As we proved in Chapter 1, it is budget deficit that is the major source of excessive money emission, a "bomb" which under unfavorable circumstances can undermine relatively vulnerable stabilization achieved.

Even a superficial glance at the existing budget problems shows that prospects of overcoming fiscal crisis in nearest years are very difficult.

The share of consolidated budget revenues in GDP has reduced down to less than 20%, and considering all factors it can be reduced further in nearest future, or at best it will remain at the present level. The reasons may be found in the continuing crisis of the state-owned industrial sector, in vigorous development of small-scale private firms and in decreasing enterprises' profitability as a result of inflation rate reduction (elimination of inflationary profits), real appreciation of Tenge and growing competition. The new Tax Code and improvement of the tax administration can partially counteract it, but more probably will not lead to full overcoming of this trend within two-three coming years.

In any case, Kazakhstan will remain for many years a country with relatively low tax potential because of low per capita GDP, large share of agriculture, small-scale trade and services in the GDP structure and the role of natural economy. In its turn, it means the need for stable, but not temporary reduction of state expenses and state liabilities, especially in social sphere and socio-cultural services (far below the standards inherited from the Soviet economy). This process will be very painful both from social and economic points of view, but necessary.

The pension system may prove to be the most "explosive" chain in the public finance system. In Chapter 3 we pointed out the elements of the current pension system in Kazakhstan that can become the source of a serious financial crisis in the near future.

The extremely low demand for money is in our view one of the two main problems of monetary policy, apart from too extensive financing fiscal and quasi-fiscal deficit by

the NBK. In Chapter 1 we proposed serious changes in orientation of the monetary and exchange rate policy in order to improve trust in Tenge in the nearest future.

A separate group of economic and political issues is related to Kazakstan's participation in the Customs Union with Russia, Belarus and Kyrgyzstan. We fully appreciate economic and political benefits of free movement of goods, people and capital, especially between countries that have long tradition of co-existence, but at the same time we doubt in the effectiveness of the customs union concept, and still more - of the payment union concept. In our opinion, creation of the Customs Union at the present stage is premature since there are significant differences in the level of economic development and speed of market reforms of the Union member states. Under the circumstances of free convertible national currencies, we doubt the need for the Payment Union. In our opinion, in this situation the most optimal solution from the economic point of view is to create free trade zones. More detailed arguments in this area are discussed in Chapter 6 and in separate working papers.