

Strengthening Public Finance for Inclusive and Resilient Growth in Kazakhstan

Discussion on findings of Public Finance Review

Astana, September 2023



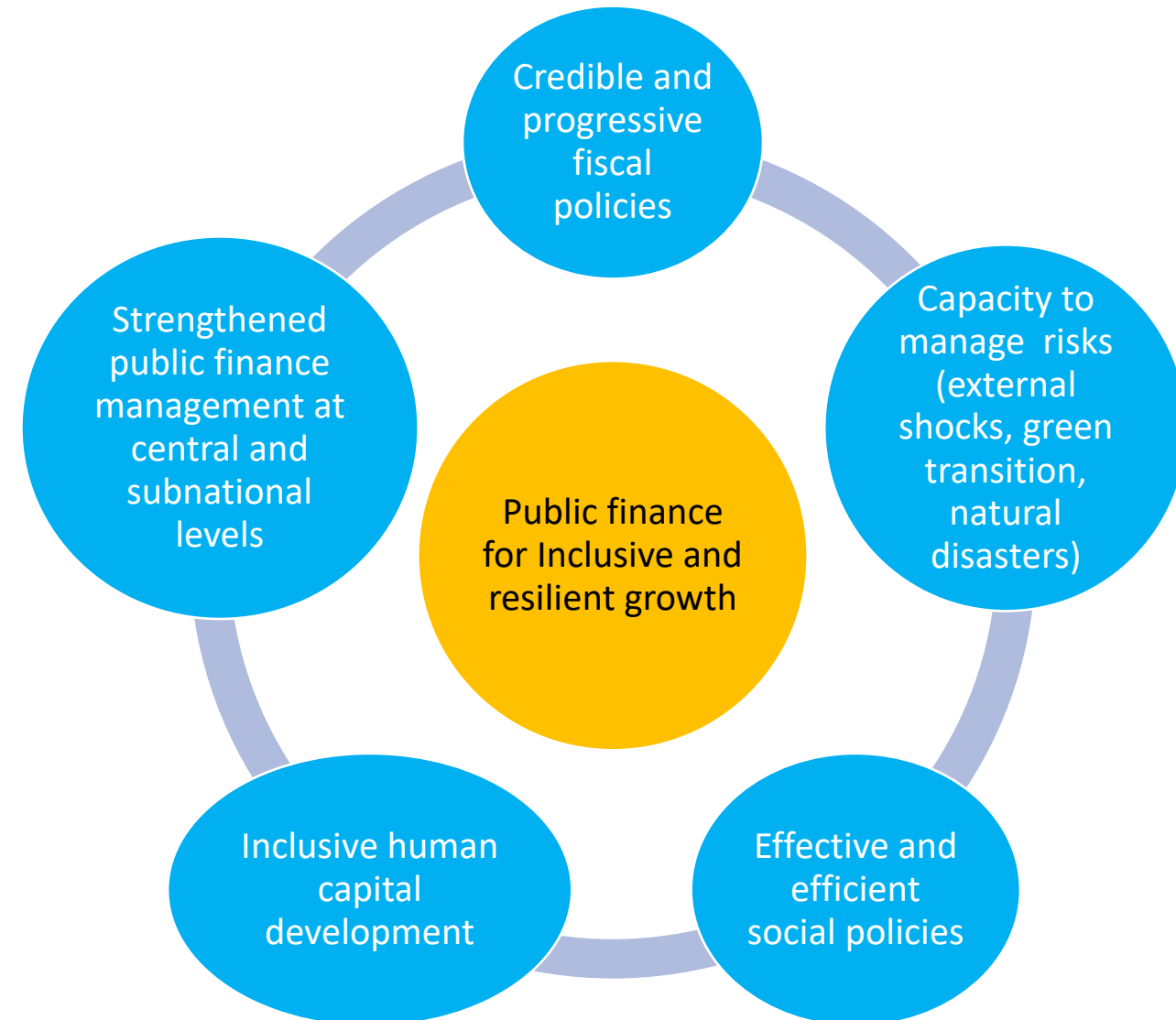
Contents of Kazakhstan Public Finance Review

| | |
|---|-------------------------------------|
| 1 | Fiscal policy framework |
| 2 | Quasi fiscal footprint |
| 3 | Revenue policy and mobilization |
| 4 | Education spending |
| 5 | Social protection spending |
| 6 | Budgeting and planning |
| 7 | Inter-governmental fiscal relations |

| | |
|--|---------------------------|
| | Macro-fiscal policies |
| | Sector analysis |
| | Public finance management |

The development context and why public finance

- Kazakhstan's had an impressive growth trajectory.
- Resource wealth drives businesses and underpins growth stability.
- But the **development model is facing challenges**
 - Sluggish productivity growth.
 - Lingering inflationary pressure.
 - Private sector led growth based on human capital and innovation are still lagging.
 - Growing concerns over wealth inequality.
 - Exposure to green transition risks



