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Macroeconomics, Trade & Investment

SHAPING TOMORROW: REFORMS FOR LASTING PROSPERITY

KAZAKHSTAN ECONOMIC UPDATE - WINTER 2023-24

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Foreword and Acknowledgements

The *Kazakhstan Economic Update* (KEU) is a semi-annual report analyzing recent economic developments, prospects, and policy issues in Kazakhstan. The report draws on data available through December 2023 as reported by the Government of Kazakhstan, the National Bank of Kazakhstan (NBK), and additional information collected as part of the World Bank's regular economic monitoring.

This report was authored by Azamat Agaidarov (Economist), with contributions from David Stephen Knight (Lead Economist, Program Leader) and Natasha Sharma (Senior Economist). It draws upon the World Bank's extensive analytical work on Kazakhstan, incorporating findings from the *Country Economic Memorandum 2022: Dependence, Distance, Dispersion - Options for Upgrading Kazakhstan's Economy* (led by Somik Lall, Ivailo Izvorski); *Kazakhstan: Country Climate and Development Report 2022* (led by Daniel Besley, Sandeep Kohli), *Public Finance Review 2023: Strengthening Public Finance for Inclusive and Resilient Growth* (led by Sjamsu Rahardja, Kathrin Plangemann), *Boosting Productivity in Kazakhstan with Micro-Level Tools: Analysis and Policy Lessons* (led by Mariana Iootty, Asset Bizhan and Paulo G. Correa), and Policy Notes (developed by sector teams).

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Overview

Kazakhstan's economic outlook for the next two years is one of steady growth, driven in part from its continued reliance on hydrocarbons and by stronger consumer spending. After rebounding from the adverse impacts of Russia's invasion of Ukraine in 2023, growth is expected to slow to 3.4 percent year-on-year (y-o-y) in 2024 due to lower-than-expected oil production. Real GDP is forecast to grow by 4.5-5 percent in 2025 as the expansion of production capacity in existing oilfields is set to boost exports and spur growth of the petrochemical industry in 2025 and beyond. Investment in mining and manufacturing is anticipated to be steady. Household spending growth is expected to strengthen in 2024 as inflation subsides and financial conditions ease.

Elevated inflation is expected to fall, but still remain above the central bank's target in 2024 and 2025. Inflationary pressures started to ease in 2023, falling to 9.8 percent in December 2023, following monetary tightening. Achieving the National Bank of Kazakhstan's (NBK) inflation target of 5 percent could be possible provided there is no premature monetary loosening alongside implementation of fiscal consolidation plans. Continued measures to remove distortive subsidized interest rate policies will improve the effectiveness of the transmission of monetary policy.

The banking system remains resilient to external shocks, including the spillover effects of Russia's invasion of Ukraine. The non-performing loan ratio stood at 3.2 percent in November 2023. Banks have maintained robust funding and ample liquid assets, exceeding regulatory thresholds, though there are signs of rising credit risks, which warrants continued surveillance and mitigation.

The current account is expected to remain in a deficit at 3.0 and 2.3 percent of GDP in 2024 and 2025, respectively. Higher demand for imports and falling export receipts against the backdrop of lower oil prices led to a current account deficit of about 3.3 percent of GDP in 2023. The NBK's gross international reserves stood at seven months of import cover. The deficit is expected to persist in 2024 and decline steadily, while inward foreign direct investment flows are projected to continue, largely destined to the mining sector.

The draft budget plan for 2024-26 moves towards fiscal consolidation. Budget stimulus measures, largely targeted to social welfare programs, resulted in an estimated consolidated budget deficit of 1.8 percent of GDP in 2023. The government is planning to gradually decrease the deficit in the medium term in line with the fiscal rule to preserve fiscal buffers. Government debt is sustainable, but debt servicing costs have been increasing, reflecting the reliance on domestic debt in a context of high domestic interest rates.

Kazakhstan's growth outlook faces several downside risks emanating from both domestic and external factors. Russia's invasion of Ukraine and the resultant tensions in and near the Black Sea could lead to further disruption of Kazakh oil exports via the Caspian pipeline, which would have severe economic and fiscal repercussions given the importance of the hydrocarbons sector. Any major unscheduled maintenance in the oil fields as well as unexpected delay in the development of the Tengiz oil field might curtail production and dampen economic growth. Unforeseen external pressures and volatility of the tenge could lead to higher inflation. Furthermore, given Kazakhstan's economic ties with Russia, the risk of secondary sanctions continues to be a concern, which would dent confidence, deter FDI, and undermine growth.

The special section of this Economic Update examines Kazakhstan's growth challenges and the underlying structural weaknesses and proposes reform priorities for long-term development. Between

2018-22, average GDP per capita growth was 1 percent, well below the average of 3.3 percent for upper middle-income countries. Delivering a better quality of life and higher incomes for citizens in a global context that is committed to decarbonization requires rethinking reform priorities.

Reforms to Boost Greener, Inclusive, and Resilient Economic Growth
Reforms to raise productivity and market contestability
• Promote market contestability through effective competition and regulatory policies
• Promote competition in network industries such as telecommunications, transport, and electricity
• Revise business support programs with a focus on transparent criteria and evaluation processes for accessing business support
• Reform SOEs for sustainable growth through profit-driven efficiency, stronger governance, open competition, and clear ownership
Reforms to boost human capital
• Prioritize equity and quality in education funding through expanded per-capita funding to all districts and schools with need-based adjustments and targeted grants for higher education and vocational training
• Elevate the teaching profession and enhance learning by transforming teacher education and assessment practices and aligning technical and vocational education programs with dynamic industry demands
Reforms to facilitate spatial transformation and regional development
• Facilitate relocation for jobseekers to access opportunities and incentivize movement to areas with high demand through workforce training programs, relocation assistance schemes, and affordable housing initiatives
• Empower local governments through devolution of authority and resources to build essential infrastructure, attract businesses, and create a dynamic environment for residents
Climate actions
• Accelerate renewable energy investments, have a robust carbon price across energy and industry through reform of the emissions trading system, plan for the gradual closure of existing coal generation plants, promote energy efficiency measures in buildings and other sectors, and plan for the electrification of the passenger vehicle fleet
Reforming fiscal policy framework in decarbonized future
• Implement decisive revenue mobilization measures by cutting down the current high level of tax expenditures and reducing tax exemptions • Simplify the fiscal rules and adopt a countercyclical fiscal stance, establish rigorous criteria for using Oil Fund reserves, and re-align fossil fuel subsidies to promote climate goals

I. The External Environment

Global economic growth is expected to continue slowing, down from 3 percent in 2022 to 2.6 percent in 2023 and 2.4 percent in 2024, marking the third consecutive year of deceleration. These economic growth forecasts are notably lower than pre-pandemic levels and before Russia's invasion of Ukraine. This reflects the effects of tighter monetary policy aimed at curbing inflation, more restrictive credit conditions, and sluggish global trade (Figures 1 and 2).[1]

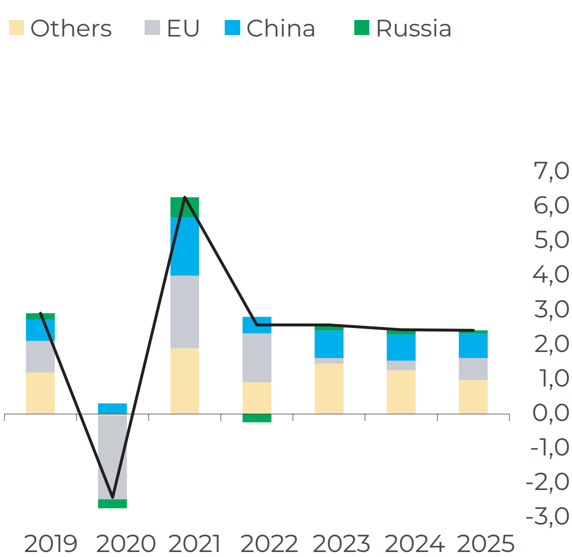
[1] World Bank, (2024), Global Economic Prospects, January 2024.

The euro area economy, a key trading partner for Kazakhstan, slowed in 2023 but is projected to gradually strengthen in 2024 and 2025. Economic growth is expected to have fallen to just 0.4 percent in 2023, from 3.4 percent in 2022, as tight financing conditions impacted both investment and consumer spending. Russia's ongoing invasion of Ukraine continues to restrain firms' activity, particularly in the manufacturing sector, which has spillovers in the services sectors. Germany, the largest economy in the euro area, is projected to contract in 2023 due to the delayed impact on incomes stemming from the significant energy price shock in 2022 and subdued foreign demand. As inflation declines and real incomes recover, growth in the euro area is projected to rebound to a still-modest 0.7 percent in 2024 and to 1.6 percent in 2025, driven by an upswing in demand for exports and improved credit supply conditions.

China's growth is expected to slow, notably from 5.2 percent in 2023 to 4.5 percent in 2024, the slowest expansion in over three decades, and decelerate further in 2025. China is grappling with deflation in contrast to other economies experiencing high inflation. Producer prices fell for 15 consecutive months up to December 2023, declining by 2.7 percent y-o-y. Growth is expected to further decelerate in 2025, primarily due to weak domestic demand and a downturn in the property sector, which may affect demand for raw materials. This slowdown is compounded by structural constraints such as elevated debt, demographic headwinds, and less fiscal space, limiting the capacity to boost infrastructure spending.

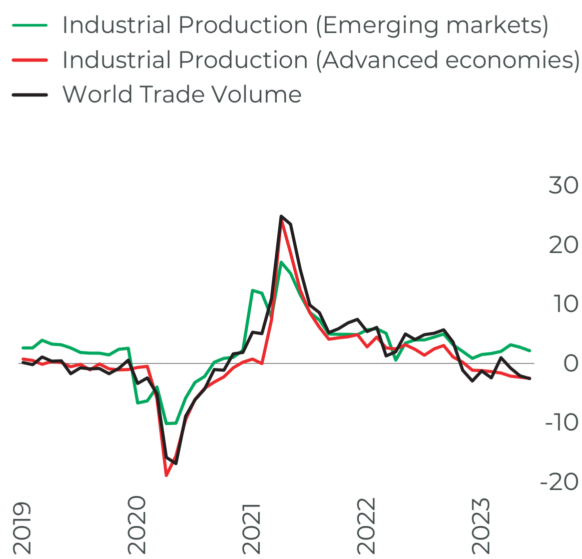
After a contraction in 2022, the Russian economy is expected to have expanded by 2.6 percent in 2023, largely due to higher government spending. An increase in expenditures on defense and

Figure 1 Kazakhstan trade-weighted world output *(percent, y-o-y)*



Source: World Bank Global Economic Prospects, January 2024.

Figure 2 Industrial production and global trade slows *(percent, y-o-y)*

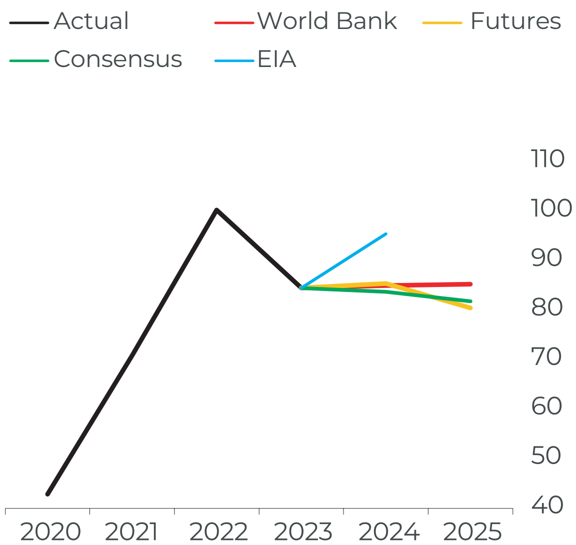


Source: IMF World Economic Outlook, October 2023.

social transfers have given a boost to economic growth in 2023. Amidst a continued depreciation of the ruble, additional capital control measures have been implemented on large exporters. With resurgent inflation, Russia's central bank raised its interest rate five times in the second half of 2023, reaching 16 percent in mid-December– more than double the rate in July. Growth is projected to slow to 1.3 percent in 2024, and then to 0.9 percent in 2025.

