Chapter 2

Macroeconomic context, public governance and business environment in Kazakhstan

This chapter sets out the macroeconomic context for the review. It describes the main macroeconomic trends that have marked the life of Kazakhstan after its independence in 1991, analyses the main challenges for the development of the competitiveness of Kazakhstan, points out the efforts required in order to address those specific concerns, and scrutinises the main indicators concerning the quality of the institutions and the business environment.

The economy of Kazakhstan is characterised by three main factors, which set this country apart from most OECD countries:

- resource wealth,
- remote location, and
- dispersed settlement (lack of agglomeration).

These three features largely define the character of the country and present specific challenges to its development. This chapter will highlight the problems that these factors present for the promotion of the competitiveness of Kazakhstan and point to the importance of institutions, and hence to the presence of sound regulatory processes and tools, for the sustainable development of the country.

This chapter will suggest that if diversification is central to any sustainable development strategy for Kazakhstan, the emphasis should be on fostering the emergence of new activities and not on top-down industrialisation policies. As a matter of fact, although diversification rarely takes place without significant policy intervention (Hausman and Rodrik, 2003), interventionist policies have often failed to deliver when they have translated into a pick-and-choose exercise. The experience of other countries has shown that diversification efforts are likely to involve a great deal of trial-and-error. Their outcomes cannot be determined *ex ante*. Thus, policies to improve the overall business environment, and in particular those favouring market entry and competition, are of crucial importance in order to provide a level playing field for enterprises.

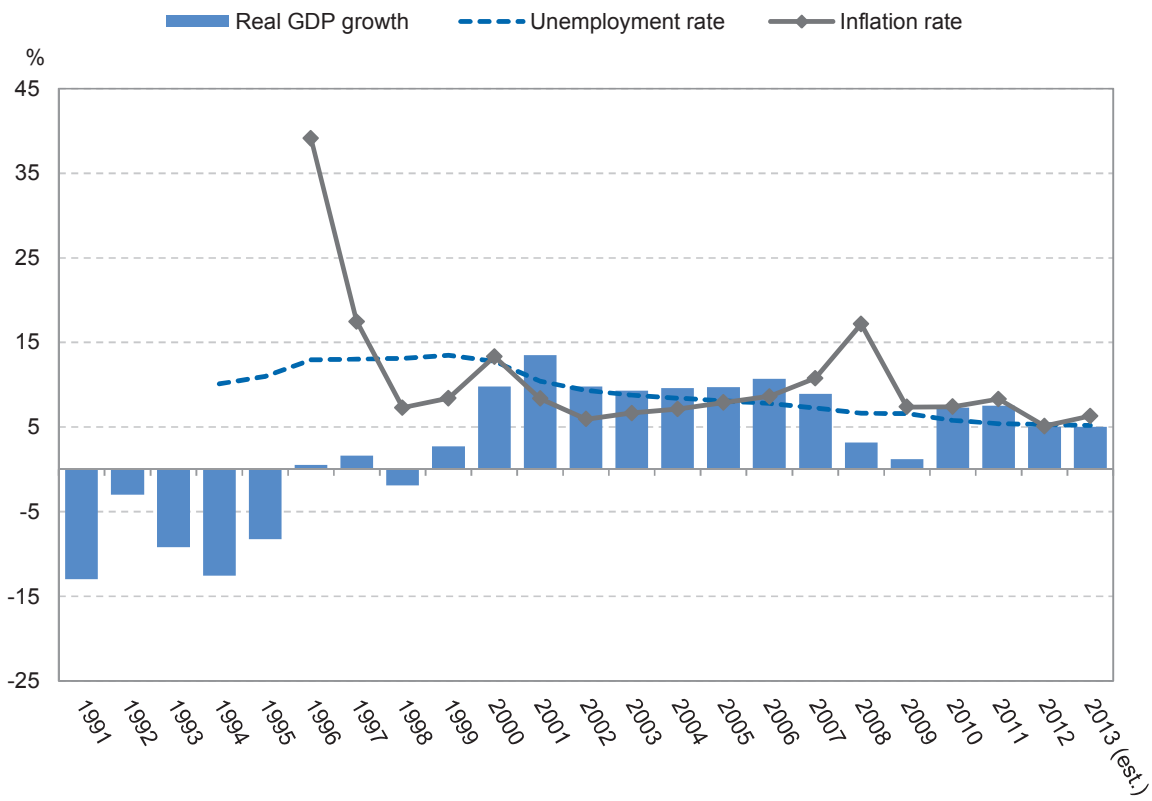
In order to explore the link between the quality of institutions and the definition of a sound trajectory of development, this chapter will first of all describe the main macroeconomic trends that have marked the life of this country after its independence in 1991. In doing so, it will take into account the achievements obtained in terms of poverty reduction and education and briefly mention some of the main policy interventions of the authorities. It will then analyse the three main challenges for the development of the competitiveness of Kazakhstan defined at the beginning of this section and point out the efforts required in order to address those specific concerns. Finally, this chapter will scrutinise the main indicators concerning the quality of the institutions and the business environment in order to indicate the main achievements which have been obtained in the last few years, but also the areas of reform that will need more attention in the future.

Macroeconomic trends after 1991

Kazakhstan became an independent country in December 1991, following the dissolution of the Soviet Union. The disruption of the Soviet system disrupted supply chains and created shortages of inputs and loss of markets for many enterprises. As a result, between 1992 and 1995, the economy of Kazakhstan registered a severe collapse, and real GDP dropped by more than 40% on the official numbers. The situation started changing in 1996, but it was not until the beginning of the 2000s that the country registered stable GDP growth. In particular, in 1999, considerable exchange rate depreciation increased the domestic profitability of oil exports and favoured the

accumulation of increased budget resources into the National Fund of the Republic of Kazakhstan, which was used as a buffer to counterweight the volatility of oil prices. Strong foreign investment inflows, high oil and commodity prices and conservative fiscal policies allowed Kazakhstan to achieve economic stability and stunning growth. Real GDP growth exceeded 10% per year between 2000 and 2007 (CAGR, Compound Annual Growth Rate), one of the highest growth rates in the world (Figure 2.1).