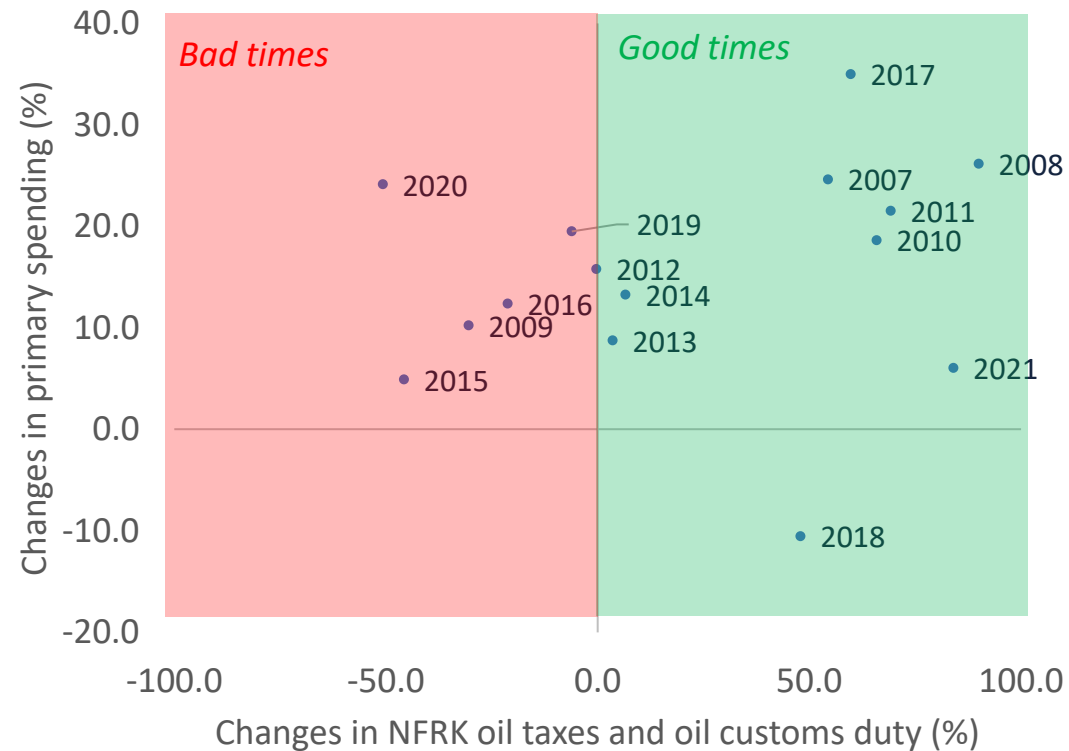


Fiscal framework

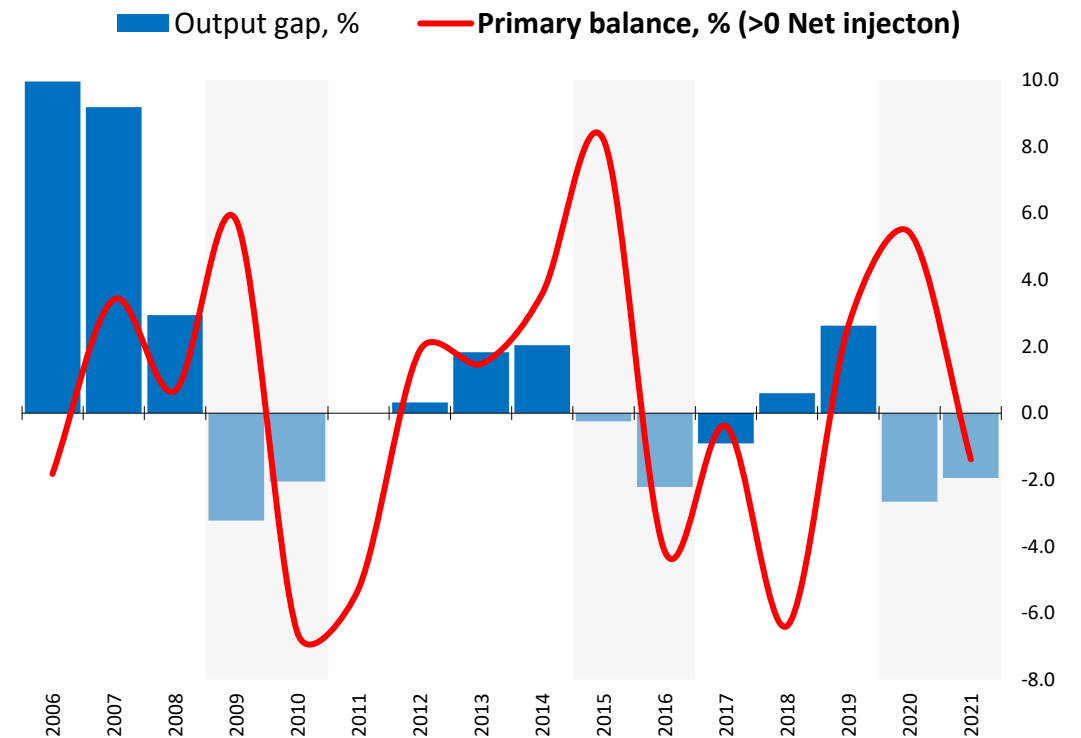
Mind the gaps

The fiscal framework responded well to “bad times”, but not so much during “good times”

Spending and changes in oil revenue across years (2007 – 2021)



Output gap and primary balance as percentage of GDP



Further considerations for the fiscal rules

Good

- Cap on expenditure growth is a good addition to the non-oil deficit target

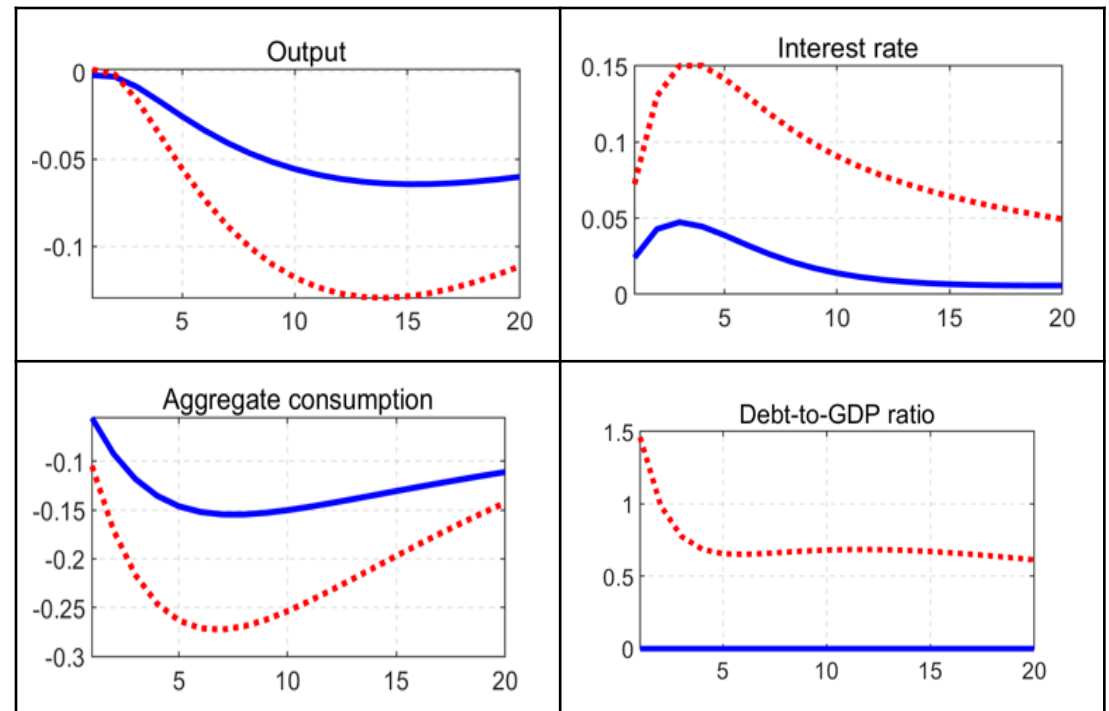
More work

- The new NFRK withdrawal rule can complicate macro-fiscal management (see modeling results)
- Consider having an escape-clause and trim the discretionary use of NFRK.

Important

- Consistent implementation
- independent assessment on fiscal policy performance.

DSGE model simulation of 10 percent negative oil price shock on key macroeconomic variables



— Benchmark

--- New fiscal rules

— New fiscal rules

Addressing other gaps in the fiscal framework

Prepare and publish a medium-term debt management strategy.

- Outlines cost-risk trade off for government borrowing choices.
- Informs the public and parliament on the selected public debt strategy.
- Protects the government (public debt-manager) against unintended outcome.

Managing risks from quasi-public sector operations (SOEs, extra budgetary funds)

- At the minimal, publish risks to the budget from public sector losses and debt.
- More critical: set a clear ownership policy on SOEs and extra budgetary funds.

Managing fiscal exposure to green transition: early actions are needed

- Potential impact of global green transition: 2.5-3 percent decline in GDP per capita, 3 percentage point increase in public debt/GDP by 2050.
- Potential impact of climate shocks (draught and floods): 1.2 - 2.2 percent of GDP.
- Early actions are needed:
 - Broaden revenue base (e.g.: excise on all fuels) and reduce tax leakages.
 - Improve targeting and delivery of social protection.
 - Promote market for disaster risk insurance.

