Chapter Five

CONCLUSIONS AND APPROACHES
Conclusions

The transition to a market economy means the gradual reorganisation of the entire economic structure and social relations. Kazakhstan, the largest Central Asian Republic, started this process with the advantage of having large natural, mineral and fuel resources.

In Chapter One, Kazakhstan's position is analysed in Central Asian region. The chapter first discusses the economic conditions at independence and thereafter review the progress made during the last decade both for the region and Kazakhstan. Thereafter, energy resource endowment and sector performances are described briefly for the region, and in details for Kazakhstan. The chapter is empirical in nature using secondary data from various sources to build the arguments. Following are the broad finding of this chapter:

- The region is an important geo-political region – apart from being resource endowed investment destination – because of its potential to influence economic and political developments in neighboring countries of Asia and several other parts of the world.

- Kazakhstan, as compared to other Central Asian states, was in much better shape at the time of independence. Resource endowments, diversified agriculture and industry and relatively stable polity have helped this country in embarking on transition path faster than many of its neighbours.
In energy scene, the region holds huge potential in terms of diversity and availability, but mainly constrained by following factors.

- The energy transportation system (oil and gas pipelines and electricity transmission lines) was built to serve the internal needs of the FSU, and its configuration does not reflect present political boundaries.
- Weak administrative capabilities, geographical constraints and the historical economic legacy are hampering modernization of the energy sector.

Environmental safety aspects have also been traditionally ignored in the states of Central Asia resulting in disastrous consequences. These are also challenges, which need to be overcome to seriously reap the fruits of potential.

In the major part of last decade, however, Kazakhstan has witnessed contraction in domestic energy demand / consumption. According to the World Bank, per capita commercial energy use has on an average declined by 11.6 percent annually between 1990 and 1997. Kazakhstan has potential to develop energy sector based on resources other than oil and gas, with certain constraints. In coal, due to its poor quality, investment in technologies (increasing the efficiency of ash-and gas cleaning equipment), which are locally unavailable. In atomic energy, having a scientific research base of four reactors, Kazakhstan needs skilled scientists / engineers and international know-how for operation, including safety aspects. In hydropower there are issues of geography, logistics and environment.
In Kazakhstan, Oil and natural gas among them holds higher promise because it has attracted interests from one and all. About 50% of energy needs in Kazakhstan are catered by oil and natural gas. It holds more than half of the Caspian region’s proven oil reserves and 80 percent of its estimated possible oil reserves.

In Chapter Two, oil and gas sector of Kazakhstan is described in detail with potential and concerns. Again, it is an empirical chapter based largely on secondary information.

It has a well-developed oil and gas industry since 1911, when oil was first extracted in the west of the republic. In current infrastructure, apart from about 160 oil fields, Kazakhstan has three major oil refineries supplying the northern region (at Pavlodar), western region (at Atyrau), and southern region (at Shymkent).

In terms of performance, Kazakhstan is expected to generate huge surplus of oil for exports. In natural gas, however, situation would be opposite. Recent initiatives have been enumerated in this chapter. There are huge and large-scale interests, by foreign companies, in various oil and gas projects. However, on ground, very few of them are moving, due to various reasons like, chaos, shortage of funds, weak institutional & legal structure, infrastructural bottlenecks, environmental hazards, outside pressures (or influences) and dependence on Russia.
Dependence on Russia is the biggest single factor having direct bearing on the fortune of Kazakhstan's oil and gas sector. Under the former Soviet Union, Kazakhstan's pipeline network was integrated with the Russian pipeline system, and all of Kazakhstan's oil was exported through the Russian pipeline system. Other concerns are ownership rights of Caspian Sea and environment.

Despite possessing huge potential on the basis of endowments, future development of this sector, and the Kazakh economy, is largely dependent on, apart from domestic policies and politics, politics of the region which involves some of the global players. So much so that this attention is being compared with 'The Great Game' of 19th Century between Russia and Britain. However, politics apart, challenges are many.

In Chapter Three, the recent debates about the political and economic implications of energy development in Central Asia and the Caucasus are covered. Three of the new states of this region—Azerbaijan, Kazakhstan, and Turkmenistan—hold sizeable reserves of oil and gas, most of it located beneath or near the Caspian Sea.