Figure 2.1. Main economic indicators, 1991-2014



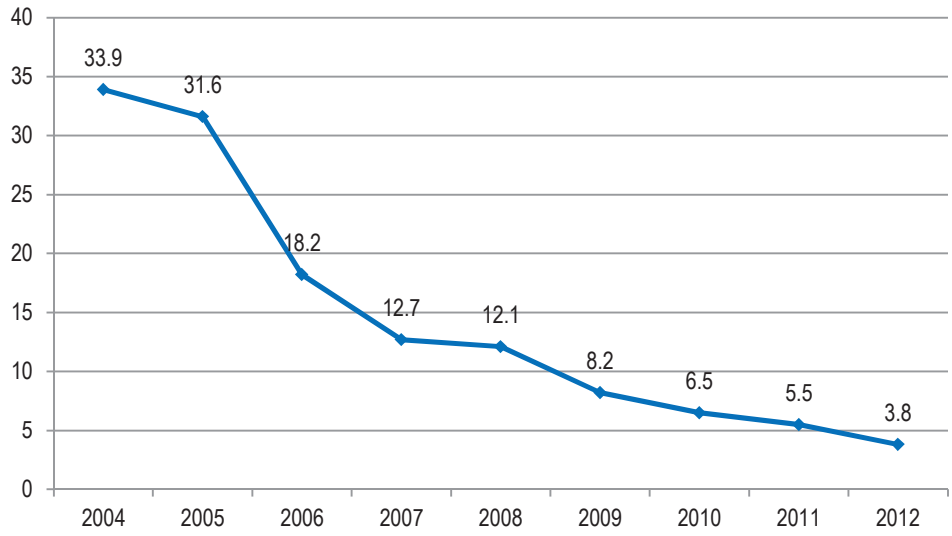
Source: Ministry of Economy of the Republic Kazakhstan, "Основные социально-экономические показатели", (Main socio-economic indicators), www.economy.kz/region/spravka/pokazateli/index.php/; International Monetary Fund (2014), *World Economic Outlook: Recovery Strengthens, Remains Uneven*, April.

However, in 2007, a real estate bubble burst, prompting the authorities to use the National Fund to bail out the banks and to finance a stimulus package. The intervention, launched in late 2008, pledged USD 10 billion (the equivalent of the 9.5% of GDP), and succeeded in stimulating the economy without raising inflation or accumulating public debt. As a result, while GDP growth dropped to about 1.2% in 2009, it quickly rebounded in 2010, and real GDP grew at a compound average annual growth rate of just over 6.1% in 2010-13. This achievement was remarkable given that, in the meantime, oil fell sharply in 2008-09 and then, after recovering, largely stabilised from 2011.

The social situation also improved considerably after 1999. Rapid output growth resulted in increased average incomes and reduced poverty. The percentage of the population living below the national poverty line dropped from almost 34% in 2004 to 3.8% in 2012 (Figure 2.2), while per capita GDP, on a purchasing-power-parity base, rose

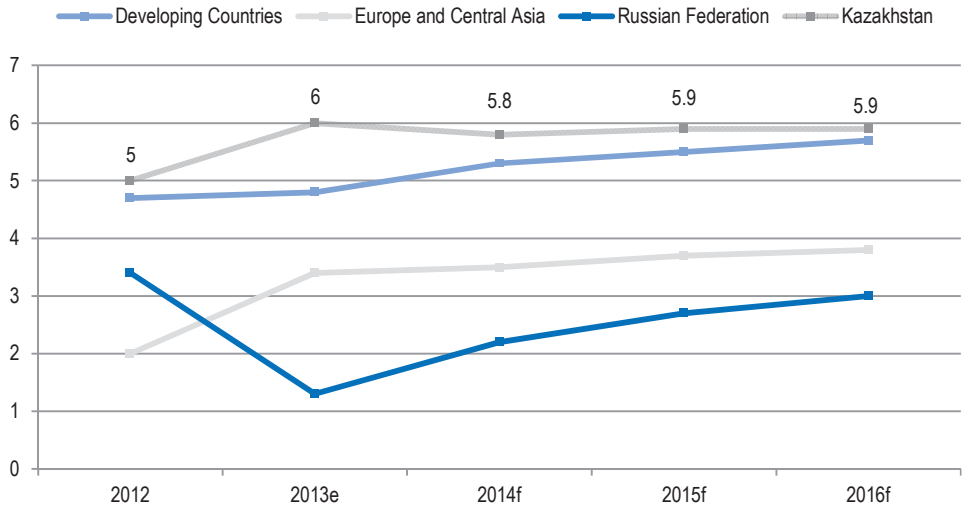
in the same period from 7 734 USD to 13 525 USD (IMF, 2013). Total unemployment was also reduced from 8.4% in 2004 to 5.3% in 2012 and it is expected to remain largely stable in the next few years (*ibid*, 2013). Education has also been a main concern for national authorities. In 2009, Kazakhstan ranked first on UNESCO's "Education for All Development Index" by achieving near-universal levels of primary education, adult literacy and gender parity. These results have reflected Kazakhstan's efforts of expanding pre-school access and free, compulsory secondary education. For the next ten years, Kazakhstan has announced further major reforms across all education levels.

Figure 2.2. Poverty headcount ratio at national poverty line



Source: OECD elaboration on World Bank (2014c), *World Development Indicators database*, http://data.worldbank.org/indicator/SI.POV.NAHC/countries/KZ?display=graph.

Figure 2.3. GDP growth (%)



Notes: e= estimate; f=forecast.

Source: World Bank (2014c), *World Development Indicators database*.

Kazakhstan is now in the group of upper-middle income countries and, with an economic growth projected to remain well above 5% per year on average over the next few years (Figure 2.3), it will rapidly turn into a high-income country. The new "Kazakhstan, 2050" strategy emphasises the diversification of the economy through improved industrialisation, infrastructure development and investment in human capital. This is likely to be an important turning point for Kazakhstan, which aims to become one of the 30 most developed countries in the world by the middle of this century. However, to succeed in their objective, national authorities have to address the three main challenges mentioned at the beginning of this chapter.

The three main challenges to competiveness

Resource wealth

The availability of abundant resources, especially minerals such as oil, gas, copper and gold are certainly an important source of revenue for Kazakhstan. In 2010, resource extraction alone accounted for the 20% of the GDP (Table 2.1). The oil and gas industry will most likely continue to be the main driver of development in the medium-to-long term. According to the BP Statistical Review of World Energy 2013, Kazakhstan accounts for 2% of world crude oil production and 1.8% of world proven reserves and for the 0.6% of world gas production (0.7% of world proved oil reserves).

Table 2.1. Contribution to GDP by sector (%)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Agriculture	8.11	8.72	8.00	7.86	7.12	6.37	5.50	5.66	5.32	6.15	4.51
Industry	32.60	30.67	29.47	29.09	29.29	29.79	29.55	28.29	32.16	30.54	32.90
Resource extraction	13.04	11.43	12.12	12.09	13.62	15.79	16.12	15.06	18.71	17.85	19.48
Processing industries	16.50	16.45	14.50	14.22	13.31	12.04	11.63	11.49	11.77	10.87	11.32
Utilities	3.06	2.80	2.86	2.78	2.36	1.95	1.80	1.74	1.68	1.82	2.10
Construction	5.18	5.47	6.34	5.99	6.06	7.84	9.80	9.44	8.09	7.89	7.70
Pub. administration	2.34	2.02	1.97	1.87	2.17	2.08	1.87	1.94	1.70	2.05	2.09
Education	3.70	3.64	3.48	3.46	3.73	3.47	3.15	3.26	2.82	3.24	3.23
Health & social	2.02	2.10	2.05	1.81	1.93	1.71	1.55	1.66	1.48	1.79	1.73

Source: OECD elaboration on data of the Agency for Statistics of the Republic of Kazakhstan.