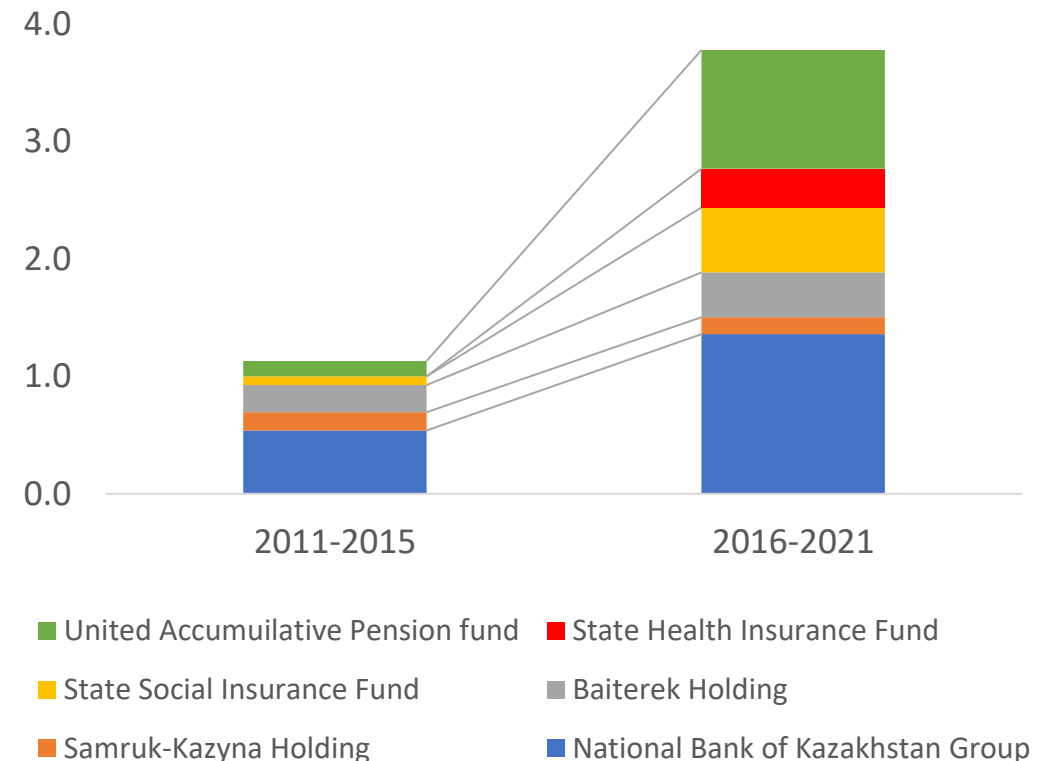
Quasi-Fiscal Footprint

Can they be better managed?

The rise in quasi-fiscal activities (QFAs) casts a shadow in Kazakhstan's public finances

- **Not yet part of the fiscal framework** and can complicate macro-fiscal management.
- **Potentially distorts markets and weakens policy levers.**
 - Credit subsidies and NBK's involvement
- **Losses from QFAs can expose fiscal risk.**
 - Losses by public utility companies, extrabudgetary funds, SOEs.
 - Bank bailouts.
- **Accountability framework for using public funds for QFAs is weak.**
 - Verification on the impact of QFAs is lacking.

Gross quasi-fiscal activities by large SOEs and key extrabudgetary funds as percentage of GDP



QFAs on bank bailouts cost taxpayers and left them with limited recourse

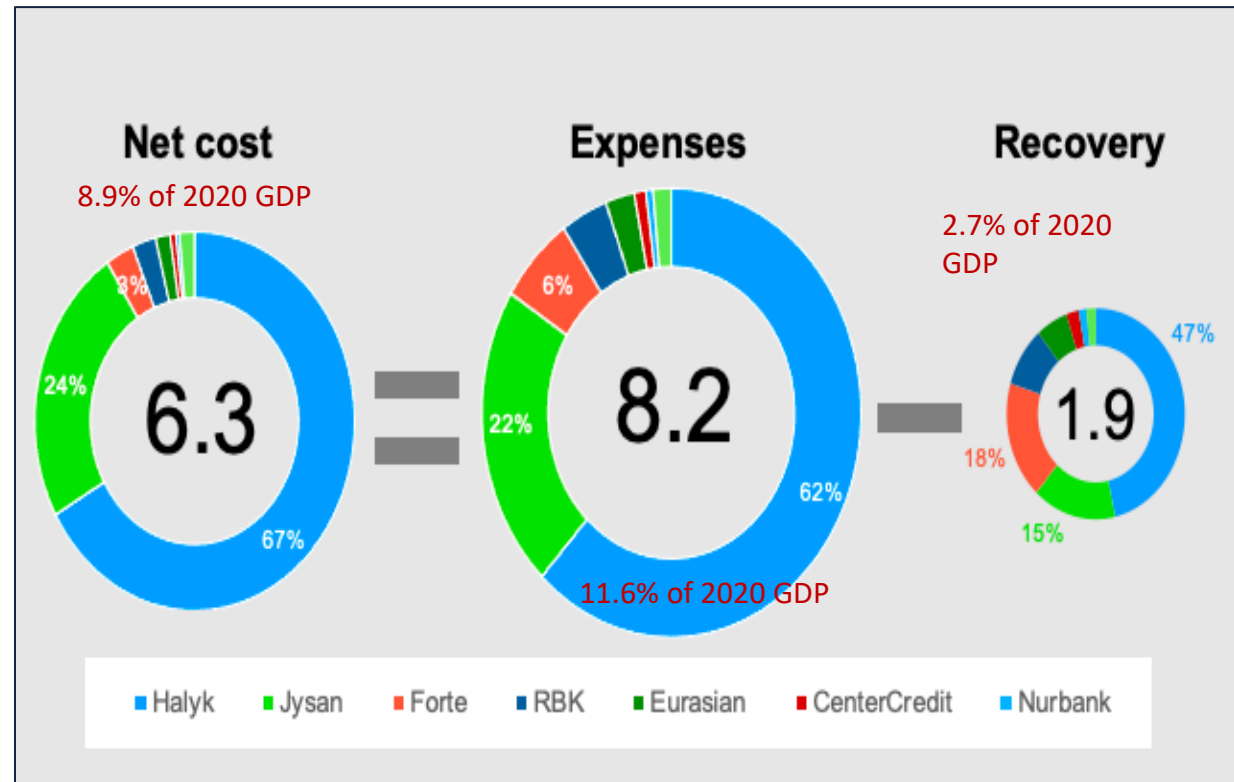
It is not about bailing out troubled banks per-se.

It is about NOT using public funds to socialize bank losses.

Net cost (2009-2020) reached 6.3 trillion KZT (8.9% of 2020 GDP).

- Purchase of assets at origination price.
- Issuance of debt with underpriced coupon.

Total bank bailout net cost for 2009–2020 in terms of trillion tenge 2020 present value



Further actions are needed to systematically manage and monitor QFAs

- **Include QFAs as part of the fiscal framework:**
 - Projected QFAs should be part of the consolidated public sector budget.
 - Include in the fiscal risks assessment from implementing QFAs.
- **Improving accountability of QFAs.**
 - Verify and discuss with the parliament the performance and appropriateness of QFAs.
 - Review QFAs with negative impact on market development: consider alternative approach.
- **Reforming the use of public funds for bank bailouts.**
 - Stop the purchase of problem assets at origination prices.
 - Avoid underpricing bond coupons issued for bank rescue.

Kazakhstan Allows Citizens to Withdraw Pensions Savings as Part of Broader Pension System Reform

BY ASSEL SATUBALDINA in NATION on 26 JANUARY 2021

NUR-SULTAN – Starting January 23, Kazakh citizens are able to withdraw part of their pension savings to improve their housing conditions on an online platform run by the Otbasy Housing Construction and Saving Bank, a subsidiary of the Baiterek national holding.



The savings can be used to pay back a mortgage loan, buy new housing, pay a down payment, build a house, partially or fully repay the debt under long-term lease agreements and refinance a housing mortgage loan.

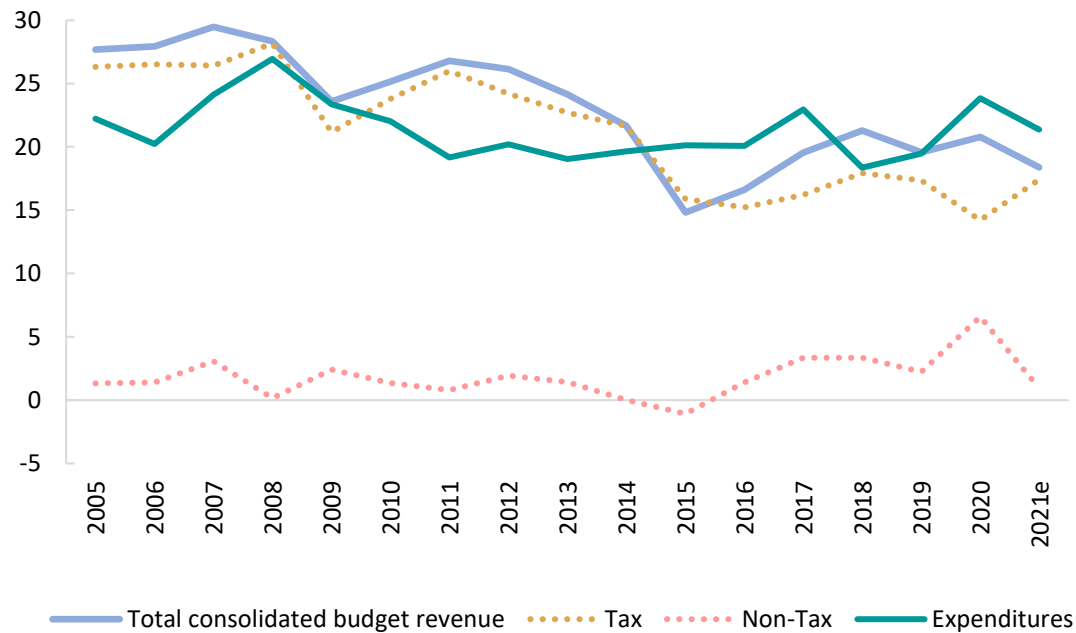
Approximately 100 billion tenge (US\$257.43 million) was allocated by the Samruk Kazyna Sovereign Wealth Fund to reduce unemployment and improve living standards among the rural population as of September.