The scale of these reserves is often exaggerated: the Caspian region will never approach the Persian Gulf in terms of its importance for global energy security. But its reserves are sizeable enough to justify the intense interest of the international energy industry. Corporations are playing a central role in Caspian oil and gas development, but much of the debate ignores or minimizes their role, seeing the situation instead as a balance-of-power.
competition among external states: Russia, Turkey, Iran, China, and the United States. The chapter details the shortcomings of this purely geopolitical approach and notes some analyses that supplement this perspective with an understanding of the commercial aspects of Caspian energy development. These two approaches help in understanding the various forces in play in Caspian. As far as pipelines are concerned, a strong case, however, can be made that the goals of oil companies in the Caspian – finding commercially optimal ways of bringing Caspian oil and gas to market – are quite commensurable with the goal of peace and co-operation.

Politically speaking, multiple pipelines are the best solution, since this outcome would help encourage the emergence of a stable new balance of power in which no external state or states dominate the region. But commercial viability makes this option unlikely, at least in the foreseeable future. An approach towards exports that eschewed or postponed the construction of massive regional pipelines in favour of a number of smaller, cheaper export routes could possibly serve both commercial and political ends. This would require following conditions to be implemented:

- No regional power, including Iran, be excluded completely from the game.
- All players to move away from zero-sum thinking
- USA to adopt more effective policy by avoiding excessive emphasis on Russian neo-imperialism, which is both unhelpful and inaccurate.

The Chapter identifies the key question i.e, what will be the domestic impact of the coming hydrocarbon boom? The experience of other countries and
experts opinion suggest that oil money could have pernicious effects both economically and politically, in stark contrast to the rosy scenarios that are often taken for granted. Emergence of weak and corrupt elites to distribute the booty associated with oil and gas wealth, distorted utilization of money and increased volatility are major reasons behind this unexpected fiasco.

The Chapter Four attempts to analyse the economic developments, especially in energy sector, in Kazakhstan. As in other energy-rich, developing countries, exaggerated calculations of future resource wealth have lead Kazakhstan's leaders to view the energy sector as the engine for future economic development.

However, Kazakhstan's short-term approach to realizing such development has resulted in policies that could have negative long-term implications. Kazakhstan's leaders have invited an unprecedented level of foreign involvement through rapid privatization of the energy sector. From the perspective of Kazakhstan's leaders, the short-term gains from such policies include diffusing popular discontent, attracting capital investment, and increasing the power of the central government. In addition, foreign companies are increasingly responsible for the social and economic well-being of Kazakhstan's population. However, the consequences of such policies are quickly becoming apparent as expectations of an oil windfall lead to overspending, exorbitant borrowing, and increased public protests. In addition, underdevelopment of other sectors of the economy, a weak system of tax collection, and greater reliance on foreign assistance could cause Kazakhstan to devolve into a quasi-state that is inter-nationally recognized but
able neither to meet the basic social needs of its population nor to achieve even minimal levels of economic growth.

This scenario, however, is not inevitable. To avert such a crisis, the Kazakhstani government should increase domestic tax collection and expand domestic markets. In addition, the Kazakhstani and other governments having interest in the country can take steps to decrease the expectations of a vast and imminent energy windfall, encourage greater investment in non-energy sectors, and foster a more open political system.

Major long-term consequences of the energy policy adopted by the government are

- The failure of the influx of oil and gas revenues to benefit the vast majority of the population has already contributed to growing popular discontent about the state of Kazakhstan’s economy and, consequently, to the erosion of support for so-called market reform. Moreover, by my own estimates, the number of recorded public demonstrations and strikes has increased approximately 17 times since mid-1995 and the unrecorded incidence is likely to be even higher. These protests have occurred not only to call attention to Kazakhstan’s deteriorating economic conditions but also to demand some relief.

- The central government’s tendency to borrow against future oil and gas revenue and to engage in overspending will undoubtedly impede Kazakhstan’s future economic and political development. In 1996, Kazakhstan was already spending nearly 10 percent of its budget revenues on servicing its external debt, and, as a direct result, dramatically
cut all social programs. Thus, high levels of foreign debt are likely not only to hinder economic growth but also to impede the state's capacity to perform basic functions, such as the provision of basic public goods and social services.

