

# Kazakhstan – The Rise of the Asian Panther

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## Abstract

The Republic of Kazakhstan witnessed incredible growth of its real Gross Domestic Product (GDP) between 2000 and 2007 with real GDP exceeding at least 9% per year. Many international investors, scholars, and political leaders would like to know if this growth is sustainable. Unfortunately, accurately forecasting economic growth can be a daunting task. Consequently, the goal of this paper is to take a different approach and study the factors that could aid or severely hinder Kazakhstan's long-run economic growth. Although Kazakhstan has immense mineral and petroleum wealth, factors are unfortunately at work that would prevent Kazakhstan and its citizens from realizing this wealth. This paper examines recent developments in Kazakhstan and the factors that will affect its long-run economic growth.

**Keywords:** Asian tigers; corruption; Customs Union; Dutch Disease; export growth oriented; Kazakhstan; petroleum

## Introduction

The Republic of Kazakhstan is the world's ninth largest country and is located in the heart of Eurasia. Kazakhstan's geography is diverse with wide deserts, vast sweeping steppes, and mountainous terrains. This large country has two blessings. A small population of approximately 16 million in 2009 (Agency on Statistics of the Republic of Kazakhstan 2010, p. 5), and possesses vast mineral and petroleum wealth. Kazakhstan's riches are petroleum, natural gas, copper, aluminum, gold and chromium (Deloitte Touche Tohmatsu 2009; Verme 2007). Consequently, international investors, Kazakhstani<sup>1</sup>, and world leaders believe Kazakhstan will be a rich country one day. Political billboards in Almaty dot the landscape that 2030 will be Kazakhstan's time. Kazakhstan will join the elite club of rich, developed countries.

The potential for Kazakhstan to be a wealthy country is there. Kazakhstan boasted an incredible 13.5% GDP growth rate in 2001 and grew continuously at least 9% for seven years (International Monetary Fund 2010b). Similarly, the Asian tigers reached and sustained real

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<sup>1</sup> Kazakhstani refers to a citizen of Kazakhstan, while a Kazakh refers to an ethnic group who are indigenous to Kazakhstan.

GDP growth rates often exceeding 10% per year for decades. However, Kazakhstan is inflicted with the same problems of the other former Soviet Republics. In order to gain insight about Kazakhstan's long-run economic growth, the economy of Kazakhstan is compared to the Asian tigers. The goal of this paper is to outline the strengths and weaknesses of the Kazakh economy and explain how this may aid or hinder future economic growth.

The title of this paper may be unusual. Kazakhstanis refer to themselves as the Asian panther. Kazakhstanis are proud of their culture and economic prosperity after President Nursultan Nazarbayev declared independence of Kazakhstan from the Soviet Union on December 16, 1991. They know their country is rich in minerals and petroleum, and their economic development is different from the Asian tigers. Thus, they use the word panther to distinguish themselves from the tigers.

## **The Asian Tigers**

The Asian tigers are Hong Kong, Singapore, South Korea, and Taiwan, and they are export growth oriented (Dollar 1992). Export growth orientation is the governments promote and expand exports relative to imports, creating a trade surplus. The Asian tigers expand industries where they have a comparative advantage. The governments provide financing and incentives to key industries, they learn from the mistakes of the industrialized countries and avoid them, and protect their "infant" industries from foreign competition. Furthermore, to sustain the trade surplus, the governments impose trade barriers on manufactured goods from other countries and allow raw materials to enter freely the country. The Asian tigers also tend to devalue their currency relative to the U.S. dollar and are able to keep their real exchange rates stable with low volatility (Dollar1992). Furthermore, the Asian tigers are not endowed with abundant natural resources (Lim 1994). The low trade restrictions ensure a low cost supply of raw materials to supply their factories. This Mercantilistic policy causes rapid industrialization and creates manufacturing jobs. Japan similarly used this growth strategy for its phenomenal development, rising from the ashes of World War II to become the second largest economy in the world within one generation.

A trade surplus causes an inflow of financial capital into a country. Their central banks and businesses accumulate hard currency like U.S. dollars and Euros. Some of this currency is reinvested in the Western countries to buy real estate, stocks, bonds, or government debt. The businesses also invest and import machines and equipment from the Western countries. Moreover, the rapid industrialization creates jobs and expands the tax base. Thus, governments of Asian tigers tend to have the lowest budget deficits in the world and their governments tend to be a small sector of their economies. Moreover, low government deficits and debt does not crowd out private investment. Asian tiger governments do not have to rely on monetizing the debt to cover budget shortfalls. Consequently, the central banks in the Asian tiger countries can keep inflation rates low (Lim 1994). Nevertheless, this does not mean limited government. Governments of Asian tigers are not democratically elected. Their governments have a strong central authority to manage their development and growth during rapid transition. Furthermore, the governments in China, South Korea, and Taiwan use corporatism to direct and control the economic growth and development of their industry. Governments form associations as an intermediary between the state and industry. The associations help align the economic interests of the industries with the state (Unger and Chan 1995).

The Asian tigers have well developed banking systems and their citizens are high savings (Lim 1994). A well-developed banking system is critical for economic development. Financial

intermediaries channel savings into investment activities. Thus, businesses have a source of funds to invest in infrastructure, buildings, machines, and equipment. Businesses can adopt new production technologies and modernize their industries. Consumers and families can invest in homes, cars, and appliances using bank loans. Furthermore, a country with a strong financial system and strong property rights can attract international investors, boosting the investment rates within the country. High investment rates accelerate capital accumulation and fuel high economic growth (Dollar 1992; Lim 1994). The Asian tigers have real investment to GDP ratios ranging between 21.7% and 41.4% in 2007 (Heston, Summers and Aten 2009).

Citizens in Asian tiger countries have high levels of human capital. The government encourages its citizens to pursue vocational and technical training (Lim 1994), and also improve the literacy rate. Higher levels of human capital increase the quality of labor, accelerate the speed of adapting new technology, and boost workers' productivity (Benhabib and Spiegel 1994). Productivity is a strong growth factor and is responsible for approximately two-thirds of the real GDP growth of the United States. Finally, Asian tiger governments encourage their citizens to become entrepreneurs. This strong entrepreneurial spirit causes individuals to establish their own businesses, creating wealth and reducing dependence on the government for their livelihood.