Revenue performance and policies

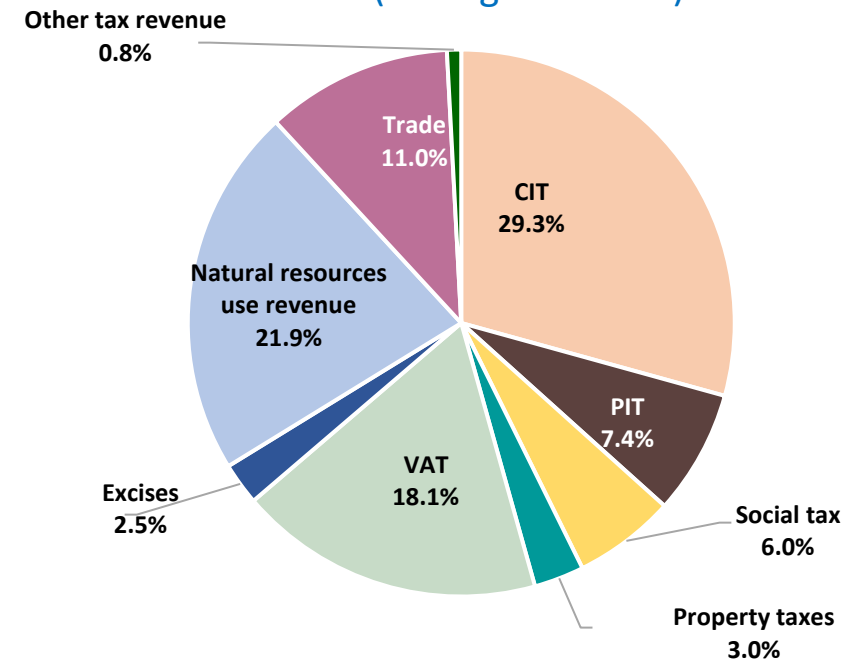
*Addressing the underwhelming
performance and low progressivity*

Revenue collection trending down, volatile, and unbalanced by tax type

Revenue Collection and Total Public Expenditure
(2005–21), % of GDP



Composition of tax revenues
(average 2005-21)



Weak tax buoyancy and tax productivity, and substantial revenue gaps

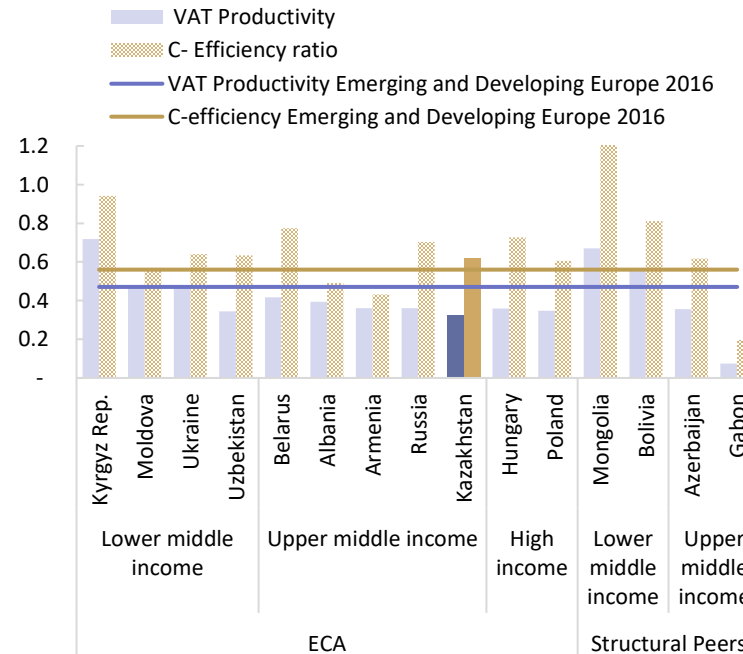
Most tax collections do not keep up with GDP growth

Responsiveness of revenues to GDP growth, 2005–2020

| Tax Type Buoyancy | Buoyancy |
|------------------------------|----------|
| Total Tax Revenue | 0.74 |
| Personal income tax (PIT) | 0.89 |
| Corporate income tax (CIT) | 0.49 |
| Social tax | 0.60 |
| Property tax | 0.91 |
| Value-added tax (VAT) | 0.84 |
| Domestic | 1.27 |
| Imported | 0.66 |
| Excise | 1.09 |
| Natural resource use revenue | 0.77 |
| Trade tax | 1.33 |
| Exported | 2.11 |
| Imported | 0.77 |

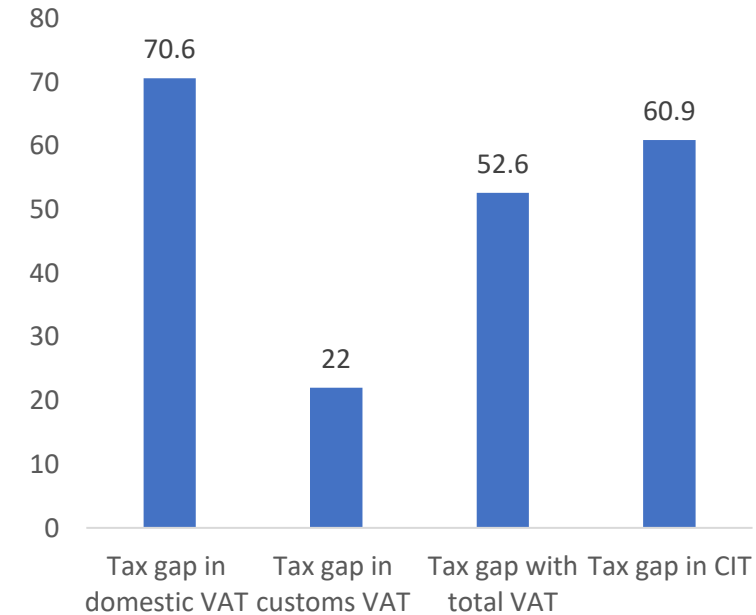
Productivity in most tax collections are lagging

VAT productivity ratio and C-efficiency, 2019



Estimated shortfall in tax revenues against potentials due to various benefits and exemptions

