

# Kazakhstan: Taking Advantage of Trade and Openness for Development

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Second Report under the Studies on International/Regional Trade Integration  
Joint Economic Research Program: Government of Kazakhstan and The World Bank



Report No. XXX-KZ

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July 10, 2012

Poverty Reduction and Economic Management Unit (ECSPE)  
Europe and Central Asia Region

**Currency Equivalent Units**  
 (as of June 7, 2012)  
 Currency Unit = Kazakhstani Tenge  
 US\$1.00 = 147 KTG  
**Government Fiscal Year**  
 January 1 – December 31  
**Weights and Measures**  
 Metric System

## Acronyms and Abbreviations

ADB	Asian Development Bank	NTMs	Non Tariff Measures
BEC	Broad Economic Category	PREM	Poverty Reduction and Economic Management
BKR	Belarus, Kazakhstan, Russia	PRMTR	PREM Trade Department
CA	Central Asia	OECD	Organization for Economic Development
CAREC	Central Asia Regional Economic Cooperation	OTRI	Overall Trade Restrictiveness Indices
CES	Common Economic Space	R&D	Research and Development
CET	Common External Tariff	SEZs	Special Economic Zones
CIS	Commonwealth Of Independent States	SMEs	Small and Medium Enterprises
PCI	Product Complexity Index	SPS	Sanitary and Phytosanitary
CU	Customs Union	TFP	Total Factor Productivity
EU	European Union	TRI	Trade Restrictiveness Index
ECA	Europe and Central Asia	TRICs	Turkey, Russia, India, and China
FDI	Foreign Direct Investment	UNCTAD	United Nations Conference on Trade and Development
GATS	General Agreement on Trade and Services	UNESCO	United Nations Educational, Scientific and Cultural Organization
GDP	Gross Domestic Product	VAT	Value-Added Tax
GOK	Government of Kazakhstan	US	United States
HS	Harmonized System	USAID	United States Agency for International Development
ICT	Information and Communication Technologies	WB	World Bank
ITU	International Telecommunications Union	WITS	World Integrated Trade Solution
MFN	Most-Favored-Nation	WTO	World Trade Organization
NTBs	Non-Tariff Barriers		

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## Acknowledgments

This report is the second analytical product of the Joint Economic Research Program of the Government of Kazakhstan (GOK) and the World Bank (WB) in the area of trade. The first report, published in January 2011, was entitled “Assessment of Costs and Benefits of the Customs Union for Kazakhstan.”

This work was conceptualized and carried out collaboratively by Government of Kazakhstan (GOK) and World Bank (WB) teams. On the government side the work was led by Ruslan Sultanov, director of the Center of Trade Policy, Kazakh Ministry of Economic Development and Trade and on the WB side by Ekaterine Vashakmadze, task team leader. It has benefited from support from of Sebnem Akkaya, WB country manager for Kazakhstan, and Mona Haddad, manager of the International Trade Department (PRMTR), WB. The core team was comprised of Thomas Farole, Daria Taglioni, Mariem Malouche, Sebastian Saez, Monica Alina Mustra, Vilas Pathikonda, Aijan Turjanova and Gaukhar Balykbayeva.

The report is based on background reports and technical work conducted under the direction of Ekaterine Vashkamadze. We gratefully acknowledge the contributions of Vilas Pathikonda on coordination and synthesis of this report.

The background report on trade competitiveness in goods was prepared by a team led by Thomas Farole and Daria Taglioni, senior trade economists, PRMTR, and including Deborah Winkler, consultant to PRMTR; and Vilas Pathikonda, consultant. Consultants Aijan Turjanova and Olivier Cattaneo also made valuable contributions.

The background report on the services sector was prepared by a team led by Sebastian Saez and Daria Taglioni, senior trade economists, PRMTR, with substantive contributions from consultants Olivier Cattaneo and Martin Molinuevo and analytical and quantitative assistance from consultant Saurabh Mishra.

The technical work in the area of nontariff measures was led by Mariem Malouche, trade economist, PRMTR, with substantive contributions from Olivier Cadot, Madina Kukenova, Michael Friis Jensen, Paolo Vergano, and Gaukhar Balykbayeva.

The background report on trade facilitation was prepared by a team led by Monica Alina Mustra, trade specialist, PRMTR, and carried out by consultant Ranga Krishnamani. The report received substantive contributions from Liliya Repa, consultant.

This report also benefited from the comments of peer reviewers John Litwack, Ian Gillson and Paul Brenton, strategic advice from Uri Dadush and suggestions from Jean-Christophe Maur. Ilyas Sarsenov provided helpful advice to the team. Giuseppe Manzillo provided various technical inputs. Gulmira Akshatyrova, Oxana Schmidt and Zakia Nekaïen-Nowrouz provided excellent technical support throughout the process. The team wants to extend its special thanks to Budy Wirasmo for his invaluable help in professionally redesigning the report.

The report builds on the first phase of this work, especially on analyses of trade policy by David Tarr, Jesper Jensen, and Oleksandr Shepotylo.



The WB team is particularly grateful to the Kazakhstan economic team—Kairat Kelimbetov, Zhanar Aitzhanova, Madina Abylkassymova, Timur Souleymenov, Timur Zhaxylykov, Marina Sirotina, Aliya Alimbetova—for their invaluable strategic insights and close collaboration during the second stage of this joint project.

The team also benefited from meetings with the private sector in Kazakhstan, including senior managers at ACME Co., Air Astana, Baker & McKenzie, Becker, Belkyamit, Curtis, Grata, KCell, KPMG, Linkage and Mind, Metro, PricewaterhouseCoopers, Rakhat and Tranko. The team received advisory support and consultation from Oraz Jandosov and Laziza Sabirova of Rakurs think tank in Kazakhstan.

The team is also appreciative for the support of Tatiana Zhdanova, Vice-President of the Chamber of Commerce and Industry of Kazakhstan. Industry associations the team met with include: Almaty Chamber of Commerce, Association of Customs Brokers of Kazakhstan, Association of Furniture and Woodworking Industries, Association of Producers of Soft Drinks and Juices, Astana Chamber of Commerce, Atameken National Economic Chamber, Chamber of Auditors, European Business Association Of Kazakhstan, Kazakh Freight Forwarding Association, Union of Commodity Producers of Food Processing Industry, and Union of International Road Transport Carriers of Kazakhstan.

The team also benefited from the guidance of Yvonne Tsikata, Saroj Jha, Ivailo Izvorski and Kazi Mahbub-Al Matin. The team wants to extend its special thanks to Francisco Galrao Carniero for his invaluable help in finalizing the report.

## Executive Summary

1. **Over the last decade, rapid growth in Kazakhstan's economy has led to a remarkable increase in per-capita income and a reduction in poverty.** Kazakhstan's output doubled as a result of a decade of 8 percent economic growth a year and GDP per capita reached US\$ 11,245 in 2011, which placed Kazakhstan among the world's top 10 middle-income countries, close to the per capita income of Russia and twice as high as China's. The reduction in poverty has been remarkable: in 2001, 46.7 percent of the population was below the national poverty line, but in 2011 that figure dropped to 5.4 percent. Kazakhstan has accomplished what many other energy exporters have not. Large resource endowments, an existing industrial base, as well as market-oriented reforms during the years of transition contributed to these favorable numbers.
2. **Despite the significant success achieved over the past decade, the Government of Kazakhstan recognizes the need to diversify its economy and improve the competitiveness of the private sector.** Doing so will allow progress along non-income dimensions of development to catch up with the rapid increase in per-capita income. Another related challenge that motivates reforms in Kazakhstan is job creation, especially of well-paid jobs consistent with Kazakhstan's income level. Few jobs are being created in the private sector, so there is heavy reliance on the state and state-owned enterprises, and many people remain self-employed and occupied in subsistence agriculture. Furthermore, Kazakhstan's economy is heavily exposed to external shocks such as declines in commodity prices which could severely affect the country's fiscal and current account balances and the real incomes of Kazakhstan's people, as in 1999 and 2009.
3. **Though the global environment is in flux, Kazakhstan is well-positioned to build on its rich resource endowment to broaden and deepen development through trade and international integration.** Commodity prices are likely to remain volatile looking ahead, but the medium-term demand for Kazakhstan's natural resource exports means they will likely remain an important driver of growth. Regional trends are likely to present opportunities. There are four emerging growth poles in Kazakhstan's neighborhood: China, India, Turkey, and Russia, which can serve as both sources of imports and destinations for exports of both goods and services. Finally, the context within which trade policy in Kazakhstan is conducted is being transformed by the customs union between Kazakhstan, Russia, and Belarus; the planned Common Economic Space between these countries, and the advance of Kazakhstan's negotiations to enter the WTO. Kazakhstan's relationship with its Central Asian neighbors could also evolve based on Kazakhstan's strategic transit position, macroeconomic and political stability, expanding productive capacity, and as a source of investment.
4. **Kazakhstan is fortunate that abundant natural resources allow it to tap into the reservoir of knowledge, skills, and state-of-the-art technology that the global economy offers.** The US, EU, and other advanced economies will continue to be critical sources of skills, goods, services, and foreign direct investment (FDI) because for the foreseeable future they will continue to lead in technology and innovation. The benefits of openness, therefore, can be substantial in terms of positive effects on productivity and competitiveness. At the same time, opening these markets to Kazakhstan's own goods and tradable services exports will not be easy. Kazakhstan will have to make strenuous efforts to meet their very demanding quality standards, but the payoff could be considerable.
5. **A review of trade outcomes presented in this report confirms that Kazakhstan is experiencing an increasing concentration of exports, and is following a pattern of specialization in resource- and capital-intensive products.** Not surprisingly, given the surge in oil exports, more than 70 percent of the merchandise export

basket is concentrated in energy and minerals. Even outside of these exports, other sectors are becoming more concentrated. Structural trends suggest that in the last decade Kazakhstan has gone through a steady, if relatively slow, process of specialization away from labor-intensive toward natural resource- and capital-intensive products. Non-resource-based export volumes are increasingly concentrated in a few major products. This has implications for volatility and perhaps for development of the private sector.

**6. The increasing product concentration does not appear to reflect a lack of experimentation by exporters.**

While the variety of products exported narrowed considerably, a share of exports came from products that were new or grew from a very small base, and there have been several big successes. However, experimentation seems to be dimmed by very low export survival rates, suggesting that market access or supply-side factors may be impeding diversification and competitiveness. It also appears that Kazakhstan has not taken advantage of specialization to reap gains through differentiation and quality. In key sectors, Kazakhstan's exports are concentrated increasingly in less complex products that have limited scope for quality differentiation and tend to compete in their main markets near the bottom of the quality ladder.

**7. Service exports have been growing on the back of transport services, but the role and development of services and the services trade is lower for Kazakhstan than for its peers.** Building a competitive services sector is critical for development but also to take advantage of trade and openness. Both exports and imports of services have expanded rapidly over the past two decades, but their share of total trade and total output is relatively low. Growth in service exports has been driven by transport services, and there is a high trade deficit in modern business services. The increase in imports of ICT and business and commercial services reflects the growing importance of high-quality, low-cost services as inputs for production of both goods and other services. Where the domestic producer base of such services is not sufficiently developed, such imports demonstrate the necessity of these services for economic development.

**8. As an input into the government's trade policy strategy development, this report identifies four areas where policy adjustments and regulatory reforms could increase export competitiveness.** Kazakhstan must adjust its approach on four closely interrelated dimensions: (i) balancing regional integration efforts of the customs union with Russia and Belarus and the Common Economic Space with international integration, and maximizing the benefits each offers; (ii) building competitive goods sectors by shifting from targeted sector support to cross-cutting trade-enabling efforts; (iii) building efficient services by promoting competition and being more open to global skills and knowledge; and (iv) developing a comprehensive trade and competitiveness agenda and the institutional capacity to carry out this agenda.

***1. Balancing regional integration efforts (BKR Customs Union and future Common Economic Space) with international efforts (WTO) and maximizing the benefits each offers***

**9. Kazakhstan should ensure that the benefits from the Customs Union (CU) and Common Economic Space (CES) with Russia and Belarus outweigh the negative consequences, and should use the WTO accession process to drive the country's overall reform process.** The Government of Kazakhstan aims to use regional integration to expand its markets and foster diversification. The government considers the CU with Belarus and Russia to be a major step in that direction. Because free trade agreements between the countries were already in effect before the CU treaty was signed, the main CU-related changes so far have been the adoption of a common external tariff (CET) and customs code and the elimination of customs clearance at internal borders. To harmonize its tariffs with those of the other CU members, Kazakhstan had to raise its barriers to trade with the rest of the world.

**10. Prior to the customs union, trade re-oriented away from Russia and diversified in terms of markets, both overall and within non-resource sectors.** Looking ahead, trade potential exists with both China and CU partners, although trade costs hinder intra-regional trade within Central Asia. The composition of trade with Russia, and to a lesser extent Central Asia, emphasizes their importance in terms of Kazakhstan's product diversification into new non-commodity export products.

**11. The Customs Union's CET has caused diversion of trade, especially away from technologically more advanced inputs from industrialized countries.** The customs union has diverted a portion of Kazakhstan's trade back toward Russia. The effect has been most pronounced in access to intermediate inputs, where CU partners have taken market share from other sources, mainly the EU but even from China. The CU has accentuated Kazakhstan's specialization in energy, minerals, and metals. However, it has also offered isolated market opportunities for other exports such as footwear and machinery, and while this success is notable, it remains to be seen if under a future WTO scenario these products can remain competitive after tariff protection is reduced. It is too early to discern a definite conclusion about the CU's impact on foreign investment into Kazakhstan, one of the main purported benefits of the CU.

**12. Current integration efforts risk being unduly tilted toward the CU at the risk of undermining the process of global integration and complicating the trade environment.** This pertains not only to tariffs, where alignment with the CU external tariff has diverted imports toward the CU from the rest of the world, but also non-tariff measures, where instead of adopting international standards the country is adopting CU technical regulations, and in the area of services liberalization, which could crowd out the best global operators.

**13. Existing constraints in the trading environment as well as new constraints created by the CU can both be alleviated by accession to the WTO that is underway for CU members.** Membership in the CU reduces Kazakhstan's room to maneuver in setting tariffs on goods and crafting exceptions, which will have to conform to those agreed by Russia. However, Russia's accession to the WTO entails significant liberalization for its CU partners. As Russia's external tariffs drop with accession, they will be followed by Kazakhstan—Russia's average most-favored-nation (MFN) tariff is scheduled to fall from 11.5 percent to 8.6 percent. To maximize benefits of the CU, the report recommends that Kazakhstan, in addition to positioning itself for WTO accession commitments, take leadership of the CU reform agenda, increase competitiveness in emerging sectors to compete with Russian firms, and step up efforts to attract FDI intended to serve the entire CU market.

## ***II. To build competitive goods sectors the government's focus should shift from targeted sector support to more effective cross-cutting, trade-enabling efforts***

**14. The increasing concentration of the export basket is problematic to the extent that it is reflective of trade barriers and supply-side constraints.** At this point in its economic development, specialization may simply imply fading of non-competitive industries, and therefore on its own is not a negative development. However, exploration of differences between successful and less successful sectors and products allows us to provide useful insights into the nature of constraints.

**15. Successful exports have common characteristics that are not shared with less successful exports.** The current successful non-resource exports (such as processed metals, inorganic chemicals, and frozen fish) all have short value chains, are less sensitive to transport times, depend on natural resources, and are all capital-intensive. Those products are typically not produced by small and medium enterprises (SMEs), and are generally less reliant on

links between services and goods. This reinforces the specialization trends observed, and suggests that supply-side policies and behind-the-border impediments may be barriers to the growth of non-traditional exports.

**16. Removing constraints to competitiveness will take far more than sector-specific interventions.** The report makes the case that targeted investments are not a substitute for creating a broad trade-enabling environment. The report addresses the impact of non-tariff measures and poor trade facilitation in inhibiting access to inputs and access to markets. Progress in tariff policies, NTMs, and trade facilitation are key factors that will directly affect the extent of access to competitive inputs and markets and therefore long-term productivity and competitiveness of Kazakhstan. All three areas have been identified as requiring reforms to support rather than impede Kazakhstan's trade and openness. Making fast progress in NTMs and trade facilitation was identified as the critical factor that can compensate for loss of welfare associated with an increase in tariff protection from the CU (World Bank 2012) and reduce the negative impact of the CU on the long-term productivity of Kazakhstan.

**17. Considerations related to the CU complicated a system of non-tariff measures already in need of reform.** Kazakhstan relies extensively on concepts, legal instruments, and physical quality/standards infrastructure that date back to the Soviet period. Because they do not take into account technological developments, current technical regulations discourage innovation. Reform plans are heavily influenced by external developments. The CU added to the number of Kazakhstan's technical regulations, changed the direction of harmonization from EU standards to CU standards, made certification more difficult, and brought uncertainty to the private sector. In particular, the CU has prompted harmonization with Russian technical regulations that often do not conform to best practices. The CU has translated into another layer of technical regulations and administrative requirements that is creating confusion and suppressing both imports and exports.

**18. Kazakhstan's limited improvements in the area of trade facilitation and logistics inhibit access to inputs and markets and the ability of the country to serve as a regional trade hub.** On international indicators, Kazakhstan's logistics performance declined precipitously from 2010 to 2012, after improvements in previous years. The country continues to find itself near the bottom of countries worldwide (176 of 183 countries in 2012) on the Trading across Borders measure of the World Bank Doing Business indicators. In this report, we present a desk review of existing analytical work to give a fresh perspective on existing problems and emerging opportunities. Connectivity overall is increasing as efforts are underway to upgrade and reconstruct the road and rail corridors of the country, but these efforts must be supplemented by improvements in the quality and efficiency of logistics services, as well as reducing delays at customs and other border agencies.

### ***III. Kazakhstan should focus on building efficient services by promoting competition and being more open to global skills and knowledge***

**19. Crucial for job creation and growth prospects are the size and efficiency of Kazakhstan's domestic services sector, especially backbone services.** Although the services sector already accounts for 53 percent of Kazakhstan's GDP and 52 percent of its jobs, it is bound to increase in importance as incomes rise. In the most advanced economies services provide well over 80 percent of all jobs. High-quality and efficient intermediate service inputs, strong service links with other economies, and robust service exports are all features of a competitive services sector. While progress is being made, Kazakhstan is falling short of providing the requisite mix of ingredients to achieve these objectives.

**20. Kazakhstan underperforms in a wide range of domestic services.** While Kazakhstan has a generally liberal service regime overall, restrictive conditions are still present within certain sectors (e.g., telecommunications, transport, and professional services). As a result, in Kazakhstan backbone services such as telecommunications and certain subsectors within transportation are both expensive and inefficient by international standards. Institutions and the regulatory environment matter greatly for services. In addition to formal restrictiveness, informal barriers to entry and operation of competitive service providers and operators are widespread. Key service sectors remain in public or quasi-public ownership with limited exposure to competition. Importantly, national content rules and restrictions on employment are increasingly stringent, preventing temporary movement of workers. A more efficient service sector will raise living standards, make the entire economy more productive, and enhance the competitiveness of goods exports.

**21. The process for accession to the WTO can help stimulate reforms.** There is a considerable scope for specific commitments on trade in services and FDI where CU requirements are not binding. While the CES objective of achieving free movement of capital and labor within the CU is laudable—it may help make Kazakhstan’s services sector more efficient and competitive—much greater gains can be achieved through WTO accession. With WTO negotiations there is the possibility of locking in reforms that will encourage Kazakhstan to draw on labor and foreign financing. Russia’s accession to the WTO will have a considerable impact, especially for the services sector. A recent assessment (World Bank 2012) found that Russia’s GDP is expected to increase by about 3 percent in the medium term (5–10 years) and 11 percent in the long-term, and almost three-fourths of the estimated gains will come from improved quality and lower prices for services. Kazakhstan needs to accelerate its reforms to boost competitiveness of its services sector to avoid creating a wider productivity gap with Russia if that country’s WTO accession allows its services sector to rapidly liberalize and reform.

#### ***IV. Kazakhstan must strengthen its institutional capacity to design and implement trade policies***

**22. Developing and implementing an integrated trade agenda requires a comprehensive approach, effective and capable institutions, solid analytical underpinnings, and effective links with the private sector.** A similar approach is needed in each specific technical area, such as expanding access to markets and competitive inputs through streamlining of non-tariff measures and trade facilitation.

**23. Without institutional development, important initiatives may flounder, or worse, harm exporters.** The country may fall short of reaching worthy goals to promote trade competitiveness, or financial and human resources may be spent without tangible benefit. Trade policy and trade-enabling institutions need to catch up with the dynamically developing segments of the economy and enable development of other potentially competitive segments. This will ensure that benefits from rapid resource-driven income growth enhance rather than impede development.

**24. Improving coordination and dialogue and bolstering sources of data and knowledge will aid the capacity to design and effectively implement national trade policies.** Enhancing coordination, including inter-ministerial coordination of trade policies and the competitiveness reform agenda, as well as institutional mechanisms for public-private dialogue will make it possible to formulate and implement effective policies that recognize the best interests of the private sector and exporters. The policy-making process must also take advantage of rich data sources (especially firm-level micro-data) and use national statistics on services and services trade more efficiently. Throughout this report we highlight areas where firm-level data would allow one to hone the analysis. Targeted surveys and assessments of the regulatory impact of NTMs and current service sector policies, as well as monitoring

trade facilitation will enhance Kazakhstan's ability to identify bottlenecks and adjust them as needed in the interest of the private sector. In parallel with ongoing trade policy and competitiveness reforms, Kazakhstan should use the enhanced knowledge of the trade landscape to bolster activities in the area of trade and investment promotion.

**25. This report is structured as follows.** Chapter 1 analyzes the performance of Kazakhstan's trade. Chapter 2 presents an overview of recent developments in Kazakhstan regional and international trade integration. Chapter 3 examines in detail key issues related to market access, focusing on non-tariff measures and trade facilitation and logistics. Chapter 4 examines the services sector and offers a roadmap for actions to enhance its competitiveness. Chapter 5 addresses building institutional capacity for the trade and competitiveness agenda.

**26. The report's recommendations are summarized in the following table.** In order of the four main messages of the report, they cover balancing regional and international integration efforts, measures to improve access to inputs and export markets by reducing non-tariff barriers and through trade facilitation measures, raising the quality and efficiency of the services sector, and strengthening institutional capacity to implement an effective trade policy and competitiveness agenda.

**Table 1. Policy Recommendations**

I. Balancing regional integration efforts (BKR Customs Union and future Common Economic Space) with international efforts (WTO) and maximizing the benefits each offers (Chapter 2)
<ul style="list-style-type: none"> <li>• Use the WTO accession framework rather than the CU and CES to reform the system of TBT, SPS, customs valuation, liberalization of services regimes, transparency in trade, rights of foreign investors and subsidy limitations.</li> <li>• Take leadership in CU and CES to accelerate the reform process.</li> <li>• Focus on increasing private sector productivity to improve ability of Kazakh firms to compete within the CU market.</li> <li>• Enhance efforts to attract FDI intended to serve the entire CU market by establishing Kazakhstan as the most investor-friendly destination.</li> </ul>
II. Improve access to inputs and markets (Chapter 3)
Non-tariff measures
<ul style="list-style-type: none"> <li>• Implement an integrated approach to NTM reform by promoting coordination within the government and between the government and the private sector.</li> <li>• Improve information underpinning of NTMs by: (i) Completing and validating the NTM database, keeping a current inventory of NTMs; (ii) Undertaking a regulatory impact assessment of NTMs and making NTMs transparent.</li> <li>• Ensure that new standards and technical regulations that are adopted are not trade restrictive and promote technological upgrading and innovation by: (i) Exploring the use of alternative trade facilitation instruments in the CU context such as mutual recognition agreements; (ii) Adding flexibility to technical regulations by initiating the transition from mandatory to voluntary certification.</li> <li>• In the longer term, build on these actions to comprehensively reform technical regulations, standards, and the quality infrastructure.</li> </ul>
Trade facilitation and logistics
<ul style="list-style-type: none"> <li>• Generate high-level commitment and integrated approach to trade facilitation by developing and implementing an institutional arrangement tailored to Kazakhstan's circumstances and allowing private sector involvement.</li> <li>• To improve connectivity, make targeted investments in road infrastructure, establish incentives to update trucking fleets, upgrade rail rolling stock and rail beds, resolve rail interface, and infrastructure problems.</li> <li>• Increase the capacity of logistics service providers and the freight forwarding industry, including through advanced training, upgrading warehouses, and adjusting multi-modal regulations.</li> <li>• Resolve border crossing issues by harmonizing procedures and facilitating interagency cooperation on information-sharing and risk management, and benchmark progress through a time-release study.</li> </ul>
III. Raise the quality and efficiency of the services sector (Chapter 4)
<ul style="list-style-type: none"> <li>• Improve knowledge and coordination within the government and with the private sector on service sector issues.</li> <li>• Reform services sectors to encourage competition and attract competitive providers by improving the competition framework, using international commitments to lock in reforms, and adopting measures to upgrade skills.</li> <li>• Develop and align the services export promotion strategy and offensive strategy for trade negotiations.</li> </ul>
IV. Strengthen institutional capacity to design and implement a national trade and competitiveness agenda (Chapter 5)
<ul style="list-style-type: none"> <li>• Upgrade analytical capacity, including the use of firm-level data, regulatory impact assessments, and national services statistics.</li> <li>• Improve coordination of trade policy and larger competitiveness-enhancing issues, including inter-ministerial coordination and public-private dialogue.</li> <li>• Enhance capacity to carry out trade and investment promotion.</li> </ul>



# Chapter 1. Kazakhstan's Trade Performance

## A. Introduction

**1.1. The Kazakh economy has grown rapidly over the past decade, thanks to a booming commodities sector and rising global prices for oil and gas.** The positive result of this growth is an increase in Kazakh per capita income, which until 2008 had risen steadily at 10 percent per year for 10 years. Beyond these headline figures, however, are many important topics to be explored: How has the structure of Kazakhstan's non-energy and minerals economy changed over the past decade? Which subsectors/products are emerging and which are declining? How does performance differ in capital-, resource-, and labor-intensive subsectors? What is the nature of competitiveness in these emerging and declining products and what does this say about the evolving specialization of Kazakhstan's exporters? Are exporters able to compete through quality differentiation? How are service exports performing and how is the structure of the service export basket evolving?

**1.2. This chapter provides a view into the changing export basket, starting with the finding that the concentration of the export basket in natural resource exports has increased to 70 percent.** Non-resource-based export sectors are also growing, but concentrate around few products. The overall specialization pattern reflects the strength of natural resources, capital-intensive activities, and the decline of labor-intensive activities. Specialization has reduced the overall number of exported products, but this belies substantial experimentation in new products, although they have high rates of failure. Non-resource export sectors such as metals, agriculture, and chemicals are showing increasing specialization in simpler products with limited differentiation. Supply-side constraints, including a range of factors that affect the ability of Kazakh producers to deliver goods and services at competitive prices in foreign markets, deserve to be examined based on the nature of successful exports and the high mortality rate of new exports.

**1.3. While the role of services and services trade is lower for Kazakhstan than for its peers, service exports have been growing fast, outpacing those of other middle-income countries.** This growth is driven, however, mainly by traditional services, and in particular transport services. Modern backbone services that are necessary to enhance productivity in a modern economy are lagging behind. Although there has been some diversification into modern tradable services such as ICT, finance, and other business services, Kazakhstan remains a large net importer.

**1.4. This chapter first analyzes features of merchandise export growth, focusing on the dynamics outside of energy and minerals.** The chapter then describes the performance of service exports, which have seen surprisingly robust growth. The final section discusses what we can learn from trade performance to help identify barriers in the trading environment. This sets the stage for later chapters that discuss these barriers in more detail.

## B. Kazakhstan's Performance in Goods Exports

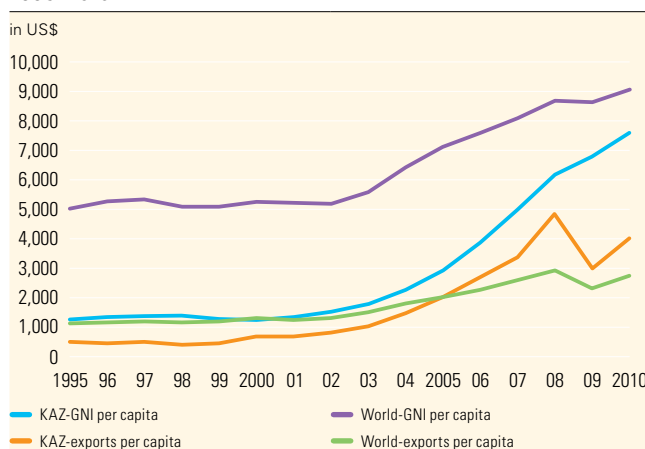
**1.5. This section of the chapter reviews Kazakhstan's performance in goods exports, including composition,**

**growth, diversification, and quality.**<sup>1</sup> While much of the analysis covers the period through 2010, we focus in this chapter primarily on the decade leading up to the global financial crisis in 2009. This is for three reasons. First, this period represented a decade of sustained growth in global demand and was the decade during which Kazakhstan's oil and gas sector came fully on stream. It is, therefore, a useful time period over which to assess the evolution of the country's trade competitiveness. Second, the substantial decline in trade during the crisis skews the results for an analysis that aims to measure changes over time. Finally, we take up the more recent trends (2010 and 2011) in the next chapter, where we focus on trade performance under the newly-established CU with Russia and Belarus. Throughout this section of the chapter, we underline of how the use of Customs and industry census firm-level micro-data, which was not available for this report, can enrich the analysis.

**1.6. The most important headline indicator is the growth in income driven by export revenue.** Between 2000 and 2010 Kazakhstan's gross national income (GNI) per capita grew six-fold in nominal terms, rapidly closing the country's gap with the world average income (Figure 1.1). Growth in Kazakhstan was 3.5 times the global average and even 20 percent higher than in China over the decade. Exports were a major catalyst of growth, expanding at an average of almost 20 percent annually. Kazakhstan's exports per capita were just over half the global average in 2000; by 2010 at more than US\$4,000 per capita they were 50 percent higher than the global average. Mainly because of the export boom, Kazakhstan has reached upper-middle-income status, and has been able to invest in modernizing both economic and social infrastructure. One outcome has been a massive reduction in poverty: in 2001, 46.7 percent of the population was below the national poverty line; by 2009 this was true of only 8.2 percent (World Bank, 2012).

**Figure 1.1. Kazakhstan's Exports Pushing the Country's Income Per Capita Toward the Global Average**

Kazakhstan and World Income Trends: Exports and GNI Per Capita, 1995–2010



Source: World Development Indicators (World Bank)

Note: GNI per capita (Atlas method) in current US\$; exports per capita include goods and commercial services, in current US\$.

### *Export Basket Is Experiencing Concentration in Natural Resource Exports*

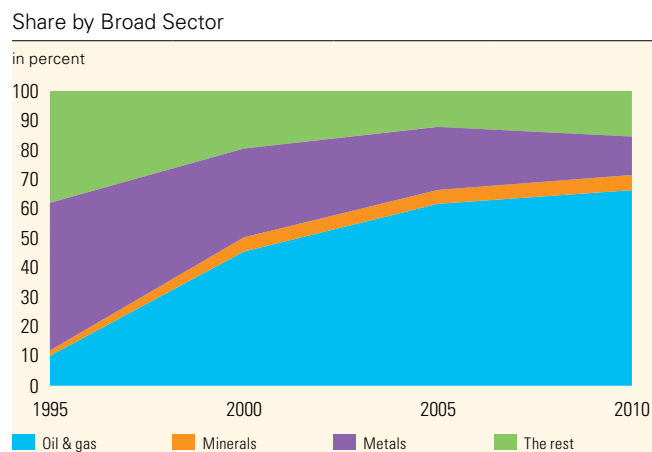
**1.7. This boom would clearly not have been possible without the performance in natural resources<sup>2</sup>, and especially oil and gas, also helped by the growth in global prices for the sector over the decade.** Between 2000 and 2010, oil and gas exports grew at an average of 23 percent a year, reaching US\$32 billion. Naturally, the economy has become increasingly concentrated around oil and gas. Taken together, natural resources, (i.e. oil, gas, minerals) now account for more than 70 percent of exports (Figure 1.2).

<sup>1</sup> The principal source of data for the analysis presented in this chapter is the UN Comtrade database available through the World Integrated Trade Solutions (WITS) platform. This is broadly in line with the Kazakhstan's own reported trade figures. In order to allow for comparisons with other countries, however, we must use the standardized data from UN Comtrade. Exports are analyzed mainly in value terms, but where prices are important, they are also analyzed in volume terms.

<sup>2</sup> A note on terminology: "natural resources", sometimes abbreviated as "resources", is used to refer to energy (oil and gas) and minerals. These sectors are excluded in some charts. Because metals are a large part of the remainder of the export basket, in certain figures, where marked, they are also excluded. In the HS2002 nomenclature, "energy" refers to HS two-digit code 27, while "energy and minerals" refers to HS 25-27, and "metals" refers to HS 71-83. Therefore, "non-energy" excludes HS27, "non-energy and minerals" excludes HS25-27 and "non-energy, minerals and metals" excludes HS25-27 and HS 71-83.

1.8. The resource riches that fuelled the recent export boom raise a number of challenges. Of course, increasing concentration does not necessarily mean the rest of the economy is performing poorly, so we must be careful to avoid assuming that the observed concentration is inherently malignant. But most immediately, there is a risk of excessive volatility of growth, as heavy dependency on commodities and lack of control over growth factors (i.e. global prices) may make the country vulnerable to external shocks (see Box 1.1).

**Figure 1.2.** Export Product Basket is Increasingly Concentrated around Natural Resource Exports



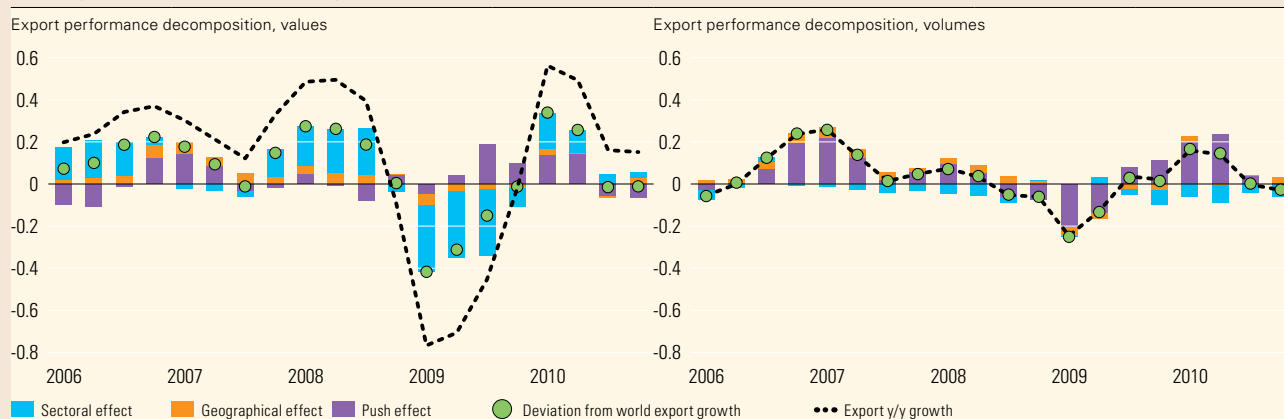
Source: Authors' calculations based on data from UN Comtrade.  
Note: Scale for Hirschman-Herfindhal index is 0 (diversified) to 1 (concentrated).

### Box 1.1. Being Pulled Along: Impact of Global Commodity Prices on Kazakhstan's Export Growth

The global economic crisis was a stark demonstration of the risks to commodity exporters like Kazakhstan of their exposure to fluctuations in global prices. Exports collapsed by 40 percent from 2008 to 2009. Upon recovery in 2010 they were still almost 20 percent below their 2008 levels; imports, meanwhile, continued to decline in 2010 to .5 percent below their 2008 peak. The left panel of the figure illustrates how significantly Kazakhstan's trade performance deviates from global trends, in both directions. For the past decade, the standard deviation of Kazakhstan's trade demand (exports and imports) was more than twice the global average. Comparing the left and right panels, we see that the correlation between market share changes and the global cycle is practically one-to-one in volume terms and highly correlated in value terms. Variance for exports originates in price shocks (sectoral effects). Though much weaker, the variance in volumes is still enough to impose considerable volatility on domestic economic performance. Similar analyses for a sample of

**Figure B1.1.** Kazakhstan's Export Growth Deviates from Global Trends because of Sectoral Effects (Price Shocks)

Decomposition of Kazakhstan's Export Performance (2006–10)



Source: Gaulier, Taglioni and Zignago (forthcoming).

99 countries suggests that larger and more diversified exporters have more stable exports and market shares (see Gaulier, Taglioni and Zignago, forthcoming). Moreover, there are differences even among commodity exporters: Baunsgaard et al. (forthcoming) find that the elasticity of the domestic economy to price swings is more pronounced for energy and metal exporters like Kazakhstan than for food and raw materials exporters.

The impact of global prices on commodity exporters means that their performance is largely out of their control. In Figure B1.1 and Table B1.1 we assess the degree to which Kazakhstan's recent export growth has been due to pull factors explained by compositional effects (sectoral and geographic performance globally) or to push factors explained by competitiveness effects.<sup>3</sup> We find that while Kazakhstan increased its world export market share by 6.6 percent over this period, the good performance is almost entirely explained by growth based on compositional and price effects rather than the improved competitiveness of its own products. This result is even more extreme pre-crisis, when a negative contribution of performance in volume terms was more than offset by price developments.

**Table B1.1. Kazakhstan's Goods Performance Explained by "Pull Effects"**

Decomposition of export growth into "pull" and "push" factors: Kazakhstan vs peers (2005–10)

	Export growth	Export market share change	Pull factors (specialization, composition effects), of which:		Push factors ("performance", i.e. export market share growth without composition effects), of which:		
			Geographical	Sectoral	Overall (Value)	Price component	Volumes component
Kazakhstan	15.9%	6.6%	2.1%	3.1%	0.7%	0.6%	0.1%
of which in 2005–08	21.2%	11.8%	3.2%	6.5%	0.2%	0.7%	-0.5%
Azerbaijan	43.1%	33.7%	-0.9%	4.4%	26.5%	1.2%	25.0%
Russia	12.4%	3.0%	0.9%	3.1%	-1.2%	0.6%	-1.8%
Chile	10.9%	1.6%	1.2%	0.7%	-0.5%	0.0%	-0.6%
Indonesia	12.5%	3.1%	0.3%	1.5%	1.1%	0.3%	0.8%
Korea	11.4%	2.1%	2.5%	-2.2%	1.6%	-2.5%	4.1%
Mexico	9.9%	0.5%	-4.7%	1.3%	4.1%	1.4%	2.6%

Source: Gaulier, Taglioni and Zignago (forthcoming).

Note: Figures are in average annual growth 2005–10.

Being a commodity exporter partly explains the dependence of export performance on pull factors. Other commodity exporters, such Russia and Chile, also saw a negative contribution of push factors in volume terms, although some, like Indonesia, were able to improve their performance by transitioning to a more diversified production base. From 2005 through 2010, Indonesia's world market shares increased by 3.1 percent. This was less than half the increase of Kazakhstan, but about one-third of it (1.1 percent) came from push factors, mostly from improvements in volume terms (0.8 percent). In contrast, diversified manufacturing economies like Korea and Mexico grew mainly through enhanced competitiveness. For example, Korea's exports grew by 11.4 percent, which increased its world market share by 2.1 percent. These gains came entirely from a spectacular upgrading and diversification of the products Korea offers, which translated into a 4.1 percent increase of competitiveness in volume terms, though this was partly offset by decreasing price effects. For Korea pull factors played only a minor role.

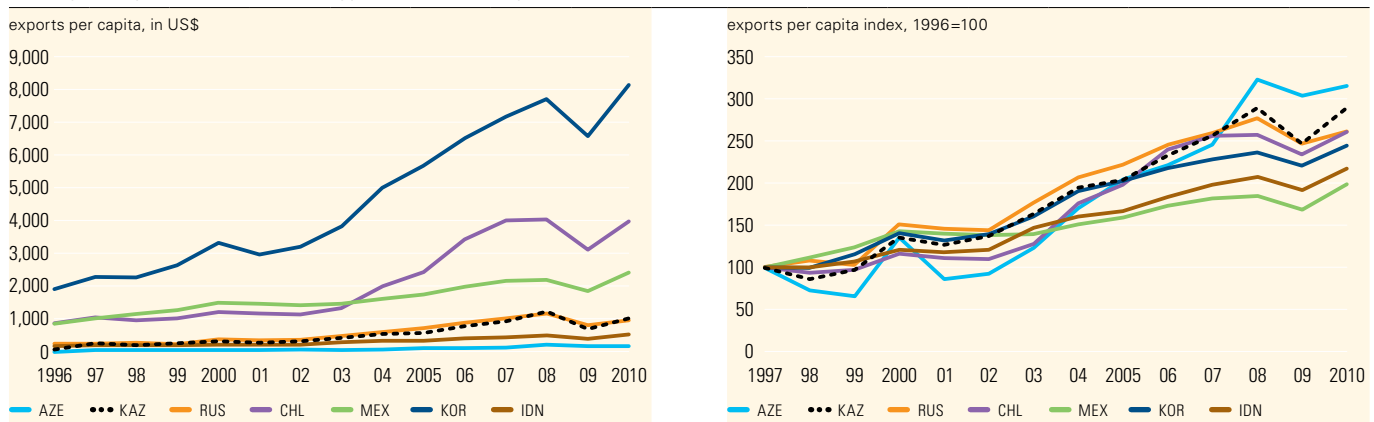
<sup>3</sup> We assume that country A is more competitive than country B if its exports and market shares increase over and above those of countries having the same composition of exports.

## Non-Resource-Based Export Sectors Are Growing, But Also Concentrating Around Few Products

1.9. Given the dominance of the energy sector in Kazakhstan, it is not surprising that export volumes outside the sector are relatively limited, but there is evidence to suggest they are beginning to gain some growth momentum in recent years. A comparison with peers<sup>4</sup> (Figure 1.3) shows a picture of limited but growing export activity outside of natural resource exports. At about US\$1,000 in exports per capita Kazakhstan performs in the middle of the pack, trailing far behind diversified manufacturers like Korea, Mexico, and Chile, but slightly ahead of Russia and well ahead of Indonesia and Azerbaijan. On the other hand, it is growing (from a small base) faster than most other countries in the peer group, trailing only Azerbaijan.

**Figure 1.3. Non-Natural Resource Exports are Limited (left) but Growing (right)**

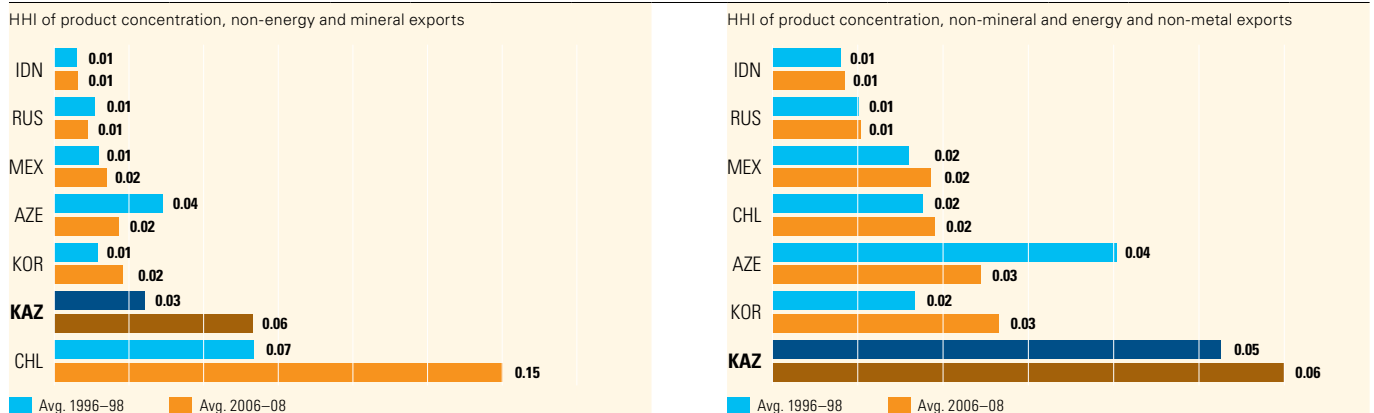
Per Capita Exports other than Energy and Minerals Exports, Kazakhstan v. Peers (1996–2010)



Source: Authors' calculations based on data from UN Comtrade.