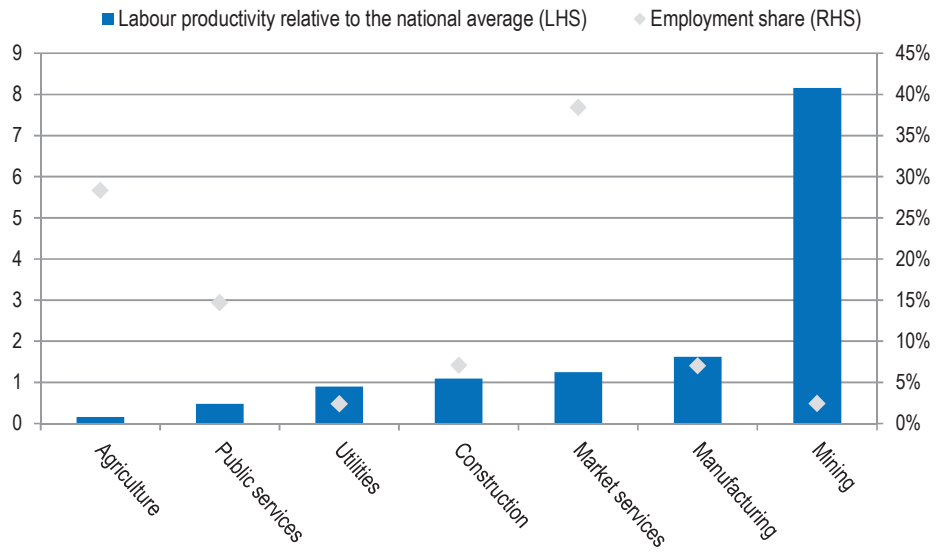
Metals are the other mainstay of the economy. According to InvestKazakhstan (2012), the state investment promotion agency, Kazakhstan in 2012 was the world's leading producer of uranium (since 2009), ranking third for titanium, seventh for zinc, eighth for lead, 13th for iron ore and 15th for copper. On the whole, the mining industry accounts for 30% of total export earnings with almost 80% of the mined and processed ore being exported. Hydrocarbons and metals together constituted over 85% of exports in 2013.

Despite the widespread discussion in the economic literature about a possible "resource curse", the evidence suggests that resource-rich countries do, other things being equal, have higher levels of GDP per capita (see in particular Wright and Czelusta, 2004, and World Bank, 2014). Countries like Norway, Australia and Canada, at least, have managed to escape the resource curse, such as it may be. Moreover, a growing theme in

the literature suggests that the resource curse is a political economy phenomenon, often linked to institutions, rather than an economic problem per se (Ross, 1999; Tompson, 2005; Dunning; 2008). The economic challenges are, for the most part, well understood – by policy makers in resource-rich countries, as well as academic researchers – and they are things that policy can, in principle, address (Ahrend, 2006). The curse, if it exists, arises as a result of political economy factors that may bias governments against making the right policy choices.

Nevertheless, Kazakhstan's rich resource endowments entail certain problems that policy makers must address. First, the domestic economy and, in particular, the state budget are vulnerable to commodity price volatility. The capacity to buffer the economy against commodity price cycles is critical to ensuring long-term development. In this respect, Kazakhstan's authorities have performed rather well: fiscal policy has been very prudent and resource windfalls have been saved. Secondly, the resource-extraction sector is not a good source of job opportunities, as it is highly capital-intensive and employs few people. In 2010, only a little more than 2% of the total population worked in resource extraction (which, as noted above, accounts for the 20% of GDP), while agriculture (which generates 4.5% of GDP) accounted for 28% of employment, market services 38% and public services the 15%. As is clear from Figure 2.4, a large share of employment is concentrated in relatively low productivity activities, while productivity in resource extraction is roughly eight times the national average.

Figure 2.4. Employment share and labour productivity by sector in 2010



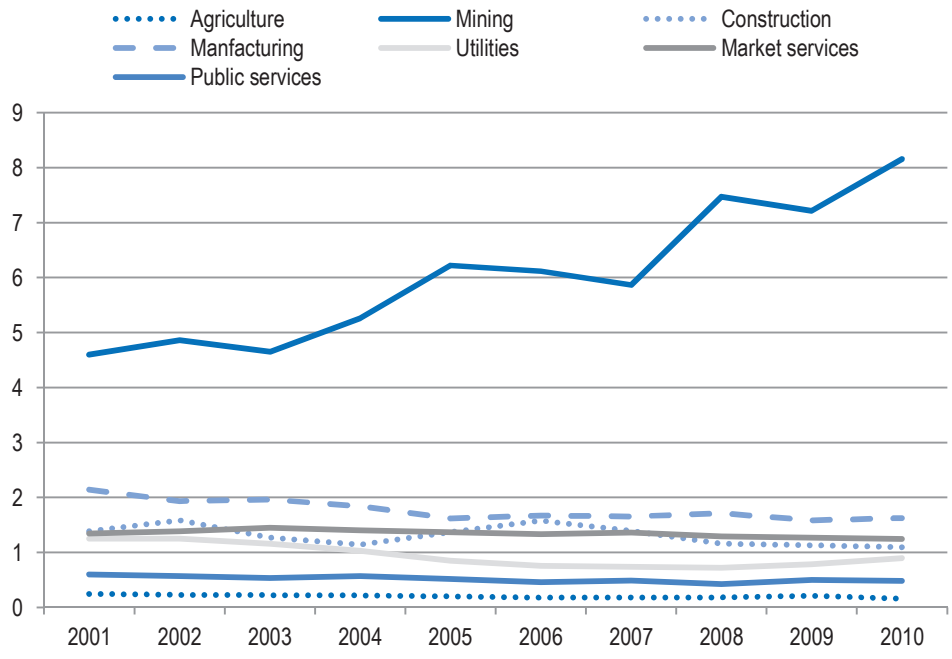
Note: National productivity average=1. Labour productivity relative to the national average on the Left Hand Scale (LHS) and Employment share on the Right Hand Scale (RHS).

Source: OECD elaboration on Ministry of Economy of the Republic Kazakhstan, "Main socio-economic indicators", www.economy.kz/region/spravka/pokazateli/index.php/.