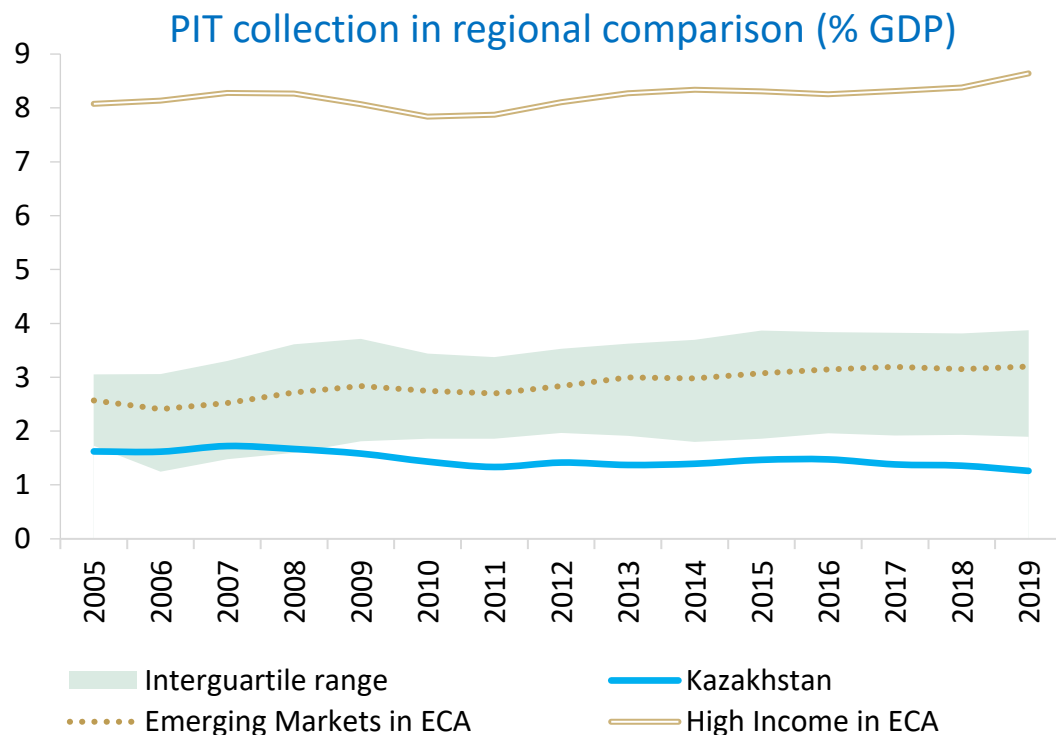
Projected tax gap (percentage)



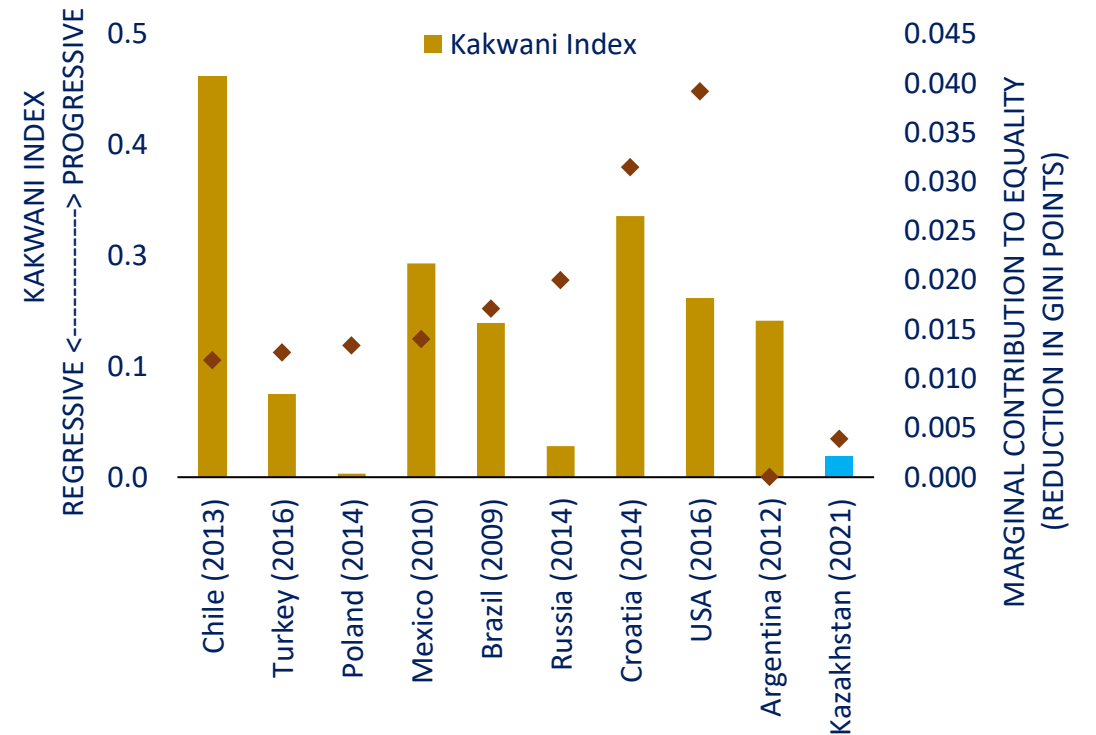
Kazakhstan's tax policy is among the least progressive

Diverging path in PIT collection: while the average is going up, Kazakhstan is going down

Direct (income) tax in Kazakhstan is among the least progressive



Progressivity of direct taxes in selected countries



Priorities for revenue policies

Rationalize tax incentives

- Review existing incentives and institute a Tax Expenditure Analysis/Report

Simplify the special tax regime for SMEs

- Use annual revenue turnover as a single eligibility criteria
- Apply the same VAT threshold for those in the standard and special tax regime.

Make PIT more progressive

- Raise the basic deduction and eliminate various exemptions.
- Introduce more progressive PIT structure.
- consider introducing wealth tax in the medium term

Reform the VAT regime

- Harmonize VAT threshold with threshold defining SMEs in the special tax regime

Broaden the excise coverage

- Review and consider broadening excise on all fossil fuels.
 - Excise on fuels at 25% of EU rates potentially adds tax revenue up to 4% of GDP by 2030
- Consider further raising excise on tobacco

Make tax administration as enabler

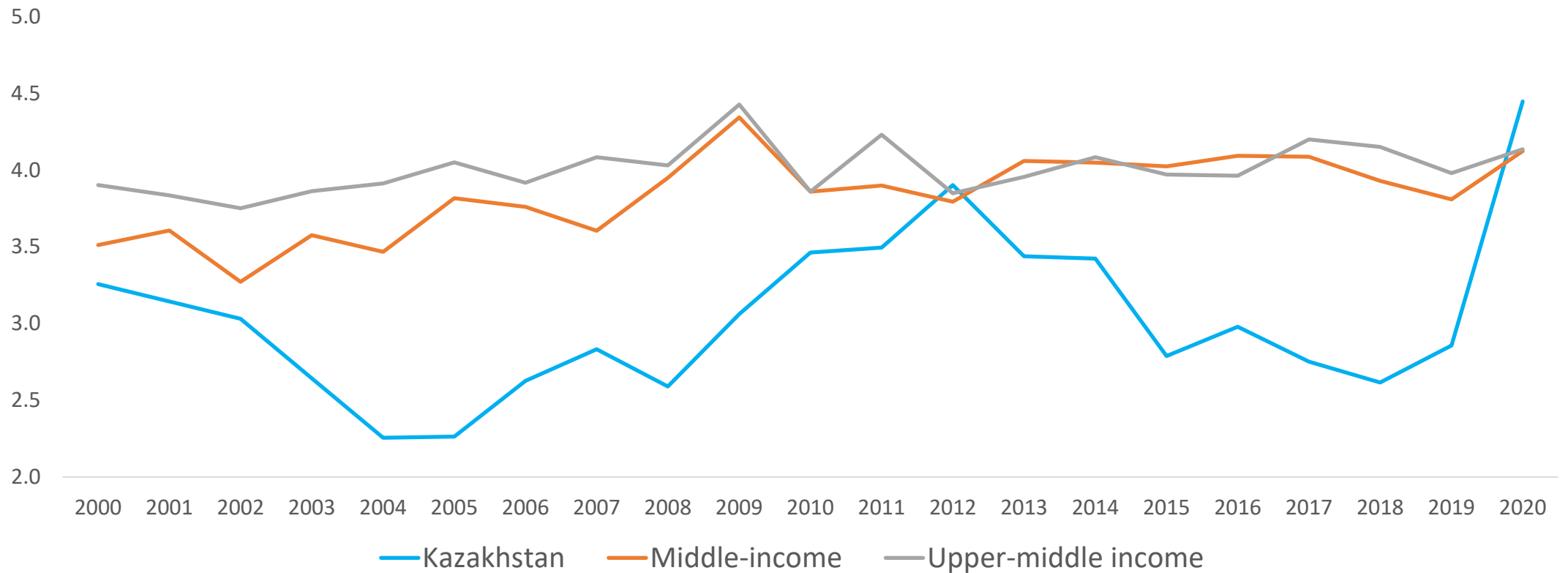
- Effectiveness of tax policies depend on the quality of tax administration.
- Continue the path to modernize tax administration.