**Figure 1.4. Exports are Concentrating Even Outside of Natural Resource-based Sectors**

Hirschman-Herfindahl Index of Export Product Concentration



Source: Authors' calculations based on data from UN Comtrade (WITS).

1.10. However, concentration is high and increasing in the non-energy sector. This is true across all measures: the basket of export products, the top export products, and the breadth of export products. This is also not simply a function of the dominance of the metals sector. Exports have concentrated outside of these sectors as well. Figure

<sup>4</sup> Throughout this chapter we use a standard set of “peers” in many of the analyses in order to put Kazakhstan’s performance into context. These peers were selected to include major oil and gas exporters in Kazakhstan’s region (Azerbaijan and Russia), middle income natural resources exporters that have diversified successfully (Chile and Indonesia), and countries that have moved further on to become upper income, highly industrialized countries (Korea and Mexico).

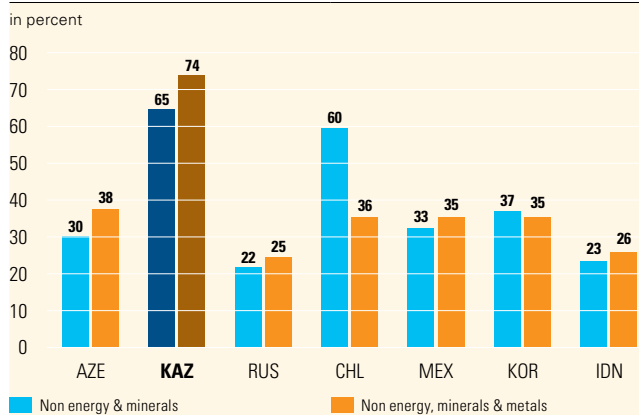
1.4 shows the standard Hirschman-Herfindahl of product concentration over a decade and relative to peers. In non-energy and mineral exports (left panel) among peers Kazakhstan is behind only Chile, and concentration has doubled over the past decade. Excluding metals, which account for two-thirds of Kazakhstan's non-energy and minerals exports, we see (right panel) that the HH index is just as high as with metals included, and Kazakhstan's product concentration is here the highest among all peers.

**1.11. Another way to look at concentration is to assess the degree to which a few major products dominate the export basket.** Again, on this measure, Kazakhstan is highly and increasingly concentrated (Figure 1.5). Almost two-thirds of Kazakhstan's non-energy and minerals exports come from just 5 products out of a potential of about 1,200. Again this is the highest among the peer countries and is at least twice as high as every exporter except Chile. Four of the five products are metals,<sup>5</sup> the fifth is wheat. Setting aside metals we find the structure even more concentrated, with almost three-quarters of all exports accounted for by just five products—two to three times the concentration found in peer countries.

**1.12. This may reflect a benign pattern of specialization, where unprofitable products disappear from the export basket,** or it may have more malignant causes, such as declining attempts to experiment or a situation where marginal products are increasingly unable to survive. This is explored further below.

**Figure 1.5. A Few Major Products are Dominating the Non-Resource Export Basket**

Share of Top 5 Export Products, 2010



Source: Authors' calculations based on data from UN Comtrade (via WITS).

Note: At HS 4 digit level (HS 2002); Non energy and minerals excludes HS25-27; Non energy, minerals & metals excludes HS25-27 and HS 71-83.

### *Specialization Pattern Reflects Ascendancy of Natural Resources, Capital-Intensive Activities, and Decline of Labor-Intensive Activities*

**1.13. The concentration of exports reflects continuing specialization of the Kazakhstan economy in natural resources and capital-intensive activities.** Figure 1.6 gives some perspective on how this specialization evolved between 1995 and 2009. In 1995 Kazakhstan had a fairly balanced trade pattern, with only exports of ores having any notable imbalance (positive or negative)—and even here the trade surplus was no more than 5 percent. Among peers, it had one of the most balanced trade portfolios. By 2009, however, fuels had grown rapidly to record a nearly 25 percent trade surplus; meanwhile, manufacturing plummeted to a 15 percent trade deficit and commercial services also fell into significant deficit. Only agriculture and food maintained a rough balance, although both shifted from surplus to deficit.

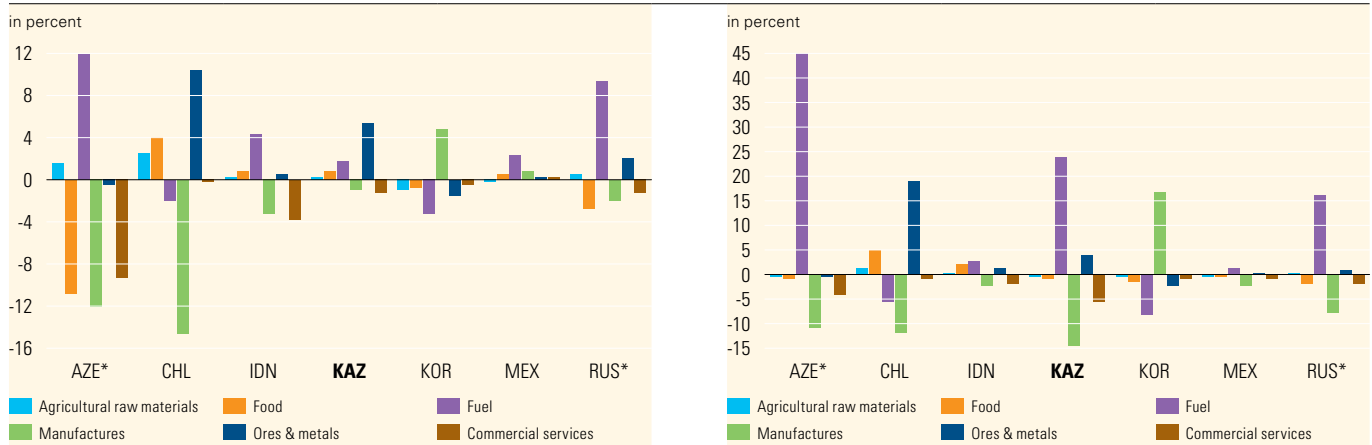
**1.14. Focusing on agriculture and manufacturing goods, several important trends can be discerned.<sup>6</sup>** First, particularly in recent years chemicals have become increasingly dominant. Second, vegetable exports (mainly wheat and other grains) have fluctuated but remain important. Third, although all the other sectors are relatively small, most of them experienced moderate growth in the pre-crisis decade but have suffered steep declines since. This is

<sup>5</sup> These are: refined copper (7403), ferro alloys (7202), radioactive chemical elements (2844), and unwrought zinc (7901).

<sup>6</sup> While here we present the main trends, the reader is referred to the background papers for the details.

**Figure 1.6. Kazakhstan has Shifted to a Less Balanced Trade Pattern**

Trade Balance by Broad Sector, 1995 vs. 2009



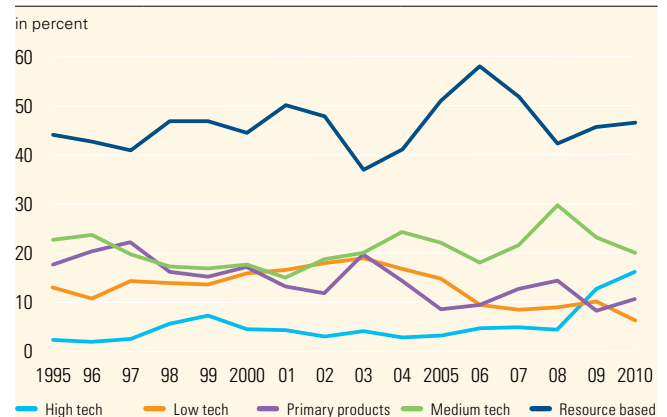
Source: UN Comtrade (WITS).

particularly true for machinery, which is potentially a major source of opportunity for technology-intensive production. Sectors that have continued to grow despite the crisis, in addition to chemicals, are animal products (driven by fish exports), and the stone / glass sector. Textiles, on the other hand, had both much slower pre-crisis growth and a very sharp contraction during the crisis; and the footwear, wood, and miscellaneous manufacturing sectors have virtually disappeared.

1.15. The most robust sectors are increasingly those that are natural resource- and capital-intensive, especially those linked directly to **Kazakhstan's energy and minerals sectors**. This explains not only the metals sector but also the chemicals sector, where the majority of recent growth comes from "natural uranium and its compounds" (which could plausibly be categorized as a mineral) and "aluminum oxide" (which derives directly from aluminum, a major metals export). Together these products account for about 75 percent of all chemicals exported, up from 43 percent in 2000. Indeed, while the technological classification of Kazakhstan's exports (Figure 1.7) suggests that resource-based exports account for about 50 percent of non-energy and minerals exports, the figure is probably much higher because the large majority of exports classified as "high technology" are actually these very same inorganic chemicals.

**Figure 1.7. Outside of Resource-Based Sectors, Limited Structural Change Since 1995**

Technological classification of non-energy and minerals exports, 1995–2010



Source: Authors' calculations based on data from UN Comtrade (WITS).

1.16. By contrast, sectors that are labor-intensive (textiles and clothing; footwear) are in decline; low-technology products dropped from a high of 20 percent of exports in 2003 to less than 10 percent by 2010 (Figure 1.7), and products that are technology-intensive (machinery and electronics; transportation equipment) are struggling to break through. Finally, agricultural goods have shown mixed results. Support for this finding can be observed in the data on imports, which shows that the top four sectors for China's exports to



Kazakhstan are (in order): footwear, hides and skins, textiles and clothing, and machinery and electronics. In the first two, China now accounts for more than 50 percent of all imports.

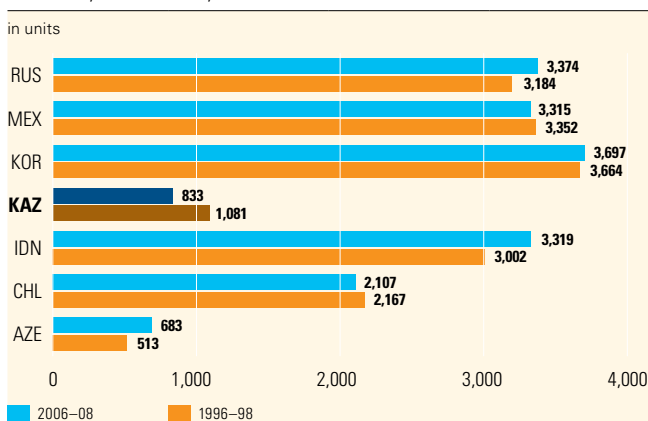
**1.17. The level of structural change at the top of the non-energy, minerals, and metals export basket has changed very little over the decade (Figure 1.7).** Of a universe of more than 5,000 potential products, only 5 of the top 20 non-energy, minerals, and metals exports in 2010 were not in the top 20 a decade earlier, and only 3 (linseed, frozen fish, and airplanes) were outside the top 30. Similarly only 3 of the top 20 exports in 2000 had fallen out of the top 20 by 2010 (melons, caviar, and dead [inedible] horses). This does not preclude experimentation, or churn with the export basket, among products with small volumes, as we will see later.

**1.18. Specialization has resulted in a significant decline in the number of products.** Figure 1.8 puts this in international context, showing that much of the decline in export variety is out of line with the experience of Kazakhstan's peers, even those in highly natural-resource-intensive economies. The number of products Kazakhstan exported declined by 22 percent over the decade; Kazakhstan was the only country among the peers to experience any substantial decline. Overall, Kazakhstan now exports only 1,037 non-energy and minerals products (only 833 if metals are also excluded), the lowest variety among peers except for Azerbaijan, and only one-third or less the level of other peers.

**1.19. The central questions are thus (i) whether this decline in export variety reflects a decline in experimentation or a problem with the survival rates of exporters; and (ii) whether that in turn reflects specialization in areas of comparative advantage or inefficiencies related to market access or supply side constraints.**

**Figure 1.8. Number of Non-Resource Based Products is Declining**

Number of HS-6 Level Products Exported Excluding Energy, Minerals, and Metals, 1996–98 vs. 2006–08



Source: Authors' calculations based on data from UN Comtrade (WITS).  
Note: Products whose export value falls below US\$10,000 threshold excluded.

### *Significant Experimentation, a few “Big Hits”, but High Mortality*

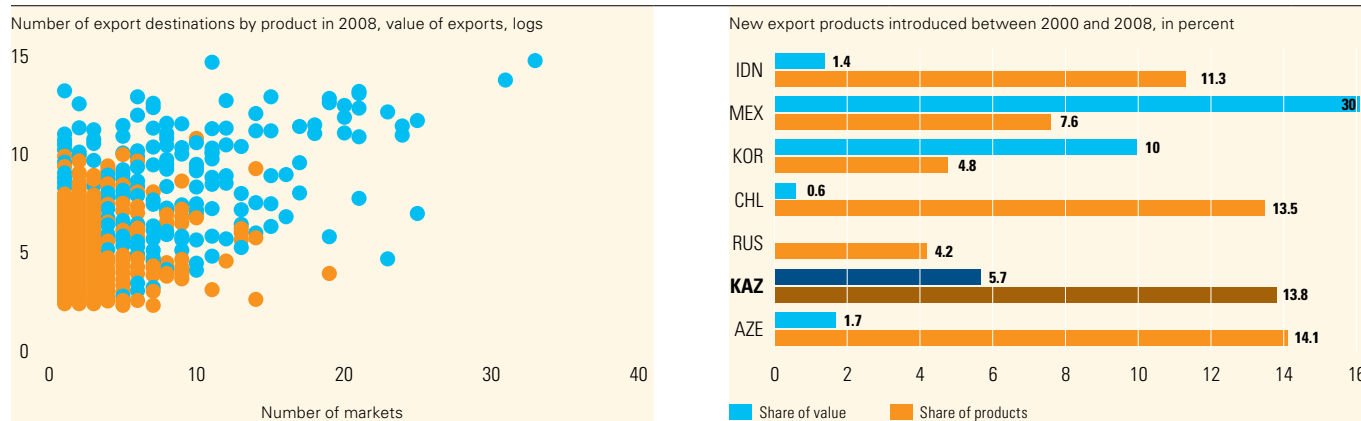
**1.20. There is indeed significant experimentation despite the relatively low number of export products (Figure 1.9).** The left panel plots the number of markets reached per product against each product's logged export value in 2008. The orange dots represent products exported in 2008 that did not exist in Kazakhstan's country's export basket before 2000. Many of these products have relatively high export values and some, within only a few years, reached a large number of export markets. This suggests that, despite its narrow range of exports, Kazakhstan has been successful with what Easterly and Reshef (2009) call “big hits.” Using the same data, the right panel shows the share of non-energy and minerals export products, with their share of value, in the 2008 export basket that were not in the 2000 export basket. Kazakhstan has one of the highest shares of new products (13.8 percent) and by far the highest share of value coming from new products during the decade.

**1.21. The “big hits” (in terms of new products or expansions of variety) generally come from metals or inorganic chemicals.** Several big hits include zinc (from US\$2m in 2000 to US\$250m in 2010), refined copper wire (from US\$5m to US\$200m), and in the chemicals sector uranium, which grew from only US\$11m in exports in



**Figure 1.9. Significant Experimentation (left) a Factor in High Share of New Products (right)**

Experimentation in Non-Energy and Minerals Exports



Source: Authors' calculations based on data from UN Comtrade (WITS).

Note: On left panel, orange dots represent products exported in 2008 that were not exported in 2000.

2000 to US\$1,642m in 2010. Beyond metals and chemicals, most of the emerging product groups (those that had a limited presence a decade ago but have grown significantly since) are foods and beverages, again suggesting that this sector is an emerging source of diversification. Frozen fish fillets grew from less than US\$1m in 2000 to over US\$100m by 2010. Milled products grew erratically but still emerged as significant over the decade—for example “wheat or meslin flour” exports grew from an average of US\$18m per year to over US\$200m a decade later.

**1.22. An initial analysis of experimentation and survival during the period of 1998–99 to 2009–10 demonstrates the scope of these phenomena.** We find that there were 334 existing products<sup>7</sup> (at the start of the decade), but more than 700 new products introduced during the decade. The survival rate by the end of the decade was 79% for existing products but only 27% for new products. The experimentation rate, or the share of potential additional products in a broad product category that appeared in the export basket at one time or another, was high, but particularly in metals, textiles, and manufactured goods. Survival rates were low across the board, but highest survival rates are in some foods, chemicals, minerals, and some electrical/manufactured products. Survival rates were low in textiles, some apparel, wood based products, animal-based products, and a number of manufactured products, but also surprisingly in metals. Generating a clearer understanding of the dynamics of experimentation and survival would require firm-level data.

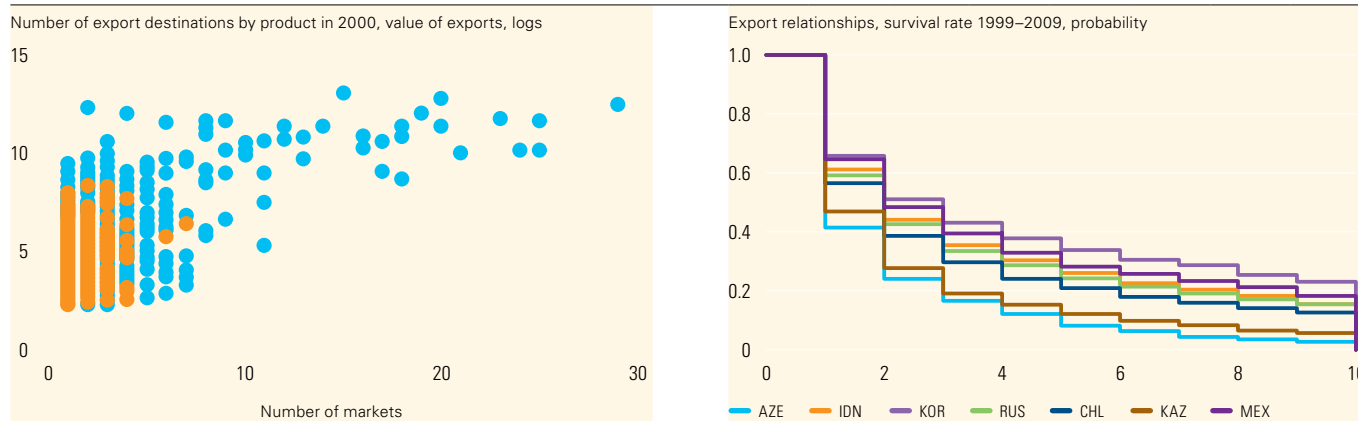
**1.23. These low survival rates, or mortality, offset the contribution of experimentation to the export basket.** As we saw earlier in Figure 1.7, structural change since 1995 is limited. Experimentation may not be having much of an impact on the structure of the export sector because of the high mortality. Kazakhstan's exporters have systematically lower survival rates (Figure 1.10, right panel), with only 30 percent of product-market relationships surviving beyond two years. This is only half the survival rate experienced by exporters in Chile, Mexico and Korea, and 50 percent lower than in Russia and Indonesia. The products leaving the market include some with apparently significant export values (Figure 1.10, left panel, y-axis), but very few have extensive market coverage (x-axis). Most of the highest-value exiting products are specific iron and steel varieties (e.g. “Cold rolled iron or non-alloy steel, coil, width >600mm, t >3mm, nes”) which more likely reflect specific customer relationships than any trend in competitiveness. Moving to a higher level of aggregation, exits include the live animal and meat sector along with several disparate, mainly labor-intensive, sectors, while declining sectors are more varied but include prepared foods

<sup>7</sup> Here, “products” refers to products at the HS four-digit level, rather than products at the HS six-digit as in elsewhere in the report.

and textiles. Few product groups suffered serious wholesale collapse (rather than declining variety), although the meat sector (HS2), which accounted for US\$ 60m in exports in 1997, virtually disappeared in the 2000s, only to bounce back somewhat in 2010.

**Figure 1.10. Product Exits (left) Cause Low Overall Survival Rates (right)**

Product Exits and Export Survival in Non-Energy and Minerals Exports



Source: Authors' calculations based on data from UN Comtrade (WITS).

Note: Orange dots represent products exported in 2000 that were not exported in 2008 (exits).

*With access to firm-level data it would be possible to test these questions on experimentation and survival by looking at within-sector and within-firm patterns. It would be possible to see, for example, how different types of firms experiment (nearby products, jumps to new sectors) and in which markets they do so (Russia, EU, etc.) and to link these experimentations and patterns of survival to specific firm characteristics.*

*One interesting illustration of the importance of firm-level data is in Reyes and Taglioni (forthcoming). They show survival rates measured at the product-market destination-year level and compare them with survival rates when the firm dimension is added. The results from the two exercises indicate that in South Africa, within apparently durable export relationships, there is a lot of firm churning. Productive, large and experienced firms are more likely to survive, and geographical rather than product diversification is most helpful (Carballo and Volpe 2008, and Goerg, et al. 2008). SMEs, especially those going to only a few destinations, are most vulnerable.*

*From a policy perspective, this information supports well-targeted policy interventions. In this example there seems to be a clear need for policies aimed at helping SMEs to diversify their destination base. Firm-level data would make it possible to be even more specific and evaluate the impact on survival and geographical diversification of a range of possible policies, e.g. branding improvement, programs designed to enhance R&D, and programs to improve access to finance for certain categories of firms.*

### ***Non-Resource Sectors Show Specialization in Simpler Products with Limited Differentiation***

**1.24.** If the trend in Kazakhstan of increasing concentration in the non-energy export basket reflects a constructive process of specialization, rather than a crowding-out of non-energy investment opportunities (e.g. through Dutch disease effects), the result should be improved productivity in the specialized sector and potential for higher product quality and variety in these sectors. This could be significant because it might offer a route to sustainable growth in resource-intensive sectors.

**1.25.** Given data availability limitations on this study, it is not possible to analyze trends in productivity. In terms of variety, we have found already that export variety has grown most in product groups where Kazakhstan has become specialized. We can also assess two aspects of quality: (i) the degree to which exports in which Kazakhstan has a comparative advantage have shifted toward more complex products; and (ii) the relative unit prices achieved by its exports in these sectors.

*With access to firm-level data, it would be possible to understand how productivity trends link with export performance and diversification (in terms of products and markets). It would also be possible to understand the degree to which firm specialization has improved productivity. Similarly, it would be possible to assess whether over time more specialized firms upgrade by expanding to more complex products or upgrading product quality, and more generally what firm characteristics are associated with expansion of variety and quality upgrading.*

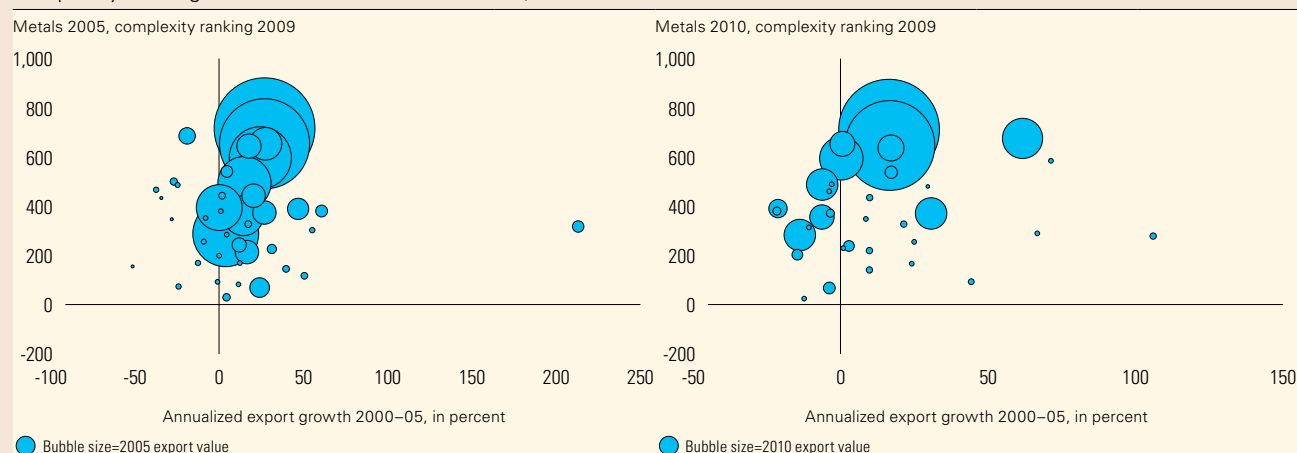
**1.26.** This study analyzed Kazakhstan's complexity and quality in three sectors: metals, chemicals, and agricultural goods. The first two sectors are those in which Kazakhstan has shown increasing specialization. The

### Box 1.2. Complexity and Quality of Kazakhstan's Metals Exports

Kazakhstan exports most of the metal products indexed (56 of the 63 products covered), although its exports are highly concentrated at the low-complexity end of the product range. The figure indicates that not only was there greater product concentration (and slower growth) in the metals sector between 2005 and 2010, but that concentration is increasingly shifting toward the low-complexity end of the sector. In 2010, Kazakhstan's median metals export had a complexity rank of 338, down slightly from 332 in 2005; but the average rank of its top five products (which account for 80 percent of exports in 2010) declined significantly from 500 in 2005 to 605 in 2010. Kazakhstan's most complex metals export that has any significant volume is "Iron/steel 3–4.75mm thick sheets", which ranks 70th in the PCI, and is Kazakhstan's 14th largest metals product (\$28m value). The following graphs of complexity plot Kazakhstan's metals products according to the product's rank in the Product Complexity Index (PCI) and the size and growth of Kazakhstan's exports.

**Figure B1.3. Metals Moving to Low-Complexity End of Product Range**

Complexity Rankings of Kazakhstan's Metals Products, 2005 and 2010

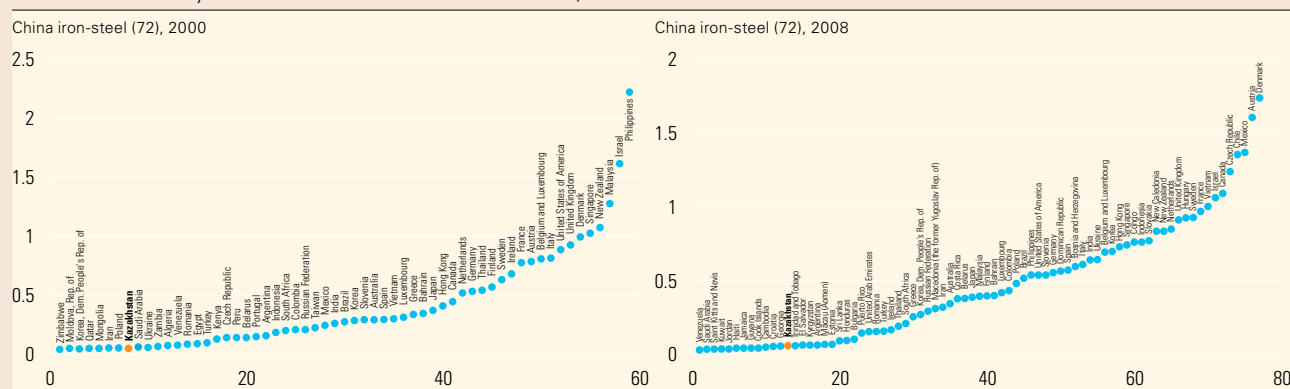


Note: Higher rank reflects a "worse" position (the higher up in the y-axis the lower is the product's complexity).

To assess quality in the metals sector, we focus on the largest export product group, iron and steel, and on the Chinese market, which is increasingly Kazakhstan's most important metals market. Kazakhstan is one of the lowest quality players, but over a decade it has slightly increased its relative quality position in a market increasingly crowded with competitors. The graphs on quality show Kazakhstan's position on the "quality ladder" in China (its main destination market). The quality ladder shows the relative rank (higher quality to the right and further up on the y axis) and quality position (relative unit price) against all other exports to that market.

**Figure B1.4. Kazakhstan Maintains a Relatively Low Quality Position in Iron and Steel**

Kazakhstan's Quality Performance of Iron and Steel in China, 2000 and 2008



Note: Higher rank reflects a better position (the further right in the x axis, the higher is the product's quality). We analyze quality ladders here at a highly aggregated level (HS2) as such the relative quality positions of the countries may reflect the range of products in which the exporter participates in the sector rather than actual quality differences in specific products.

Source: Authors' calculations based on data from Comtrade (via WITS) and BACI.

third is one which is a sector important for diversification and where performance has been mixed for the past decade. The sectoral analysis shows that Kazakhstan's exports are concentrated in product groups that on the whole have limited scope for quality differentiation. Moreover, its exports are concentrated in products that are at the lower ends of both the complexity scale and the quality scale, despite increasing concentration not only between sectors but also within the product baskets in most sectors. Thus, specialization has not yet translated into high-value-added and quality-differentiated products. The results for the metals sector are presented in Box 1.2. Chemicals and agricultural goods are presented in the appendix.

**1.27. While competing on quality is the exception rather than the rule among Kazakhstan's exporters, there are some anecdotal stories of quality emerging.** For example, in the chemicals sector, the phosphate mining and manufacturing company Kazphosphate has introduced sophisticated technology that, its managers say, has allowed it to take advantage of the growing market for high-quality phosphate products. In particular, the upgrades have reportedly allowed it to double the output of acid and sodium tripolyphosphate, and improve the acid to food quality, opening new markets in the EU, where the product is in great demand. In textiles, despite declining performance in the sector overall there are reports of the exports of high-quality ski-wear.

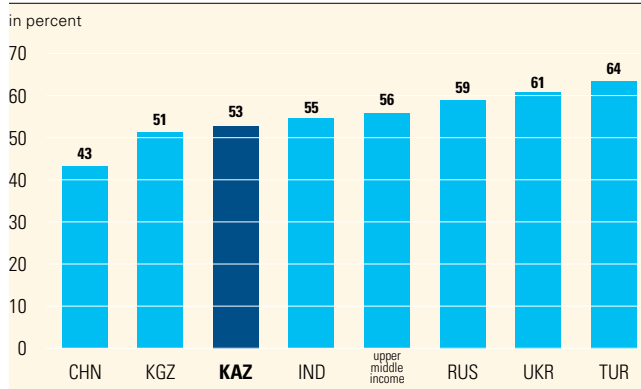
*Using unit values to make inferences about the role of product quality in determining export patterns is problematic because factors other than quality also affect prices. With access to firm-level characteristics, such as investment in R&D, the proportion of skilled to unskilled workers in a company, and the nature and quality of inputs, it would be possible to alleviate reservations on using unit values for assessing quality.*

## C. Kazakhstan's Performance in Service Exports

### *Role of Services and Service Trade in Kazakhstan is Smaller Than for Peers*

**Figure 1.11.** Services Constitute Relatively Low Share of Output in GDP

Services Output in GDP, 2010



Source: World Development Indicators, 2012.

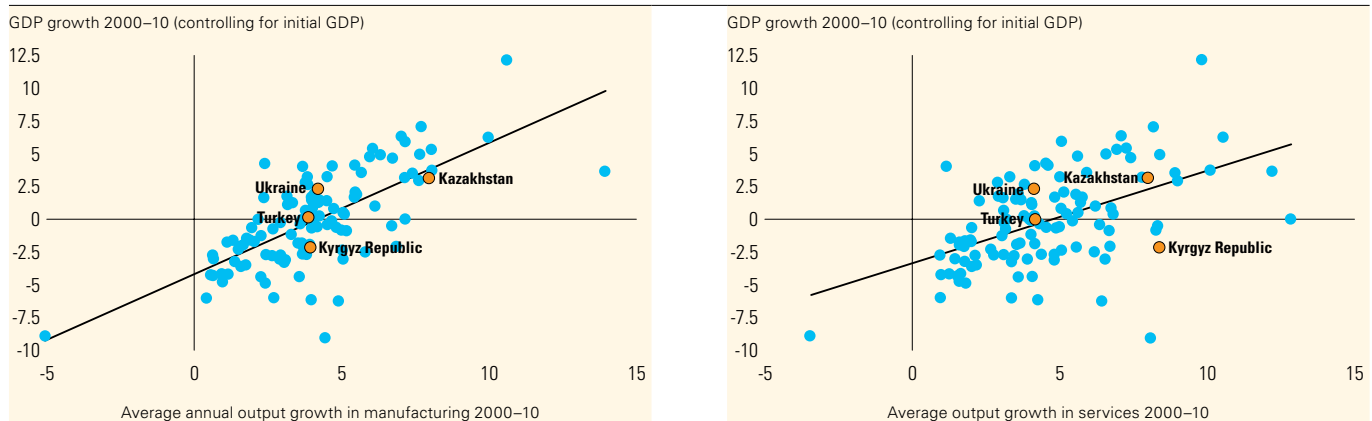
1.28. Services represent more than 50 percent of GDP in Kazakhstan, which puts the country slightly below the average for upper-middle-income countries but above other Central Asian countries and China (Figure 1.11). Russia and Ukraine, with services representing close to 60 percent of their GDP, while services represent over 70 percent of GDP in advanced countries.

1.29. Figure 1.12 gauges the relative importance of services and manufacturing to Kazakhstan's growth over the last decade. It shows that manufacturing and services grew in parallel. As a result, the relative share of services to GDP has remained constant in recent years, despite the growth in natural resource exports.

1.30. The importance of services trade (that is, imports plus exports, relative to GDP) is smaller for Kazakhstan than for most countries, even countries with similar endowments and development level. While

**Figure 1.12.** Services Output Growth Has Kept Pace with Manufacturing

Manufacturing (left) and Services (right) Output Growth v. GDP Growth, 2000–10

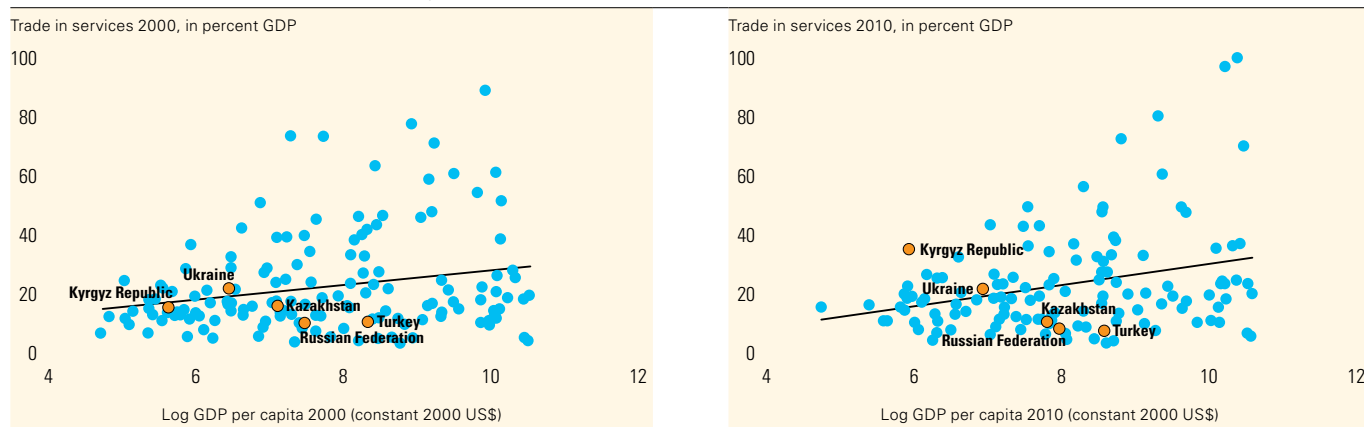


Source: World Development Indicators, 2012.

this may be partly due to reliance on commodities, it also indicates that there is ample scope for diversification through growth in services exports. The share of services trade in GDP dropped by half in the last decade, from nearly 20 percent in 2002 to 10 percent in 2010 (Figure 1.13). Of this 10 percent, exports represent only one-third, while the other two-thirds are imports.

**Figure 1.13. Low and Declining Share of Services Trade in GDP**

Service Trade in GDP, 2000 (left) and 2010 (right)



Source: World Development Indicators, 2012.

**1.31. Kazakhstan imports far more services than it exports.** Figure 1.14 shows that Kazakhstan is largely dependent on imports of services, with a large services trade deficit and imports valued at twice as much as exports. By contrast, other middle-income countries generally have relatively balanced trade in services.

### *Service Exports are Growing on the Back of Transport Services*

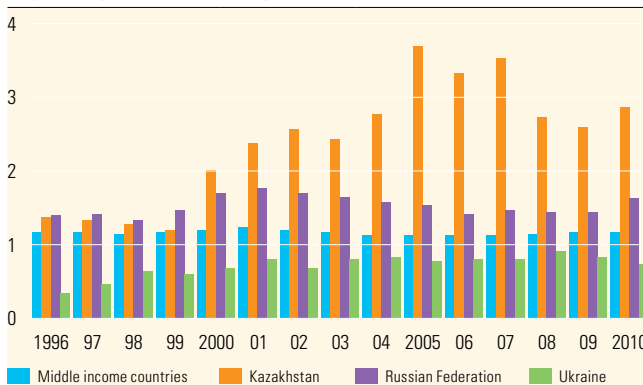
**1.32. The performance of services exports is muted relative to goods, while still growing fast.** Figures 1.15a and 1.15b show that during the period up to 2008 when the prices of many of Kazakhstan's commodities were booming, export of goods grew faster than exports of services. Not only did its exports of services grow faster than worldwide, but they also outpaced other middle-income countries and the Russian Federation in particular (Figure 1.15).

Not only did its exports of services grow faster than worldwide, but they also outpaced other middle-income countries and the Russian Federation in particular (Figure 1.15).

**1.33. The comparison of the Kazakhstan services export basket in 2000 and 2011 (Figure 1.16) suggests that services like transportation and travel remain predominant.** Transport services have increased as a share of the export basket (from 49 to 52 percent between 2000 and 2011), while travel has declined (from 38 to 30 percent). The high share of transport in services exports is characteristic of a resource-rich country that is also both a landlocked and

**Figure 1.14. Kazakhstan Runs a Large Trade Deficit in Services**

Import/Export Ratio v. Comparators, 1996–2010



Source: World Development Indicators, 2012.

## Figure 1.15. Service Exports Have Experienced Robust Growth

Figure 1.15a: Exports of Goods and Services Index

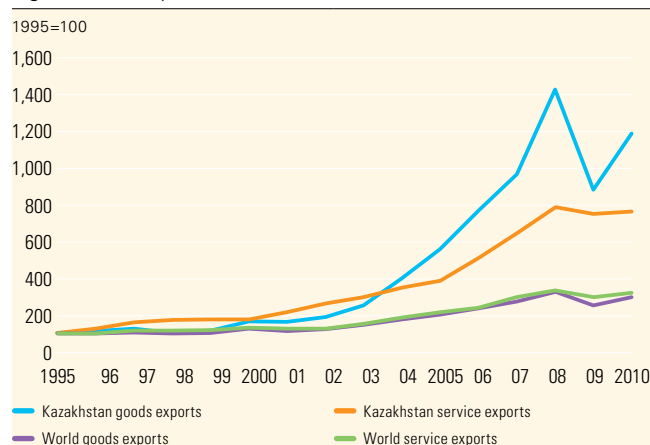
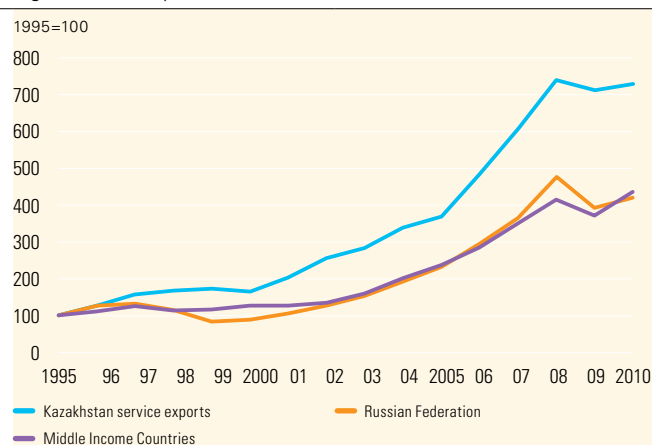


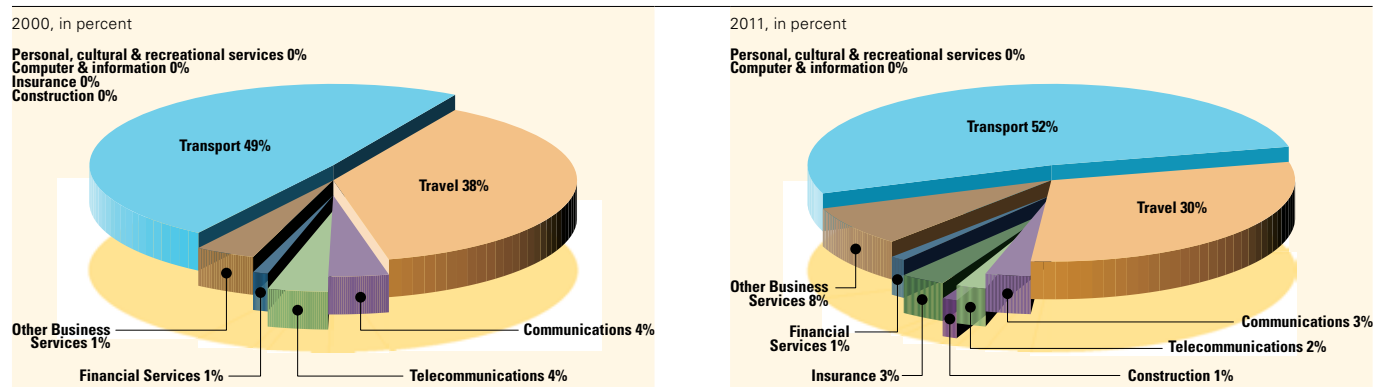
Figure 1.15b: Exports of Services Index



Source: World Development Indicators, 2012.

## Figure 1.16. Service Exports Are Concentrated in Transport and Travel

Composition of Service Exports in Kazakhstan, 2000 and 2011



Source: UNCTAD, <http://unctadstat.unctad.org/TableViewer/tableView.aspx>

oil-rich economy in transition. But the data also reveal an incipient diversification toward modern services exports<sup>8</sup>, such as “other business services”, which include professional and technical services as well as operational leasing.