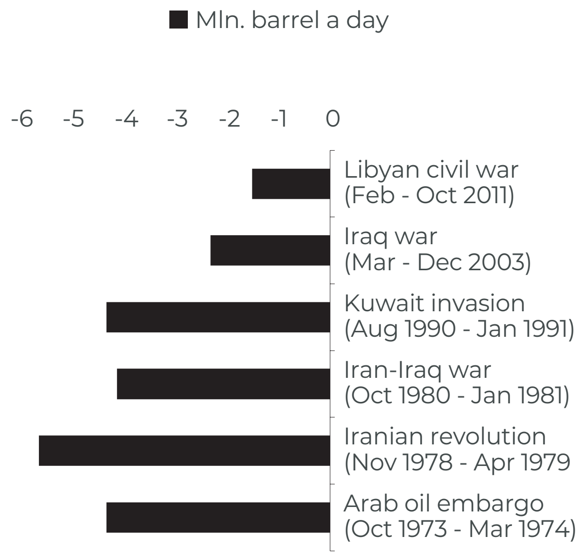
The latest conflict in the Middle East has increased uncertainty in markets, which has contributed to enhanced volatility of oil prices. Oil prices declined in 2023 largely due to moderating demand. The baseline forecast for global growth is predicated on assumptions that the conflict does not escalate further and disrupt oil supply, and oil prices are expected to remain stable in 2024 and 2025 (Figure 3). The oil market is expected to see a slight surplus of supply in 2024, leading to increased stocks. The conflict between Israel and the Palestinian territories affected oil markets in late 2023. Historical precedents of conflict-driven supply disruptions suggest that an escalation of tensions presents a major upside risk to oil prices (Figure 4).

Figure 3 Global oil price forecast
(US$ per barrel)



Source: Bloomberg; Consensus Forecasts; U.S. Energy Information Administration; World Bank (2023).

Figure 4 Conflict-driven oil supply disruptions



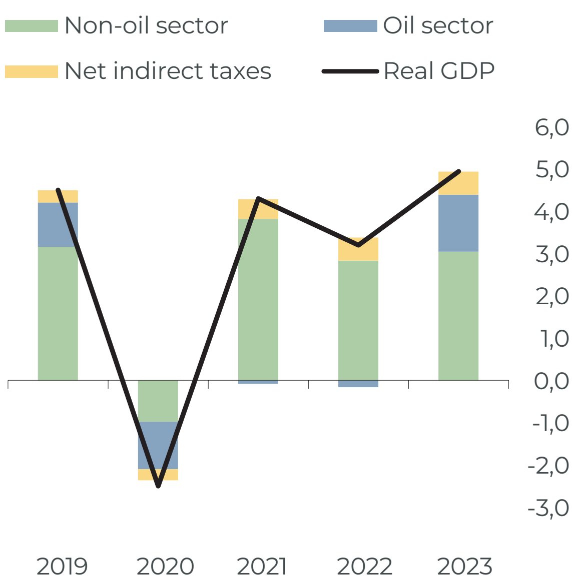
Source: International Energy Agency (IEA 2014).

II.Economic Growth and Inflation

In 2023, the Kazakh economy began rebounding from the adverse impacts of Russia's invasion of Ukraine. Growth picked up from 3.2 percent in 2022 to 4.9 percent y-o-y in 2023 supported by fiscal expansion, rising oil production, and an influx of Russian migrants that have bolstered domestic consumption and investment.2 Following 2022, which saw the most substantial decline in living standards since 2015, real incomes have begun recovering (0.2 percent y-o-y increase in the first

[2] Since the beginning of 2023, new business registrations grew by 7.5 percent.

Figure 5 Real GDP growth remains strong *(percent, y-o-y)*



Source: Bureau of National Statistics, WB estimates.

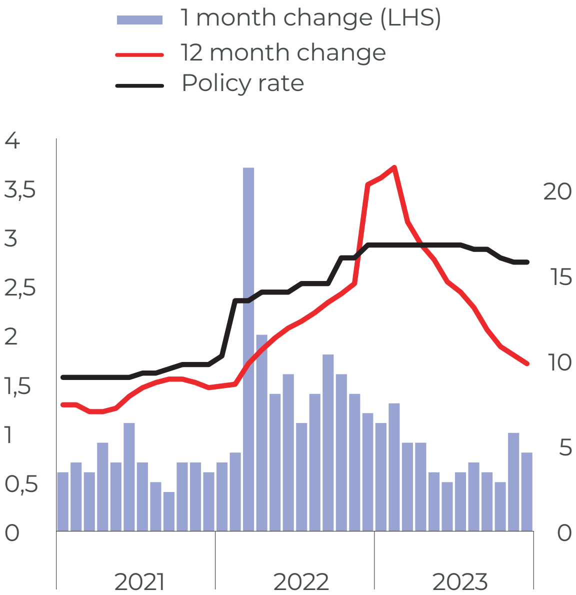
Figure 6 Growth was broad-based across demand components *(percent, y-o-y)*

Source: Bureau of National Statistics, WB estimates.

nine months of 2023), supported by falling inflation, moderate increases in real wages (3.5 percent y-o-y in the third quarter), and a strong labor market (4.7 percent in the third quarter). This is likely underpinning greater consumer spending. Robust growth of retail trade and car sales, 7.7 and 19.5 percent y-o-y, respectively, in 2023, indicate strong consumer spending. On the production side, the pick-up in growth was in large part attributed to the robust performance of the extractive industries. In 2022, shortly after the start of Russia's invasion of Ukraine, oil production contracted due to disruptions in flows through the Black Sea Caspian Pipeline, which transports 80 percent of Kazakh oil. The disruption was short-lived, and oil production has since rebounded by 6.9 percent y-o-y in 2023. Manufacturing grew by 4.1 percent y-o-y, supported by sectors such as metal processing, chemicals, and vehicles. Transport and logistics services also grew by almost 7 percent y-o-y in 2023 due to strong domestic demand and buoyant external trade (Figures 5 and 6).

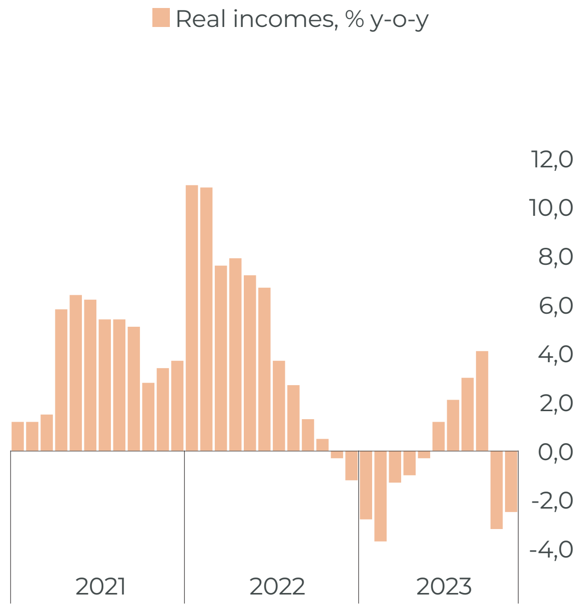
Following a rapid surge in 2022, inflation is now largely back under control. Policymakers have been challenged to rein in inflation, which escalated in 2022, driven by regulatory wage increases following the January 2022 riots, the depreciating currency, which elevated import costs, and rising international food prices. Consumer price index (CPI) inflation reached a two-decade high of 21.3 percent in February 2023, before subsiding to 9.8 percent y-o-y in December (Figure 7). While food price inflation saw a sharp deceleration from 23.1 percent in October 2022 to 8.5 percent in December 2023, services inflation remained relatively persistent, standing at 12.4 percent in December (only 1.7 percentage points lower than a year earlier). The government initially imposed price caps on select staple products and liquified petroleum gas but later removed these measures. Following the steady decline in inflation, the NBK cut the policy rate by 1.5 p.p. through January 2023, to 15.25 percent. However, heavy rainfall which has affected the September harvest, coupled with the lagging effect of fiscal stimulus, could hamper inflation reduction efforts in the near term (Figure 8).

Figure 7 Inflationary pressures ease
(y-o-y, percent)



Source: Bureau of National Statistics, WB estimates.

Figure 8 Real incomes gradually increase



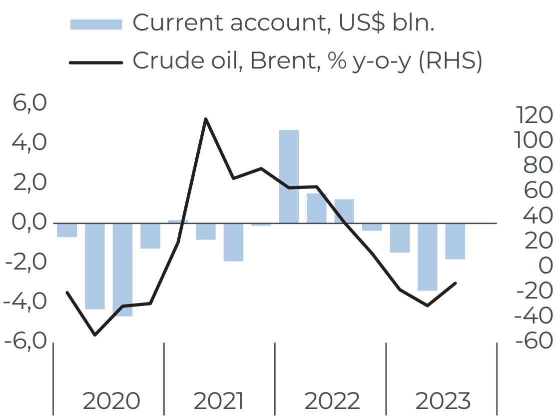
Source: Bureau of National Statistics, WB estimates.

III. The External Balance

The current account shifted to a deficit in 2023 due to weaker oil prices and strong demand for imports. In the first nine months of 2023, the current account registered a deficit of US$6.7 billion, marking a reversal from the surplus of US$7.4 billion recorded in January-September 2022.[3] In January-September 2023 merchandise exports of goods declined by 8.5 percent y-o-y in nominal terms, largely due to a 20 percent plunge in oil prices (Figure 9). Concurrently, imports surged by 24.6 percent during the same period due to strong domestic demand for final and intermediate goods and increased exports to Russia. The trade surplus nearly halved to US$14.6 billion compared to the same period last year. Following the post-pandemic reopening, demand for imports has markedly increased, attributed in part to a strong economy and robust domestic demand. Net inflows of foreign direct investment (FDI), primarily directed at the mining sector, continued and helped to cover the current account deficit. The tenge depreciated slightly against the US dollar by 2 percent y-o-y in December 2023. Gross international reserves of the NBK, excluding foreign exchange (FX) assets of the National Fund of the Republic of Kazakhstan (NFRK), dropped by 9.1 percent to US$31.9 billion, standing at 7 months of import cover in the third quarter.[4]

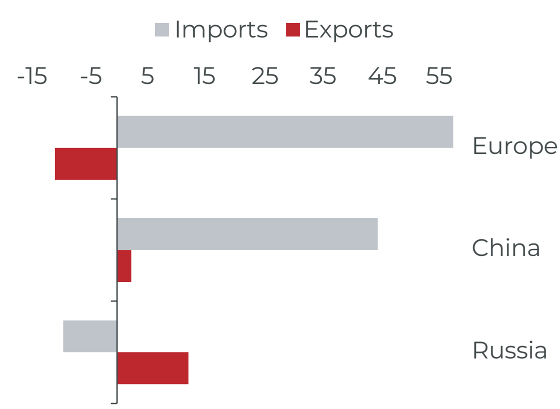
Russia's invasion of Ukraine has reshaped trade patterns in the region. Imports from Kazakhstan's key trading partners, Europe and China, grew by 60 percent and 45 percent y-o-y, respectively, in the first nine months of 2023. Sanctions have led to a decrease in exports from EU countries to Russia. Simultaneously, Kazakhstan's exports to Russia picked up by 12.3 percent y-o-y, while imports from Russia fell by 9.2 percent. Notably, there was an increase in exports to Russia of machinery, technology, and equipment (2.1 times), tractors (2.6 times), pipes and tubes made of plastic (7.1 times), ceramic products (6 times), and clothes and other textile products (2 times) (Figure 10).