Public spending on education

Mindful about what to spend on

Kazakhstan public spending has increased sharply

Government spending on education as percentage of GDP

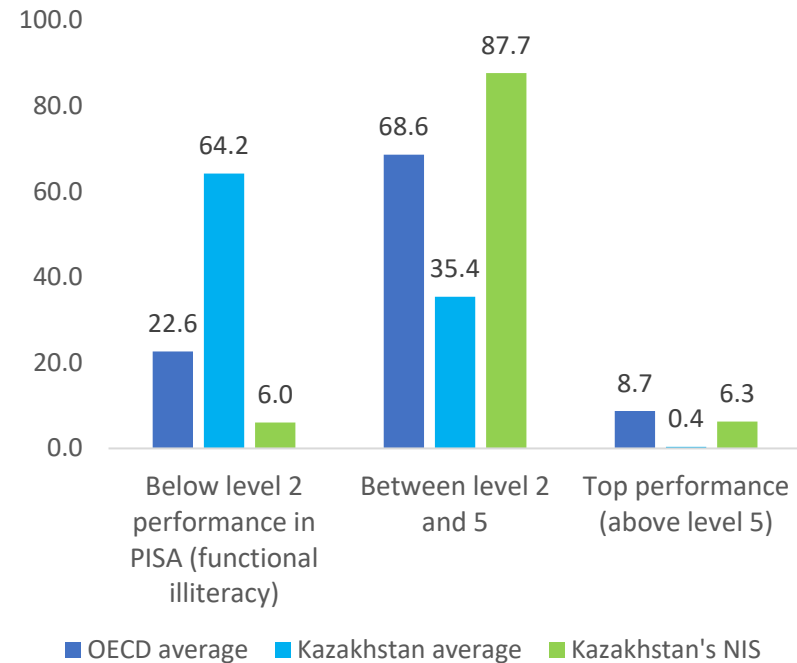


The system created bulk of low performers with elites of high performers

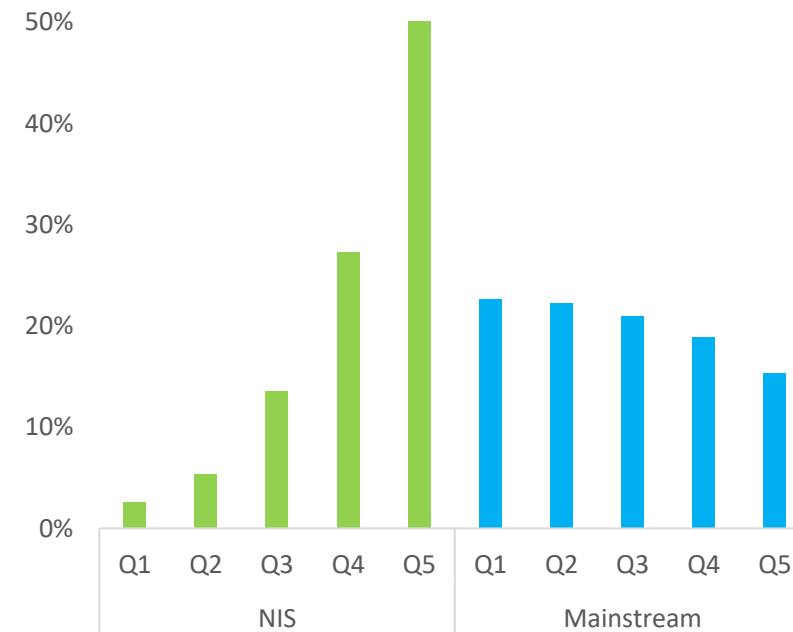
While most students in mainstream schools are functionally illiterate, students of elite public schools performed better than OECD average.

Students at elite public schools disproportionately are from well-off families.

Performance of 15-years old students in PISA (2018)



Distribution of students' socio-economic status in the NIS and mainstream schools across quintiles

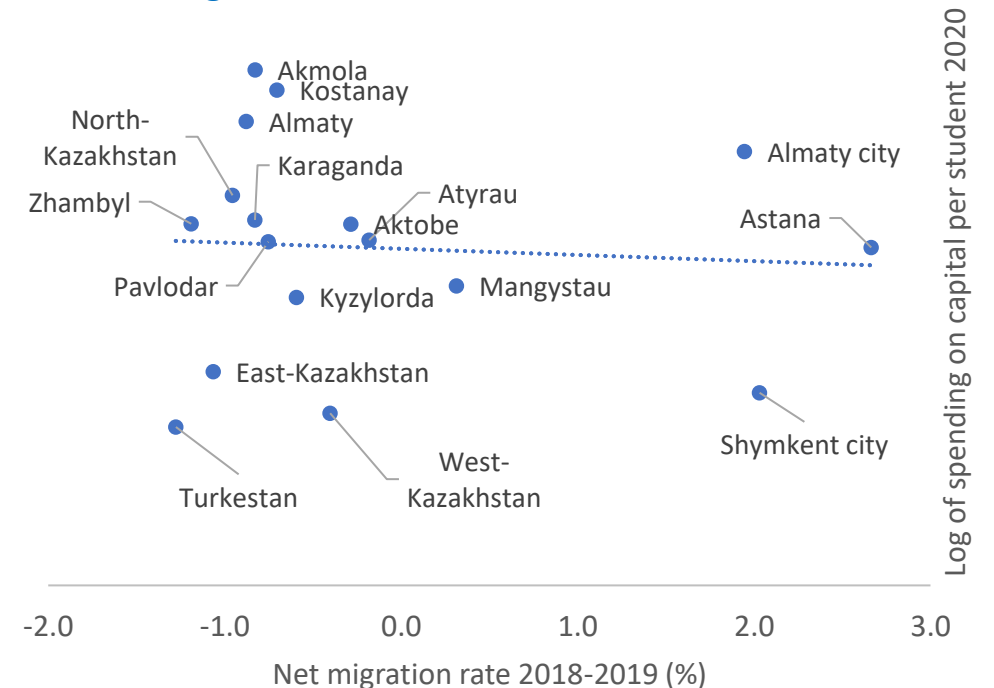


Improved results will not come only by raising teacher's salary...

- **Planning for school infrastructure spending is sub-optimal.**
- **Teachers' remuneration system (*Stavka*) incentives in-class teaching hours.**
 - Not for developing materials and professional capacity building.
 - Skewed supporting already high-performing students.
- **Wide variation of students-teacher ratio.**
 - Redeployment of teachers is needed.

.. If capital spending is not responsive to regions' dynamics

Capital spending per student and net migration rate across regions



Key policy options

Optimize school infrastructure network and teaching effectiveness

- Better localized planning.
- Attract private sector participation in preschool.
- Redeployment of existing teachers.
- Monitor efficacy of teachers' reform.

Improving local delivery of education services

- Between 25 to 46 percent of subnational governments' budget is spent on education
- Weak connection between central planning and regional needs.

Improve institutional accountability

- Utilize data for monitoring outcome and decision making.
- Better transparency in budget execution.
- Empowerment and clarify responsibility of subnational governments.

Target support to socio-economically disadvantage students and those with lagging education outcome.

