

KAZAKHSTAN: A PROGRAM FOR TOMORROW

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I am really thankful to the Organizers for invitation and opportunity to address this Conference, most remarkable due both to the topic and participants. Prior to speaking, I should note that my opinion does not necessarily coincide with the official views of Kazakhstan Government.

In a nutshell, my vision for the tomorrow's agenda is as follows:

1. **Changing the role of government** that should step away from involvement in economy and concentrate on advancing the social sphere and infrastructure, judicial system and law enforcement.
2. **Development of institutions** at all levels: political parties, Chamber of Commerce and Industry, consumer and professional associations, non-government organizations (NGOs), etc, regarded as elements of future civil society.
3. **Launching integrated and interrelated long-term programs** in education, health, sports and physical culture, social security and housing.
4. **Reforming natural monopolies.**
5. **Development of financial system**, with focus on the stock market, housing financing (mortgage and saving schemes), life insurance, financial leasing and plastic cards.

6. **Government service reform**, with introduction of electronic government, social package for civil servants and effective fight against corruption.
7. **Economy diversification program** focused on development of small and medium business, tourism, science-intensive industries and services.
8. **Transfer to international standards** in areas where these exist (Basle banking regulations, ISO quality standards or Lisbon Convention on the Recognition of Qualifications concerning Higher Education in the European Region), and best practices in areas not covered by standardization.
9. **Lowering taxes and streamlining taxation system**, as well as improvement of inter-budgetary relations.

To begin with, we should recognize that the post-Soviet period has virtually ended. As a matter of fact, funds acquired due external conditions should not be necessarily funneled to restore past programs. We should also admit that the current economic model, which has been built by and large spontaneously but not thanks to pinpointed activities of reformers, presents post-socialist capitalism with intrinsic specifics. At the same time, these particular features do not compose *a third way*. Hence, in future we should move ahead towards our own version of a socially oriented market economy, taking into account all problems that upset European countries with inflated social expenditures.

On the whole, everyone understands in which direction to proceed. As for the means, time limits and resources, each country resolves these problems individually. At that, the transition trajectory is never set beforehand within formally approved programs. It finds its way through practical reforming, political compromise and resistance to change on the part of certain economic agents. Since this rule is universal, greatly different from each other are the German, Swedish and British models in Western Europe, as well as those taken up by Japan, South Korea and Singapore in East Asia.

Hence, one subject on the Conference agenda seems to be quite perplexing, i.e. the role of international organizations. At best, it might be of marginal significance. However, one should not expect from them any kind of effective input at this stage of reformation. These entities were of help in early 1990s. But those times are virtually over, which seems the best outcome for all parties involved. As for today, the focal point should be on regional integration and national interests.

1. Government Role

In the 1990s, when some Western experts labeled transitional economies as developing countries, Polish and Hungarian representatives took offense, insisting that former Socialist states rather deserve the title of *misdeveloped*. Nowadays, many CIS states do not differ greatly from the developing world. So, the choice seems to be obvious – either working hard to move closer towards the industrialized countries, following the path of Singapore, Taiwan and Central European countries, or drifting at varying speed towards the third world.

The same refers to the role of government in our countries. Apart from being obviously excessive (not only in liberals' opinion), this role is also disoriented since the government is heavily involved in areas where the market can do the main job alone (economy, finances). At the same time, the government seems to be too meek in performing its classic functions – primary and secondary education, healthcare, law enforcement, infrastructure, etc. Obviously, this mix comes from residual effects of the Soviet period during which everything belonged to the state combined with early 1990s, when the state was extremely weak. But it is this very mix that hampers the advance of reforms. If we rely only on bureaucracy, the process would proceed *back to the USSR*, but in a considerably worse version.

What we need is a complex of measures to weaken the government function in areas where it is either excessive or irrelevant, and to strengthen it in areas where the market is not capable or too weak to offer the required assortment of quality services to the public. Instead of direct participation of the state, which often distorts market activities, we need information support, macroeconomical stability, guarantees for contract fulfillment and protection of property right.

