

## **Tax Reform: Creating the Modern System**

**Daniel A. Witt**

President, International Tax and Investment Center

**Charles E. McLure, Jr.**

Economic Adviser, International Tax and Investment Center

Senior Fellow, Hoover Institution, Stanford University

### **I. Introduction**

In 1995 Kazakhstan adopted the most modern tax code of any member of the Commonwealth of Independent States (CIS). The reformed tax code included a value added tax, income taxation of both individuals and enterprises, and a variety of excises, as well as several less important taxes. While the 1995 tax code was not perfect, it represented a vast improvement over the tax system inherited from the former Soviet Union, and it set the stage for subsequent reforms. In early 2001 legislation for further improvement of the tax system has been enacted by the Parliament and is awaiting the President's signature.

This paper examines Kazakhstan's creation of a modern tax system. The next section provides background information on the pre-1995 tax reforms. Section III describes the objectives of the 1995 reforms. Section IV outlines the 1995 reforms and describes known defects of the 1995 legislation. Section V discusses the 1997 introduction of tax holidays. Sections VI and VII discuss the taxation of natural resources and intergovernmental fiscal relations. Section VIII provides concluding remarks that bring this historical overview up to date.

### **II. Background for Tax Reform<sup>1</sup>**

Kazakhstan is the ninth largest country on earth, and one of the least densely populated. (It has five times the surface area of France, but 30 percent of the population.) Prior to the Soviet period, the native people were mostly nomadic, relying primarily on raising livestock and minor trading. In addition to spurring the development of mining (which was economically justified) planners in the former Soviet Union (FSU), undertook uneconomic industrialization and the cultivation of the "virgin lands" of the area, largely for defense and ideological reasons. Since much of Kazakhstan's industry and agriculture does not accord with comparative advantage, transition to a market economy involves wrenching adjustments. Thus, following the dissolution of the Soviet Union, economic output fell precipitously, with devastating effects on public finances, as well as on real wages and living standards.

Kazakhstan has enormous reserves of oil and gas, as well as substantial other mineral resources. Located south of Russia and between China and the Caspian Sea, Kazakhstan is land-locked; this is of vital economic importance, due to the need to construct a pipeline across Russian soil--and thus pay tribute to Russia--in order to export oil and gas. Because of its dependence on exports of oil,

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<sup>1</sup> This is drawn from Asian Development Bank (1999, chapter 1), which contains references to source materials.

Kazakhstan will probably suffer a problem common to many resource-rich nations, “Dutch disease,” the inability to export anything but a few natural resources.<sup>2</sup>

When Kazakhstan became an independent nation at the end of 1991, it inherited the Soviet tax system, which relied heavily on turnover taxes and transfers of enterprise profits to the budget.<sup>3</sup> While some changes had been made between 1991 and 1995, the pre-reform tax system was woefully inadequate for a market economy, in part because the first reforms adopted simply mimicked the flawed changes being made in Russia. Income tax rates generally were not unreasonable (except for certain idiosyncrasies and sporadic episodes of excessive rates), but tax bases contained inappropriate provisions that reflected the Soviet system of accounting. For example, interest on long-term debt was not a deductible expense, but investment financed from own resources (rather than budgetary sources) could be written off immediately, and repayment of loans was deductible under the same circumstances. Losses could not be carried forward. The income of individuals (except for interest) was subject to a variety of schedular taxes; there was no global individual income tax.

Although Kazakhstan replaced the turnover tax with a value added tax (VAT) at the beginning of 1992, its VAT, being patterned after that in Russia, differed from the standard destination principle, consumption-based tax implemented using the credit-invoice method. First, the subtraction method, in which tax is paid on the difference between sales and purchases, was used in the taxation of commerce. Second, no credit was allowed for purchases of capital goods. Third, the origin principle, rather than the destination principle, was applied to trade with other members of the CIS; this was also true of excises.

### **III. The Objectives of Tax Reform**

In January 1994 the International Tax and Investment Center (ITIC) was asked to help the Government of Kazakhstan prepare a new tax code.<sup>4</sup> As ITIC suggested, the formulation of the new tax code followed a two-stage process: first a “White Paper” defining the objectives of tax reform was prepared and then the code was drafted, based on those objectives. This allowed Kazakhstan to avoid an error that commonly plagued tax reform in Central and Eastern Europe (CEE) and the former Soviet Union: beginning tax reform with no clear idea of the proper objectives of reform and no strategy for reaching them, creating instability, complexity, inequities, and distortions and discouraging both foreign and domestic investment.<sup>5</sup> This section describes the objectives proposed in the ITIC white paper.<sup>6</sup>

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<sup>2</sup> Gelb and associates (1988) examines the experience of several oil-rich countries in combating Dutch disease.

<sup>3</sup> For more details, see Asian Development Bank (1999, chapter 1); more generally, see Martinez-Vasquez and McNab (2000).

<sup>4</sup> In its work on tax reform in Kazakhstan ITIC was eventually joined by advisers from the International Monetary Fund, the Organisation for Economic Co-operation and Development, the U.S. Treasury Department, the Barents Group (the U.S. Agency for International Development’s contractor for fiscal reform in the CIS), and the EU-TACIS (Technical Assistance for the CIS) program. The Government’s “Concepts Paper” had been prepared before this cooperation began.

<sup>5</sup> McLure (1995a) notes that the instability of tax laws is one of the primary impediments to investment in small business in the Czech Republic, Hungary, and Poland.

The Government's "Concepts Paper" that formed the basis for legislation was generally consistent with these objectives.