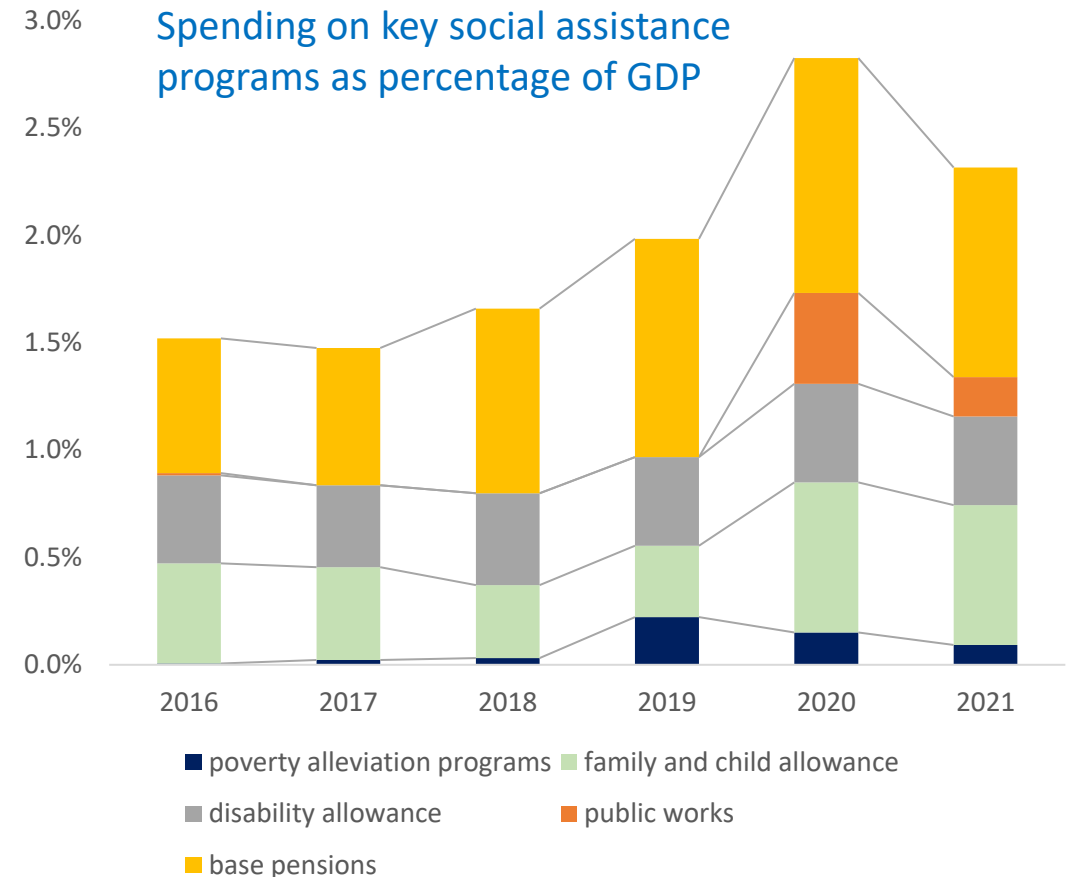
- Include equity criteria in per-capita financing.
- Change teachers' remuneration system.

Public spending on social
protection

*Opportunity for better design and
systematic evaluation*

Social protection is among the highest component in total government budget.

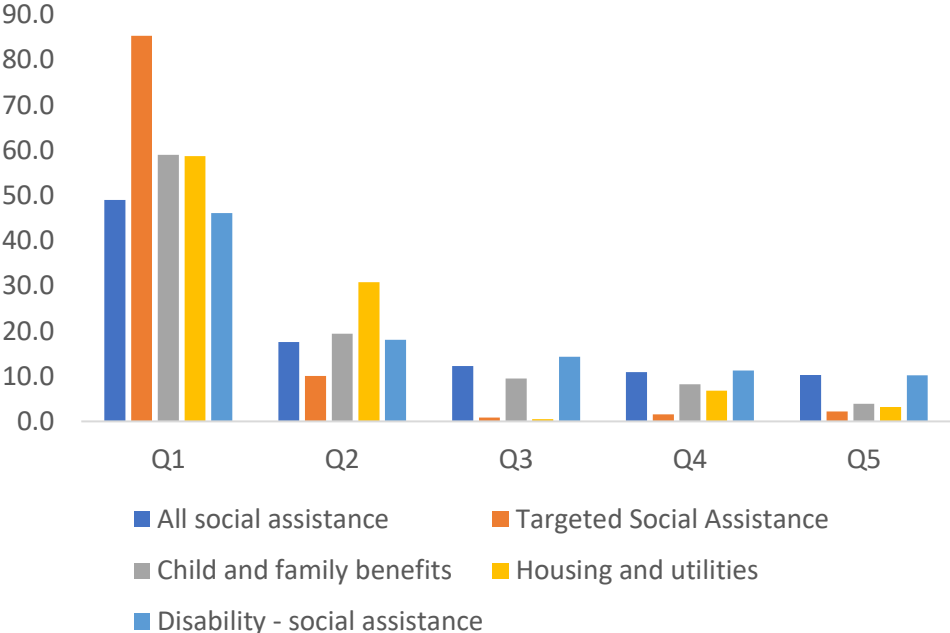
- **Sizeable size increase**
 - 4.9 % of GDP in 2006-2009 to 5.5 % in 2018-2021.
- **Significant increase in social assistance (SA), mostly for categorical programs.**
 - Small poverty-targeted social assistance (TSA) – less than 0.2% of GDP.
- **Large and growing social insurance.**
 - Low participation from informal workers.
- **Modest active labor market programs (ALMPs)**
 - Skewed towards entrepreneurship program (grants, microloans)



Targeted social assistance (TSA) has the best performance, although resource allocated is very small.

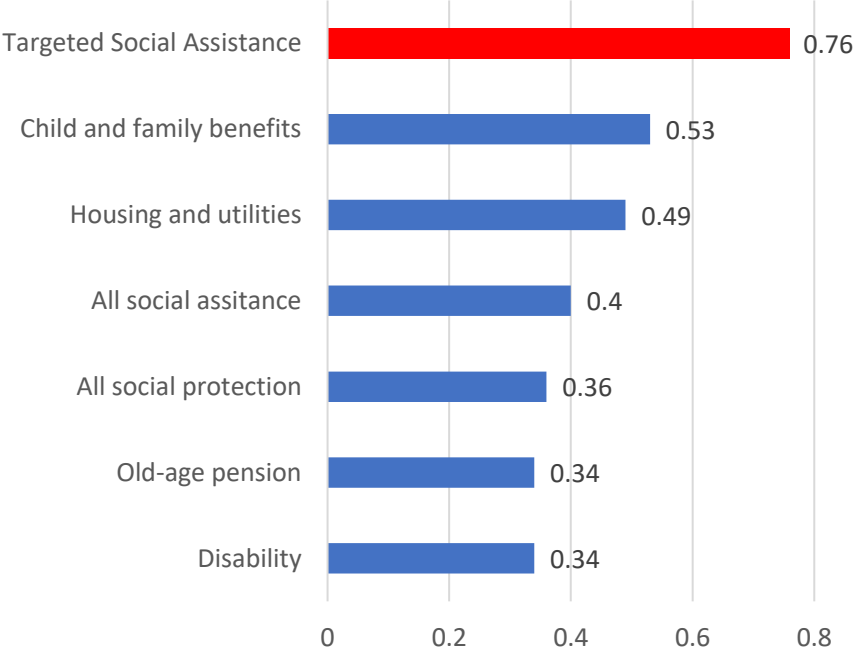
TSA is benefiting the poor the most

Benefits incidence for SA programs across income quintiles, 2021, percent



TSA is the most effective SA instrument, despite limited resources allocated

The benefit-cost ratio of SP programs, 2021



Improving the design of social assistance can free up resources for poverty-targeted program