- The official shift in focus toward the energy sector and away from other sectors, combined with the government's failure to bolster tax collection, will also have serious long-term negative economic and political consequences for Kazakhstan. Although unemployment remained relatively low in 1997, since 1998 it has been on the rise in manufacturing and even began to spread into energy sector enterprises as the force of falling oil prices squeezed profit margins. The effects of rising unemployment are already being felt in declining tax revenue, rising poverty levels, lack of access to health care, and increasing out-migration. Over the long-term, not only are these trends likely to increase but so are the necessary budgetary outlays required to address them adequately. For example, since unemployment is predominant among "the young [and] those with low levels of education or mismatched skills" and out-migration is occurring among middle-aged skilled laborers, addressing this problem does not mandate revitalizing industry alone. It also will require massive government investments in vocational training and technical education.

- Yet, without adequate tax collection institutions, it will be increasingly difficult for the government to generate the necessary revenues with which to make these investments. In fact, poor revenue performance has already contributed to disproportionate declines in the social safety net, in public investment, and the funding of public services. As of 1998, "public expenditures [were] running at about a third to a half of pre-independence
levels in real terms." Ironically, the modest amount of rents that Kazakhstan is estimated to achieve, even with a slight upward trend in world oil prices, is far less than what can be achieved by improved tax collection efficiency."

Taxation is also germane to the future of democracy in Kazakhstan. Without a viable tax system it is unlikely that Kazakhstani citizens will ever develop the direct and reciprocal relationship with their state that has long been recognized, at least implicitly, as the basis for democratic governance. The very purpose of democracy is to devise domestic institutions that effectively channel societal demands to the country's leadership. These leaders are compelled to be responsive to societal demands, not only because they depend upon societal support to retain public office but because their position and ability to govern depends upon the payment and collection of taxes from society. Taxation has also historically served as a basis for demanding popular enfranchisement. One only need recall the cry of the American revolutionaries—"no taxation without representation"—to grasp the significance of this link between society's economic contribution to the state and its political leverage. By relying on foreign rather than domestic sources of revenue, Kazakhstan's leaders can afford to delay democratization and instead neglect societal interests in pursuit of their own. The experience of other resource-rich states is also instructive here, since the majority of them have followed similar development trajectories.

The short- and long-term effects of Kazakhstan's short-sighted energy sector policies are perhaps even more striking. Overly optimistic
Chapter Five

expectations of oil and gas wealth, combined with an increasing reliance on foreign investment, have greatly diminished the government’s commitment to direct social spending. Since 1991, “spending on the social safety net as a share of GDP fell by over a third from 11.2 percent in 1992 to 6.6 percent in 1996 ... [r]eal benefit levels have declined substantially ... [and] pensions remain at less than 50 percent of 1993 levels.” The short-term consequences of lower social spending are visible in the increasing rate of poverty and incidences of health risks and epidemics. From 1996 to 1998, the gap between Kazakhstan’s wealthiest and poorest citizens “widened dramatically,” and, according to the Red Cross, “three-quarters of Kazakhstan’s 15.7 million people live below the poverty line.” Both the number of people infected with tuberculosis and the number of deaths from the disease have also risen rapidly since 1996. In 1998, “the incidence of tuberculosis in Kazakhstan [was] about seven times that in the West, with at least 50,000 people, or 67 out of every 100,000, suffering from the disease.” Western aid organizations and local medical professionals alike cited the “lack of resources” for treating patients as well as poor nutrition and bad hygienic conditions stemming from the sharp decline in living standards since independence as the primary causes. It is not difficult to imagine the long-term consequences of these trends: the spread of disease throughout Kazakhstan and into neighboring states, the debilitation of an entire population due to poor health, and spiraling healthcare costs in a country with extremely limited fiscal resources.
A second, and directly related, effect is the emergence of cycles of protest, crack-down, and co-optation in Kazakhstan over the past few years. The government's initial strategy of utilizing prospects of energy wealth to diffuse popular discontent has instead led to increasing social unrest. The official response, however, has been to either threaten, punish, or attempt to co-opt opposition leaders, rather than to address Kazakhstan's mounting social and economic problems. Since 1996, the emerging pattern is for the government to ignore protestors' demands as long as possible, to make modest concessions (if any at all), and to punish their leaders. Opposition leaders are often induced to accept a position within the government in lieu of continued police harassment and in exchange for their silence. The series of strikes and standoffs that took place in October and November 1997 is a case in point. Demonstrators were initially warned, then ignored, and then physically prevented from carrying out their planned march. Those involved in leading the strikes, particular union leaders, were either punished with jail sentences and fines or "offered" an official governmental post.