### **A. Revenue Adequacy**

Revenues must be adequate to finance the proper functions of government, without resort to inflationary finance. The transition to a market economy has profound effects on both the need for revenues and the capacity to raise revenue. Government(s) must assume responsibility for social services (e.g., education and health care) formerly provided by state enterprises and a social safety net must be provided to cushion the burden of transition. Yet it becomes more difficult to raise revenues, as enterprises fail, privatization of state enterprises places enterprise managers and tax administrators in an adversarial relation, and the development of the private sector increases the workload and difficulty of the problems facing the tax administration.

### **B. Economic Neutrality**

If markets are to allocate resources efficiently, taxation must not distort economic decisions. Indirect taxes must apply equally to all forms of consumption (and not to business purchases), and direct taxation should tax all income uniformly, without regard to its source or use. There are two important exceptions to this rule of uniformity: taxes on economic rents and taxes related to the benefits of public spending do not distort choices; indeed, benefit taxation is needed to avoid artificially favoring such spending. Considerations of economic neutrality, equity, and administrative feasibility militated against the use of tax holidays and investment incentives to encourage saving and investment.

### **C. Encouragement of Saving and Investment**

Tax policy should not discourage saving and investment, which are important to the transition to a market economy, the economic development of the country, and a higher standard of living. Thus, for example, there should be no VAT on capital goods, and it should be possible to carry losses forward and offset them against future income. To prevent double taxation of income originating in Kazakhstan, which could create an overwhelming impediment to investment, it is essential that the income tax qualify for foreign tax credits in capital-exporting countries.<sup>7</sup>

### **D. Fairness**

Fairness has both horizontal aspects (involving equal treatment of equals) and vertical aspects (reflected in progressive taxation intended to take account of differences in ability to pay). The perception of fairness may be as important as the actuality, especially in a country with a justified mistrust of government. Fortunately, both horizontal equity and the perception of fairness are furthered by the same type of system that achieves economic neutrality, a uniform system. The proper degree of

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<sup>6</sup> Asian Development Bank (1999, chapter 2) states and explains these objectives more fully. See also Martinez-Vazquez and McNab (2000).

<sup>7</sup> Many countries, including the United States, tax the worldwide income of their residents, but allow a credit for income taxes paid to other governments, provided those taxes exhibit certain characteristics.

progressivity, and thus the proper structure of income tax rates, is not something on which foreign advisers (or domestic ones, for that matter) are well qualified to offer advice, beyond noting the disadvantages of high rates.

### **E. Low Statutory Rates**

Low tax rates minimize the adverse effects of taxation, including the inequities and economic distortions that are inevitable in any tax system, as well as disincentives to work, save, and invest. It is generally desirable to have rates that approximate those in the home countries of potential investors, to avoid discouraging foreign investment.

### **F. Simplicity**

Simplicity is perhaps the most important objective of tax policy for a country in transition from socialism, because neither local taxpayers nor the tax administration has the experience or the expertise needed to cope with a complicated tax system. Unfortunately, it is difficult to design a system that provides both the simplicity required by local taxpayers and the certainty needed by multinational corporations.

A simple system would rely heavily on withholding and would require relatively few individuals to submit tax declarations. Primarily those engaged in business would need to submit declarations. This implies the acceptance of schedular elements, such as final withholding taxes on interest and dividends. A system in which the individual is the tax-paying unit is simpler than one based on the joint income of couples or families. Deductions for the taxpayer and dependents can be used to “personalize” the income tax (that is, to make it reflect the circumstances of the taxpayer). But it would be a mistake to allow deductions for personal expenditures; this adds to complexity, as well as often being indefensible on grounds of equity and economic neutrality. A uniform system is often simpler than a highly differentiated one.

## **IV. The 1995 Reforms<sup>8</sup>**

The 1995 tax code contained the basic legal framework for taxation at all levels of government, except for customs duties, contributions for social insurance, and state duties (essentially fees for legal documentation). Whereas there were almost 50 different taxes before tax reform, there were only about a dozen after reform. This section describes the most important of these (the income tax, the VAT, and excises), as initially enacted.<sup>9</sup>

### **A. The Income Tax**

*Taxpayers.* Both legal entities and individuals are subject to income tax. Simple partnerships (including consortia), except those engaged in exploitation of mineral resources, are not taxpayers; the partners pay tax on the shares of income attributed to them. (Partnerships and similar entities engaged in exploitation of mineral resources are treated as taxpayers, not conduits.) Resident individuals and

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<sup>8</sup> This description draws heavily on Asian Development Bank (1999, chapter 3).

<sup>9</sup> We have chosen to present the description in the present tense, to preserve the flavor of appraisals made at the time of the reforms.

resident legal entities are taxed on their worldwide income, with credit for income tax paid to other nations. Foreign enterprises and non-resident individuals pay tax only on income from local sources. Entities are residents if they are incorporated in Kazakhstan or have their place of management there. An individual is considered a resident if he or she is physically present in the country for 183 days during a twelve month period.

*Income of individuals.* Individuals comprise the tax-paying unit. Taxpayers are allowed an exemption equal to one “monthly calculation index” (MCI) for the taxpayer and each dependent family member. Because this figure (which replaced the minimum wage in this calculation) has always fallen below the cost of living, it has minimal effect in creating a tax-free threshold. Among the types of income that are exempt from tax are interest on state securities, scholarships, alimony, state pensions, various other benefits (e.g., for pregnancy, disability, and loss of breadwinner), and most income of veterans of World War II.