Child and family benefits

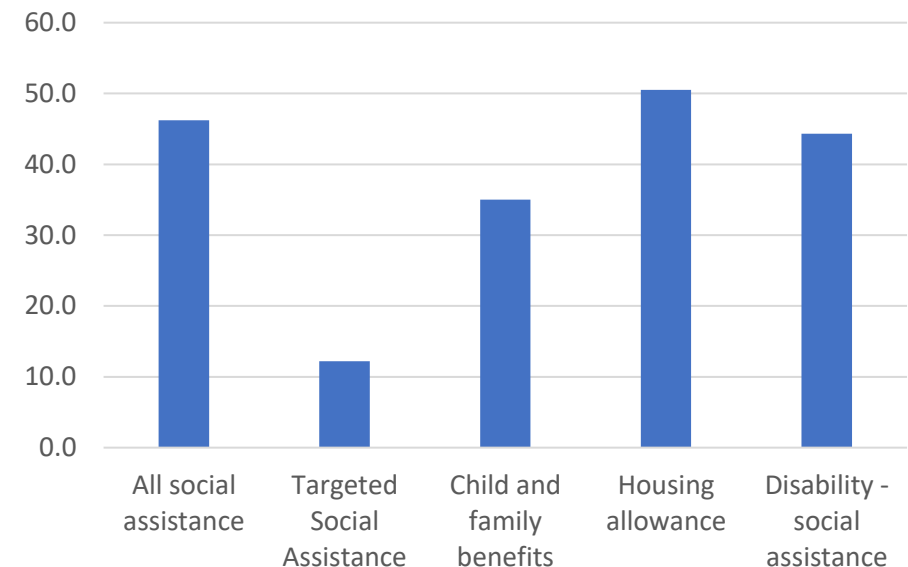
- Consolidation and better targeting can save about 0.14 percent of GDP.
- Potentially double resources for TSA at no cost.

Housing utility allowances:

- Run by subnational governments and are means-tested.
- Review to improve design and implementation.

Some programs have sizeable non-poor beneficiaries

Estimated Leakage of SA programs (percent), 2021



Policy options for other components of the Social Protection system

Social insurance:

- Bring more workers to the formal sector.
- Review governance and sustainability of the fund.

Active labor market programs:

- Review the efficacy of the program.
 - Impact of entrepreneurship program?
 - Impact of skills training on job placements?
- Improve profiling of the participants for better targeting.

Budgeting and Planning

Moving from tools for compliance to processes for achieving results

Overall challenges in budgeting and planning process

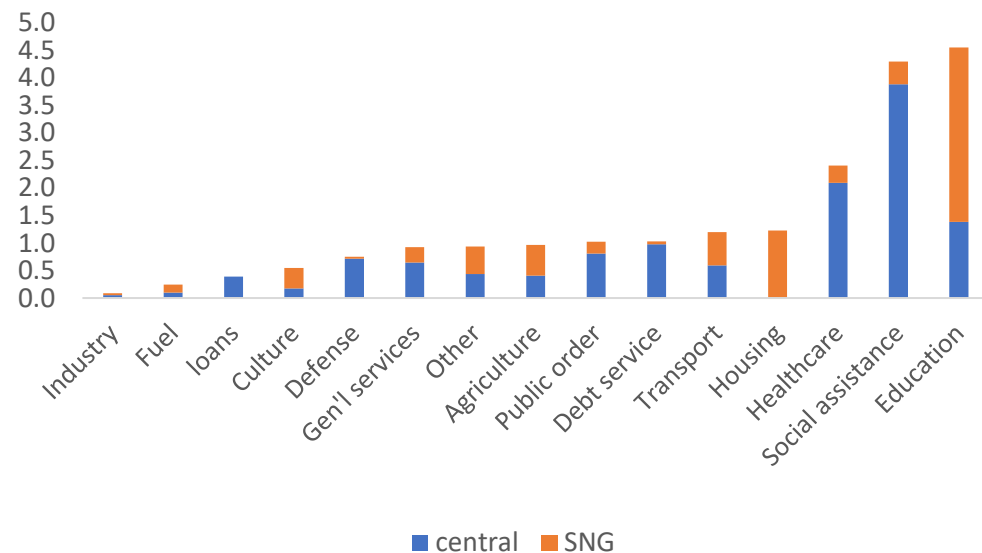
- **Implementation gap**
 - Link between spending and the stated strategic goals are not always obvious.
 - Ineffective performance monitoring and evaluation.
- **Over-focused on compliance**
 - Programs are overusing output indicators – ticking the boxes.
- **Transparency improved, but the effectiveness is questioned.**
 - Not all information shared are useful – limiting citizens' engagement
 - Some programs have spending declared as spending on “others”.
- **Inclusivity and green transition are not reflected**
 - Gender dimension is still missing.
 - “Brown activities” are not clearly reflected in the budget.
- **Opaque inter-governmental fiscal transfers**
(Continued in the next part).

Intergovernmental Fiscal Relations

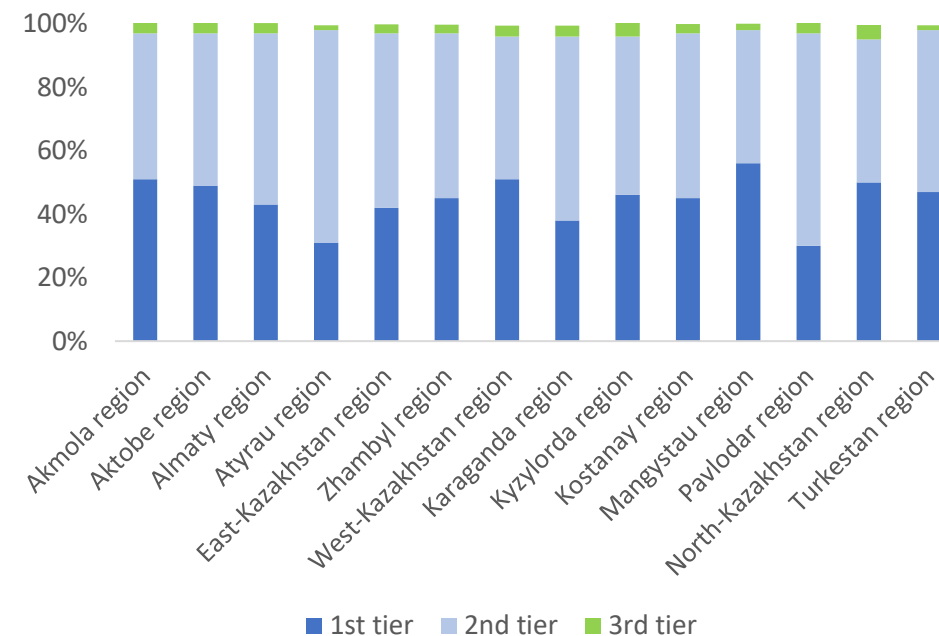
Opportunity to address complex and opaque transfers system

Division of functions/tasks between central and subnational governments (SNGs) is clear

Division of spending responsibility between central and SNGs (trillion, 2021)



Spending by each tier of subnational government (% of spending by each tier, by oblast, 2021)



Subventions (transfers) and withdrawal are to reduce variations in SNGs own-revenues.

But the current system for financing SNGs is opaque and unstable

So far so good? Not really...

- **Complex methodology to determine transfers from central government to oblasts.**
 - Too much attempt to equalize scope and level of public services across jurisdictions (Order no.139).
- **Transfers system to lower tiers (raions, okrugs) is not clearly spelled out.**
 - Dependent on shares of CIT, PIT, social taxes collected in their jurisdictions.
 - Risks of negotiations for resources across levels within SNG.

Reform priority should be on the transfer system.

- **Simplify the system for determining transfers from central government to oblasts**
 - One option would be to bring oblasts' per-capita revenue up to a fixed percentage of the national average.
- **Provide more stable source of revenues for lower level SNGs by clarifying the transfer system from oblasts**

Rakhmet Sizge