The risk is of having an oil and mining sector, with a small number of extremely high-productivity jobs, and a set of high-value business services connected to it, alongside a large mass of low productivity sectors dominating the rest of economy. As is

clear from Figure 2.5, this inter-sectoral productivity dispersion is increasing rapidly.[1] In 2010, value added per Kazakh worker stood at 17 000 USD, while the average in developed countries was 90 000 USD. Farm workers are even less productive. In the same year, value added in agriculture and forestry amounted to USD 3 000, compared to an average of USD 50 000-70 000 in developed countries.[2]

Figure 2.5. Labour productivity relative to the national average in 2010 (national average=1)



Source: OECD elaboration on data on Ministry of Economy of the Republic Kazakhstan, "Main socio-economic indicators", www.economy.kz/region/spravka/pokazateli/index.php/.

In this context, the government realises that it has to foster restructuring in existing non-resource tradable sectors and the emergence of new activities in order to attain higher rates of overall productivity. Only by generating a wider range of high-productivity employment opportunities can it hope to offer the great mass of its citizens the quality of life to which they aspire. In April 2011, it launched "Productivity 2020", a USD 1 billion programme aimed at supporting innovative industrial development. The main focus is on assisting large and medium-sized companies in modernizing existing production facilities and managerial processes and, where appropriate, developing new facilities. Target indicators of the programme include a 50% increase on 2011 levels of labour productivity by 2015 and a doubling of labour productivity by 2020.

However, resource wealth further complicates the business of diversification, in at least two ways. As is well known, the presence of a large and highly profitable resource-extraction sector can complicate life for producers in non-resource tradables. This is the so called "Dutch disease", a term which was coined in connection with the Netherlands' development of natural gas deposits in the 1970s and which usually refers to a situation in which a country suddenly discovers large natural resources. The export of those resources boosts the equilibrium exchange rate and puts pressure on the competitiveness of the other tradable sectors of the economy.

Moreover, rising commodity prices attract labour and capital into the resource-extraction sector, which can offer higher wages and rates of return. This is a process, sometimes referred to as factor drainage, which ultimately leads to a change in the relative prices of the factors of production that all domestic producers have to face. Price escalation brings about a further reduction of the competitiveness of the non-resource tradable sector (Corden and Neary, 1982). In addition, commodity boom can fuel domestic demand more generally, putting upward pressure on prices, especially in non-tradable sectors. This further hurts the competitiveness of non-resource tradables producers. So, if the strengthening of the exchange rate is often the most visible symptom of the Dutch disease, this can unfold even in the absence of nominal currency appreciation.

Box 2.1. **Does Kazakhstan have Dutch disease?**

The last IMF Country Report (No. 13/291) on Kazakhstan of September 2013 pointed out three main factors that seem to indicate that the country is affected by the Dutch disease:

1. The prices of non tradables (as proxied by services, excluding administratively controlled utility prices) have been consistently growing faster than the prices of tradables (proxied by nonfood goods).
2. There are some signs of both direct and indirect de-industrialisation as tradables have been losing share in both GDP and employment. In particular, there has been some mobility of labor out of non-resource tradables into non tradables.
3. When compared to productivity, real wage growth in Kazakhstan over the last 12 years has been higher economy-wide and in all main sectors, except for construction. The connection is particularly evident in manufacturing, a sector where productivity (unlike in most other emerging market economies) did not grow faster than that in services. At the same time unit labor costs (calculated using sectoral deflators) stayed broadly stable. This was due to favorable price dynamics: manufacturing prices grew at an annual average rate of 17 percent correlated with oil prices, which is not surprising given that many industries within manufacturing are closely linked to the oil sector.

Source: IMF (2013b), "Republic of Kazakhstan, Selected Issues", *IMF Country Report* No. 13/291.

These pressures can be very hard for all non-resource tradable producers, but they are even tougher to overcome for nascent firms and sectors trying to establish themselves in highly competitive global markets. Moreover, the volatility of growth that often characterises economies with a heavy reliance on resource exports can act as a further impediment to diversification. As a matter of fact, if the authorities are unable to prevent boom-and-bust cycles, it is new firms and new activities that are likely to bear the brunt of the busts (Gonzalez et al., 2013). In a perfectly functioning market, more productive firms survive and less productive firms are forced to exit. In reality, there is almost always an incumbency advantage, as well: other things being equal, older firms are more likely to survive than new ones. Lenders and suppliers, for example, may be less likely to support new entrants under stress than they are to back older firms, with which they have longer relationships. Older firms also frequently enjoy an additional advantage in terms of their relationships with the public authorities.

The critical point is that, where cyclical volatility is high, the relative importance of incumbency as a determinant of firm survival becomes even more important and that of productivity diminishes. Gonzalez et al. (2013) show how steady growth can strengthen the selection effect of productivity, while downturns favour incumbents. Thus, any attempt to sustain growth over the long term and to foster the emergence of new tradable activities and sectors will require extremely prudent macroeconomic management, with a view to limiting growth volatility, and a specific effort to ensure quality institutions in order to support market entry and competition. The authorities in Kazakhstan have hitherto performed remarkably well with respect to the first of these priorities: macroeconomic policy has been oriented towards buffering the domestic economy from commodity-price volatility. The second is more difficult and is addressed below. It is here that institutional and regulatory reforms must play a critical role.

Remoteness and connectivity

Even in a technologically advanced world, geography still matters. The geography of a place is effectively defined by a combination of physical and human geographies. The more people inhabit a place, the more its character will be defined by latter, i.e. by human beings and their activities (for a more detailed explanation see OECD, forthcoming). Proximity or remoteness to the major world markets, as in the case of Kazakhstan, is an important feature of the geography of a place and it is particularly relevant to the analysis of competitiveness, as it has a direct impact on productivity. Such an impact operates through various channels that affect both supply and offer.

First of all, remoteness tends, ceteris paribus, to weaken competition, since consumers of intermediate inputs and final goods have less choice of potential suppliers. In that sense, distance is a form of protection: local tradables producers may enjoy an advantage in local markets, since the cost of entry for outsiders is higher, but the market is by definition small and the lack of competition is bad not only for consumers but also for producers who might be oriented towards external markets but who rely on local supplies of intermediate inputs. Secondly, remoteness reduce the scope for enhancing productivity by limiting the potential to exploit economies of scale or other so-called "agglomeration economies" (*ibid*., 2014). Thirdly, it may reduce not only current trade opportunities, but also the ability of agents in a place to identify new opportunities. Thus, there are costs both in a static and in a dynamic perspective.