For example, the financial sector. The state can and should engage in licensing and regulation, foster development of this sector and even play on primary and secondary markets, whenever the market needs support. I mean partial credit guarantees for small and medium business, guarantees for export operations from political risks, long-term credits from development banks if commercial banks refuse to extend them, and refinancing of banks on secondary markets in mortgage crediting. However, there is absolutely no point to have direct government participation in the capital of ordinary

commercial banks and insurance companies, which is still common practice in our region.

2. Development of Institutions

Any kind of society is similar to a living organism and requires a spinal column. And it was the bureaucracy that has been this backbone in our region in past years. At that, there is still no clear-cut and publicly accepted division between political and administrative officials. Most of them feel accountable only to the higher echelons, but not to the public. As a result, we have a rigid hierarchy able to resist the central government in cases when its activities threaten the structure's interests. As these customs are extremely durable, there are no fundamental differences between Russian bureaucracy of mid-19th and early 21st centuries over all CIS republics. Apart from the public servants and the president (in some countries), our region has no other potent institutions – political parties are just emerging, the army has thankfully never been a political player, and the church has lost its stand during the Soviet period.

For the reforms to be successful, our region needs three components, i.e. a strong president enjoying popular support, a group of reformers and an apparatus that would assume and implement the novelties. Apparently, the main problem is with the apparatus, which distorts, blocks or sabotages many initiatives. Consequently, the public regards reforms as another misfortune.

Parallel with improvement, training and educating the bureaucracy in view of its susceptibility to changes, we should voluntarily build a *parallel backbone* for a future society. The state machine is not something to be rebuilt in a whiff. So, at first we should

create *islands of competence*, say, independent Central Bank and statistical agency, as well as departments that never existed before. We need incubators for generating a new breed of medium-level officials, as well as a relevant monitoring system. Most importantly, the state should consistently assist development of non-governmental institutions, which could in future make a system of checks and balances for the omnipotent bureaucracy, as well as a basis for building civil society.

3. Social Sphere

In the USSR, the healthcare and education systems were among the best in the world. However, they fitted only the Soviet society and planned economy. With that society and that economy long departed, the systems remain largely unchanged. The difference is in curtailed financing, lower quality of services and insertion of market elements, often bizarre and impulsive. In other words, the new basis did not receive a new superstructure. I should say that enhanced financing would hardly improve the quality. First of all, we need systemic reforms. Education has been internationally standardized, with the Lisbon Convention setting forth quite appropriate yardsticks – 12-year secondary education and three-level higher education (bachelor's degree, master's degree, PhD). But healthcare and social security have no such standards. And there is no country with recognized optimal systems ready for prompt implementation.

Evidently, in absence of adequate healthcare and education one cannot maintain a competitive economy, and in absence of effective social security one cannot have a stable society. However, no CIS republic has performed thorough reforms in these fields, except for Kazakhstan with its funded pension system. In many cases, residual

financing prevails, with no one willing to recognize that skilled labor and material reserves from the USSR heritage will not last forever.

Primarily, we should establish the minimal standards feasible for the state in view of the system's first level available for every citizen. These services should include a guaranteed scope of free medical care, pay-as-you-go pensions with stepwise transfer to demogrants (basic guaranteed pension) and allowances, as well as preschool care, secondary education and vocational training.

Workers in legal economy need funded pension schemes (involving obligatory and/or professional contributions) for pensions, social and medical insurance, which would make the second level.

The third level is to be built via voluntary contributions of citizens willing to retire early or receive better services.

The same scheme is applicable to housing. Certain categories of population and residents of homes to be demolished should receive government-built social housing not subject to privatization. Lower middle class should acquire a housing savings scheme to receive budgeted premiums if they exceed the yearly established accumulation level. And the upper middle class should obtain mortgaging, with the government role limited to bank refinancing on secondary market and participation in a fund to guarantee mortgage credits.