Figure 9 Current account turns into deficit as oil prices decline *(US$, billions)*



Source: Bureau of National Statistics, WB estimates.

Figure 10 Trade patterns have changed since Russia's war in Ukraine *(Q3, y-o-y percent change is US$ value amounts)*



Source: Bureau of National Statistics.

[3] Based on Haver Analytics data.

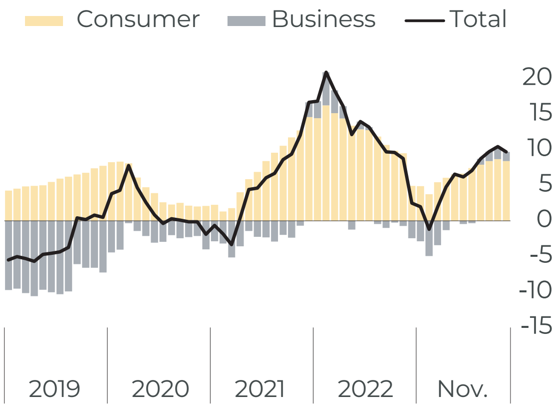
[4] The NFRK, established in 2000, is a sovereign wealth (oil) fund, which is integrated into the government's consolidated budget.

IV. The Financial Sector

The banking system remains resilient but rising credit risks should be closely monitored. Banks have maintained robust funding and ample liquid assets, exceeding regulatory thresholds, due to past government support and a robust economy. The banking system's Tier 1 capital ratio (CET1) stood at 19.6 percent in November 2023 (compared to 17.6 percent a year earlier) while liquid assets remain unchanged and on average represent 29.6 percent of total assets. Profitability improved in 2023 with return on assets rising to 4.7 percent in November (3.6 percent a year ago), propelled by high interest income, and it stands at historically high levels – well above other countries in the Central Asian region. Yet, there are signs of rising credit risks. While the official non-performing loans ratio stood at around 3.2 percent in November, total overdue loans were double that level and higher in nominal terms by 26.7 percent compared to January 2023. Therefore, the credit risk in the banking system should be closely monitored and mitigated, including on a consolidated basis and covering related party transactions.

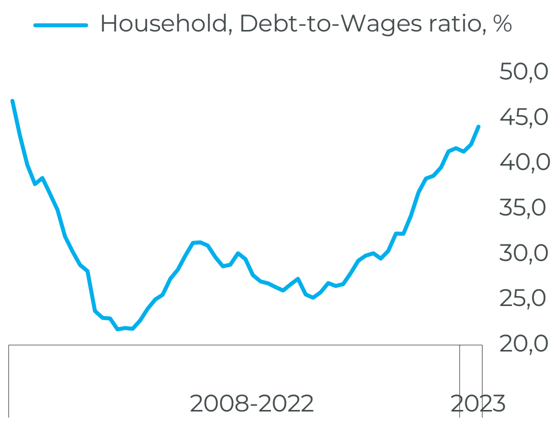
The demand for loans remains strong. Credit to households increased by 9.7 percent y-o-y in real terms in November 2023 and household debt rose in the third quarter of 2023 (Figure 11). Government policies have played a crucial role in the rising household debt levels, as banks continue lending at subsidized rates thanks to substantial fiscal support from the government. Commercial lending has recently started to pick up, growing slightly by 3.1 percent in real terms in November (Figure 12).

Figure 11 Demand for loans remains robust *(y-o-y in real terms, percent)*



Source: Bureau of National Statistics data, the National Bank of Kazakhstan, WB estimates.

Figure 12 Household debt picked up



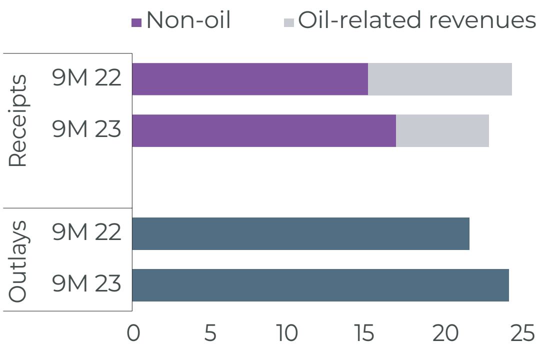
Source: Bureau of National Statistics data, WB estimates.

V. Fiscal Policy

Robust growth in expenditure has driven a fiscal expansion in 2023. The consolidated fiscal balance turned to an estimated deficit of 1.3 percent of GDP in the first nine months of 2023, marking a shift from the 2.7 percent surplus recorded in the first nine months of 2022. Overall, budget revenues decreased to 22.9 percent of GDP in the first nine months of 2023 from 24.3 percent in 2022 as oil-related revenues weakened (Figure 13). Oil-related revenues fell by an estimated 3.3 percentage points to 5.9 percent of GDP due to the decline in oil prices, while non-oil tax revenues increased by 1.8 percentage points to 16.9 percent of GDP in the first nine months of 2023, driven by enhanced collection of corporate income and value added taxes (VAT) as the government moved to close loopholes and crack down on tax evasion. Hikes in excise duties on gasoline and other oil products in 2023 also contributed to higher tax revenues. Following the social unrest in January 2022, the government expanded funding for welfare enhancing programs, such as targeted social transfers to low-income families through the Digital Family Card, a rise in the nominal minimum wage (which includes wage hikes for around 350,000 public sector workers), an increase in salaries for doctors and nurses, and higher pension payments (by 12 percent in nominal terms in 2023). Budget expenses also increased on healthcare and education and debt service (Figure 14).

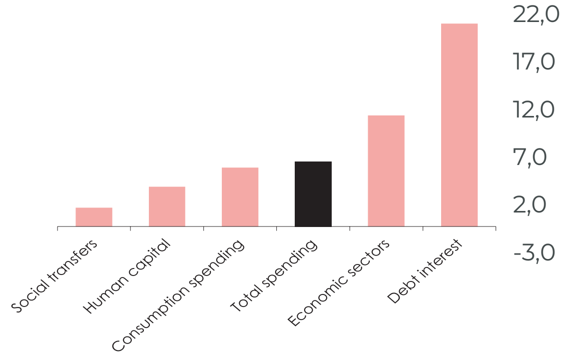
Interest spending on government debt surged as domestic interest rates increased. Rising borrowing costs, exacerbated by the government's reliance on domestic funding sources, have resulted in a sharp increase in the debt interest expenses, which have risen as a share of non-oil tax receipts to 12.6 percent in the third quarter of 2023 from 11.6 percent during the same period of last year. In September 2023, government bond yields, which indicate the cost of government financing, remained elevated across various maturities (Figures 15 and 16).

Figure 13 Budget spending grows while lower oil prices drive down revenue *(percent of GDP)*



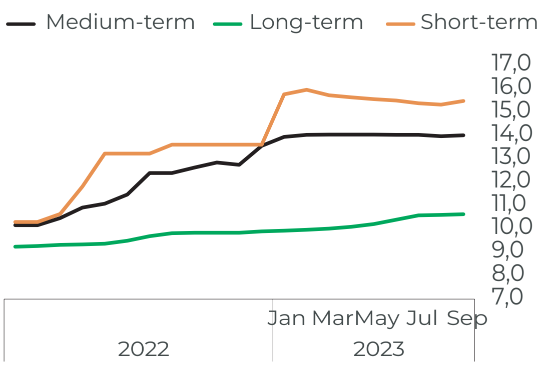
Source: Bureau of National Statistics data, Ministry of Finance.

Figure 14 Real growth in spending components *(percent, 9M y-o-y)*



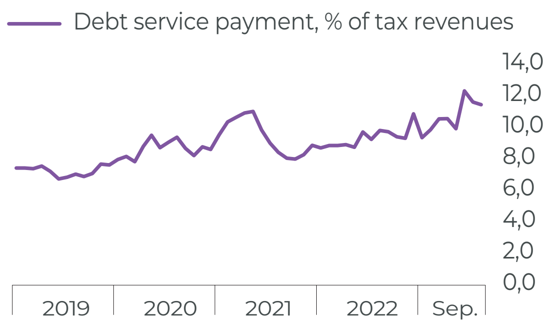
Source: Ministry of Finance, WB estimates.

Figure 15 Government bond yields shot up *(percent)*



Source: National Bank of Kazakhstan, Haver analytics.

Figure 16 Debt servicing cost moves up *(percent of tax revenue)*



Source: Haver analytics, WB estimates.
Note: Debt interest expenses are seasonally adjusted. Debt interest spending calculated using 5-month MA.

VI. Economic Outlook and Risks

Economic growth is forecast to decelerate to 3.4 percent in 2024 before rebounding to 4.5-5 percent in 2025, largely driven by oil production. The 2024 projection has been revised downward from our previous estimate due to expected stagnation in oil production. This stagnation stems from maintenance in major oilfields and Kazakhstan's compliance with OPEC+ production cuts.[5] The outlook improves in 2025, with growth projected to reach 4.5-5 percent, fueled by an anticipated increase in oil production. Planned expansions at the Tengiz field are expected to bolster exports

[5] Kazakhstan pledged an oil production cut of 82,000 bpd in 2024: https://www.opec.org/opec_web/en/press_room/7267.htm

and the petrochemical industry.[6] Official estimates are that oil production will increase by about 6-8 percent in 2025. This ramp-up in the oil sector is expected to significantly contribute to GDP growth, potentially up to one-third. Household spending is likely to gradually strengthen in 2024 as inflationary pressures and tighter financial conditions ease. Steady growth is also anticipated in investments, particularly in mining and manufacturing. Beyond the forecast period, as production stabilizes, economic growth is expected to revert to its potential rate of around 3-3.5 percent per year.

While inflation is projected to moderate throughout the forecast period, it will remain above the target in 2024 and reach the target range only by 2026. By the end of 2024, inflation is expected to decline to around 8 percent y-o-y, before gradually moving towards the NBK's inflation target of 5 percent thereafter. This trajectory reflects the expected full effects of tightened monetary policy combined with a gradual easing of external pressures. However, the lagged effect of increased budget expenditure and the volatility of the tenge exchange rate may yet pose upward risks to inflation. Given that inflation and inflation expectations remain above the target, maintaining a tight monetary policy stance is crucial for the authorities. Fiscal consolidation efforts should continue, and concrete steps towards demonstrating adherence to fiscal rules are necessary to credibly put inflation on a downward trajectory. Respecting the central bank's independence and implementing the reduction of subsidized lending programs will further strengthen the effectiveness of the monetary policy framework.

As inflation recedes and economic growth continues, household well-being is likely to improve. The unemployment rate, which rebounded to pre-pandemic levels, is projected to remain stable at around 5 percent. Over the medium term, the poverty rate is expected to decrease further from an estimated 14.6 percent (at US$6.85 per day) in 2023. However, high prices of basic items will remain a key factor impacting the population, especially the poorest households.

The current account is expected to maintain a deficit due to moderate oil prices. Steady oil prices and robust demand for imports are expected to result in a shrinking trade surplus, while companies with FDI inflows will continue to repatriate profits, leading to a significant primary income deficit. Consequently, the current account is projected to remain in deficit at 3 to 2.3 percent of GDP in 2024 and 2025. On the financing side, inward FDI flows, mainly for mining industries and geological exploration of minerals essential to the green transition, are expected to continue. Central Bank FX reserves are projected to remain adequate, equivalent to more than seven months of prospective imports.

[6] The Tengiz Future Growth Project is expected to raise production at Kazakhstan's largest oil field by 260,000 barrels per day (bbl/day), or about 40 percent. The full startup of the project is expected by the end of 2024. The project is a major investment with an estimated budget of US$ 47 billion.