*Business income.* Deductions are allowed for most business expenses. There are, however, limitations on interest expense (intended to combat thin capitalization), reserves for bad debts (limited to actual losses), research and development (which must be amortized, instead of deducted when incurred), and charitable contributions (limited to 2 percent of taxable business income). In the case of transactions not made at arms length with related parties that are non-resident or that benefit from tax preferences, the tax administration can adjust transfer prices to reflect arms’ length prices.

All businesses are subject to the same rules for the determination of taxable income; there is no simplified regime for small taxpayers. Whereas initially taxpayers were allowed to choose between cash and accrual accounting, the use of accrual accounting is now mandatory.

Accounting for tax purposes (e.g., for inventories) generally must conform to financial accounting, except in the case of depreciation. Depreciation is based on pooled accounts, rather than individual asset accounts, except in the case of structures (for which individual accounts are required). That is, depreciation is allowed up to specified percentages of the undepreciated values in five asset pools (plus individual structures). The maximum depreciation rates allowed for the six categories of assets and the assets in the categories are:

<u>Category</u>	<u>Rate</u>	<u>Types of assets in pool</u>
1	25%	Pipelines; equipment used for extraction and processing of natural resources; computers; peripherals and data processing equipment;
2	20%	Auto track machinery to be used on the roads, kits and accessories, special tools;
3	15%	Automobiles; trucks; trailers; buses; machinery and equipment, including metal-working equipment; electronic equipment; construction equipment; agricultural machinery and equipment; office furniture;
4	10%	Depreciable assets not included in another category;
5	8%	Equipment used in rail, sea, and river transportation; machinery and equipment used in generation and transmission of electric power and heating; power transmission lines; communications devices;
6	7%	Buildings, facilities, and structures.

Expenses incurred for geological study and preparatory work for the extraction of natural resources (including subscription and commercial discovery bonuses) form a special group to be depreciated at the same rate as group 1 (25 percent) for the first 5 years after commencement of

extraction, with the balance written off anytime after that at the option of the taxpayer. In addition, “technological equipment” with a life of at least 3 years can be written off at any time at the discretion of the taxpayer. Deductions for the costs of reclamation can be taken over the life of a natural resource project.

Repairs are deductible, up to 10 percent of book value. First-in, first-out (FIFO), last-in, first-out (LIFO), and average cost are acceptable methods of inventory accounting. Inflation adjustment is allowed for inventories and, as prescribed by the Government, for book values of depreciable assets. Business losses can be carried forward 5 years (7 years in the case of taxpayers engaged in extraction of natural resources), but are not indexed for inflation. The fact that the taxpayer has the option not to claim the maximum allowable depreciation provides some latitude to extend the effective loss carryforward period.

*Tax rates.* Marginal tax rates on the taxable income of individuals range from 5 to 40 percent. By comparison, legal entities pay a tax rate of 30 percent, except in the case of entities devoted primarily to farming; for them the tax rate is 10 percent. A withholding tax of 15 percent is levied on interest and dividends. For individuals this is a final tax; interest and dividends need not be included in income subject to individual income tax. By comparison, local enterprises pay tax on such income, but are allowed credit for tax withheld. There is a branch profits tax of 15 percent.

*Withholding and advance payments.* Tax is withheld on employment income, pensions, and payments to foreign persons. Those with taxable income not subject to withholding (essentially those engaged in business) must make advance payments of tax on a monthly basis.

*Filing requirements.* Individuals and legal entities must file tax declarations if they have: a) income not subject to withholding (essentially business income); b) construction or purchases in the tax year exceeding a given amount, c) foreign bank accounts, or d) foreign-source income. Given the withholding of tax on income from employment and the exemption of interest and dividends, most individual taxpayers will not be required to file tax returns; the primary exception is those engaged in business.

*Imputation of income.* Business taxpayers operating mainly with cash or having few employees can employ a simplified method of accounting for tax purposes. Where there are accounting violations or loss or destruction of records, the State Tax Committee can impute income based on assets, turnover, or production costs. Where income declared for tax purposes is inconsistent with personal expenses, the latter can be employed to impute income.

## **B. Value Added Tax**

The VAT is essentially a standard consumption-based, credit/invoice method, destination-principle tax of the type found in most advanced Western nations. That is, tax liability is calculated by subtracting tax shown on invoices for purchase from tax on sales. Credit is allowed for tax on capital goods, as well as tax on other business purchases. Imports from non-CIS countries are subject to VAT; exports to such countries (and international transport) are zero-rated; that is, no VAT is due on exports, but credit can be claimed for VAT on purchased inputs. Trade with the CIS is treated differently; like most other members of the CIS, Kazakhstan applies what is sometimes called a “restricted origin method” VAT to CIS trade. Exports to the CIS are taxed, and credit is allowed for VAT on imports paid to other members of the CIS.

Taxpayers are legal persons and individuals engaged in business that are registered for VAT. Registration is mandatory for businesses with turnover in excess of a minimum amount. Voluntary registration is allowed for those with turnover below the minimum.

The base of the VAT is relatively comprehensive; it includes services, as well as goods. Exemptions are more-or-less standard; they include the lease and sale of land and buildings, financial services, activities of non-profit organizations, funeral services, services provided by the state, and privatization and sale of enterprises.