In other words, the government function should vary with the population categories – maintaining minimal standards for everyone until introduction of real means

testing, social assistance to vulnerable categories, social insurance for workers, and a chance for people to save money within various schemes organized and supervised by the state.

4. Natural Monopolies

Bearing in mind that our economies greatly depend on production, processing and transportation of raw materials, with energy-saving technologies mostly unused, the key issue is in tariffs and performance of natural monopolies. In this area, we should also establish a clear-cut role of the state that must maintain an appropriate presence, ensuring fair and objective regulation. The government is to retain ownership of only arterial systems – main railways, pipelines and power lines. But transportation, gas or power production should be transferred to the competitive sector. At that, the regulator (overall or sector) should straightforwardly set rules ensuring equal access of all operators to the main lines, in order to prevent preferences in favor of state or quasi-state companies.

Absolutely vital is separate accounting for various operations, which is non-existent but would provide a clear view of cross-subsidizing inside the companies. The remaining government *arterial* corporations should operate following the principle of *approved costs plus rated profitability*. And the tariff should indicate the investment component. As for the corporations' investment programs, these should be coordinated with the regulator and approved within the national budgetary process. A portion of their shares should go to the stock market to ensure additional external control from private investors. Boards of directors should be at least by one third made up of independent directors, with president, vice-president for acquisitions and financial director employed

via open international contest. Another must seem to be selling extraneous assets, as well as selling or remodeling subsidiaries and/or affiliated firms.

These measures would make natural monopolies transparent, and attract private investment into transportation, renovation of the car and engine fleet, power production and distribution and related segments, find investment into reconstruction and building of main railways, power lines and pipelines.

5. Financial System

In the financial sector, advance to international standards seems to be the simplest solution, as these exist in practically any segment, i.e. *Basle standards* – for banks, *Bank for International Settlements Bank* – for payment systems, *IAIS* – for insurance, and *IOSCO* – for the stock market. There are no final recommendations for deposit insurance funds and no standards for accumulation pension systems. But practical experience exists for 15 countries, so best practices may be used. The combination of available standards and best practices has produced very good results in Kazakhstan. During the past 4.5 years the GDP in dollar equivalent has doubled, the financial sector has grown by 600 and public deposits – by 800 percent.

The financial sector should be open to foreign participants. However, during the transitional period there may be limitations for the foreign capital share, with its level reaching 100 percent in certain institutions. During past three years the share of foreign banks in Kazakhstan's assets has been on a stable decline. If the trend holds, next year no major foreign bank (*CityBank*, *ABN AMRO* or *HSBC*) will enter the top ten. At that,

foreigners control 17 out of 34 commercial banks, and regulatory structures openly favor attracting new major foreign players to the banking market to enhance competition.

The important thing is to have a holistic concept for development of the entire financial sector, because banking, insurance and stock markets usually develop in discord, bringing about distortions. As practice of many countries shows, if the state fails to play the governing role and assist development of the stock and insurance markets, banks will dominate in all segments to affect competition and service quality in the long term.

Obviously, the corporate bonds segment competes with bank credits on the assets side, and accumulation insurance policies run against bank deposits on the side of liabilities. Hence, these products must be offered not only by bank-affiliated companies, and, on the whole, all segments of the financial system should develop at equal rate.

For our region it is also vital to make the government adopt laws and taxation that would support development of such products as financial leasing, plastic cards, mortgage credits and housing savings schemes, life insurance and pension annuities. Life shows that in absence of government leadership, introduction and, moreover, wide use of these products may be procrastinated for many years. Currently, even Russia has no complete set. Absolutely essential is a market of government securities with clear-cut rules and a loan plan extending for one year or, still better for three years. At that, auctions for various securities should be regular, with securities having both a fixed rate and the one adapted to inflation level. Only availability of long government securities (15-20 years) will produce standard instruments and develop a market for long-term corporate and mortgage bonds.