Table 1. Kazakhstan: Key Macroeconomic Indicators, 2020-2026

	2020	2021	2022	2023	2024	2025	2026
					projections		
National income and prices							
Real GDP growth	-2.5	4.3	3.2	4.9	3.4	4.7	3.6
Oil sector growth	-5.8	-0.4	-0.8	7.1	0.1	8.2	1.3
Non-oil sector growth	-1.3	5.2	3.9	4.1	4.1	3.8	3.8
CPI inflation (end of period)	7.5	8.5	20.3	9.8	8.0	6.7	5.6
External accounts			*in percent of GDP*				
Current account balance	-6.4	-1.3	3.5	-3.3	-3.0	-2.3	-1.2
Exports of goods and services	28.8	36.4	41.4	33.0	31.9	32.9	32.2
Oil exports	13.9	15.8	20.8	16.4	15.5	16.3	15.1
Imports of goods and services	27.2	25.1	26.3	26.3	25.6	25.7	25.5
Foreign direct investment, net	3.4	1.0	3.5	3.3	3.1	3.2	3.1
NRFK assets, end-period	34.3	28.1	24.7	23.3	22.8	23.4	24.1
NBK reserves, end-period	20.8	17.4	15.6	15.2	...	...	...
Total external debt	95.8	83.3	71.2	64.2	60.6	57.3	55.1
Monetary accounts							
Reserve money growth	41.8	12.1	8.4	8.3	8.4	8.5	8.6
Policy rate, year-end (in %)	9.00	9.75	16.75	16.50			
Consolidated fiscal accounts */			*in percent of GDP*				
Revenues	18.0	17.6	22.0	21.8	19.9	19.5	19.3
Expenditures	24.5	21.9	21.6	22.6	21.7	21.0	20.1
Consolidated budget balance	-6.5	-4.3	0.4	-0.8	-1.8	-1.6	-0.8
Public Debt **/			*in percent of GDP*				
Government debt	24.9	23.7	22.5	22.7	23.7	25.7	26.8
External	10.7	10.0	8.6	7.4	7.0	6.4	6.0
Domestic	14.1	13.8	13.9	15.3	16.7	19.3	20.8
Government debt service (% of revenues)	6.0	7.0	6.4	5.6	5.6	5.1	5.0
Memoranda							
Nominal GDP (billions of US dollars)	171	197	225	260	289	322	354
Nominal GDP per capita (thousands of US dollars)	10.4	11.5	13.1	14.3	15.8	17.1	18.4
Oil price - Brent (US$ per barrel)	42.3	70.4	99.8	83.1	81.0	78.0	78.0

Sources: Government and NBK data and WBG staff estimates and projections. f=forecast.

Note: */ The consolidated budget comprises the state and local governments, and the NFRK

**/ Includes only the debt of the state and local government and government guarantees. Does not include SOE debt.

The draft budget plan for 2024-26 envisages fiscal consolidation, with a gradual reduction of the fiscal deficit. The overall deficit of the consolidated budget is projected to gradually decrease in the medium term, from an estimated 1.8 percent of GDP in 2024 to 0.8 percent in 2026. The government plans to achieve fiscal consolidation by increasing aggregate expenditures at a slower rate than nominal GDP.[7] Planned expenditures will be guided by the fiscal rule, where the government has committed to reach a non-oil fiscal deficit of 5 percent of GDP by 2030. To meet its fiscal consolidation targets and priority expenditure needs, the budget plan for 2024-2026 envisages that spending on the wage bill and capital expenditure will decrease in real terms, while expenditures on social transfers and human capital will slightly increase. Meanwhile, debt service payments have risen significantly compared to pre-pandemic levels and are expected to remain high in 2024 due to elevated domestic interest rates, and then gradually subside in subsequent years as inflation and interest rates decrease.

On the revenue side, ongoing efforts to increase non-oil revenues are expected to continue. Based on current oil price projections, oil-related revenues are projected to decrease, while efforts to improve tax administration along with planned revisions to the Tax Code will help sustain non-oil tax revenues. The draft 2024 budget includes guaranteed and targeted transfers from the Oil Fund in line with the fiscal rule. Dividend payouts from state-owned enterprises (SOEs) are expected to contribute to total revenues, including through the NBK's repurchase of shares in the state-owned oil and gas company using resources from the Oil Fund, which also highlights the extent of state-backed activities in the economy.

Government debt, including state guarantees and sureties, is projected to increase gradually over the medium term but remain relatively low and manageable. Public and publicly guaranteed (PPG) debt stands at 23 percent of GDP in 2023 and is projected to rise gradually to 27 percent of GDP in 2026. The debt trajectory is highly sensitive to shocks, particularly to those stemming from volatile oil prices and depreciation of the exchange rate. A decline in oil prices tends to be a drag on economic growth and could deteriorate fiscal and external accounts, leading to currency depreciation. For example, a one-third reduction in growth and a 2-percentage point increase in the primary fiscal deficit within the next two years would see debt reach 35 percent of GDP by 2028. The possibility of declining oil prices over the long-term is more prominent as global decarbonization efforts continue.

The growth outlook faces several risks from both domestic and external factors. Russia's invasion of Ukraine and resulting tensions in and near the Black Sea leave Kazakhstan vulnerable to disruptions in oil exports via the Russian controlled Caspian pipeline, which could have serious economic and fiscal implications for Kazakhstan. Any major unscheduled oil field maintenance and delay in the development of Tengiz oilfield could also dent production and impact growth. Inflationary pressures could prove more persistent than anticipated if, for example, climate-induced events like droughts or heavy rainfall reduce crop yields and trigger a rise in domestic food prices. This, in turn, could dampen economic growth and may require sustained higher volumes of targeted support, increasing fiscal costs. The risk of secondary sanctions on Kazakh firms and banks continues to be a concern given Kazakhstan's wide and deep economic ties with Russia and geographical proximity.[8] Kazakhstan has become a transit point for the import of dual-use goods to Russia. If imposed, sanctions could bring sizable economic costs, erode confidence and hamper FDI, undermining prospects for economic growth. An upside risk is that stronger growth in China or higher oil prices could have a positive impact on Kazakhstan's economic outlook.

[7] The core elements of this fiscal rule include the reduction of the non-oil deficit in the state budget and the imposition of a cap on budget expenditures. This cap should not exceed the sum of the average real GDP growth over the past 10 years and the inflation target.

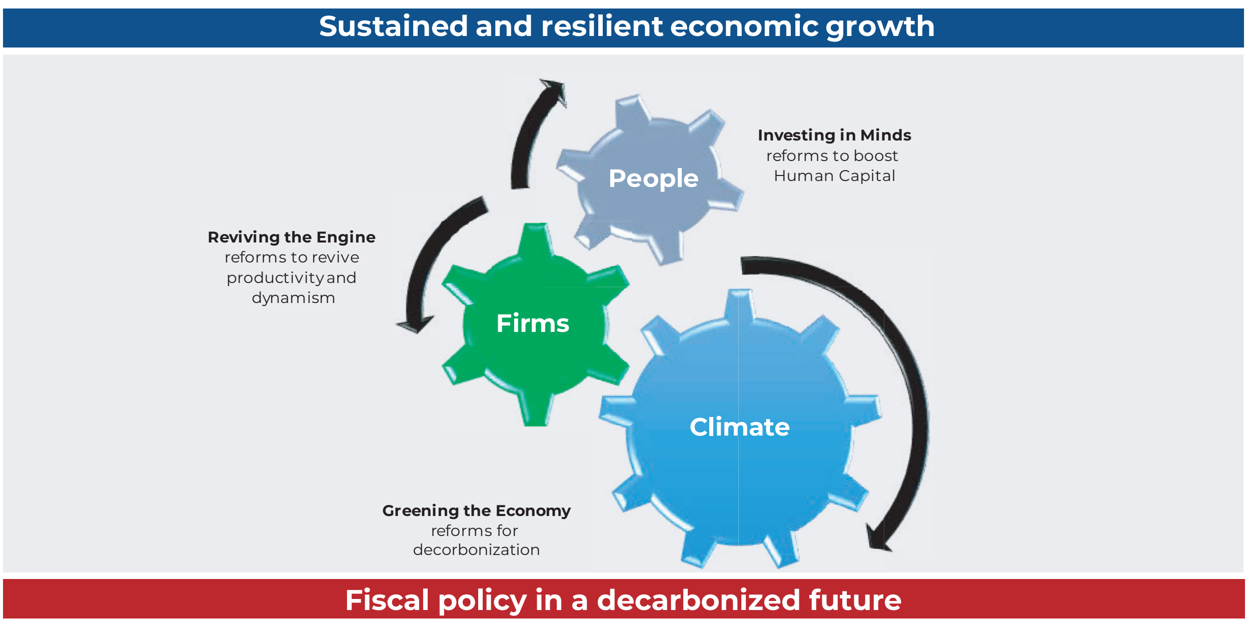
[8] Psaledakis, D., & Shalal, A. (2023, December 23). US takes aim at financial institutions with new Russia sanctions authority. https://www.reuters.com/world/us/us-takes-aim-financial-institutions-with-new-russia-sanctions-authority-2023-12-22/

VII. Special Section: Reforms for Lasting Prosperity[9]

[9] The report draws upon an extensive analytical work program on Kazakhstan incorporating findings from the Country Economic Memorandum 2022: Dependence, Distance, Dispersion - Options for Upgrading Kazakhstan's Economy (Somik Lall, Ivailo Izvorski); Kazakhstan: Climate Country Diagnostics Report 2022 (Daniel Besley, Sandeep Kohli), Public Finance Review 2023: Strengthening Public Finance for Inclusive and Resilient Growth (Sjamsu Rahardja, Kathrin Plangemann), and Policy Notes (developed by sector teams).

This focus section discusses Kazakhstan's structural growth challenges within the broader global transition towards decarbonization and suggests priority reforms. The focus section draws on the World Bank's extensive knowledge work, which highlights the importance of boosting human capital, reviving productivity and dynamism, and accelerating the green transition. Enhancing human capital through improvements in education quality, access to training, and promoting lifelong learning will empower the workforce and foster innovation. Supercharging productivity and dynamism entails addressing structural weaknesses, promoting competition, and creating an enabling business environment to spur entrepreneurship and investment. Simultaneously, transitioning towards a decarbonized future requires diversifying the energy mix, adopting renewable sources, and implementing sustainable practices to reduce the carbon footprint. As the country charts its course towards a low-carbon future, fiscal policy emerges as a crucial tool to ensure robust growth and a resilient development path. By focusing on these areas, Kazakhstan can position itself for a prosperous and sustainable future (Figure 17).

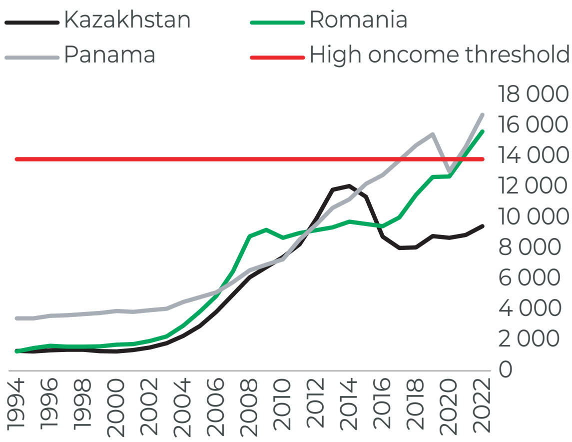
Figure 17 Reforms to drive growth and sustainability



Growth challenges and structural weaknesses

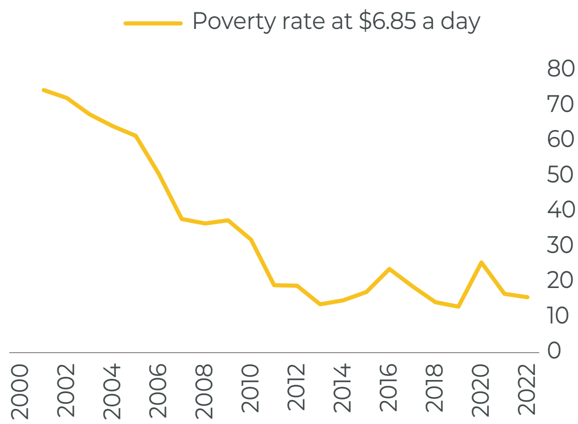
Since gaining independence from the Soviet Union, Kazakhstan has seen impressive economic growth that raised living standards and reduced poverty. Its success was built on the first generation of market-oriented reforms, after gaining independence, when trade barriers were removed, a big chunk of state assets were privatized, and the oil and gas sector was opened to foreign investors. The promise of newfound wealth, driven predominantly by the energy resource sector, has fueled economic growth. In less than three decades, GNI per capita increased sevenfold, with the country currently accounting for nearly two-thirds of Central Asia's GDP, and Kazakhstan became an upper middle-income economy in 2006. Growth was accompanied by improving living standards and a decline in the poverty rate (Figures 18 and 19).

