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KAZAKHSTAN: STRENGTHENING PUBLIC FINANCE FOR INCLUSIVE AND RESILIENT GROWTH

PUBLIC FINANCE REVIEW – OVERVIEW REPORT

Kazakhstan: Strengthening Public Finance for Inclusive and Resilient Growth

Overview of the Public Finance Review

Kazakhstan is endowed with fiscal buffers from oil revenues, but its public finances need improvement if the country is to support inclusive and resilient growth. This Public Finance Review (PFR) acknowledges the progress already made by the Government of Kazakhstan to improve fiscal and budgeting policies, and maintain a relatively low level of government debt. However, the PFR also concludes that the country's public finances are undermined by a lack of clarity in the overall fiscal stance, the proliferation of quasi-fiscal activities (QFAs) and deficiencies in monitoring the risks that these QFAs pose to the budget, low productivity in revenue collection, low progressivity in revenue policy, significant inefficiencies in spending in key areas, and underdeveloped monitoring and evaluation in budgeting and program implementation. Given the importance of education and social protection in public spending, this PFR stresses the need to improve the efficiency, equity, and effectiveness of public spending in education, and the targeting and evaluation of the social protection system.

Improving public finance policies has never been so important for Kazakhstan, given the challenging prospects for growth. Despite the end of the COVID-19 crisis, near-term external conditions remain challenging. The main risks arise from uncertainties in global economic growth, volatile commodity prices, and geopolitical conflicts such as Russia's invasion of Ukraine. Kazakhstan also faces high consumer prices, with inflation reaching 20 percent year-on-year (y-o-y) in December 2022—the highest level since 2016. The nationwide protests in January 2022 added pressure for more accountable, inclusive, and transparent approaches in public finances. The unrest also tested the Government's capacity to respond to growing concerns over wealth and income inequality. Although Kazakhstan has a Gini coefficient of only 0.29 (2021), this statistic is misleading due to underreporting in surveys, and contrasts with the fact that the World Inequality Database suggests that the top 1 percent of income earners in Kazakhstan possess nearly 30 percent of the country's wealth compared with just 5 percent of that wealth for the bottom 50 percent of the population. Continued volatility in oil prices also exposes oil revenues, which contributed 35 percent to the government budget, to the risk of sharp fluctuations.[1] Kazakhstan is also exposed to climate change and the green transition, which expose the budget to climate-related disasters and the possibility of slower growth in oil revenues going forward.

The Government has taken steps to improve public financial management (PFM). In 2022, the Government adopted the *Concept of Public Finance until 2030* as a framework to preserve fiscal space by controlling spending, raising revenue, limiting public debt, and improving transparency in budget reporting. The Concept aims to reduce the non-oil deficit, which remained elevated at 9.9 percent of GDP between 2019 and 2021, to just 5 percent. It also outlines the 2030 debt limits as a percentage of GDP: total public debt[2] (28.3 percent at 2021) and quasi-public sector debt (23.6 percent of GDP in 2021) should not exceed 53.2 percent of GDP. To preserve fiscal buffers, Kazakhstan aims to increase the assets of the National Fund of the Republic of Kazakhstan (the NFRK, or the "Oil Fund"), which stood at US$55 billion at the end of 2021 (28 percent of GDP), to US$100 billion by 2030. The Government has also introduced changes in the

[1] Using the Government's classification of oil revenues on general government budget: customs duty from oil export and transfers from the National Fund of Republic of Kazakhstan.

[2] Covering central government, local governments, government guaranteed, and central bank.

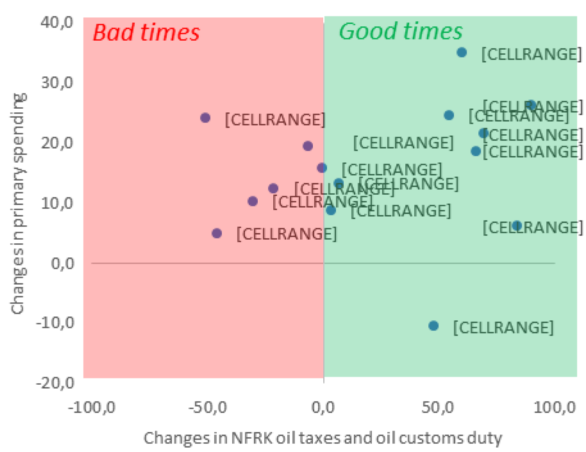
budgeting and planning processes to ensure that they are better aligned with Kazakhstan's development priorities.[3]

While these are all positive steps, this PFR identifies other important areas in public finance that warrant attention for policy reforms.

Fiscal framework and debt management: mind the gaps

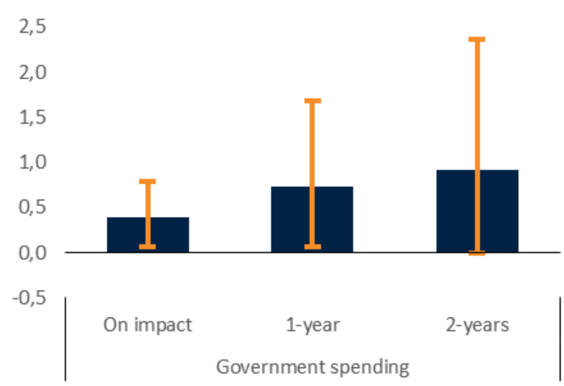
While the fiscal responses during bad times were decisive, fiscal policies can be strengthened to sustain macroeconomic stability and ensure better spending results. As an oil-rich country, Kazakhstan has the fiscal buffers to deliver strong fiscal responses to reduce the impact of negative oil price shocks on growth. However, during *good times*—when higher oil prices boosted customs duty from oil export and tax revenues to the Oil Fund—fiscal spending also tended to increase (Figure 1). Kazakhstan has done little to undertake fiscal consolidation when oil revenues have improved, with a notable exception in 2018. Since the impact of fiscal spending on growth increases over time, the fiscal framework needs to avoid perpetuating a loose fiscal posture that risks overheating the economy and weakening macroeconomic stability. This is because fiscal spending has a positive impact on growth and the impact is likely to grow over time. A 1.0-percent increase in real government spending is expected to increase non-oil GDP by 0.7 percent after one year and 0.9 percent after two years (Figure 2). The high confidence interval of the estimated multipliers, however, implies the impact of fiscal spending on non-oil GDP can be higher or lower. Kazakhstan can consider fiscal policies that help build fiscal buffers during periods of high oil prices and deliver better spending efficiency.

Figure 1. **Percentage changes in primary spending in *good times* and *bad times* across years (2007–2021**)



Source: World Bank team calculations.

Figure 2. **Fiscal spending multiplier on non-oil GDP**



Source: World Bank team calculations using quarterly data from 2005 to 2019.

Streamlining the fiscal rule to avoid complication convolution from multiple targets can strengthen

[3] Kazakhstan started introducing performance-based public administration tools in 2007. The Agency of Strategic Planning and Reform was set up in 2019 to coordinate the planning of major government programs and strengthen the alignment between plans and performances. The Government also has introduced series of amendments to the Budget Code to improve budget implementation, including government procurement and spending by cities of republican importance (Almaty, Astana, Shymkent) and their surrounding districts.

the fiscal framework. Currently, the fiscal rule contains several features, such as an expenditure rule, a non-oil deficit target, a public debt target, a debt service payment threshold, and a withdrawal rule from the NFRK. Having too many features in the fiscal rule can complicate the implementation without necessarily strengthening its credibility. The Government expenditure rule caps the growth of nominal government spending, if properly designed, can bring expenditure pressures under control during good times, while creating needed fiscal buffers. Expenditure rules are also more transparent and can be easily understood and monitored in real-time.[4] Combining this with a clear rule on the non-oil deficit would simplify the fiscal rule. However, the Government may want to reconsider fixing the annual Oil Fund transfers to the government budget—equivalent to the Fund's oil revenue at a low pre-determined oil price— as part of the fiscal rule. Such fixing can further complicate macro-fiscal management and may not be compatible with the target of keeping government debt below 27.5 percent of GDP by 2030. A modeling exercise suggests that, under a negative oil-price shock, fixing transfer from the Oil Fund to the budget may cause public debt to rise to allow counter-cyclical fiscal spending.

Eliminating the discretionary use of the Oil Fund, adopting a well-designed escape clause, and having an independent fiscal institution to assess fiscal policies can strengthen the credibility of the fiscal framework. There is still strong discretionary power to use the NFRK for targeted transfers for *the development of critical infrastructure and implementing projects of national importance*, at times and in circumstances that are not clearly specified.[5] While this decision can only made by the President, this practice nonetheless risks undermining the credibility of the fiscal rule. An escape clause would introduce more transparent criteria for departures from the fiscal rule in the face of exceptional circumstances. Currently, the practice is to amend the approved budget and switch into a crisis budget. A case in point is the COVID-19 pandemic, which triggered the suspension of the fiscal rule. Operationally, an escape clause can be tied to indicators such as a deviation of GDP growth from its long-term trend, or a rise in the unemployment rate. Kazakhstan may want to consider having an independent fiscal institution, with well-circumscribed responsibilities, to perform independent macroeconomic projections, and review fiscal performance and the fiscal stance.