The Republic of Kazakhstan shares several characteristics with the Asian tigers. Kazakhstan has a strong and growing banking system, trade surpluses that bring an inflow of financial capital into the country. Kazakhstanis have a strong entrepreneurial spirit, and the national Kazakh government is fiscally strong and has strong growth in tax revenue. Kazakhstan even repaid its loans in full early from the International Monetary Fund (2010a) in 2000. However, Kazakhstan's economic growth is different from the Asian tigers. The Kazakh economy is overshadowed with a large controlling bureaucratic legal system that is infested with corruption. Kazakhstan's petroleum and mineral wealth may hinder its growth and development via the Dutch disease phenomenon. Furthermore, Kazakhstan may isolate itself from the international community by joining the newly formed Customs Union with the Russian Federation and Belarus. Finally, Kazakhstanis differ significantly in one cultural trait from their Western counterparts. This trait can become a growth hindrance.

## **Kazakh Economic Development**

President Nursultan Nazarbayev was appointed the President of Kazakhstan by the Supreme Soviet on April 24, 1990 and continued as President after Kazakhstan's independence. He has been the one and only President since Kazakhstan's independence. Further, he exerts considerable control over the bicameral Parliament, judiciary, and local governments (Karatnycky 2002, pp. 330-334; Spechler 2008). One claim to his immense power is transition to a market economy takes times. A strong President is needed to hold society together, as society rapidly transforms. People require time to change their thinking and perceptions to the outside world and incorporate foreign ideas into their society.

In the early 1990s, President Nazarbayev made great strides towards a market economy. After Kazakhstan's independence, he immediately deregulated prices and allowed market exchange rates for its national currency, the tenge (Spechler 2008). The Kazakh government also privatized the apartments, stores, and small businesses via voucher privatization. The government distributed vouchers for low prices to its citizens and the citizens used the vouchers to buy the state's assets. However, the Kazakh economy is still dominated by large monopolies

in the agriculture, energy, transportation, and communication industries (Boner 1998; Brada 1996; Spechler 2008).

The Kazakh government encourages foreign investment into its joint ventures with its large state owned companies. Governments use joint ventures as a means of control over business activities under its jurisdiction. Furthermore, the government usually becomes a majority shareholder in the joint ventures. Nevertheless in Kazakhstan's case, the government tends to be a minority shareholder, because of the immense financial capital required to develop new oil and natural gas fields. Moreover, the Western companies bring financial capital, technology, and managerial experience. The European Bank for Reconstruction and Development (2009) estimated that the private sector of Kazakhstan comprised of 65% of its GDP in 2009, which is much lower than the Eastern European countries. Furthermore, Kazakhstan received high marks for price and exchange rate liberalization and small-scale privatization, but low marks for governance, enterprise restructuring, and competitive policies (European Bank for Reconstruction and Development 2009, Chapter 1 p. 4).

The Republic of Kazakhstan appears on the surface to be a great investment opportunity for international investors. Of course, investment in Kazakhstan is fraught with lurking danger. The Republic of Kazakhstan is plague with a severe deficiency; it inherited the Soviet legal system. The Soviet system can be described accurately in three words: bureaucratic, slow, and arbitrary. Unfortunately, a legal system cannot be jettisoned. It can only be modified or changed slowly over time. Many laws, rules, and regulations created during the Soviet era still exist to this very day in the Republic of Kazakhstan. The problem is institutional memory. Many bureaucrats who control and manage the bureaucracies today were trained and educated under the Soviet Union. Furthermore, many high-ranking party members in the Communist party of the Soviet Republic of Kazakhstan dominate the top echelons of the modern Kazakh government (Murphy 2006). The only thing that changed was the rhetoric and names of the government agencies. Thus, their thinking and decisions are similar. As the state transitioned from Communism to a market economy, the bureaucracies still administer and control the state, but they also extended their control over the newly formed private sector (Luthans, Stajkovic, and Ibrayeva 2000).

Kazakhstan has another problem with its market economy. The clans and supporters of President Nazarbayev own and control large segments of the economy (Karatnycky 2002, pp. 330-334). As the state and business interests become intertwined, government leaders use the state to enhance and protect their businesses, and limit competition (Conybeare 1982; Luthans, Stajkovic, and Ibrayeva 2000; Murphy 2006). Limited competition encourages rent seeking behavior and increases x-inefficiency (Conybeare 1982). Consequently, companies may not minimize costs, tend to be mismanaged, and the workers work below their productivity. The political leaders may also inflate their salaries and use nepotism to fill high-level positions in their businesses. Unfortunately, markets cannot impose discipline, because the large industries lack competition and state leaders have little competition in elections (Conybeare 1982).

The strong leadership style of President Nazarbayev and his clan have created a weak judicial branch. Although the entrepreneurs and property owners have legal rights set forth by the Kazakh Constitution, a weak judicial system may not enforce the law (Karatnycky 2002, pp. 330-334). Moreover, the judges are loyal to the President and may also be corrupt, biased, and easily bribed (Boner 1998; Karatnycky 2002, pp. 330-334). Consequently, poor property rights create uncertainty in investment. Both international investors and Kazakhstanis will under invest in Kazakhstan, because the fear that their investments will become stranded or expropriated. For

example, the Kazakh government frequently changes its laws, regulations, and taxes. Contracts and legal agreements signed today may become illegal or non enforceable in the future (Luthans, Stajkovic, and Ibrayeva 2000). Furthermore, the Kazakh government passed a new law on September 27, 2007 that allows the Kazakh government to revise or rescind contracts with Western firms, if the firm's activities jeopardize national security (Akhmetova and Daumov 2008). If one party can change the terms of a contract at any time, then a contract is not longer binding and does not really exist. International investors may believe they do not have a sufficient degree of legal protection to risk their capital and investment (Luthans, Stajkovic, and Ibrayeva 2000).