There is a single tax rate of 20 percent. It is applied on a tax-exclusive basis, that is, to the value of sales net of VAT itself. Excises, customs duties, and fees are, however, included in the base for VAT. Initially the tax code provided the option of using either cash or accrual accounting, but the cash option was soon eliminated.<sup>10</sup>

### **C. Excises**

Excises are imposed on such commonly excisable goods and services as alcoholic beverages, tobacco products, motor fuels, passenger vehicles, and gambling, and also on sturgeon and salmon and their roe, furs and hides, apparel made of fur or trimmed with fur, crystal, and firearms. In addition, there is a 5 percent tax on crude oil. Rates on alcoholic beverages and tobacco products are specific (i.e., a certain amount per liter), but are stated in European Currency Units, to prevent their being eroded by inflation; ad valorem rates are applied to other goods and to gambling. The base for ad valorem excises excludes the excise, VAT, customs duties, and fees. Like the VAT, excises are imposed on the restricted origin basis; that is, they apply to production, except that for export beyond the CIS, and to importation, except from the CIS. Rates applied to non-CIS imports of alcoholic beverages and tobacco products are generally substantially higher than those on local products. (Rates on other products do not show this differentiation.)

### **D. Administrative Matters**

The tax code covers administrative matters, as well as the tax structure. It provides a statute of limitations, collection powers, appeals procedures, confidentiality of taxpayer information, and rules against conflicts of interest. While some of the collection powers accorded the State Tax Committee are standard, others are potentially quite onerous and subject to abuse. The State Tax Committee can require banks to assign it priority in collection orders; it can demand payment from the bank accounts of the taxpayer's debtors, it can place liens on the taxpayer's property and sell it at auction; and it can suspend the taxpayer's export operations.

### **E. Appraisal**

#### **1. Tax structure: general**

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<sup>10</sup> When a cash-basis taxpayer sells to an accrual-basis taxpayer, VAT revenues can suffer. The buyer takes credit for accrued VAT liability on purchases, but the seller does not report taxable sales until cash is received. While this treatment is problematic and open to abuse, it is not nearly as troublesome as the situation in which the same taxpayer reports sales on a cash basis and claims credits for accrued liability for tax on inputs. See Summers and Sunley (1995).

Judged by the objectives described in the previous section, the 1995 tax code, as initially enacted rates fairly high; certainly, it provides the basis for a modern tax system. On paper, the new tax code is relatively neutral and fair, and rates are relatively low. It is difficult to judge revenue adequacy, which depends in part on both expenditure reform and the quality of tax administration, as well as the tax structure.

The tax code is not as simple as would have been desirable, especially for individuals and small business. The complexity for small business may have been inevitable; as noted earlier, it is difficult to craft a “one size fits all” solution that is simple enough for small domestic business, while providing adequate certainty for large multinational investors.

The VAT is probably more complex than is appropriate for a country at Kazakhstan’s stage of development. This reflects the genesis of the tax: a model statute patterned after the VAT currently employed in the European Union. A simpler system might have been more appropriate, at least as an interim measure.

## **2. Defects of the 1995 legislation**

Although the 1995 legislation followed fairly closely the advice of foreign advisers, which was based on best international practice, it deviates in several respects that are likely to discourage investment.

### **a. VAT on capital goods**

The tax code provides immediate credit for VAT on capital goods, as is appropriate, but excess credits are not subject to rapid refund. (Firms making limited taxable sales in the domestic market, such as those in the natural resource area, generally have excess credits. Excess credits can be used to offset liability for other taxes. This is of little value until a venture shows a profit.) The need to pay tax on capital goods that can be reclaimed only much later, if at all, can be a major impediment to investment, especially in capital-intensive industries where investment is subject to long gestation periods.<sup>11</sup> The problem is especially serious in a time of high inflation, since postponed credits quickly lose real value.

It is administratively difficult and risky to implement a full-blown system of refunds for excess VAT credits, due to the possibility of fraud. It would be desirable, however, to introduce a system that relieved the existing burden on investment. For example, imports of capital goods might not be taxable when undertaken by approved investors. In the first instance, exemption might be limited to capital goods that could not conceivably be diverted to household use. (e.g., oil-field and mining equipment and equipment used in processing natural resources). Eventually the exemption might be broadened to encompass most, if not all, imports by approved buyers, and sales by domestic suppliers of such firms might also be zero-rated. While this approach would discriminate against those not eligible for this special treatment, this would be an acceptable cost to pay to avoid disincentives to the development of the nation’s natural resources.

### **b. Loss carryforward**

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<sup>11</sup> Summers and Sunley (1995, p. 2061) note that there will also be economic distortions, because effective tax rates will depend on the capital intensity of production. Moreover, there may be a disincentive to export.



It is common for new ventures to incur losses during their early years of operation. If such losses cannot be used to offset future income, taxation discourages investment. The 5 year limitation on loss carryforwards (7 years in the case of taxpayers engaged in exploitation of natural resources) is likely to be much too restrictive in the case of major capital investments with long gestation periods, for example, in the natural resource area. The latitude to postpone deductions for depreciation alleviates this problem, but does not eliminate it, since the values of depreciable assets are not indexed for inflation. The carryforward period should be lengthened or perhaps made indefinite. Even this would not provide a fully satisfactory solution in a time of rapid inflation, as losses not utilized to offset income quickly would lose substantial real value. This highlights a more serious problem, to be discussed next.

### **c. Lack of inflation adjustment**

The measurement of income from business and capital is based on nominal amounts (that is, amounts fixed in monetary terms), with only limited adjustment for inflation. This implies that such income is likely to be mismeasured during a time of inflation. The failure to adjust the value of depreciable assets, inventories, and outstanding credit (or interest income) results in overtaxation, but the failure to adjust the value of indebtedness (or interest expense) produces undertaxation, with the net effect depending on the debt and asset structure of an enterprise.