Publishing a strategy that articulates the approach to manage debt should be considered. The *Concept of Public Finance* describes several debt limits for 2030, such 27.5 percent for government debt, 32 percent for public (government and central bank) debt, and 53.2 percent for public and quasi-public sector debt. To achieve this objective, the Concept mentions the need to keep debt service costs below 10 percent of the republican (central government) budget, impose mandatory approval for the quasi-public sector to raise external debt, and impose stricter limits for government external debt. While these limits suggest determination, they fall short in articulating some key issues, such as the potential costs and trade-offs of different strategies (composition, and sources of financing), the effect of shocks (on the oil price, exchange rate, and growth) on debt trajectory, and comparisons of different funding strategies based on realistic estimates of cost and risks. There is also a need to determine the issuance of government debt jointly with the use of NFRK assets as net public debt. All of these are typically presented in a medium-term debt management strategy (MTDS), which Kazakhstan has yet to publish.[6] Equally important is that having a published MTDS will help the Government in explaining to the public how it intends to sustain government financing at the lowest possible cost and acceptable risks.

Kazakhstan's fiscal framework needs to manage risk exposures from climate shocks and the green transition, including through taxing fossil fuels to internalize carbon emission. Droughts and floods, both exacerbated by climate change, cost Kazakhstan an average annual loss of 1.2 percent of GDP. These losses are expected to increase under a moderate climate change scenario to 2.2 percent of GDP. In a world

4 It is notable that, as of 2017, half of the then member countries of the EU had in place a national expenditure rule.

5 Government of Kazakhstan, 2022. "On Approval of the Concept of Public Finance Management of the Republic of Kazakhstan until 2030".

6 By June 2022, 69 developing countries already published MTDS.

in which many countries are ramping up decarbonization, a gradual decline in the oil price may reduce real GDP per capita by 2.5–3.0 percent compared with the baseline projection by 2050. Managing this risk would require the Government to embed stress testing from different scenarios of green transition and climate shocks in the medium-term economic and fiscal framework. As also discussed later, the Government might consider expanding the coverage of excise to all fossil fuels, which can would revenue and build incentives to reduce carbon emissions. A gradual increase in excise rates on all fuels to 25 percent of the level specified under the EU directive will gradually increase tax revenue up to 4 percent of GDP by 2030 (World Bank, 2022). The projections also suggest that recycling 40 percent of the excise revenue as cash transfers for the bottom 40 percent of the income distribution could more than offset the negative impact of a higher fuel price on their consumption.

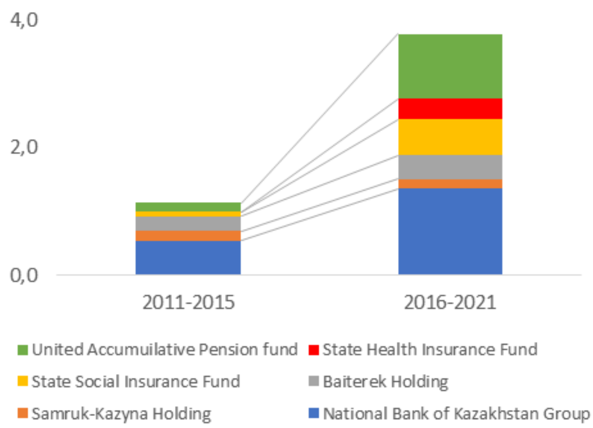
Quasi-fiscal activities: can they be managed?

The proliferation of quasi-fiscal activities (QFAs) casts a shadow over Kazakhstan's macro-fiscal management. Between 2017 and 2019, Kazakhstan's general government spending stood at about 21 percent of GDP compared with an average 31 percent for upper middle-income countries. But this relatively modest level fails to reveal the actual fiscal footprint. Gross spending of QFAs was about 3.8 percent of GDP in 2016–2021, three times higher than in 2011–2015 (Figure 3). For example, in 2021, the Government tasked the Unified Accumulated Pension Fund (UAPF) with facilitating a payout of 1 percent of GDP to support the housing program. The Kazakhstan Sustainable Fund (KSF) under the National Bank of Kazakhstan (NBK) also provided support for housing loans that amounted to 0.4 percent of GDP. These QFAs, carried out by extra budgetary funds and state-owned enterprises (SOEs), are not part of the medium-term fiscal framework and generate a deficit-biased fiscal stance. They also undermine the design of fiscal policy and thus create the risk of an excessive stimulus. Several extrabudgetary funds are financing the government budget and subsidizing QFAs through the purchase of bonds at a discount or the placement of deposits at below the market rate, which can cause losses for the funds.

Further actions are needed to systematically monitor QFAs and the risks that they pose to the budget. The Government should define extra-budgetary funds in a way that is consistent with the Government Financial Statistics Manual guidelines, which can help include QFAs carried out by the UAPF, the Problem Loan Fund, and the KSF in a consolidated government budget. The Government should also consider reporting contingent liability risks from QFAs by extra-budgetary funds and the quasi-public sector. A preliminary analysis on utility companies owned by the regional governments of Astana and Almaty suggests that in 2020, the policy to sell heating, gas, power, and water at below cost could have caused a substantial deficit of about 2.2 percent of GDP. Thus, QFAs can generate contingent liabilities for the Government that require analysis and monitoring. In this context, the Government might consider instituting systems to monitor risks from SOE operations along profitability, liquidity, and solvency metrics. This will allow Parliament to more effectively engage in monitoring and supervising the macro-fiscal implications of QFAs by extra-budgetary funds, which also enhances the accountability of those funds.

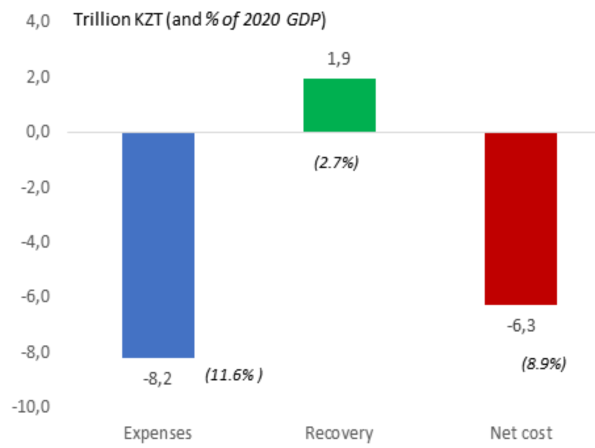
The use of public funds for bailing out banks without taxpayers' recourse is inequitable, as it constitutes a transfer of public funds to the banking sector and should be restricted. The prevailing bank bailouts between 2009 and 2020 (Figure 4) are estimated to have cost taxpayers as much as KZT 8.2 trillion in 2020 present value (about 11.6 percent of 2020 GDP) and resulted in an estimated recovery of KZT 1.9 trillion in 2020 present value (about 2.7 percent of 2020 GDP). These were mostly thanks to the PLF purchases of banks' non-performing loans (NPLs) at 100 percent of their origination price. In some cases, the KSF also provided bailouts by purchasing debt issued by troubled banks at a low price. For example, the bailout of the ATF Bank in 2020 was structured with a coupon of 0.1 percent—almost no return for taxpayers' money. Taxpayers must have recourse on the future profits of the bailed-out banks to realize a meaningful return. Such returns should cover part of the alternative cost of increasing sovereign borrowing and indebtedness or not investing taxpayers' money into public services.

Figure 3. **Gross quasi-fiscal activities by large SOEs and key extrabudgetary funds as a percentage of GDP**



Source: World Bank team calculations from published financial statements.

Figure 4. **Total bank bailout net cost for 2009–2020 in KZT trillion 2020 present value.**



Source: adapted from Mare, Melecky, and Muria (2022).

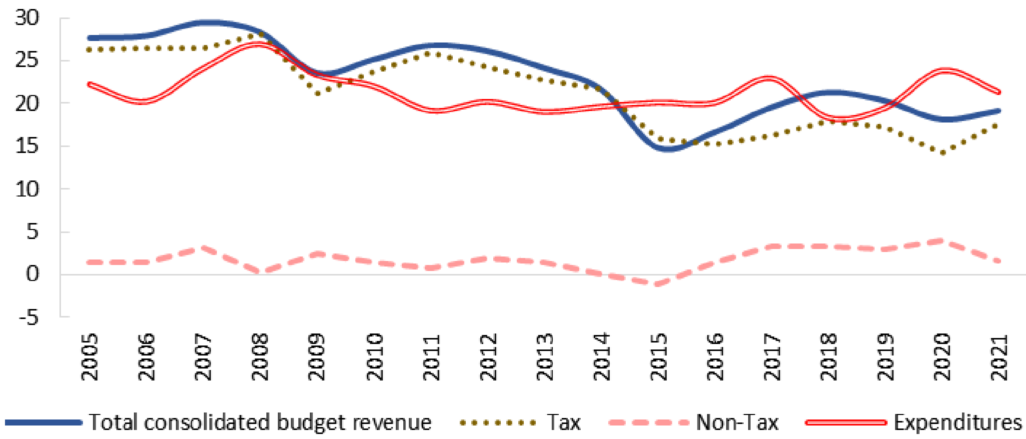
QFAs by the NBK can complicate macro-fiscal management. In 2021, the NBK supported various government initiatives, such as housing loan/mortgage program and state programs (Employment Roadmap, Nurly Zhol, and for priority sectors), which amounted to about 0.7 percent of GDP. While the support was part of a concerted effort to sustain economic recovery after the COVID-19 crisis, prolonging the NBK's involvement in supporting those programs risks undermining the credibility of the central bank's core mandate to maintain price stability. In this regard, the NBK may wish to consider transferring the fiscal agent function of the KSF Joint Stock Company to the Government (this type of transfer was already done with the Problem Loan Fund). This would enable the Government to put the KSF under the Government's consolidated budget reporting and incentivize transferring the support measures to firms and individuals from off-budget to on-budget programs, or through public financial institutions such as the Baiterek Holding.