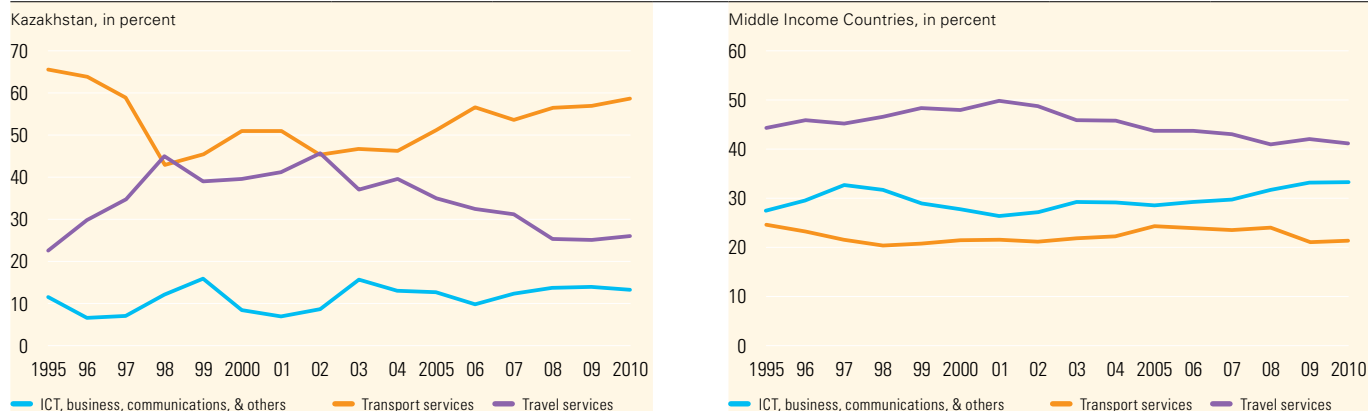
### Service Exports Show Incipient Diversification into Modern Services

1.34. Exports of modern non-tradable services represent only 10 percent of total service exports, compared to about 35 percent for middle-income countries as a group (Figure 1.17). While the baseline is still low, business services grew to represent 8.7 percent of exports in 2011. A small market for e-commerce is also developing, with the most popular activities being e-trade in air and rail tickets and mobile phone payment services.

<sup>8</sup> Formally, we define modern services as: finance; computer & information (ICT); royalties and license fees; and other business services. Traditional services comprise: communications; insurance; transportation; travel; construction; and personal, cultural and recreational services. Throughout this report, we focus on commercial service exports, and exclude government services. Backbone services are usually considered to be: finance, transportation, and telecom services.

**Figure 1.17. Relatively Low Share of Modern Services for Kazakhstan**

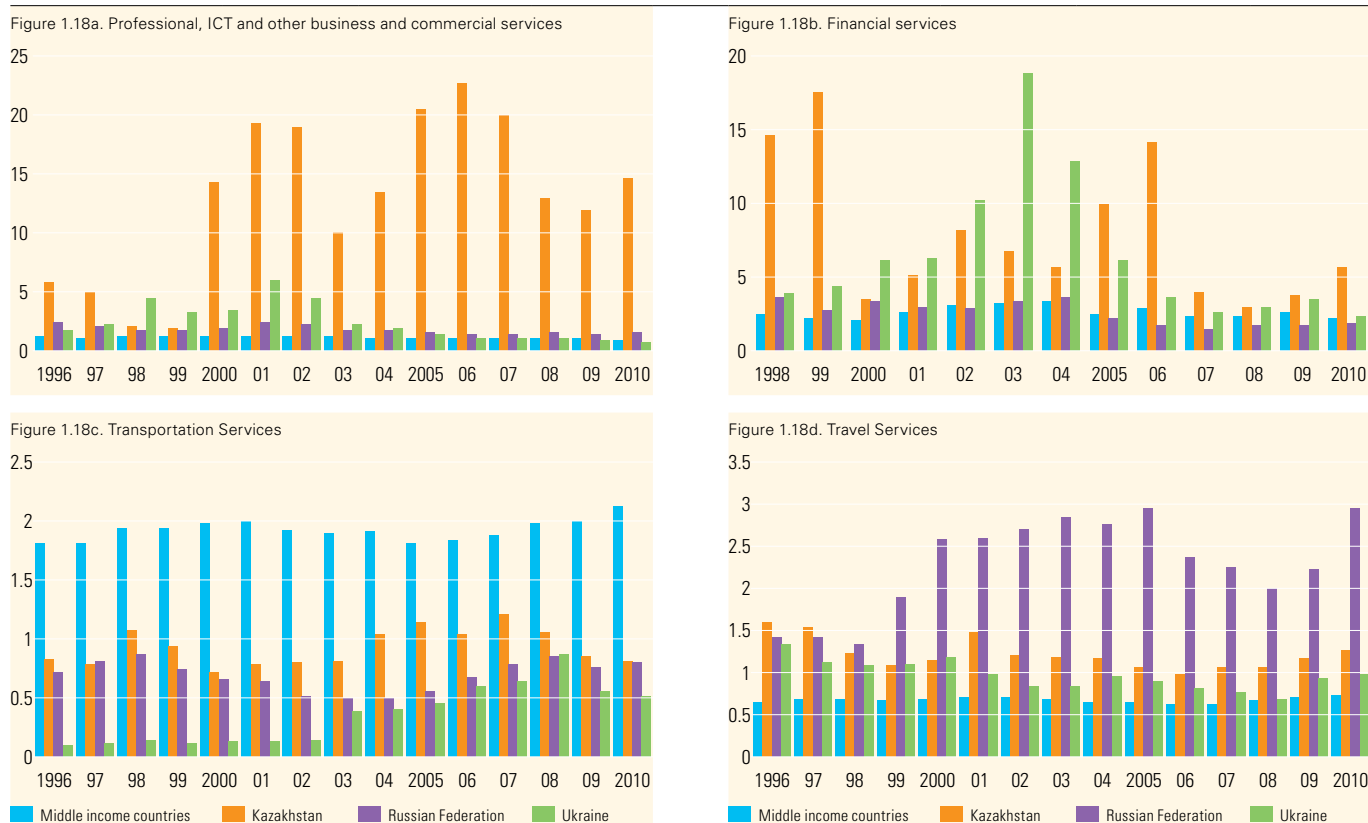
Share of Modern Services, Transport and Travel in Service Exports



Source: World Development Indicators, 2012.

**Figure 1.18. Kazakhstan Runs Higher Trade Deficit Than Peers in Modern Services**

Import/Export Ratio by Sectors v. Comparators, 1996–2010



Source: World Development Indicators, 2012.

**1.35. The composition of Kazakhstan's services trade deficit reveals that it lacks a comparative advantage in the modern intermediate sectors necessary to enhance and sustain trade and growth through diversification and value added.** Indeed, its services exports are dominated by traditional segments (especially transport services), but its imports are concentrated in modern intermediate services. Partly because it is landlocked, Kazakhstan's service exports basket is dominated by transport services. Kazakhstan's services deficit is most important in the

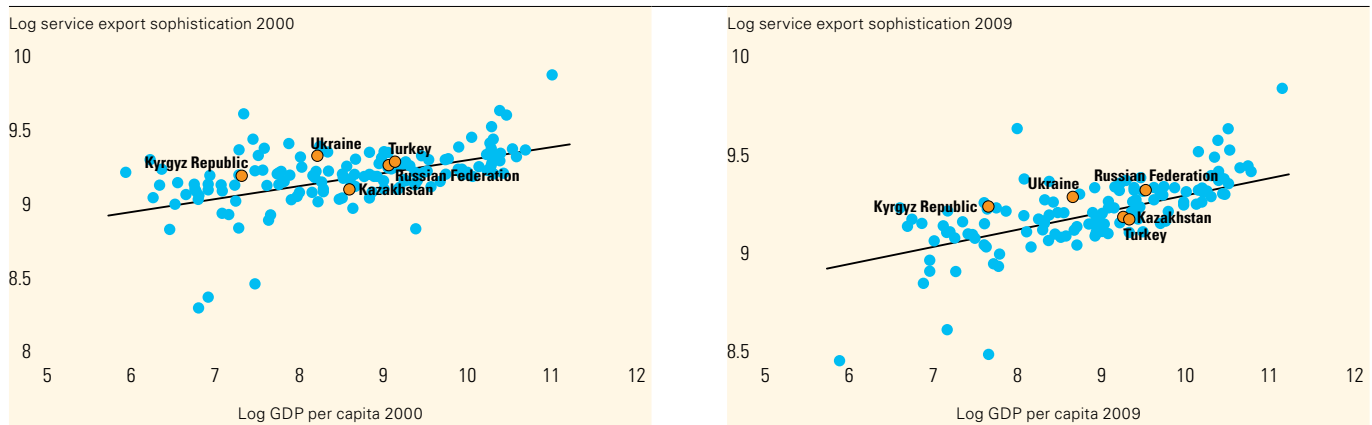


following categories: other commercial services (such as ICT), professional and other business services, and financial services. Figure 1.18a shows that since 2000 the ratio of imports to exports of professional, ICT, and other business and commercial services was mostly above 15 to 1. Imports of financial services were also consistently higher than exports (Figure 1.18b). On the other hand, the country runs a surplus in transportation trade (that is, import/export ratio is less than one) has a balanced trade in travel services.

**1.36. Based on the structure of the services export basket, services export sophistication has remained below what would be predicted by its level of income.** Details of how the measure is constructed are given in the Appendix. Based on Mishra et al (2011), this measure of export sophistication in services is an extension of the one Hausmann, Hwang, and Rodrik (2007) developed for goods. Intuitively, it captures whether a country's export basket consists primarily of services typically exported by high-income economies, viewed as relatively sophisticated, or by low-income economies, viewed as relatively less sophisticated. This measure is relevant because even though emerging countries are increasingly exporting sophisticated services, sophisticated services tend to be produced by higher-income countries. According to this measure, Kazakhstan's export sophistication in services has remained relatively steady and below what would be predicted by its level of income (Figure 1.19).

**Figure 1.19. Sophistication of Service Exports Declining Over Time**

Log Service Export Sophistication and GDP Per Capita, 2000 and 2009



Source: Authors' calculations on the basis of methodology in appendix; WDI, 2012.

## D. Salient Features of Trade Performance

**1.37.** The analysis of trade performance presented this chapter—in particular, the exploration of the differences between successful and less successful sectors and products—allows us to provide a rough characterization of barriers that are holding back competitiveness and diversification. However, arriving at firmer conclusions will require analysis of firm-level data analysis that is not yet available:

- **Resource based / short supply chains v. complex inputs / long supply chains:** Successful sectors and products like metals, inorganic chemicals, and even frozen fish are all based on local natural resources, with relatively limited value added. Related to this, and potentially critical, they tend to have short supply chains: they minimize transport costs and time, minimize transaction costs, and minimize the need for coordination among economic agents and between agents and regulators. Products that tend to rely on more complex supply chains, like transport equipment, other machinery, and even meat (relative to fish) have fared less well. *This*

*indicates challenges with supply chain management, transportation, market coordination, and access to quality and cost-effective imported intermediates.*

- **Low sensitivity to transport costs and time:** Kazakhstan's most successful exports are in metals, bulk chemicals, and minerals. Products in these sectors have relatively high unit prices and are therefore less sensitive to transport costs. They also tend to be items that are not used in "just-in-time" value chain production. This pattern holds true in other sectors like the agri-food, where Kazakhstan specializes in milled products rather than dairy, and in frozen rather than fresh fish. With products like machinery, transport, and textiles that lend themselves to value chain production and where transport costs and time are sensitive, Kazakh exporters have struggled to break through, and have generally been forced to rely on regional markets, such as the Commonwealth of Independent States (CIS). *This again, emphasizes the importance of efficient transport services to competitiveness outside traditional commodities.*
- **Reliance on natural resources and capital versus labor (either low-wage or high-skilled):** The sectors that have been successful (metals, chemicals, grains) tend to make heavy use of natural resources and capital and limited use of labor, while sectors that require large-scale low-wage labor (apparel, footwear, electronics) have continued to decline. Sectors like electrical machinery that rely on highly skilled labor also seem to be struggling to break through, and even within sectors, the concentration in low-complexity, low-quality products is evidence of a weakness in knowledge-intensive activities, in terms not only of design and production but also marketing. Competitiveness seems to be declining also in low-skill activities that are labor-intensive and price-sensitive, which relates to wages and labor productivity. *Kazakhstan has a significant gap to close if it is to move up to more skills-intensive production.*
- **Business scale:** Almost all the successful products and sectors benefit from economies of scale, while sectors dominated by small and medium enterprises (SMEs) struggle. This is a symptom of SME productivity challenges and the existence of barriers (regulatory, access to finance, etc.) that place particular burdens on SMEs in Kazakhstan. Firm level analysis would allow us to detect the key bottlenecks to SME performance.
- **Standards and quality upgrading:** The evidence of this report highlights a subdued performance in terms of implementation of standards and quality upgrading. The few example of successful diversification in Kazakhstan suggest that foreign market demands are a key source of quality upgrading and standards. Hence, while the CU, China, and other emerging markets may be attractive from an export growth perspective, evidence from exporters in Kazakhstan and other countries suggests that sophisticated markets like the EU offer quality and technology spillovers. In the fish sector, for instance, Kazakh exporters worked closely with partners from the EU (mainly Germany and France) to ensure they could comply with EU sanitary standards and earned EU certification for their processing plants. In the meat sector, by contrast, the main market is Russia, where similar standards issues arose at the border, but there was less interest and potential for partnering with importers to raise quality and ensure compliance.<sup>9</sup> Domestically, it is therefore important to attract quality foreign investors and distributors that can raise the bar in their demands for quality from local suppliers. In the agri-food sector, for example, international retailers like Metro A.G. are helping facilitate quality improvements across the board. *Integrating with sophisticated firms through trade and investment can have a positive pull effect on quality across the supply chain.*
- **Linking services and goods:** The patterns described for successful products and sectors—reliance on local natural resources, short supply chains, internal scale economies, low product complexity, low sensitivity to transport—also spotlight the relatively limited links between goods-producing and services sectors. More complex products in the sectors where Kazakhstan is competitive will undoubtedly rely more on sophisticated business services for information technology and communications (ICT) and engineering services as well as transport and logistics. For example, the expansion of globally competitive firms like Metro A.G. into the retail

<sup>9</sup> The performance in fish and meat is partly linked to corporate efforts and partly to the government effort. Private effort alone cannot satisfy EU regulations.

and services sector is already opening up opportunities for the Kazakh agri-food sector to export. With more sophisticated transport and logistics, exporters might be able to move to higher-value varieties. The lack of competitiveness in services may be a serious constraint on the potential of the goods sector.

## E. Conclusions

**1.38. The energy sector tends to overshadow the rest of the Kazakh economy in both size and performance.** To understand the opportunities for diversification and how the rest of the economy may enhance the competitiveness of the Kazakh economy, this chapter focused on the non-energy and minerals (“non-resource”) sector.

- **Non-resource exports started from a relatively low base, but have been growing rapidly for the past decade.** Structural trends in the non-resource export base suggest that during the last decade Kazakhstan has gone through a steady, if relatively slow, process of specialization. Exports have become concentrated within sectors and around a few dominant products. As a result, in the past decade export variety decreased and volumes became increasingly concentrated in a few major products.
- **Increased product concentration does not appear to reflect a lack of experimentation by exporters.** A share of recent export growth came from products that were new or grew from a very small base, and there have been several big hits. However, the potential for experimentation seems to be dimmed by very low export survival rates.
- **It appears that Kazakhstan has not taken advantage of specialization to reap gains through differentiation and quality.** Kazakhstan’s exports in key sectors are concentrated increasingly in low-complexity products that have limited scope for quality differentiation and tend to compete in their main markets near the bottom of the quality ladder.
- **Both exports and imports of services have expanded rapidly over the past two decades, increasing their share of total trade flows to about 20 percent in 2010.** This expansion is mainly a result of growth in transport services, but there is a high trade deficit in modern business services. The increase in imports of ICT and business and commercial services reflects the growing importance of high-quality, low-cost services as inputs into the production of both goods and other services. Where the domestic producer base of such services is not sufficiently developed, such imports demonstrate the necessity to attract the services and tasks necessary for economic development.
- **Finally, this chapter also discussed the characteristics that successful exports have in common, characteristics which are not shared with less successful exports.** The current successful non-resource exports (processed metals, inorganic chemicals, and frozen fish) all have short value chains, are less sensitive to transport times, depend on natural resources, and are all capital-intensive. Those products are typically not produced by small and medium enterprises (SMEs) and are generally less reliant on links between services and goods.

**1.39. Firm-level data were not available for the analysis presented in this chapter, but given the heterogeneity among firms that generate the aggregate trade flows, firm-level analysis would be invaluable to refine and extend the conclusions.** Firm-level data are already collected by various agencies in Kazakhstan and could be made available with appropriate safeguards to protect confidentiality, which has been done in many countries worldwide. Examples of areas where analysis of trade competitiveness could be enhanced with firm-level analysis have been provided in shaded boxes throughout the chapter. With firm-level data, one can better analyze export dynamics, including patterns of entry, expansion, diversification, upgrading, and exit based on firm types, sectors, and markets.

More discussion is devoted to the uses of firm-level analysis in the final chapter of this report.

**1.40.** Before assessing trade barriers and services competitiveness, the next chapter reviews Kazakhstan's dynamic external environment, focusing on the evolution of its trading partners and the effects of the BKR customs union.

## Chapter 2. Kazakhstan's Changing Trade Landscape: Regional and International Integration

### A. Introduction

**2.1. The external environment for Kazakhstan's economy, particularly its exports, is in extreme flux.** Exporters are confronting tightening global demand, changing global growth patterns, and a rapidly evolving trade policy. The massive trade expansion of the late 1990s and first half of the 2000s, when the global economy was firing on all cylinders, is unlikely to return any time soon, yet opportunities exist for Kazakhstan. Its neighborhood includes four of the emerging high growth poles of the world—China, India, Turkey, and Russia, which can provide imports as wells as offer destinations for exports for both goods and services. The rapid expansion of Kazakhstan's trade relationship with China shows the value of being geographically close to high growth countries. Whether Kazakhstan will be able to profit fully from such geographical proximity will also depend on its trade policies. These policies are greatly affected by the customs union between Kazakhstan, Russia, and Belarus; the planned Common Economic Space between these countries; and the advance of Kazakhstan's negotiations to enter the WTO.

**2.2. Following a review of trade performance and the composition of exports in the previous chapter, this chapter focuses on merchandise trade patterns and shows that prior to the customs union, trade reoriented away from Russia and diversified in terms of markets, both overall and within non-resource sectors.** These patterns are now reverting. As predicted by a previous World Bank study, the customs union has diverted a portion of Kazakhstan's trade back toward Russia. The CU has only accentuated Kazakhstan's specialization in energy, minerals, and metals, but has offered isolated market opportunities for other exports such as footwear and machinery. This success is notable, but it remains to be seen if under a future WTO scenario these products can remain competitive. One of the major purported benefits of the CU for Kazakhstan is increased foreign investment, but it is too early for a definite conclusion.

**2.3. Looking ahead, trade potential may exist with both China and CU partners, although trade costs hinder intra-regional trade within Central Asia.** The composition of trade with Russia, and to a lesser extent with Central Asia, emphasizes their potential importance in terms of product diversification into new non-commodity export products.

**2.4. Section B of this chapter presents an analysis of market diversification over the previous decade and current trade potential.** Section C analyzes the impact of the CU in detail, and Section D concludes with several ways to mitigate the negative impact of the CU.

### B. The Changing Landscape of Kazakhstan's Trade

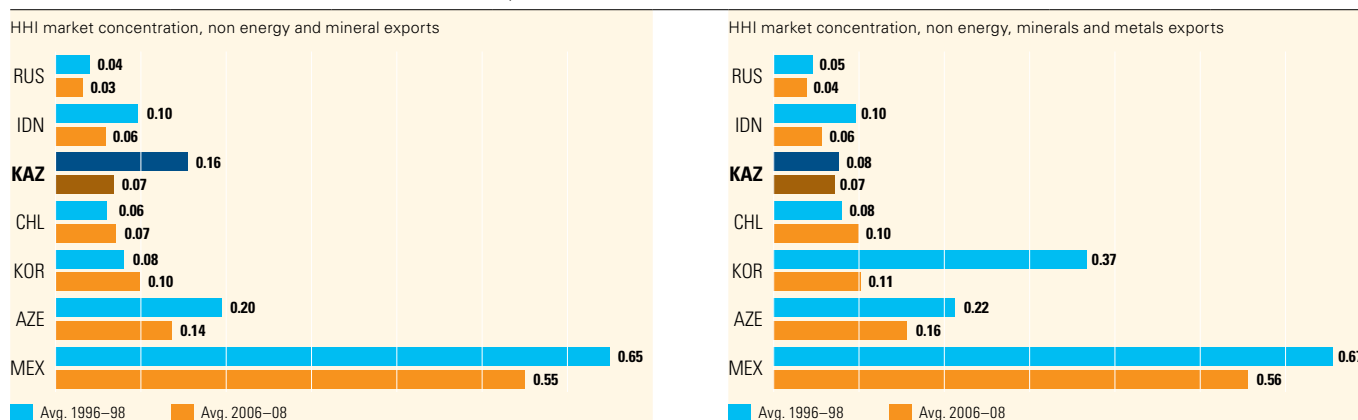
#### *Exports Have Diversified Geographically*

**2.5. Although Kazakhstan's exports have become increasingly concentrated from a product perspective, markets for exports have become much more diversified.** Geographic market concentration in non-energy and

minerals exports has more than halved. Kazakhstan, which already had a geographically diversified export profile a decade ago, is now even more diversified (Figure 2.1, left panel). Even excluding the dominant metals sector (right panel), exports (non-energy, non-mineral, non-metal) were already well diversified geographically, and markets have since diversified further.

**Figure 2.1. Exports Well-Diversified Geographically**

Hirschman-Herfindhal Index of Market Concentration, 1996–98 vs. 2006–08



Source: Authors' calculations based on data from UN Comtrade (WITS).

### *Prior to CU, Trade Re-Oriented Away from Russia toward the EU, China*

**2.6. In diversifying markets, the one constant for Kazakhstan has been the decline in Russia's importance as an export destination.** Russia accounted for 43 percent of all Kazakhstan's exports in 1996-98 (Table 2.1) and more than 60 percent of non-energy, minerals, and metals exports. By 2008 this had declined to 11 percent of total and 30 percent of non-energy exports. For total exports (left panel), the shift was dramatically toward the EU (from over 20 percent to over 50 percent) and China (from 7 percent to 14 percent). But for non-energy, minerals, and metals exports, the shift favored other major trading partners (from 6.5 percent to 21.3 percent), such as Turkey and Central Asia, while the EU remained the largest destination (growing from 19 percent to 22 percent).

**2.7. Table 2.2 gives details about the mix of destinations by sector and product group (HS 2-digit level).** What is striking is that the most important products and the ones that have had the greatest growth success over the decade are those that have strong markets outside Russia and Central Asia. For example, as copper exports grew at twice the rate of iron and steel, the share of exports to China grew from 29 percent to 64 percent, though in iron and steel China's share was constant and most share growth came from Russia. Similarly, the boom in inorganic chemicals coincided with a fall in the share of CU partners, from 70 percent in 2000 to just 17 percent in 2010, while China's share grew from 2 percent to 46 percent. Finally, the fish export boom is closely tied to the development of export markets in Europe, and the meat bust to a collapse in exports to Russia and an inability to find alternate markets. Generally, where volumes are small, more regional markets (CAREC and Russia) dominate. This emphasizes their potential importance from the perspective of product diversification and the introduction of new non-commodity export products despite these markets being relatively less important for export volumes overall.

**2.8. Compared to exports, Kazakhstan's import structure was relatively stable in the decade leading up to the crisis and entry into the CU (Table 2.3), with two conspicuous exceptions: China and Russia.** While China

**Table 2.1. Prior to CU, Exports Re-Oriented Away from Russia**

Kazakhstan's Export Destinations 1996–98 vs. 2006–08

	96–98	06–08	CAGR		96–98	06–08	CAGR
All merchandise exports				Non energy, minerals, and metals exports			
<b>EU-27</b>	<b>21.3</b>	<b>51.2</b>	<b>24.1%</b>	<b>EU-27</b>	<b>19.3</b>	<b>22.3</b>	<b>12.0%</b>
Germany	4.5	11.9	34.5%	Germany	3.0	4.8	15.7%
Italy	5.0	8.2	28.1%	United Kingdom	3.0	3.3	11.3%
France	1.9	6.8	38.8%	Italy	7.1	3.2	1.9%
Romania	0.3	5.3	64.8%	France	0.6	2.2	24.6%
Austria	1.9	2.7	31.2%	Poland	1.3	1.5	12.0%
Greece	0.9	2.4	33.8%	Rest EU-27	3.6	6.1	27.0%
Spain	0.4	2.3	45.9%	<b>BRICs</b>	<b>66.3</b>	<b>36.9</b>	<b>4.0%</b>
Netherlands	0.3	2.3	51.6%	China	5.0	5.4	10.5%
Rest EU-27	4.8	7.5	26.2%	Russia	60.8	30.9	3.1%
<b>BRICs</b>	<b>51.0</b>	<b>25.8</b>	<b>13.9%</b>	India	0.4	0.4	8.2%
China	7.3	13.9	30.2%	<b>Other large trading partners</b>	<b>6.5</b>	<b>21.3</b>	<b>24.3%</b>
Russia	43.2	11.4	6.8%	Turkey	..	5.4	..
India	0.5	0.3	14.8%	Kyrgyz Republic	2.1	3.7	17.0%
<b>Other large trading partners</b>	<b>12.7</b>	<b>14.7</b>	<b>23.9%</b>	United States	2.7	3.5	13.0%
Ukraine	5.8	4.7	19.5%	Azerbaijan	1.5	3.1	18.3%
Turkey	3.9	4.5	23.8%	Switzerland	0.1	3.0	54.4%
United States	2.9	3.9	26.0%	Afghanistan	..	2.6	..
Switzerland	0.1	1.6	60.7%	<b>Rest of World</b>	<b>8.0</b>	<b>19.6</b>	<b>25.8%</b>
<b>Rest of World</b>	<b>14.9</b>	<b>8.3</b>	<b>15.0%</b>				

Source: UN Comtrade (WITS).

Note: data for 1996–98 excludes Brazil (no data available).

accounted for only 1 percent of Kazakhstan's imports in 1996–98 its share had grown to 10.5 percent by 2006–08. This corresponded to a similar decline in imports from Russia (47 percent to 37 percent). Yet despite the decline in relative share, nominal imports from Russia still grew 19 percent annually over the period.

*With access to firm-level data it would be possible to understand whether the shift in markets was a function of sector or individual firm shifts; in other words, are the same firms that once sold to or bought from Russia now selling to or buying from China? Or have new exporters influenced the pattern of product and sector trade with China and Russia? If so, was the breakthrough in new markets and products due to domestic firms or foreign-owned firms that brought know-how, skills, and capital to tap new products and new markets?*

**Table 2.2. Growth of Major Products Tied to Variety of Markets**

Kazakhstan Exports by Destination for Selected Product Groups, 2000 and 2010

2000		Total (US\$'000)	BKRCU	CAREC	EU-27	China	USA	Other
Metals	Iron and steel (HS72)	1,445,733	8%	0%	15%	29%	13%	35%
	Copper (HS 74)	623,441	1%	0%	30%	29%	16%	24%
	Zinc (HS79)	224,078	2%	0%	47%	0%	32%	19%
Chemicals	Inorganic chemicals (HS28)	546,147	70%	3%	16%	2%	8%	1%
	Organic chemicals (HS29)	9,375	68%	6%	26%	0%	0%	0%
	Pharmaceuticals (HS30)	476	66%	12%	22%	0%	0%	1%
Agribusiness	Meat (HS02)	625	99%	1%	0%	0%	0%	0%
	Fish (HS03)	7,356	90%	1%	7%	1%	0%	1%
	Cereals (HS10)							
	Milled products (HS11)							
2010		Total (US\$'000)	BKRCU	CAREC	EU-27	China	USA	Other
Metals	Iron and steel (HS72)	2,753,898	14%	1%	12%	30%	8%	35%
	Copper (HS 74)	2,512,937	4%	0%	6%	64%	0%	26%
	Zinc (HS79)	609,783	2%	0%	37%	19%	0%	42%
Chemicals	Inorganic chemicals (HS28)	2,192,564	17%	0%	19%	46%	3%	15%
	Organic chemicals (HS29)	2,712	42%	0%	11%	12%	0%	35%
	Pharmaceuticals (HS30)	6,889	4%	33%	0%	0%	0%	64%
Agribusiness	Meat (HS02)	9,281	97%	3%	0%	0%	0%	0%
	Fish (HS03)	120,691	7%	0%	84%	0%	1%	7%
	Cereals (HS10)							
	Milled products (HS11)							

Source: UN Comtrade (WITS).

*Trade Potential Exists with China and CU Partners Currently*

2.9. Given its central position and relatively larger domestic market, it is often recommended that Kazakhstan become a leader in or facilitator of regional supply chains in Central Asia. So far there is little evidence that this is being realized, and the rapid growth of trade with China and the CU with Russia and Belarus seem likely to further push back the relative importance of Central Asia for Kazakhstan.

2.10. Kazakhstan is one of the countries least integrated with CAREC-7<sup>10</sup> countries (Table 2.4), a grouping that includes the five Central Asian republics plus Mongolia and Azerbaijan. Even including two additional countries to the standard five, only 6 percent of Kazakhstan's non-energy exports stay within this regional group. While the share of non-energy imports sourced from the CAREC-7 has doubled in 10 years, at just over 2 percent it is still extremely low. By contrast, Kazakhstan trades substantially more with its CU partners, Russia and Belarus.

2.11. Partially due to trade costs, gravity model predictions of Kazakhstan's trade with regional partners suggest that the potential for further growth within Central Asia is limited and that in fact trade between

<sup>10</sup> CAREC-7 countries include Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan plus Mongolia and Azerbaijan. The designation excludes China, Pakistan and Afghanistan, which are also participating members of CAREC.



Kazakhstan and regional partners is already higher than should be expected (Figure 2.2), although trade with Russia and Belarus is as predicted. The reasons for the predictions of “overtrading” include the high cost of trade between Kazakhstan and its Central Asian regional partners, its geographical remoteness and lack of ocean outlets, and the small economies of partner countries. Non-energy trade with China is slightly below predictions, and given India’s size and proximity (Delhi is only 3.5 hours by plane), trade with India is dramatically below model expectations.

**Table 2.3.** Import Partners Rather Stable, but China Increasing and Russia Declining

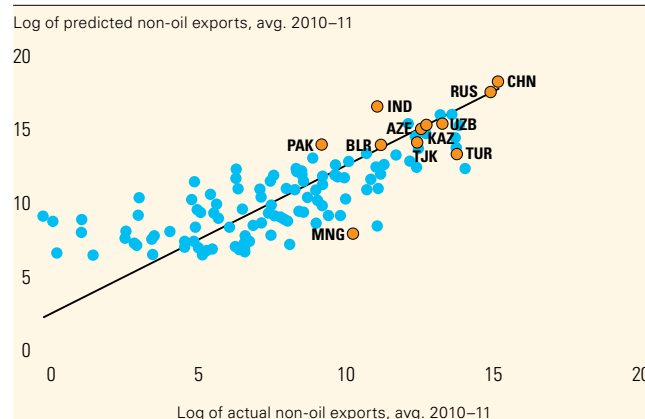
Kazakhstan’s Imports by Origin, 1996–98 and 2006–08

	96–98	06–08	CAGR
<b>EU-27</b>	<b>24.5%</b>	<b>24.4%</b>	<b>21.9%</b>
Germany	7.2%	7.4%	22.2%
Italy	1.6%	4.1%	33.5%
France	1.4%	2.1%	27.3%
United Kingdom	3.4%	2.0%	15.9%
Rest EU-27	10.8%	8.8%	19.4%
<b>BRIC Countries</b>	<b>48.8%</b>	<b>48.4%</b>	<b>21.8%</b>
China	1.1%	10.5%	52.8%
Brazil	0.4%	0.6%	26.4%
Russia	46.7%	36.7%	19.0%
India	0.6%	0.5%	21.3%
<b>Other large trading partners</b>	<b>11.3%</b>	<b>15.9%</b>	<b>26.2%</b>
Ukraine	2.2%	4.9%	32.5%
United States	4.1%	4.9%	24.0%
Japan	0.9%	3.5%	39.5%
Turkey	4.1%	2.6%	16.6%
<b>Rest of World</b>	<b>15.4%</b>	<b>11.3%</b>	<b>18.3%</b>

Source: UN Comtrade (WITS).

**Figure 2.2.** Given High Trade Costs, Intra-regional Trade Already More than Predicted

Gravity Model Predictions of Kazakhstan’s Bilateral Trade in Non-Energy Sectors, 2010–11



Source: Authors’ calculations based on data from Comtrade (WITS) and CEPII.

**Table 2.4.** Relatively Low Importance of Central Asia Currently for Kazakhstan

Trade among CAREC Countries and with CU Partners (Percent Share of Non-Energy Products)

Country	Exports to CAREC		Imports from CAREC		Exports to Russia & Belarus		Imports from Russia & Belarus	
	2000	2010	2000	2010	2000	2010	2000	2010
Azerbaijan	28.4%	7.5%	5.5%	4.8%	35.7%	23.0%	..	4.4%
<b>Kazakhstan</b>	<b>4.8%</b>	<b>6.4%</b>	<b>1.1%</b>	<b>2.2%</b>	<b>32.3%</b>	<b>27.9%</b>	<b>22.1%</b>	<b>19.0%</b>
Kyrgyz Rep.	12.4%	14.8%	10.4%	11.9%	42.9%	49.2%	45.1%	17.1%
Mongolia	0.1%	0.1%	1.8%	..	7.7%	7.2%	28.0%	20.8%
Tajikistan	3.4%	9.1%	37.2%	..	73.3%	21.7%	20.7%	..
Turkmenistan	0.6%	5.0%	5.4%	..	71.2%	20.6%	21.3%	..
Uzbekistan	6.5%	11.4%	..	..	54.3%	33.6%	16.9%	..

Source: Comtrade (via WITS).

*With access to firm-level data, it would be possible to understand what kinds of firms are trading with CU partners, China, regional partners, or elsewhere. Are they all trading globally, or are certain types of firms more likely to focus on one market or another? These data would also make it possible to assess which margins of trade give more scope for increasing exports generally and to specific markets: would exports increase most by helping more firms to export? enter new markets? increase their product range? increase how much they export? Finally, it would be possible to assess whether firms that export to the EU or China face tougher competition and higher mortality rates than firms whose market is the CU, and whether the trends have changed over time.*

**2.12. The preceding discussion raises a question about Kazakhstan’s “natural” trading partners.** Kazakhstan has limited integration with Central Asian partners, and considerable potential for better integrating with China, but a major question is whether the CU might have potential. Based on the product-level structure of trade, Kazakhstan seems to have more complementarity with Belarus than it does with Russia. Kazakhstan’s exports do not correspond as well with Russia’s imports (6.0), but Russia’s exports do better with Kazakhstan’s imports (17.8). With respect to Belarus, Kazakhstan’s export structure matches better than its import structure (35.2 and 18.3, respectively) (Table 2.5). We certainly cannot dismiss the possibility of greater intra-regional trade, but it would require a reduction in trade costs. A previous report (World Bank 2010) outlined a strategy for expanding trade and fostering diversification in Central Asia through regional and domestic measures to improve connectivity. It focused on the latent export potential in boosting Kazakhstan’s agroindustry exports through raw inputs from southern neighbors and framed Almaty as a potential regional logistics and agro-processing hub.

**Table 2.5. Potential for Integrating with China and CU Partners Greater Than Central Asia**

Bilateral Trade Complementarity Indices, Total Merchandise Trade<sup>11</sup>

From:	To: Azerbaijan	Belarus	China	Kazakhstan	Kyrgyz Rep.	Mongolia	Russia	Tajikistan	Turkmenistan	Uzbekistan
Azerbaijan		30.2	16.2	<b>11.2</b>	5.6	5.8	3.9	8.9	3.1	8.3
Belarus	16.9		12.3	<b>18.3</b>	16.6	32.2	12.6	21.7	15.7	16.5
China	29.3	24.5		<b>31.5</b>	18.4	22.4	39.1	20.2	24.3	23.3
<b>Kazakhstan</b>	<b>5.7</b>	<b>35.2</b>	<b>23.9</b>		<b>8.1</b>	<b>7.5</b>	<b>6.0</b>	<b>12.2</b>	<b>3.7</b>	<b>11.3</b>
Kyrgyz Rep.	11.4	9.2	7.9	<b>11.8</b>		9.0	11.7	9.3	7.7	7.6
Mongolia	1.6	6.9	16.5	<b>8.1</b>	2.2		2.7	4.6	1.2	6.1
Russia	10.7	48.0	27.4	<b>17.8</b>	15.1	23.9		19.8	8.3	16.6
Tajikistan	5.7	4.9	5.1	<b>4.2</b>	3.5	5.6	5.5		4.8	5.9
Turkmenistan	2.6	19.0	8.1	<b>8.8</b>	9.9	20.1	3.2	14.7		7.1
Uzbekistan	9.3	18.1	9.2	<b>9.3</b>	7.9	9.8	10.6	9.0	6.1	

Source: Authors’ calculations based on Gillson and Reyes (2011) and data from Comtrade (via WITS).

11 The bilateral complementarity index between two countries  $j$  and  $k$  can be defined as:  $C_{jk} = 100 - \sum_i \{ |M_{jk} - X_{ji}| \div 2 \}$  where  $X_{ji}$  represents the share of good  $i$  in total exports from country  $j$  and  $M_{jk}$  represents the share of good  $i$  in total imports to country  $k$ . The index is a measure of the similarity between the export basket of one country and the import basket of another. The value of the index ranges from zero to one hundred, representing no complementarity and a perfect match, respectively.

## C. Inception of the Customs Union and its Impact to Date

### *CU Raised Tariff Protection by 70 Percent*

**2.13. The decision by Russia, Kazakhstan, and Belarus to form a customs union marked a major change in the trade policy, which affected the degree of integration of three large CIS countries.** Kazakhstan's stated rationale for joining the CU, which took effect in 2010, was that it would help attract investment to Kazakhstan and smooth the way to a common economic space of 170 million people. With free trade agreements between the three countries already in place, the major changes brought about by the CU have been adoption of the CET and a new customs code, and elimination of customs clearance at internal borders.

**2.14. The CET affected more than 11,000 tariff lines, covering all goods.** Transition rates were established for 409 tariff lines. For some lines, the transition period ended on July 1, 2011. For others (such as certain medical and pharmaceutical products), the transition will not be complete until 2015. The CET increased Kazakhstan's tariffs, with trade-weighted average tariff protection levels rising by more than 70%, from 6.72 to 11.51 percent. Tariff dispersion measured by standard deviation of the average effective rate also increased (World Bank 2012).

**2.15. With the completion of Russia's WTO negotiations in late 2011 and ratification in mid-2012, and announcements that Kazakhstan intends to accede by the end of 2012, there will likely be changes that to bring down the country's import tariff rates.** Russia's average tariff rate is scheduled to fall from 11.5 percent to a most-favored-nation (MFN) level of 8.6 percent. Meanwhile, since Kazakhstan must adjust to the current CET reality, this section reviews the changes the CU brought about and describes what can be gleaned from aggregate product-level customs data through 2011.

**2.16. A recent World Bank report (2012) on the impact of the CU on Kazakhstan predicted that the higher tariffs brought about by the CET would have a negative effect on Kazakhstan's welfare.** Using a 57-sector computable general equilibrium (CGE) model, the study concluded that with its higher external tariffs, as of mid-2011 Kazakhstan was losing 0.2 percent in real income per year. While manufacturing sectors were expected to expand, reflecting higher protection, services would contract because they would not be protected. The costs to business and consumers of imports would rise and resources would shift to areas of inefficient (protected) production. Perhaps most important from a dynamic perspective, the model predicted a decline in technology imported from more technologically advanced countries as a result of tariff-induced diversion to CU partners, a result which would threaten Kazakhstan's long-term productivity gains. To offset the negative net impact of the CU, substantial progress in facilitating trade and easing nontariff barriers needs to be made. In the study's most optimistic scenario, enough progress in reforming these areas could even have a positive net welfare impact—but without reform, Kazakhstan would continue to lose out (Table 2.6).

**2.17. While the model predicted trade diversion, the following sections shows what has happened so far.** As a caveat, two major trends cloud the picture because they occurred as the CU went into effect: recovery from the 2008–09 crisis (though this was followed quickly by the EU's return to crisis) and the continued economic rise of China, which borders Kazakhstan to the east. Given the very short time frame since implementation of the CU, these trends make it even more difficult to isolate impacts the CU has had on trade patterns.

**Table 2.6.** Negative Welfare Impact of CU and Opportunities to Offset This Impact

World Bank (2012) Study Results: Welfare Change From Customs Union Under Three Scenarios

	Customs Union Immediate Impact	Customs Union Outlook		Decomposition of Optimistic Scenario	
	2011 tariffs Transition rates	Pessimistic <sup>a</sup>	Optimistic <sup>b</sup>	Regional cuts in Transport Costs	Regional cuts in NTBs
As % of consumption	-0.2	-0.3	1.5	1.4	0.4
As % of GDP	-0.1	-0.1	0.7	0.7	0.2

Source: World Bank (2012).

a. Pessimistic scenario: Future tariffs.

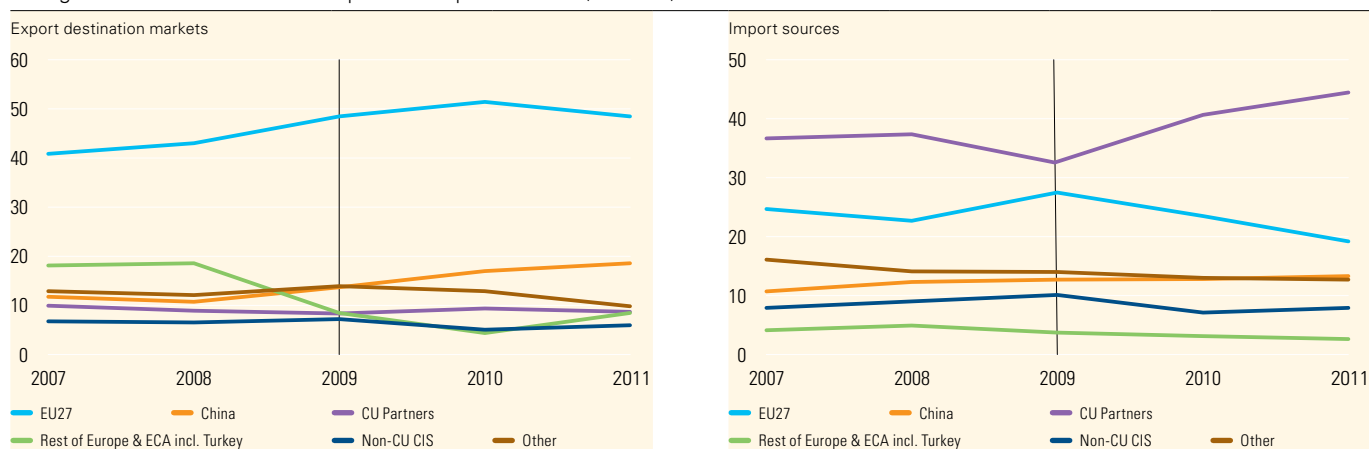
b. Optimistic scenario: Future tariffs; regional cuts in non-tariff barriers and transport costs

*As Predicted, CU Policies Diverted Trade Away from EU and Toward Russia*

2.18. From 2009 through 2011 Kazakhstan has seen significant diversion in imports from previous sources toward CU partners: the share of imports from CU partners increased from 32.6 percent to 44.5 percent, and the share from the EU27, traditionally the second largest source, dropped from 27.4 percent to 19.3 percent (Figure 2.3). A parallel story is what has been happening with China. Despite the higher tariff barriers it faces, China has steadily increased in importance to both imports and exports.

**Figure 2.3.** CU Shifted Kazakhstan's Trade Toward CU Partners, Especially Imports

Change in Share of Kazakhstan's Import and Export Partners (2007–11)



Note: Horizontal line marks end of 2009, after which CU implemented.

Source: Kazakhstan Customs Authority.

2.19. Tables 2.7 and 2.8 give some perspective on how import and export patterns vary by market and product group. In both imports and exports, the EU has declined across virtually all product groups. CU partners have expanded their share, making considerable gains in all eight of the largest product groups; the CU accounts for more than 75 percent of all imports to Kazakhstan. However, its export shares to CU partners grew in only three of the top eight categories. China was a faster-growing export partner for Kazakhstan than CU partners Russia and Belarus, with growth notable in each of the top three export product categories: minerals (including oil and gas), metals, and chemicals.