In assessing the remoteness of a country, one has to remember that "remoteness" is always a relative term. Remoteness is about being unconnected to somewhere. Certainly, the simple physical distance to major markets matters: distance increases travel times and shipping costs, which have to be paid either by the buyers (with higher prices) or by the producers (with lower profit margins). However, straight-line distance is not all that matters: maritime transport is cheaper and more flexible than overland transport and it requires less dedicated infrastructure. The level of "economic connectedness" also matters. Australian wheat farmers, for example, though located in a very remote place, are extremely well connected. They are deeply integrated into international grain markets and very well informed about what is happening on them. By contrast, the residents of many small towns along the US Appalachian mountain chain, which are among America's poorest places, are physically very close to some of the world's biggest factor and consumer markets, but they are poorly linked to those markets and thus largely disconnected from activities taking place only a short distance away (OECD, 2014).

Box 2.2. **The contribution of economic geography to GDP per capita**

Recent OECD work exploring the extent to which economic performance can be accounted for by economic geography points to a number of findings that are extremely relevant for Kazakhstan. Employing an augmented Solow model as a benchmark and using data on 21 OECD countries over the period 1970-2004, Boulhol et al. (2008) look at *i)* a variety of indicators of proximity to major markets, *ii)* the specific impacts of telecommunications and transport costs, and *iii)* the significance of natural resource endowments. Their major conclusions may be summarised as follows:

1. While the impact of proximity/distance depends to some extent on the measure used, all of the indicators of distance are found to have statistically significant effect on GDP per capita, with the exception of population density. For countries such as Australia and New Zealand, lower access to markets compared to the OECD average could lower GDP per capita by up to 10%. Countries like Belgium and the Netherlands, conversely, are found to benefit greatly from their location at the heart of Europe.
2. With respect to transport and telecommunications costs, they find no evidence that the importance of distance in the transportation of goods has diminished since 1970, despite the fact that transport costs have fallen relative to the value of transported goods. Transport costs continue to have a negative and significant impact on GDP per capita, depressing it in remote countries like Australia and New Zealand and raising it in, e.g., Canada and the United States, albeit by a smaller margin: the effect appears to be asymmetrical, hurting peripheral countries more than it helps centrally located ones (the smaller effects found here are consistent with the idea that transport costs are only one aspect of costs related to distance).
3. The cost of international telecommunications, by contrast, has fallen to the point where it is not significant for any OECD country.

In one extension of the model, the authors explore the possibility that the returns to investment in research and development are negatively affected by geographic remoteness. They find that the effectiveness of private R&D intensity is significantly influenced by the degree of urban concentration but not by distance to major markets.

Source: Boulhol, H., A. de Serres, M. Molnar (2008), "The contribution of economic geography to GDP per capita", *OECD Economics Department Working Paper No. 602*, 14 April; OECD (forthcoming), *Territorial Review of Krasnoyarsk*, OECD Publishing, forthcoming.

Connectivity can strengthen competition and deepen both product and labour markets. However, it can bring about new competitive threats, too. As noted above, the costs of distance guarantee a form of protection for local producers, since potential importers face higher costs. Removing that protection (i.e., improving external connectivity) can be painful in the short term, even if beneficial over the long run. Moreover, the promotion of new areas of specialisation requires a specific effort in remote places. In order to export, local producers need a productivity advantage great enough to offset all the costs outlined above: being as good as their rivals is not good enough. They have to be better (*ibid*, 2014). This is the challenge that confronts tradables producers in Kazakhstan's non-resource sectors.

In such circumstances, the authorities need to ensure the proper functioning of market institutions and guarantee that transport costs are not inflated by regulations that reduce efficiency and impede competition – as they very often do. Transport sectors have traditionally been heavily regulated and are often largely exempt from the provisions of

standard competition legislation. While many OECD countries have liberalised domestic transport sectors in recent decades, international transport is still subject to extensive regulation, much of which serves to undermine competition, particularly in road, rail, maritime and air freight. The challenges for Kazakhstan are fairly clear, given its very poor ratings on connectivity and transport infrastructure The World Economic Forum's (WEF) Global Competitiveness Index 2013-2014 showed that the country was 64th out of 148 for the overall quality of its infrastructure. However, Kazakhstan had a very bad score for the quality of roads (117th), port infrastructure (135th) and also air transport infrastructure (89th). That was compensated by the quality of the railroad service (27th).