Revenue policies: underwhelming and unprogressive

Kazakhstan's tax revenues as a percentage of GDP have been trending down during the past 15 years (2005–2021). The depressed revenues narrow the fiscal space and thereby limit the possibility for expanding public expenditures for sustainable growth, inclusivity and progressivity. After being stable initially, at almost 27 percent of GDP during 2005–2008, tax revenues declined significantly to just 14.2 percent of GDP in 2020 (Figure 5). Kazakhstan's tax performance, while slightly above the average for resource-dependent countries, has been lagging compared with the world average of 18.4 percent in 2019 (Figure 6). The decline in non-oil revenues as a share of GDP threatens to further constrain spending in the face of growing expenditure needs and keep the non-oil budget deficit unmanaged. The decline in oil revenues following the drop in oil prices during 2014–2015 has led to declining government revenues as a percentage of GDP.

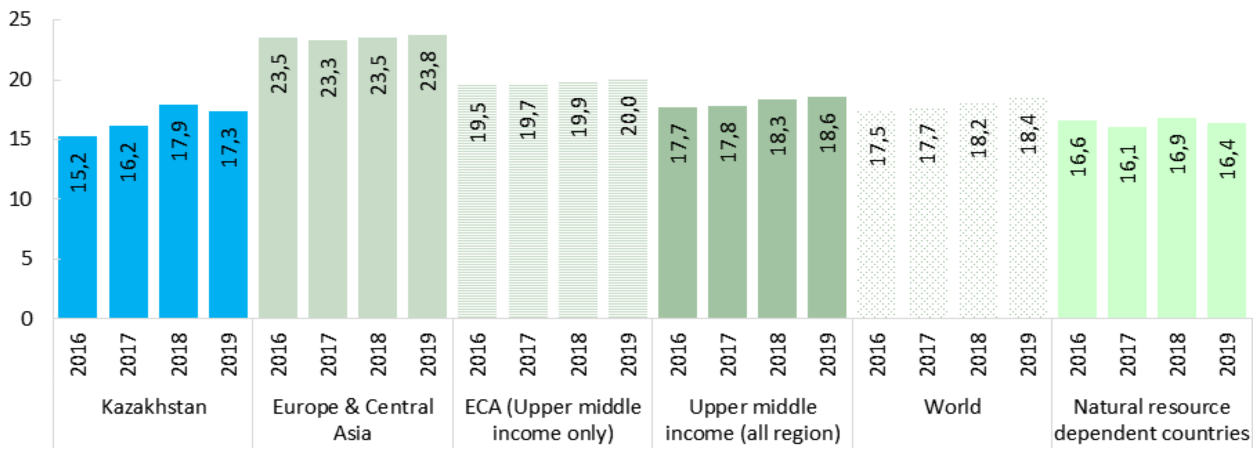
Most tax collection performance, except for excise and trade taxes, is suboptimal. Tax buoyancy—the extent to which tax collection responds to changes in the tax base—is weak. Over the period 2005–2020, tax buoyancy for all combined tax revenues stood at 0.74, meaning that growth in tax collection is less than economic growth. The highest tax buoyancy occurred for the tax on international trade, standing at 1.3, whereas tax buoyancy was lowest for corporate income tax (CIT), the social tax, and the tax on natural resources use.

Figure 5. **Revenue collection and total public expenditures (% of GDP), 2005–2021**



Source: World Bank team calculations.

Figure 6. **Tax revenue in international comparison (% of GDP)**



Source: World Bank team calculations.

Fiscal incentives, granted through various tax and expenditure instruments, are subject to executive discretion and are presumably responsible of a considerable revenue gap. The incentives are granted through CIT, customs duties, value-added tax (VAT), and investment subsidies (e.g., investment tax credits). They are spread across the Tax Code and other legislation, primarily the Entrepreneurial Code. Tax incentives are also subject to discretion by executive decisions (for example, the Entrepreneurial Code allows for tax incentives for sectors that are deemed a priority by the Government). This tends to create loopholes for a list of priority sectors to be expanded over time. A preliminary analysis on tax expenditures in Kazakhstan estimates that Kazakhstan's combined tax revenue gap for CIT and VAT was about 7.8 percent of GDP in 2021.[7] The incentives can also potentially create perverse incentives for firms to stay small or perpetuate an uneven playing field among businesses, undermining competition and productivity growth.[8] To attain the ambitious goal of tax intakes of 25 percent of GDP by 2025, it is most pertinent for the country to rationalize and reduce substantially the current magnitude of the revenue foregone from the major direct and indirect taxes.[9]

[7] A background analysis carried out after the completion of Tax Administration Reform Project.

[8] Evidence on the usefulness of tax incentives in promoting desirable outcome are mixed (see Section 3.4.3).

[9] The World Bank is advancing the follow-up TA to support the Government to institutionalize and build the capacity to analyze tax expenditures.

The structure of the special tax regime was intended to lower collection costs for small businesses, but this can have a negative effect on private sector productivity. The classification and structures are complex and open up a multitude of loopholes. The dual eligibility criteria of annual turnover and the number of employees to determine tax rates for individual entrepreneurs' risk being inherently conflicting. For example, a fixed deduction is applied to businesses with certain employee limits but can also be applied for those with a certain annual turnover. The segregation within the regime (based on patent and simplified declaration) is distortionary and thereby incentivizes businesses to split (so that their turnover stays at the defined level for the patent group with lower rate) and to hire employees informally (without formal declaration to self-exclude from the simplified declaration group). All of these are expected to exert negative impacts on neutrality, the fairness of the overall tax system, competition, productivity, and private sector job creation.

The Government should consider systematically rationalizing and restructuring the system of tax incentives and simplifying the overcomplex special tax regime. These measures are to be conducted through cross-agency reviewing of the various incentives and instituting the publication of a tax expenditure report. To simplify the special tax regime, the core focus on the reforms would follow a two-step process. The first step would be to structure the special tax regime with the use of annual turnover as the *single* eligibility criterion. The second step would be to apply the same VAT threshold to classify those that migrate into the standard tax regime and those that remain in the special regime.

Also recommended are lowering the overly high VAT threshold, rationalizing the multiple exemptions and, over the long term, considering raising the VAT standard rate. Kazakhstan's VAT collection as a share of GDP is half the average of emerging markets in the region (Figure 7). More notable, compared with ECA peers, in 2019, Kazakhstan had the lowest VAT productivity (0.32); and in terms of C-efficiency, the country ranks seven (0.617) out of 11 ECA countries, just slightly higher than the C-efficiency average of emerging and developing countries in Europe of 0.56 (Figure 8). Further reductions of the VAT threshold (and reducing the scope of inefficient VAT exemptions) are recommended to expand the VAT net and improve its productivity. A lowered VAT threshold will be used to harmonize with the revised threshold defining small and medium enterprises (the group of taxpayers granted special tax regimes). The simple regional average and the median of VAT thresholds ranged between US$66,000 and US$83,000, significantly lower than the one in Kazakhstan of US$113,000 equivalent.

Figure 7. **VAT collection in regional comparison (% of GDP)**

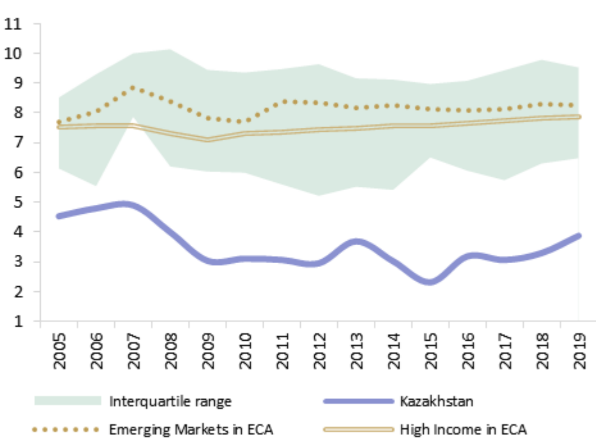
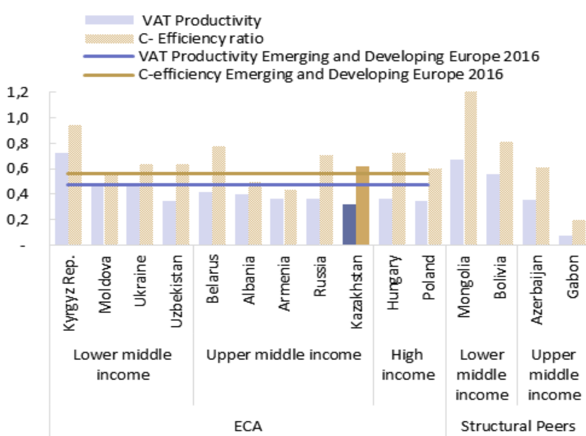


Figure 8 **VAT productivity and C-efficiency comparison, 2019**



Source: World Bank team calculations.