**Table 2.7. EU Share Declining Across Export Product Groups, China Gaining, CU Mixed**

Change in Share of Export Destinations Since CU for Product Categories

	share of KAZ exports (RHS)	Change in share of KAZ exports since CU				
		CU partners	EU-27	China	Non-CU CIS	Other
Minerals	77.8	0	9	4	-1	-12
Metals	13.2	7	-10	5	-2	1
Chemicals	3.6	-19	-6	20	-2	7
Vegetables	1.7	-6	-0	0	19	-13
Stone/glass	1.9	0	-17	0	-1	18
Machinery/electronics	0.6	8	-5	0	-3	-0
Foodstuffs	0.3	-1	-1	0	13	-11
Transportation	0.3	2	-29	1	8	18
Textiles/Clothing	0.2	13	-4	-12	1	2
Animal	0.1	-10	16	-1	-3	-2
Plastic/rubber	0.1	-11	-4	14	-8	10
Hides/skins	0.0	4	34	-35	5	-8
Miscellaneous	0.1	3	-16	1	5	7
Wood	0.1	-20	22	0	1	-2
Special	0.0	17	-0	24	11	-52
Footwear	0.0	0	-17	0	-1	18

Source: Kazakhstan Customs Authority.

Note: Figure shows difference in average share of Kazakhstan's exports by destination in 2007–09 versus 2010–11 in HS two-digit product categories; top 10 HS-2 categories cover 99.6 percent of all exports.

**Table 2.8. EU Share Declining Across Import Product Groups, CU Gaining, China Mixed**

Change in Share of Import Source Markets Since CU for Product Categories

	share of KAZ exports (RHS)	Change in share of KAZ imports since CU				
		CU partners	EU-27	China	Non-CU CIS	Other
Machinery/electronics	24.7	5	-6	6	-0	-4
Minerals	13.8	5	-1	-0	-4	-0
Transportation	11.2	6	-3	3	3	-9
Metals	9.9	15	-2	-2	-10	-1
Chemicals	8.2	2	-4	1	0	1
Miscellaneous	7.7	12	-1	-4	-1	-6
Foodstuffs	5.5	3	2	-0	1	-6
Plastic/rubber	4.9	8	-6	0	-1	-1
Wood	4.0	-1	-6	1	0	7
Vegetables	3.1	-12	-1	3	20	-11
Stone/glass	2.7	10	-3	-2	-2	-3
Animal	2.0	1	3	-1	-3	-0
Textiles/Clothing	1.7	-2	-8	4	-1	7
Footwear	0.5	-0	-10	12	-0	-2
Special	0.2	-12	8	0	6	-2
Hides/skins	0.1	3	-12	10	-0	0

Source: Kazakhstan Customs Authority.

Note: Figure shows difference in average share of Kazakhstan's imports by source in 2007–09 versus 2010–11 for HS two-digit product categories.

2.20. Chinese imports seem to have been less affected by tariff increases. Since the CU was signed, imports from EU have lost share in almost every product category. There is some evidence that this is related to the tariff increases EU imports have faced—certainly the biggest share declines have come in the two product categories mentioned, where increases in tariffs were highest. On the other hand, despite similar tariff increases, China's performance has not been nearly as bad (Figure 2.4). In fact, China even gained share in most categories (although losing shares in categories important for Chinese exports like textiles and clothing, footwear, wood, and vegetables).

### *CU Resulted in Some Market Opportunities for Kazakhstan's Non-Resource Exports*

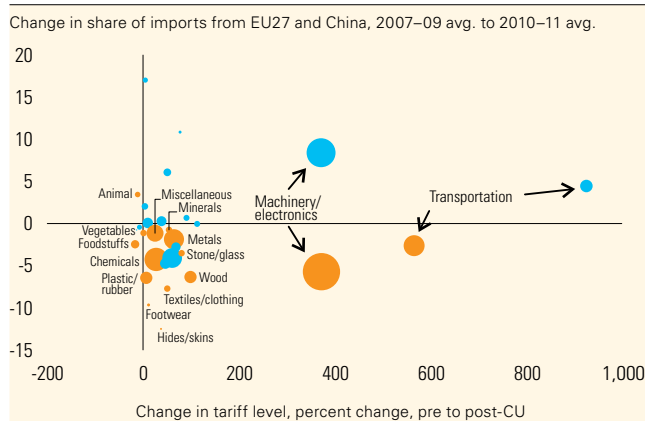
2.21. After only two years, it is not yet possible to be sure how much the CU has affected export diversification. Trends in broad product categories suggest that it has accentuated Kazakhstan's specialization (Figure 2.5). The country's trade balance with CU partners has improved only in the two sectors where Kazakhstan was already strongest—minerals and metals. In fact, Kazakhstan runs a trade deficit with Belarus and Russia for every single product category, even minerals and metals.

2.22. On the other hand, while trade deficits may have increased in most categories, exports to CU partners more than doubled from 2009 to 2011, from \$3.6m to \$7.6m. Although this could be attributed not just to the CU but to recovery from the global financial crisis, substantial increases in exports occurred in such areas as food, machinery, footwear, and stone/glass (Table 2.9). This suggests increasing intra-CU specialization, two-way trade within these categories, and opportunities to tap into sources of demand within the CU as economic integration continues. On the other hand, the CU agreement has not altered some previous trends, such as the decline of chemical and vegetable exports to Belarus and Russia.

2.23. Looking in a more disaggregated fashion at fastest-growing HS two-digit export products, of the 17 (of 96 HS2 products) that are growing healthily in the CU, most are in sectors other than minerals and metals, foods (oil seeds, confectionery); chemicals and plastics; clothing and footwear; machinery; and furniture (Table 2.10). This suggests that access to the protected CU markets may have positive short-run effects

**Figure 2.4. Roughly Equivalent Tariff Increases Faced Have Hit EU Harder than China**

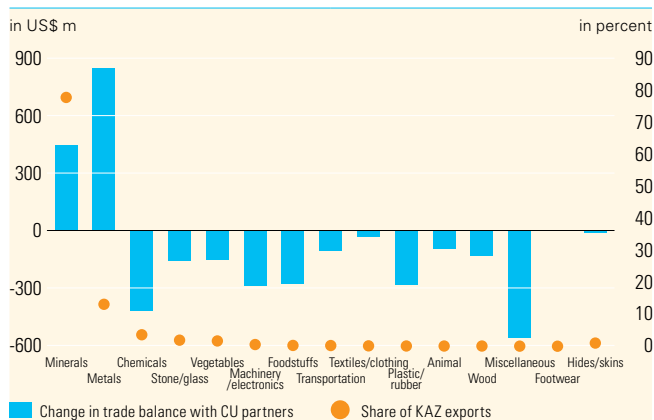
Relationship between CU Tariff Changes and Market Share Changes in Kazakhstan, EU-27 (yellow) vs. China (blue)



Source: Authors' calculations based on Kazakhstan Customs Authority data and UNCTAD Trains data.

**Figure 2.5. Trade Balance Worsened Relative to CU Partners in Most Product Categories**

Change in Kazakhstan Trade Balance with CU Partners, 2010–11 vs. 2007–09



Source: Kazakhstan Customs Authority.

Note: Trade balance reflects average exports and imports in periods 2007–09 and 2010–11; Share of exports represents product category share of total Kazakhstan exports to all global markets in 2011.

**Table 2.9. CU May Have Boosted Certain Export Products Such as Food, Machinery and Footwear**

Exports to CU Partners by Broad Product Category, Value and Share

	Value (in \$million)					Share (%)				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Minerals	2,206	3,402	1,829	2,912	4,222	46	53	51	52	55
Metals	836	1,250	757	1,570	2,020	17	20	21	28	27
Chemicals	1,045	940	637	757	636	22	15	18	13	8
Machinery/electronics	232	269	126	177	361	5	4	4	3	5
Textiles/Clothing	89	56	59	66	70	2	1	2	1	1
Vegetables	231	234	102	64	64	5	4	3	1	1
Plastic/rubber	28	44	24	31	50	1	1	1	1	1
Foodstuffs	25	29	22	23	48	1	0	1	0	1
Transportation	50	117	12	11	42	1	2	0	0	1
Footwear	1	1	1	1	40	0	0	0	0	1
Miscellaneous	5	6	5	3	22	0	0	0	0	0
Stone/glass	5	12	3	4	22	0	0	0	0	0
Animal	24	27	19	13	15	0	0	1	0	0
Wood	9	9	5	3	3	0	0	0	0	0
Hides/skins	3	0	0	1	2	0	0	0	0	0
Special	-	-	0	1	1	-	-	0	0	0

Source: Kazakhstan Customs Authority.

**Table 2.10. Fastest-Growing Exports to CU Include Non-Traditional Exports**

Kazakhstan's Fastest-Growing Exports (HS2) to CU Partners

HS2 products	Share of CU exports 2011	KAZ exports to CU partners (US\$'000)	
		2008	2011
Oil seeds and oleaginous fruits; mi	0.2%	5,438	11,778
Sugars and sugar confectionery	0.2%	11,689	17,207
Cocoa and cocoa preparations	0.2%	92	12,635
Ores, slag and ash	29.7%	1,527,403	2,263,108
Organic chemicals	0.3%	4,331	20,482
Plastics and articles thereof	0.4%	20,367	29,410
Articles of apparel and clothing ac	0.1%	1,165	11,135
Articles of apparel and clothing ac	0.2%	676	17,267
Footwear, gaiters and the like; par	0.5%	1,442	39,343
Articles of stone, plaster, cement,	0.2%	8,336	14,003
Articles of iron or steel	1.6%	32,425	123,206
Copper and articles thereof	6.5%	144,286	497,916
Aluminum and articles thereof	3.4%	21,503	261,673
Tin and articles thereof	0.1%	0	10,542
Nuclear reactors, boilers, machiner	3.6%	179,256	273,068
Optical, photographic, cinematograp	0.2%	3,526	12,326
Furniture; bedding, mattresses, mat	0.1%	1,631	5,050

Source: Kazakhstan Customs Authority.

Note: Table shows all HS 2 products with a 2011 export value of at least US\$5 million to CU partners and a at least 50 percent growth in value of CU exports between 2008 and 2011 (equivalent to 14.4 percent CAGR); Share of CU exports represents product category share of total Kazakhstan exports to CU partners in 2011.

by helping stimulate growth in nontraditional exports. However, under a future WTO scenario, Kazakhstan may not remain competitive in at least some of these sectors (e.g. clothing, footwear, furniture).

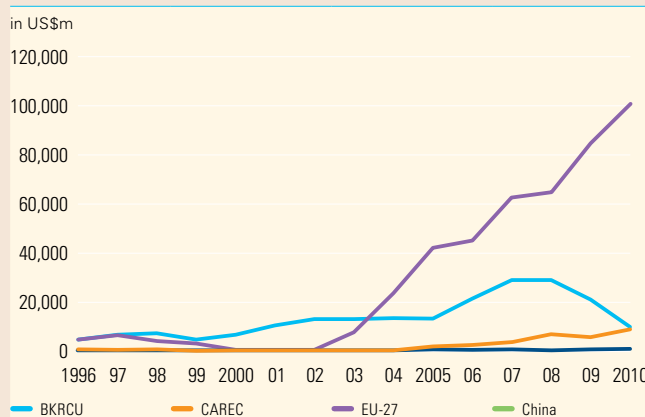
*With access to firm-level data it would be possible to understand how much the CU has encouraged individual exporters to change their trade patterns and whether the shifts are related to the products they trade or to specific firm characteristics (e.g., size, ownership, even location within Kazakhstan). This could help the government to better anticipate the direction of future trade patterns and how traders might react to such policy changes as WTO accession. Econometric analysis of firm-level data would also make it possible to quantify how tariff and nontariff changes required by the CU have impacted individual firms, and through which channels.*

### Box 2.1. Impact of Market Dynamics on Fish and Meat Exports

The figures below indicate how changing market dynamics have impacted fish and meat exports. Russia has always been an important market for Kazakh fish, but the rapid growth of exports is due to opening new export markets in the EU. There is no evidence that the CU has contributed to any tangible increase of fish exports to CU partners.

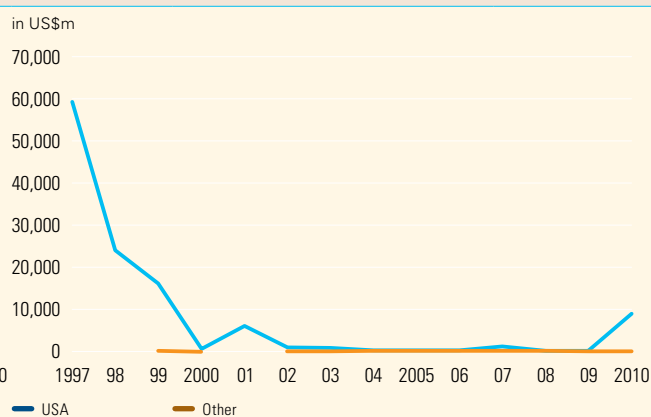
Meat exports, by contrast, were and still are almost exclusively destined for Russia, but after the break-up of the Soviet Union this market declined steadily through the 1990s; and because of some supply side problems, Kazakhstan's meat industry was unable to secure new markets. Comtrade data on Russian imports show, however, significant imports of meat from Kazakhstan in 2010 (the latest year available) although this does not show up in export data from the Kazakhstan Customs Authority (see below). There does, however, seem to be potential to leverage the CU to support a return of the beef export sector. Indeed, the government is putting significant resources into rebuilding the sector and is targeting 60,000 tons of exports (again primarily to Russia) within five years, with expansion globally to 180,000 tons by 2020.

**Figure B2.1. Fish Exports by Market: 1996–2010**



Source: Comtrade (via WITS).

**Figure B2.2. Meat Exports by Market: 1996–2010**



### Impact of CU on Foreign Investment into Kazakhstan Cannot Yet be Determined

**2.24.** One of the intended benefits of the CU was to attract more FDI. Kazakhstan was expected to be an attractive destination, for example, for those investors looking to enter the Russian market but not prepared (for



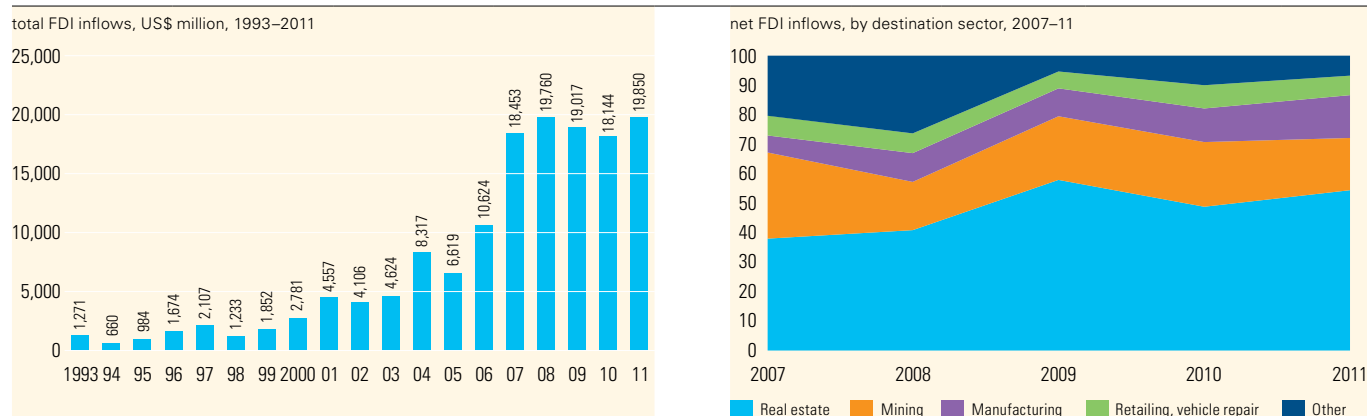
investment climate or other reasons) to invest directly in Russia. Two years into the CU, it seems as though it would be possible to gauge whether the private sector thinks the CU has indeed made Kazakhstan more attractive.<sup>12</sup>

**2.25. FDI inflows indeed increased dramatically in 2007 before the crisis, fell somewhat in 2009 and 2010, and then rebounded to nearly \$20 billion in 2011 (Figure 2.6, left panel).** FDI inflows increased 9 percent in 2011; however, this was far below the growth of global FDI flows (17 percent).<sup>13</sup> The majority of FDI from 2007 through 2011 went into real estate, followed by energy and minerals—together these sections accounted for as much as 80 percent of total FDI inflows for the period (Figure 2.6, right panel). While the manufacturing sector has been a relatively minor recipient of FDI, its share grew substantially in 2010 and 2011, reaching 15 percent, US\$3 billion, in 2011. The metals sector dominates manufacturing FDI, accounting for up to 80 percent of these inflows. It is primarily responsible for the significant growth of manufacturing FDI observed in 2010 and 2011.

*With access to firm-level data it would be possible to track the changing structure of exporting firms in terms of ownership composition (share of FDI) and how this varies by sector. It would then be possible to assess how the degree of FDI ownership impacts trading patterns, decisions to expand into new markets and products, productivity, quality upgrades, and many other critical issues.*

**Figure 2.6. Increasing FDI Inflows Concentrated in Oil Production, Metals and Non-Tradables**

FDI Inflows to Kazakhstan: by Value (left) and Share by Sector (right)



Source: National Bank of Kazakhstan.

**2.26. The EU-27 is by far the largest source of investment and despite the crisis has grown in importance (Figure 2.7).** In 2011 EU-based firms accounted for close to 60 percent of all FDI in Kazakhstan. The biggest trends are the relative decline in FDI from the U.S. and the relative growth from China. FDI from Russia has been stagnant in recent years.

**2.27. How the CU has shaped these FDI trends is not readily discernible.** One reason is that while data is available on FDI by source country and by sector, there are no data on sectoral breakdown of investment by source country. And even if this data did exist, without knowing more about investment specifics, it would be difficult to

<sup>12</sup> Of course, given the dominance of large sectors like oil, gas, minerals, and metals in Kazakhstan it will, as always, not be simple to discern trends in the non-energy and minerals sector. In addition, global macro trends, particularly related to the continuing global economic crisis, may also obscure the underlying trends.

<sup>13</sup> [http://www.unctad.org/en/docs/webdiaeia2012d1\\_en.pdf](http://www.unctad.org/en/docs/webdiaeia2012d1_en.pdf)

know if the investments were linked to CU dynamics. As we know, Kazakhstan is exporting substantially more metals to CU partners now. And we know that in recent years there has been a significant increase in FDI in the Kazakhstan metals sector. What we do not know is whether these two facts are directly linked.

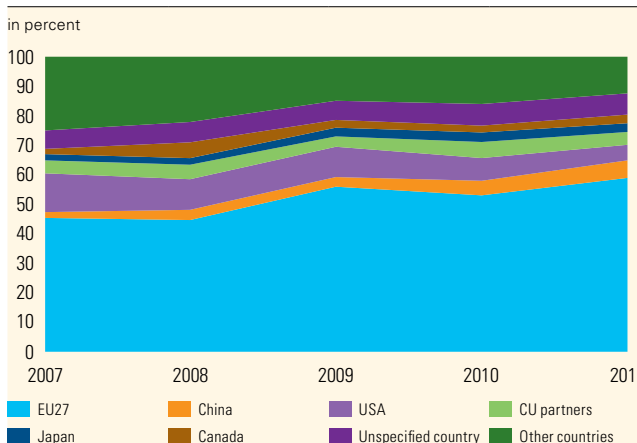
#### D. How can Kazakhstan get Maximum Benefit from the CU?

**2.28. How can Kazakhstan maximize benefits from the CU?** There are several strategies that Kazakhstan could pursue in order to better leverage the CU, including:

- **Pushing beyond the CU to WTO.** Relative to the CU, Kazakhstan has much more to gain from the next stages of trade policy reform, mainly WTO accession. Certainly the WTO offers the prospect not only of putting the tariff regime back on a more liberal path (thus giving producers in non-resource-intensive sectors access to intermediate inputs at competitive price and quality levels), but also opening up the market to build a more competitive services sector. Kazakhstan should use the WTO accession framework rather than the CU and CES to reform the system of TBT, SPS, customs valuation, liberalization of services regimes, transparency in trade, rights of foreign investors and subsidy limitations.
- **Taking leadership of the CU reform agenda, starting with NTMs and trade facilitation.** Given the obvious power imbalances in the CU, reforms will only be to the advantage of Kazakhstan if it takes an offensive position as the CU's reform leader. This should start with the NTM and trade facilitation agenda, which, as discussed in detail in the next chapter, should deal with the greatest barriers to Kazakhstan reaping gains from the CU. Clearly, taking leadership of the CU reform agenda will not be easy. To take up—and deliver on—leadership, Kazakhstan must accurately evaluate the CU regulatory regime to identify all trade restrictions that are distortive and an actual or potential detriment to export diversification, quality upgrading, and adding more value. To achieve this and also negotiate effectively on the WTO and CES, Kazakhstan needs much more effective government capacity for trade policy.
- **Prioritizing reforms to increase competitiveness in emerging sectors.** Although the CU does seem to support Kazakhstan's specialization in minerals and metals, in sectors that have the potential to emerge but are still marginal—in particular agribusiness (outside of wheat), chemicals, and possibly machinery—Kazakhstan's exporters are confronted with Russian firms that are often more competitive. To realize the potential of these emerging sectors will require a fast-track reform agenda to raise their competitiveness.
- **Targeting FDI.** One of Kazakhstan's potential gains from the CU would be to become the base for FDI to serve the entire CU. This could be particularly valuable in facilitating diversification because FDI can offer an immediate step-change in participation in new or emerging sectors. More importantly, FDI offers the possibilities of spillover of technology and knowledge to support upgrading throughout Kazakhstan's commercial sector. Other than outside of sectors where Kazakhstan is already specialized, why would foreign investors come to a small, landlocked market to serve Russia and Belarus, when they could locate either inside the dominant market (Russia) or in the market at the doorstep of Europe (Belarus). However, neither of these markets could

**Figure 2.7. Major Source of Foreign Investment is EU**

Share of FDI Inflows By Source Country, 2007–11



Source: National Bank of Kazakhstan.

be considered investor-friendly, so the opportunity may still be there—if Kazakhstan can establish itself as a clear investor-friendly alternative.

## E. Conclusions

**2.29. Kazakhstan is facing a changing external environment as it confronts tightening global demand, changing global growth patterns, and rapidly evolving trade policies.** Changes on the horizon include a Common Economic Space and WTO accession. In this context, this chapter has outlined the evolution of trading partners over the last decade and the impact of changes arising from recent membership in the CU.

**2.30. It may be too early draw any solid conclusions about the impact of the CU on Kazakhstan's growth and its efforts to diversify, but early indications are that benefits have been limited.** Prior to the CU, trade partners diversified away from Russia, but after the CU went into effect, trade flows, especially imports, diverted from the EU across several sectors toward Russia. Intra-CU trade has furthered Kazakhstan's specialization in energy, minerals, and metals, although under a protected environment, Kazakhstan has seen an opening in some non-resource market opportunities within the CU. Given data limitations, it is hard to glean a positive impact of the CU on FDI.

**2.31. As described in the first chapter, it would be possible to extend this chapter's analysis with access to firm-level data.** Questions that could be answered using firm-level data include:

- Was the shift in markets away from Russia over the last decade and then a reversion toward Russia a function mainly of shifts among sectors or individual firms? Have new exporters influenced the patterns of trade with China and Russia?
- Which margins of trade give more scope for increasing exports generally and to specific markets? For example, would exports increase by helping a greater number of firms to export, helping existing firms enter new markets and increase their product range, or increase how much they export of a given set of products?
- How has the CU changed the trade patterns of individual exporters and were the shifts related to products they trade or to specific firm characteristics? How have tariff and non-tariff changes in the CU affected individual firms?

**2.32. To mitigate any negative impact of the CU, this chapter recommends continued efforts toward WTO accession that could offer more benefits to Kazakhstan than regional arrangements,** taking leadership of the CU reform agenda, increasing productivity in emerging sectors to compete with Russian firms, and stepping up efforts to attract FDI intended to serve the entire CU market.

**2.33. The next chapter will explore trade barriers that impede market access and access to critical intermediate inputs,** including non-tariff measures and trade facilitation bottlenecks as critical areas that may impede development of competitive export sectors outside of energy and minerals. They are discussed both as areas in need of ongoing reform as well as complications brought by the CU.

## Chapter 3. Improving Access to Markets and Competitive Inputs

### A. Introduction

**3.1. Access to inputs and markets is critical for a landlocked and large country like Kazakhstan to reach competitive scale and encourage constant upgrade of quality and sophistication of production and exports.** Market access matters for imports as well as exports, particularly given the increasing importance of global value chain production in which access to timely, high-quality imports is critical to an exporter's competitiveness. Tariff policy, NTMs, and the degree of trade facilitation are factors that directly affect the extent of access to competitive inputs and markets and therefore long-term productivity and competitiveness.<sup>14</sup> The international indicators assessing Kazakhstan's trade enabling environment dropped over the last two years. On the World Economic Forum's Global Enabling Trade Index, Kazakhstan's score declined between 2010 and 2012 in absolute terms from 3.71 to 3.5 and its rank dropped from 88th place out of 125 economies to 105th place out of 132 economies.

**3.2. The previous chapter described the impact on trade patterns of Kazakhstan's move from a generally liberal tariff regime to the customs union's Common External Tariff.** This chapter shows that this diversion has been especially apparent in intermediate inputs. This potentially inhibits inputs of the highest quality, typically from the most advanced industrial economies, and access to the full range of inputs from any producer worldwide. Indeed, the EU's import share of intermediates was significantly hurt. While tariffs may come down in the case of WTO accession, they will likely still be substantially higher than prior to the CU.

**3.3. Kazakhstan's reform of non-tariff measures to upgrade its trade regulations in preparation for WTO accession was also shifted by considerations related to the CU.** As described in this chapter, the CU added to the number of Kazakhstan's technical regulations, changed the direction of harmonization from EU standards to CU standards, made certification more difficult, and brought uncertainty to the private sector. The chapter recommends increasing transparency, continuing with the adoption of voluntary certification, balancing between regional and multilateral commitments, and having a comprehensive and coordinated reform agenda that, among other things, leverages WTO accession to minimize negative impact from the CU on Kazakhstan.

**3.4. Kazakhstan's uneven progress in improving the level of trade facilitation and logistics limits access to inputs and markets and the ability of the country to serve as a regional trade hub.** On international indicators, Kazakhstan's logistics performance declined precipitously from 2010 to 2012. While connectivity overall is increasing, Kazakhstan's efforts to improve road and rail infrastructure must be supplemented by improvements in the quality and efficiency of logistics services, as well as reducing delays at customs and other border agencies.

**3.5. Section B of this chapter details how CU tariffs have inhibited access to intermediate inputs.** Section C assesses the fast-evolving state of NTMs, both national and regional, Section D discusses Kazakhstan's performance in trade facilitation and logistics, and Section E provides conclusions.

<sup>14</sup> With free trade in inputs, "each country essentially confers a positive technological externality on its trading partner" (Markusen 1989). Feenstra et al. (1999) show that an increase in input variety is positively correlated with TFP.

## B. Tariff Policy

**3.6.** The previous chapter showed that 70 percent increase in Kazakhstan's tariff protection level due to the CU caused diversion of imports from EU toward CU partners, and this section focuses on the impact of that tariff increase on intermediate inputs. Given the link between imports and productivity, the degree to which trade diversion has impacted intermediates has likely undermined Kazakhstan's competitiveness. Intermediate inputs are essential, particularly in context of increasingly integrated global value chains, and success in these sectors (especially advanced sectors like machinery, electronics and automobiles) is dependent on access to high quality inputs. However, this is where the CET has brought the biggest tariff increases. Table 3.1 shows that, aggregated across broad product categories, machinery/electronics faced a nearly 400% increase in average tariff and transportation equipment faced between a 500% and 900% increase. With WTO accession of Russia and potentially its CU partners, these rates will decrease, but still will likely remain higher than previously was the case.

**3.7.** In this context, the following demonstrates how the CU has been problematic. With regard to intermediate inputs, trade diversification has been particularly strong, as CU partners have taken share from both EU and China. While CU partners have taken a significant share of the Kazakhstan market across most categories of goods, they have done particularly well in intermediates (Table 3.2). In the Broad Economic Category (BEC) of intermediate inputs, imports from CU partners increased from 34 percent in 2009 to 48 percent in 2011, while imports from EU-27, the second main source of intermediate inputs, decreased from 25 percent to 19 percent. Even China, which had been growing its share of intermediates through 2009, has lost a significant share, from 15 percent in 2009 to 12 percent in 2011.

**3.8.** The main concern for Kazakhstan is accessing inputs of the highest quality, typically from the most advanced industrial economies, and accessing the full range of inputs from any producer worldwide. In other words, for any given product, Kazakhstan's producers may now be more restricted based on price to a smaller range of the quality ladder within the CU, even though a much larger variety at all quality levels is available from

**Table 3.1.** CET Brought Highest Tariff Increases in Areas of Transport and Machinery/Electronics

Percent Change in Simple Average Tariff, By Product Category, Pre- to Post-CU, EU-27 and China

	EU27	China
Transportation	563%	925%
Machinery/electronics	371%	371%
Wood	98%	91%
Stone/glass	80%	68%
Metals	64%	59%
Minerals	53%	112%
Textiles/clothing	50%	50%
Hides/skins	37%	77%
Chemicals	27%	38%
Miscellaneous	25%	46%
Footwear	11%	4%
Plastic/rubber	6%	9%
Vegetables	1%	3%
Animal	-12%	-14%
Foodstuffs	-18%	-8%

Source: Author's calculations based on UNCTAD Trains data

**Table 3.2.** Share of CU Partners Has Increased in Kazakhstan's Intermediate Imports

Sources of Kazakhstan's Intermediate Imports

	2007	2008	2009	2010	2011
CU Partners	44.2	39.9	33.8	43.6	47.5
China	11.3	15.8	15.1	13.6	12.4
EU27	20.1	20.4	25.3	22.0	18.7
MENA	0.9	0.9	0.7	0.8	0.7
Non-CU CIS	10.1	9.9	12.1	5.6	6.3
North America	4.1	4.0	4.3	4.8	5.5
Rest of Asia	3.4	3.0	3.7	4.2	4.4
Rest of Europe and ECA incl. Turkey	4.2	4.1	2.9	3.1	2.4
Other	1.8	2.1	2.1	2.4	2.1

Source: Authors' calculations based on UNCTAD Trains data

producers outside the CU. Innovations that enter the world marketplace may only be available at higher cost than was previously the case.

*With access to firm-level data it would be possible to understand how firms have shifted their sources of imported inputs since the CU and whether the shift has been larger in some sectors than others. More importantly, it would be possible to link the changing sourcing patterns to outcomes like productivity, quality (unit prices achieved), and value added.*

## C. Non-Tariff Measures

**3.9. Tariff diversion is happening and impacting access to inputs (and market access), but from our analysis a bigger problem are actually non-tariff measures.** Box 3.1 describes the regulations that are typically considered NTMs. It is estimated that one-third to two-thirds of traded goods are affected by at least one NTM. Unlike tariffs that directly push up directly the price of imports and indirectly affect import quantities, NTMs tend to limit quantities directly and cost indirectly. NTMs tend to have as much of a trade-reducing effect as tariffs. Estimates by Hoekman and Nicita (2008) suggest that halving the ad valorem equivalent of NTMs (from about 10 percent to 5 percent) would boost trade by 2–3 percent. Some NTMs are called nontariff barriers (NTBs) when they intentionally aim to restrict trade; an example of import quotas that limit the quantity of some goods that may be imported. However, since the WTO forbids quantitative restrictions, NTBs have been reduced.

### *NTMs Are in a Period of Transition and Data Gaps Exist*

**3.10. Kazakhstan has traditionally been portrayed as a relatively open economy because of its relatively low tariff protection, liberal non-tariff regulations and intentions of harmonizing NTMs with the EU.** After joining the CU, Kazakhstan has changed its trade policy direction and is in the process of transition from a national trade regime to a supranational one. In terms of NTMs, this transition raises several concerns, including a multi-country NTM governance process, the presence of several choices to address NTMs at the regional level, and the manner of achieving better regulations, i.e. a regulatory environment that is economically efficient while serving legitimate societal objectives. Initial analysis demonstrates that Kazakhstan is in the process of aligning its trade policies with Russia's more protectionist policies, characterized by higher external tariffs and more stringent standards and technical regulations.

**3.11. Data on NTMs in Kazakhstan is scarce, if available at all.** The efforts are under way to improve this data gap and collect the NTM information following the new guidelines and universal NTM nomenclature adopted by UNCTAD, the WTO, and other development partners.<sup>15</sup> In addition, NTMs suffer from a fragmented authority because of their diverse nature: typically a large number of government agencies and ministries, including Health, Agriculture, Trade, Industry, Standards and Metrology bureaus, issue and enforce NTMs. These agencies often do not coordinate with each other, or coordinate only weakly. Nonetheless, as import tariffs have been reduced

<sup>15</sup> In light of the lack of raw and solid data on NTMs, this section relies to a large extent on consultations with the government and the private sector, as well as anecdotal evidence. However, the World Bank is providing technical assistance (TA) to the government of Kazakhstan to improve the transparency and the knowledge state on NTMs. The TA program includes various mutually reinforcing activities: (i) NTM data collection according to the international nomenclature of NTMs; (ii) action plan on moving from mandatory to voluntary certification; and (iii) build government capacity to review the impact of NTMs, in particular the list of the CU licenses and quotas.

### Box 3.1. Nontariff Measures and Competitiveness

Nowadays, NTMs are typically trade-related regulations, such as product standards or labeling requirements that are imposed for legitimate purposes, such as protecting public health or the environment, but that may restrict trade intentionally or unnecessarily. Governments may twist normal health and safety standards or custom procedures so as to place additional costs on foreign exporters, thereby limiting imports. UNCTAD has a standard nomenclature for defining NTM categories that is perhaps the most comprehensive definition of NTM. It includes:

- Sanitary and phytosanitary measures (SPS)
- Technical barriers to trade
- Preshipment inspection and other formalities
- Price controls
- Licenses, quotas, prohibitions, and other quantity control measures
- Charges, taxes, and other paratariff measures
- Finance measures
- Anticompetitive measures
- Trade-related investment measures
- Distribution restrictions
- Restrictions on post-sales service
- Subsidies (excluding certain export subsidies included under export-related measures)
- Government procurement restrictions
- Rules of origin
- Export-related measures

When poorly designed and adopted with little consultation with the private sector, NTMs may hurt competitiveness by constraining the ability of companies to outsource key inputs, putting them at a competitive disadvantage on international markets. NTMs also often complicate day-to-day business and distract managerial attention. Firm surveys highlight demands for more transparency about NTMs across countries.

With the prominence of NTMs and their relatively opaque impact on imports and the exports that rely on imports, streamlining NTMs is important to any competitiveness agenda. Since governments can use NTMs to pursue different policy objectives and they may be implemented by a variety of government agencies, it is crucial that they be transparent, consistent, efficient, and nondiscriminatory, and distort trade as little as possible. In reality, NTMs habitually lead to excessive, complex, costly, and often redundant procedures that dampen the competitiveness of importers and exporters, even when the public policy objectives behind them are legitimate.

*Source: Authors.*

worldwide and locked in under the twin pressures of multilateral rounds and preferential agreements, NTMs have grown significantly until they are now one of the largest concerns in trade policy. As a result of a multi-agency effort, NTM data collection has improved worldwide in the past couple of years, mainly in emerging economies of East Asia and Latin America, but also in Africa and South Asia. Kazakhstan is the first country in Europe and Central Asia to have initiated the NTM data collection (Table 3.3).



**Table 3.3.** Kazakhstan Has Become the First ECA Country to Initiate NTM Data Collection

NTM Data Collection Worldwide

	LAC	NA	ECA	MENA	SSA	SA	EAP
Covered	Argentina		E.U.	Egypt	Kenya	Bangladesh	Japan
	Bolivia			Lebanon	Mauritius		Philippines
	Brazil			Morocco	Tanzania		Indonesia
	Chile			Tunisia	Uganda		Cambodia
	Colombia				Senegal		Laos
	Ecuador				Namibia		HK, China
	Mexico				Burundi		
	Paraguay				Madagascar		
	Peru				South Africa		
	Uruguay						
	Venezuela						
Expected 2012/13	Costa Rica		Kazakhstan		Cameroon	India	China
	Guatemala					Pakistan	
	Honduras					Sri Lanka	
	Panama						
Large countries missing		USA	Russia	Turkey	Nigeria		Korea
		Canada					Malaysia

Source: authors.

*Unilateral Reforms Made Some Progress but CU Considerations Have Become the Focus*

**3.12. The design of trade regulations reflects increasingly regional commitments rather than unilateral and multilateral considerations.** The government of Kazakhstan has made considerable unilateral progress in past years to upgrade its trade regulations in preparation for WTO accession by the end of 2012. It also signed an agreement with the EU to comply with the European legislation in 2005, and that process was close to completion in 2010. Internationally recognized accreditation had also been established and certification institutions had been privatized. Yet the core of the system, the formulation of technical regulations and the use of mandatory certification has essentially remained in place. The current system still emphasizes government control and uses prescriptive mandatory technical regulation and inflexible government-driven conformity assessment methods to manage quality issues. The NTM agenda is currently mostly driven by regional integration considerations. For example, CU members signed an agreement on technical regulations in November 2010, adopting a common regime to be applied to imports into the CU. Members have also adopted a work program to draft common technical regulations and standards.

**3.13. Discussions with government and businesspeople indicate that technical regulations and certification procedures have become more stringent.** For example, although the CU members signed an agreement on mutual accreditation in 2009, the Russian legislation still stipulates that only Russian certification authorities can issue certificates and declarations of conformity to Russian GOST standards.<sup>16</sup> Private firms revealed that the Russians still

<sup>16</sup> GOST standards are a collection of standards covering general and technical specifications as well as safety requirements covering applied by Russia and former states of the Soviet Union, including Kazakhstan in about 20 industries.



require that Kazakh firms be inspected and registered by the Russian certification authority to be able to export to Russia. In fact, it was reported that individual Russian regions sometimes required certifications.

**3.14. In fact, various options exist in terms of regulatory simplification of technical regulations in regional blocs, going from simple information sharing to mutual recognition and full harmonization.** The Belarus-Kazakhstan-Russia (BKR) CU is currently a mixture of partial harmonization and mutual recognition. A number of products have been granted mutual-recognition status. In parallel, a number of new, harmonized regulations have been adopted collectively by the CU for application in all member States.

**3.15. Technical regulations should be used exclusively to regulate a narrow set of legitimate objectives, such as consumer safety and safeguarding the environment, while leaving other quality management issues to market forces and private initiatives often in the form of voluntary standards.** Moreover, the alignment with international standards is recommended to reduce the trade restrictiveness of technical regulations. However, the positive effects of harmonization depend on the appropriateness of the given international standards. Some standards address problems for which the optimal configuration of the standards depends on local conditions such as institutional capacity. The WTO SPS and TBT encourage the use of international harmonization as a trade facilitation tool but stop short of making harmonization mandatory.

### *Transition to Voluntary Certification Will Bring Benefits*

**3.16. On a positive side, the government is planning to move from mandatory to voluntary certification to technical regulations,<sup>17</sup> increasing the range of choices for the private sector on how to comply with Kazakh technical regulations, thus raising incentives to innovate and modernize compliance technologies.** Voluntary certification (like the EU approach, which is the benchmark Kazakhs prefer) would allow open voluntary standardization system to support regulation.<sup>18</sup>

**3.17. Employing a system of voluntary certification to technical regulations allows products to operate on a free market basis.** Certification of a product is performed at the applicant's initiative, whether by a product's manufacturer or importer desiring to introduce the product into a market. Voluntary certification systems are easier to implement and more cost-effective than mandatory certification systems that require product approvals, inspections and certifications before a product enters the market. No approval is required before a product enters the market through voluntary certification, which can result in significant cost savings and lead times. The resources saved in this transformation will directly benefit producers, Kazakhstan and its consumers. Kazakhstan may consider it necessary to maintain mandatory certification for certain high risk products. In these instances, mandatory certification should be based on international standards, with minimal deviation for matters deemed necessary by Kazakhstan. Furthermore, mandatory certification requirements should not be used as technical barriers to trade and should facilitate the uniform mutual recognition of all products conforming to these technical requirements at all Kazakh customs points of entry, as well as eventually throughout the entire Customs Union. Therefore, the burdens caused to manufacturers and traders for guaranteeing consumer and environmental product safety within Kazakhstan can

<sup>17</sup> Voluntary certification is used to establish performance-based technical regulations rather than the prescriptive technical regulations common in Kazakhstan today. Performance-based regulations focus on defining the objective of the regulation while allowing flexibility in the choice of conformity assessment.

<sup>18</sup> In the European approach, technical regulations define 'essential requirements' which are the objectives of regulation, while the means by which to achieve compliance are left to the choice of the private sector. European standardization bodies set standards through an open, consensus-based process. Firms complying with such standards are assumed to be in compliance with the technical regulations, but may choose different means to comply, as for example their own procedures, conditional on their ability to demonstrate that such alternative means of compliance meet the objectives of the technical regulations defined as the 'essential requirements'.

be minimized by ensuring mandatory certification based on international standards and is required only once, thereby preventing trade-restrictive duplicative conformity assessment measures.

**3.18. The transition to voluntary certification requires a strategic approach focusing on resources and political will.** It should also take place in areas where the chances of success are the greatest and the rewards in terms of private sector benefits and the realization of public objectives like consumer safety or environmental protection are the highest. To this end, consensus-building and consultations with the private sector and civil society is crucial. The strategic approach should develop knowledge of the challenges the current technical regulation system poses to its end users: the private sector, consumers and the Kazakhstan government. Simultaneously, Kazakhstan must learn from foreign models and international best practice while adapting these lessons to the needs of Kazakhstan using a strategic approach.

**3.19. Moreover, this process will require legislative and regulatory reform.** As provided in Kazakhstan's Law on Technical Regulation and as committed by Kazakhstan under the applicable WTO transparency rules and obligations, the proposed changes and amendments of Kazakhstan's legislation will have to be communicated to the interested parties and comments received from the interested parties will have to be taken into consideration. This requirement opens up a possibility negotiate Kazakhstan's WTO accession terms, in light of possible bilateral deals and preferential trading arrangements.

### *Balancing Alignment with Regional Partners and International Partners Essential*

**3.20. The regional agenda should be viewed as a stepping stone for, and not becoming an obstacle to, global integration.** A major source of uncertainty is the stringency of CU technical regulations and certification requirements that are applied to import and export with the rest of the world. One Kazakh firm reportedly had to apply Russian certification requirements—inspection of foreign firms by the Russian certification authority—to import from Latin America. Another example is related to the preparation of a new CU regulation on Volatile Organic Compounds (VOC) emissions for wood particle plates used by the furniture industry (see Box 3.2). Policymakers should make sure that CU technical regulations and standards not only respond to legitimate concerns, such as food safety, but also are formulated in a way that offers real protection without inflicting unnecessary costs on firms and consumers, or are becoming a disguised way to restrict trade. As far as non-technical measures are concerned, complicated tariff-quota schemes seem to make their appearance for some agricultural products (e.g. meat) motivated by complicated infant-industry schemes. According to the spirit of WTO disciplines, border measures should rely as much as possible on ad-valorem tariffs rather than QRs and complicated instruments like tariff-quotas (TRQs).<sup>19</sup> Yet in a number of agricultural products, the CU has involved a move in the opposite direction for Kazakhstan, as a largely tariff-based regime has been replaced by a complicated TRQ one with a mixture of ad-valorem and specific tariffs.