It is possible to avoid part of the overtaxation by accelerating depreciation, allowing LIFO accounting for inventories, or providing periodic revaluation of assets, as contemplated in the 1995 tax code. But this neglects the effect inflation has on the real value of debt and interest. An accurate measurement of real income requires adjustment of the balance sheet to reflect the effects of inflation. While this is done in several Latin American countries that have previously experienced rapid inflation (e.g., Chile and Colombia), and was introduced in Romania several years ago, it is complicated and could not reasonably be required of all business taxpayers in Kazakhstan.

An alternative that is reasonable for foreign investors is to allow the use of a foreign (“functional”) currency (the dollar in the case of American firms) for tax accounting. This would insulate the tax liabilities of such investors from the differential effects of inflation experienced in Kazakhstan, relative to that in the currency used for accounting. The obvious problem with this approach is that it discriminates against local investors (and perhaps against foreign investors from countries with relatively high rates of inflation).

### **c. Taxation of expatriates**

The income tax makes no allowance for benefits paid to expatriates working temporarily in Kazakhstan, such as home leave, educational benefits for children, and cost of living allowances. Moreover, the tax code provides only a distinction between non-residents (who pay tax only on Kazakhstan-source income) and residents (who pay tax on income from all sources, including investments in their home countries). It would be appropriate to have a third category, non-permanent residents (who would pay tax on income from foreign sources only to the extent remitted to Kazakhstan). Failure to provide a more appropriate treatment of expatriate workers can be a serious impediment to foreign investment, much of which depends on the expertise of expatriates.

### **d. VAT on intra-CIS trade**

It is generally agreed that the VATs “restricted origin principle” treatment of trade within the CIS is unfortunate. It restricts national autonomy over VAT rates. (Ideally, rates would be uniform under such a system.) Moreover, it is inconsistent with the generally accepted view that revenues from a VAT should go to the jurisdiction where consumption occurs, not where production occurs.<sup>12</sup> Unfortunately, this is not a problem that Kazakhstan can easily solve for itself; it needs the cooperation of the other members of the CIS, especially Russia. Any attempt to implement the destination principle for intra-CIS trade would be stymied by the lack of adequate border controls.<sup>13</sup>

### 3. Tax administration

The chief problem with the tax system of Kazakhstan is not structural, but administrative; Kazakhstan lacks the trained personnel to implement a modern tax system. In this it is hardly unique among countries in transition from socialism. Administrative deficiencies undermine achievement of all the goals identified above: revenue suffers, the system is not as fair or as neutral as it appears to be, and it is not as simple--except to the extent it can be ignored. It is thus essential to improve the quality of both tax compliance and tax administration.

### V. Tax Holidays

One of the remarkable phenomena of the past 40 years has been the rise and fall of interest in tax holidays and various forms of investment incentives. This pattern is seen perhaps most clearly in Latin America, where, during the 1950s and early 1960s, tax holidays and other incentives were seen as a means of encouraging saving and investment and channeling investment into activities “of special importance for economic development.”<sup>14</sup> Already in decline, this strategy received an intellectual body blow from the U.S. Tax Reform Act of 1986, which eliminated many tax incentives and lowered tax rates dramatically.<sup>15</sup> Even so, this pattern of interest in tax incentives has been repeated in much of Central and Eastern Europe and in the Former Soviet Union. While some countries of CEE that were in the forefront of offering incentives have learned from their mistakes, Kazakhstan apparently has not.<sup>16</sup>

Tax incentives suffer from a variety of problems and a substantial amount of research questions the efficacy of policy of industrialization based on tax holidays.<sup>17</sup> First, they reflect the *dirigist* mentality of central planning--a mentality that impoverished the countries of the Communist bloc. There is little

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<sup>12</sup> It is also one reason once given by government officials for refusal to allow credits and refunds for tax on capital goods (a view that has since been abandoned): why should Kazakhstan give credits for tax that has been paid to Russia or Ukraine, which export substantial amounts of capital goods to Kazakhstan?

<sup>13</sup> For further discussion, see Summers and Sunley (1995, pp. 2062-66).

<sup>14</sup> The words in quotation marks paraphrase the typical target of incentives. Another component of this interventionist strategy was the use of protective tariffs to encourage import substitution in selected sectors.

<sup>15</sup> On the worldwide tax reform movement of the 1980s, including foreign reactions to U.S. tax reform, see Tanzi (1987) and (1988) and Whalley (1990).

<sup>16</sup> See OECD (1995).

<sup>17</sup> This section draws heavily on McLure (1999). See also the papers in Shah (1995).

evidence that politicians and bureaucrats can reliably pick “winners and losers” better than the market; if they cannot, tax incentives distort the allocation of resources. Second, tax incentives undermine both the fact and the perception of equity. They inherently violate horizontal equity, because income is treated differently, depending on its source, and they commonly also violate vertical equity, because only the wealthy (along with foreigners) can take advantage of incentives; since such inequities are not likely to go unnoticed, the perception of equity suffers. Third, tax incentives--especially tax holidays--complicate tax administration and compliance, something a country in transition from socialism can ill afford. Fourth, tax incentives provided to investors from countries that tax the worldwide income of their residents and allow source-country taxes to be credited against liability for home-country taxes may provide no incentive for investment in Kazakhstan, instead benefiting the treasury of the home country.<sup>18</sup> Finally, if — as is common — incentives are provided at the discretion of bureaucrats or politicians (implicitly, via pressure on bureaucrats, if not explicitly), they are an open invitation to corruption.