Performance in personal income tax (PIT) collection has been declining and the flat rate structure, combined with low exemption threshold, lacks progressivity. Kazakhstan's PIT collection declined from 1.5 percent of GDP in 2016 to 1.3 percent of GDP in 2019 and PIT collection is lower than the regional average (Figure 9), while productivity is comparatively low (Figure 10). Throughout the period 2016–2019, the country's PIT collection in terms of GDP accounts for just one-fifth of the PIT share of the ECA regional average and one-half of the share in upper middle-income countries. The flat and low PIT rate of 10 percent is also accompanied by a low threshold for basic deduction, which subjects low-wage earners to the same rate as better-off individuals. The PIT also offers multiple exemptions for capital gains, dividends, and interest income. Kazakhstan neither levies taxes on net wealth nor on inheritance or gifts, which further negatively impacts on the fairness and progressivity of the income tax instrument.

Figure 9. P**IT collection in regional comparison (% GDP**)

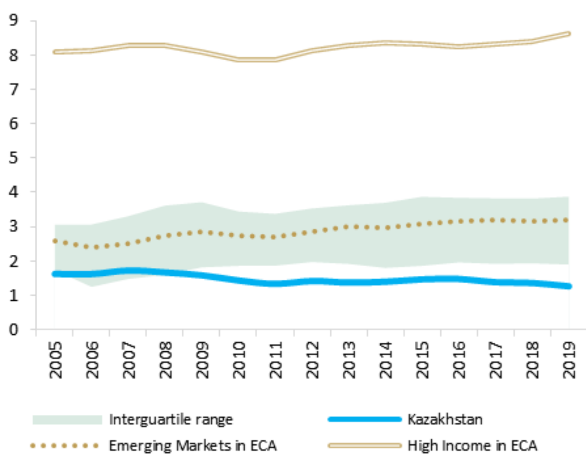
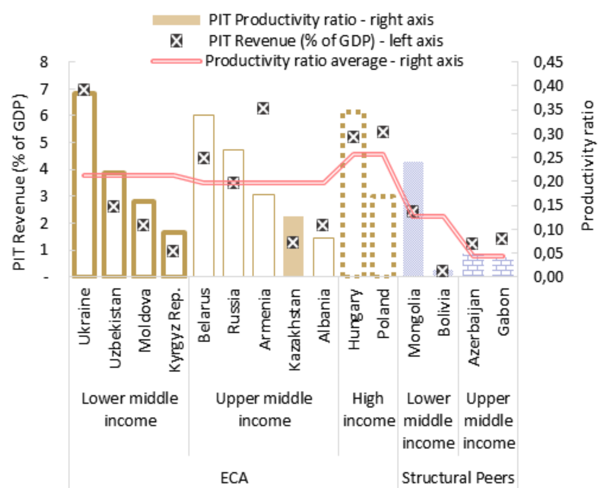


Figure 10. **PIT productivity ratio, 2019**

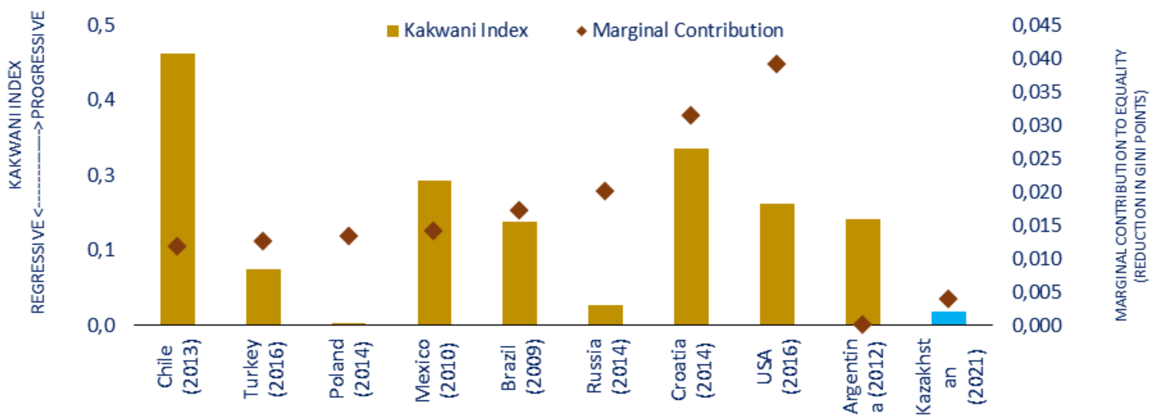


Source: World Bank team calculations.

The focus of reforms of PIT should be on raising the basic deduction, introducing a progressive tax structure to replace the current low flat rate, and improving the capital income tax regime. Compared with its peers, direct taxes in Kazakhstan are notably less progressive and more pronounced in the PIT regime. Inherently, the progressivity of PIT in Kazakhstan is similar to those in the Russian Federation and Poland, both with the similar general flat rate structure (Figure 11). The current flat, low PIT rate could be transformed to a progressive, graduated structure, including the exempt bracket (with higher threshold). The existing set of numerous income tax exemptions violates the standards of a comprehensive income tax base, depletes the base, and compromises the integrity of the regime. These exemptions should be reviewed and rationalized to lay the ground for the sequenced transformation of the flat PIT rate into a progressive structure. Over the medium term, the Government should consider introducing wealth or inheritance tax. Such reform measures aim to enhance revenues and equity.

Tax policy can do more to support environmental protection. The current excise tax on motor vehicles is simply based on car engine size and does not conform to an effective environmental tax. This type of excise tax is not based on the types of fuel used, the aging of the vehicle, or other factors with negative effects on the environment, and thus cannot serve as a relevant proxy for greenhouse gas (GHG) emissions or air pollutants. The current excise tax structure also omits other types of green taxes, such as road tax, taxes on plastic bags, old tires, and waste. A review of the environment and carbon tax could begin by looking at the existing excise coverage of fuels with the purview to expanding the base to cover all fuel sources and rationalize the rates. The proposed carbon tax would complement the current Emission Trading System and the two would help create a minimum and maximum carbon price.

Figure 11. **Progressivity of direct taxes in selected countrie**s



Source: Argentina (Rossignolo 2017); Brazil (Higgins and Pereira 2017); Chile (Martinez-Aguilar et al. 2016); Croatia (Inchauste and Rubil 2015); Mexico (Scott 2013); Poland (Goraus and Inchauste 2016); the Russian Federation (Popova et al. 2018); the United States (Higgins et al. 2018); and Turkey (Cuevas et al. 2020). Kazakhstan: Bornukova and Nebiler (2023) based on Kazakhstan 2021 HIES.

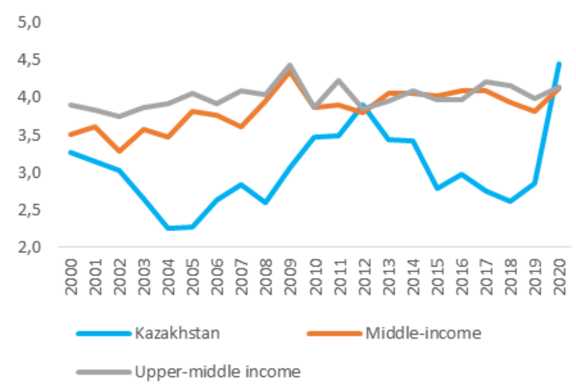
Note: Kakwani index is calculated as the difference between the concentration coefficient of the tax and the Gini coefficient of Market Income plus pensions. The Kakwani index for taxes will be positive (negative) if a tax is globally progressive (regressive). Marginal contribution to equality is the difference between the Gini coefficient without the fiscal intervention and the Gini coefficient of all income components together. There is no marginal contribution calculated for Argentina. The United States' results are preliminary.

Public spending on education: more efficiency and enhanced equity

Kazakhstan's prolonged under-spending on education, coupled with policies that channeled resources toward academic excellence raised learning outcomes for a few, while leaving many students behind in their acquisition of human capital. Between 2000 and 2018, Kazakhstan spent between 2.3 and 3.9 percent of GDP on education (**Figure 12**), lower than upper middle-income countries (3.8 to 4.4 percent of GDP). Meanwhile, in 2018, Kazakhstan spent more than four times per-student on Nazarbayev Intellectual Schools (NIS), which cater to just 0.4 percent of students in secondary schools. Currently, about two out of three students are ill-equipped to succeed in the modern world of work, as illustrated by a 64 percent functional illiteracy rate (PISA 2018, **Figure 13**). Students on average in Atyrau are four years behind their peers in the NIS, while the poorest and most disadvantaged are lagging significantly behind the average.

