



A DIAGNOSTIC STUDY OF KAZAKHSTAN'S SPECIAL ECONOMIC ZONES AND INDUSTRIAL ZONES

April 2018

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Contents

Tables, Figures, and Boxes	v
Acknowledgments	vi
Abbreviations	vii
Currency Equivalents	vii
Executive Summary	viii
I Introduction and Background	1
A. Background	2
B. Purpose	3
C. Main Aspects of Special Economic Zones and Industrial Zones	3
D. Economic Environment	4
E. Contribution and Organization of This Diagnostic Study	8
II Methodology and Key Concepts	9
A. The Crucial Role and Essence of Transparency concerning Special Economic Zones and Industrial Zones	9
B. The Vital Concept of “Incrementality”	11
C. The Importance of Total Factor Productivity and Its Proxies	12
D. The Role of Industrial Policy in Economic Development	13
E. Facilitation Measures versus Incentives	15
F. “Second-Best” Considerations	15
G. Market Failure and Public Goods	16
H. Trade Liberalization, Structural Reform, and Trade Adjustment Assistance	17
III Global and Regional Developments and Their Implications for the Special Economic Zones and Industrial Zones	19
A. Kazakhstan’s Membership in the World Trade Organization	19
B. Kazakhstan’s Membership in the Eurasian Economic Union	23
C. The Central Asia Regional Economic Cooperation Program Corridor, the People’s Republic of China’s New Silk Road Initiative, and National Infrastructure Plans	26
IV A Legislative and Institutional Framework for—and the Main Features of—Special Economic Zones and Industrial Zones	29
A. Special Economic Zones	29
B. Industrial Zones	48
C. The Main Features of Kazakhstan’s Special Economic Zones and Industrial Zones	50
D. Priority Investment Projects and Strategic Investment Projects	53

V	Evidence concerning the Effectiveness of Special Economic Zones and Industrial Zones	54
	A. Theoretical Observations concerning the Effectiveness of Incentives	54
	B. Empirical Evidence from Kazakhstan	59
	C. Empirical Evidence from Other Countries	65
VI	Lessons from Other Countries' Successes and Failures	68
	A. Introduction	68
	B. The Experience of the People's Republic of China with Its Special Economic Zones	68
	C. India's Experience with Its Special Economic Zones	77
	D. Cambodia's Experience with Its Special Economic Zones	82
VII	Principles and Guidelines concerning the Design and Role of the Special Economic Zones and Industrial Zones	84
	A. Introduction	84
	B. Empirical Evidence concerning the Performance of Kazakhstan's Special Economic Zones and Industrial Zones	84
	C. Lessons from Abroad	85
	D. General Principles	86
	E. Specific Guidelines	89
	F. Concluding Remarks	92
	Annex: Corrective Fiscal Incentives for Research and Development	96

Tables, Figures, and Boxes

Tables

1	Total Factor Productivity Growth in Member Countries of the CAREC Program and Eurasian Economic Union, 1999–2014	5
2	Summaries of the Decrees on the Special Economic Zones in Kazakhstan	31
3	Summaries of the Goals of the Special Economic Zones in Kazakhstan	32
4	Profiles of the Special Economic Zones in Kazakhstan	33
5	The Main Preferential Features of Special Economic Zones, Industrial Zones, and Priority and Strategic Investment Projects	43
6	Key Numerical Indicators of Special Economic Zones' Economic Performance, Actual to 31 December 2015	60
7	Flows of Foreign Direct Investment into the Countries of the Commonwealth of Independent States, 1994–2015	67
8	Incentives Granted to Companies in India's Special Economic Zones	77

Figures

1	Methodology of the Diagnostic Study on Kazakhstan	10
2	Government Investments in the Infrastructure of Special Economic Zones	30
3	The Current Institutional Structure for the Development of Special Economic Zones	43
4	The Procedure for Creating an Industrial Zone	49
5	Headline Corporate Tax Rates, 2015	56
6	Countries' Shares of the Kazakhstan Stock of Inward Foreign Direct Investment, 2015	57
7	Output Growth and Contribution of Labor, Capital, and Total Factor Productivity for Cambodia, the People's Republic of China, and India	73
8	Guiding Principles and Specific Guidelines	94
Annex:	Underinvestment in Research and Development and the Efficient Corrective Incentive	96

Boxes

1	The World Trade Organization's Rules Pertaining to Special Economic Zones and Industrial Zones	20
2	Eurasian Economic Union Rules Pertaining to Free (Special) Economic Zones	24
3	The Effectiveness of Tax Incentives in Attracting Foreign Direct Investment	58
4	The First Modern Special Economic Zone—Shannon Free Zone, Ireland	69