Over the long-term, the continuation of these cycles may lead to the radicalization and regionalization of the opposition. As the government bureaucracy continues to shrink under Nazarbaev's streamlining program, for example, he will have fewer positions with which to buy-off the opposition's leaders. Similarly, as regional socio-economic differentiation increases and competition between central and regional elites over spheres of influence intensifies, the opposition might find it in its best interest to direct its grievances toward regional leaders.
Approaches

There are several significant steps that the Kazakhstani leadership can take in order to avert what appears to be an impending crisis.

• First, the Kazakhstani government should prepare itself for a moderate and protracted flow of oil revenues rather than a gusher. It must eliminate the widespread perception that energy wealth and foreign investment can act as a panacea for the country's social and economic ills. Government officials should focus their efforts instead on securing domestic sources of present and future revenue streams and securing investment to develop them. These efforts should also include building state institutions that have the capacity to prescribe and collect taxes.

• Second, the government should emphasize building an internal pipeline system in Kazakhstan for bringing oil and gas to the domestic market. Their focus to date has been on securing regional support and foreign investment for the construction of external pipelines to bring Kazakhstan's oil and gas to foreign markets. Yet, an internal pipeline system is also key to Kazakhstan's future development. This will not only decrease Kazakhstan's reliance on its northern (Russia) and southern (Uzbekistan) neighbors for energy supplies and its need to barter commodities for energy, but will also lay the foundation for broadening domestic industrial development.

• Third, the Kazakhstani government should encourage greater development in the manufacturing and agricultural sectors. This is key to achieving a healthy economy (and avoiding Dutch Disease) as well as to reducing poverty levels, both of which require broad-based growth. In
contrast to Azerbaijan, to which the Soviet legacy bequeathed little economic potential aside from its oil reserves, Kazakhstan inherited an industrial base in its north and east and produced a substantial portion of Soviet grain. This history provides grounds for some optimism. Yet, both its manufacturing and agricultural sectors are severely constrained by huge debts, dilapidated equipment, formidable export obstacles, and poor environmental conditions. In the short-term, the first two of these constraints can be mitigated through privatization, which Kazakhstan has already pursued in its manufacturing sector but not in its agricultural sector. This strategy is also problematic, however, in that it fails to address several long-term developmental issues, including the country’s collapsed educational and medical systems and the state’s weakening institutional capacity to provide such services. These are the key areas toward which the Kazakhstani leadership should turn its present attention and the developed country (particularly, U.S. government) should direct any future aid. One of Kazakhstan’s first steps should be to alter its privatization strategy to stress direct taxation of foreign companies so that the central and regional governments can develop the institutional capacity to build (or rebuild) local infrastructure on their own. The encouragement of competition among domestic entrepreneurs for the opportunity to perform these functions themselves should follow soon afterward.

- Fourth and closely related, Kazakhstan should resist the temptation to close its borders to free trade. Recent research demonstrates that those countries rich in natural resources that maintained a commitment to free trade were also the most successful economically. Open borders have
encouraged mineral-rich countries to develop competitive manufacturing sectors.

- Finally, and perhaps most importantly, if Kazakhstan is to address all of its underlying social and economic problems, it must reopen its political space by allowing public dissent, freedom of the press, and truly competitive elections. Democratization is the key to ensuring that Kazakhstan's citizens can hold their leaders accountable for the ways in which oil and gas revenues are used. While this is no guarantee that the use of oil and gas revenues in Kazakhstan will be economically efficient, it will decrease corruption levels by making financial dealings in the energy sector more transparent. The need for transparency can provide a sufficient incentive for government officials to separate their private interests from their public office and to strengthen central institutions responsible for collecting and redistributing state revenue. Norway, the one petroleum-rich country that was able to avoid the "common pitfalls of state-led development," was able to retain democratic institutions as it started to accrue oil rents.