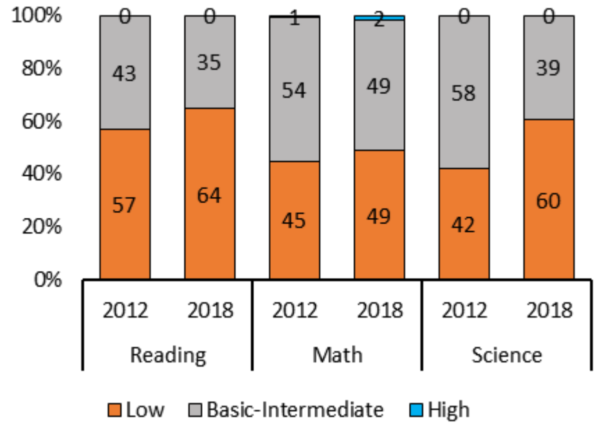
The Government has substantially increased public spending on education over the past four years. Between 2018 and 2022, education spending increased by 48 percent in real terms due to a variety of factors. Expenditures rose during the COVID-19 pandemic as the Government pursued different modes of emergency remote learning/distance learning. The Government also expanded early childhood education, which is particularly crucial for mitigating the learning differences across different socio-economic groups. The decision to adjust teachers' salaries in line with the labor market over four years has also led to an explosion in public financing on education.

Figure 12. **Government spending on education as a percentage of GDP**



Source: World Bank team calculations from WDI. 2001 and 2003 data for Kazakhstan were extrapolated.

Figure 13. **Proportion of students' performance based on the PISA proficiency test**



Source: World Bank team calculations using PISA (2018) database and data from the MoF.

As demand for a higher quality education system has risen amid a population bulge, Kazakhstan needs to introduce measures to increase the efficiency, effectiveness, and equity of spending to get more for its investments. The demand for more school spaces is high because of population growth and migration into the large urban centers of Almaty, Astana and Shymkent, and in certain regions. But poor school infrastructure planning, as shown in Figure 14 and Figure 15, is causing students to have to study in double-shift and triple-shift schools, which account for 75 percent of school spaces, reducing their learning time and undermining education quality. As a response, the National Education Policy plans to construct 1,000 additional schools. With these additional schools, more teachers will also need to be deployed. To meet these demands, efficiencies need to be explored through a better rationalization of schools and the teaching force, especially at the post-primary level. Kazakhstan's population is widely scattered across a large geographical area, and it is important to continue to provide early years education close to each catchment area. However, from the secondary grades, a focus on larger schools catering to larger catchment areas, bringing together larger numbers of teachers, needs to be pursued.

Figure 14. **Weak correlation between capital spending per student in 2020 and regional net migration rate**

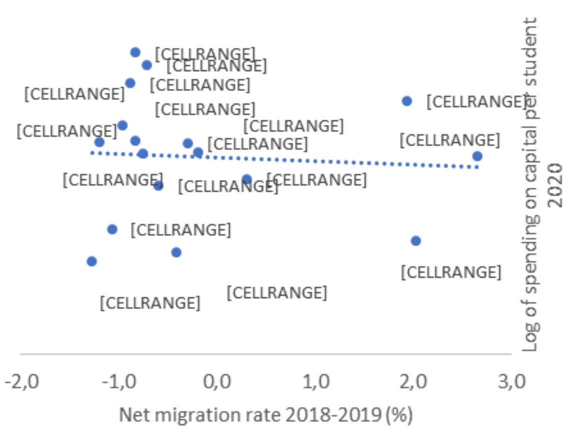
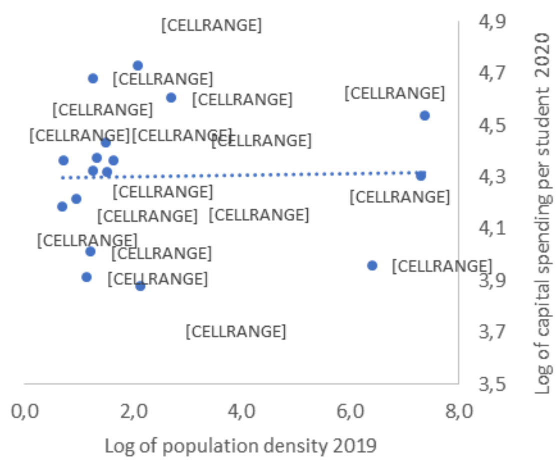


Figure 15. **Weak correlation between capital spending per student in 2020 and population density**

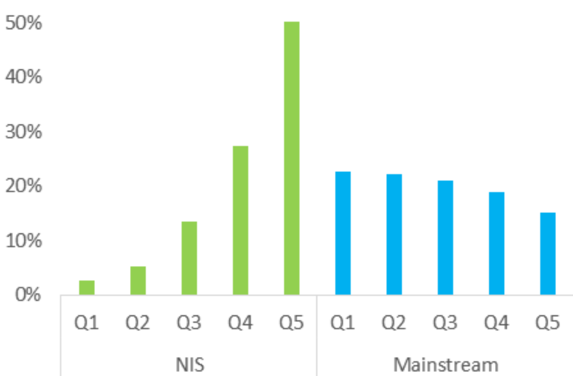


Source: World Bank team calculations using data from the MoF and the Bureau of Statistics.

While raising teacher salaries may improve the competitiveness of the teaching profession, it should not be the focus of improving teaching outcomes. After consecutive raises, teacher salaries are approaching market competitive rates (except for pre-school education). But the national average ratio of students to teachers in Kazakhstan (9.5 students per teacher in general secondary education) is low compared with the OECD average (13 students per teacher for secondary and vocational programs). In the 40 percent of small schools across the country, the student-to-teacher ratio is as low as 4.4, with some schools even reporting having more teachers than students. These low student-to-teacher ratios, especially in rural schools, together with official teaching workloads, are suboptimal and creating inefficiencies in the system. In addition, the teacher remuneration system (*Stavka*) and teacher salary calculation that rewards performance improvement among high-achieving students further reduces the effectiveness of the profession to build human capital equitably across the nation. The system incentivizes spending more time teaching rather than preparing quality teaching materials and providing one-on-one student support to students. Therefore, increasing salaries is unlikely to impact teacher effectiveness or lead to improved learning outcomes until there are changes in the *Stavka* system and workload optimization.

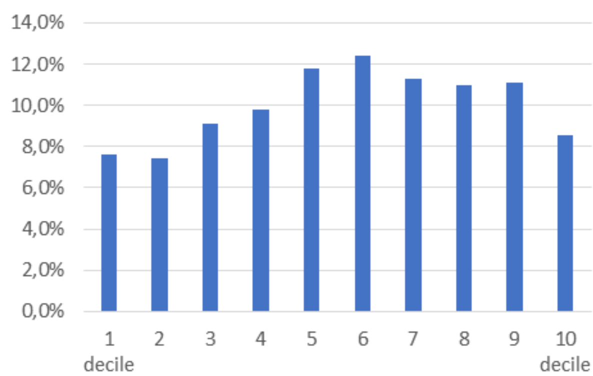
Equity is a crucial and missing dimension of education spending in Kazakhstan. While NIS students have significantly lower functionally illiteracy (6 percent) than the 22.6 percent for the OECD average, in contrast, 64.2 percent children in mainstream public schools in Kazakhstan are functionally illiterate.[10] But the NIS intake is less progressive as most of the students come from better socio-economic status (Figure 16). Scholarships also appear to be regressive. In 2021, about 8 percent of households in the top decile income distribution received scholarship transfers, yet only 34 percent of households in the bottom 40 percent of the income distribution received scholarship in the same year (Figure 17. To make the system more equitable, the recently introduced funding formula will need to integrate an equity element to financially support the learning of students who are from disadvantaged groups and who may need additional resources and pedagogical support. Assessment of the continued support to the NIS system through public funds will also need to be reviewed. Finally, better quality data, transparency in reporting, use of data for decision-making, and more decentralized planning will enhance accountability within the system and boost its ability to respond to demands for timely, efficiency and effective allocation of resources.

Figure 16. **Distribution of students' socio-economic status in the NIS and mainstream schools across quintiles**



Source: World Bank team calculations using PISA 2018 database.
Note: The sample coverage is students participarting in PISA.

Figure 17. **Scholarship incidence in Kazakhstan (for students under 25 years old)**



Source: World Bank team calculations based on 2021 HIES.

[10] Functional illiteracy is defined as inability to operate successfully in the modern world economy. For PISA, it is calculated as the proportion of students of 15 years of age who perform below level 2 proficiency in math, science, and reading literacy.

Spending on social protection: better design and targeting

The budget allocation for social protection and transfers has increased substantially along with Kazakhstan's increased commitment to improve social welfare. The social protection (SP) system covers a wide range of vulnerabilities and social risks and functions for reducing poverty. It covers social assistance (SA), social insurance, and active labor market programs (ALMPs). Between 2017 and 2021, spending on social transfers stood at 22.3 percent of total government expenditure (4.8 percent of GDP), up from 19.9 percent in 2011–2016 (4 percent of GDP). Although the COVID-19 pandemic caused a sharp increase in spending on SP, the overall increase in spending also reflected a gradual increase in spending on SA, which rose from 1.6 percent of GDP in 2017, to 2.2 percent in 2019, and 2.5 percent in 2021 (Figure 18).