**3.21. To reform Kazakhstan's SPS and TBT rules, it is necessary to align them with the legal, regulatory, economic, and institutional frameworks of both the CU and other trading partners, notably the EU.** The Kazakh framework must also meet the expectations expressed in Kazakhstan's WTO Accession Protocol and what is being further negotiated in Geneva.<sup>20</sup> Simultaneously, the framework must meet domestic needs for transitional

19 A tariff-quota or tariff-rate quota (TRQ) is a system whereby a certain duty rate (the "in-quota tariff", typically low) is payable up to a certain quantity (the "quota"), after which additional quantities are hit by a higher duty rate (the "out-of-quota tariff"). The use of TRQ is fairly widespread in agriculture.

20 The Russian accession protocol on TBT/SPS will impact the Kazakh regime through the CU. The team has not been able to consult the draft Kazakh WTO accession protocol, but presumably it is partly modeled on the Russian one – since the intention of creating a Common Economic Space assumes developing a common technical regulation framework.

### **Box 3.2.** The Dangers of Over-Stringent Technical Regulations

According to consultations with the government and the private sector in Kazakhstan, Russia's Ministry of Health is preparing a regulation on Volatile Organic Compounds (VOC) emissions for wood particle plates used by the furniture industry. VOCs are widely used as solvents in glues that enter the manufacturing of household furniture, carpets, paints and varnishes. They are known to be greenhouse gases and ozone-depleting substances, and widely suspected to be also allergens and carcinogens. They are sometimes responsible for higher levels of air pollution indoor than outdoor, which is a serious issue since most households spend close to 70% of their time indoor.

E.U. member States started regulating VOCs in the 1980s, and disparate levels of regulation were consolidated in Council Directive 1999/13/EC on the limitation of emissions of volatile organic compounds due to the use of organic solvents in certain activities and installations, known as the VOC Solvents Emissions Directive, which covers occupational safety, and others. Product-level tolerance limits on VOCs are set by EN120 at 8 mg of formaldehyde for a hundred-gram wood-particle plate, equivalent to 0.124 mg/m<sup>3</sup> of air or 0.1 ppm under standard testing conditions set out in standard 717/1. There is no specific emissions level for furniture itself.

According to information gathered by the private sector in Kazakhstan, the new regulation considered by Russia's Ministry of Health, slated to enter in force CU-wide in 2014, would set this level at 0.4 mg/100g, or about half the E.U.'s maximum tolerance limit (MTL). This would be an unrealistic level both in terms of what is needed to protect human health and the environment and in terms of compatibility with local production capabilities in all three member states.

The case illustrates several dangers of a regulatory process that is not subject to a Regulatory Impact Assessment:

- providing a convenient non-tariff barrier that can be activated at will;
- It may be triggered by upstream interests promoting the use of massive wood rather than particle plates; this may not necessarily be a bad thing from an environmental point of view but should be a reasoned decision;
- It may be simply a way of putting all producers and importers in a state of permanent violation of rules, facilitating the extraction of irregular payments upon inspections.
- An unrealistic MTL may end up being enforced only at the border and in a discretionary manner. It is quite possible that none of these consequences is intended, but their mere possibility illustrates the dangers of regulations being designed with insufficient use of existing checks and balances.

*Source: authors.*

arrangements and for standards and technical regulations addressing legitimate domestic regulatory goals, such as food safety. Finally, Kazakhstan's future SPS and TBT rules should be harmonized with international standards as appropriate, and introduce international best practices for technical regulations and standards. A further complication is that Kazakh quality standards, according to the private sector, are not keeping pace with international development. This is particularly true for higher technology sectors and, critically, agro-foods. The latter in particular harms the prospects of diversification, both within the CU and toward the EU.

**3.22. In addition, the regional agenda on NTMs, in particular standards and technical regulations, while collaborative in principle and based on full consensus, seems to be mostly driven by the Russian authorities, with the Kazakh authorities mostly reacting.** Even in the absence of manipulative intentions, harmonization can

contribute to lock in trade patterns in a hub-and-spoke structure, reinforcing the potential for the Common External Tariff to generate trade diversion, an issue that is already significant for the Belarus-Kazakhstan-Russia CU.

### *Important to Clarify Way Forward Especially With Respect to WTO Accession*

**3.23.** Beyond this transition phase, it does not seem to be entirely clear what model the BKR CU is aiming for. The current environment is therefore characterized by a combination of national regulations with new technical regulations developed at the level of the CU and a variety of certification procedures. What is needed are greater transparency, a clearer roadmap, and a formal dialogue with the private operators to clear up the confusion and uncertainty about what is being applied, even by private certification bodies.

**3.24.** A critical question is whether Russia's (and eventually Kazakhstan's) accession to the WTO will reverse and reduce the NTBs that the CU has increased (see Box 3.3). For Kazakhstan, then, it will not be enough to

#### **Box 3.3.** The Customs Union's Nontariff Regime and Russia's WTO Accession

Russia's accession to the WTO is a major milestone because the obligations of the Russian Federation to reduce nontariff barriers will affect the other CU parties. The transmission channel through which Russia's WTO obligations spread to Belarus and Kazakhstan is the Customs Union Commission (CUC), established in 2007, and charged with, inter alia, making decisions about nontariff regulations on trade in goods. CUC decisions are binding on all CU members. This process was formalized in May 2011 in the CU Treaty on the Multilateral System, which established that, upon the WTO accession of any CU member, the WTO agreements and the commitments of that member would become an integral part of the CU legal framework.<sup>21</sup>

The CU agenda has been driven by its largest party.<sup>22</sup> Among the wide range of nontariff measures accepted by the CU are procedures for declaring goods, customs valuations, and import licensing as well as SPS and TBT measures. For example, Russia requires import and export licenses for pharmaceuticals and goods with encryption technology and local registration of individuals and firms involved in importing and exporting.

As part of its WTO accession negotiations, Russia has relaxed some of these measures. For instance, import licensing for some alcoholic drinks and ethyl alcohol products has been simplified, although an activity license is still being required, and a number of import licensing requirements for drugs used in veterinary medicine were lifted in late 2011.

Furthermore, Russia has committed to abide by WTO obligations on issues relating to NTMs, in particular those relating to MFN, national treatment, import and export procedures, and the quantitative restrictions found in the GATT,<sup>23</sup> as well as the terms of the WTO Agreement on Import Licensing. However, Russia has expressed the opinion that many of these NTMs were legitimate under the WTO agreements, although other WTO members have expressed doubts.<sup>24</sup>

21 The EurAsEc Customs Union Commission is in principle to dissolve on July 1, 2012, to be superseded by the new Eurasian Economic Commission (EAEC), charged with leading the integration process towards the completion of the Single Economic Space between the three countries. Negotiations expected to define the nature and specific attributes of the EAEC are underway.

22 The CU voting rights are distributed as follow: Belarus, 21.5%; Kazakhstan, 21.5%; Russian Federation, 57%.

23 Namely, Articles I, III, VIII and XI of the GATT.

24 See Protocol of Accession of the Russian Federation to the WTO (WTO documents WT/ACC/RUS/70 and WT/MIN((11)/2, paras 218-223, 275, 431-433, 443).

just let the WTO process happen and assume the NTB problems will simply disappear. Instead, it will be critical to thoroughly understand the CU regulatory regime and use the WTO process to attempt to eliminate restrictions to trade that harm Kazakhstan.

**3.25. The government should also be aware of the risks that the benefits of the CU in terms of trade facilitation may be both uncertain and partially offset by other issues.** The example with trucks is a good case in point. Chinese trucks are typically of low quality and do not last long in the country's harsh utilization conditions. They sometimes even generate road hazards because of faulty design or poor quality of key components, which current technical regulations do not control effectively. The CU, which eliminated a 15% fee on Russian trucks,<sup>25</sup> has led to a redirection of Kazakh truck imports away from China. However well-established Russian truck makers like Kamaz have refrained from passing on the benefit of duty elimination to buyers, raising their prices instead of lowering them (at least in nominal terms). According to field interviews, this pricing behavior would simply be the reflection of full order books. In addition to not benefitting from lower prices, buyers must now seek import declaration from authorities in Astana before they can register the trucks. This additional process takes several weeks, and costs considerable fees to customs brokers. How really burdensome is the additional paperwork given that a truck order is a relatively large transaction is difficult to assess, but the overall picture of (i) ineffective safety regulation, (ii) weak pass-through of tariff reduction given existing market structures, and (iii) additional paperwork suggests the need for some streamlining of the regime.

**3.26. The government is making efforts to deal with the transition to the CU and a number of tripartite and domestic coordination committees have been set up.** However, there are continuing problems with:

- **Vision and direction:** It is not apparent that there is a clear vision and plan for the transition.
- **Technical capacity:** While there is no reason to doubt the technical capacity of individuals involved in the process, the imbalance in capacities between Russian and Kazakh agencies will make it challenging for the Kazakh side.
- **Too little consultation with the private sector:** Consultation with the private sector is ad hoc; there is a need to make it more formal and transparent, and involve both large firms and SMEs. This approach draws on the capacities of the private sector to design efficient compliance strategies. Technical knowledge is often concentrated in firms rather than the public administration, which could then focus on the objectives of regulation rather than the technicalities of means of compliance.

**3.27. The above analysis indicates that the development of new CU technical regulations and standards has created a lot of confusion and uncertainty for the private sector, deterring the business environment, and dampening the potential for the emergence of a dynamic exports sector, at least during this transition period.** There is also a considerable risk that regional considerations may distract the Kazakh authorities from their multilateral commitments years after the government's efforts to comply with the EU legislation, and while preparing for the WTO accession. It has also made it difficult to assess the level of openness/restrictiveness of the current NTMs. Finally, regional reforms such as the certification procedures adopted at the regional level to facilitate trade are not being necessarily implemented, putting at risk the benefits expected in terms of increased regional trade.

**3.28. In order to consolidate unilateral advances achieved by the government of Kazakhstan so far, and to prevent drifts toward unwanted outcomes, Kazakhstan should reinforce its own analytical capabilities in**

<sup>25</sup> The CU also allows Russian truck exporters to pay only the difference between the higher Russian VAT rate (18%) and the lower Kazakh rate (12%), rather than the full VAT rate, providing them with an additional cost advantage.

order to play a constructive role and defend strong positions in the CU's intergovernmental bodies. Donors and development agencies can help in this process by providing technical assistance to national regulatory bodies and agencies involved in CU-level negotiations.

**3.29. Moving forward, the government should adopt a strategic approach towards the introduction of voluntary certification and an Action Plan, and including (i) A thorough review of Kazakhstan's system of technical regulation and conformity assessment (i.e., certification); (ii) consultation with all constituencies; (iii) technical assistance tailored to the specific legislation and procedures applicable to the specific sectors and/or products; and (iv) training potentially in the form of twinning programs and study tours to the benefit of specific officers of Kazakhstan Committee for Technical Regulation and Metrology, so that they may develop the required skills to organize and manage the system of voluntary certification by witnessing firsthand how it operates in best practice countries**

**3.30. More generally, the government should also strengthen the institutional mechanism to drive the NTM agenda.** Based on international experience, and since regulatory reforms affect a number of players, the political support and commitment of the government and all authorities involved must be secured. The institutional arrangement has better chances to succeed if (1) it is driven by a high level of the administration with a mandate that is supported by law or decree; (2) it brings in all stakeholders; (3) it ensures the participation of the highest officials responsible for administering measures, including agency staff; and (4) it has the necessary technical and financial resources to conduct its mandate, which means that officials involved in the regulatory process must receive not only the tools they need but also training and skills improvement. Moreover, to support a politically independent, long-term process, the private sector and other interested parties should be given a more active role. International experience with competitiveness efforts shows that the reviewing body must have authority to conduct the review and be independent of agencies responsible for issuing the regulations. Reviews are less effective when they are conducted by an internal unit within a regulatory agency because regulators tend to want to keep their regulations in place (Cadot, Malouche, and Saez 2012).

## D. Trade Facilitation and Logistics

**3.31. This trade facilitation and logistics assessment of Kazakhstan is based on a desk review that pulls together the considerable amount of analytical work already undertaken by national agencies in Kazakhstan as well as international agencies to give a fresh perspective on existing problems and emerging opportunities.** It adopts a system-wide approach based on measures of logistics performance, quality and competence of logistics services and degree of integration of the logistics system, customs and infrastructure.

**3.32. Trade facilitation measures refer to the time, cost and the predictability associated with trading across borders.** Several institutions and agencies-both private sector and state agencies- play a role in trading across borders. These include the public sector agencies responsible for providing the transport infrastructure (roads, railways, ports and airports); land border posts (customs, immigration, security, health and others); private sector providers of road and logistics services (freight forwarders, clearing agents and so on). The efficiency depends on each link and node operating as efficiently as all others. When freight reaches a node like a border-crossing point, it may have to travel only a short distance, but the time taken for processing the paper work can be extreme in view of the need to ensure that entry/exit of people and freight meet legal requirements of adjacent countries. Efficiency requires that the time taken to pass through the nodes is as minimal as possible.

**3.33. Trade facilitation depends on several interrelated factors.** First, it depends on the quality of the transport (roads, rail, ports and airports) and efficient delivery of transport services (trucking, port and efficient aviation services). Second, it depends on the various border agencies which are responsible for expedited cargo clearance at the borders. Different state agencies are typically involved for in border-clearance activities. In addition to customs, the other state agencies include inspections of driver passports, visas and drivers licenses by border police/ troops/ immigration officers, inspections of vehicles for vehicle certificates and vehicles roadworthiness by transport officials, and agriculture, veterinary and public health inspections carried out by government agencies.

**3.34. For obvious reasons, landlocked developing countries are particularly dependent on the performance of their trade and transit connections; they are at a disadvantage because they cannot control shipping conditions outside their borders.** Importing into a landlocked developing country typically takes a week longer than for its coastal neighbors, but times can vary widely. Since the Almaty Declaration on landlocked developing countries at the Almaty Ministerial Conference in October 2003, assistance has increased substantially, including corridor projects, customs reform, multimodal transport, railroad projects, and restructuring airport and aviation services.

**3.35. Kazakhstan has the potential to position itself as a regional logistics hub.** Although landlocked and far from gateway ports in China, Russia, Georgia, Kazakhstan is on a major Central Asian transit route, which brings opportunities for Kazakhstan to diversify. First, it has a strategic location among high-growth emerging economies—India to the south, Russia to the north, and China to the east—and it is also on the fabled Silk Road trading route between China and Europe. It is also near the Caspian Sea, so that Kazakhstan can serve as a bridge to East Europe. Finally, access to the sea by crossing from Kazakhstan is the most viable option for the doubly landlocked countries of Uzbekistan, Kyrgyzstan, and Tajikistan to reach gateway ports in China.<sup>26</sup>

### *Momentum in Improving Overall Logistics Environment Has Stalled*

**3.36. While the government recognizes the importance of logistics for positioning Kazakhstan as a regional hub, the momentum towards reforms may have stalled.** The World Bank's 2012 Logistics Performance Index (LPI), a global multidimensional assessment of logistics performance, ranks Kazakhstan 86 out of 155 countries in terms of international logistics performance.<sup>27,28</sup> Kazakhstan's performance trajectory has been uneven over time as the country improved from a position of 133 in 2007 with a score of 2.12 (35% of the best performer, Singapore), to 62 in 2010 with a score of 2.83 (60% of the best performer, Germany) but then declined in 2012 to a rank of 86 with a score of 2.69 (54% of the best performer, Singapore) (Figure 3.1).

**3.37. Between 2010 and 2012, Kazakhstan drastic decline in overall LPI rating was driven by a slight decline in quality of transport infrastructure; along with major declines the costs of international shipments and timeliness (Figure 3.2).** At the same time, Kazakhstan showed distinct improvements in the efficiency of

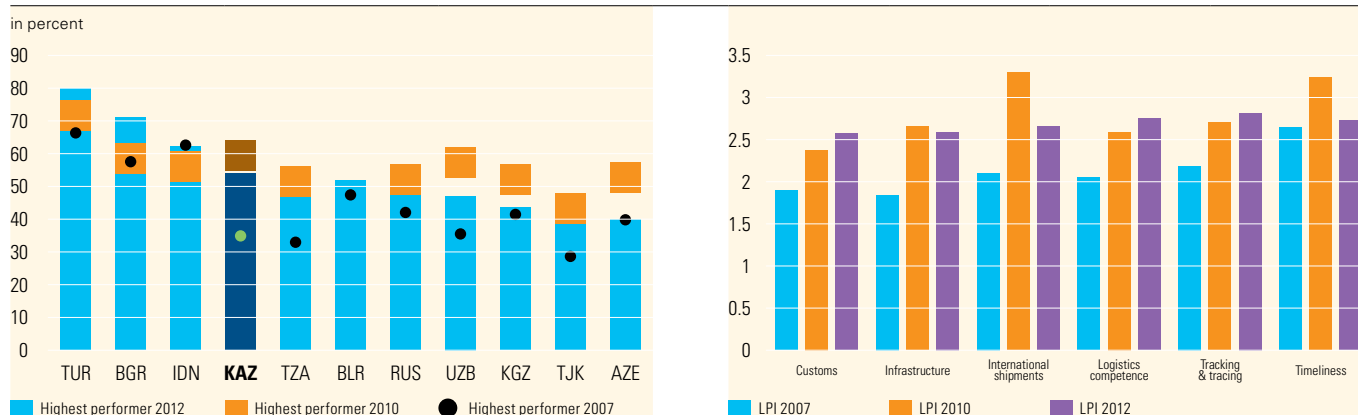
<sup>26</sup> These countries are cut off from China by some of the highest mountain ranges in the world. Security considerations prevent connectivity by roads through Afghanistan in the south. The only other reasonable alternative is the railway/road route via Turkmenistan and Iran to Turkey or to the deep water port of Bandar Abbas in Iran (World Bank 2012 and Kittain 2008)

<sup>27</sup> World Bank (2012). "Connecting to Compete. Trade Logistics in the Global Economy" Washington DC.

<sup>28</sup> The LPI covers the entire supply chain, and as the results are based on a survey of the perceptions of over 1,000 logistics professionals worldwide, it is a useful tool for comparing the logistics performance across countries and identifying key reform priorities within countries. The logistics performance (LPI) is the weighted average of the country scores on the six key dimensions of the logistics environment of countries: 1) Efficiency of the clearance process (i.e., speed, simplicity and predictability of formalities) by border control agencies, including customs; 2) Quality of trade and transport related infrastructure (e.g., ports, railroads, roads, information technology); 3) Ease of arranging competitively priced shipments; 4) Competence and quality of logistics services (e.g., transport operators, customs brokers); 5) Ability to track and trace consignments; 6) Timeliness of shipments in reaching destination within the scheduled or expected delivery time.

**Figure 3.1. Improvements in Logistics Performance Have Lost Momentum**

Logistics Performance Index, Kazakhstan v. Peers (left) and Trend in Component Scores (right)



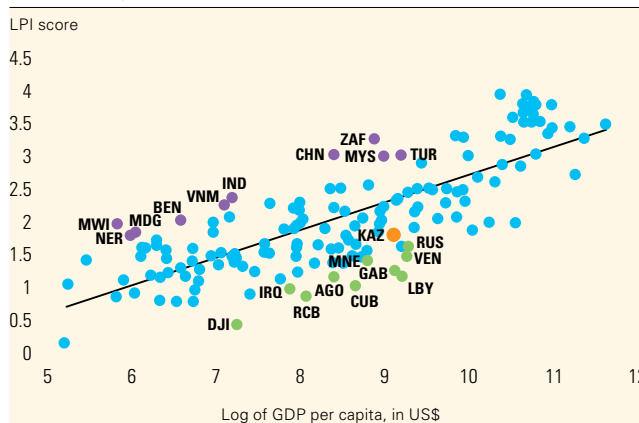
Source: LPI 2012, WB.

the clearance process, quality and competence of logistics services and tracking and tracing. Despite its overall decline, it performs well relative to the Central Asia region, and is still comparable to the average performance of countries in the broader Europe and Central Asia region. Kazakhstan performs better than the Europe and Central Asia average in customs performance, infrastructure, logistics competence, tracing and tracking, but now the country lags way behind on timeliness.

**3.38. Income alone cannot explain why performance varies widely among countries in certain income groups, particularly in the low- and middle-income groups of countries.** The dispersion within income groups suggests that policy, as well as level of development, affects logistics performance. It is worthwhile noting that in the case of landlocked or island countries, the LPI may capture access problems outside the country being assessed; for example, in the case of Kazakhstan, transit difficulties.

**Figure 3.2. Kazakhstan Underperforms Relative to Income Level**

Cross-Country Comparison of Logistics Performance Relative to GDP Per Capita



Source: World Bank LPI 2012

Note: Grey markers represent high performers, red markers represent average performers and yellow markers represent low performers.

**3.39. Consistent with the major decline of the LPI rating on timeliness, anecdotal evidence suggests that the state of trade facilitation and logistics has deteriorated recently, with major time delays.** Many traders see serious and growing problems associated with rail shipments from China. One major company bringing in supplies intended for the Christmas season was hit by delays so long that by February, the company was forced to reroute the supplies from China's southern ports to the Baltics and bring them to Kazakhstan by road.



## *Transport Infrastructure and Transport Services: Connectivity Has Improved*

### **Roadways**

**3.40. Kazakhstan's trade-related infrastructure consists of roads, railways, ports and the aviation sector.** About 60 percent of freight in long-haul traffic is by roads. The road network stretches over 88,400 km; East Kazakhstan, Almaty, Karaganda, and Kotanay regions have the most roads. Five international roads pass through Kazakhstan. The main challenge facing traders has been the poor quality of the roads for both international and local traffic. The network has consisted of mainly Class III stretches of road that have been in need of repair or complete replacement.

**3.41. However, there has been significant improvement in both internal and external connectivity, following the investments in road infrastructure through time.** This is particularly true at the level of interstate roads; that is, roads that cover adjoining countries and on corridor routes. Kazakhstan's transport strategy until 2015 aims at developing a highway network to support continental and transcontinental transit in both north-south and east-west dimensions.<sup>29</sup>

**3.42. In the past it was assumed that road infrastructure investments would significantly reduce the transport prices to the traders and other end-users of transport services.** Although such investments facilitated road transport and lowered the transport costs for the trucks carrying cargo on the corridors, there was no clear impact to the end-users of transport prices in the form of lower transport prices.<sup>30</sup> Freight tariffs (US\$/ton including unofficial payments) on long-haul traffic in Kazakhstan (at \$180/ton) are lower than in Tajikistan, Uzbekistan and Turkmenistan (\$200/ton on average), but higher than in Azerbaijan, Georgia, Armenia and Moldova (\$165/ton).<sup>31</sup>

**3.43. Road prices depend on the structure of the trucking industries and the payments made at border posts, both official and unofficial.** In Kazakhstan, as in many developing countries, trucking services are provided by small operators who are specialized according to the type of commodities. Competition between freight forwarders does not exist in practice, with market shares being predetermined. Moreover, cumbersome transit regimes induce delays at the borders, which have a serious impact on truck utilization.

**3.44. To escape the resulting multiplicative effects on trade costs, enhancing regional cooperation and implementing efficient transit systems on trade corridors is critical to help reduce logistics costs and develop sustainable export-oriented activities.** Kazakhstan depends on trade corridors for access ports or regional trade partners. Kazakhstan also depends on trade and transit systems set up with bigger neighbors, which are not always good logistics performers themselves.

**3.45. Carriage of freight across land borders in Kazakhstan, though improved, remains unpredictable in terms of money and time required (including a large component of informal payments en route).** Like other Central Asian Republics, Kazakhstan inherited membership in European institutions, including the United Nations Economic Commission for Europe (UNECE). Hence, countries are parties to the international transit regime—initially

<sup>29</sup> In 2011, the government of Kazakhstan announced its policy of providing about KZT 2,800 billion for developing the country's road network until 2014. Along with state budget funds, Kazakhstan is also attracting private investors and international financial organizations to finance infrastructure projects. One of the projects now underway is the road reconstruction from Almaty to Khorgas on the corridor linking Kazakhstan with Western China and Western Europe. With the Customs Union between Russia, Belarus and Kazakhstan, this border crossing will be one of the main entry points from and to China (World Bank 2011).

<sup>30</sup> World Bank (2009). "Transport Prices and Costs in Africa." Washington DC.

<sup>31</sup> World Bank (2006). "Economic Cooperation in the Wider Central Asia Region."

known in French as Transport Internationaux Routiers (TIR). However, TIR is mainly used for very long distance, high-value shipments that are mainly carried by operators from outside the region.

**3.46. Other cross-border movements along the corridors in Kazakhstan take place in a framework of bilateral or trilateral agreements, and these are a source of cost, and time delays at border crossings.** Although the TIR infrastructure is available for regional trade and transit, much of regional trade is operated by small-scale truckers who are unlikely to meet TIR standards or are unwilling to use the TIR. To fill this gap, the Asian Development Bank (ADB) and the CAREC (Central Asia Regional Economic Cooperation) have considered a transit system for intraregional movements that would apply most of the procedures developed under TIR, but with significantly lower charges because of the lower cargo values, lower duty liability, and less sophisticated transport equipment used. This project was not supported by other key organizations, including the UNECE and the World Bank. Indeed, international experience confirms that the “TIR lite” approach is unlikely to be robust. As of the beginning of 2011, no technically advanced proposal of a regional regime is in existence.

## Railways

**3.47. Railways are an alternate mode for roads in long-haul traffic.** Rail transport in principle offers potential benefits over road freight transport in the form of lower prices over long distances, shorter transit times resulting from possibly higher speeds, shorter border-crossing waiting times and fewer *en route* delays. For high-volume, low-value goods that form much of the trade structure of Kazakhstan, freight at the regional corridor level can be served by well-run railways at lower cost than road transport.<sup>32</sup> Besides providing security against the risks of isolation should road transport be disrupted, rail services provides competition to the road trucking industries, which otherwise can inflate transport charges for moving freight.<sup>33</sup>

**3.48. In Kazakhstan, as in the rest of Central Asia, railways were the most important mode for long-haul traffic.** The railway system covers 14,205 kilometers and connects the country with the Russian Federation, Uzbekistan, Kyrgyzstan, and China. About 30 percent (4,143 km) of the network is electrified, and at the end of the inventory of rolling stock consisted of 1,684 locomotives and 100,424 cars. Total freight turnover hit 311.62 billion tons km at the end of September 2011, with 158.42 billion ton going by rail.

**3.49. Railway potential remains underutilized.** As in the case of roads, Kazakhstan inherited the railway systems of the former Soviet Union. The system was designed without reference to current borders between countries that were not conceived at the time. Railway crosses borders in a few areas which produce great inefficiencies for border-crossing management as well as requiring numerous agreements between countries on tariff structures, maintenance regimes and traffic management. As a consequence, there has been a push by individual countries to construct new lines to ensure routes remain within the jurisdiction of their country. A main concern at this stage is to modernize the management structure and practices of the countries’ railways, clearly separating out regulatory functions, opening the way for private-sector initiative in railway activity, and encouraging strong competition with the other transport modes on a level playing field.

**3.50. Efforts are underway to improve rail services.** More recently, various consortia of railway companies and freight forwarders have started operating regular container trains to Central Asia from China, Europe and Russia. While few of these offer direct services, the transit times, even allowing for the change of trains at railway hub cities,

<sup>32</sup> Transport costs for moving bulk goods by railways are generally low—typically less than 0.03 per ton kilometer. And on relatively dense freight-oriented railways, they can be even lower at less than \$0.02 per ton km. World Bank (2011). “*Railway Reform. Toolkit for Improving Rail Sector Performance*” Washington DC.

<sup>33</sup> World Bank (2009). “*Transport Prices and Costs in Africa*.” Washington DC.

are still competitive with truck services and tariffs are lower and reliability higher. There remain operational problems in the longer-distance services, particularly gauge changes between Russian and Chinese railways, but these are being addressed by the operators themselves with the support of the EU agencies. For some of these services, the railway authority operates the trains, and the freight forwarding member of the consortium buys train capacity on a block basis and on-sells that capacity to its clients. In this way, the railway operator focuses on its specialty of trains operations and has a known revenue stream on which to plan services, while the freight forwarder specializes in marketing the capacity provided by the operator and bears the commercial risk of finding customers and applying flexible market pricing.

**3.51. Kazakhstan also needs to look at improving rail transport infrastructure issues on the border with China.** Priority should be given to investments at the border crossing points of Dostyk—to improve trans-loading facilities because China uses international gauge-tracks and Kazakhstan uses the Russian Federation standard—and Korgas, which has the highest throughput of trucks.

**3.52. The main priorities identified with respect to road and rail transport include:**

#### **Road**

- Improve the capacity of road networks by upgrading existing roads to Class I and Class II standards.
- Promote investments in modern truck fleets including foreign investments and establish credit options so that local truck/trailer fleet owners can modernize.

#### **Rail**

- Improve railway capacity at the main border crossings with China, particularly Dostyk and Korgas, through investment in new trans-loading facilities.
- Increase storage capacity in cities located at critical rail nodes.
- Improve the quality and supply of rolling stock by attracting FDI for investment in modern rolling stock.
- Reform the regulation of railways. This requires modernizing the management structure and practices of railways by separating out regulatory functions, allow private initiatives, and encourage competition with the other transport modes.

**3.53. With respect to seaports, Aktau port, which is situated on the eastern coast of the Caspian Sea, is the only sea port of Kazakhstan.** Land routes from Europe to Central Asia, South Asia and China have three broad alternatives: through Russia, through Iran or through Azerbaijan, which requires a crossing of the Caspian Sea.<sup>34</sup> The port provides an alternative via the Volga-Don Channel to using the port of Iran for accessing the ports of the Black Sea. The port is used for international shipping of dry cargo, crude oil and oil products. Due to its advantageous geographical position, the port continues to serve the north-south and east-west shipping ways. The port underwent a reconstruction with the process completed in 1999, and the port's capacities for loading and unloading dry cargo went up to 1.55 million tons while the capacities for oil transshipment were maintained at 8.8 million tons annually. The port is undergoing an expansion in the northern direction, which will increase the capacity of the port to handle bulk-oil and dry cargo is expected to increase substantially.

**3.54. With respect to the aviation sector, lack of development restricts Kazakhstan's ability to accept all types of aircrafts in many airports and limits the country's traffic capacity.** Since 2011, plans are underway

<sup>34</sup> [www.aktau.kz.org](http://www.aktau.kz.org)

for developing the airport's complexes, taking into accounts the growing needs and requirements of international standards.

### *Logistics Services: Services Offered Must Be Expanded, Quality Upgraded*

**3.55. Logistics services are a derived demand which in turn also open new opportunities to trade.** Logistics services have to adapt to technological and economic changes. Technological changes are reducing the need for proximity between the producer and the consumer. These changes are also allowing the fragmentation of production into tasks that may be performed in different locations (Feenstra, 1998). Fragmentation that affects production of both goods and services means that vertically connected production process, i.e. process that takes place in one location, can now be undertaken in different regions or countries (Jones, 2000). Communication, logistics, and financial services among others, allow the connection among tasks.

**3.56. Therefore, there are several operational imperatives that should be considered in the pursuit of an improved global framework for logistics services:** a) a desire to facilitate participation in shared production networks; b) the desire, especially in middle income countries, to move into higher value-added activities; c) the need to encourage greater competition in services and drive down costs and d) emerging demands, especially to diversify exports and minimize negative impact on the environment. These are all forces place growing demands on the performance of the country' logistics system. Unless the system adapts to growing or emerging demands, then it can be a hindrance to greater trade competitiveness and growth.

**3.57. Firms in Kazakhstan believe that speed, stability, safety and cost concerns, and lack of value-added services around basic core businesses are the areas where improvements are most needed.** The main problems with logistics services that they identify are:

- **Monopolistic trucking services:** Lack of competition in long-haul trucking services means that prices are higher and deliveries unreliable. This is an issue that was also discussed in the previous section. The problem is exacerbated by system-wide underinvestment in modernizing trucking fleets.
- **Quality issues with clearing agents:** This, too, is linked to a lack of competition and a need to upgrade quality and technology.
- **Overhead charges and informal payments:** Transit, both public and private, is subject to "overhead" charges for unnecessary services, charges, and bribes that can add 50 percent or more to transport costs. A World Bank staff assessment estimated such payments at roadside checkpoints at US\$800–US\$900 per truck per trip.<sup>35</sup>

**3.58. More than 70 Kazakh enterprises offer logistics-related services, among them express and courier companies, customs brokers, freight forwarders, multimodal transporters, manufacturers, and traders.** Express and courier companies are mainly subsidiaries of multinational corporations that oversee domestic distribution with their own warehouses and truck fleets. Locally licensed customs brokers, freight forwarders, and multimodal transporters shepherd cargo through customs and move it on to its final destination; several offer integrated solutions. Manufacturers and traders have their own trucks and warehouses for managing their supply chain.

<sup>35</sup> Based on field trip.

**3.59. A number of logistics centers provide warehousing and transportation, but there is a lack of adequate warehouses, especially for perishable goods.** Domestic companies hesitate to containerize cargo because the technical and documentation requirements are unclear and using this mode to ship is expensive.

**3.60. Multimodal transport is still in its infancy in Kazakhstan, and because it is not specifically regulated, the rules for each of modes it entails must be applied, and the liability regimes are different.** The occupation of multimodal transport operator is not officially recognized, and separate contracts are needed for each mode, which increases the associated time and costs.

**3.61. Only a few freight forwarders are able to offer comprehensive (global) services, and these are mainly branches of international companies.** As a result, shippers often have to enter into contracts with forwarders in each country along the transport corridor. This leaves responsibilities and liabilities unclear.

### ***Customs and Border Management: Modernization Underway but Delays Still Plague Traders***

**3.62. Kazakh Customs has implemented new customs initiatives to reconcile the twin goals of enforcing compliance with that of expediting the cargo clearance process of traders deemed to be usually compliant, most notably through the introduction of electronic declarations.** The Government of Kazakhstan's focus on customs reform over the last several years has led to strengthening of the legislative base, increase in revenue collection, and the simplification of certain cargo clearance procedures.<sup>36</sup> Some of the customs modernization initiatives are a requirement for the WTO accession.

**3.63. Kazakhstan Customs has been implementing a modernization program for the past several years.** Reforms already introduced include the use of the Harmonized Customs Code, creation of a Single Administrative Document (Goods Declaration, GD), and electronic submission and processing of declarations, both at the seaports and at the major land borders. These improvements which are ongoing have resulted in a significant reduction in clearance times as well as an increase in the collection of customs duties and taxes. However, at present there are two different IT systems for submitting the goods declaration.

**3.64. Long queues at land border-crossing points due to the requirements of the different state agencies remain a problem.** While customs is an important border agency, inspections and clearance from various ministries are required for border clearance. These include clearance by the transport ministry or agency, for checks on vehicles for road worthiness, checks for veterinary and phyto-sanitary measures (this may include documentary evidence and sometimes physical inspection of cargo as well and inspection and sanitary and quarantine inspections). In fact, LPI data also shows evidence that Customs are ahead of other border agencies across all levels of logistics performance. Since Customs is approximately one-third of the total clearance time, this reinforces the continued importance of facilitation initiatives geared to enhance the integration of border agencies.

**3.65. Estimates by USAID show that crossing the border can take up to six hours.** The identified problems include permits from several controlling authorities for the vehicle to enter China, multiple state control points at the border, doubling procedures and documents by different controlling authorities and lack of access to information.

<sup>36</sup> World Bank Kazakhstan Customs Modernization project. The project has three components. The first is aimed at institutional development of the customs control committee, designing training programs to raise the level of staff professionalism and implementing cost-based financial system to regulate and monitor the cost of custom services (a requirement for WTO accession). The second component is to align existing legislation with international best practices and the third is developing an information and communication technology system based on proven technologies used in modern customs administration and customized for Kazakhstan's conditions.

Customs is also considering of setting up a single window to facilitate trade procedures. Realizing the full potential of customs modernization efforts will require that trade documents be simplified. Another concern relates to obtaining permits; for example, where there are SPS and veterinary requirements, the trader must submit several types of document to ministries.

**3.66. Crossing borders by road is complicated by divergent interpretation and application of border procedures.** Because there is a lack of equipment at most crossings, most checks are manual. The government has moved actively to foster inter-agency coordination at borders, most notably by introducing “integrated control” at the main border. Since 2010, Customs has taken on the inspection and control function for all border agencies and the government has introduced scanning machines at several centers.

**3.67. Both exporters and importers indicate that the CU has made crossing borders more difficult, primarily because certification and documentation requirements are not clear.** Importers also report significant problems with customs authorities imposing rates based on reference price values substantially over the invoiced amount, leading to higher taxes and or lost time due to inspections.

**3.68. For customs and border management reforms to be effective and sustained, performance indicators are required for monitoring progress.** The WCO Time Release Study (TRS) provides a methodology to identify the time taken by each of the regulatory agencies. TRS are usually used to measure the time taken for the release of imported goods to the trader/customs broker/agent from the arrival of goods at the port/airport/land border. In the case of exported goods, the time is measured from the point when exported goods enter customs control to their departure from customs control (defined as the time of vessel or aircraft departure). Measurement of time release tailored to Kazakhstan conditions is a worthwhile exercise as it can establish a pre-reform benchmark and thus assist in assessing the progress made by customs modernization initiatives.

### *High-Level Commitment, Stakeholder Involvement and Tailored Institutional Arrangement Essential*

**3.69. For Kazakhstan to realize its potential to position itself as a regional logistics hub in the region, only a concerted effort similar to those driven by a high level commitment as in countries like Malaysia and Indonesia will yield significant results in this area (Box 3.4).** Reforms must be implemented as coherent packages, and they require sustained, long-term attention for sustainable results. It is instructive to note that all top performers in the LPI have developed and maintained a long tradition of strong public-private partnership and dialogue; good cooperation between policymakers, practitioners, administrators, and academics; a comprehensive approach in the development of transport services, infrastructure, and efficient logistics; and consistent policies in transport and logistics.

**3.70. However, the institutional arrangement to achieve results is country-specific and needs to be tailored to local circumstances.** Policymaking is a responsibility shared among the different government agencies in charge of transportation policies and investment, commerce, industry, and customs and border management. In advanced and emerging economies, transportation agencies have usually led the coordination efforts; while in developing countries the agencies in charge of commerce and economic development have played a major role in promoting a transformative trade facilitation and logistics agenda. No country has a ministry for logistics. Instead, a collective framework that includes the private sector is important for consistent implementation. Canada, China, Finland, Germany, Malaysia, and Morocco have all introduced councils or similar coordination mechanisms for bringing the stakeholders together.

### **Box 3.4.** Innovative approaches to border agency cooperation: the Philippines and Indonesia

In 2010 and 2011, the Philippines government developed—and began to implement—a national single window system for trade. The system has already automated 33 government agencies' import and export permit and licensing requirements. Many of those agencies did not have automated back-office functions until 2011, but all are now connected to the system, and more than 80 paper-based processes are in the process of being fully automated. Traders can access the system online—first to submit and pay for permit applications- and then to track approval and clearance. Key performance indicators show that the system has reduced the time it takes traders to apply for various permits and licenses and be granted them.

The Indonesian government has also launched a national single window system, one that now links the national customs system with more than 25 government agencies. The new system's implementation brought to light conflicting trade regulations issued by various ministries over time, revealing a need to regularly review and harmonize trade-related regulations. The system also established a mechanism for regular private sector consultation. Initially created to fix deficiencies in system implementation, the consultation mechanism quickly evolved into a more general forum, where traders discuss trade regulations with government officials. These discussions have led to some regulations being simplified—and some being repealed.

In both countries, customs hosts the national single window system's information and communications technology infrastructure. Also in both countries, the system's design and development involved both public and private stakeholders. The Philippines's system was led by customs, Indonesia's by the Coordinating Ministry for Economic Affairs (directly led by the Deputy Minister for Industry and Trade Affairs\*). Although the two countries used different coordination mechanisms, each improved its border management substantially—without resorting to expensive, likely disruptive, organizational restructuring.

\*Source: Special address by H.E. Mari Pangestu, Minister of Tourism and Creative Economy of Indonesia, ex-Minister of Trade for Indonesia and co-coordinator of the Task Force on Poverty and Development for the United Nations Millennium Project. <http://go.worldbank.org/I3RZU91930>.

## **E. Conclusions**

**3.71. Progress in tariff policy, NTMs, and trade facilitation are key factors that will directly affect the extent of access to competitive inputs and markets and therefore long-term productivity and competitiveness of Kazakhstan.** All three areas have been identified as requiring major reforms to support rather than impede Kazakhstan's trade and openness. In addition, as described in Chapter 2, making fast progress in NTMs and trade facilitation was identified as the critical factor that can compensate for the loss of welfare associated with an increase in tariff protection from the CU (World Bank 2012) and reduce the negative impact of the CU on long-term productivity. After reviewing the significant impact of tariffs on import patterns of intermediate goods, Chapter 3 explored the areas of NTMs and trade facilitation and recommended a series of actions that can assist the authorities in accelerating reforms.

**3.72.** The main recommendations of this chapter are:

### **Reforming Non-Tariff Measures (NTM)**

- Implement an integrated approach to NTM reform by promoting coordination within the government and between the government and the private sector.

- Improve information underpinning of NTMs by:
  - a. Completing and validating the NTM database, keeping a current inventory of NTMs; and
  - b. Undertaking a regulatory impact assessment of NTMs and make NTMs transparent.
- Ensure that new standards and technical regulations that are adopted are not trade restrictive and promote technological upgrade and innovation by:
  - a. Exploring the use of alternative trade facilitation instruments in the CU context such as mutual recognition agreements; and
  - b. Adding flexibility to technical regulations by initiating the transition from mandatory to voluntary certification.
- In the longer term, build on these actions to comprehensively reform technical regulations, standards, and the quality infrastructure.

### **Improving Trade Facilitation and Logistics**

- Generate high-level commitment and integrated approach to logistics and trade facilitation reform by developing and implementing an institutional arrangement tailored to Kazakhstan's circumstances and allowing private sector involvement.
- Improve connectivity through targeted investments in road infrastructure and provide incentives to update trucking fleets, upgrade rail rolling stock and rail beds, and resolve rail interface and infrastructure problems.
- Increase the capacity of logistics service providers and the freight forwarding industry, including by advanced training, upgraded warehouses, and adjusting multi-modal regulations.
- Resolve border crossing issues by harmonizing procedures and facilitating interagency cooperation on information-sharing and risk management, and benchmark progress through a time-release study.



## Chapter 4. Building a Competitive Services Sector

### A. Introduction

**4.1. Services are a major source of employment and a critical factor for competitiveness in every sector of the economy.** The services sector in Kazakhstan will expand, modernize, and deepen as the country develops and labor reallocates from agriculture to the services sector. Kazakhstan's accession to the WTO will speed up this transformation as documented in the World Bank study on the impact of WTO accession. This process needs to be understood and supported, including through specific actions that will help this transition to minimize the negative effects while securing maximum benefits for Kazakhstan.

**4.2. Efficient, low-cost, and high-quality services generate economy-wide benefits.** Goods production requires efficient services such as communication, transportation, and logistics services (logistics services were covered in the previous chapter). Services, in turn, require goods for their delivery—transportation services move goods while communication, financial, and professional services are supported by computers and high-tech equipment. Services also provide the links with other economies and can be a potential source of exports. Historically, trade in services required that buyer and seller be in close proximity, but recent ICT innovations have turned several non-tradables into tradable services.

**4.3. Kazakhstan has a generally liberal services regime overall, however, restrictive conditions are still present within certain sectors which are fundamental sources of productivity enhancement.** As a result, in Kazakhstan backbone services such as telecommunications and certain subsectors within transportation are both expensive and inefficient by international standards. Institutions and the regulatory environment matter greatly for services. Key service sectors remain in public or quasi-public ownership with a limited exposure to competition. Importantly, national content rules and restrictions on employment are increasingly stringent, preventing access to skilled professionals.