The Kazakh bureaucrats add more capriciousness to the legal system. They can hinder the entrepreneurial spirit and stymie the growth in new businesses. Kazakhstan has numerous contradictory laws, regulations, and licensing requirements (Luthans, Stajkovic, and Ibrayeva 2000). As the rules and laws become increasingly vague, complex, and ambiguous, poorly paid bureaucrats can extract bribes for approval of licenses, registration, and permits. These bureaucrats have wide discretion whether to approve or not approve licenses and registration. Hence, businesses people need to develop contacts with government officials and they may try to use their government contacts to limit their competition by outbidding the bribes of their competitors (Luthans, Stajkovic, and Ibrayeva 2000). Unfortunately, corruption introduces price distortions into the economy, raises businesses' costs, creates uncertainty, and hampers the creation of new businesses. Thus, the market prices do not reflect scarcity, but reflect the level of bribes and uncertainty created by government. Another complication is public officials are paid less than the private sector. Thus, the best workers migrate from the public to the private sectors. Then the bureaucracies become staffed with incompetent personnel over time (Conybeare 1982; Spechler 2008).

Corruption is a severe problem in Kazakhstan. In 2010, the Republic of Kazakhstan was ranked 124<sup>th</sup> out of 147 countries in terms of corruption. A higher ranking indicates higher levels of corruption. In contrast, the Asian tigers are blessed with low levels of corruption. Hong Kong, Singapore, South Korea, and Taiwan were ranked 12.5, 4, 35, and 34 respectively<sup>2</sup> (Heritage Foundation 2010). Corruption is a problem in all the former Soviet Republics and is a legacy of the Soviet legal system. The overly complicated, bureaucratic Soviet legal system forced people and entrepreneurs to learn ways to circumvent complex legal system using bribes and government connections<sup>3</sup>. Thus, corruption became a way of life and imbedded into their psyche.

Another factor that fosters growth of corruption is tax evasion. Tax evasion is a severe problem in Kazakhstan. Tax evasion limits government funding and thus, government pays its bureaucrats low salaries, including the tax inspectors. Thus, if scofflaws and violators are caught, they may pay bribes to avoid paying taxes (Pomfret 2003). When government is poorly funded, then government is more likely to be corrupt (Conybeare 1982). This corruption is very difficult to extinguish and nearly impossible for government to implement accountability measures. Businesses and government officials involved in corruption are not likely to expose or

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<sup>2</sup> Any ties in the rankings were averaged, which is why Hong Kong has a ranking of 12.5.

<sup>3</sup> Some view corruption as efficient in this case. However, agreements and contracts arising out of corruption are in general non-enforceable. Consequently, corruption creates uncertainty, making it inefficient (Aidt 2003).

review the corruption, because bribes become an important source of income to the bureaucrats (Gerring and Thacker 2005).

The Kazakh government has reformed its tax laws and has been lowering the tax burden on its citizens. For instance, the Kazakh government imposes a flat income tax of 10%, a value added tax (VAT) of 12%, and property taxes remain low, ranging from 0.5 to 1% of a property's value. Moreover, the Kazakh government imposes a flat corporate tax rate of 15% (Deloitte Touche Tohmatsu 2009). Although the Kazakh government imposed low flat taxes on its citizens, the Kazakh government has been increasing its rent seeking behavior on foreign firms. The Kazakh government sells the rights to mine minerals or extract petroleum, levies export taxes on petroleum and minerals, collects corporate income taxes, imposes fines and fees on the mining/petroleum companies, and is coercing larger ownership shares in the joint stock companies. Since the 2008 Financial Crisis, the Kazakh government has done the following:

- The Kazakh government accused the Karachaganak Petroleum Operating (KPO) joint venture of “illegal profits,” and violations of tax and labor laws. The Kazakh government expelled several expatriates for labor violations, claimed the joint venture produced beyond its production quota, and seeks \$2.5 billion in damages (Embassy of the Kingdom of the Netherlands 2010a). KPO is a private joint company composed of BG group, Eni, Chevron, and Lukoil with market shares of 32.5%, 32.5%, 20%, and 15% respectively. The Kazakh government through the state petroleum company, KazMunaiGas, seeks a 10% share (Rotondi and Migliaccio 2010).
- The Kazakh government similarly accused the Kashagan project of cost overruns and delays. Consequently, the Kazakh government, via KazMunaiGas, doubled its share in the joint venture (Embassy of the Kingdom of the Netherlands 2010a).
- The Kazakh government expropriated the Asoom assets in Kazakhstan in July 2010. Asoom is a Moldovan petroleum and natural gas company. The company owned the rights to extract oil and gas from the Borankol and Tolkyn fields. The company invested approximately \$1 billion in the fields and paid \$500 million in fees and taxes to the Kazakh government over 11 years. The problems began in 2008 when Asoom made a significant petroleum reserve discovery and refused to sell its interests to KazMunaiGas (Expropriation News 2010).

The Kazakh government's expansion and interference in its petroleum and mining industries causes two problems that will dampen its future growth. First, the Kazakh government is expanding state enterprises (Gerring and Thacker 2005) via though public corporations. More government ownership leads to more corruption, higher x-inefficiency, and rent seeking behavior on behalf of the state. Second, foreign investors have another reason not to invest in Kazakhstan. Foreigners will stop the flow of financial capital, modern production technologies, and efficient management practices. Finally, the Kazakh government uses fines and penalties to enhance its positions into joint ventures. If a judicial system is weak and subservient to the executive branch, then the fees and penalties are arbitrary and capricious. Private enterprises have no protection from the state.

## The Kazakh Banking System

The Asian tigers have well-developed banking systems and a highly developed banking system is a driver of economic growth. The Republic of Kazakhstan similarly has a well-developed banking system (Spechler 2008). Kazakhstanis are comfortable in depositing their savings in Kazakh banks and ATMs are springing up around bank branches and shopping malls. The Kazakh government helped foster the rapid development of the banking system by implementing four measures. First, Kazakhstanis can choose which denomination for their banking account, either the Kazakh tenge or U.S. dollars. The public remembers the tenge devaluations in 1998 and 2008 well, and consequently, they tend to save in U.S. dollars. Second, Kazakhstanis have deposit insurance through the Kazakhstan Deposit Insurance Fund. Third, the government pays retired citizens their monthly pension via deposits into bank accounts. Many employers also replicated this practice of depositing payroll into employees' bank accounts<sup>4</sup>. Finally, President Nazarbayev passed a law in 2006 allowing Kazakhstanis to deposit funds legally into bank accounts, even from unreported activities. The goal is to infuse banks with deposit funds. Then the banks can grant loans to businesses and households that foster economic growth.