The SA system is diverse and generous, but it is mainly focused on supporting selected categories of the population rather than directly targeting the most impoverished. Spending on categorical programs, especially for families with children, has steadily increased from 0.3 percent of GDP in 2018–2019 to 0.7 percent in 2020–2021 (Figure 19). These programs are not means-tested and are not necessarily benefiting those who are most in need. For example, about 35 percent of child and family benefits are non-poor (do not belong to the bottom 10 percent of income distribution) compared with 12 percent for the targeted social assistance (TSA) program.

Figure 18. **Spending on SP programs as percentage of GDP, 2016–2021**

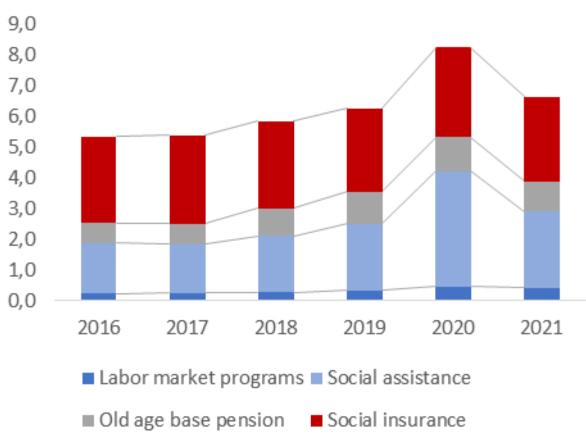
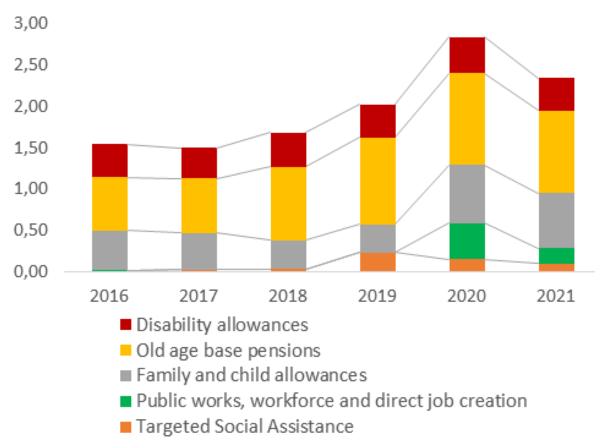


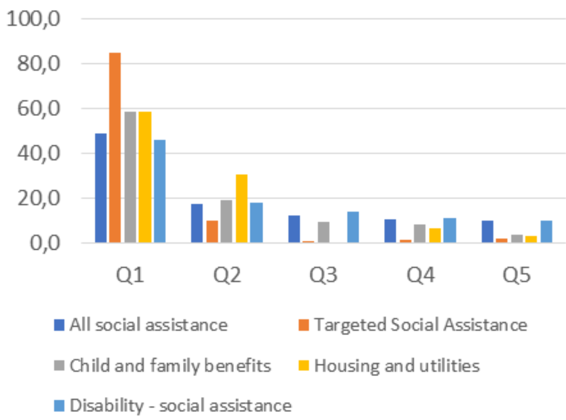
Figure 19. **Spending on key SA programs as percentage of GDP, 2016–2021**



Source: World Bank team calculations using data published by the authorities.

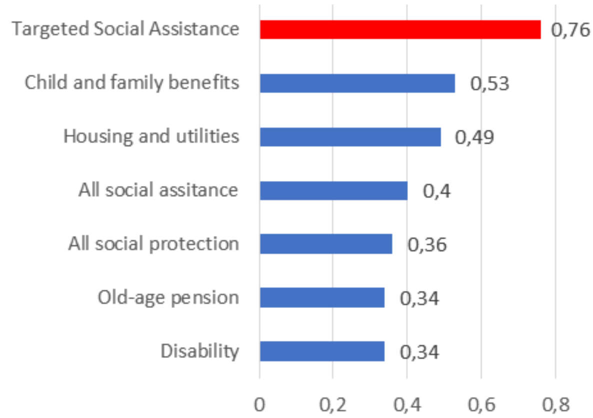
Compared with other SA programs in Kazakhstan, TSA performs better in reaching the poor and is more effective in reducing poverty. The distribution of beneficiaries illustrates that TSA has the highest share among all direct and indirect beneficiaries (82.5 percent) in the lowest quintile, compared with overall SA programs (Figure 20). Also, the benefit incidence for the first income quintile (Q1), the amount received by Q1 as share of total amount of transfers for TSA is 85.3 percent. TSA program also achieved the highest ratio between poverty gap reduced and cost spent relative to all programs (Figure 21). Expanding the scope of poverty-targeted (means-tested) programs from the current low level would result in a stronger poverty-reducing impact. This will require amending the national poverty line, which is currently set at a relatively low level, to define the eligibility and size of the TSA.

Figure 20. **Benefits incidence for SA programs across income quintiles, 2021, percent**



Source: World Bank team calculations using ADePT based on HIES 2021 data.

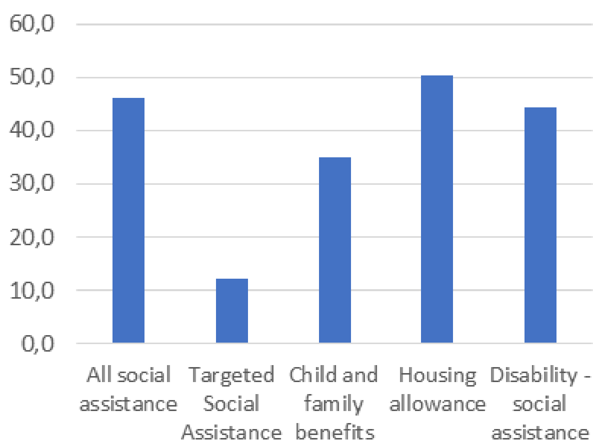
Figure 21. **The benefit-cost ratio of SP programs, 2021**



Source: World Bank team calculations using ADePT.

There are potential gains from improving the design and implementation of SA programs by minimizing exclusion and inclusion error. About 31 percent of the bottom decile of income distribution are not covered by the SA program and about 46 percent of SA beneficiaries are defined as non-poor, being above the bottom decile of income distribution (Figure 22). The estimated program leakage is noticeable, especially for the housing allowance, and child and family benefits, with about 50 and 35 percent of recipients belonging to the non-poor, respectively. An analysis on benefits overlap for SA programs reinforces the need to improve the design and targeting of certain programs to improve efficiency. For example, 1.1 percent of recipients of child and family benefits are also recipients of TSA, a program which is targeted for the poor (Table 1). This implies a substantial share of recipients of the child and family benefit program are non-poor. Similarly for housing utilities benefit, which is implemented by subnational governments and designated for the poor, 14.3 percent of the recipients are TSA recipients, which suggests the need to improve the design of the housing utilities support program.

Figure 22. **Estimated leakage of SA programs (percent), 2021**



The Government can potentially achieve better efficiency from consolidating the categorical programs for families with children and the TSA program, and convert both into one poverty-targeted program. For 2021, reducing leakage through better targeting and design of support for families with children could potentially provide KZT 177 billion of resources (0.14 percent of 2021 GDP) that can be redeployed for poverty targeted programs such as TSA.[11] Given that the size of TSA in 2021 was 0.1 percent of GDP, such savings could potentially be used to double the resources for TSA at no cost.

[11] According to the Adept analysis, the 60% of non-poor households (Q3-Q5) receive 21.6% of child and family benefits in total. The Adept analyses a group of family and child benefit programs, which includes: (i) State allowance to large families with four or more minor children living together; (ii) State basic social benefits for loss of a breadwinner; (iii) Allowance for child birth; (iv) State allowance to a caregiver of a disabled child; (v) State allowance to Mothers of large families, awarded pendants "Altyn Alka", "Kumis Alka" or previously received the title "Heroine Mother" and awarded the Order of the "Parent Glory"; and (vi) Allowance for care of child under the age of 1. Total expenditures for these types of

Table 1. **SA programs: benefits overlap (percent), 2021**

	Other benefits received				
Recipient of	Old Age Pension	Targeted Social Assistance	Child and family benefits	Housing and utilities	Disability benefit
Old Age Pension[12]		0.1	11.1	0.1	8.1
Targeted Social Assistance	15.2		41.9	1.9	8.6
Child and family benefits	33.6	1.1		0.1	11.8
Housing and utilities	50.0	14.3	20.9		17.6
Disability benefit	29.8	0.3	14.4	0.1	

Source: World Bank team calculations based on ADePT data.

Expanding the non-pension category of the social insurance system requires further analysis.[13] Social insurance protects citizens from different social risks and is funded by participations through salaried contributions. Social insurance (excluding contributory pension) spending increased to about 0.4 percent of GDP in 2021, mostly driven by benefits for childcare and pregnancy. Expanding the coverage of social insurance in Kazakhstan requires further analysis to overcome limited participation of self-employed workers, bringing informal workers into the formal employment system, and the sustainability of the State Social Insurance Fund.

While Kazakhstan implements a comprehensive set of active labor market programs (ALMPs), their contribution to the likelihood of recipients finding quality jobs has not been systematically analyzed. Existing and future AMLPs need additional quality assessment and regular monitoring on how the activities could benefit the overall population of Kazakhstan, specifically including the poor and other vulnerable groups, in the long term.