Tax holidays are vastly inferior to investment incentives, *if* tax incentives are to be provided. Perhaps most important, under a regime of tax holidays, affiliated enterprises engaged in both taxed and exempt activities can be expected to manipulate transfer prices to shift income from taxable activities to exempt activities. If, for example, agriculture is exempt (or accorded a preferential rate, as in Kazakhstan), but agro-industry is not, prices of agricultural products will be inflated. If both these sectors are exempt, forward vertical integration into marketing will allow shifting of profits from marketing back into the exempt sectors.) In principle, this abuse can be controlled by monitoring transfer prices, but only at the expense of enormous administrative resources.<sup>19</sup> Finally holidays exempt all returns to investment, including extraordinary profits.

Nor does business generally advocate tax incentives. Serious potential investors are much more likely to be interested in political and economic stability.<sup>20</sup> In this regard it is useful to quote the Business and Industry Advisory Committee (BIAC) of the OECD (1990):

Given the choice between lower tax rates and incentives, foreign investors will generally prefer the former, since it results in a simpler tax system with greater certainty and fairness to all investors.

Similarly:

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<sup>18</sup> Of course, not all countries tax on a worldwide basis and some of those that do (but not the United States) allow tax sparing — credits “as if” the source country had imposed tax. In these cases (and when a potential investor credits that exceed tax on foreign-source income) incentives may have their intended effects.

<sup>19</sup> Vito Tanzi, former head of the Fiscal Affairs Department of the International Monetary Fund (1995, p. 139) has expressed the following view about the use of transfer pricing in the international arena:

It may not be too far-fetched to predict that in a technologically evolving world, the allocation of income by the use of transfer prices may be subject to increasing challenges and may thus become progressively more controversial.

It is hard to believe that a country such as Kazakhstan, which lacks administrative resources, can handle the analogous problem in the domestic market, as it must if it is to prevent the type of abuse described in the text.

<sup>20</sup> This view is also supported by surveys of investors in Kazakhstan conducted by the ITIC.

...the international business community believes generally that it is preferable to have lower tax rates rather than incentives. This approach leads to a simpler, more predictable tax system in which foreign investors have confidence that their projects are not being treated less favorably than those of their foreign or domestic competitors.

While theoretically less desirable than tax holidays, because they encourage the substitution of capital for labor, investment incentives are less easily abused. But not all investment incentives are equally desirable. Investment credits tend to stimulate short-term investment, because they apply to reinvested capital recovery.<sup>21</sup> For this reason, Kazakhstan should use partial expensing (first-year deduction of investment), *if* it is to provide tax incentives in the effort to stimulate economic development. Like both economic depreciation and immediate expensing, partial expensing (with economic depreciation of the remainder) is neutral with respect to investment decisions.<sup>22</sup>

It is against this backdrop that, in 1997, Kazakhstan introduced legislation authorizing the grant of tax holidays for selected industries. Such a policy represents a serious retreat from the principles of uniformity and economic neutrality that, for a while, gave Kazakhstan the only modern tax system in the former Soviet Union. Kazakhstan should eliminate the existing defects in the tax code that deter investment, identified in the previous section; only then should it even consider tax incentives. If it is to provide tax incentives, it should allow partial expensing; it should not provide tax holidays. Under no circumstances should it provide incentives on a discretionary basis.

## **VI. Deferred Issues in Taxation, I: Taxation of Mineral Resources**

The 1995 tax code did not adequately address two important issues, the taxation of mineral resources and the so-called tax-assignment problem. The next two sections discuss these issues.

The 1995 tax code provided for three types of taxes on natural resources: bonuses (due on subscription, commercial discovery, and extraction), royalties, and excess profits tax, but does not specify details of any of them. Subsequent legislation (passed at the end of 1996) provides a few more details, but is still not adequate. A matter of continuing tension is the extent to which provisions should be specified by law or decided in negotiations with potential investors.

Excess profits tax (EPT) is to be due if the rate of return on a project exceeds 20 percent. Tax is to be paid at marginal rates that climb from 4 percent to 30 percent as profitability rises from 20 percent to 30 percent. For this purpose (and for income tax purposes) projects are to be “ring-fenced.” That is, EPT and income tax must be paid on highly profitable projects, even if the same taxpayer is involved in other projects that are less profitable (or even losing money). The method of calculating rate of return for purpose determining liability for EPT is not clear.

The 1996 amendments provide that there will two regimes that must produce an equivalent effect: one based on the tax code (including EPT) and one (including all taxes other than EPT) based on profit sharing agreements (PSAs). Thus the code implicitly recognizes that EPT and PSAs are alternative ways of reaching profits in excess of some specified amount or rate. It will, however, be

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<sup>21</sup> Sunley (1973) and Harberger (1990) make this point. To offset this bias, investment credits commonly are larger (as a percentage of investment) for longer-lived assets.

<sup>22</sup> Harberger (1980) demonstrates this.

difficult to meet the requirement that EPT and PSA must reach equivalent results. Neither the tax code nor the regulations indicates how this is to be done.

Several specific provisions deserve special notice. First, taxpayers are not allowed to consolidate the activities they conduct under various contracts; instead, such activities are “ring-fenced” for purpose of both income tax and EPT. It would be more common and more appropriate to allow consolidation, at least for income tax purposes, so that losses incurred under one contract can be offset against income from another. This avoids the disincentive to investment caused by the asymmetry that occurs when income is taxed but losses cannot be offset.