One outlet for bank loans was the Kazakh mortgage market. The Kazakh government created mortgages in 2000 and Kazakhstan experienced strong growth in the real estate market. The rapidly appreciating property values created wealth for its citizens. Unfortunately, a strong and growing banking system may help to contribute to the formation of asset bubbles, as the bank loans accelerate the appreciation of assets. For example, condominiums in Almaty were approximately \$5,000 in 1995 and rapidly appreciated to approximately \$100,000 by 2008. Furthermore, Astana experienced large growth from the construction industry, because the President moved the country's capital from Almaty to Astana in 1997 (Verme 2007). However, the 2008 Financial Crisis stopped the growth of the construction industry. Large construction companies, such as Kuat Construction Company, went bankrupted. Real estate prices have not started falling yet, because the demand for apartments remain strong as new homebuyers are purchasing existing apartments in 2010. Urbanization is causing Kazakhstanis to leave the villages and migrate to the cities. Even if Kazakhstan has falling real estate prices, the impact may be minimal<sup>5</sup>. First, many families outright own their flats. Mortgages are a small portion of the ownership market. Second, the Kazakh government has taken over the construction of bankrupted, partially completed apartment buildings. The Kazakh government plans to complete these construction projects and give them to its citizens.

After the 2008 Financial Crisis, the Kazakh government nationalized its largest banks that teetered on bankruptcy and began intervening in its currency market. The Kazakh government bailed out its banks by using the joint stock holding company, Samruk-Kazyna. Samruk-Kazyna is a public company and is the majority shareholder in the country's largest banks, which are BTA Bank, Halyk Bank, Kazkommertsbank, and Temirbank (Embassy of the Kingdom of the Netherlands 2010b; Aitekenov and Abdrakhmanova 2008). Moreover, Samruk-Kazyna tends to be the majority shareholder in a variety of energy enterprises in Kazakhstan

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<sup>4</sup> I am not sure if businesses are legally required to deposit salaries into banks; however, the tax authorities have a means to verify people's income. Tax evasion is a problem in Kazakhstan.

<sup>5</sup> The original city dwellers benefited, because they bought real estate prices when they were low. However, the new comers from the villages face much higher real estate prices, putting them at a disadvantage.

(Aitekenov and Abdrakhmanova 2008). Finally, the National Bank of Kazakhstan (the central bank) has also been intervening in their currency markets, preventing further depreciation of the tenge. The tenge experienced devaluation in February 2009 and the National Bank of Kazakhstan imposed a band between 127.5 and 165 per U.S. dollar (Embassy of the Kingdom of the Netherlands 2010b).

The Kazakh government's indirect ownership of banks and heavy industries is systemic in the way the government does business. The Kazakh government intervened in its banking system in three ways. First, the National Bank of Kazakhstan strengthened regulations over time, forcing many banks to exit the market and concentrate market power into a few large banks. In 1995, Kazakhstan had 200 banks (Barsukov n.a., p. 258). By 2010, Kazakhstan only had 34 banks (Kazakhstan Deposit Insurance Fund 2010). Second, banks tend to loan to politically connected companies and corporations, while the entrepreneurs and small businesses may have difficulty in getting loans (Luthans, Stajkovic, and Ibrayeva 2000). Finally, not only did the Kazakh government nationalize many of its banks, the government also controls the central bank. The Minister of Finance and an assistant to President Nazarbayev both serve as board members on the National Bank of Kazakhstan and the central bank is the sole shareholder of the Kazakh Deposit Insurance Fund (National Bank of Kazakhstan 2010). Although the heavy hand of government intervenes in the Kazakh banking system, both the Kazkommerts and Halyk Banks earned profits for 2009, and BTA and Temir banks are expected to earn profits in 2010 (Embassy of the Kingdom of the Netherlands 2010a; 2010b).

## **A Cultural Trait**

Some Asian cultures develop strong paternalistic relationships between leaders and the followers. This cultural trait is common in some Asian tigers and Kazakhstan. The superior whether it be the President, manager, or supervisor provides care, guidance, protection, and nurturance to the subordinates and workers. In return, the workers and subordinates have to be loyal and subservient to the superiors (Ardichvili 2001). Although this paternalistic relationship can inhibit the growth and development of a country, the Asian tigers have strong market oriented economies that easily overcome this hindrance. Unfortunately, this cultural trait is another growth hindrance for Kazakhstan.

Kazakhstanis are not allowed to question authority figures. Thus, employees are not allowed to question, criticize, or debate managers, supervisors, or presidents of companies and corporations. Kazakhstanis are not allowed to question, criticize, or ridicule the President of Kazakhstan and this constitutes a crime in Kazakhstan (Karatnycky 2002, pp. 330-334). The ability to not able to question authority creates a serious problem. This paternalistic relationship may encourage corruption and stifle academic freedom in the schools, colleges, and universities.

Making it illegal to criticize or ridicule the President grants a blanket of protection to the whole Kazakh government. For instance, if one is not allowed to criticize the President of Kazakhstan, does this not extend protection to the government agencies and bureaucracies? The President of Kazakhstan is the head of all government agencies in Kazakhstan. If one called a bureaucrat corrupt, is this not insulting the President? The bureaucrat is a cog on a wheel in the government machinery. Thus, he works for a government agency that is an extension of the President. What mechanisms do Kazakh citizens have in reporting corrupt politicians and bureaucrats? Thus, corrupt bureaucrats are given free reign. If one criticizes the Kazakh government, then this person can be charged with a crime and be punished. Bureaucrats can hide behind a veil of secrecy and maintain their illegal, corrupt activities.