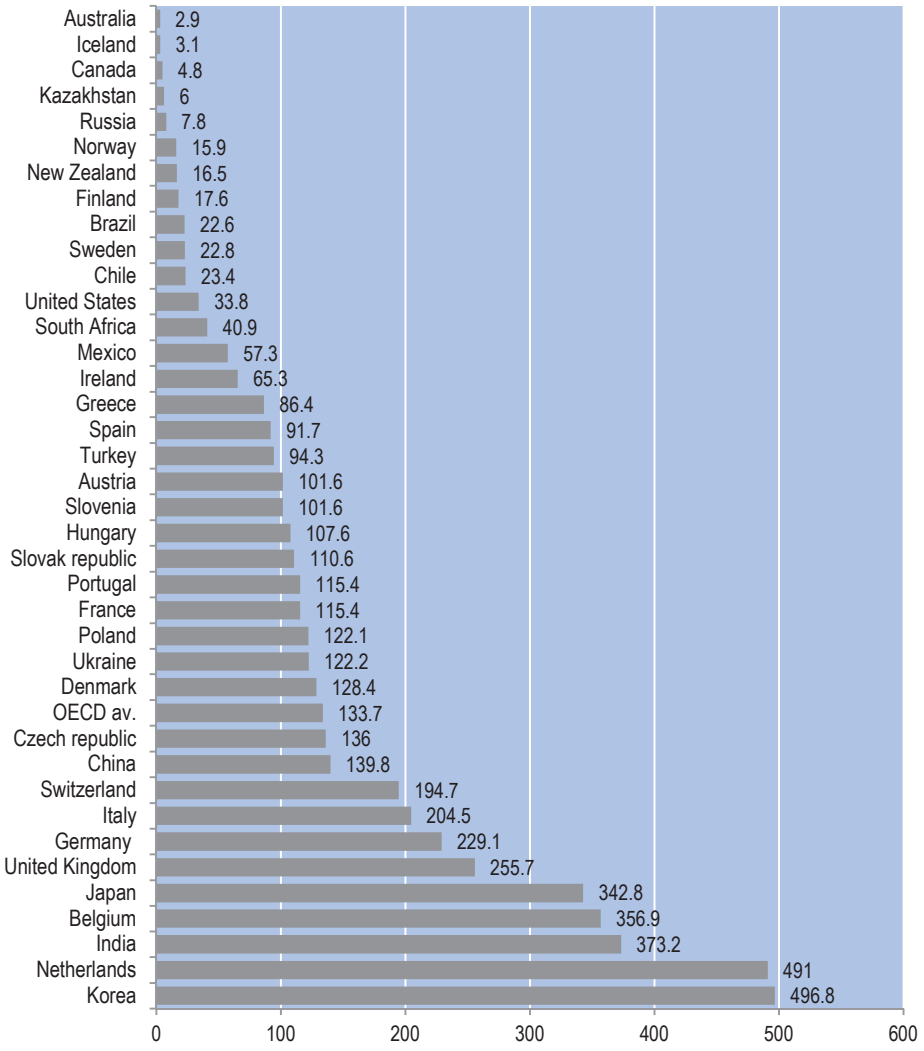
Density of population

Kazakhstan has a surface area of 2 724 900 square kilometres, larger than any OECD country except the United States, Australia and Canada. Its surface area corresponds roughly to that of EU-15, though it is smaller than Russia, China, Brazil and India. However, the main geographical characteristic of the country is a vast territory, mostly uninhabited. In 2010, it had 16.7 million inhabitants, making for a population density of 6.16 inhabitants per square kilometre. Among OECD countries, only surpassing Canada, Iceland and Australia have lower population densities (Figure 2.6).

In some low-density OECD countries, low overall population density is offset to some extent by concentration of population in a small number of relatively large cities, which makes it easier to generate economies of scale and to realise the benefits of agglomeration. Thus, the Nordic countries consistently rank among those with the highest concentrations of population and economic activity (OECD, 2011). This is not the case in Kazakhstan: the country has only one city with a population – 1 million – the former capital, Almaty (1.4 milllion in 2011). Only two cities have between 500 000 and 1 000 000 inhabitants – Astana, the capital, and Shymkent. Indeed, the overall urbanisation rate at the last census was only around 54%, though this may be taken as a lower bound, since registration restrictions for rural migrants in cities mean that the census data probably understate the true figure. Nevertheless, such a pattern of settlement means that considerations outlined above concerning the challenges of low density apply with particular force in Kazakhstan.

The low-density Nordic countries have tended to combine high internal concentration with very low levels of inter-regional inequality (OECD, 2011). Kazakhstan, by contrast, not only has a very dispersed pattern of settlement, it has a very large inter-regional disparities in income and productivity. In 2010, roughly 41-42% of the population lived in regions with GDP per capita below 70% of the national average (mainly rural areas of Zhambyl, South Kazakhstan, Almaty, North Kazakhstan and Akmola Oblasts). At the same time, 47% of GDP was generated in Almaty, Astana, Atyrau and Karaganda regions, which account only for the 24.7% of population. The problem with such a distribution of the population is that economies of scale are harder to achieve. Factor and product markets are thinner. So, not only does competition tend to be weaker, but the scope for diversification is also more limited. That said, this also implies that Kazakhstan has plenty of scope to benefit over the long term from the on-going trend towards greater concentration of population and activity.

Figure 2.6. Population density in OECD and in selected non-OECD countries, 2010



Source: OECD and Ministry of Economy of the Republic Kazakhstan, "Main socio-economic indicators", www.economy.kz/region/spravka/pokazateli/index.php/.

Regional market potential

Taking into account the core-periphery nature of economic development, the OECD Regional Policy Division has recently constructed an indicator of Regional Market Potential-RMP (see Ahrend et al., forthcoming) to reflect the challenges that a country has to face in connection to its location, its distance to the major markets and its size. The indicator for any given economy is based primarily on its size and density (own market potential) and on the size of all other economies, weighted in the indicator by its distance to it. (Some other factors are also included, such as common language, common frontier and past colonial links, as the literature suggests that these can enhance economic integration even after controlling for size and distance.) The RMP is the first effort to develop an indicator for a fairly comprehensive list of regions from OECD and non-OECD countries: regional market potential is computed for more than 400 regions in 29 countries, accounting for more than 75% of 2012 world GDP; the remainder of the world

economy is included as entire countries, owing to lack of the necessary data on regional GDP. This has some implications for the results, since countries' scores are likely to be better when they included as whole countries (as Kazakhstan is in this data set) rather than as regions. Nonetheless, with most large economies presented on the basis of their regions, the results provide a more nuanced picture of the world's (shifting) economic centres of gravity than has been possible hitherto.

In 2009, in terms of regional market potential, Kazakhstan ranked in the third quintile, i.e. in the middle ranks globally. Its peers would include Australian Northern territories, Northern Canada, some regions of Southern Brazil. In these calculations, Kazakhstan has been considered as a whole and not decomposed in regions. Certainly, the country would score lower if it were broken into regions. For example, all oil-producing regions in Russia score lower than Kazakhstan, apart from Tyumen. Even with Kazakhstan entered as a whole, the results suggest that its location represents a challenge; it is not so favourably positioned geographically, especially if one bears in mind that the centre of gravity of its giant neighbour, China, is very much on the south-east coast, far from Kazakhstan.

The good news for Kazakhstan is that its location is improving over time. It ranks in the top quintile in the world in terms of change in market potential over the period 1995-2009. That is partly the result of its own growth over recent years and partly a consequence of the shift in the world economy's centre of gravity eastwards, towards China and the wider Asia-Pacific region (the declining market potential of much of Western Europe and the eastern United States is symptomatic of this shift). Of course, geography is not destiny: making the most of Kazakhstan's improving position will require appropriate policies, infrastructure investments and other steps to strengthen its international integration.

Institutional quality and business environment

One crucial factor that allows countries to channel mineral revenues efficiently towards productive investments is the presence of strong, transparent and efficient institutions. The absence of corruption, together with high levels of transparency and accountability and a strong commitment to a long-term economic agenda based on steady productivity improvements, are important conditions to ensure that natural resource exports support long-term growth and diversification. There has been great deal of work in recent years measuring the quality of institutions (see Kaufmann and Kraay, 2008, for a review), as well as considerable debate concerning the relationship between institutional quality and economic performance. While it is widely accepted that there is a link between the two (e.g., Woolcock, 1998; North, 1990; Acemoglu et al., 2001 and 2005; Easterly and Levine, 2003; Dollar and Kraay, 2003; Rodrik et al., 2004), the nature of their relationship is still under discussion.

Institutional reform is an area where Kazakhstan has undoubtedly achieved some progress, but where much is still to do. The Governance Research Indicator Country Snapshots (GRICs), elaborated by the World Bank, allow to have a rapid look at the evolution of some general indicators and to compare them across countries (Table 2.2).

The improvement of the rule of law from 1996 to 2012 is the most striking feature of these data. Even if Kazakhstan still lags to countries like Sweden or Poland on this indicator, the progress since the beginning of the period under observation is evident and the contrast with transition country peers like Ukraine and Russia is significant. The considerable importance of Foreign Direct Investments (FDIs) in Kazakhstan has made

reforms in this area a priority and the efforts made by the authorities have produced rather good results. If other indicators concerning political stability and government effectiveness have had a rather positive overall performance, indicators like control of corruption and regulatory quality show much less evident progress.