Figure 18 GNI per capita *(Atlas US$)*



Source: World Development indicators.

Figure 19 Poverty rate *(% of population)*



Source: World Development indicators.

Yet early periods of economic success masked vulnerabilities and a profound problem that the country faces. Since the Global Financial Crisis in 2008, when Kazakhstan saw both the banking crisis and the bursting of a construction bubble, the country has experienced a significant slowdown in economic growth. Average real GDP growth, which was around 10 percent during 2000-2007, has halved to less than 4 percent in 2010-2022. One of the main contributors to this slowdown has been stalled productivity growth, defined as the total factor productivity. Although productivity slowdown has been a global phenomenon, Kazakhstan's productivity decline has been particularly dramatic. In fact, following each past crisis, the economy has never succeeded in fully recovering and attaining the pre-crisis level of output (Figure 20). With slowing dynamism, Kazakhstan is likely already caught in what is commonly referred to as a "middle-income trap". This term characterizes the situation where a country experiences stagnant growth and struggles to advance beyond the middle-income level (Figure 22).[10] [11]

The benefits of Kazakhstan's commodity-driven strong growth performance have primarily accrued to the well-off elites, and the growth has not trickled down equally to all segments of society. Rising wealth inequality is a problem that is not unique to Kazakhstan, but it is particularly susceptible given its heavy dependence on natural resource flows. Despite the country's significant natural resource wealth, the government has faced challenges in delivering an inclusive development agenda, and social discontent is elevated over increasing wealth inequality, which resulted in the social and political crisis of January 2022.[12] The richest 10 percent of Kazakhs control more than 60 percent of the country's wealth, while the poorest 10 percent control less than 5 percent (Figure 21).[13] This level of disparity creates social tensions, erodes solidarity, hinders social mobility, and risks

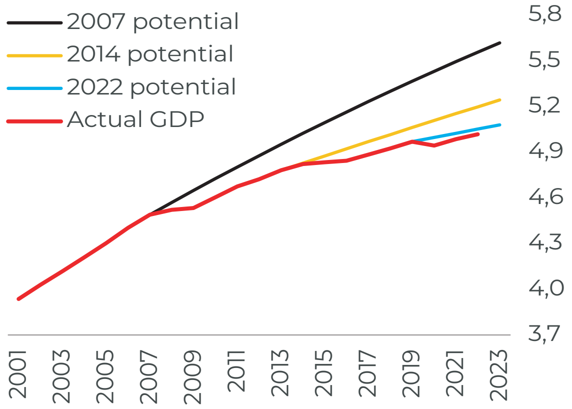
[10] H. Kharas and H. Kohli, "What Is the Middle-Income Trap, Why do Countries Fall into It, and How Can It Be Avoided?" Global Journal of Emerging Market Economies (2011), 3(3), 281–289.

[11] World Bank, (2013), China 2030: Building a Modern, Harmonious, and Creative Society.

[12] "The Diplomat, (2023), "Kazakhstan's Bloody January: Day 1 - Zhanaozen to Aktau."

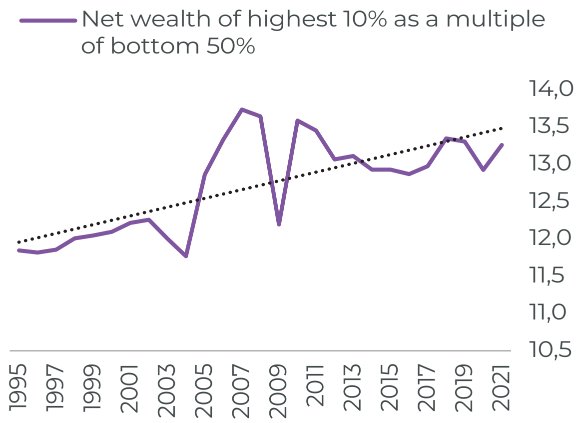
[13] The net wealth of the top 10 percent of the population in income distribution has, on average, been 13.1 times that of the bottom 50 percent of population between 2010 and 2021, increasing from 12.3 times in the period from 2000 to 2007.

Figure 20 Evolution of real potential GDP level *(index (log) 2010=100)*



Source: World Development indicators, WB calculations.

Figure 21 Wealth inequality



Source: World Inequality Database.

undermining the country's social cohesion.[14] Limited opportunities for economic advancement and social mobility may also be contributing to out-migration, which can have detrimental effects on the country's development agenda.[15] [16] Going forward, the declining trend in growth may pose hurdles to poverty reduction efforts and exacerbate inequality, further marginalizing those already at a disadvantage.

As the early successes fade into history, it is becoming evident that maintaining and accelerating economic growth in a rapidly changing global landscape calls for a reevaluation of the country's reform agenda. In line with the population's expectations, Kazakhstan will need a more vibrant and faster growing economy that would generate the needed resources and opportunities to address social challenges, improve infrastructure, and enhance public services. Without prioritizing economic growth and decisive structural reforms, the country can be left in an ongoing stagnating position. This calls for a focus on implementing pro-growth and productivity enhancing reforms to raise Kazakhstan's economic standards to those of wealthier countries in the high-income cohort**.**

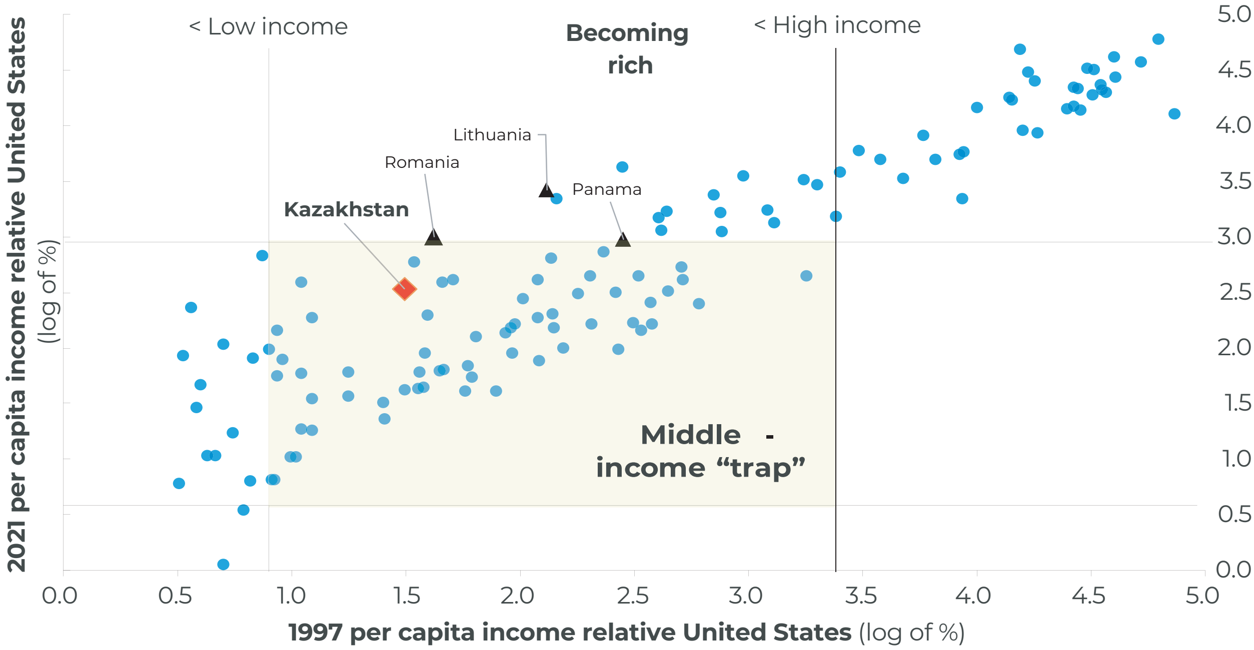
Kazakhstan's lackluster growth performance can be attributed to a combination of weak productivity and underlying structural weaknesses within the economy. The most obvious weakness is evident in capital investment, which decreased from an average of 26 percent of GDP before 2007 to less than 23 percent over the last decade (Figure 23). Kazakhstan has consistently allocated fewer funds to research and development, even below the average for upper middle-income countries (Figure 24). The banking crisis in 2008-2009 impeded the flow of credit to businesses, and diminished demand likely dampened incentives for investment and innovation. In real terms, the stock of credit for businesses in 2022 was about 35 percent lower than its 2007 level.

[14] L. Chancel, T. Piketty, E. Saez, G. Zucman et al., World Inequality Report 2022.

[15] From 2012 to 2022, the net external migration of the population has consistently been negative, with the most significant contributions coming from urban and skilled individuals.

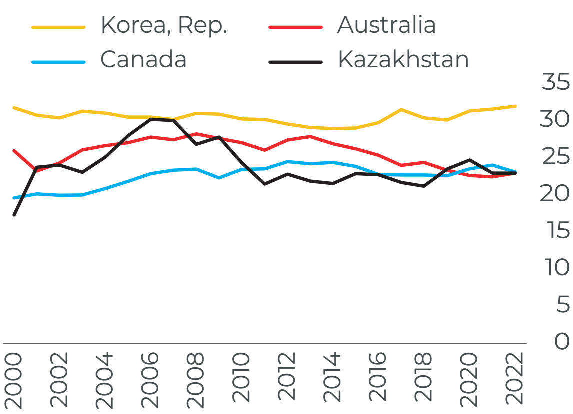
[16] IMF, (2015), Causes and consequences of income inequality: A global perspective.

Figure 22 The middle-income trap



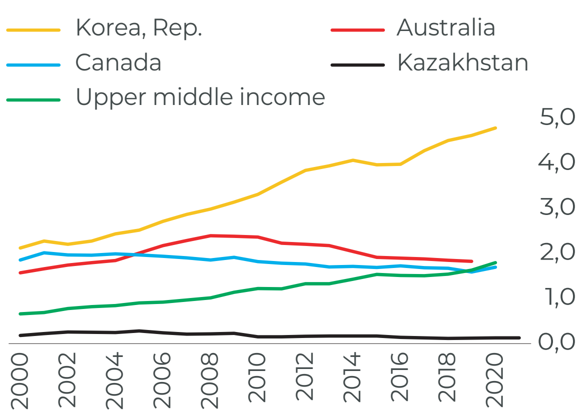
Source: World Development indicators, GNI per capita, Atlas method (current US$), WB estimates.

Figure 23 Capital investment
(percent of GDP)



Source: World Development indicators.