**4.4. This assessment of the service sector is based on limited available information, in terms of both statistical information as well as information on the regulatory environment, but several key indications for the future can be drawn.** The general message of this chapter is to develop and implement a roadmap for reform actions that improve the services landscape and make the most of Kazakhstan's WTO accession to reform the services sector. This chapter recommends focusing efforts to: (i) improve knowledge and coordination, (ii) reform services sectors to encourage competition and attract competitive service providers, and (iii) develop and align the services export promotion strategy and offensive strategy for trade negotiations.

**4.5. Section B of this chapter describes key features of a competitive service sector,** Section C reviews the policies that affect services, especially the level of restrictiveness, and Section D provides an outline of tactical measures to improve services and services exports. Section E summarizes the chapter.

## B. Objectives of Developing a Competitive Services Sector

4.6. In addition to increasing service exports, developing intermediate services and service links with other economies to foster participation in global value chains are important focus areas for a competitive services sector.

### *Developing Intermediate Services*

4.7. **Service constraints are prevalent in Kazakhstan.** According to the 2009 World Bank enterprise surveys of 544 Kazakh firms, 37 percent considered transport to be a major constraint, compared with only 18 percent of firms in the rest of Central Asia and Eastern Europe. Moreover, 31 percent of Kazakh firms considered access to finance to be problematic, compared with 25 percent in the other countries surveyed. Similarly, in telecommunications Kazakhstan scores behind many other countries on a range of parameters of access, cost, and quality. For instance, in 2009, Kazakhstan had fewer than 5 fixed Internet subscriptions per 100 inhabitants against 42 for Russia and 8 for China, and the charges for a fixed broadband Internet connection were much higher (i.e. 150 percent more costly than in Russia). Finally, the country averaged 56 faults per 100 fixed telephone lines a year; Russia had only 20 and India just 3. The problems may be explained by the fact that in 2009, annual investment in telecom services in Kazakhstan was as little as 5 percent of what the Russian Federation invested and 1 percent of what China and India invested.

4.8. **Intermediate services are crucial inputs in domestic production processes.** With the “second unbundling”—the fragmentation of production first geographically and then organizationally (Baldwin 2006)—trade in services, particularly business services, can be both a dynamic component of trade and a means of export diversification. Increasing tradability allows the cross-border exchange of services that previously required providers and consumers to be in proximity (Ghani 2009; Ghani and Kharas 2010). During the recent financial crisis, trade in business services as well as investment flows proved to be more resilient than trade in goods and less elastic to uncertainty (Borchet and Mattoo 2009; UNCTAD 2009).

4.9. **Intermediate services are inputs into the production process, and they facilitate transactions across space (ICT and logistics services) and across time (financial services) (Hoekman and Mattoo 2009; Francois and Hoekman 2009).** In transition economies, liberalization in telecommunications, electric power, railway transport, road transport, water distribution, and banking has been found to stimulate manufacturing exports (Berulava 2011).<sup>37</sup>

4.10. **To illustrate the potential, in Kazakhstan, we can focus on the link between agri-food and services.** How could the services trade enhance this performance? The answer lies in effective distribution services, IT and business services (especially software), human resources, and logistics solutions. For instance, there is cross-country evidence that distribution has important backward linkages with agriculture. Foreign distributors can boost productivity in linked industries through richer variety, lower markups, and lower quoted prices. In Kazakhstan, Metro A.G. is the only foreign distributor to open supermarkets. Success has been rapid: Metro opened six trade centers in its first three years and plans another five in the next three years, for a total investment of KZT 38 billion. The centers are built by Kazakh contractors, and two-thirds of the construction materials are purchased in Kazakhstan.

<sup>37</sup> Similarly, Alexander (2012) finds that there are significant labor productivity gains in Russian industries from services liberalization.

**4.11. The positive spillover effects of Metro’s investment in the services sector are already clear.** It has done a great deal to improve quality and sanitary standards in Kazakhstan; it put on over 200 workshops for Kazakh producers on quality assurance and international food safety standards that can help to ensure worldwide acceptance of Kazakh products (e.g., for raw meat and chilled poultry). It has also supported international food safety certification for over 100 local producers (Metro 2012). Once certified, Metro suppliers will find it easier to meet the quality requirements of other private buyers and government import regulations everywhere (Global Food Safety Initiative), opening up new export markets.<sup>38</sup>

### *Increasing Efficiency of Service Links to Foster Participation in Global Value Chains*

**4.12. The efficiency of services “links” will determine the level of trade integration of Kazakhstan and its ability to participate to global value chains.** Improving the efficiency of transport, logistics, and telecommunications and other backbone services is important for trade integration and export-led growth. It is also necessary so that Kazakhstan can compete with cost-efficient emerging countries. In a globalized economy, where final and intermediate goods cross numerous borders before reaching the consumer, services links will facilitate trade and dictate production relocation and trade routes.

**4.13. In order to improve the services sector and ensure that it helps to integrate Kazakhstan in the global economy and in international value chains, policy makers should give priority to elaborating an offensive trade policy strategy that goes beyond the identification and focus on specific sectors (see next section).** What is important is to build the understanding of the service economy in Kazakhstan through a better use of existing statistics and build-up of additional data; ensure better intra-governmental coordination and increasing responsiveness to the needs of the private sector; perform more effective regulatory assessments and best regulatory practices. In addition it is important to build on existing relations (Europe remains the largest destination of Kazakh exports) and identifying new opportunities; for instance, in a recent report, Kaznex Invest stressed the export potential of engineering and construction services to Afghanistan (reconstruction), and the success of local law firms like Grata points at the potential of cross-border legal services, consulting and other business services exports to Central Asia, etc. This can be done by offensive services trade negotiations strategy and trade promotion strategy.

**4.14. The new opportunities, if seized by Kazakhstan, could contribute to ease the stress on the labor market: new jobs created by trade are predominantly in the services sector and benefit both women and the youth.** Greater economic integration increases the demand for skilled workers and could benefit young graduates. Upgrading within global services value chains—e.g. from BPO to KPO—could also serve the same objective, justifying an emphasis in the services trade negotiations not only on low-skilled but also high-skilled labor movements and a further liberalization of trade in professional services.

<sup>38</sup> Each international (private) buyer and each importing market will have their own requirements in the form of private quality requirement or government import regulations. Metro certification of meat, on its own would not in itself open up for EU exports. That would require a much larger effort including reform of the Kazakh government regulatory system and better animal health management. However, raising the bar to achieve Metro certification would undoubtedly make meeting the requirement of other private buyers and government import regulations easier.

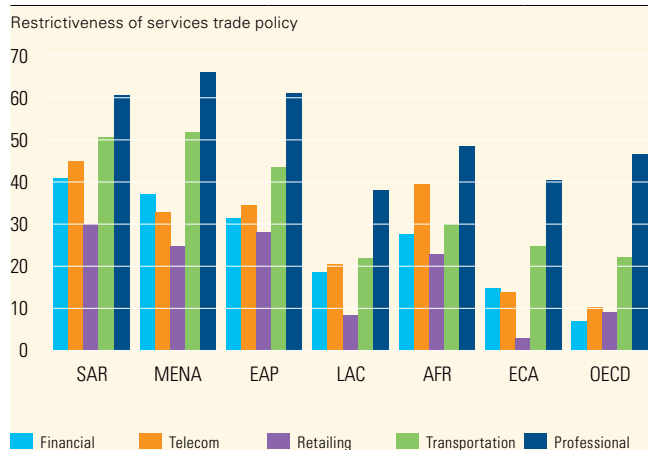
## C. Policies That Affect Services Trade in Kazakhstan

### *Kazakhstan Has Liberal Service Regime Overall*

4.15. In the ECA region as a whole, countries have a fairly open services regime compared with other regions and countries at similar levels of income. Figures 4.1 and 4.2 compare how Kazakhstan regulates services with other countries in the ECA region and in other regions. Large differences exist between sectors in terms of their restrictiveness.<sup>39</sup> Throughout the region there are significant restrictions on transportation services and professional services, but far fewer restrictions on financial, telecommunications, and retail services. Figure 4.3 highlights the correlation between restrictiveness and incomes.

**Figure 4.1. ECA Region Less Restrictive Than Others**

Services Trade Restrictions by Sector and Region

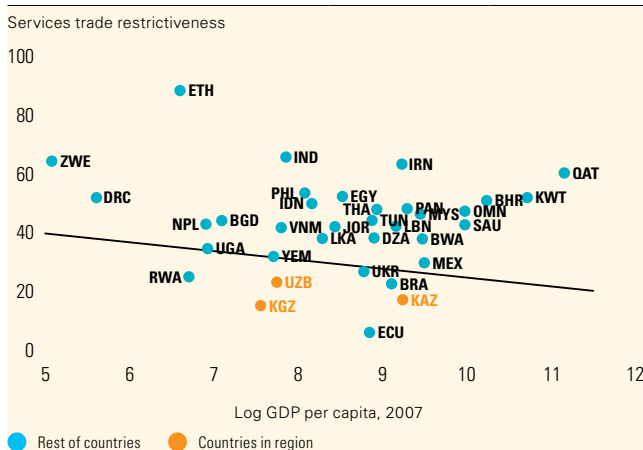


Source: Borchert, Gootiiz and Mattoo, (2010, 2011).

Note: Figure 4.2 is based on individual results for 102 countries.

**Figure 4.2. Restrictiveness Decreases as Income Increases**

Restrictions on Services and Per Capita Income



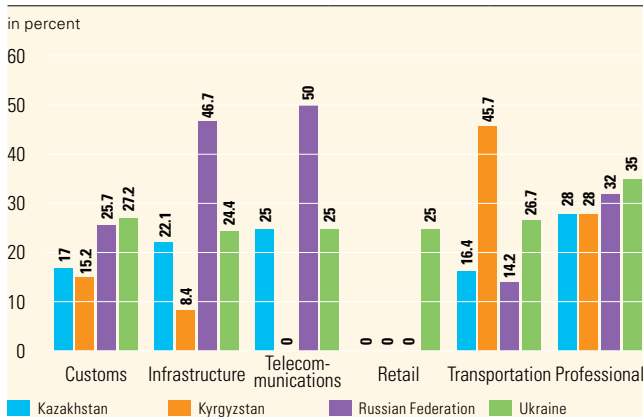
4.16. Within the generally relaxed ECA regulatory environment, where does Kazakhstan fit in? From Figure 5.4 it appears that Kazakhstan's is relatively more open to services than the rest of the region, which suggests that Kazakhstan may have a comparative advantage over its neighbors, especially with the other members of CU, in attracting service providers to serve the region.

### *Restrictive Conditions Are Still Present Within Critical Service Sectors*

4.17. While relative to other countries both within and beyond the region, the services regime

**Figure 4.3. Kazakhstan Less Restrictive Than Neighbours**

Service Trade Restrictions in Selected ECA Countries



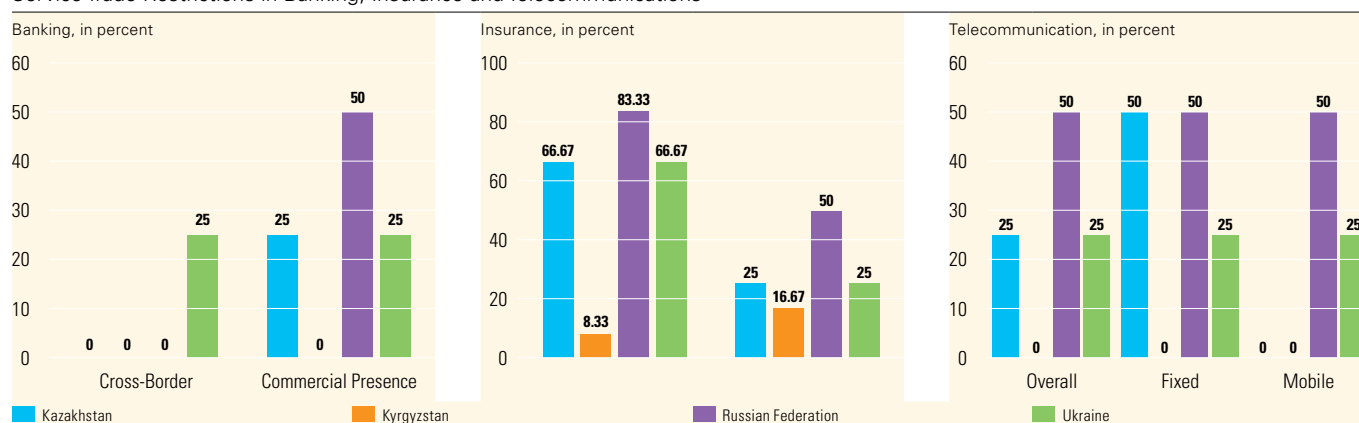
Source: Borchert, Gootiiz, and Mattoo (2010, 2011).

<sup>39</sup> The methodology to build restrictiveness indexes is explained in Appendix 3.

in Kazakhstan is relatively open, averages can obscure the heterogeneity among and within sectors. In Kazakhstan (Figures 4.4) there are fewer restrictions on financial services, banking, and reinsurance services than on insurance. Limitations in fixed line telecommunications is the source of the relatively high restrictiveness in that sector. In professional services, auditing services is more restricted than others. Thus the more positive aggregate picture hides restrictive conditions in certain sectors, which, if liberalized, could give the country a competitive edge. Accession to the WTO will probably mean fewer sector-specific restrictions, though which changes are likely will not be clear until negotiations are concluded.

**Figure 4.4. Varying Services Trade Restrictiveness by Sector**

Service Trade Restrictions in Banking, Insurance and Telecommunications



Source: Borchert, Gootiiz and Mattoo (2010) and (2011).

**4.18. In telecom services foreign ownership is limited to 49 percent if the supplier provides intercity or international telecom services, owning the infrastructure.** As part of the WTO accession process Kazakhstan has offered to eliminate these limits within 2.5 years after accession. However, while investment of more than US\$150 million is subject to government approval, there are no restrictions to the voting shares that may be held in a telecom entity that is not an operator according to the above definition.

**4.19. Similarly in banking, there are tough restrictions on foreign ownership and additional requirements for banks with foreign participation.** Finally, entry into the insurance industry through a branch or acquisition of a state-owned insurer is not allowed. Kazakhstan has offered to allow entry through branches for foreign banks and insurance companies within five years to WTO accession.

**4.20. With regard to professional services, there are nationality requirements in auditing services and for legal representation in courts.** The state authority has discretion in approving applications for auditing firms, which must have at least three locally licensed auditors. For legal advice on foreign and domestic law, however, no license is necessary, and foreign degrees are recognized (Figure 4.5).

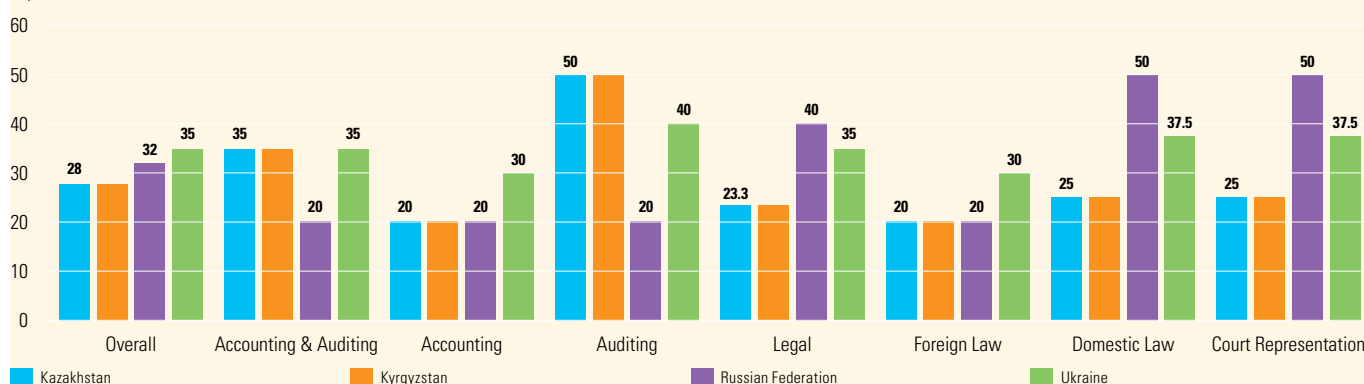
**4.21. Jensen and Tarr (2007) estimate that razing barriers against foreign providers of business services, as Kazakhstan should do to comply with WTO regulations, would expand the variety of services offered and substantially increase total factor productivity in all the industries that use business services,<sup>40</sup> specifically,**

<sup>40</sup> This includes sectors such as telecommunications, financial services, most business services (largely professional services and consulting services of various types) and transportation services.

**Figure 4.5. Professional Services Sectors Have Varying Levels of Liberalization**

Professional Services Restrictiveness Indexes

in percent



Source: Borchert, Gootiiz and Mattoo (2010) and (2011).

in the medium term Kazakhstan will gain an estimated 6.7 percent in consumption (3.7 percent of GDP) from WTO accession and long term gains as much as 17.5 percent (9.7 percent of GDP). Almost 75 percent of the gains would be achieved from liberalizing services. More open access for foreign providers would make it possible to import specialized capital and labor and a greater variety of services, especially in telecommunications, banking, and transport—again lowering the cost of doing business and raising productivity economy-wide.

### *Liberalization is Not Sufficient: Institutions Also Determine Competitiveness*

**4.22. Liberalization is critical for promoting services exports.** However, its benefits are usually thwarted by inadequate implementation of supportive measures, inadequate efforts to introduce competition, failure to enforce regulation, failure to institute policies to ensure that the poor can access services in liberalized markets, inappropriate sequencing of reforms, and inadequate foreign assistance to help with reform. It is well established that institutions are central to economic development (Acemoglu et al. 2001).

**4.23. For example, in logistics services, Kazakhstan appears to benefit from a relatively liberal regulatory environment, but the quality of its services scores lower than countries with equally liberal regimes.** Figure 4.6 illustrates this point by quantifying the impact of restrictive services regulations on performance and quality of logistics services for a sample of countries, including Kazakhstan.<sup>41</sup> Figure 4.6a shows that the higher the level of restrictiveness (y axis) the lower the performance of the logistic sector (x axis). Kazakhstan emerges as having a relatively liberal regulatory regime in logistic services. It also posts a higher than average price competitiveness compared to equally liberal countries. Figure 4.6b, however, shows that, despite the low overall restrictiveness of logistics service regulations the quality of the services is lower than average. This could be based on restrictive

<sup>41</sup> This graph serves to visualize a regression model of logistics quality on services policy openness in the transport sector, conditional on additional covariates. The specifics of the regression behind this graph are as follows: the dependent variable is one sub-component of the LPI index called “Competence and quality of logistics services: very low (1) to very high (5)” in 2009. The explanatory variable of interest is the STRI score for the transportation sector. Additional covariates include the log of GDP in 2007, the log of GDP per capita in 2007, the percentage of urban population, population density, and a dummy variable for landlocked countries. In this regression, the policy variable is assumed to be endogenous and thus is instrumented for using a political institutions variable (Polity IV’s democracy index). The graph’s axes cannot be interpreted directly as they show the residuals from auxiliary regressions involving the dependent variable on all covariates except STRI (vertical axis) and the STRI variable on all other covariates (horizontal axis). However plotting residuals from both regressions against each other yields a graph in which the linear relationship between both auxiliary variables exactly resembles the coefficient on STRI in the model described above. That is, the slope of the line shown in the graph (and the value reported below) equals the estimated regression coefficient on the policy variable.

regulations in parts of the logistics services chain or a variety of other bottlenecks described in the previous section. This notwithstanding, Kazakhstan still appears to have a comparative advantage in the broader region, which is partially due to the relatively friendly regulatory environment. For example, with a much more restrictive regulatory environment, logistic services in Russia are also very costly and of low quality.

**Figure 4.6. Quality of Logistics Low Despite Liberal Regime**

Figure 4.6a. Restrictiveness and Competitively Priced Logistics Services

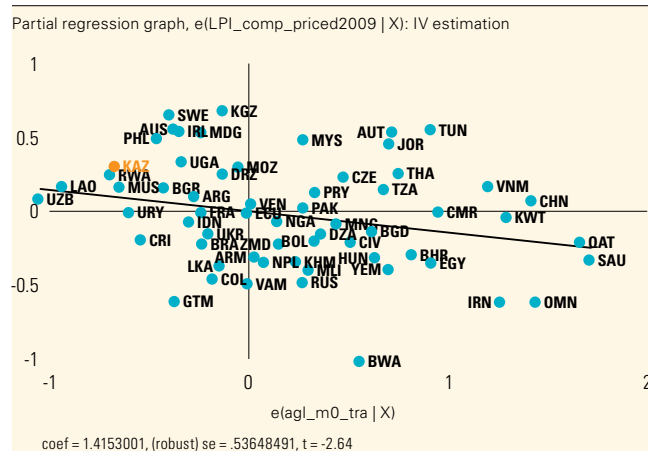
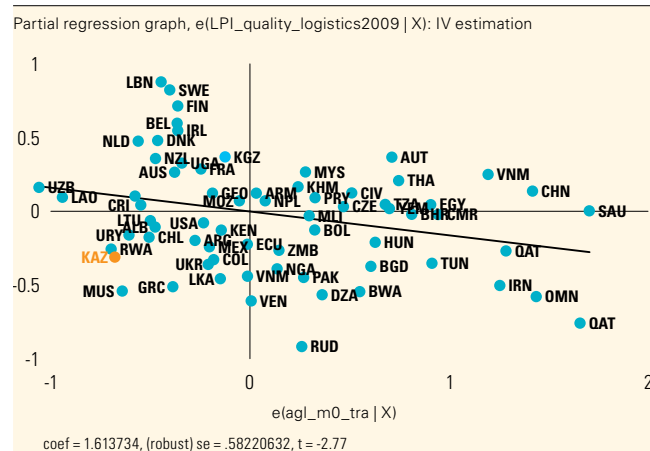


Figure 4.6b. The Relationship of Logistics Restrictiveness and Quality



Source: the 'transport sector STRI' on the horizontal axis as taken from the "Services Trade Restrictions Database" described in Borchert, Ingo, Batshur Gootiiz and Aaditya Mattoo (2012), "Policy Barriers to International Trade in Services: Evidence from a New Database", World Bank, forthcoming.

**4.24. Certain institutions may matter more for development of services sectors than other sectors.** This is true for three reasons as described by Goswami et al. (2012): (1) because services are usually intangible, they cannot be inspected by consumers before they are bought. As a consequence, there is more market failure due to asymmetric information in services markets. (2) "Vocational services" that require specialized distribution networks (e.g., roads and rails for land transport, cables and satellites for telecommunications, and pipes for energy distribution) are characterized by the prevalence of natural monopolies or oligopolies. Independent regulators are needed to promote competition in intermediate or final service markets. (3) Unlike most goods, services tend to be customized, which means both the supplier and the consumer need to make relationship-specific investments. Once these investments are made, there costs of switching to another supplier (or consumer) are high. Thus, the fear of ex-post default can ex ante reduce incentives to make investments, and contract-enforcing institutions arguably assume greater importance than they have for goods. Similarly, there is more willingness to purchase an information-processing service outside the firm if there is confidence in a country's laws and law enforcement. For example, a firm will be much more willing to outsource transcription of medical diagnosis or confidential financial information if it has confidence in host country privacy and data protection laws.

**4.25. With regard to contract-enforcing mechanisms, mechanisms to address market failures and asymmetric information, and independent regulators, Kazakhstan is not strong on the regulatory or institutional guarantees that are needed for a vibrant and competitive services sector.** Though it scores better than the Russian Federation on most accounts, except for remarkable political stability its performance is consistently lower than that of its neighbors in emerging Asia and Europe. Normalized scores on terms of rule of law and regulatory quality are about twice as high in the Asian or European region and Kazakhstan's scores on accountability and control of corruption are even worse. Respondents in field interviews identified the legal costs as a major obstacle to doing business in Kazakhstan. The laws are full of inconsistencies and very open to ambiguity,

leaving ample scope for litigation. Improving the functioning of the court system is therefore an absolutely necessary condition if the Kazakh service sector is to thrive.

**4.26. Insecurity about the effects of the law and informal barriers can create a degree of trade restrictiveness that in effect contradicts prima facie openness.** According to Vakulchuk et al. (2011), informal barriers decrease productivity in Kazakh services exports by almost 50 percent. Inability to rely on the law has been pointed out, for example, with regard to work permit rules, which “continue to change and are subject to a wide range of local authority interpretation” (PricewaterhouseCoopers, 2011). Despite the adoption in 2000 of a Code of Ethics by the Foreign Investors Council, corruption is also a major deterrent to business operations.

**4.27. In addition, in Kazakhstan, there are problems that relate to the role of the state in certain activities and governance.** Not only does the prevalence of the state limit the scope of foreign investment in an already small market, but state-owned companies seemed to be even less interested in expansion in Central Asia than their private peers (Vakulchuk, et al. 2011). Moreover, due to strict public procurement rules – with even more stringent national content conditions, ancillary services are also affected. For example in professional services public tenders emphasize lower prices, which de facto exclude major international firms. The 20 percent public procurement price differential also keeps local services providers from becoming competitive and exploring new markets abroad.

### *National Content Rules and Restrictions on Employment Increasingly Stringent*

**4.28. Local content requirements have become more stringent, which could pose problems for WTO accession.** Along with the prevalence of the state, they also help shrink even further actual openness in services markets nominally open to international competition. This is a serious risk because it amplifies the constraints on a country with a small population. To some extent, these rules also contradict the state support scheme put in place by the 2003 Law on Investments that created an exemption from customs duties on imported equipment required for investment projects (i.e., an incentive to import inputs that do not meet local content rules).

**4.29. Kazakhstan has become increasingly stringent on the movement (visa) and employment (work permit) of foreign nationals, with the intent of maximizing the employment of Kazakh nationals.** First introduced in the Law on Employment in 2000, the 2011 quota on foreign employment has been fixed at 0.75 percent of the economically active population of Kazakhstan (approximately 63,500 work permits). Securing visas and work permits can also sometimes take as long as four or five months, and they can be denied sometimes without justification or possibility of appeal. Moreover, work permits are location-specific; foreign workers cannot be moved from one office to another within the country. They are also category-specific: in 2011, foreign staff was limited to 50 percent of category 1 (managers, etc.), and 30 percent in 2012; and to 30 percent of categories 2 and 3 (specialists and skilled workers), down to 10 percent in 2012. These constraints are particularly harmful to the services sector, which relies heavily on quick access to highly qualified personnel who are not always available locally. Paradoxically, exceptions have been carved out for the oil and gas sector, which plays against the government’s goal of diversification.

**4.30. While the objectives of national content policies might be legitimate, they are not achieving the desired outcomes, and the government has not invested enough in capacity building programs that would ensure an adequate supply of local human capital.** A recent World Bank report (2011), suggested that Kazakhstan adopt the following best international practices:



- Commission an impartial review of successful local content policies around the world and an inventory of Kazakhstan's requirements. The review should identify options for measuring local content for production-sharing agreements.
- Ease procedures for obtaining working permits and be flexible about the ratio of foreign to local workers, particularly when a project is just beginning or when special skills are needed.
- Instead of setting local content quotas, consider a requirement for new entrants to undertake explicit supplier development programs.
- Reward foreign companies that make an extra effort to help local suppliers with tax deductions or other payments to partially reimburse their expenditures in helping local industries.

**4.31. Partnerships with foreign firms can be part of the solution but will require improvement of the business climate and the security of foreign investments and contracts.** Finally, a careful analysis of the likely impact of FDI directed to sectors other than extractive industries; the local content rules; and the presence of the state in the services economy could provide guidance in a review of local content requirements.

## D. Key Actions and Reforms

**4.32. Reforming services will require extensive preparation in terms of policy design and implementation.** This report is the first effort to present an overall reform agenda. More sector-specific and targeted work needs to be undertaken to develop a detailed roadmap of concrete actions in each broad area. In addition, the capacity building and institutional reform required to effectively design and implement reforms in services sector is beyond the scope of the current program.

### *Improve Knowledge and Coordination*

**4.33. First, there are several areas in which better knowledge and coordination can inform design of reforms and identify the bottlenecks that need to be addressed to ensure its effective implementation:** (1) maintain and utilize better statistics on trade in services, particularly in terms of disaggregation of trade flows as well as origin and destination of trade flows; (2) gain a clearer picture of how regulation is affecting the economy, (3) assess the export potential of service sectors, and (4) improve communication both within the government and between the government and stakeholders.

### **Improve National Statistics on Services and Services Trade**

**4.34. It is impossible to elaborate a services trade strategy without a finer picture of the country's performance and potential.** The Manual on Statistics in International Trade in Services provides guidance on best practices, and Kazakhstan could benefit from technical assistance to improve its national services trade statistics. As with goods sectors, the country should leverage the wealth of firm-level microdata that it already collects. Kazakhstan collects customs transaction data on services under the authority of the Central Bank. Devising a policy to make these data available for research and analysis while preserving their confidential nature, would greatly enhance the scope and detail of the analysis of competitiveness in Kazakhstan and therefore the nature and precision of the policy recommendations that can be offered.

## Prepare a Regulatory Assessment of Services Sectors

**4.35.** A regulatory assessment consists of (i) an inventory of active laws and regulations “affecting services and trade in services”, (ii) an assessment of their impact; and (iii) propositions for alternative regulations and institutional arrangements. More specifically, it collects information and analyzes:

- what regulations are in place; how laws and regulations are framed; what objectives are pursued; and how efficiently they are achieved;
- whether domestic regulations are rooted in international standards or international best practice;
- how user-friendly rules and administrative procedures are; how and by whom regulations are applied; and how trade- and investment-friendly domestic regulatory regimes are; and
- whether domestic objectives can be attained with regulation that puts fewer restrictions on trade and investment.

**4.36.** In general, services are affected by both horizontal and specific regulations. Typical of the former, which affect a wide range of activities, are investment, competition policy, migration, and labor market regulations. Specific regulations affect a sector (prudential regulation of financial services), a subsector (engineering services), or an activity (distribution of pharmaceutical products).

**4.37.** Regulatory quality depends both on the regulation-making process and the institutions that apply the regulations. Reform proposals that do not assess whether a country should also reform or create the necessary institutions to issue and enforce laws will be ineffective. Institutional arrangements will be assessed in comparison with recommended international practices, which usually emphasize transparency, necessity, due process, and non-discrimination.

**4.38.** An example of regulatory assessment is the World Bank Restrictiveness Index, which makes it possible to determine how restrictive services regulations are across the board and in sectors, compared to other countries. But this exercise covers only five sectors only, and within these focuses on specific activities. For instance, there is no information available with regard to media services, or a subsector like engineering or architectural services. Moreover, the focus is mainly on regulations that discriminate against foreign providers; it is not within the scope of the analysis to assess whether regulations that do not discriminate against foreigners nevertheless undermine the efficiency of a sector (e.g., restrictions on advertisement, anticompetitive practices, or price controls).

**4.39.** Why is such an assessment advisable? As a starting point for any regulatory reform or trade negotiations such as WTO accession, a regulatory diagnostic would help the government assess the situation and identify, for each services sector as well as horizontally across sectors, rules that need to be rescinded, rules that need to be refined, and new rules that should be introduced. It could also be useful for the government to define commitments it could make in the context of the single market or WTO accession negotiations and any required adjustment period. This diagnostic phase would also be an opportunity to establish a multi-stakeholder, public-private dialogue.

## Assess Export Potential of Service Sectors

**4.40.** Kazakhstan has identified a number of services sectors in its 2010-14 National Program of Accelerated Industrial and Innovative Development as priority sectors. However, there is no clear assessment of the country's

services export potential, such as through a SWOT analysis (Strengths, Weaknesses, Opportunities and Threats). Such analysis (Box 4.1) can inform the country's offensive strategy in trade negotiations and export promotion efforts discussed later.

#### **Box 4.1.** Example of SWOT Analysis for Legal Services for Kazakhstan

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Openness to foreign lawyers through automatic recognition of foreign license (except in criminal cases, which does not significantly affect the country's attractiveness to law firms).</li> <li>• Presence of major global law firms, with associated business opportunities (interfirm trade) and knowledge transfers.</li> <li>• Major infrastructure and subsoil exploitation projects that have attracted massive FDI and related business opportunities for law firms in such fields as corporate finance, mergers and acquisitions, real estate, and energy.</li> <li>• A common civil law tradition and language facilitating the export of legal services.</li> <li>• A central position between Europe and Asia.</li> <li>• Lower cost than main competitors.</li> </ul>	<ul style="list-style-type: none"> <li>• Skill shortages among nationals, especially because the curriculum is not always adapted to the needs of international practice (e.g., English language).</li> <li>• Small scale of local firms and the local market.</li> <li>• Quotas on the employment of foreign nationals and difficulties with visas that affect the operation of global law firms.</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>• To become a platform for legal services exports in Central Asia where neighboring countries have a lower endowment in human skills and are less attractive to global law firms.</li> <li>• A growing market for knowledge process outsourcing in legal services.</li> <li>• Expanded market access through the CU with Russia and Belarus, the WTO accession, and other regional trade integration initiatives.</li> </ul>	<ul style="list-style-type: none"> <li>• A small domestic market and risk of closure of local law firm offices if foreign investors are kept out of the country by too restrictive national content laws or contractual/legal instability.</li> <li>• Opening of the legal market with Russia as part of the single market and competition of firms benefiting from a free movement of services, capital, and people.</li> <li>• Risk of skill losses to foreign firms in the single market with Russia.</li> <li>• Risk of protectionist reactions and closure of foreign legal markets.</li> </ul>

Source: Authors.

#### **Improve Communication within the Government, and with the Private Sector**

4.41. Unlike trade in goods where policy issues are usually addressed by just two or three ministries, usually Finance, Trade (or Industry), and Agriculture, services are regulated by numerous institutions which may include, besides the ministries mentioned, transportation, public works, education, health, telecommunication, the central bank, financial services regulators, and sectoral authorities, among other agencies (Box 4.2). In general, there is no single ministry in charge of "services trade policies and regulations," and the technical ministries and agencies all have different prerogatives. Defining a services trade strategy requires a holistic approach and regular consultations between technical ministries. Best practice also invites participation from the private businesses that actually trade and are therefore most aware of the barriers they face, both domestically and abroad.

## Box 4.2. The Policy-Making Benefits of Intra-Governmental Coordination

Given the regulatory intensity of many services activities and the range of sectors involved, close coordination between government agencies is critical. Promoting an effective process of intra-governmental coordination is likely to generate a number of positive policy-making externalities. These include the following:

*Create holistic government positions:* Services negotiations are information-intensive. Coordination is essential for building negotiating positions based on a complete understanding of national priorities, and to ensure that negotiators are well-informed of the entire range of factors that influence the domestic services market. In countries with federal systems, such coordination can help ensure that federal negotiators are well equipped, in both knowledge and mandate, to address questions from trading partners about subnational measures.

*Create an information base on measures affecting trade in services:* One of the substantive obligations flowing from most trade agreements covering services is to provide trading partners with accurate information on domestic regulation that affects trade in services. A central inventory or focal point (preferably, a database) of regulatory measures, and a means for keeping it inventory current is needed for meeting such transparency obligations.

*Identify the effects of specific measures on achievement of economic or social policy objectives:* Governments at all levels need to periodically review whether domestic policies and regulations are effective in achieving economic and social policy objectives, and analyse their trade or investment effects.

*Create awareness of how services trade regulation affects sectors where commitments are scheduled, such as notification requirements:* In developing new policy initiatives, all parts of government need to be sensitized to the need to take into account current services trade commitments, consider incorporating international standards where applicable, and meet any notification requirements.

*Avoid duplication in consultations:* To retain the cooperation especially of small and very small service firms, it is important that they not be surveyed unnecessarily. If a government entity needs to consult with firms under its direct mandate, it should coordinate with the trade ministry so that any services-related issues can be covered instead of the firms having to respond to different initiatives. It is also important to find a balance between engaging intra-governmental partners on issues of mutual concerns but not inundate them with too much information or too many requests. Setting up regular lines of communication and assigning specific individuals can help to quickly address issues without creating unnecessary process.

*Contribute to continuous assessment of the impact of services trade liberalization:* In most countries, data for impact analysis is the responsibility of the national statistical agency. However, recourse to anecdotal information can also be useful. For instance, services trade agreements address the issue of the flow of services, while data collection typically looks at populations of service industries. Also, services agreements cover four modes of supplying services, while data collection typically deals only with cross-border trade (Modes 1 and 4), a small amount of in-country trade such as tourism or education services (Mode 2), and very little in foreign affiliate trade (Mode 3). Third, a particular service may also be exported by goods manufacturers and firms in related industries; simply surveying a single service industry may therefore not give a complete picture of export activity. Goods trade statistics include services exported by manufacturers, including both services bundled with goods (e.g., maintenance or training agreements) and stand-alone services sold by manufacturers to foreigners (e.g., financial services, consulting services). Bundled services sold to foreigners need to be distinguished from domestic service transactions that are merely embedded in exported goods and not exported separately. It is helpful to alert all government agencies that collect data to issues that need assessment and the consequent data requirements.

Source: Marconini and Suave (2010) based on OECD (2002), Managing the Request-Offer Process, Paris: OECD.

**4.42. There are different models for trade policy coordination, in services as well as goods.** The U.S. Trade Representative is responsible, among other things, for coordinating trade policy, including negotiations, with all relevant agencies and the Congress. The EU arrangement is more complex and has different levels of decision making, but it does provide a forum for coordination between the Commission, the Council of Ministers, the Member States, and the European Parliament (Jank and Silber 2007).

**4.43. Although the legal structure for trade policy is different, the US and EU systems have some features in common.** First, success demands coordination at a high level of all ministries and agencies responsible for services policies and regulations. Second, coordination should also take place within at different horizontal levels, executive and legislative branches, ministries and regulators, as well as vertically between knowledgeable officials responsible for the formulating and executing policies. Third, coordination should also provide opportunities for the private sector participation and consultation. Box 4.2 explains the benefits and objective of an effective coordination mechanism.

### *Reform Service Sectors to Encourage Competition and Attract Competitive Providers*

**4.44. Equipped with better knowledge and understanding, the second set of actions involves accelerating reform of services sectors to encourage competition and attract competitive providers and operations.** This will contribute to upgrading skills and transfer of modern technologies and know-how, with economy-wide benefits. The WTO accession process offers an optimal chance to move this agenda forward. Implementing this agenda requires decisive actions to: (1) ensure that there is a competitive framework for the services sector; (2) use international commitments to lock in reforms and increase their credibility (3) adopt measures to upgrade skills.

#### **Ensure that there is a Competitive Framework for the Services Sector**

**4.45. Kazakhstan should reform its services sector to harness fully the benefits of trade and competition by liberalizing the sector and thus removing unjustified or inefficient barriers to trade.** It is also important that Kazakhstan refrain from putting up new barriers to trade and address foreign investors' concerns about legal/regulatory certainty. In addition, to creating a more predictable and stable environment for services and services providers, Kazakhstan should adhere to international best regulatory practices (Mattoo and Payton 2007, Arvis et al, 2010).

**4.46. These reforms should also ensure that liberalization not only benefits consumers, but creates no new vested interests.** Authorities should promote competition and adopt and implement best regulatory practices, by sector. Economy-wide, the independence and the resources of Kazakhstan's competition authority could be increased.

#### **Use International Commitments to Lock In Reforms and Increase their Credibility**

**4.47. Since Russia has joined the WTO, negotiation of the terms of Kazakhstan's accession could be accelerated.** According to Jensen and Tarr (2008), over 70 percent of the gains expected from WTO accession are related to removal of barriers to FDI in the services sector. The occasion of WTO accession should be used to attract some of the best international service providers to Kazakhstan. Accession to the WTO would help accelerate and

increase the credibility of services sector reforms that Kazakhstan might make, such as removing some limits on employment of foreign nationals. This is particularly important because legal instability and uncertainty are seen as major obstacles to foreign investment in Kazakhstan.

**4.48. WTO accession could also remedy part of the problem related to size and market access by offering export opportunities beyond traditional markets.** Finally, accession will facilitate Kazakhstan export diversification goals by establishing transparent and more predictable conditions for accessing world markets, and will allow Kazakhstan to address frictions with its main trading partners or in new markets within the protection of a rule-based system (see Appendix for a detailed analysis).

**4.49. Since most gains expected from WTO accession are in the services sector, Kazakhstan would need to make sure that the CU single market does not negatively affect the dynamic of WTO accession.** Since the CU agreement preceded accession to the WTO, it should benefit from grandfather rights, though its compatibility with GATS Article V might be raised during or after the negotiations. In any case, Kazakhstan's priority should be to become a WTO member and later start negotiations on services within the CU so that any progress with the latter does not jeopardize the former.

### Upgrade Skills by Easing Restrictions on Foreign Labor and Improve Workforce Development

**4.50. The shortage of technical and managerial skills is the main drag on Kazakhstan's competitiveness and trade in services (Table 4.1).** To address this shortage, companies, unable to hire foreign workers, often hire foreign consultants. This practice is not efficient. Foreign consultants cannot substitute in the productive process on the line for technically competent engineers and agro-technicians. To address this shortcoming, two things have to happen.

**Table 4.1. Human Capital and Skills in Kazakhstan**

Variable	Kazakhstan Russian Federation				Europe and Central Asia		East Asia and the Pacific		High Income	
	actual	normalized	actual	normalized	actual	normalized	actual	normalized	actual	normalized
Gross tertiary enrollment, 2009	41.05	5.96	77.19	9.15	58.13	7.41	27.86	4.37	69.68	8.62
Internet access in schools (1-7), 2010	4.1	5.65	4.1	5.65	4.84	7.14	5.02	7.52	5.41	7.98
Public spending on education (% of GDP), 2009	3	2.39	n/a	n/a	5	7.43	3	2.39	5	7.43
Quality of science and math education (1-7), 2010	3.8	4.66	4.4	6.41	4.46	6.64	4.71	7.75	4.84	8.17
Quality of management of schools (1-7), 2010	3.6	2.67	3.8	3.89	4.36	5.9	4.42	6.3	4.94	7.98
Prof. and tech. workers as % of labor force, 2008	21.9	4.81	33.71	8.77	n/a	n/a	n/a	n/a	n/a	n/a
Extent of staff training (1-7), 2010	3.6	3.21	3.7	3.89	4.11	6.18	4.52	8.05	4.63	8.17
Reliance on professional management (1-7), 2010	3.5	1.45	3.9	3.44	4.58	6.11	4.93	7.67	5.18	8.13
Local availability of specialized research and training (1-7), 2010	4	4.66	4.1	5.27	4.59	7.1	4.45	6.79	5.07	8.4

Source: Knowledge Assessment Methodology, 2012, World Bank, <http://go.worldbank.org/JGA05XE940>

Note: Normalized results are on a 0-10 scale, with the top performing country as a 10, and all other countries a percentage of that top score. The top 10% get a normalized score between 9 and 10, and so on.

As discussed previously, in the short term, removing the barriers to employment of foreign skilled workers should be government's priority. In the long term, vocational programs need to be developed to systemically address the need. Initially, such programs can be based on agreements with foreign institutions. One example is the agreement between the Ministry of Agriculture and the Hungarian government to offer in Hungarian agricultural universities courses for Kazakh students.

**4.51. Considering how much it needs skills, Kazakhstan could review all the laws relating to movement and employment of foreign personnel to identify any serious negative effects on services trade.** The 2007 *Rules on Hiring Foreign Labor* and the *Law on Employment*, as revised in 2011, have not operated to simplify issuance of work permits; nor have the increases in quotas been sufficient to meet the needs of the companies.