Ring-fencing makes more sense for the EPT, and is customary under production-sharing agreements, to which the EPT is supposed to be equivalent. Without ring-fencing, those with existing successful activities have an advantage over new entrants. (Even an economically marginal discovery may be profitable, because it reduces EPT.) Moreover, they have an incentive to engage in tax-motivated contracts to reduce EPT. (Thus they may offer to pay a greater proportion of costs than the proportion of profits they receive, because of the implied reduction of EPT.) Assuming that EPT is ring-fenced, it may be desirable to make the EPT a deductible expense in calculating the income tax (instead of following the reverse “stacking” procedure). This avoids the necessity of allocating the income tax between contracts that are ring-fenced for EPT purposes.

Contrary to general practice (in both the new tax code, as it applies to other sectors, and the taxation of mineral resources in other countries), Kazakhstan treats partnerships in the mineral resource sector as taxpayers, rather than as “flow-through” entities (with taxation of the various partners on their shares of income derived from activities in Kazakhstan). This has the effect of unduly limiting the way partners in joint ventures can arrange their activities for tax purposes. Since investors in a particular project organized as a joint venture may come from more than one nation, they will be governed by the treaties their respective countries have concluded with Kazakhstan. Treating a joint venture as a taxpayer limits the possibility to arrange activities to reduce taxation in home countries and thus to reduce the cost of doing business in Kazakhstan.

## **VII. Deferred Issues in Taxation, II: Tax Assignment<sup>23</sup>**

The issue of tax assignment — “who (which level of government) should tax what?” — is important, since the method of tax assignment inherited from the Soviet Union is imbedded in a system of intergovernmental fiscal relations (IFRs) that is totally inappropriate for a market economy. Unfortunately, the only significant change made in tax assignment in the new tax code went in the wrong direction; it shifted the individual income tax from a source of subnational revenue to a “regulating tax” (a term to be explained below).<sup>24</sup> ITIC provided a comprehensive report on IFR to the government in 1996.<sup>25</sup>

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<sup>23</sup> This discussion is based on Asian Development Bank (1999, chapter 7 and 8).

<sup>24</sup> In fairness to ITIC’s Kazakhstani counterparts, we note that the Western advisers paid altogether too little attention to this issue until this change had been made by inadvertence.

<sup>25</sup>See Asian Development Bank (1999). Charles McLure conducted this study on behalf of ITIC.

The broad outlines of the Soviet system can be described as follows. Target levels of expenditures are determined for each level of subnational government.<sup>26</sup> (At one time this was done by the application of “expenditure norms” — quantities and prices set by the planners; more recently there has been a tendency simply to adjust prior budgetary allocations for inflation.) Some of the revenues needed to finance these expenditures are budgeted to be provided by subnational taxes — taxes whose revenues flow only to the subnational governments, although they are administered by the central government’s State Tax Committee. The remaining budgetary gap is covered by subnational shares of “regulating taxes” and, if necessary, by subventions from the central government. Sharing rates for regulating taxes are not uniform across oblasts; they are set at levels that are estimated to cover the expenditure needs of individual oblasts (and are, in this sense, “regulating”). Subvention oblasts tend to be poor oblasts whose level of taxable economic activity would be inadequate to provide the revenues needed to cover budgeted expenditures, even if they were allowed to retain all revenues collected on their territory. Despite — or perhaps because of — the technocratic origins of this system, discretion and bargaining play a large role in determining the fiscal resources available to various subnational jurisdictions.

There are many problems with this “gap-filling” system of revenue assignment. First, it provides virtually no fiscal autonomy to subnational governments, since these governments have essentially no control over the level expenditures or its financing. Shared taxes are better seen as grants than as subnational taxes.<sup>27</sup> Second, leaving aside this issue (which renders the allocation of revenues from particular regulating taxes largely irrelevant), the allocation of revenues from shared taxes makes no sense. Excises are allocated to the subnational jurisdiction where importation or production occurs, not to the jurisdiction where consumption occurs, as is more appropriate and common in the West. Revenues from the value added tax and the enterprise income tax go to the oblast where enterprises are chartered. These allocations could not form the basis of a conventional system of tax assignment — at least not a rational one.

It is useful to decompose the tax assignment problem into four choices: which taxes subnational governments are allowed to levy, which level of government defines tax bases, which level sets tax rates, and which level administers taxes.<sup>28</sup> The choice to tax rates is by far the most important for subnational fiscal autonomy — provided, of course, that the tax bases assigned subnational governments provide adequate revenues in the aggregate. By comparison, some taxes are inappropriate for subnational governments (for example, taxes that interfere with either external or internal trade), and excessive subnational discretion over the definition of the tax base and tax administration can be counterproductive, by causing complexity and duplication of administration and compliance. This

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<sup>26</sup> The process described here for determining the budgets of oblasts also occurs at lower levels of government, with budgets of each level being “nested” in that of the next higher level. Under the FSU, the budget of Kazakhstan, like that of the other 14 republics, was decided in a similar way. Thus this system is sometimes called the “matrushka doll” model of IFR.

<sup>27</sup> Bahl and Linn (1992, p. 434) express the same view.

<sup>28</sup> See Asian Development Bank (1999, chapters 7 and 8) and McLure (1995b) and (1997a).

suggests that the optimal approach to tax assignment would rely on subnational surcharges on taxes legislated and collected by the central government.<sup>29</sup>

Tax assignment in Kazakhstan should follow the following general principles:

The individual income tax should be assigned to the oblast where taxpayers reside;

Excises should be assigned to the oblast where consumption occurs;

Enterprise profits should be divided among oblasts on the basis of a formula;

The VAT should be a levy of the central government.