Figure 24 Research and development
(percent of GDP)

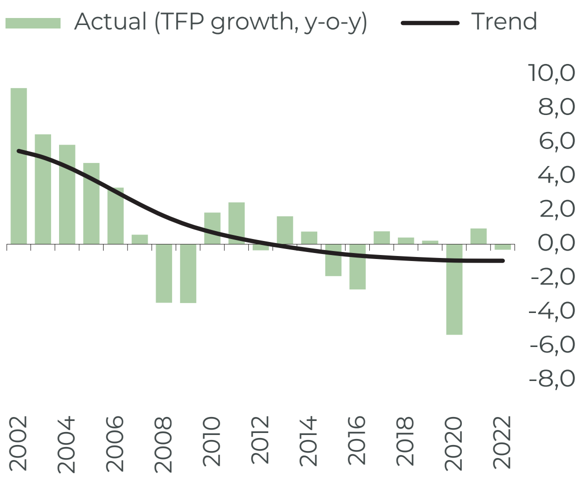


Source: World Development indicators.

Consequently, after expanding on average at a strong pace of 4.5 percent annually in 2000-2007, total factor productivity (TFP) growth has declined to a rate of 0.9 percent a year between 2012 and 2022.[17] While slower productivity expansion has been a global phenomenon, Kazakhstan's lack of

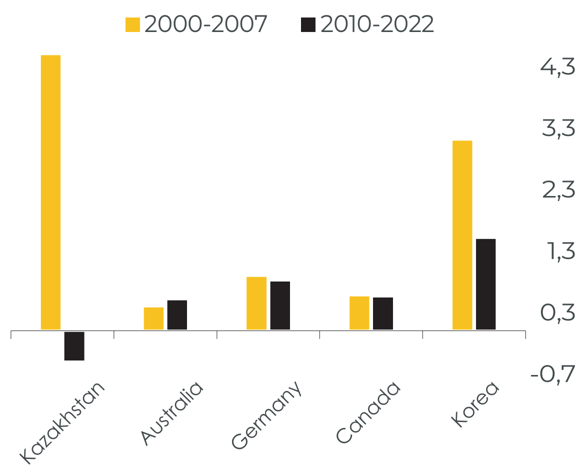
[17] Excluding 2020, the average TPF growth was still negative of 0.4 percent.

Figure 25 TFP growth *(% in 2000-2022)*



Source: WB estimates based on official data.

Figure 26 Average TFP growth *(percent y-o-y)*



Source: OECD.

productivity increases for a decade is a serious problem. This was truly Kazakhstan's "lost decade" (Figures 25 and 26).[18]

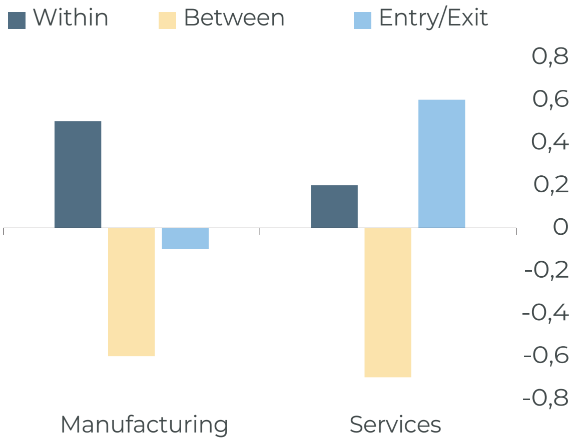
The limited productivity growth is mirrored in the weak dynamism of the private sector. Decomposition of productivity growth over the 2011–18 period, based on firm-level data, into three elements such as firm upgrading, allocative efficiency, and business dynamism shows that firms in Kazakhstan experienced poor results across all three components in both the manufacturing and the services sectors, representing two-thirds of GDP.[19] The between-firm effect, in particular, has been negative on average. Meanwhile, the other two components have not been high enough to compensate and create a highly positive net effect. The net productivity effect has been nearly zero for both manufacturing and services, aligning with the results obtained from aggregate macroeconomic statistics. Overall, there was a low contribution of firm upgrading (within), poor allocative efficiency (between), and limited business dynamism (entry and exit) (Figure 27). Firm-level analysis shows a concerning trend of declining firm dynamism, which hampers the process of creative destruction. Data shows that the entry density of new firms into the formal sector, a standard proxy of entrepreneurship, is insufficient and much lower than the regional averages and well below relative to the country's income per capita (Figure 28).

The prevalence of extensive state support has likely inadvertently contributed to the emergence of a large pool of "zombie" firms that are barely surviving and lack the motivation to expand. Evidence for 2019 shows that formal private firms in Kazakhstan do not grow as they age, underinvest in R&D, are less willing to introduce innovative products and processes than their

[18] World Bank, (2018), Kazakhstan Country Economic Memorandum: Reversing Productivity Stagnation.

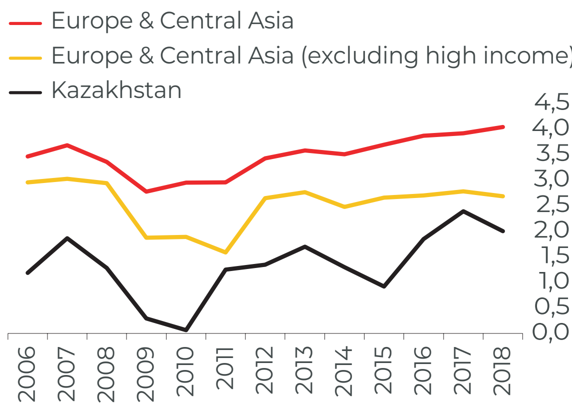
[19] Mariana Iootty, Asset Bizhan, and Paulo Correa, (2022), Boosting Productivity in Kazakhstan with Micro-Level Tools: Analysis and Policy Lessons.

Figure 27 Melitz-Polanec decomposition of TFP growth *(percent in 2011–18)* [23]



Source: WB estimates.

Figure 28 New firm entry density, 2006–18



Source: Based on World Bank Entrepreneurship data set. Note: New business entry density is defined as the number of newly registered formal, private limited liability firms per 1,000 working-age people (ages 15–64).

regional peers, and fail to realize the trade gains of import and export activities. A crucial driver for economic development is the speed at which the average business grows over its life cycle.[20] The limited entry of new firms and the constrained exit of low-productivity ones, which can survive thanks to the extensive state support, has created an environment where firms have weak incentives to expand and drive out less productive competitors.[21] [22]

Limited diversification and low manufacturing base

Kazakhstan has not increased the knowledge value of its exports with higher-value products. The economy remains heavily dependent on commodity exports with small manufacturing base. On average, manufacturing has contributed only around 12 percent of GDP over the past decade, roughly half the level observed in upper-middle-income countries. The structure of exports has only experienced a slight change over the past 20 years, with petroleum products remaining dominant at 70 percent in the export basket. This makes the country vulnerable to fluctuations in global commodity prices. When oil prices have fallen, Kazakhstan's economy tends to experience a recession (Figure 29). While efforts have been made to diversify the economy, progress has been limited. The manufacturing base remains small, and diversification primarily involves a shift

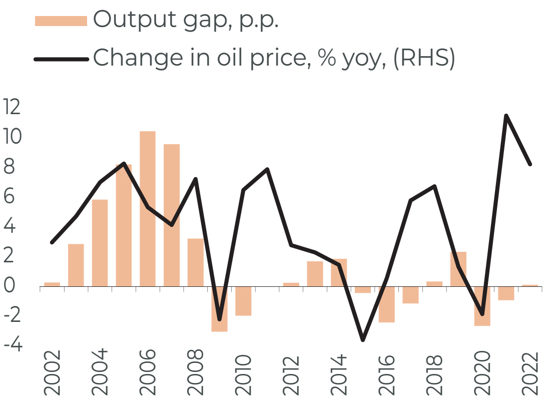
[20] Marcela Eslava, John Haltiwanger, and Alvaro Pinzón, (2019), "Job creation in Colombia vs the U.S.: "up or out dynamics" meets "the life cycle of plants".

[21] According to recent PFR findings, the government continues to implement quasi-fiscal activities (off-budget spending) through various subsidized liquidity provision programs to support the economy. While spending by QFEs during 2011–2015 amounted, on average, to 1.13 percent of GDP, such spending rose in 2016–2021, on average, to 3.65 percent of GDP.

[22] World Bank, (2021), Kazakhstan's Productivity Quest: Unleashing Financing for Dynamic Firms.

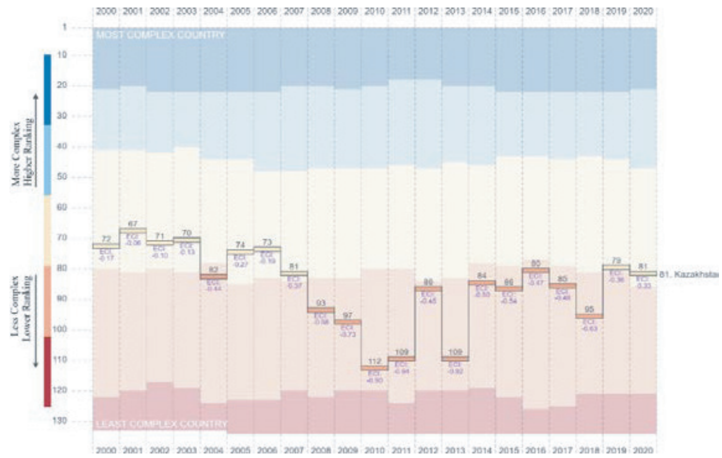
[23] The Figure was produced using the micro level data shared by the government and presented as part of Iootty et al. (2022).

Figure 29 Economic cycle vs oil price developments



Source: World Development indicators, WB estimates.

Figure 30 The Atlas of Economic Complexity



Source: The Atlas of Economic Complexity.

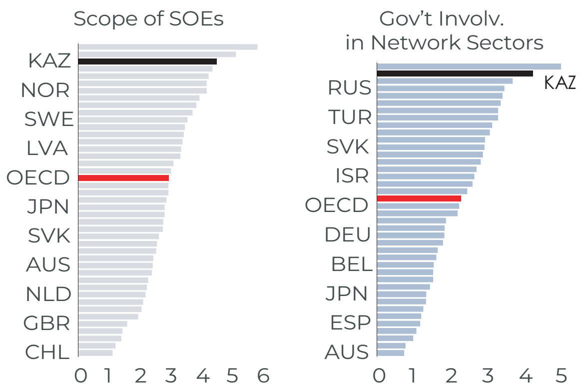
towards non-tradable services such as trade and real estate. The Economic Complexity Index (ECI), which measures the knowledge value of export base, has not substantially increased, highlighting the limited advancement in diversifying towards more sophisticated and higher-value products (Figure 30). Agriculture has consistently fallen short of its considerable potential that includes Kazakhstan's abundant endowment of fertile land and proximity to countries with large demand for food.

Uneven level playing field and the dominance of SOEs

The significant presence of public ownership in the economy limits the growth potential of the private sector. Despite concerns regarding the concentration of economic power, there is no shortage of large firms in the Kazakh economy. Large private firms emerged mainly in the extractive industries after privatization of state assets in the early 1990s and the subsequent influx of FDI from multinational corporations. They continue to play a crucial role in supporting the government's development objectives. However, the legacy of state-controlled enterprises has persisted, as many SOEs have been retained or re-established. The government continues to hold significant stakes in other key industries, including banking, transportation, telecommunication, and utilities, where the private sector can successfully operate (Figure 31).[24] The dominant presence of SOEs in these key enabling sectors, combined with the complicated regulatory environment, has constrained FDI attraction outside of the extractive sectors. SOEs in Kazakhstan are primarily presented by conglomerates Samruk-Kazyna and the Baiterek Fund. Additionally, there are about 6,000 small, mostly unprofitable enterprises operating under various government agencies.

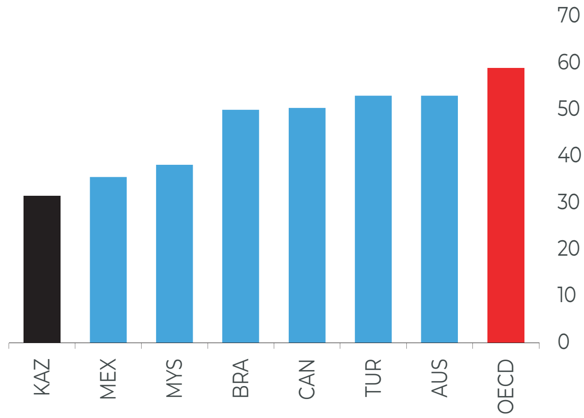
[24] World Bank, (2023), Kazakhstan Country Economic Memorandum: Dependence, Distance, Dispersion - Options for Upgrading Kazakhstan's Economy.