Students, teachers, and professors at the schools, colleges, and universities are not likely to criticize the government. Any projects, programs or analysis are not seriously critiqued or analyzed. For example, many students in 2010 are researching the Customs Union among Belarus, Russia, and Kazakhstan. All their reports and research have one common theme. Kazakhstan will benefit from the Customs Union. The reason is simple. President Nazarbayev believes Kazakhstan will benefit, thus Kazakhstan has to benefit. Consequently, all research reports are slanted favorably to what the government wants. Any criticisms and problems are not emphasized. Companies, educational institutions, and government can have only one point of view. They all coincide with the desires and wishes of the President. Other viewpoints entail danger and shortened careers. Consequently, if leaders choose a wrong direction to traverse, no opposition can voice their concerns and point in another direction. Government leaders can make bad decisions and nobody is allowed to critique or voice their opposition to these decisions.

## **The Dutch Disease**

The Asian tigers are countries with outward looking economies. Their export industries compete with companies and industries from developed countries (Gerring and Thacker 2005; Lim 1994). Through trade, the export industries form links and relationships with the international business community. Moreover, free trade enforces standard business practices, and requires government to be transparent (Gerring and Thacker 2005). Transparency and standard business practices are important for international investment. Finally, the export industry creates spillover effects. As international trade expands the export industries, secondary industries expand their production to supply the export industries (Frank 1968).

Kazakhstan is export oriented and has three major exports: petroleum, minerals, and wheat. Kazakhstan is the second largest petroleum producer of the former Soviet Union. Consequently, the regions that experienced strong growth in Kazakhstan are areas where the mining industry expanded (Verme 2007). Kazakhstan's export industries are fueling trade surpluses and flows of financial capital into the country. Exports are important for a country's development, because they are a source of money. As citizens accumulate foreign currency, they can in turn buy imports (Frank 1968).

Resource rich countries tend to suffer from the Dutch disease. The Dutch disease is the foreign investors invest in the resource rich sector, such as petroleum and minerals, causing a country's real currency exchange rate to appreciate. A real appreciating exchange rate puts the export industries at a disadvantage. Then the exporting manufacturing industries have no comparative advantage and the country never develops a competitive export industry. Unfortunately, resource rich countries tend to have poor GDP growth rates in the long run (Egert and Leonard 2008; Lim 1994).

Petroleum is an important driver for the Kazakh economy. The percentage change in the world's annual petroleum price is plotted with Kazakhstan's inflation rate. The left vertical scale is the inflation rate in percent while the right vertical scale is the percent change in the nominal first purchase price for petroleum. The petroleum price and inflation move in opposite directions. The people of Kazakhstan may view the petroleum price as a barometer of the health of their economy. If the petroleum price falls, people panic and stock up on goods and services, creating inflation. The people are preparing for an imminent recession. Government may also be "printing money" through the central bank, as a lower petroleum price weakens its revenues

from petroleum. However, inflation that is created from the “printing money” would have to occur rapidly with a small time lag, which may be possible for a country with a small population.

Resource rich countries have another complication. The political leaders know their country has petroleum and mineral wealth. Thus, they believe they have the right and arrogance to interfere with business affairs, and pass bad laws and regulations. This also hinders international investment and harms long-run economic growth. For instance, Kazakhstan exports petroleum, minerals, and wheat. The next logical step is to take these raw materials, and manufacture them into intermediate and finish products. Manufactured products have higher values and potentially generate more revenue and profits for businesses and industries. Kazakhstan does not export any intermediate or final products on a large scale. With the creation of the Customs Union, the Republic of Kazakhstan will most likely become a raw material supplier for the Russian and Belarusian manufacturing industries.

Kazakhstan has another problem in its long-term development. It is dependent on the revenues from petroleum and minerals. Unfortunately, the petroleum and mineral world prices are highly volatile and unpredictable (Kalyuzhnova 2006). Product exports with volatile prices cause fluctuations in a country’s flow of money (Frank 1968). The volatility causes petroleum revenue to the Kazakh government to fluctuate. Figure 2 shows Kazakhstan’s real GDP growth rate, current account as a percentage of GDP, and percent change in the petroleum price. The left vertical scale is for GDP and the current account, while the right scale is for the petroleum price. Kazakhstan’s economic growth and current account surplus depend on petroleum’s price. Another observation is Kazakhstan had only four current account surpluses for 2000, 2004, 2008, and 2010. The 2010 is a forecast.

The Kazakh government created a National Fund to help smooth government revenue from volatile world prices. The Kazakh government deposits revenues from petroleum, minerals, and corporate tax revenues into the National Fund (Kalyuzhnova 2006). The National Fund helps create sustainability for Kazakhstan’s future growth, because petroleum and minerals are depletable resources. Each barrel of petroleum or ton of minerals extracted and exported today is a loss to future generations. Sustainability requires the government to create two income streams: consumption and investment. The government allocates part of the fund to the government budget while the rest is invested for the future. Once the petroleum and minerals have been depleted, society still has the investments in the National Fund.

President Nazarbayev started the National Fund in August 2000 by Presidential decree. The Kazakh government withdraws a fixed amount each year for government revenue, while the rest is invested in low risk securities in the Western countries. Moreover, the Kazakh government also uses the fund to stabilize government finance. The President is allowed to transfer funds to government to cover national and local government deficits. The fund requires transparency and accountability (Kalyuzhnova 2006). Unfortunately, the public has little knowledge of this fund, and the Kazakh government has low transparency (Kalyuzhnova 2006; Spechler 2008). The Ministry of Finance (2010) publishes aggregate totals for the fund and provides no details about its investment activities. The National Fund is approximately 5 billion tenge or \$34 million as of September 1, 2010. Furthermore, the National Bank of Kazakhstan manages the National Fund with a governing board appointed by the President (Kalyuzhnova 2006). The President is also the chair of the National Fund (Spechler 2008).