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Abbreviations

ADB	Asian Development Bank	IT	information technology
ASCM	Agreement on Subsidies and Countervailing Measures	km²	square kilometer
ASEAN	Association of Southeast Asian Nations	MAT	minimum alternate tax
CAG	Comptroller and Auditor General	MFN	most favored nation
CAREC	Central Asia Regional Economic Cooperation (Program)	MID	Ministry for Investments and Development
CET	common external tariff	MNE	Ministry of National Economy
CIT	corporate income tax	OECD	Organisation for Economic Co-operation and Development
DTA	domestic tariff area	PIT	Park of Innovative Technologies
EAEU	Eurasian Economic Union	PPP	public-private partnership
EOU	export-oriented unit	PRC	People's Republic of China
EPZ	export processing zone	SEC	social-entrepreneurial corporation
ETDZ	economic and technological development zone	SEZ	special economic zone
FDI	foreign direct investment	SHFTZ	(Shanghai) Pilot Free Trade Zone
FTZ	free-trade zone	SMEs	small and medium-sized enterprises
GATS	General Agreement on Trade in Services	R&D	research and development
GATT	General Agreement on Tariffs and Trade	TA	technical assistance
GDP	gross domestic product	TAA	trade adjustment assistance
GVC	global value chain	TRIM	Trade-Related Investment Measure
HIDZ	high-tech industrial development zone	TFP	total factor productivity
ICRIER	Indian Council for Research on International Economic Relations	US	United States
		VAT	value-added tax
		WTO	World Trade Organization

Currency Equivalents¹

(as of 2016)

Currency unit	–	tenge (T)
\$.0045 (in 2015) and \$.0029 (in 2016)	=	T1.00
\$1.00	=	T221.73 (in 2015) and T342.16 (in 2016)

¹ National Bank of Kazakhstan. Official Exchange Rates. 2016. <http://www.nationalbank.kz/cont/2016%20eng10.pdf>.

Executive Summary

A Diagnostic Study of Kazakhstan's Special Economic Zones and Industrial Zones

A. Background

As approved by the Asian Development Bank (ADB) in December 2014, the Regional Policy and Advisory Technical Assistance for Supporting Industrial Park Development in the Central Asia Regional Economic Cooperation (CAREC) region is intended to improve the policy framework for planning, developing, and upgrading industrial parks in member countries of the CAREC Program, in order to increase the region's productivity and international competitiveness. It focuses on two pilot countries, Kazakhstan and the Kyrgyz Republic, which best represent the different levels of progress among the CAREC developing member countries with regard to their industrial parks and other special types of economic zones. Indeed, the 13th CAREC Ministerial Conference, held in Bishkek, Kyrgyz Republic, on 5–6 November 2014, endorsed a framework for economic corridor development and the operationalization of this framework through a memorandum of understanding on the Almaty–Bishkek Corridor Initiative, the first effort to promote cooperation between Kazakhstan and the Kyrgyz Republic at the city level.

It was envisaged that this technical assistance (TA) would consist of two components. The first involves a pilot diagnostic study of each of these two countries, whose zones do not appear to have met with much success. The purpose of each diagnostic study is to evaluate the zones' performance and, in the light of this evaluation, suggest general and specific guidelines as to how the zones might be overhauled (if not abolished in some instances). The second component of this TA entails outlining a strategic framework for each of the two countries' zones, with the ultimate goal of driving both countries' industrial development. It was also envisaged that the two diagnostic studies together with the strategic frameworks would provide useful lessons for other CAREC countries.

The key question, therefore, is whether economic zones can serve as cost-effective catalysts for inclusive economic growth and development—rather than as mere enclaves—in two quite different countries, given the evolving regional and global economic environments. For example, whereas the Kyrgyz Republic's main export is labor, whose remittances account for around 30% of its gross domestic product (GDP), Kazakhstan is well endowed with natural resources, particularly oil and gas, which account for over 60% of its exports and nearly 25% of its GDP. Moreover, the Kyrgyz Republic's per capita GDP is roughly 10% that of Kazakhstan's. As both countries are located in Central Asia, however, neither has direct access to seaports, so both share certain market disadvantages—for instance, long distances and, for some destinations, multiple border crossings to reach main logistics hubs and global markets.

B. The Purpose of the Diagnostic Study

This diagnostic study provides an overview of the features, functions, and effectiveness of Kazakhstan's 10 existing special economic zones (SEZs) and, to a much lesser extent, its 42 industrial zones, in order to identify and correct their shortcomings and formulate guidelines in accordance with international rules and best practices, so as to enhance their contributions to the success of the country's economic development strategy. Attention is focused primarily on the SEZs, as few of the industrial zones are as yet operational. The main purpose is to highlight the principal features of the SEZs and IZs; in the case of the SEZs, it also evaluates their performance with reference to specific numerical targets (no such targets exist for the IZs). These targets pertain especially to the SEZs' objectives of increasing employment, and attracting export-oriented activities (in three of the SEZs), as well as investment, including foreign direct investment (FDI), along with the resulting acquisition of new technologies. At the same time, this diagnostic study provides some guidelines as to how the existing SEZs (and IZs) could be modified to improve their cost-effectiveness. Clearly, these zones need to be adapted to the evolving international economic environment, especially given Kazakhstan's recent (2015) accession to the World Trade Organization (WTO) and its membership in the Eurasian Economic Union (EAEU), the new "One Belt, One Road" initiative of the People's Republic of China (PRC), as well as its adherence to

multilateral and regional trade rules. These agreements and resulting rules are facilitating the country's integration into regional and global value chains (GVCs). Participation in GVCs, which account for 80% of world trade, presents Kazakhstan with opportunities to gain access to international markets and thereby exploit not only its comparative advantage, but also to benefit from scale economies together with transfers of new technology and know-how, all of which are major sources of improved total factor productivity (TFP), and thus living standards.