Table 2.2. Governance indicators, 1996-2012 (percentile ranks)

	Kazakhstan			Ukraine	Russia	Poland	Sweden
Indicators	1996	2004	2012	2012	2012	2012	2012
Voice and accountability	18	17	16	39.8	19.9	81.0	99.5
Political stability	29	48	36	41.7	20.9	83.4	90.0
Government effectiveness	13	28	40	31.6	40.7	71.8	98.6
Regulatory quality	40	33	38	28.7	38.8	78.5	99.0
Rule of law	12	15	31	26.1	23.7	72.0	99.1
Control of corruption	9	11	21	15.8	16.3	71.8	99.0

Note: A higher score denotes a better rank.

Source: World Bank Governance Research Indicator Country Snapshots (2013).

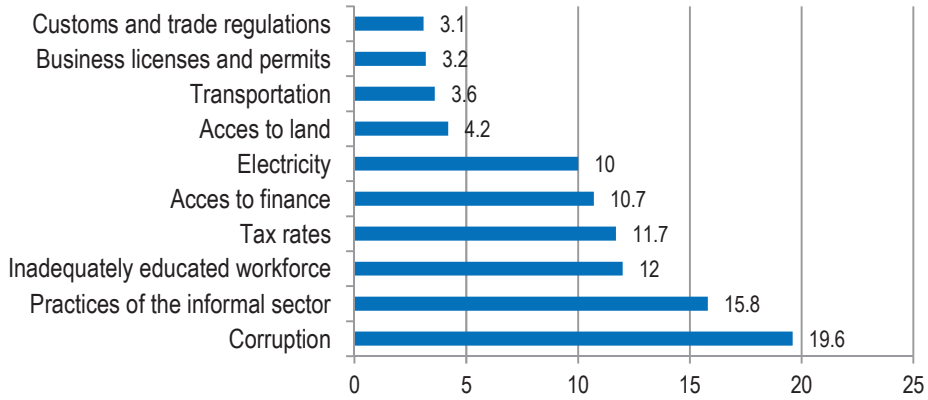
Voice and accountability is another interesting indicator which not only shows a deterioration since 1996, but which puts Kazakhstan well behind countries like Russia (40.9) and Ukraine (34.5), as well as other post-Soviet neighbours like Kyrgyzstan (22.6). As a matter of fact, while consultations via advisory councils have been made mandatory in Kazakhstan since 2009, there is no systematic mechanism of open, public consultation, open to ordinary citizens or interested groups, on either primary or secondary legislation. The criteria for the selection of the people to involve in the advisory councils are still rather unclear and their representativeness is limited. Regulatory quality, according to the World Bank, has also slightly deteriorated since 1996, but that has to do more with the relative dynamism of other countries than with any poor performance on the part of Kazakhstan. However, such a result serves as a salutary reminder of the fact that, in a competitive world where others are actively improving their institutions and policies, modest reforms may be insufficient to prevent a country from losing ground.

The Corruption Perception Index (CPI) is another widely used indicator that shows how corrupt a public sector is perceived to be. It is a composite index, a combination of surveys and assessments of corruption, collected by a variety of reputable institutions specializing in governance and business climate analysis. In 2013, Kazakhstan was 140th out of 175 countries surveyed in terms of CPI, with a score of 27 on a scale from 0 to 100, where 0 means that the country is perceived as utterly corrupt and 100 perfectly clean. The CPI is not a verdict on the level of corruption, but it shows how the public sector is perceived internally. The results obtained prove that corruption is widely acknowledged as one of the main problems when dealing with the public administration, even more than in countries like Russia that, in the same year, was in the 127th rank.

The enterprise survey recently conducted by the World Bank in Kazakhstan adds interesting insights on the same problem. The survey involved business owners and top managers of 600 firms (selected taking into account their size and their geographical location), interviewed between July 2012 and December 2013. It found that the biggest

obstacle experienced by private sector firms in Kazakhstan, in the view of the respondents, was corruption, followed closely by the existence of practices of the informal sector (Figure 2.7).

Figure 2.7. Top 10 business environment constraints



Source: World Bank (2013), Kazakhstan Enterprise Survey.

The comparison with the results obtained in other countries shows two interesting elements (Table 2.3). First, the court system is not perceived as major constraint to doing business. Secondly, the value of the gifts expected in order to secure a government contract is relatively smaller than in other countries, but the so called "bribery depth", that is percentage of public transactions where a gift or an informal payment is required, is on average much higher than in other Eastern European and Central Asian countries (23.8% vs. 9.3%). This suggests that petty corruption is the real problem. If so, that would imply that corruption was a particular impediment to diversification, since small firms and start-ups tend to find it harder to protect themselves from bureaucratic predators than big, well-connected and well-resourced companies. The evidence is not conclusive, but this would be consonant with what other indicators show regarding the strength of investor protection. In other words, Kazakhstan appears to have created conditions conducive to large-scale investment by strategic foreign investors but it may have much more to do to create a business environment that is favourable to entrepreneurship.

Kazakhstan ranked 50th out of 148 countries in the World Economic Forum's (WEF) Global Competitiveness Index in 2013-2014, showing a rapid improvement since 2011-12 when it ranked 72nd. The WEF ranking is based on surveys of business executives in a country and reflects perceived strengths with respect to factors concerning twelve main pillars: institutions, infrastructure, macroeconomic environment, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation. In particular, according to the last WEF survey, the country is globally in the middle ranks (55th) on the quality of its institutions. At the same time, it has benefited from an efficient labour market (15th position globally) and a stable macroeconomic environment (23rd), but it is still struggling in areas like innovation (84th), business sophistication (94th) and financial market development (103rd). Interestingly, the impact of rules on FDIs, which have been one of the main drivers of growth in the country, is still very important and, in this respect, Kazakhstan is lagging behind many countries (91st position). At the same time, the burden of customs is considerable (75th).