## The Customs Union

Belarus, Russia, and Kazakhstan formed a Customs Union that started operating in 2010. All three countries agree to remove all trade barriers and duties among themselves, but erect a common customs with uniform tariffs for outsiders. The import duties for non-members range as high as 30% and importers have to pay the VAT tax of 12% for Kazakhstan (Deloitte Touche Tohmatsu 2009). Russia and Belarus have different VAT tax rates. Furthermore, these countries are in talks of establishing a common market, where the members allow the free flow of capital, investment, and labor among themselves. The net benefits of a customs union are ambiguous. The benefits of a customs union are the integration of two or more economies. Firms have access to larger markets, more consumers, and more potential investors. More trade fosters more competition; monopolies in one country can compete with monopolies in other countries. Moreover, regions within the union can specialize in products and services as free trade links all regions within the union. If international investors believe their investments will be safe within a customs union, then they may invest within the union to sell products and services to its citizens, circumventing the high tariffs and gaining access to larger markets.

A customs union unfortunately may be a hidden form of trade protection. The countries may isolate themselves from the international community and create barriers to outside trade and foreign investment. Larger markets may allow some industries with economies of scale to grow and become natural monopolies for the whole Customs Union. Moreover, the new trading rules and regulations may increase the size, scope, and influence of the bureaucracies, increasing corruption. Executives and investors may pay bribes and kickbacks to circumvent trade barriers and restrictions. Trade protection may increase problems of x-inefficiency and can lead to further rent seeking behavior by the government (Gerring and Thacker 2005). Furthermore, the Kazakh government may view tariffs on imports and exports as another revenue source. Tariffs are easier to collect than income taxes, because government has better control over its ports. Countries with widespread income tax evasion tend to rely on tariffs and export taxes.

The Customs Union has an ambiguous impact on market prices. The Customs Union has three scenarios. First, a Customs Union may lower market prices. If the Custom Union members were already major trading partners, then the Customs Union eliminates all trade barriers and tariffs among themselves, reducing market prices. The leaders of the Customs Union espouse this view. Second, some products like electronics, computers, and cars are made outside the Customs Union. Then the union becomes a form of trade protection, and government collects more duties and tariffs. Importers pay the VAT tax and custom duties, causing the scenario with the highest market prices. Finally, the Customs Union may cause trade diversion. Trade shifts from the outside countries to members of the Custom Union members. Thus, market prices will be lower than the high tariff scenario, but higher than the prices before the creation of the Customs Union.

Another problem of the Customs Union is the amount of economic freedom enjoyed by the people and businesses of these countries. Economic freedom is the ability of people and businesses to engage in business, own, alter, or sell property, freedom to move resources unhindered by their government. Economic freedom is difficult to measure and quantify, and are judgment calls of the designers. This paper uses the Heritage Foundation (2010), because the index is systematically calculated for the last 15 years, giving a trend of countries over time. The Heritage Foundation Economic Freedom Index is a composite index of 10 measures: business freedom, financial freedom, fiscal freedom, freedom from corruption, government spending, investment freedom, labor freedom, monetary freedom, property rights, and trade freedom.

The data is from the Heritage Foundation and was calculated in the following manner. If a country was missing one observation, then linear interpretation was used to compute the missing value. If two or more observations were missing, or an end point was missing, then the country was eliminated from the data set. One important assumption was made. The methodology of the survey data may have changed from year to year, especially the corruption index. Thus, the assumption is the ranking is independent from the methodology. Although, the methodology may change the raw scores, these scores still lead to the correct relative ranking of the countries.

The Customs Union among Belarus, Russia, and Kazakhstan has a severe deficiency. According to the Heritage Foundation (2010), Belarus is considered repressive, Russia is borderline repressive, while Kazakhstan is neither repressive nor economically free. The Freedom Index is shown in Figure 3 and ranks Belarus, Kazakhstan, and Russia out of 147 countries between 1998 and 2010. Kazakhstan clearly became more economically free after 2003. However, its trade partners largely remain not economically free. Russia is clearly the hegemon and will influence Kazakhstan and its economic freedom. One natural question arises. Why did Kazakhstan join the Customs Union? One reason is the President is looking for Kazakhstan's future survival. Unfortunately, Kazakhstan is a landlocked country. Kazakhstan depends on Russia and China to transport its oil, because the pipelines flow through the territories of China and Russia (Askari 2003; Raballand and Andresy 2007). Moreover, Gazprom owns many of the pipelines passing through Russia, and the Russian government is a majority shareholder in Gazprom (Gazprom 2010). Consequently, Kazakhstan needs to establish a stable relationship with Russia, so Kazakhstan can export its petroleum to the world, via Russia. China may go along with the Customs Union, because it needs the petroleum for its industries more than the need to export products to Kazakhstan and its low population of 16 million.

Kazakhstan unfortunately is aligning its economic growth to Russia and Belarus with repressive economic systems. Another complication is the corruption levels in these countries. The corruption ranking is shown in Figure 4. After 2008, these three countries are considered quite corrupt. They rank among the most corrupt countries in the world. Further, they were also former Soviet Republics that inherited the Soviet legal system. Therefore, corruption will be a standard business practice in the customs union and it may grow in scale, as these three countries integrate economically.

The customs union unfortunately will create more problems in Central Asia. Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan are landlocked countries in Central Asia and this region is strife with instability. Kyrgyzstan had two revolutions in 2005 and 2010; Uzbekistan is a police state; while Tajikistan suffered from a civil war. They will have to join the Customs Union (leading to the revival of the new and improved Soviet Union), align themselves with a country with access to the outside world, or become more isolated from the international community.

## **Conclusion**

The detriment to Kazakhstan is the long Russian occupation of Kazakhstan and the long exposure to the Soviet legal system. The structures of a planned economy are still intact from the old days. The Soviet mentality is also prevalent; government leaders have the right and duty to interfere or intervene in any affairs under its jurisdiction, despite any person's rights under the constitution. Kazakhstan also has a weak judicial system, weak property rights, and systemic

corruption; these factors make the Kazakh legal system arbitrary and capricious. Unfortunately, these factors create uncertainty, increase business costs, and hamper the creation of new businesses.

Another complication is the Kazakh government started the nationalization and interference into its petroleum and mining companies. If Kazakhstan did nationalize all its industries, it still has the ability to export its minerals and petroleum. Nevertheless, problems will arise in the future, when Kazakhstan wants to develop new fields, start new companies, or use new technologies from the West. Nationalization turns off the spigot of international investment. Hindering the flow of international investment will lead to lower long-run economic growth.