Budgeting, planning, and monitoring system: focus on performance, not compliance

Improving the budgeting and planning systems, and ensuring their alignment with key development objectives are key for improving the efficiency and effectiveness of fiscal policy. Mindful of this importance, Kazakhstan has introduced performance-based budgeting and strengthened the alignment of budget performance and strategic plans. The Government also has strengthened the core legal and institutional framework for budgeting and PFM systems based on Organisation of Economic Co-operation and Development (OECD) experiences.

Despite those changes, the linkages between budget and strategic plans reflect formal compliance with Budget Code requirements rather than a performance-oriented approach. Budget programs are mapped to

[12] The ADePT software does the analysis based on HEIS data. The HBS questionnaire captures whether the individual/household received a pension, without distinguishing it by pillar (base, solidarity or funded).

[13] Because of lack of data, this PFR does not cover contributory pension program managed by the Unified Accumulative Pension Fund and the analysis on the sustainability of State Social Insurance Fund.

many strategic objectives, and indicators for budget programs are mainly process-oriented or output-oriented, and not linked to actual program results, much less to strategic goals. There is also a wide variation in the quantity and quality of indicators and targets across ministries.

The systems to monitor and evaluate budget performance are not yet functioning as an integrated management tool. First, the effectiveness of the system is hampered by non-coordinated monitoring initiatives, such as the new state planning system and the annual evaluation system, which are led by different units. Second, the tools for monitoring progress in budget implementation merely collect statistical information on outputs, not outcome indicators. The budget information published through online portals and citizens' budgets are not always accessible or presented in a user-friendly format. Lastly, instead of establishing a culture of improving performance, activities are monitored in a control-and-punish mode, causing fear among officials for missing targets.

The Government can consider refining the institutional framework, guidelines, and processes to ensure their use, and thereby help budgeting and planning deliver the agreed outcomes. This could be done by including implementation status (on or off track) and agreed corrective actions. Linking indicators with work and budget programs will also help identify budget gaps or duplications. Once done, budget and planning indicators in various plans (National Development Plan, Concepts, National Projects, plans of ministries and agencies) need to be aligned at different levels, to track their implementation. Spending reviews can be introduced to analyze spending performance and identify the scope for efficiency gains or spending prioritization. Requiring completion reviews for key projects, including comparisons of actual and planned costs, will facilitate learning from program implementation. But, more importantly, the Government should consider institutionalizing independent ex-post evaluation of large and strategic government projects and programs, with widely disseminated lessons learned also being considered.

There are opportunities for green public sector performance actions that Kazakhstan might want to pilot and implement throughout the budget cycle. At the planning and policy-making level, a clear integrated legal and policy framework for climate change could be established, building on the Paris commitments and the National Development Strategy 2025, and upgrading relevant strategic and policy documents as needed. At the performance, monitoring and evaluation levels, performance indicators that are relevant to climate and environmental policy objectives could be included. At the medium-term budgeting level, changes to revenue and expenditure over the medium term could be analyzed (e.g., changes to petrol excise revenues brought about by the greater use of electric vehicles). From the expenditure side, lack of clarity in the amount allocated for energy and fossil fuel subsidies in Kazakhstan's government budget undermines transparency on the allocation of public expenditures. Different instruments can be developed, including a climate change expenditure review, budget tagging, and green public investment management and procurement.

Transparency of public finances: making budget documentation more useful

Kazakhstan has made budget documentation widely available and has implemented public participation mechanisms. An Access to Information Law, approved in 2015, further reinforces the constitutional rights of citizens to obtain information held by public bodies (with limited exceptions). It encompasses a right to request and receive information, as well as an obligation for governments to publish information proactively. The Government has also developed different Open Government initiatives, including monitoring and communication channels with citizens, and has implemented Public Councils, a platform for civil society to voice its opinion on important public issues.

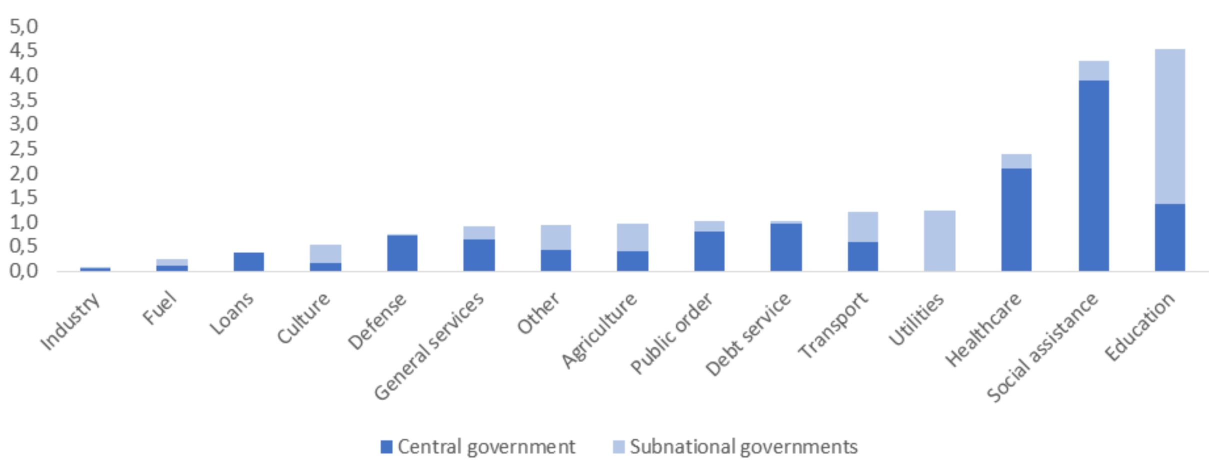
While these have been an important step toward increased transparency, there is still little evidence that this has facilitated or promoted greater citizen engagement. So far, the availability of information has not translated into greater citizen participation. While a deeper understanding of what drives the citizen-state relationship is required, it seems that the country emphasizes formal compliance on public finance transparency but not the actual use of the information. For example, information about public procurement and other government activities is available on government websites, but it is not presented in a form that would aid public understanding. Civil budgets are presented in a general format and with information that is not meant to generate citizens' feedback. Kazakhstan can promote initiatives to facilitate civil society participation in the legislative process, which includes capacity building, public awareness campaigns, modernized and more user-friendly public consultation processes, and a greater disposition to consider and incorporate citizens' feedback to policy-making decisions.

Improving the quality of budget reporting can make the shared information more useful for policy discourse and formulation. Over one-quarter (27.5 percent in 2020) of total local education expenditures is classified as "other expenses", without clarification. This presentation limits the transparency in budget spending and undermining the credibility of the Government's commitment to improve PFM.

Inter-governmental fiscal relationship: complicated transfers formula

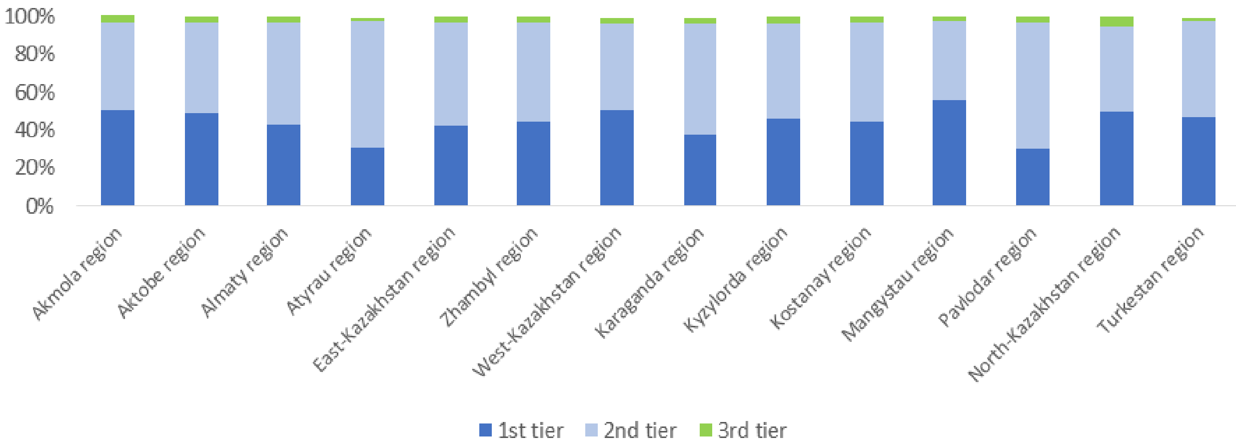
Improving public services also depends on strengthening the capacity of Kazakhstan's subnational governments (SNGs) to address local development priorities. Similar to most countries, in Kazakhstan SNGs are at the frontline in engaging with the population and delivering key public services. They account for roughly 40 percent of total government spending and are responsible for a wide range of public services, including primary and secondary education, regional and local transportation, and public utilities (Figure 23). As such, improving the capacity of SNGs to deliver public programs that can effectively respond to local development needs therefore becomes a critical policy agenda. The functional divisions of responsibilities of SNGs are defined in Law of Local Government and Self-Government and the Budget Code. First-tier SNGs (i.e., *oblast* governments) account for about half of total SNG expenditures within their territories, with the proportions ranging from 30 percent in Pavlodar to 56 percent in Mangistau. Second-tier SNGs (*raions* and cities of *oblast* significance) account for nearly all the remainder. The spending of third-tier SNGs—*okrugs*, villages and cities of *raion* significance—is extremely small. Meanwhile, third-tier SNGs account for an average of 3 percent of total SNG expenditures in Kazakhstan's 14 *oblasts*, with the proportion ranging from 1.5 percent in Turkestan to 4.3 percent in Kzyl-Orda.