The assignment of revenues from the taxation of natural resources is inevitably controversial in a resource-rich country such as Kazakhstan.<sup>30</sup> There are questions of equity (the division of the revenue between levels of government), neutrality (the possibility that resources will be misallocated to resource-rich regions that can levy lower non-resource taxes or provide higher levels of public services than other regions), political philosophy (whether the taxed resources are the “heritage” or “patrimony” of the entire nation or only of the region), and implications for political stability (whether it is necessary to assign a substantial portion of revenues from resource taxes to subnational governments, as in Russia — an issue that may not arise in Kazakhstan) It seems likely that the resource-rich oblasts will have more fiscal resources, per capita, than most other oblasts.

Like many systems of IFR, IFR in Kazakhstan are likely to suffer from two structural problems: vertical fiscal imbalance and horizontal disparities. The former occurs when one level of government is unable to finance the services appropriate to it with the taxes assigned to it. Commonly, as in Kazakhstan, the top level of government has relatively greater fiscal capacity than the lower levels of government. The usual solution, and the one proposed for Kazakhstan, is a system of grants. Grants are also likely to be needed to overcome the second problem, horizontal differences in the fiscal capacity of oblasts, which are commonly related to the level of economic activity in various regions (and exacerbated by the assignment of revenues from taxes on natural resources to subnational governments where resources are located).

It is crucial that such grants not follow the “gap-filling” model of the past and that they not be based on bureaucratic discretion and bargaining. Rather, to create incentives for local autonomy and responsibility, grants should be structured in such a way as to preserve, to the extent possible, the marginal incentives that would face subnational governments in the absence of grants.<sup>31</sup> Moreover, they should be based on formulas that limit the latitude for discretion and bargaining.

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<sup>29</sup> For qualifications and practical problems, see Asian Development Bank (1999, chapter 7).

<sup>30</sup> See McLure (1994).

<sup>31</sup> There is an obvious theoretical exception to this rule: grants provided to induce subnational governments to take account of spillovers of benefits between jurisdictions should reflect marginal benefits to non-residents. Decision-making in Kazakhstan appears to be sufficiently far from the model of decentralization underlying this theory that it can probably safely be ignored for the foreseeable future.

## **VII. Concluding Remarks**

While the tax code Kazakhstan adopted in 1995 — the most advanced in the CIS at the time — was not without defects, it created the foundation for a truly modern tax system. A new Tax Code has been approved this month and will enter into force on 1<sup>st</sup> January 2002. The new Code is twice the size of the 1995 code (as amended). It incorporates virtually all aspects of the tax system and is the paramount tax legislation. Time and space do not however permit here a detailed comparative analysis with 1995 Code.

The new Code takes into legislation much of tax practice which has been the subject of regulation or Instruction under the 1995 Code. It seeks thereby to codify practice and make it more precise; but it also thereby probably sacrifices flexibility and almost ensures that the legislative history of the 1995 Code – with more than 30 major amendments in five years – will need to be repeated. In some areas, such as the taxation of natural resources (e.g. royalty and EPT calculations), simply transferring rules from regulations to legislation would moreover not necessarily clarify these elements.

The new code seeks to clarify the rights and duties of taxpayer and regulator, to prescribe an improved tax service and to settle responsibilities between central and regional tax authorities, in favour of the former. An improved disputes system is foreshadowed; but this cannot be pursued in isolation from wider legal reform, just as the professional development of the State Tax Service may not proceed satisfactorily in isolation from overall civil service reform.

More work still needs to be done on revenue assignment, in conjunction with further reform of the Budget Law and of local government, in order to develop a robust system of intergovernmental fiscal relations which can cope with pressures from the resources-rich regions and encourage greater self-support on the part of other regions. Politically-understandable equalisation between regions can still lead to excessive, negotiated grants from the Centre.

It is unfortunate for reasons stated earlier, that opportunity has not been taken with the new Tax Code, to abolish the system of investment incentives introduced by the 1997 Law on State Support for Investments. This law currently is being re-drafted and would continue the undesirable and imperfectly-transparent system of tax concessions beyond 2002. It is encouraging that progress has been made in reforming the VAT, in Kazakhstan and the CIS, to introduce destination-principle VAT. Whether the new Code should provide for a lower (16 percent) VAT rate than previously (20 per cent) depends on whether revenue pressures persist.

As noted elsewhere, a critical problem remains that of tax administration, more so than tax structure. Onerous elements for investors include the electronic monitoring of (large) taxpayers first introduced in 1999 and since ratcheted up; (non) implementation of tax treaties, particularly in respect of administration of withholding tax which can have the effect of thwarting the purposes of the treaties; and imperfect comprehension of the special tax regimes for major (PSA/JV) projects.

The new Code moreover, consistent perhaps with other government “localisation” policy initiatives, seemingly raises the cost of employing expatriates through changes to the rules on Income Tax liability and on social fund scope and calculation method.

One monumental change, which also qualifies the primacy of the tax Code, concerns Transfer Pricing, now the subject of a separate new law which entered into force 5<sup>th</sup> January 2001 and explicitly supplants Transfer Pricing provisions of the Tax Code. Again, time and space hardly permit here a professional critique of the new regulation of transfer Pricing. It is however clear that the new legislation



does not fully accord with international OECD Transfer Pricing Guidelines; and that the tax administration will struggle both to develop adequate regulation and to implement satisfactorily that regulation. Discussion of transfer pricing thus promises to become an important issue between investors and regulators.

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