Another growth hindrance is the Republic of Kazakhstan joined the Customs Union with the Russian Federation, and Belarus, potentially isolating itself from the international business community. Russia will become the dominant partner of the Customs Union and the hegemon. The economic integration will also align the economic growth of Kazakhstan to the growth of Russia. Moreover, the Customs Union is igniting fears of the new Soviet Union and may also undermine the power base of President Nazarbayev. Kazakhstanis were proud of their independence from Russia after two centuries of occupation. Dissent, fear, and protests may arise, as Kazakhstanis fear the reoccupation and control of their country by Russia again. On the other hand, another source of instability is the death of President Nazarbayev. His death will trigger a power vacuum, possibly creating chaos. Although the President has three daughters, he has no son to carry forth the legacy. The mood of Kazakhstanis is the next President will not be as receptive to free markets and capitalism as President Nazarbayev.

A natural question arises. How did Kazakhstan experience incredible real GDP growth rates between 2000 and 2007? Three explanations can help explain this. First, the booming real estate market created a plethora of construction jobs and increased the wealth of property owners. Second, much of the Kazakh economy is underground or hidden (Luthans, Stajkovic, and Ibrayeva 2000). Thus during this time, the Republic of Kazakhstan had a de facto deregulated economy. The economy appears to be deregulated with a low tax burden, because the government is limited in funding, and the government does not have the funding to enforce compliance with the rules and regulations. Unfortunately, foreigners have to follow all the rules and regulations, or risk being deported. Finally, Kazakhstan exports petroleum, minerals, and wheat, which brings financial capital into the country.

Will Kazakhstan still grow at its phenomenal rate? The answer is complex and depends whether Kazakhstan's positive sources of growth can dominate and surmount its negative sources. The positive sources of growth are a low population, strong banking system coupled with a strong real estate market, a de facto deregulated economy, and large reserves of minerals and petroleum. However, the negative factors of growth are corruption, a capricious legal system, weak property rights, nationalization of its industries, trade protection through the newly formed customs union, and the volatility in the world's prices for petroleum and minerals. Of course, a barometer of economic prosperity is net immigration into a country. People do not immigrate to countries where they believe their future will be bleak and fraught with uncertainty. The Central Intelligence Agency (2009) estimated that Kazakhstan lost 3.28 citizens per 1000 from emigration, even with the large flow of illegal residents from Kyrgyzstan and Uzbekistan.

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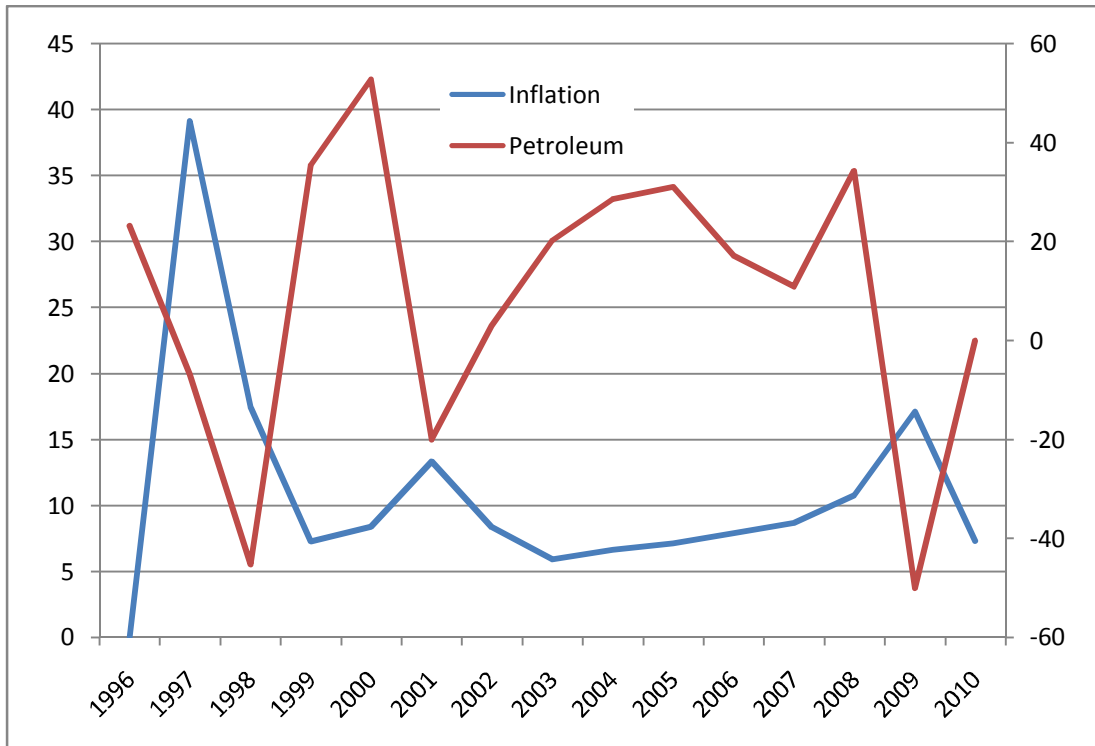


Figure1. Kazakhstan's Average Inflation Rate and Percent Change in the nominal petroleum price

Sources: International Monetary Fund (IMF) 2010b and Energy Information Administration (EIA) 2010.