**4.52. In addition to removing excessive barriers to the employment of foreign skilled workers, the government could continue to adapt the education and qualification of Kazakh nationals to the needs of an innovative society.** (Nazarbayev University is a good illustration of government activism in this area). Since there is a lack of qualified teachers, reform of the educational system will take sustained efforts. Box 4.3 presents examples of workforce development policies in competing countries. The specific example below demonstrates the types of activities that can be undertaken:

- 1. First, to take full advantage of the private sector and foreign companies already operating in Kazakhstan.** Such presence can make a major contribution to the transfer of knowledge and skills. This can be done through their ongoing operations (staff training) or through other types of contributions, e.g., involvement by Tata or Shell participation in the government's vocational training programs, or by assigning their staffs to teach at universities, as Ernst and Young did for accounting classes in KIMEP. This is another reason to relax the law on foreign employment for highly qualified personnel. Partnerships with foreign firms have been identified, for instance, in the railways sector, as an essential element to secure knowledge (remedying skill shortages) and technology transfers (World Bank 2011). Moreover, Metro A.G. not only

#### **Box 4.3.** Skills Upgrading in Developing Countries

In many countries, investment in human capital is primarily state-driven but services exports are usually driven by the private sector. Several countries are experiencing a mismatch between the skills the market requires and the skills the education system is producing. For instance, Kenya is in principle relatively well-endowed with graduates who could work in business services firms, but new graduates need to receive a substantial amount of additional training to catch up with international standards. Similarly, in the Philippines, not all college graduates are ready for the labor market requirements: only 10 percent of contact center applicants are hired immediately, and the Technical Education and Skills Development Agency provides educational grants for "near hires." Because Malaysian graduates lack the skills the market needs, in 2008, about 25 percent of graduates of public universities were still unemployed six months after graduation. Thus, Malaysia has a shortage of skilled human capital and must turn the situation around to enhance the export of knowledge-based services. In India, the demand for skills has prompted a powerful private sector response in terms of investment in education and training. In Egypt, the private sector has partnered with the government to train undergraduates to work in their firms while still in university. Thus there are ways to repair a mismatch between skills business requires and skills produced by the education system.

*Source:* Authors, based on Goswami et al., 2012.

employs 1,249 people in Kazakhstan, it also transfers skills to bring local producers up to its standards, and offers apprenticeships to build professional skills at the college and university level (Metro 2012; see also World Bank 2011a, for more extended examples).

2. **Second, trade in educational services by sending Kazakhs students abroad and by establishing branches of foreign universities in Kazakhstan.** The Bolashak scholarship program is a good illustration of salutary government efforts in providing an educational service for Kazakhs students; this program could be improved further by setting quotas by discipline to ensure that skills gained abroad match the needs of the Kazakh economy, in particular for engineers and technical specialists. With regard to establishing branches of foreign universities, the ties forged by Nazarbayev University with leading foreign universities (such as Duke in the US) demonstrate the potential for deeper cooperation with foreign centers of excellence, such as business schools.

### *Develop and Align a Services Export Promotion Strategy and Offensive Strategy for Trade Negotiations*

**4.53. The third key action for developing the services sector is to create export opportunities for Kazakh services companies (through an offensive trade negotiations strategy), and in parallel provide export promotion services to help them take advantage of these same opportunities.** Both guided by the broader trade and competitiveness agenda, export promotion and trade negotiations should be informed by the SWOT analysis described earlier and aligned with each other. Recently, Kazakhstan passed a law to authorize Kaznex Invest to extend its activities to promote the services sector. Kaznex Invest may benefit from technical assistance to design programs tailored to Kazakhstan's needs, inspired by successful experiences in competing countries (Box 4.4).

## **E. Conclusions**

**4.54. Building a competitive services sector is critical for development but also to take advantage of trade and openness.** High-quality and efficient intermediate service inputs, strong service links with other economies, and robust service exports are all features of a competitive services sector. While progress is being made, Kazakhstan is falling short of providing the requisite mix of ingredients to achieve these objectives.

**4.55. Kazakhstan has a generally liberal service regime.** However, restrictive conditions are still present within critical sectors and subsectors (e.g. telecommunications, transport, professional services). These areas are also essential to encourage development of internationally competitive tradable services. In addition to formal restrictiveness, informal barriers to entry and operation of competitive service providers and operators are widespread and are particularly pernicious. Informal barriers may partially explain why the performance of logistics services, for example, is inconsistent with its per capita income level. WTO accession offers an opportunity for rapid reform to attract top operators and providers on a competitive basis and to benefit from global knowledge and talent. In the future, facilitating access to best technologies and competitive inputs while embracing the benefits of larger markets should guide the services reform agenda. Finally, human capital/labor skills bottlenecks also undermine services sector competitiveness.

**4.56. This chapter made several recommendations for actions and reforms to bolster the services sector in Kazakhstan:** (i) improve knowledge and coordination within government and with the private sector on service-sector issues, (ii) reform services sectors to encourage competition and attract competitive providers by improving the



#### **Box 4.4.** Strategies for Promoting Services Exports

Several countries have successfully implemented sector-targeted policies to enhance services exports. Those are of two types: 1) policies for improving the business environment in specific sectors and 2) policies to promote services exports more directly.

First, some policies promote an enabling business environment, giving the private sector, national or foreign, access to better infrastructure, incentives, and streamlined regulation environment. There is little doubt, for instance, that India's services exports were driven by the absolute pool of skilled IT professionals, and the availability of management and entrepreneurial skills. However, the establishment of software technology parks that aimed to overcome bottlenecks in infrastructure and institutions may have further facilitated India's services exports. In the Philippines, active private participation led to establishment of the Philippine Economic Zone Authority (PEZA), with a structure similar to that of Software Technology Parks of India (STPI). By allowing duty-free imports of computer hardware, the STPI promoted software development. Firms in STPIs were allowed tax exemptions, guaranteed access to high-speed satellite links and reliable electric power, including core computer facilities, turn-key office space, and communication facilities, and could import equipment duty-free and without licenses. Firms were allowed to repatriate capital investment, royalties, and dividends free once they paid any taxes due. The Government of Egypt encouraged exports of software services by a policy of technology cluster, establishment of smart villages, and investment in human capital. More recently, since the early 2000s Chile has adopted policies to attract foreign investment in IT services exports. Interestingly, rather than pursuing a wider reform agenda, governments in a variety of countries have used targeted policies to enhance exports in sectors that are politically noncontroversial, such as ICT.

More recently, some countries have undertaken more traditional export promotion policies in the services sector similar to those that had long existed for goods. In Brazil, the government has combined financial support through the Brazilian Development Bank (BDNES) with promotion programs through APEX-Brasil, the Brazilian Trade and Investment Promotion Agency. BNDES has targeted mainly construction and construction-related exports. Similarly, in 2006, the Chilean export promotion agency ProChile started a fund for promoting a wide range of services exports. However, the program is too new and has limited funds, so its impact has not yet been substantial.

*Source:* Authors, based on Goswami et al., 2012.

competition framework, using international commitments to lock in reforms, and adopt measures to upgrade skills, and (iii) develop and align the services export promotion strategy and offensive strategy for trade negotiations.

## Chapter 5. Designing and Implementing Effective Trade and Investment Policy

### A. Introduction

**5.1. Kazakhstan's rich resource endowment has the potential to support Kazakhstan's structural transformation and deepen its development.** At the same time, the country faces changing patterns of global trade and investment and a changing regional trade policy environment following the implementation of the BKR CU and upcoming WTO accession. Taking advantage of opportunities will require that Kazakhstan: (i) balances regional integration efforts of the customs union with Russia, Belarus, and the Common Economic Space with international integration through WTO accession, and maximizes the benefits each offers; (ii) builds competitive goods sectors by complementing a strategic sector support with cross-cutting trade-enabling efforts; (iii) builds efficient services by promoting competition and by being more open to global skills and knowledge, and (iv) develops a comprehensive trade and competitiveness agenda and the institutional capacity to carry out this agenda.

**5.2. Developing and effectively implementing an integrated trade and competitiveness agenda is a medium- to long-term undertaking that requires country-wide reforms, specifically targeted at reducing barriers to export markets and inputs and building a competitive domestic service sector, as described in the previous two chapters.** The sector-specific actions may be identified in these areas, but this requires a detailed analysis at the sector and firm level.

**5.3. Chapters 3 and 4 examined in detail key reform areas that should be core elements of this integrated trade and competitiveness agenda.** These chapters also identified a specific set of actions that should be implemented to make progress in trade and competitiveness. Chapter 5 focuses on the institutional aspects to enable development and implementation of an integrated trade and competitiveness agenda. The chapter argues that the government should focus on three key areas to strengthen capacity for designing and implementing effective trade and investment policy:

- i. Coordination of trade policy and larger competitiveness issues, including inter-ministerial coordination and public-private dialogue;
- ii. Analytical capacity, including the use of firm-level and sector-level data and national services statistics; and
- iii. Trade and investment promotion activities.

**5.4. Also critical for creating trade enabling environment are progress in other economy-wide areas that limit supply-side responses including governance and corruption, investment climate and business environment, and human capital and labor skills.** These important areas have been discussed but not fully addressed in this report.

**5.5. Section B of this chapter makes the case for greater coordination of trade policy and pro-competitiveness reforms.** Section C describes the need for upgrading analytical capacity, Section D focuses on trade and investment promotion activities, and Section E offers conclusions.

## B. Improving Coordination of Trade Policy and Pro-Competitiveness Reforms

**5.6. The challenge of export diversification in Kazakhstan is made more difficult by the rapidly changing trade and investment landscape in which the country finds itself.** It is clear that accelerated planning and implementation of the CU may have made things more difficult for Kazakhstan's producers and exporters, at least in the short term. The stakes become even greater as the Common Economic Space and WTO accession come to the fore. It is critical that Kazakhstan improve capacity for understanding how the new competitive landscape will impact Kazakhstan's firms and industries, and to prepare the private sector for these changes. This will require two forms of coordination: 1) improving inter-ministerial coordination and 2) putting in place an institutional mechanism for public-private dialogue.

**5.7. Improving inter-ministerial coordination:** Trade covers all sectors of the economy and all aspects of production. Along with a commitment from the highest level of government and a well-defined trade and competitiveness strategy, roles and responsibilities of various ministries must be laid out. Policy coordination is a crucial part of the success of any export development strategy. In many countries the responsibility for policy implementation can be scattered among various ministries and departments, with each ministry's interest slightly different. Finance ministries may be most concerned about continued revenue generation. Other ministries responsible for certain sectors may tend to take a protective stance towards that sector. Negotiations related to WTO and the Common Economic Space address issues well beyond trade and industry. The failure of government to be aligned can undermine the potential for Kazakhstan to benefit from trade policy, and more broadly to progress on its aims of diversification and competitiveness.

**5.8. Poor coordination can have negative effects if policies intended to boost exports are undermined by other economic policies.** In the area of non-tariff measures, trade-related regulations, such as product standards or labeling requirements that are imposed for legitimate purposes, such as protecting public health or the environment, may restrict trade intentionally or unnecessarily. In the area of trade facilitation and logistics, for example, border agencies may go too far in protecting against public safety threats or smuggling and ratchet up administrative burdens on traders.

**5.9. Putting in place an institutional mechanism for public-private dialogue:** Dialogue with stakeholders including the private sector is critical to the trade and competitiveness agenda, and many countries with successful export programs have emphasized this. Business must provide information about commercial issues that government officials do not have. Seeking buy-in from private sector representatives also builds credibility in policies.

**5.10. The dominance of commodity sectors in Kazakhstan's economy has contributed to a situation whereby large, well connected firms in the priority sectors tend to have good information and access to lobby for policy.** By contrast, smaller firms without connections struggle to have their voice heard, and are often unaware of important changes that will affect them. The onus lies with both the public sector and the private sector. The public sector has established only few effective institutional mechanisms through which to engage with the private sector, that go beyond basic dialogue and resolving problems. The private sector, meanwhile, has on the whole relatively weak industry associations. As the country sets up an agenda for pro-competitive reforms and moves toward the Common Economic Space and WTO, it is critical to improve the channels of communication and engagement with the private sector in order to be better informed for negotiations, as well as to better prepare the private sector for changes that are likely to take place.

## C. Upgrading Analytical Capacity

**5.11. Global analysis, sectoral analysis and firm-level analysis can all be used to understand the impact of potential trade policy changes and also understand how changes at one level can impact changes in another level.** It is important to ask the right questions and use cost-benefit analysis and other tools before initiating agreements with other countries. For example, firm-level or sectoral-level analysis can shed light on how firms or sectors are affected by major changes in trade policy. Firm-level analysis is also a window into how firms make decisions and cope with constraints in their operating environment. Understanding the firm landscape can allow policymakers to understand better the determinants of trade performance and the precise policy tools that can be used to increase competitiveness.

**5.12. Global CGE and Partial Equilibrium Analysis:** The World Bank team has already constructed two computable general equilibrium (CGE) models for Kazakhstan. The first in 2007 assessed the WTO accessions package under negotiation at the time. The second in early 2012 assessed the impact of the customs union. Of importance currently is extending the latest general equilibrium assessment of the CU to assess the impact of the Common Economic Space; WTO-accession related policy changes; and to assess the impact of changes within China, Russia and other major trading partners on Kazakhstan. The latter will require developing a modern multi-region model. Although a significant modeling extension, the model would also contain some modeling features that are not in the present model, including agglomeration externalities in countries outside of Kazakhstan that are currently only modeled within Kazakhstan. Based on the experience of Kazakhstan in the CU, it would also be valuable to update the pessimistic scenario (no improvements on NTM and trade facilitation) and optimistic scenario (substantial improvements). Partial equilibrium models can also be used to assess impacts on specific sectors, particularly those most likely to be affected by trade policy changes.

**5.13. It is critical that analytical capacity is enhanced within the government as well as in independent analytical centers and think tanks through their participation in the relevant training programs and joint projects.** Counterparts must identify the personnel who will be tasked with learning to build the models and carrying out the analysis. These staff must complete a basic training on trade policy, its impact, the use of modeling, linkages, scenarios and interpretation. Depending on the initial skillset available and requirements of the policymakers, there are four options for developing local capacity (Box 5.1)

**5.14. Firm-Level Analysis:** With availability of Customs and Industry Census micro-data, it is now possible to analyze firm-level export dynamics, including patterns of entry, expansion, diversification, upgrading, and exit from exports based on firm types, sectors, and markets. Examples of areas where analysis of trade competitiveness would have been enhanced by the use of micro-data have been provided throughout the report. In order to deliver effectively on their policy development, advocacy, and trade promotion support mandates, it is critical that the institutions involved in setting up a pro-competitiveness reform agenda as well as those involved in trade policy and trade promotion are able to make use of these advanced analytical tools for understanding trade performance and determinants.

**5.15. Kazakhstan already collects a rich variety of firm-level data under the authority of the Agency of Statistics of the Republic of Kazakhstan for census and balance sheet information, of the Customs Control Committee for customs transaction data on goods and of the Central Bank for customs transaction data on services.** Devising a policy to make these data available for research and analysis while preserving their confidential nature, would greatly enhance the scope and detail of the analysis of competitiveness in Kazakhstan and therefore the nature and precision of the policy recommendations that can be offered.

### Box 5.1. Options for Developing Capacity In CGE Modeling for Trade Policy Analysis

The World Bank has developed two CGE models for Kazakhstan: (1) WTO accession (with services and FDI) and (2) Customs Union impacts, without services effects. Both models were programmed in GAMS /MPSGE. Going forward, there are four choices for training in these models depending on initial capacity of the analysts and requirements of the policymakers.

- (1) **Capacity to be an informed user.** (i) A large number of possible scenarios would be provided in Excel pivot table format. Experts will be trained to interpret the results and provide an explanation or make relevant presentations. This would involve email exercises and in person training. The focus would be on developing economic understanding to do economic interpretations.
- (2) **Capacity to define scenarios and run the model to execute them.** To run the model, about one week of training is required in GAMS. It is not necessary to know MPSGE to do additional scenarios. It is likely best to combine this with the user training mentioned above, but it could be separate. Excel spreadsheets of scenarios would not be provided since the participants should produce their own scenarios.
- (3) **Capacity to change or update the data.** This would be in addition to the scenario training or user training. If no prior GAMS training, participants would need to devote about one month. About seven days of additional instructor time is required.
- (4) **Capacity to change the model.** Users would need to learn MPSGE to change the equations of these models. Simple models can be developed quickly. But experience has shown that it takes about 6 months of work with this software to get to the point where you understand it well enough to modify models as complex as these. It is best to work as a team—with different skills. Additional instructor time is about 15-20 days.

Source: World Bank Trade JERP team.

**5.16. The analysis of trade competitiveness, in particular, requires two types of data.** First, customs data on the universe of goods and services imports and exports at the transaction level, which are collected by the Customs Committee (goods) and the Central Bank (services). Second, data on other firm-level information, which is collected through a range of surveys undertaken and maintained by the Agency of Statistics of the Republic of Kazakhstan, in particular the Report on Financial and Business Enterprise and the Business Registry survey.

**5.17. Why does firm level data matter?** To start with, a vast and growing empirical research has shown that firms react very differently to shocks depending on their specific characteristics, most notably productivity, size, technological content, R&D content, quality of output, quality of inputs, entry/exit barriers and trade frictions in the main sector of specialization. Hence average or aggregate performance, i.e. the one gathered through more aggregate indicators, is not sufficient as it doesn't give information on how firms are dispersed around the average and how shocks affect this dispersion. This is particularly a problem in Kazakhstan. The high specialization in scale intensive sectors suggests that a few firms dominate exports. Therefore, it is particularly important to go beyond these firms and be able to evaluate how to help high performing SMEs to grow and export and how they respond to shocks and competitive challenges. Second, firms' export outcomes are the result of different types of decisions. It is not necessarily the same set of determinants that motivates firms decisions to expand or contract production as opposed to changing product specialization, entering or exiting specific markets and entering or exiting export activity altogether. Being able to isolate the dynamics relative to these different components of a firm's export activity is therefore important. Third, merging information on exports, imports, and the economic characteristics of individual firms allows to directly associate trade outcomes to determinants and constraints.

**5.18. This exercise is ever more important, as many countries are moving in this direction and finding ways to make this information available for research and policy analysis.** For example, the World Bank has recently established a database of exporter firm dynamics for more than 40 countries, and ensures compliance with local legislation in each case. Beyond the World Bank initiative, many countries worldwide recognize the importance of taking advantage of the wealth of information from microdata and there are a wide range of models for making available the highly confidential micro data for analytical purposes that Kazakhstan could evaluate and choose from. Being able to assess a country's trade performance and firm behavior relative to exporters in other countries and identifying specific sectors or specific groups of firms where exporters struggle to survive, policymakers could draw conclusions on how to allocate resources for assistance in a more efficient manner is an effective way to identify avenues for export growth and diversification.

## D. Enhancing Trade and Investment Promotion Activities

**5.19. In Kazakhstan's case, where there is a major focus on promoting diversification, the role of both investment promotion and export promotion, and their links to national industrial policy and support for SME competitiveness, will be important.** Establishing and maintaining competitiveness in export markets requires not only getting the microeconomic environment right to support exporters and ensuring investment is channeled to the firms and sectors that are most able to exploit sources of comparative advantage, it also requires addressing market and information failures, providing public goods, and improving coordination and the diffusion of knowledge and best practices. Here, governments play an important role—through export and investment promotion activities—in the provision of a broad range of instruments designed to support exporters and to attract investment in export-oriented activities.

**5.20. While it is important that attention be paid to putting in place effective institutions and programs for investment and export promotion, this should not take priority over reforms to the business environment, policies to promote productivity enhancement, and addressing market access.** Indeed, without resolving those issues, investment in trade and investment promotion is unlikely to be well spent. As such, trade and investment promotion can be seen as a second-tier concern because piling significant resources into export and investment promotion without addressing some of these fundamental competitiveness gaps may be wasteful.

**5.21. Parallel efforts are needed.** In particular, attracting foreign investment outside the energy and minerals sector is important, as FDI can catalyze the export sector, as well as be a source of knowledge and technology to facilitate productivity gains in the domestic sector. The issues discussed here focus on: i) investment promotion, export promotion, and SME support; and ii) the role of special economic zones (SEZs).

### *Investment Promotion, Export Promotion, and SME Support*

**5.22. The Government of Kazakhstan has put significant efforts and resources in recent years into investment and export promotion, as well as programs to promote the emergence and competitiveness of domestic firms.** Four major “2020” programs are in place targeting these issues (see Box 5.2). In general, the Government appears to be taking the right types of initiatives to promote competitiveness and FDI attraction. The biggest challenge at this point is that the institutions in place to plan and implement these programs are still nascent, and may lack the internal capacity and resources to deliver effectively on their mandate.



### Box 5.2. Governmental Programs For Promoting Investment

- **Investor 2020 Program** focuses on FDI promotion in priority non-primary, export-oriented and high technology sectors, through several types of state support, including information and analytical services and, for firms operating in special economic zones, tax investment incentives, a simplified mechanism for hiring foreign workers and one-stop-shop facilities when establishing.
- **Export 2020 Program:** enterprises eligible for this program should be export-oriented (with an export share at least 10% of their output), create new jobs and participate in the project implementation covering at least 15% of total project costs or 25% of the total project costs for property. Various kinds of state support might be made available for eligible firms: export trade financing and insurance; service support for exports (information, marketing, publication of materials to help exporters, promotion of trademarks, trade missions abroad); grants to exporters compensating up to 50% of exporters' costs for activities related to export promotion (registration and certification of trademarks abroad, training in export management, market research on entry to certain markets).
- **Business Road Map 2020** seeks to develop entrepreneurship, especially of small and medium-sized businesses; state support is offered in the form of lower interest on loans; loan guarantees, support for building of industrial infrastructure; service support for doing business (legal and accounting services) and personnel training.
- **Productivity 2020 Program** aims at accelerating modernization of existing production units and creating new facilities. It provides several categories of state support to enterprises in priority sectors, including payment of expert evaluation and feasibility studies of investment projects; subsidies for compensation of a part of the costs for loan interest and leasing payments for fixed assets acquisition; innovation grants for the manufacturing application of new products by design offices; introduction of management technologies ensuring production process optimization; financial participation in personnel training, introduction of modern management and processing technologies.

Source: OECD (2011), p. 52.

**5.23. Kaznex Invest is the main agency responsible for both export and investment promotion in Kazakhstan.** The agency was established initially for export promotion in 2007, and added the responsibility for investment promotion from 2010. Significant efforts are underway to build up the basic capacity and tools for the agency including the development of a website, market and sector research, and acquiring sector specific expertise. At the moment the agency has no specific strategy or expertise for promoting services sector exports and is in the process of trying to build this with limited resources, as discussed in chapter four. The recent completion of an OECD Investment Policy Review, along with the OECD's Sector Competitiveness Strategy report (2011) establishes a roadmap of policy and institutional steps, particularly for investment promotion. But there are no specific resources set aside for an implementation program.

**5.24. Linked to this is the need for institutions involved in trade and investment promotion as well as trade and industrial policy to upgrade their analytical capacity.** This is critical, because for countries at Kazakhstan's stage of development and transition, investment and export promotion agencies are typically critical in driving the reform agenda. But to do so effectively, they need to be equipped with the data and analytical capacity to make appropriate recommendations. At present, these institutions are failing to take advantage the data available and therefore are restricted from being able to offer more targeted policy recommendations and support programs. Specifically, the potential exploit data on customs transactions and industry census micro-data represents a missed opportunity to date.

**5.25. Finally, both the private sector and Government recognize that institutionalized dialogue between the groups is relatively poor.** This is not unusual in a transition country, where top-down industrial policy has been the tradition. It is exacerbated by the emergence of a dominant oil, gas, and minerals sector, where the nature of the dialogue between the government and the private sector tends to happen in a less public and broad-based context. While several industry associations and working groups are in place, in general dialogue remains too ad hoc and reactive, with formal mechanisms for resolving private sector problems particularly lacking. This lack of effective dialogue is particularly problematic for small and medium companies, as they are more likely to lack the special connections that larger firms tend to enjoy. For these firms it is important to have effective representative bodies. While industry associations exist, however, for the most part they are relatively weak and poorly funded.

### **Box 5.3. Special Economic Zones**

Special economic zones (SEZs)<sup>42</sup> are demarcated geographical areas within a country's national boundaries where the rules of business are different—generally more liberal—from those that prevail in the national territory. SEZs act as a tool of trade and investment policy, aiming to overcome barriers that hinder investment in the wider economy, including restrictive policies, poor governance, inadequate infrastructure, and problematic access to land.

Specifically, SEZs tend to offer export-oriented investors three main advantages relative to the domestic investment environment. First, they generally offer a special customs environment including efficient customs administration and (usually) access to imported inputs free of tariffs and duties. Second, historically at least, zones have offered a range of fiscal incentives, including tax holidays, exemptions, and reductions, as well as unrestricted movements of capital and repatriation of profits. Finally, special economic zones aim to offer a high quality investment climate, one which is a marked improvement over what is available in the country overall. By concentrating on a relatively narrowly-defined area, SEZs make it more feasible to deliver a high-quality investment environment—from the perspective of financial investment, governance, and delivery capacity—than may otherwise be possible across the economy as a whole.

Recent research (Farole, 2011) suggests that the following factors are important determinants of the potential success of SEZs as a tool for promoting exports:

- **Location:** Evidence around the world shows that zones that can leverage existing agglomerations and key trade gateway infrastructure have been successful, while those that are designed as tools for development of lagging, peripheral regions tend to fail.
- **Infrastructure quality:** The quality and cost of electricity is the most important determinant of competitiveness for manufacturing-related exporters (for services exporters, telecommunications infrastructure tends to be equally important). In too many SEZs, infrastructure provision remains of relatively poor quality.
- **Transport and trade facilitation:** Efficient on-site customs clearance, effective transport links to key trade gateways, and (perhaps most importantly) efficient port operations are critical determinants of SEZ success.
- **Investor servicing (one-stop-shops):** While these are less critical in the long-run, access to an effective “one-stop” service is often important for attracting and converting initial investors.

*Source:* Special Economic Zones: What Have We Learned? WB, 2011.

<sup>42</sup> The term “SEZ” is being used here in a generic sense to cover any one of a variety of similar regimes including “industrial free zones”, “export processing zones”, “maquiladoras”, “investment promotion zones”, “foreign trade zones”, “free zones”, and “wide area special economic zones”.



## *Special Economic Zones*

**5.26. Finally, the Government is continuing to put significant investment and export promotion resources into Special Economic Zones (SEZs) (Box 5.3).** Indeed, SEZs appear to be a favored instrument for investment attraction and diversification, and the Government is putting significant bets on them being effective. According to the OECD's Investment Policy Review (OECD, 2011), most of the state budget allocated for the 2010-2014 Program for Investment Attraction is to be channeled into the creation of two new SEZs (in Karaganda, targeting metals; and Khorgos, for trade and logistics with CIS partners) and in and five industrial parks. This is on top of the six existing SEZs, in Astana ("New City"), "Sea Port Aktau" (targeting high tech production), Almaty ("IT Park"), Ontustik (targeting textiles), Atyrau ("Petrochemical Park"), and Burabay (targeting tourism).

**5.27. To date, only Astana New City (and to a much lesser degree the IT Park in Almaty) has attracted significant investment, despite the program having been operational since 2003.** In particular, the zones designed to support investment in diversified industrial activity have failed to attract interest from foreign or domestic investors. While the weak performance of the SEZ program probably stems in part from location and strategic planning, several other critical weaknesses have been identified (OECD, 2011), including:

- **Inefficient management:** in particular the lack of a centralized agency to regulate the zones, resulting in inconsistent and often substandard regional management;
- **Lack of policy stability:** in particular, related to the tax environment;
- **Lack of funding:** insufficient funding available for infrastructure development across the zones; and,
- **Excessive bureaucratic and administrative procedures:** despite the zones being advertised as having efficient administrative and licensing procedures, the process for investors to become approved licensed has been slow in many cases.

## **E. Conclusions**

**5.28. The overall message of this report is that exploiting the benefits of trade and openness necessitates progress on four fronts: (i) balancing regional integration efforts with international integration and maximizing the benefits each offers; (ii) building competitive goods sectors; (iii) building efficient services; and, (iv) moving forward in these areas will require a comprehensive trade and competitiveness agenda.** This approach requires effective and capable institutions, solid analytical underpinnings, and capacity for export and investment promotion. Without these elements, important initiatives may flounder or even harm exporters, the country may fall short of reaching worthy goals to promote trade competitiveness, or financial and human resources may be spent without tangible benefit.

**5.29. Each of the ingredients described in this chapter will help to build and carry out the agenda in the following ways:**

- Upgraded analytical capacity, including the use of general and partial equilibrium models, firm-level data, regulatory impact assessments, and national services statistics, will allow informed policy decisions. These decisions should be based on understanding of the connections between macro-level, sectoral, and micro-level changes, and knowledge of how various constraints in the operating environment affect firms and sectors.
- Improved coordination of trade policy and larger competitiveness-enhancing issues, including inter-ministerial

coordination and public-private dialogue, will help to ensure that public agencies are not working at cross-purposes, but instead working toward a common goal and the private sector is both informed and can inform ongoing trade-related initiatives.

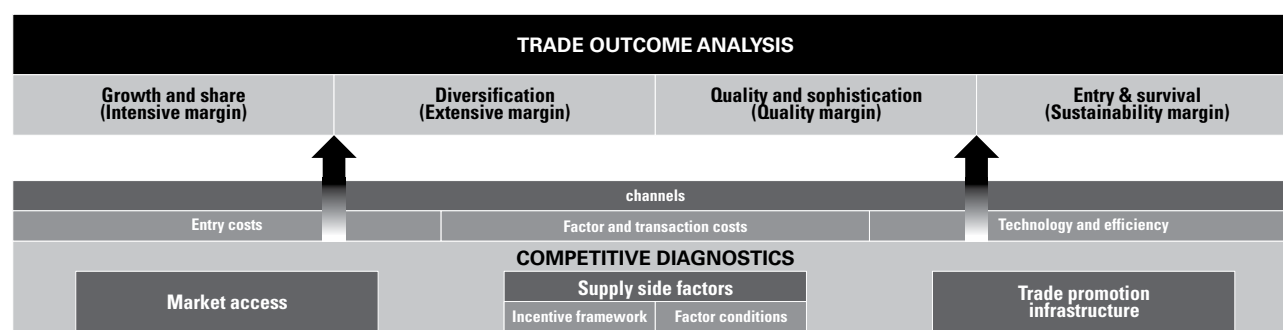
- Enhanced capacity to carry out trade and investment promotion, referring to the services offered by specialized export and investment promotion agencies and other activities such as SEZ, will allow for targeted and effective use of public funds.

## Appendixes

### Appendix 1. Objectives and Approach of the Competitiveness Assessment of Goods Sectors

We focused in this report on assessing trade competitiveness of the *outside of the energy and minerals sectors* in Kazakhstan. While it may seem odd to focus on less than 30% of the export economy, there are several compelling reasons to do so. First, as already noted, Kazakhstan has little influence on outcomes in the energy and minerals sectors, and given their dominance in the economy, any assessment of competitiveness that includes these sectors risks obscuring the others. Indeed, if we are to understand the level of current competitiveness of the economy and the factors that constrain competitiveness, we must focus on these sectors where “push” (competitiveness) factors tend to prevail. Finally, the objective of this report is to assist the Government of Kazakhstan in identifying how best to use the windfall resources from the oil, gas, and minerals sectors to develop a more modern, dynamic, and flexible economy—this will come through improving competitiveness *outside* these dominant sectors.

**Figure A1.1.** Trade Competitiveness Diagnostics Framework



This report draws on the *Trade Competitiveness Diagnostics* analytical framework developed by the International Trade Department of the World Bank, as illustrated in Figure A1.1. This approach involves analyzing trade performance (*Trade Outcomes Analysis*) along multiple dimensions of competitiveness: levels, growth, and market share; orientation and diversification; and quality and sophistication. Following this *Competitiveness Diagnostics* explores a range of issues that impact the observed performance, including potentially market access, the incentive framework faced by exporters, factor conditions, and the trade promotion infrastructure. The note is based partly on desk research, including standard sources used as part of the *Trade Competitiveness Diagnostics Toolkit*. In addition, in-depth field interviews, including individual interviews and focus groups, were conducted with more than 20 public and private sector organizations during a mission to Astana and Almaty from 22 February through 1 March, 2012.

## Appendix 2. Sectoral Analysis of Chemicals and Agricultural Products

### Chemicals

Chemicals products range across the spectrum of complexity in the PCI (from 8 to 661), with the median product in 2010 ranked at 256, somewhat more complex on the whole than metals. Within this, Kazakhstan about 60 percent of the total chemicals product range, with its top five exports (which account for 94 percent of total chemicals exports) ranking on average at 521 – Figure A1.1 highlights this skew toward the low-complexity end of the spectrum<sup>43</sup>; this changed little between 2005 and 2010, despite what seems to be a significant change in the product mix. As of 2010, Kazakhstan was not exporting any complex chemical products in any significant volume. Its most complex with any volume of note is polyurethane, but that was only US\$3.5 million in exports (ranked 98th in the PCI and Kazakhstan's 17th largest chemical export product). To assess chemicals quality (lower panels) we focus on the largest export product group, inorganic chemicals, and on the Russian market, traditionally the most important market for Kazakhstan, although China is moving up fast. Here the product ladder is very flat, indicating virtually no price or quality differentiation in the market. While Kazakhstan held one of the higher quality positions in 2000, by 2008 it had fallen considerably—although given how flat the ladder is, relative changes in quality ranking have little meaning.

#### Box A2.1. Competitiveness as the Production of Complex Goods

In their Atlas of Economic Complexity, Hausmann, Hidalgo, et al. (2011) describe a product as essentially an aggregation of the knowledge (explicit and tacit) or “capabilities” required to produce it. From this point of view it is evident that some products are a lot more complex than others – think of a high-speed computer or a jumbo jet versus plywood or a banana. Of course, more complex products offer greater returns, not only in terms of the economic rents that can be earned from them, but also—and critically from the perspective of economic growth and structural transformation—in terms of the spillovers of knowledge that they offer. Based on this logic, and backed up by econometrics, Hausmann and colleagues argue that economic growth is essentially a function of complexity: as a country grows it makes more complex products.

The authors of the Atlas have gone on to create a Product Complexity Index that ranks all significantly traded products (at SITC 4-digit level) according to complexity. Product complexity is essentially a function of the complexity of the countries that export the product. Countries in turn are ranked in complexity based on the basket of products they export—a function of the diversity of products they produces (the number of distinct products it makes) and the ubiquity of those products (how many other countries make that product).

In 2011 the index ranked 773 products, from the highest ranked, “non-mechanical or electrical instruments for physical analysis (SITC 8744), to the least complex, uranium and thorium (SITC 2860).

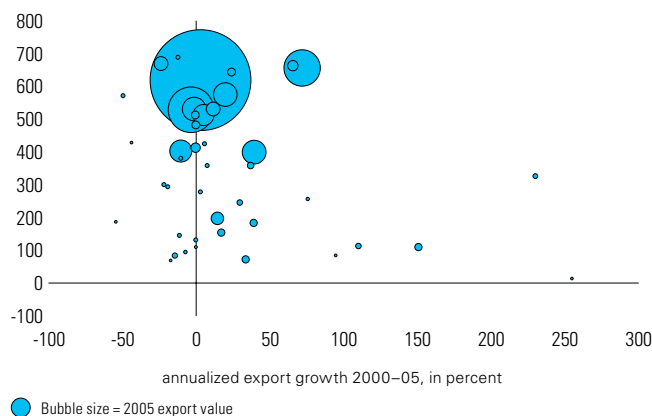
Source: Hausman, R., Hidalgo, C.A., Bustos, S., Coscia, M. Chung, S., Jimenez, J., Simoes, A., and Yildirim, M.A. 2011. The Atlas of Economic Complexity: Mapping Paths to Prosperity. Boston: MIT and Harvard University.

<sup>43</sup> Note that in the figures, we exclude Kazakhstan's largest chemicals export – radioactive chemical elements (uranium) – as it is so large relative to other exports that it skews the chart. This product is ranked 611<sup>th</sup> in the PCI (low complexity).

**Figure A2.1.** Kazakhstan's Complexity And Quality Performance: Chemicals

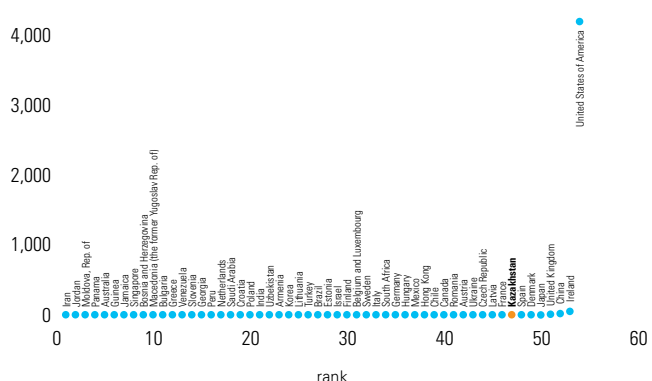
Complexity: Chemicals (2005)

complexity ranking 2009



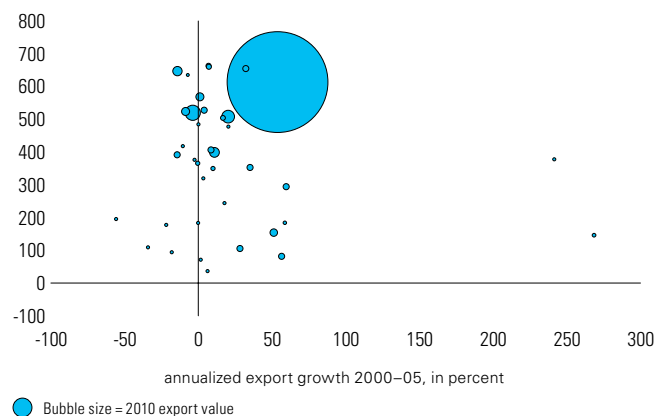
Quality: Inorganic chemicals (2000), exports to Russia

Russia: inorganic chemicals (28), 2000, rel\_quality



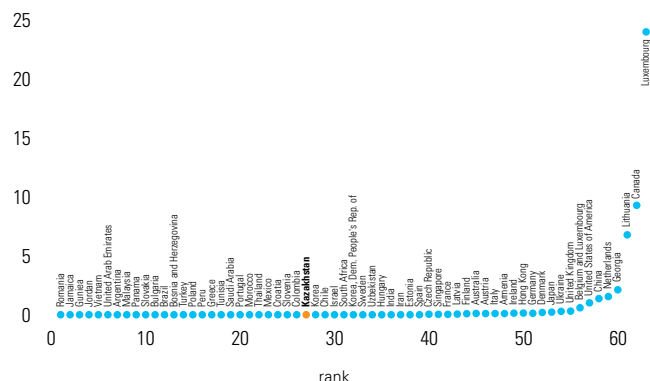
Complexity: Chemicals (2010)

complexity ranking 2009



Quality: Inorganic chemicals (2008), exports to Russia

Russia: inorganic chemicals (28), 2008, rel\_quality



Source: Authors' calculations based on data from Comtrade (via WITS) and BACI.

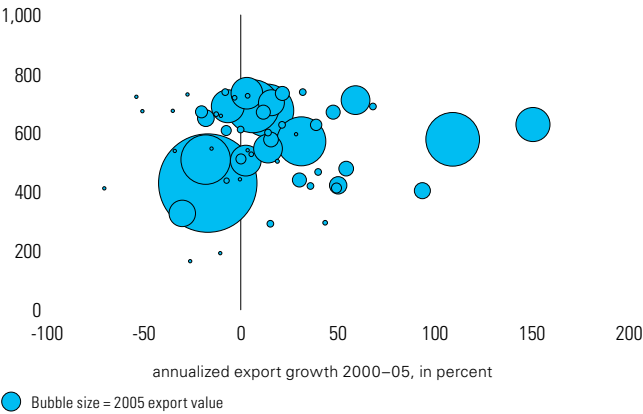
### Agricultural goods

The agricultural goods sector (Figure A2.2) ranks low in complexity, with the most complex product ranked only 76th and its median product only 579th. There seems to have been very little change in the aggregate complexity of Kazakhstan's export basket of agricultural goods between 2005 and 2010, despite concentration in the product mix. In 2010, Kazakhstan participated in 74 of the 104 agri-food export products covered in the PCI; its top five products (accounting for 84 percent of its exports) had an average rank of 605. Kazakhstan's highest-ranking agricultural export (pork) ranked only 163rd and achieved only US\$86,000 in exports. The highest-ranking export with any significant volume is chocolate (US\$10m), which ranked 295th and was Kazakhstan's 11th largest agri-food export. Interestingly, the fast-growing frozen fish fillets product ranks only 679th in terms of complexity in the PCI, making it far less complex than most meat products. For the quality assessment of quality, we focus on the fish sector and the EU market, destination for most fish exports. Again, we see a relatively flat quality ladder, indicating low price differentiation. Over a decade Kazakhstan moved up from being one of the lowest-quality suppliers in 2000 to a somewhat higher, but still relatively low, rank a decade later.

Figure A2.2. Kazakhstan's Complexity And Quality Performance: Agribusiness

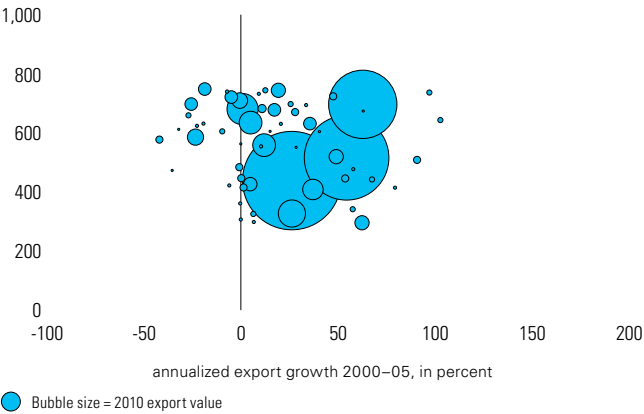
Complexity: Agribusiness (2005)

complexity ranking 2009



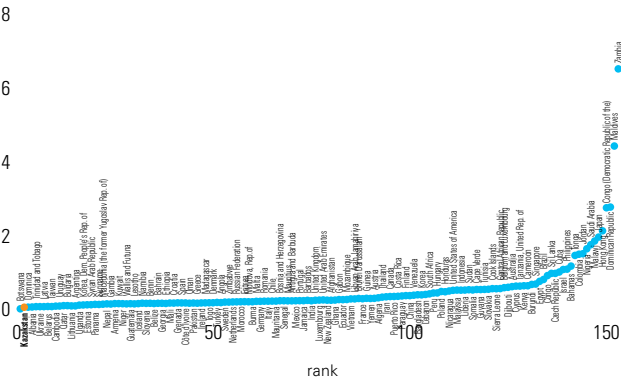
Complexity: Agribusiness (2010)

complexity ranking 2009



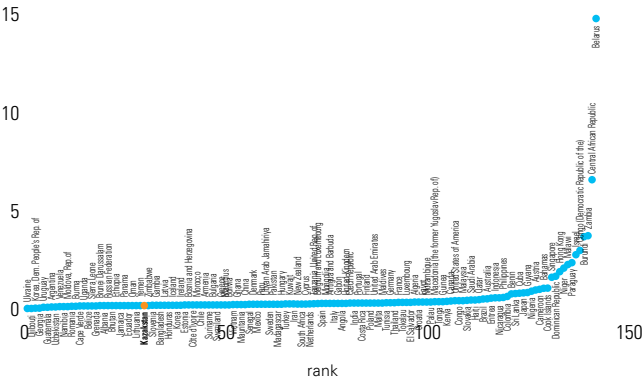
Quality: Fish (2000), exports to EU-27

EU27: fish-crustaceans (03), 2000, rel\_quality



Quality: Fish (2008), exports to EU-27

EU27: fish-crustaceans (03), 2008, rel\_quality



Source: Authors' calculations based on data from Comtrade (via WITS) and BACI.