In the long securities segments, investments will mostly come from pension funds or their management companies, as well as life insurance firms. And those will be issued mostly by mortgage banks/firms and government development institutions. If we fail to create such markets, long-term financing will become extremely difficult, which had been a fact until recently. Nowadays, mortgage credits in Kazakhstan have a maturity period of up to 15 years at 13 percent. And the *Kazakhstan Development Bank* extends credits for infrastructure projects for 7-8 years, as long-term financing has become possible with help of the Non-Government Pension Fund.

In every country the pension system structure hinges on the demographic situation and budget capacity. But our experience prompts that an optimum system should have three levels, with the bulk of resources accumulated at level two via obligatory payment of a 10-percent salary share by all workers. Level one is made by liabilities within a joint system, and level three – by voluntary contributions and/or professional schemes. The second and third levels are based on the EET principle. And now the Kazakh Non-Government Pension Fund's assets exceed the 9-percent level of GDP, which is higher than in Spain or France. And we had the new system introduced only in 1998.

6. Government Service

The only way to transform bureaucracy in a systemic manner is to use simultaneously three approaches – electronic government, social package for public servants and effective anticorruption action against those who remain unaffected by the two previous measures.

In our region the question is not about the need for electronic government, but about the method and timing. The reason is in the fact that the entire Europe, including Eastern Europe, is moving in this direction within the EC framework. Governments insist that businesses should be competitive, but the same applies to rendering government services to the public. And this is something we do not have. Once Chancellor Schroeder said: “Data, but not citizens, must do the running”. In introducing electronic government, the key issue is not in replacing the document turnover by electronic process, but maximum exclusion of physical contact between the public, businessmen and low-level officials, where main problems emerge, i.e. corruption, queuing and scandal. Electronic government is both transparent and small, just the thing we need.

Naturally, it would require investment in computer proliferation and providing both wide and cheap access to the Internet – a campaign similar to one executed in the USSR to eliminate illiteracy in 1930s. Incidentally, in discussion of the electronic government concept, businessmen proved ready to participate, as they are interested being future users.

The second approach means a social package for government servants to hold them in their positions for a 5-7-year period. The salary is not to solve the matter, as it is always higher in the private sector. And it is politically complicated to raise the salary several times higher than in government sector structures. The social package involves budget payments for medical and life insurance, extra days of paid leaves after 10-year record, additional payments to the pension fund after 5-year service, bonus payments to the housing bank account, etc., which may make people really interested without excessive pressure on state budget.

Besides, if the official leaves the job at his will or following corruption charges, bonus payments in pension funds and housing banks must be returned. Each year the servant shall have an assessment of his package in market value. Should it make 20-30 thousand dollars, there will hardly be a man risking to lose it for a 500-dollar bribe. Items 7 and 8 are quite obvious.

9. Taxation System and Inter-Budgetary Relations

There should be few taxes with low rates and clear distribution of authority between different government structures within a streamlined transparent fiscal system (where federalism is non-existent and non-required). Under discussion we have a version that could be interesting in view of an agreement between government and business. Starting from 2005, the corporate income tax will be lowered from 30 to 25 percent, after which the government is ready drop one percent a year to the 20-percent level, provided the relevant revenues grow annually by more than 10 percent, since inflation in Kazakhstan averages at 6-6.5 percent. In other words, in exchange for lower taxes, the government suggests that business should raise the collected sum and advance into legal economy.

The same scheme is offered for the social tax, its upper limit currently making 20 percent. The condition is that revenues grow annually by 15 percent and more (nominal wages in Kazakhstan grow by 12-14 percent). The rate will annually drop by 1 percent to stimulate over-the-table salaries and discharging under-the-table payments. Should the schemes be realized, by 2010 Kazakhstan will have a 20-percent corporate income tax, with the upper limit of individual income tax being the same. The economy efficiency is

to make about 11 percent, upper social tax – 15 percent, with the average of about 12 percent. As we see the situation, within such taxation limits honest operation will become profitable for every businessman.