Figure 31 Public ownership
(Note: a lower score reflects the smallest level of public ownership)



Source: OECD 2018 PMR database.

Figure 32 SME contribution to GDP *(percent)*



Source: OECD SME and Entrepreneurship outlook for 2020-2021.

The dominance of large SOEs has disrupted the level playing field, crowding out the private sector. The government often provides support to SOEs through subsidized financing, other subsidies, regulatory provisions, and bailouts. This situation hampers competition and stifles firms' productivity. In recent years, the government has taken steps to reduce the dominance of SOEs and promote private sector participation through privatization efforts and regulatory reforms aimed at creating a more competitive market environment. However, this process has been slow and uneven.

A distortive business environment has been another factor behind productivity stagnation. The business environment in Kazakhstan is characterized as rudimentary, lacking the necessary frameworks and support mechanisms to foster private sector development. Large-scale business support programs—most of them targeting micro, small, and medium enterprises (MSMEs)—have been providing incentives for promoting firm survival rather than increasing firm productivity. In particular, support programs do not encompass explicit incentives for productivity growth and contain intrinsic disincentives for MSMEs to enter new geographic and product markets that could offer higher productivity payoffs. This prevents more productive firms from growing and, as a result, dynamism, and contribution of the MSME sector remains low (Figure 32). Additionally, administrative burdens are disproportionately higher for MSMEs.[25] According to the latest Enterprise Survey for Kazakhstan, senior managers spend an average of 4.3 percent of their time dealing with regulatory compliance, and 7.7 percent of all private sector firms identified business licensing and permits as a major constraint to running their business in the country.[26] The national innovation policy provides limited incentives and opportunities for science-industry collaboration, technology commercialization, and product-process innovation, which hampers productivity growth.

[25] After conducting an extensive review of 2,823 regulations across 44 diverse economic sectors, the authorities have identified a significant 128,119 mandatory business requirements that are intended to be incorporated into the new Register.

[26] It takes an average of 65 days (79.5 for small firms) to obtain a construction permit and 26 days (34 for small firms) to get an operating license.

Policy reforms to raise productivity and market contestability

Promote pro-competition reforms, specifically in network sectors. Promoting market contestability through effective competition and regulatory policies is essential. A conducive environment that encourages competition can reduce barriers to entry, and existing firms are incentivized to raise their productivity and competitiveness. Promoting competition in network industries such as telecommunications, transport, and electricity is vital. Opening these sectors to competition can foster innovation, enhance service quality, and drive productivity improvements.

Revise business support programs. Business support programs should be targeted at firms that will yield the most productivity gains rather than being based on favoritism and bailing out unproductive firms. This requires transparent criteria and evaluation processes for accessing business support that directs resources towards firms with high growth potential. Instead of prioritizing firm size and mere survival, support programs should incentivize robust growth and productivity gains. Furthermore, it's essential to create synergies between these programs and broader policies driving green growth and digitalization.

Reform public procurement procedures to ensure fairness, transparency, and competition. Kazakhstan needs to modernize its public procurement framework to improve spending quality and efficiency and stimulate private sector participation. Progress has been made, but there is room for further improvement, particularly in procurement under SOEs like Samruk-Kazyna. Reforms should focus on promoting competitive methods, eliminating discriminatory rules, incorporating sustainability considerations, and enhancing staff skills.

SOE reform should emphasize the profit motive to drive efficiency and productivity improvements. The focus of SOE reform should prioritize profitability, efficiency, and innovation, enabling them to contribute more to overall economic growth. The objective of reforms would not be to eliminate SOEs but to enhance their performance. Strengthening corporate governance within SOEs can be implemented with measures that instill a business-oriented approach and promote responsible decision-making for increased productivity and performance.

Exposing SOEs to competition from new entrants becomes vital. By introducing competition on equal terms, SOEs will be motivated to improve to avoid being outperformed. This pressure for adaptation and productivity can lead to increased efficiency, improved service delivery, and the emergence of more productive firms in the economy.

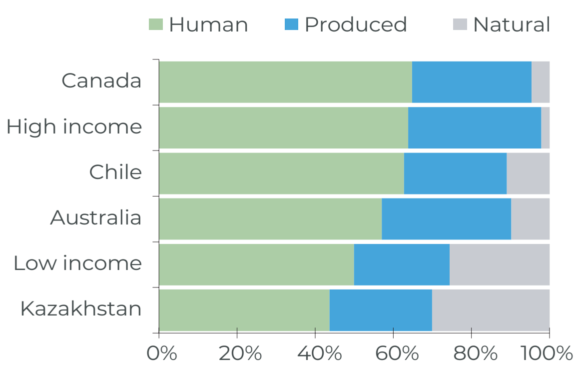
Establishing a robust SOE ownership policy is paramount. This policy reform includes the establishment of a well-defined structure that outlines the purpose, types, and objectives of state-owned property in various sectors. It also involves the creation of appropriate legal structures for SOEs, tailored to their specific purposes and governance attributes. Such a framework would enable informed decision-making regarding sectoral divestment, evaluating associated costs and benefits, and formulating potential privatization plans. Moreover, strengthening the government's ownership role and improving governance mechanisms will enhance coordination between the government and retained SOEs.

A low human capital base

Kazakhstan's human capital base mimics that of low-income countries and is well below high-income countries' standards. No country has achieved high income status with a low human capital base. Kazakhstan is no different. The country's human capital is comparable to that of low-income countries, falling significantly below the standards observed in high-income nations both in absolute and relative levels.[27] The 42 percent contribution of human capital to national wealth in Kazakhstan mimics the 40 percent average of low-income countries.[28] In comparison, countries with similar resource-oriented economies have successfully transitioned to a model where human capital accounts for the majority of their total wealth, typically around 60-70 percent (Figure 33).

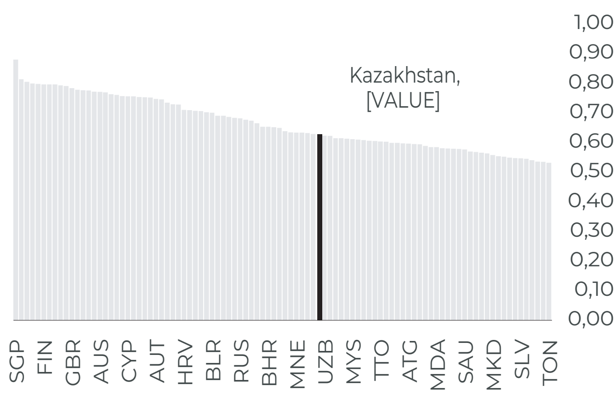
The poor and declining quality of education across the country is a major contributing factor to low human capital. Education quality is declining and becoming increasingly inequitable, undermining productivity growth and sustained prosperity for workers. A child born in the poorest quintile could expect to acquire 53 percent of her potential pre-COVID-19 as compared to her peer born in the richest quintile who will expect to acquire 64 percent of her potential (Figure 34).[29] Opportunities to develop human capital also differ across people—with rural, Kazakh language and lower socio-economic groups being severely disadvantaged. Firms cite lack of skilled labor as a principal constraint to productivity growth, with 41.3 percent of workers being employed in fields that they were not trained in.[30] Jobs have a comparatively high risk of automation, as 52 percent of jobs are at high or significant risk of being automated in Kazakhstan, compared to an OECD average of 47 percent. Yet, Kazakhstani youth are ill equipped to work in the digital economy.[31]

Figure 33 Composition of total wealth *(percentage of total)*



Source: Changing Wealth of Nations.

Figure 34 An average child is expected to acquire only 63% of his/her potential over lifetime



Source: World Bank Human Capital Index.

[27] World Bank, (2021), The Changing Wealth of Nations (CWON) 2021. A wealth accounting tool that estimates the contribution of human capital using constant 2018 US$.

[28] WB estimates based on constant 2018 US$.

[29] World Bank, (2020), The Human Capital Index 2020 Update: Human Capital in the times of COVID. Washington, DC.

[30] World Bank, (2022), Equitable Human Capital in Kazakhstan: Technical and Vocational Skills Development, Adult Learning and Labor Market Programs.

[31] Program for the International Assessment of Adult Competencies (PIAAC), 2017.

Policy reforms to boost human capital

Increase investment in education and ensure high-quality schools throughout all regions of the country. Kazakhstan has begun to invest in education and training (expenditure doubled in 2020 to over 4 percent from an average of about 2 percent for a decade) but too little has reached lower income households in rural communities. The government needs to continue to increase spending on education, focusing on programs that increase quality and equity to ensure increased learning across the board. These should include the expansion of the per-capita-financing to all districts and schools and the engagement of the private sector in mobilizing finances.

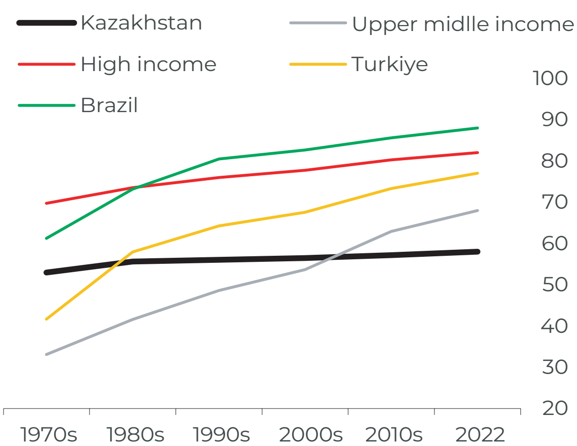
Address inequalities head on by better targeting the needy and vulnerable. Simple but significant adjustments to resource distribution policies can help address disparities and promote equitable access to education and skills development. This should include distributing state grants for higher and technical education and vocational training based on need, including need-based weights into the formula for school per-capita funding, and subsidizing early childhood education for low-income families.

Raise teacher effectiveness and improve the quality of education. To enhance teacher effectiveness, modern teacher education programs should be implemented, curricula and assessment practices should be modernized, and ongoing professional development opportunities should be provided. Ramping up innovation and aligning TVET programs with rapidly changing industry demands will equip the workforce with the skills required for the evolving job market. By focusing on these areas, Kazakhstan can make significant strides in reforming human capital, fostering a knowledgeable and skilled workforce, and driving sustainable economic growth.

Stalled transformation and low mobility

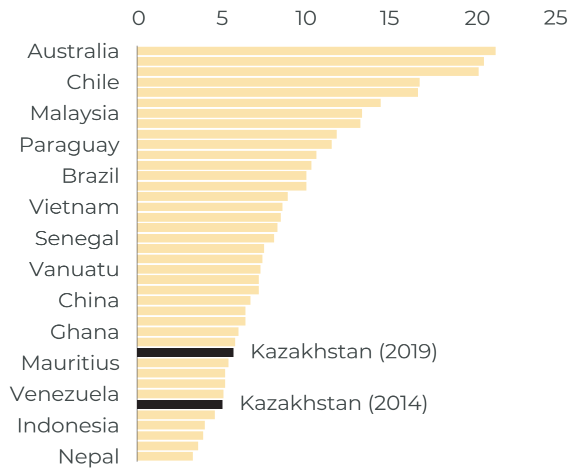
Kazakhstan has not fully harnessed the benefits of agglomeration economies. Kazakhstan is the world's ninth-largest country by territory and the 11th least densely populated. The population density is just 6 people per square kilometer in contrast to the OECD average of 37. While there are several large cities and numerous smaller towns, a significant portion of the population is thinly dispersed across the country. This dispersion contributes to the fragmentation of domestic markets, increases transaction costs for the private sector, and makes it costly to provide both infrastructure and public services. Populations tend to remain concentrated in low-density rural areas reflecting the stagnant transformation within the country. The rate of urbanization in the country is relatively low at 60 percent and has essentially remained unchanged since the 1990s (Figure 35). Lack of mobility and population dispersion hampers economic development by limiting the development of urban areas, which often serve as hubs of innovation, economic activity, employment opportunities, and investment (Figure 36). Urbanization and economic density, if well managed, generate the forces of agglomeration economies and increasing returns which are crucial for growth.