### Appendix 3. Categories of Export Services

Export Service Category	Explanation
Transportation	Transportation covers all transportation (sea, air, land, internal waterway, space, pipeline, etc) services that are performed by residents of one economy for those of another and that involve the carriage of passengers, goods (freight), rentals of carriers with crew, and related supporting services.
Travel	Travel differs from the other categories in the sense that the consumer (traveler) moves to the location of the provider (a resident of the economy) and what is covered by the travel category are those goods and services acquired during the visit (less than a year). The international carriage of the traveler is covered under transportation. The measure can be interpreted as a proxy for international tourism, business travelling and international student (even if staying longer than one year).
Communication	Communication covers (i) telecommunication and (ii) postal and courier between residents and nonresidents international transactions.
Construction	These are construction services performed by employees outside the country of the location of the enterprise. It also includes the goods the employees bring with them abroad to perform the task. Expenditures for local good though are recorded under Other business services.
Insurance	Insurance services cover insurance provided by a resident to a nonresident and vice versa. It would often be freight insurances but also other direct services.
Financial	Financial services cover financial intermediary and auxiliary services (except those of insurance enterprises and pension funds) between residents and nonresidents. This could be fees related to letters of credit, lines of credit, financial leasing, foreign exchange transaction, transaction in securities, asset management, etc, etc.
Computer Information	Computer data and new-related service transactions between residents and nonresidents. These could be data bases, data processing, hardware consultancy, software implementation, maintenance and repair of computers, new agency services, etc.
Royalties & license fees	These are exchange of payments between residents and nonresidents for the use of intangible and nonfinancial assets or property rights such as patents, copy rights, franchising, manuscripts, films, etc).
Other business	Other businesses include (i) Merchanting (the purchase of goods by a resident from a nonresident and the subsequent resale to another nonresident, during which the good does not leave the compiling country), (ii) Operational leasing without operators covers resident-nonresident leasing, and charter without crew, (iii) Miscellaneous services, including (a) legal, accounting, management consulting, public relation services, (b) advertising and market research services, (c) research and development services, (d) architectural, engineering and other technical services, (d) agricultural, mining and on-site processing services, and (e) other services between residents and nonresidents.
Personal & cultural	These services are divided into (i) audiovisual (services and fees for motion pictures—including to actors and producers, radio and television programs and musical recordings) and (ii) other (services related to museums, libraries, sporting, correspondence courses, etc).

## Appendix 4. Constructing the Measure of Services Export Sophistication

This methodology draws upon Mishra, Lundstrom and Anand (2011) and Anand, Mishra and Spatafora (2012). To formalize the notion of sophistication, a measure of export sophistication (EXPY) is constructed using the framework developed in Hausmann, Hwang and Rodrik (2007). This index aims to capture the productivity level associated with a country's export and is a proxy for the most productive set of products the country can produce at a given time. The choice of exports as proxy is guided by the idea that they reveal the production frontier as countries can be expected to export those products in which they are most productive, as well as, the availability of data.

EXPY's are computed for three categories of exports: goods, manufactured goods, and services. In order to calculate the EXPY's, each category of goods, manufactured and service exports is ranked according to the income levels of the countries that export it.<sup>44</sup> Products exported by rich countries (controlling for overall economic size) are ranked higher than products exported by poor countries. These product-specific calculations are then aggregated to construct the country-wide indices of export sophistication.

Specifically, let countries be indexed by  $j$  and products be indexed by  $l$ . Let  $p$  be an export category (that is, goods, manufacturing, or services). Total exports of category  $p$  from country  $j$  equal

$$X_j^p = \sum_l x_{jl}^p$$

Let  $Y_j$  denote the per-capita GDP of country  $j$ . Then the productivity level associated with product  $k$  in category  $p$ , equals the weighted average of per capita GDPs, where the weights represent the revealed comparative advantage of each country in that product:

$$PRODY_k^p = \sum_j \{ (x_{jk}^p / X_j^p) / \sum_j (x_{jk}^p / X_j^p) \} Y_j$$

The numerator of the weight,  $(x_{jk}^p / X_j^p)$ , is the value-share of the product in the country's category  $p$  export basket. The denominator of the weight,  $\sum_j (x_{jk}^p / X_j^p)$  aggregates the value-shares across all countries exporting that product in that category. Next, the *PRODY*s are used to compute the productivity level associated with country  $j$ 's export basket of goods, manufactured goods, or services, (export sophistication). Specifically, is the average income and productivity level associated with all products in a given category exported by a country? It is computed as the weighted average of all relevant *PRODY*'s, where the weights represent the share of the relevant product in the country's export basket. Thus,

$$EXPY_j^p = \sum_l (x_{jl}^p / X_j^p) PRODY_l^p$$

*EXPY*s are constructed for each country and for each year with available data. The *EXPY*'s are constructed using static *PRODY*'s, that is, the *PRODY* for each good is held constant at the average value during 2005–09. This means that any increase in *EXPY* measures a country's shift from low *PRODY* to high *PRODY* products, that is, the share of high *PRODY* goods, manufactures, and services in the export basket increased. The service exports data aggregation mentioned is sometimes exacerbated by the further aggregation in what the countries report.

Turning to the actual data, in general, higher-value-added goods and services have higher recorded *PRODY* (Table A4.1).

<sup>44</sup> Our focus is on commercial service exports. Government services are therefore excluded when measuring Service EXPY.



**Table A4.1.** PRODY for Various Categories of Goods and Services

	Goods					Services				
	Primary Products	Resource Based	Low Tech	Medium Tech	High Tech	Transport	Construction	Royalty & License Fees	Computer & Information	Financial
Average PRODY	10,425	14,827	13,635	19,070	21,814	10,189	11,828	12,912	17,791	22,763

The evolution over time of the *PRODYs* for each service category is presented in Tables A4.2 and A4.3. The columns on the left (transportation, travel, communication and construction) represent traditional services, while the columns on the right (insurance, financial, computer & information, royalties & license fees, other business services, and personal, cultural & recreational services) represent modern services. In general, the *PRODY* of modern services are higher and have been growing more rapidly.

**Table A4.2.** Sophistication of Service Exports, by Category, at Global Level

Year	Transportation	Travel	Communication	Construction	Insurance	Financial	Computer & Information	Royalties & License Fees	Other Business Services	Personal, Cultural & Recreational Services
1990	7,420	7,372	7,343	13,073	6,906	20,649	16,414	10,040	7,456	18,054
1991	7,936	7,489	7,307	16,415	6,956	17,560	16,073	7,424	7,342	16,303
1992	7,981	7,193	6,801	17,275	7,817	19,216	14,403	8,656	7,648	12,058
1993	8,164	7,311	4,934	14,453	7,823	17,603	14,644	8,999	7,856	6,394
1994	8,255	7,542	5,241	13,066	8,278	14,871	11,120	9,407	8,299	8,695
1995	9,214	7,691	5,937	12,780	11,222	21,643	16,844	17,054	8,698	11,607
1996	9,135	7,828	6,255	12,840	11,448	22,384	17,131	15,034	8,920	12,783
1997	9,263	7,943	6,174	8,980	11,498	23,841	18,015	11,576	9,107	13,953
1998	9,800	7,684	6,346	10,104	11,201	22,416	22,789	12,153	9,710	12,344
1999	10,319	7,951	6,503	10,210	11,075	23,612	22,433	14,409	10,013	13,216
2000	10,516	8,082	6,553	10,422	10,856	24,409	19,852	14,973	10,763	14,282
2001	11,213	8,408	6,552	9,695	10,496	25,160	18,058	15,318	11,132	14,613
2002	11,559	8,696	6,467	9,185	13,842	24,862	17,906	14,828	11,812	13,442
2003	11,870	8,769	6,926	8,232	15,187	22,486	17,961	14,670	12,725	13,615
2004	12,656	9,086	7,932	9,494	14,894	23,871	19,150	12,611	13,175	14,491
2005	12,575	9,312	9,205	11,402	15,725	25,444	19,226	14,610	13,940	15,374
2006	12,779	9,653	9,522	12,691	14,316	28,546	19,090	12,488	15,557	16,490
2007	12,751	9,986	7,518	12,593	13,721	31,167	19,129	18,158	16,191	16,192
Mean	10,189	8,222	6,862	11,828	11,292	22,763	17,791	12,912	10,575	13,550
Standard Deviation	1,870	846	1,172	2,541	2,885	3,925	2,770	3,047	2,784	2,792

Source: Authors' calculations.

**Table A4.3.** Growth in Sophistication of Service Exports, by Category, at Global Level, in percent

	Transportation	Travel	Communication	Construction	Insurance	Financial	Computer & Information	Royalties & License Fees	Other Business Services	Personal, Cultural & Recreational Services
Average Annual Growth 1991–2000	4.4	1.9	4.4	-2.3	6.9	5.7	6.9	5.8	4.7	5.8
Average Annual Growth 2000–07	2.5	2.7	2.3	7.0	0.6	6.5	3.9	7.2	5.8	3.4

Source: Authors' calculations.

Turning to the goods, manufacturing and services EXPY's, not just their mean but also their standard deviation has increased over the years; that is, countries are becoming increasingly diverse in their sophistication (Table A4.4). This suggests that the potential EXPY has increased, and some countries have started to benefit from this higher potential.

**Table A4.4.** Summary Statistics, Goods and Services EXPY (2007)

Goods EXPY			Service EXPY		
Year	Mean	Standard Deviation	Year	Mean	Standard Deviation
1980	9,706	4,592	1990	6,615	1,258
1990	10,768	4,783	1995	7,900	1,598
2000	12,182	4,586	2000	9,253	1,807
2007	12,509	4,645	2005	10,924	2,179
2009	12,714	4,848	2007	11,859	2,599

Also, countries with more sophisticated exports of either goods or services are generally characterized by a higher GDP per capita.

## Appendix 5. Services Trade Restrictiveness Index Methodology<sup>45</sup>

Despite the importance of services in a country's competitiveness, services face significant regulatory barriers. A restrictive regulatory environment weighs negatively on productivity and is associated with low quality and high cost of services while greater openness is correlated with higher economic growth. In brief, service regulations that restrict market access for new operators or discriminate against foreign service providers and weak service regulatory frameworks that discourage entry and operation of new firms affect developing countries' competitiveness and economic performance. The empirical literature confirms that the welfare gains of services openness is primarily the result of increased competition from imports and their influence in the long-run growth performance (Hoekman and Mattoo, 2008, Francois and Hoekman, 2010).

### *Characteristics of Services Barriers* <sup>46</sup>

International services transactions are impeded by a variety of regulatory barriers, especially to FDI and the movement of service-providing individuals. These barriers may be designed to restrict entry of service providers, both domestic and foreign, in a country's economy. As a consequence, countries may benefit both from domestic liberalization of their own barriers and the liberalization of barriers by their trading partners.

Barriers to trade in services also arise from regulations to address market failures. These regulations aim at fulfilling legitimate policy objectives such as protecting health and upholding competition. There are, however, two distinctions that tend to apply across many types of services and service barriers: regulations that apply to entry or establishment of firms versus their operations; and regulations that are nondiscriminatory versus discriminatory. Regulations that restrict or impede the establishment of service providers within a market will usually reduce their numbers and therefore the quantity supplied at any given price. Regulations of ongoing operations, on the other hand, may not reduce the number of suppliers, but they will increase their costs, causing them to supply a given quantity only at a higher price. Likewise, the nondiscriminatory vs. discriminatory distinction determines whether a regulation reduces only the number of foreign service providers (discriminatory) or instead raises costs and shifts supply for both foreign and domestic suppliers (nondiscriminatory). However, a regulation that impedes establishment of all new service providers, in spite of being nondiscriminatory, can nonetheless limit trade and competition by favoring a domestic incumbent (Cattaneo, et al 2010).

### *Methods of Measurement of Services Barriers*

In this report, we use the database on services regulations collected by an ongoing research project at the World Bank, undertaken within the Development Research Group, which compiles data on applied services trade policies. The aim is to compile a Services Trade Restrictiveness Index (STRI), to quantify the restrictiveness impact of regulatory measures. The survey covers five key sectors: financial services (banking and insurance), telecommunications, retail distribution, transportation, and professional services. In each sector, the survey covers measures that affect the establishment of commercial presence, restrictions on cross-border services trade, or the movement of natural persons, where relevant (Borchet, De Martino, and Mattoo, 2010 and 2011).

<sup>45</sup> Borchert, Ingo, Batshur Gootiiz and Aaditya Mattoo (2011), "Policy Barriers to International Trade in Services: New Empirical Evidence", World Bank: forthcoming.

<sup>46</sup> This section is based on Cattaneo et al (2010), chapter 1.

### *Scope of database*

The database covers 103 countries that represent all regions and income groups of the world. For each country, five major services sectors are covered that encompass a total of 18 sub-sectors:

- Financial services: retail banking (lending and deposit taking) and insurance (automobile, life and reinsurance)
- Telecommunications: fixed-line and mobile
- Retail distribution
- Transportation: air passenger, maritime shipping, maritime auxiliary, road trucking and railway freight
- Professional services: accounting, auditing, and legal services (advice on foreign/international law, on domestic law, and court representation)

Within each subsector, the most relevant modes of supplying the respective services are covered:

- Mode 1: financial services, transportation and professional services
- Mode 3: all sub-subsectors
- Mode 4: professional services

### *Data collection*

To obtain original information about applied services trade policies, World Bank has conducted surveys in 79 developing countries. The surveys were completed by local law offices which have extensive expertise in local investment laws, regulations, and the practical experience of working in these sectors. The surveys are based upon each country's objective legislative information, augmented with information on implementation of regulatory measures as applicable.

With respect to the OECD countries covered, comparable policy information was collected from various publicly available sources, including the respective country's GATS commitments and offers, WTO reports, and Economic Intelligence Unit reports, among others.

For all countries, information on cross-border air transport policies comes from the WTO's QUASAR database.

The accuracy of all policy information whether collected through surveys or otherwise, was checked with Government and Ministry officials of the countries. The information as presented in the database reflects the Government feedback, if any, in cases when the feedback deviated from the survey information.

### *Measuring the restrictions*

There are, in principle, different ways of measuring restrictions on services trade (please see the section on measurement in the Services Trade Restrictions Database descriptive paper). One way of summarizing the effect of applied policies is to represent the restrictiveness in one single index measure. We construct such a Services Trade Restrictiveness Index (STRI) at the most disaggregated level for any subsector-mode combination. This measure of openness is simple and transparent. As compared to other indices based on a fixed set of scores and weights, it avoids problems such as the double-counting of non-binding restrictions. As compared to measures which infer

restrictiveness though the impact of measures on some outcome, this measure is not dependent on the availability of data on services sector performance.

In essence, within each subsector-mode we assess policy regimes in their entirety and map the bundle of applied policies into five broad categories (with associated scores):

- Completely open (0);
- Virtually open but with minor restrictions (25);
- Major restrictions (50);
- Virtually closed with limited opportunities to enter and operate (75);
- Completely closed (100).

After assigning a score to a subsector-mode, the scores can be aggregated into sector, mode or regional indices using, at each step, the following kind of weights:

- Modal weights: a sector-specific set of weights reflecting expert judgment as to the relative importance of alternative modes of supplying a specific service;
- Sector weights: a set of weights derived from the average share of a given services sector in value-added for an average industrialized country. Sector weights are constant across countries to ensure comparability;
- Country weights: equal weights within region. Equal weights avoid a regional average score becoming completely dominated by one very large economy such as China or India, as would happen with, for instance, any kind of GDP-based weight.

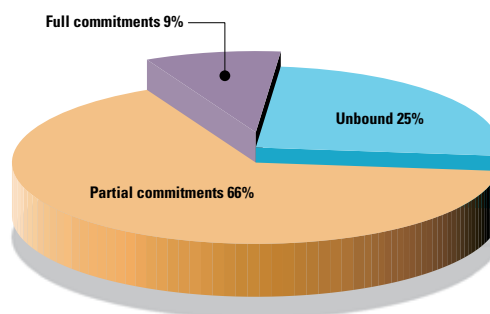
## Appendix 6. WTO Accession and Services Trade

Since Russia recently joined the WTO, the negotiation of the terms of Kazakhstan's accession could be accelerated. It is expected that Kazakhstan will shortly join the WTO. According to Jensen and Tarr (2008), over 70 percent of the gains expected from WTO accession—representing 4.8 percent of the value of Kazakh consumption—are related to the removal of barriers to FDI in the services sector, and the terms of accession could be carefully negotiated in the best interest of Kazakhstan. Accession to the WTO would help accelerating, locking-in, and increasing the credibility of reforms in the services sector that Kazakhstan might adopt as part of its trade diversification and promotion strategy or as a result of the accession negotiations. This is particularly important considering that legal instability and uncertainty are perceived as major obstacles to foreign investment in Kazakhstan. It is for instance planned that limits on foreign employment by categories would be removed once Kazakhstan becomes a member of the WTO.

**Figure A6.1.** Russian Federation GATS Services Commitments

Overall Commitment by Sectors

in percent



Source: Authors based on WTO, WT/ACC/RUS/70/Add.2 WT/MIN(11)/2/Add.2, 17 November 2011.

Note: Full commitment means there are no restrictions other than horizontal limitations applicable to all sectors; Partial commitment means there are some specific limitations applicable to the schedule service activity; Unbound means there are no commitments.

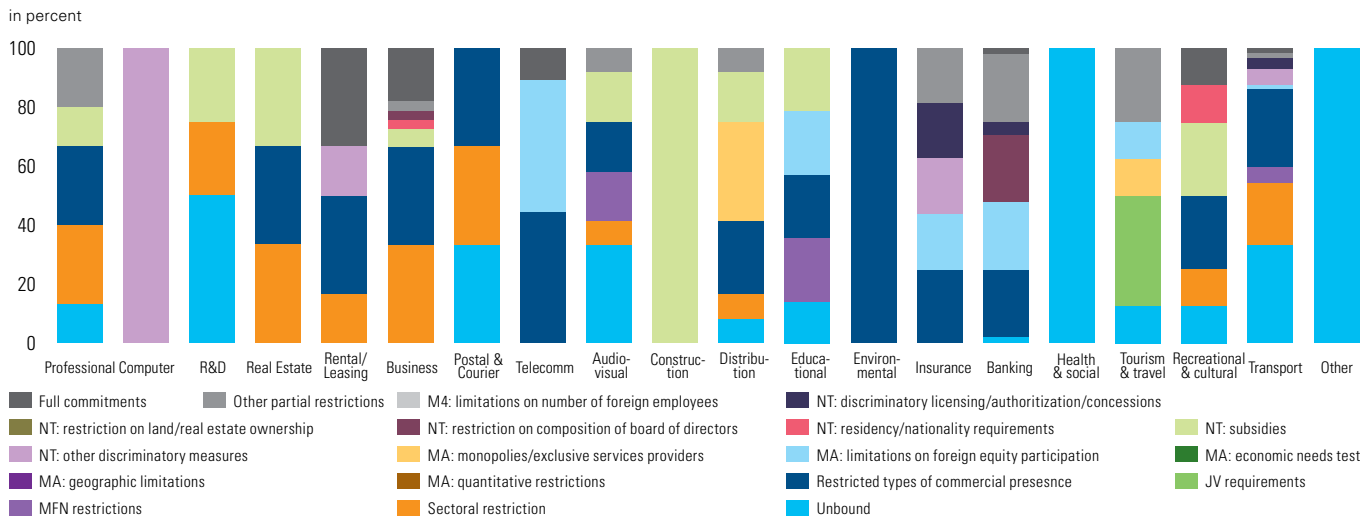
WTO accession could also remedy part of the problem related to size and market access by offering new export opportunities beyond traditional markets. Finally, WTO accession will facilitate Kazakhstan export diversification goals by establishing transparent and more predictable market access conditions in world markets, and will allow Kazakhstan to address trade frictions with its main trading partners as well as in new markets, under the protection of a rule based system.

There are several facts that Kazakhstan's authorities should consider when assessing their negotiating space in the final phase of the WTO accession process. First, generally, acceding countries adopt more commitments than other WTO members, both in terms of sectors committed as well as modes of supply included in those commitments. Second, the quality of those commitments is generally higher than for existing WTO members. This is reflected in the reduced number of limitations on market access and national treatment scheduled on specific sectors. Third, all acceding countries have to adopt in full the obligations contained in Telecommunication Reference Paper, have to take significant liberalization commitments in financial services, including through all modes of supply, and have in general to adopt commitments on cross-border Maritime and Air Transport (MAT) insurance services, as well as activities included in the Understanding on Commitments on Financial Services, for example, regarding transfer of information and processing of information. Finally, new acceding countries have adopted in general commitments for the following categories of services providers:

- Business visitors and salespeople are foreign nationals travelling abroad to negotiate the sale of a service or explore the possibility of establishing a commercial presence for their company in the destination country. Their main purpose is to facilitate future transactions rather than carry out transactions that have already been agreed upon.
- Intra-corporate transferees are employees of a service provider who are transferred to an office their company has established abroad.

- Independent professionals are self-employed workers who supply services to a company or individual in a foreign country.
- Contractual services suppliers are employees of a foreign company that does not have a commercial presence in the host country. These employees are contracted to provide a service to another firm company in the host country.

**Figure A6.2.** Russian Federation GATS Market Access and National Treatment Terms and Conditions

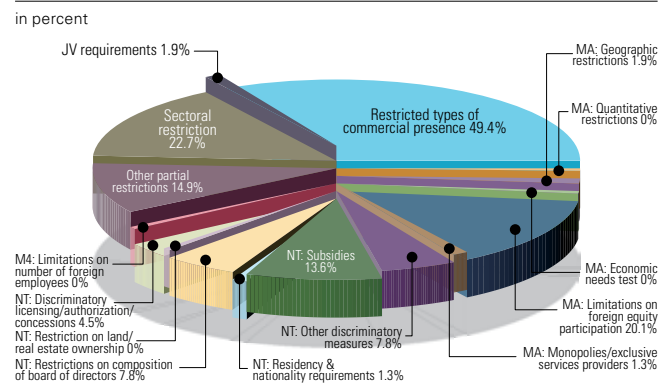


Source: Authors based on WTO, WT/ACC/RUS/70/Add.2, WT/MIN(11)/2/Add.2, 17 November 2011.

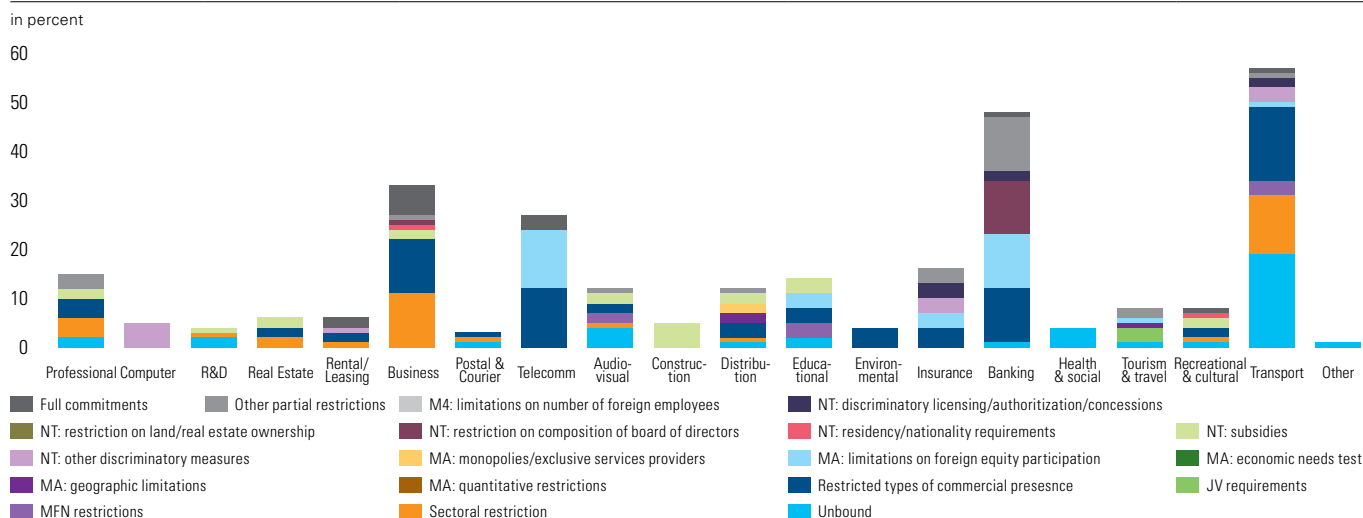
Yet within this framework, so far new acceding countries have been able to negotiate the terms and conditions in the services schedules. For instance, in the case of the Russian Federation, there are a number of more restrictive conditions for service providers willing to establish a commercial presence such as land acquisition, privatization, and type of commercial presence. Also, although the number of sectors listed is large, the Russian Federation limits in some cases the scope of the sector. This was usually the case in professional services. Another example is that there are no commitments regarding the use of subsidies which basically allow the Russian government to discriminate in favor of national providers. Finally, regarding temporary movement of natural persons, the commitments adopted are with respect to intra-corporate transferees and business visitors. Figure A6.2 describes the type of limitations, if any, applicable to the sector committed. For example, in the case of construction services the only condition scheduled is with respect to subsidies under national treatment.

Figure A6.3 confirm that commitments adopted are extensive in terms of sectoral coverage, modes of supply, and overall quality of commitments. Some limitations are specific to certain sectors such as foreign ownership which the Russian Federation was also able to maintain mainly in telecommunication and banking sectors. Moreover, Figure A6.4 confirms that limitations are concentrated in a few sectors mainly professional, business, telecommunication, banking, transport services.

**Figure A6.3.** Russian Federation: Type of Limitations Scheduled under GATS Commitments



Source: Authors based on WTO, WT/ACC/RUS/70/Add.2, WT/MIN(11)/2/Add.2, 17 November 2011.

**Figure A6.4.** Russian Federation: GATS commitments by Sector and Type of Measures

At the regional level, the entry into force of the single market with Russia and Belarus will require changes in legislation and regulation necessary to ensure the free movement of services and services providers in the region. Although there is no specific information on how the single market will integrate the service sectors into its structure, there are important decisions that should be addressed on a timely manner. First, it is urgent that Kazakhstan adopts a plan for the formation of the single market that could also take into consideration the impact of commitments made by Russia in the context of its accession to the WTO, and define the most convenient type of institutional setting to liberalize the services trade in the context of the single market: GATS-type of agreements, EU-type of liberalization, or NAFTA-type of agreement. Second, any decision will require a significant effort of organization, preparation, and information gathering, as well as consultation with private sector and other stakeholders. This is an effort that could build upon the work that is under way in the context of the WTO accession, but it will require going beyond that. For example, it will need to identify arrangements to facilitate the movement of professionals such as mutual recognition agreements. Also, it would need to go beyond issues of market access and national treatment and move toward more elaborate measures that may restrict access such as authorization and license regime in the single market. In addition, it will require gathering information on market access conditions within the single market in order to ensure that other measures limit access to those markets.

Adequate preparation and implementation are essential to the regional trade integration process so that the country can fully harness its benefits. Trade diversion and creation effects of regional trade agreements have to be properly balanced. With regard to services, there is also a plan to create a single market by 2015. Little is known, however, about the regulatory reforms that are needed to implement the single market and the impact it would have on Kazakh services trade.

For example, in the air transport, how could Air Astana and the 36 other airlines that are licensed in Kazakhstan compete with a highly subsidized Aeroflot if the skies were fully opened (i.e. to include domestic flights) between Russia and Kazakhstan? What are the reforms needed to harmonize the rules of the Kazakh Civil Aviation Committee with its Russian counterpart? Lack of preparedness might raise a number of issues in the context of the Kazakh WTO accession. Full convergence is not necessarily desirable and should be assessed in the light of different factors, such as the proximity of the regulations, the scale of operation of services providers, economies of scale for infrastructure and regulation.



The example of the European Union shows that regulatory convergence is a gradual and lengthy process, which requires important efforts and resources: the EU itself still struggles with the harmonization of its members' services regulations, as illustrated by the implementation of the Services Directive (so-called "Bolkenstein Directive"). For this reason, most countries have opted for mutual recognition agreements that represent a less costly first step towards integration. However, Kazakhstan is committed to the "single market" model and will need to adjust.

Since most gains expected from WTO accession are in the services sector, Kazakhstan would need to carefully review the impact of the single market and make sure that it does not negatively affect the dynamic of WTO accession. Provided that the agreement with Russia and Belarus has preceded accession to the WTO, the single market should benefit from grandfather rights, however, due to the absence of implementation, its compatibility with GATS Article V might be raised in the course of the accession negotiations or later. In any case, from the point of view of Kazakhstan the priority should be to become a WTO member and later start negotiations on services within the economic union with Belarus and Russia, otherwise, any progress within the latter may have implications in the former.

## Appendix 7. Kazakhstan's Position on World Bank's Knowledge Economy Indicators

This section presents Kazakhstan relative position among the pillars of the Knowledge Economy Indicators prepared by the World Bank. The KEI is an aggregate index that represents the overall level of development of a country or region in the Knowledge Economy. The KEI is built on the basis of variables grouped in four pillars of the Knowledge Economy framework:<sup>47</sup>

- An economic and institutional regime to provide incentives for the efficient use of existing and new knowledge and the flourishing of entrepreneurship;
- An educated and skilled population to create, share, and use knowledge well;
- An efficient innovation system of firms, research centers, universities, consultants and other organizations to tap into the growing stock of global knowledge, assimilate and adapt it to local needs, and create new technology;
- Information and communication technology to facilitate the effective creation, dissemination, and processing of information.

Among these factors, education and ICT pillars are the most important for the services performance, in particular, what are called modern services.

**Table A7.1.** Knowledge Economy Indicators

Country/ Group	KEI		Economic Incentive and Institutional Regime		Innovation		Education		ICT	
	recent	1995	recent	1995	recent	1995	recent	1995	recent	1995
Kazakhstan	5.04	4.93	3.96	1.95	3.97	4.03	6.91	7.26	5.32	6.48
Kyrgyz Rep.	3.82	4.42	1.58	2.61	3.12	3.41	5.32	5.48	5.27	6.17
Russian Federation	5.78	5.67	2.23	2.6	6.93	5.64	6.79	7.84	7.16	6.6
Ukraine	5.73	5.96	3.95	3.05	5.76	6.1	8.26	8.35	4.96	6.32
Europe and Central Asia	7.47	n/a	6.95	6.06	8.28	8.41	7.13	n/a	7.5	8.2
High Income	8.6	n/a	8.39	8.29	9.16	8.97	8.46	n/a	8.37	8.99
Upper Middle Income	5.1	n/a	5.18	4.98	6.21	5.08	4.72	n/a	4.28	7.24
Lower Middle Income	3.42	n/a	3.32	3.03	4.9	3.55	2.84	n/a	2.62	5.41
Low Income	1.58	n/a	1.61	1.93	2.13	2.37	1.54	n/a	1.05	n/a
World	5.12	n/a	5.45	5	7.72	7.91	3.72	n/a	3.58	7.16

Source: World Bank, Knowledge Assessment Methodology 2012, <http://go.worldbank.org/JGAO5XE940>.

Note: Four key variables serve as proxies for each Knowledge Economy pillar: Economic Incentive and Institutional Regime, Education, Innovation, and Information & Communications Technology (ICT).

Knowledge Index (KI) is the simple average of the normalized country scores on the key variables in three pillars – education, innovation and ICT. Knowledge Economy Index (KEI) measures performance on all four pillars.

The scorecards demonstrate comparative performance - the variables are normalized on a scale from 0 to 10 relevant to four possible Comparison groups – all countries, region and income groups.

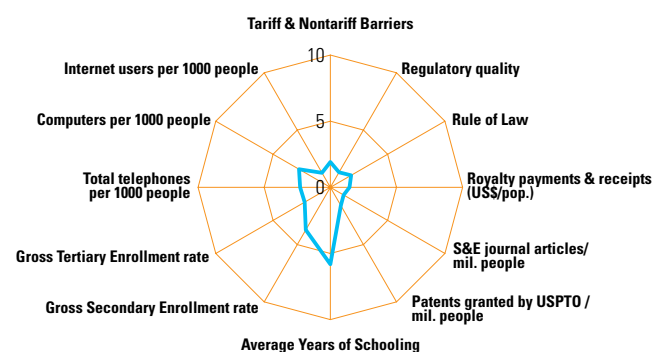
If a country performs worse over time on a certain normalized variable, this may be because it:

- actually has lost ground in absolute terms, or
- improved slower than the comparative group.

<sup>47</sup> See Knowledge Assessment Methodology, 2012, World Bank, <http://go.worldbank.org/JGAO5XE940>

Although Kazakhstan has improved its overall indicator since 1995, the improvements are explained by the reforms in the economic regime. Regarding the pillars dealing with innovation, education, and ICT, their scores have regressed compared to 1995. Figure A7.1 presents the relative scores where 1 is the lowest score and 10 the maximum score. Generally, Kazakhstan scores are all below 5, except regarding average years of schooling.

**Figure A7.1. KEI Detailed Indicators**



Source: World Bank, Knowledge Assessment Methodology 2012, <http://go.worldbank.org/JGAO5XE940>

## Appendix 8. Kazakhstan's Performance on OECD Regulatory Quality and Reform Recommendations

Recently the OECD (2012) has issued new recommendations regarding regulatory quality and reform. The recommendations which take the form of 12 principles could help Kazakhstan to diversify its economy by attracting investors to non-natural resource dependent sectors. What are these principles and why they matter for Kazakhstan?

Following Ernest and Young 2010 survey, which confirms information provided by other sources regarding governance, we identified the measures that affect business environment in Kazakhstan. In what follows we analyze the relationship amongst these measures and the regulatory principles recommended by the OECD.

According to the Ernest and Young 2010 survey, 53% of respondents felt that the level of legal and regulatory transparency and stability remains unattractive. In addition, new laws and regulations often do not take into consideration the real capacity or ability of the business community to comply, and uncertainties in applying the law. The rapid pace of legislative change leads to ambiguity in the interpretation and application of certain laws and regulations, creating uncertainty and undermining investors' confidence. The adoption of the OECD recommendations can contribute to improving investor perception, confidence, and attractiveness of Kazakhstan. In particular, principles 1 and 2 provide that governments:

1. Commit at the highest political level to an explicit whole-of-government policy for regulatory quality.
2. Adhere to principles of open government, including transparency and participation in the regulatory process to ensure that regulation serves the public interest and is informed by the legitimate needs of those interested in and affected by regulation. This includes providing meaningful opportunities (including online) for the public to contribute to the process of preparing draft regulatory proposals and to the quality of the supporting analysis. Governments should ensure that regulations are comprehensible and clear and that parties can easily understand their rights and obligations.

According to the Ernest and Young survey, the interpretation of some drafted laws can be random and indiscriminate, leading to uncertainty and a perception that an inspector will take the position that is most disadvantageous to the investor in order to avoid being accused of favoring investors and risk being suspected of being unduly lenient, increasing the number of cases that need to be resolved in court. Also, Kazakhstan is perceived as a highly bureaucratic which can mean lengthy and unnecessary delays. The Kazakh practice is very much driven by the need for comprehensive documentation to be completed in line with strict procedures. Penalties for non-compliance may be significant and disproportionate to the actual offense. Finally, investors have, in some instances, voiced concerns about the law enforcement agencies' operations.

These issues are addressed by principles 3, 4, 5, 6, 7, 8 and 9 recommended by the OECD. More specifically these principles provide that governments should:

1. Establish mechanisms and institutions to actively provide oversight of regulatory policy procedures and goals, support and implement regulatory policy, and thereby foster regulatory quality.
2. Integrate Regulatory Impact Assessment (RIA) into the early stages of the policy process for the formulation of new regulatory proposals. Clearly identify policy goals, and evaluate if regulation is necessary and how it can

be most effective and efficient in achieving those goals. Consider means other than regulation and identify the tradeoffs of the different approaches analyzed to identify the best approach.

3. Conduct systematic program reviews of the stock of significant regulation against clearly defined policy goals, including consideration of costs and benefits, to ensure that regulations remain up to date, cost justified, cost effective and consistent, and deliver the intended policy objectives.
4. Regularly publish reports on the performance of regulatory policy and reform programs and the public authorities applying the regulations.
5. Develop a consistent policy covering the role and functions of regulatory agencies in order to provide greater confidence that regulatory decisions are made on an objective, impartial and consistent basis, without conflict of interest, bias or improper influence.
6. Ensure the effectiveness of systems for the review of the legality and procedural fairness of regulations and of decisions made by bodies empowered to issue regulatory sanctions. Ensure that citizens and businesses have access to these systems of review at reasonable cost and receive decisions in a timely manner.
7. As appropriate apply risk assessment, risk management, and risk communication strategies to the design and implementation of regulations to ensure that regulation is targeted and effective. Regulators should assess how regulations will be given effect and should design responsive implementation and enforcement strategies.

In addition, in order to ensure a consistent and coherent interpretation, application, and enforcement of laws and regulations at different government levels, the OECD recommendations provide in principles 10 and 11 that governments should:

1. Where appropriate promote regulatory coherence through co-ordination mechanisms between the supranational, the national and sub-national levels of government. Identify cross-cutting regulatory issues at all levels of government, to promote coherence between regulatory approaches and avoid duplication or conflict of regulations.
2. Foster the development of regulatory management capacity and performance at sub-national levels of government.

Finally, in order to avoid unnecessary restrictions to trade, and increasing heterogeneity of laws and regulations, the OECD recommends that:

1. In developing regulatory measures, give consideration to all relevant international standards and frameworks for co-operation in the same field and, where appropriate, their likely effects on parties outside the jurisdiction.

## Appendix 9. WTO discipline, regional cooperation and international experience on SPS/TBT measures

### *WTO discipline*

The general guiding principles of WTO rules are based on the necessity and proportionality tests. By necessity test is meant that government intervention should be justified by a reasonably compelling case of market failure. By proportionality test is meant that government intervention should not inflict more damage on trade than needed to achieve the measure's objective.

Specific rules for the design of Technical Regulations (TRs) other than sanitary ones are laid out in the WTO's TBT agreement.<sup>48</sup> Beyond the necessity and proportionality tests, the disciplines contained in the TBT agreement are based on the principles of nondiscrimination and national treatment. That is, regulations should apply to all products irrespective of their origin (they could not, for instance, be relaxed on a preferential basis, which anyway would make no sense) and they should not penalize imports more than domestic products. In particular, a regulation cannot impose restrictions on imported products based on their method of production: Only the product's characteristics that are relevant for public health or the environment count.<sup>49</sup>

Rules for the design of Sanitary and Phytosanitary (SPS) measures are laid out in the WTO's SPS agreement.<sup>50</sup> The agreement's most essential rule is that the protection of the population or the environment against sanitary risks should be motivated by scientific evidence. When scientific evidence is ambiguous, Article 5.7 allows the application of the precautionary principle (imposing restrictions in anticipation of possible harm rather than after the harm has been established) provided that the measures are maintained only temporarily while further scientific evidence is actively sought.

### *Regional cooperation*

Members of regional blocs cooperate to address information problems related to SPS/TBT measures in at least three ways: by using and disseminating Good Regulatory Practice (GRPs) and engaging in regulatory co-operation; by setting and using international standards; and in the WTO context through discussion in the TBT and SPS Committees. While the term "Good Regulatory Practice" is not embedded in the SPS Agreement to the extent that it is in the TBT Agreement, many of the discussions with the SPS Committee implicitly capture similar themes. Regulatory cooperation in general is about building trust among regulators with regard to regulatory systems and outcomes, which helps to provide confidence that SPS/TBT measures will strike an efficient balance between policy objectives and trade restriction.

There are different levels of trust, formality and degree of engagement. The most basic category of cooperation is simple information exchange and trust building, which will lower transaction costs. A more advanced category of cooperation is mutual recognition of accreditation systems and testing procedures, which lowers cost for exports by enabling conformity assessment to the requirements of export markets to be carried out in domestic laboratories prior to export. Other categories of arrangements involving greater levels of trust and engagement include **mutual**

<sup>48</sup> The TBT acronym stands for "Technical Barriers to Trade."

<sup>49</sup> There are subtleties in complex cases like activities that affect endangered species. See, inter alia, Cadot, Malyszewska and Saez (2010).

<sup>50</sup> See [http://www.wto.org/english/tratop\\_e/spse/spsagr\\_e.htm](http://www.wto.org/english/tratop_e/spse/spsagr_e.htm).

**recognition** (MRA) of conformity assessment results and mutual recognition of technical regulations, including through recognition of equivalence.

In the first MRA model, mutual recognition concerns only testing and certification procedures. Even this relatively modest degree of delegation of authority is far from being universal in CUs. For instance, in the East African Community (EAC), a product that is certified to meet the common regulation in one Member State must nevertheless be re-certified if it is to be exported to another member State. In the second MRA model, any product that is cleared in one Member State is automatically acceptable without restriction in any other member State.<sup>51</sup> It requires a substantial amount of trust between member States, and is viable in the long run essentially in the perspective of a gradual harmonization of technical regulations, as happened in the E.U.

The most ambitious program is **full harmonization** of both technical regulations and associated conformity assessment procedures, which implies that all countries adopt the same set of measures. This typically means a complete overhaul of national regulatory systems, an immensely complex task. For example, while MRAs take effect at once, the harmonization of regulations can take decades. In the E.U., for instance, the process was largely completed at the end of the century, although the CU was created in 1957.

### *International experience*

International experience in terms of regulatory convergence is so wide that there is too little or too much guidance. In the E.U., the engine of mutual recognition has been tacit cooperation between the European Court of Justice and the European Commission, the landmark decision being a court one (see footnote 52). However the applicability of lessons drawn from the European experience is less than clear given that the very strong degree of supranationality that characterized the European model from the outset is unlikely to be reproducible anywhere else, in particular in an “asymmetric” CU with a strong hegemon. In NAFTA, another regional agreement with a strong hegemon, regulatory convergence is limited and no plans for full harmonization exist. NAFTA’s Chapter 11, which sets out a mechanism for the resolution of disputes between private investors and member States, could lead to de facto harmonization if private interests systematically challenged regulatory differences, but that has not been the case so far. In ASEAN, harmonization has not taken place yet, and progress has been limited to a sectoral MRA in cosmetics.

Systematic cross-country evidence suggests that both mutual recognition and the harmonization of technical regulations in regional agreements have the power to reinforce intra-bloc trade at the expense of trade with third countries, reinforcing the danger of trade diversion (see e.g. Baller 2007, Chen and Mattoo 2008, Disdier, Fontagné and Cadot 2012). This is particularly true of “North-South” agreements where the South is encouraged to harmonize its regulations with stringent Northern ones, raising its producers’ costs and pricing them out of other, out-of-bloc, Southern markets. In a context where Southern markets grow faster than Northern ones (Gourdon 2007), this can be high cost to pay.

Even in South-South agreements, harmonization can “go too tight”. For instance, Jensen and Keyser (2012) show that dairy standards harmonization in the East African Community (EAC) was set at a level so stringent that only the largest producers could comply if it were to be applied. In the authors’ words, “[t]he problem is that the new harmonized standards are largely copied from international standards designed for a context widely different from

<sup>51</sup> This principle is prevalent in the EU and was established by a crucial decision of the European Court of Justice in the 1979 *Cassis de Dijon* case. See <http://eur-lex.europa.eu>.

the East African one.” (p. 1) Unrealistic requirements are a potential problem whenever regulations perceived as “international best practice” are adopted with insufficient regard to local needs and capabilities. In the case of the East African dairy industry, the authors argue that the push came from large operators who wanted to use over-stringent (and largely redundant) sanitary requirements to put smaller operators out of business and reduce competition.



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