Figure 23. **Division of spending responsibilities between the central government and SNGs (level of spending by level of govt, KZT trillion, 2021**)



Source: World Bank team calculations using data published by the authorities.

Figure 24. **Spending by each tier of SNG (% of spending by each tier, by *oblast*, 2021)**

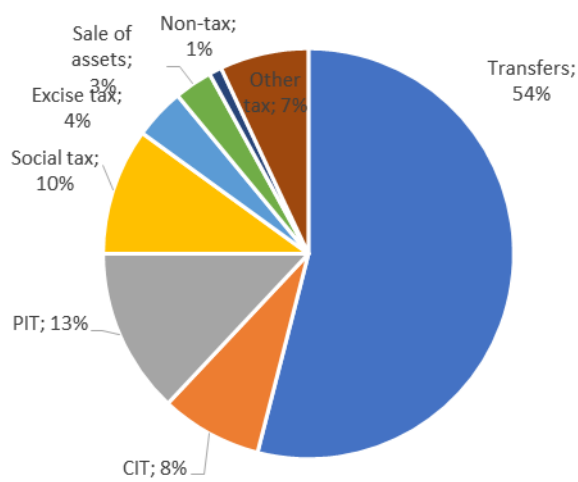


Source: World Bank team calculations using data published by the authorities.

While the functional responsibilities of SNGs are generally clear, the current system for financing SNGs is opaque and unstable. The *oblast* governments and *cities of republican importance* (first tier of SNGs) account for about half of total SNG expenditure within their territories, with the proportion ranging from 30 percent to 56 percent (Figure 24). The second tier (*raions* and cities of *oblast* significance) account for nearly all the remainder. The first problem for financing SNGs involves the system for allocating transfers from the central government to the first tier of SNGs and the accompanying system for deducting surpluses from jurisdictions whose revenues exceed their expenditure needs. Currently, the system for allocating transfers (and deducting surpluses) is overly ambitious. The methodology for calculating expenditure needs, as set out in Order No. 139, could be one of the most complicated in the world as it attempts (in vain) to equalize the level and quality of services throughout the country. In pursuing this objective, it is opaque, undermining the credibility of the inter-governmental financing system.

The second problem is that the system for financing lower tiers of SNGs is not clearly spelled out, leaving them vulnerable to the whims of higher SNG tiers. While the second and third tiers of SNGs are assigned several own-source revenues (e.g., property and vehicle taxes, excise on alcohol, tobacco, and gasoline), the yields of these revenues appear to be very small. The second and third tiers of SNGs are dependent upon shares of PIT, social tax, and CIT that are collected within their territories, and on subventions from their respective *oblasts* and the second tier (Figure 25). But *oblasts* in the second tier do not seem to have fixed criteria in making decisions on transfers of taxes and subventions for second and third tiers of SNGs. This potentially leads *akims* of the second and third tiers of SNGs having to negotiate for such resources with their respective upper tier of SNGs.

Figure 25**. Sources of SNG revenues, 2021**



Source: World Bank team calculations using MoF data.

Overall, the focus of reform in the system of intergovernmental finance should be on the transfer system. The system of transfers from first tier of SNGs to second and third tiers of SNGs should be based on stable and objective formulas. One option would be to focus on reducing, but not eliminating, disparities in per capita resources, rather than attempting to completely fill the gap between each jurisdiction's expenditure needs and its own-source revenues. By focusing on a single, readily measurable, indicator, such a system would be simpler and easier to understand, while still ensuring that all jurisdictions have at least the minimum level of resources required to carry out their functional obligations.

Areas for Reforms

This PFR suggests four reform areas. As described in Table E.1, Kazakhstan may want to consider deepening and implementing the following reform areas:

1. Sustaining macroeconomic stability and economic resilience against shocks by simplifying the fiscal rules; strengthening the institutional framework to monitor fiscal risks; strengthening public-debt management; and reducing economic distortions from QFAs.
2. Improving inclusivity and efficiency in public spending by improving access to quality education and improving the targeting of social protection.
3. Strengthening the revenue base to support spending needs by reviewing the multiple tax exemptions; and streamlining tax policies to support efficiency, equity, and green transition.
4. Improving the public finance management through strengthening the linkages between budgeting and planning; strengthening the performance monitoring and evaluation (PM&E) system and its institutional framework; improving the inter-governmental fiscal transfers; and integrating gender dimension and green budgeting across the policy cycle.

Table E.1 Summary of Reform Areas

1. Sustaining macroeconomic stability and economic resilience against shocks	2. Improve inclusivity and efficiency of spending	3. Strengthening the revenue base to support future spending needs.	4. Improving public finance management.
Simplify the fiscal rules and strengthen its institutional framework • Simplify the fiscal rules by avoiding complications from imposing multiple fiscal targets (debt service rule, debt target, and NFRK transfers using predetermined cut-off oil price). • Strengthen the credibility of the fiscal rules by eliminating discretionary power to use the NFRK, introduce an escape clause in the budget report to justify departure from deficit projection, and establishing an independent fiscal institution to review fiscal performance.	**Improve access to quality education** • Optimize the school infrastructure network and improve teacher effectiveness by reforming the remuneration (*Stavka*) system. • Target public financing to meet the needs of the socio-economically disadvantage students and those who are lagging in their learning, including revisiting the efficacy of financing the NIS, introducing equity coefficient in per-capita student financing, and incentivizing to improve educational outcome of the lowest performers. • Improve accountability by improving data collection and utilization for budgeting and empowering SNGs to deliver education results.	**Review and streamline multiple tax exemptions** • Review and rationalize incentives on CIT and the multiple exemptions on PIT and VAT. • Institutionalize cost-benefit analysis on tax incentives proposals. • Regularly publish a tax expenditure analysis as part of the Government budget report to the public/parliament.	**Strengthen linkages between budgeting, planning** • Harmonize and streamline the planning and budgeting architecture and business processes, including the development of a common program coding for planning and budget. • Strengthen organizational structures, definition of responsibilities and capacity in planning and budget units • Strengthen the medium-term perspective of budgeting and planning through the MTEF
Monitor fiscal risks, and strengthening public-debt management • Assign a ministry/agency to consolidate the reporting of QFAs across extra budgetary funds and SOEs to inform the fiscal stance. • Monitor fiscal risks from quasi-fiscal deficits and climate shocks.	**Improve the targeting of social protection** • Systematically monitor and evaluate the effectiveness of various social assistance and labor market programs against their objectives. • Increase the focus of social assistance on means-tested poverty alleviation program to improve the effectiveness.	**Streamline tax policy to support efficiency, equity, and green transition.** • Simplify the special tax regimes by using single eligibility criteria and applying the same VAT threshold. • Adhere to sector neutrality principle in CIT to reduce complexity and distortion from differentiating CIT rates across economic activities.	**Strengthen the PM&E system and its institutional framework** • Develop a single high-level PM&E system, with strong linkages to the planning and budgeting systems. • Report on implementation status and corrective actions agreed. • Require completion reviews for key projects and independent ex-post evaluation of large and strategic government projects.

• Develop and publish a medium-term debt strategy (MTDS) to inform public/parliament the preferred government borrowing strategy based on cost and risks assessment.	• Minimize inclusion and exclusion error by improving the eligibility criteria for poverty-targeted social assistance and assessing practices of certain categorical programs, such as housing allowances. • Identify options to bring in informal workers to formal employment to increase participation in social insurance system.	• Raise the PIT deduction and transform the current PIT flat rate into a progressive tax, introduce tax on capital income, and consider wealth or inheritance tax in the medium-term. • Broaden excise to all fossil-fuels to raise revenue and internalize emission cost and raise excise on tobacco.	• Ensure availability of comprehensive and user-friendly budget information. • Implement capacity-strengthening activities for Public Councils, related NGOs, and public, including budget literacy; public awareness campaigns; modernized and more user-friendly public consultation processes
Reduce economic distortions from QFAs • Assess the impact of QFAs against the stated objectives, and identify and implement alternative interventions that less distortionary, financed by the Government's budget • Consider parliamentary oversight on the efficacy and impact of QFAs by extra budgetary funds and SOEs. • Refrain the Central Bank from implementing QFAs on behalf of the Government • Refrain using public funds for bank bailouts at above market prices.			**Improve the inter-governmental fiscal transfer system** • Simplify the system for determining transfers from central government to *oblasts*, such as 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*.
			Integrate gender dimension and streamline green budgeting across the policy cycle. • Enable green spending and revenues classification, (i.e., budget tagging) • Incorporate climate change impact assessments to the M&E system. • Implement Ex ante gender impact assessment, as well as ex-post program evaluations applying a gender

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