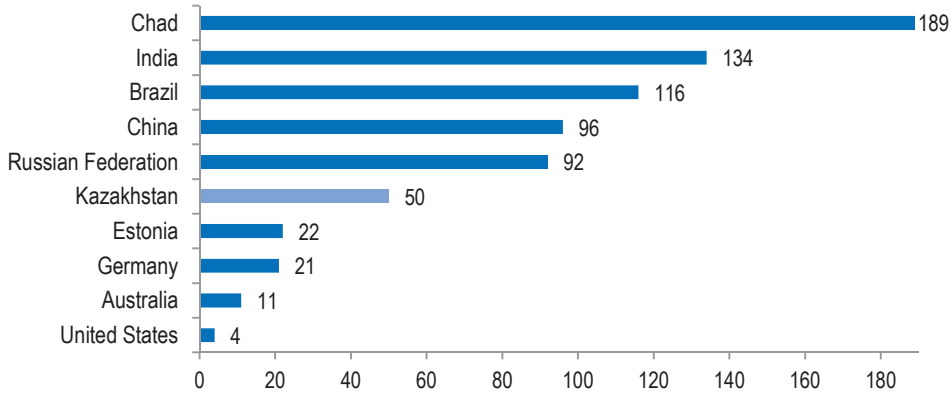
Table 2.3. Enterprise survey (percentile ranks)

Indicator	Kazakhstan	Eastern Europe & Central Asia	All countries
Percent of firms expected to give gifts to public officials "to get things done" Percent of establishments that " consider that firms with characteristics similar to theirs are making informal payments or giving gifts to public officials to "get things done" with regard to customs, taxes, licenses, regulations, services, etc.	20.9	15.5	19.2
Percent of firms expected to give gifts in meetings with tax officials Percent of firms expected to give gifts or an informal payment in meetings with tax officials.	24.7	8.3	11.8
Percent of firms expected to give gifts to secure government contract Percent of establishments that consider that firms with characteristics similar to theirs are making informal payments or giving gifts to public officials to secure government contract.	10.7	12.7	18.0
Value of gift expected to secure a government contract (% of contract value) Percentage of the contract value expected as a gift to secure a government contract. Only firms that have confirmed that they have secured or attempted to secure a government contract in the last 12 months were required to answer this question.	0.8	1.1	1.7
Percent of firms expected to give gifts to get an operating license Percent of firms expected to give gifts or an informal payment to get an operating license.	16.7	9.4	13.7
Percent of firms expected to give gifts to get an import license Percent of firms expected to give gifts or an informal payment to get an import licence.	28.4	12.7	12.6
Percent of firms expected to give gifts to get a construction permit Percent of firms expected to give gifts or an informal payment to get a construction permit.	28.8	18.5	20.9
Percent of firms expected to give gifts to get an electrical connection Percent of firms expected to give gifts or an informal payment to get an electrical connection.	39.0	10.6	14.9
Percent of firms expected to give gifts to get a water connection Percent of firms expected to give gifts or an informal payment to get a water connection.	32.7	8.5	15.5
Bribery depth (% of public transactions where a gift or informal payment was requested) Bribery depth is the percentage of transactions (out of 6 transactions dealing with utilities access, permits, licences, and taxes) where a gift or informal payment was requested.	23.8	9.3	12.7
Bribery incidence (percent of firms experiencing at least one bribe payment request) Percent of firms experiencing at least one bribe payment request during 6 transactions dealing with utilities access, permits, licences, and taxes.	29.6	12.5	16.9
Percent of firms identifying corruption as a major constraint Percent of firms identifying corruption as a major constraint. The computation of the indicator is based on the rating of the obstacle as a potential constraint to the current operations of the establishment.	20.3	28.7	37.1
Percent of firms identifying the courts system as a major constraint Percent of firms identifying the courts system as a major constraint. The computation of the indicator is based on the rating of the obstacle as a potential constraint to the current operations of the establishment.	2.9	15.5	19.0

Source: World Bank (2013), Enterprise Survey.

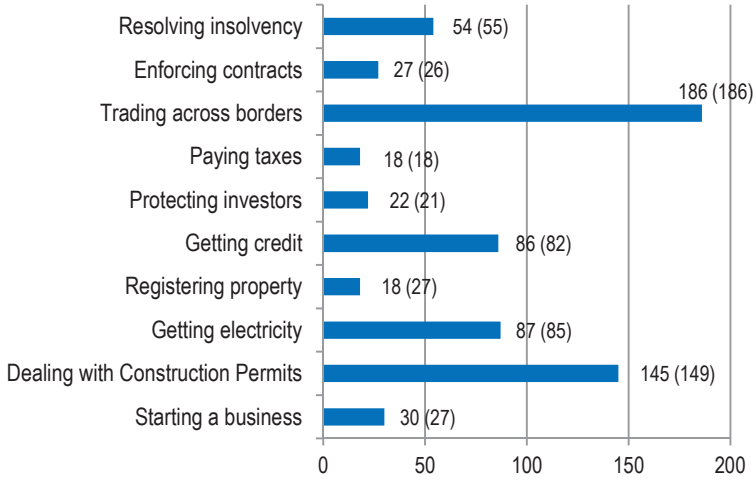
The World Bank's Ease of Doing Business indicator also shows that Kazakhstan is doing rather well, as it is the 50th country out of 189, well ahead of Russia and other CIS peers (Figure 2.8). Overall, the country is doing well on issues like registering property, protecting investors and enforcing contracts. These are sectors of particular interest for foreign investors and for the development of the resource extraction sector. However, on issues like trading across borders, dealing with construction permits, but also getting electricity and credit, it shows still many difficulties.

Figure 2.8. Ease of Doing Business 2014, ranking of selected economies



Source: World Bank (2014d), *Doing Business*.

Figure 2.9. Ease of Doing Business in Kazakhstan 2014



Source: World Bank (2014e), *Doing Business 2014*, Economy Profile: Kazakhstan.

It is important to recognise that the quality of the institutional environment has a direct bearing on competition and productivity performance. The evidence suggests that weak institutional environments are far more damaging to newer and smaller firms than to established incumbents (see also Charron et al., 2012). Large capital-intensive firms (i.e., the major players in the resource sector) are generally better able to protect their interests, as well as to bear the costs of corruption when they incur them – or, if the pressure is excessive, to exit and do business elsewhere. For new firms and sectors, which are often on the brink of viability during the early learning-by-doing phase of their development, the cost of informal payments to officials or the inability to enforce contracts efficiently (to take but two examples) may mean the difference between survival and exit. Moreover, since the factors that impede the emergence of new firms and the growth of strong SMEs effectively reduce the pressure on large firms to become more efficient, conditions that impede the entry and growth of smaller firms and new activities are likely to be directly related to productivity performance.

Notes

1. In all likelihood, something similar is occurring *within* the service sector, the average productivity of which masks large differences between high-value business services and low-value, low-productivity proximity services. The data to test such a hypothesis are not available but the experience of other countries suggests that productivity in services should vary widely across sectors.

2. http://kazworld.info/?p=10922.

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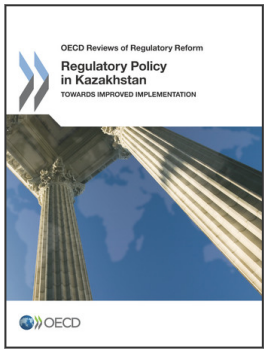

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