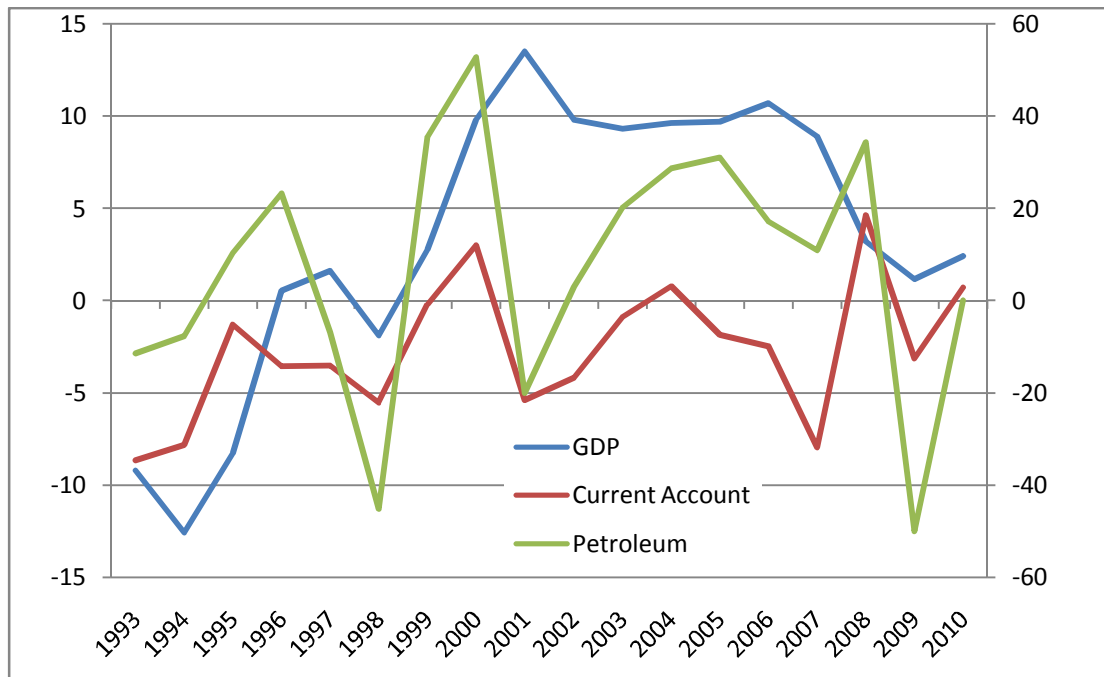


Figure 2. Kazakhstan's real GDP growth rate and current account are plotted with percent changes in the petroleum price.

Sources: IMF 2010b and EIA 2010.

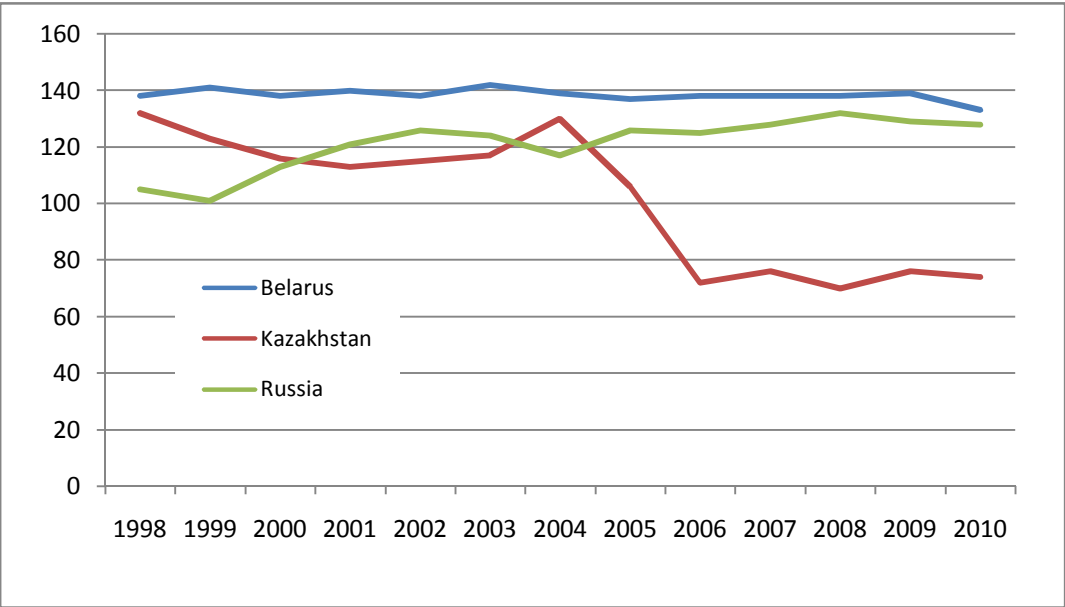


Figure 3. The Economic Freedom ranking for Belarus, Kazakhstan, and Russia

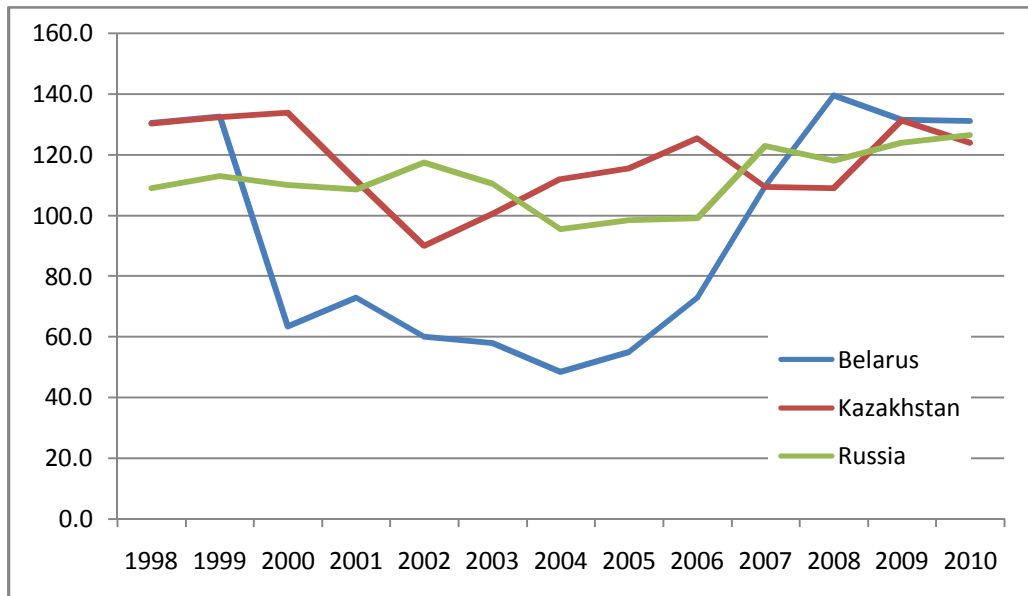


Figure 4. The Corruption Ranking for Belarus, Kazakhstan, and Russia