Figure 35 Urban population *(percentage of total)*



Source: World Development indicators.

Figure 36 Share of households who have changedthe city (place) of residence over the previous five years



Managing spatial transformation is crucial for faster growth. The efficiency with which Kazakhstan guides the process of spatial transformation and urbanization (an essential corollary to structural transformation) will determine its long-term growth potential. Kazakhstan's national development priorities include maintaining territorial cohesion and ensuring growth benefits all regions. This suggests the importance of careful management of the ongoing spatial transformation process, with emphasis on urban institutions and infrastructure, connectivity between cities and neighboring smaller towns and villages, improving basic services, and efficient functioning of urban land and labor markets.

Policy reforms to facilitate spatial transformation and regional development

Enable individuals to move to locations where job opportunities are abundant. Concerted efforts should be made to enable rural dwellers to migrate to urban areas. This can be achieved by creating favorable conditions and incentives for individuals to relocate, such as ensuring affordable housing options in urban areas. Facilitating labor mobility can help match the supply and demand for jobs across regions, contributing to stronger growth. Improving urban infrastructure is essential to support a growing population.

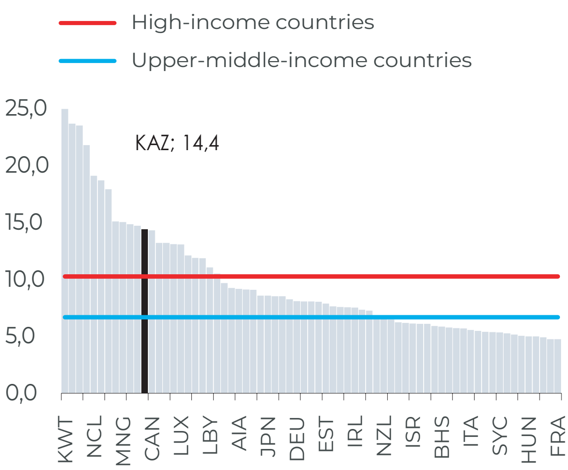
Promoting the gradual devolution of authority and fiscal resources to local levels of government can enhance regional development. Empowering local governments with decision-making authority and adequate financial resources enables them to address region-specific challenges and tailor development strategies according to local needs. This decentralization of power can lead to more effective and responsive governance, driving regional growth and ensuring a more equitable distribution of resources and opportunities.

A heavy carbon footprint

Kazakhstan is one of the major contributors to global emissions in per capita terms, reflecting the country's heavy reliance on fossil fuels and resource-intensive industries. One of the key factors driving Kazakhstan's high greenhouse gas (GHG) emissions is its substantial oil and gas production. The extraction, processing, and export of oil and gas, high energy intensity, and inefficient energy use by industry and housing contribute significantly to the country's emissions. Kazakhstan's industrial sector, encompassing sectors like mining, metallurgy, and chemical production, emits a substantial amount of GHGs. This places Kazakhstan among the largest GHG emitters in terms of ranking in the world in per capita terms (Figure 37). The government has committed to reduce its greenhouse gas emissions by 15 percent by 2030 compared to 1990 and to achieving net zero emissions by 2060.

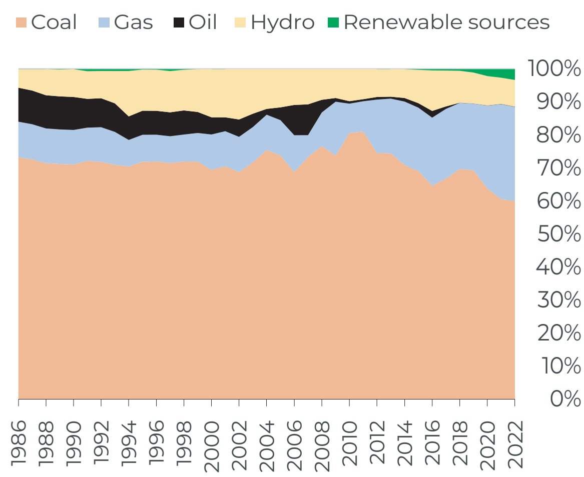
Another contributing factor to Kazakhstan's emissions is its electricity sector, which relies heavily on coal. Although efforts have been made to diversify the energy mix by incorporating renewable energy sources, coal remains a dominant source of electricity generation, leading to substantial emissions. Kazakhstan has the world's tenth-largest coal reserves, representing 230 years of production at the current rate, and coal accounts for 60 percent of electricity generated (Figure 38). The domestic dependence on cheap, subsidized coal and gas has eroded the quality of service in the power sector and the competitiveness of industry over the past decade, impeding investments in new technology.

Figure 37 CO_2 emissions
(tonnes per capita in 2021)



Source: Our World in Data.

Figure 38 Electricity production by source
(percent)



Source: Global Carbon Budget (2022).

Climate actions

Start planning for a transition away from coal and for a significant scale-up of renewable energy. Scaling-up of renewable energy is essential to reduce reliance on fossil fuels, and this involves the establishment of a robust and conducive regulatory framework for renewables, including well-structured auctions for renewable capacity, the phase out of subsidies, and the gradual increase in the price of carbon to reflect the true price of fossil fuel-based power generation. This should be complemented with a comprehensive plan for the gradual phase-out of coal, which should include refraining from constructing new coal plants and instead shifting towards cleaner alternatives. Introducing energy efficiency standards for new buildings and further promoting energy-saving measures across various sectors, such as industry, transportation, and residential, will lead to reduced energy consumption and greenhouse gas emissions. At the same time, it is important to start shifting the large agriculture sector to more sustainable practices as well as planning for the role that forests can play in lowering the costs of achieving Kazakhstan's 2060 net-zero target.

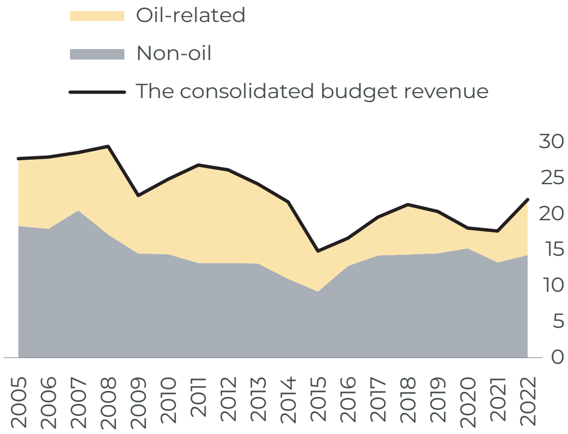
Fiscal policy framework in a decarbonized future

Kazakhstan urgently requires the implementation of more decisive revenue mobilization policies. Over the past 15 years, the country's tax revenues relative to GDP have experienced a decline. The budget revenue-to-GDP ratio has fallen from about 30 percent of GDP during 2005–2008 to a mere 20 percent of GDP in the period of 2020-2022. Kazakhstan's tax performance, measured in terms of collections relative to the size of the economy, lags behind its global peers. Tax buoyancy—the responsiveness of tax collection to changes in the tax base—is weak, with a combined tax revenue gap in 2021 estimated at about 7.8 percent of GDP (or US$14.2 billion or 35 percent of total budget revenue) due to fiscal incentives. The reduction in revenues has narrowed the fiscal space to expand public spending. To sustainably meet growing financing needs, the government should consider either raising tax rates or significantly improving collection efforts (Figure 39).

Kazakhstan's fiscal policy stance generally exhibits a pro-cyclical tendency. As a nation rich in oil resources, the government has fiscal buffers that enable robust fiscal responses to mitigate the impact of adverse shocks on economic growth. During crisis periods, the government appropriately injects additional spending to counteract downturns. However, empirical analysis indicates that when the economy rebounds from crisis and surpasses its potential (i.e., positive output gap), the government tends to delay adjusting the fiscal stance. The adherence to a pro-cyclical fiscal policy is characterized by a delay in unwinding fiscal stimulus measures in timely manner, contributing to a protracted deficit-biased stance. This deficit-biased stance has an outsized role in fueling inflationary pressure, risking overheating the economy and undermining macroeconomic stability. To mitigate the inflationary impact, the government should adopt a more neutral or countercyclical fiscal policy, adjusting its fiscal stance in a timely manner to ensure economic stability and price level moderation (Figure 40).

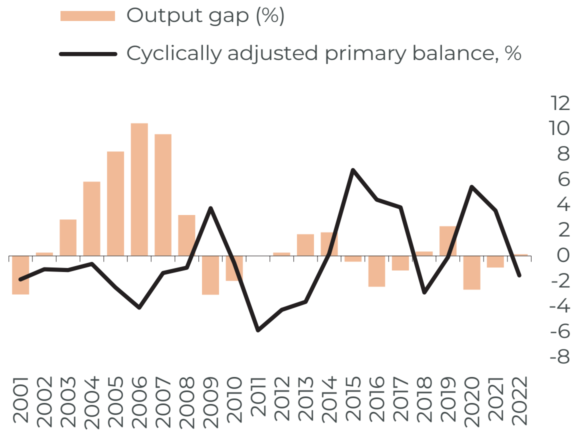
The fiscal rule allows significant discretion in the use of NFRK reserves and lacks a well-designed escape clause. Currently, there is still strong discretionary authority to deploy the NFRK

Figure 39 Revenue collection trends downwards *(percentage of GDP)*



Source: Ministry of Finance, WB estimates.

Figure 40 Fiscal policy tends to be pro-cyclical *(percentage of GDP)*



Source: Bureau of National Statistics data, WB estimates.

for targeted transfers at times and in circumstances that are not clearly specified. Although this decision is exclusively within the purview of the President, such a practice poses a potential risk to the credibility of the fiscal rule. To strengthen the credibility of the fiscal framework, the fiscal rule should incorporate more transparent criteria for departures during exceptional circumstances. Additionally, the magnitude of targeted transfers should be assessed in relation to the necessity for fiscal stimulus aimed at stabilizing the output gap, thereby preventing unwarranted interventions. This enhanced framework will contribute to a more robust and reliable fiscal rule.

In light of the global transition towards renewable energy, the critical aspects of fiscal policy reforms should include a robust carbon price such as through improvements to the Emissions Trading Scheme (ETS). The global shift towards cleaner energy sources, coupled with international climate agreements, presents fiscal challenges for a fossil fuel-producing country like Kazakhstan. As demand for fossil fuels gradually decreases, traditional revenue streams may dwindle, and generating a new source of fiscal revenues is becoming increasingly essential. Therefore, to meet the fiscal costs associated with transitioning to a greener and more sustainable energy future, the government should implement a robust carbon price including by lowering the cap on emissions allowances in the ETS to align with the desired reduction trajectory outlined in the Nationally determined contributions (NDCs). Additionally, the government might contemplate the implementation of a carbon tax in conjunction with the existing ETS mechanism as a policy measure. This would provide additional sources of revenue, helping the government to finance investments in renewable energy infrastructure, energy efficiency measures, and emissions reduction initiatives, while encouraging the reduction of emissions and fostering a transition towards cleaner energy solutions. As the EU's Carbon Border Adjustment Mechanism (CBAM) looms on the horizon, a well-designed carbon tax can act as a powerful incentive for aligning Kazakh industries with CBAM requirements and mitigating potential export penalties.

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