

Executive summary

Kazakhstan has embarked upon an ambitious reform agenda to realise its aspiration of becoming one of the top 30 global economies by 2050. As documented in Volume I of the *Multi-dimensional Country Review (MDCR) of Kazakhstan*, the country's economy and society have undergone deep transformations since the country declared independence in 1991. Gross domestic product (GDP) increased 2.8-fold between 2000 and 2014 and living standards improved for most Kazakhstanis, with the proportion of the population living on income below the subsistence minimum falling from 32% to 2.5%.

The period of accelerating growth from 2000 to 2010 owed much to exploitation of Kazakhstan's natural wealth. The oil and gas sector, generated 26% of GDP at its peak and still dominates exports, and generates about a third of public revenues. External conditions, and especially the rapid fall in oil prices, have had a significant impact on the country's economy.

The next stage of economic transformation will be more challenging, with weaker external conditions and the need for productivity gains to make a larger contribution to growth. The government has laid out an ambitious programme to modernise how the Kazakhstani state operates and works with the private sector. The president's "100 Concrete Steps" and associated programmes target the way the state operates, more than the scale or scope of its action. Efforts to expand the operating space of the private sector, ensure markets are contestable, reduce administrative burdens, and strengthen the rule of law can bring well-documented benefits to Kazakhstan. Continuing reforms to civil service and competition law can help address key constraints on development in Kazakhstan.

This report is the second volume of the MDCR of Kazakhstan. It analyses four key issues for the country's development on the basis of the constraints identified in Volume I, and provides concrete recommendations to address those constraints.

Diversification and resilience

Kazakhstan's economy grew increasingly concentrated during the 2000s, in terms both of exports and production. Diversification is an imperative for Kazakhstan's future development, to reduce its exposure to external risk as well as furthering job and value creation domestically. It has been a major policy objective for Kazakhstan since the mid-1990s but the implementation of industrial policy only came into being in earnest in 2010. Between 2010 and 2014 the process of relative deindustrialisation stopped and new major non-natural resource export products were discovered.

To increase its efficiency and ability to adapt to a rapidly changing environment, industrial policy should seek sources of flexibility in its implementation. A number of programme measures should be moved from programme to policy settings, where they can be predictable over time for economic actors. Flexibility can also be found by implementing

more indirect instruments. Experience in Kazakhstan has shown that the involvement of private sector banks in project selection can lead to more diverse sectoral allocation, enhancing opportunities for discovering new avenues to diversify. The functions of industrial policy should be expanded to include non-financial instruments that allow the economy to increase its anticipation and adaptation capacity. Finally, instruments and programmes should be rigorously evaluated and monitored for continuous improvement.

Success in diversification will also require continuous improvement in complementary inputs, especially a skills system that adequately prepares the workforce, a more developed logistics system that capitalises on the ongoing efforts to upgrade physical infrastructure, and innovation systems that link research and business more effectively.

Mobilising finance to transform the economy

Kazakhstan's financial sector is unusually shallow, which limits firms' investments and operations and impedes the economy's diversification. Scarce funding constrains bank lending. This shallowness is partly attributable to transitory factors, including the economic cycle, the legacy of unsustainable use of international credit, and a period of an unsustainably high exchange rate. Structural factors, such as uncertainty over property rights and the judicial system, and perceptions that financial statements lack integrity, also impede financial deepening.

Schemes to support firms' access to finance through interest rate subsidies and loan guarantees were effective during the financial crisis, but have limited benefits in the long term. Strengthening banks' ability to access wholesale funding would generate sustained improvements in their ability to provide credit. In the short run improved access to international wholesale financing can address this, requiring that the state maintain a good sovereign rating. Joint ventures and equity sales to international banks can also improve banks' access to international financing while strengthening their management. Other efforts to develop domestic savings need to continue, with priority given to improving the management and long-term investment strategies of the pension fund. In the longer term, the financial sector's institutional environment must become stronger to provide investors with greater confidence in their ability to protect their investments and in the reliability of financial information.

Privatisation and the role of the state in the economy

State involvement in the economy in Kazakhstan stands out among comparable and OECD countries. State-owned enterprises (SOEs) are the dominant form of state control in the economy, although price controls are also widespread. SOEs in Kazakhstan are present in a wider range of sectors compared to OECD countries. Kazakhstan has embarked on a major privatisation programme with the aim of reducing the size of the state in the economy, with close to 800 entities up for privatisation including a set of large enterprises (the "Top 65").

The privatisation programme should clearly state its objectives and be monitored on the basis of appropriate indicators. Offices responsible for privatising assets should be given adequate time and resources to prepare the assets, including due diligence, but also adjustments in the capital structure of the entity and the identification and costing of any public service obligations. The privatisation programme should be controlled ex-post by an independent body to ensure a maximum requirement of transparency and accountability, ultimately increasing credibility for investors.

The governance and management of SOEs in Kazakhstan departs in several ways from OECD best practice. The privatisation programme is an opportunity to bring ownership policy and practice more into line with OECD guidelines by developing an ownership policy defining the rationale for state ownership and the role of the state and its agents in corporate governance, centralising SOE ownership functions which are currently scattered, separating ownership and regulation functions, and developing a consistent system of reporting on state ownership.

Towards better environmental regulations

The expeditious reform of a basic environmental regulatory framework could unlock vast opportunities for green growth in Kazakhstan. Today, the country is one of the most energy-intensive economies in the world. Uncoordinated implementation of environmental requirements together with the high volume of complex environmental regulations based on unrealistic assumptions have resulted in a regulatory environment that is complicated, burdensome and costly to both the administration and industry. What is more, the evidence suggests that it does not lead to actual environmental improvement. Moreover, environmental liability in Kazakhstan remains focused on calculating and collecting monetary compensation rather than on preventing and correcting damage, reducing emissions over time and incentivising the use of best available techniques (BATs).

To improve the effectiveness of environmental quality regulation, environmental quality standards need to be revised in the light of international best practices and domestic capabilities to technically feasible and enforceable levels. The focus should shift from “end-of-pipe” solutions to integrated pollution prevention and control. Integrated environmental permits are one of the most effective ways in achieving better pollution control since the permit is linked to techniques associated with lower emissions. Furthermore, Kazakhstan should adopt the strict liability/polluter-pays model and abandon fault-based concepts for damages. Finally, Kazakhstan should be applauded for taking steps toward better use of market-based environmental policy instruments to reduce its carbon footprint, and should step up implementation efforts.



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