C. Methodology and Concepts

1. The Crucial Role of Transparency

This diagnostic study is essentially an exercise in transparency aimed at evaluating, by means of cost-benefit analysis, the cost-effectiveness of Kazakhstan's SEZs (and, to a lesser extent, its IZs) as instruments of economic policy. Transparency provides the basis for evidence-based policy making, and thus public accountability. Consequently, of the 100 concrete steps set out by President Nursultan Nazarbayev on 20 May 2015 for implementing the Government of Kazakhstan's five institutional reforms, 10 steps are aimed at improving the transparency and accountability of the state.

For the purpose of this diagnostic study, "transparency" consists of the following three key elements:

- (i) a description of the explicit and/or implicit objectives and legal and institutional framework of the SEZs, and of the SEZs' main features;
- (ii) a computation of the costs of the existing SEZs, including expenditures on infrastructure, tax revenues forgone owing to tax preferences, the administrative costs of operating the zones, the compliance costs borne by SEZ enterprises, and the undesirable side effects (including the loss of efficiency); and
- (iii) an assessment of the benefits of the SEZs, including their contributions to exports, investment, and job creation.

Cost-benefit analysis throws light on the cost-effectiveness of SEZs (and of their particular features) in achieving their objectives and providing benefits, most notably: increasing and diversifying exports, attracting FDI (and associated technologies), creating more highly paid employment, and integrating local enterprises into GVCs. It thus provides a sound fiscal basis for modifying the features of SEZs (and, to some extent, of IZs) in order to improve their cost-effectiveness (if they are not replaced by alternative policy instruments). For example, the revenues forgone as a consequence of tax incentives might have been better spent on public investments in basic infrastructure, in or around SEZs or elsewhere. Transparency is not only necessary for ensuring the cost-effectiveness of the SEZs overall, but also that of particular features of the SEZs (such as tax preferences, criteria for eligibility to operate in the SEZs, the role and financing of their managing companies, etc.) and of public spending on infrastructure. The effects of these features on the zones' performance can be difficult to disentangle, however. The lack of basic infrastructure, for example, could reduce the benefits of the particular features of the SEZs (and IZs).

Whereas the objectives and legal and institutional framework concerning the SEZs and IZs in Kazakhstan, as well as their main features, are reasonably clear, little data were available on the fiscal and other costs of the various features of SEZs and IZs, especially the individual tax preferences and administration costs, thereby hampering the cost-benefit analysis. This lack of data means that policies on SEZs and IZs are, to some extent, being made in the dark.

An additional formidable impediment to cost-benefit analysis, and thus to transparency, encountered by the ADB team was the difficulty in determining the extent to which exports, investments, and employment in the SEZs have been *incremental*; that is, they would *not* have occurred in the absence of such zones (or of some of their specific features). Hence, the data obtained and interviews conducted with SEZ officials and residents concerning, for example, exports, investments, and employment induced by the SEZs must be interpreted very cautiously. Exports from the SEZs, together with investments and employment in these zones, may have merely

displaced exports, investments, and employment that would have been generated in the rest of the country. A lack of incrementality would clearly reduce the benefits of the SEZs relative to their costs, and thus their cost-effectiveness. For example, one enterprise in the Astana–New City SEZ that had previously employed 450 persons outside the zone informed the ADB team that it had moved 90 of the employees producing a particular line of products into the SEZ, owing to the tax and nontax incentives offered there. The move, therefore, did not result in any incremental employment. In this case, however, it should be noted that, as a consequence of the tax relief, the enterprise was able to buy new equipment and used it to improve the quality of its product and the social benefits for its employees.

2. The Importance of Total Factor Productivity and Its Proxies

If not an explicit objective, the ultimate test of the success of Kazakhstan's SEZs and IZs (and, indeed, of its overall economic development strategy) is the extent to which they improve TFP, which is the key to unlocking Central Asia's potential for higher growth. The TFP of economic sectors and individual enterprises reflects the efficiency with which all the factors of production, including capital and labor, are used. It is thus a key determinant of the international competitiveness of Kazakh enterprises, and of the economy's performance as a whole. An improvement in the TFP would

- (i) enable domestically produced goods and services to compete against imports and, at the same time, pave the way for economic diversification and export-led growth;
- (ii) attract FDI, which not only augments the domestic stock of capital, but serves as a conduit for the diffusion of new technologies and managerial know-how, and can induce linkages with local suppliers by providing improved access to GVCs (usually involving multinational enterprises), and thus to international markets; and
- (iii) create more productive, and therefore higher-paid, employment.

The efficient reallocation of resources from low-productivity sectors, such as agriculture, toward more productive manufacturing and service activities, in accordance with Kazakhstan's comparative advantage, would obviously improve overall TFP. However, TFP growth is also the result of improved TFP within sectors and firms, as the most efficient enterprises gain greater market shares at the expense of those lagging behind (allocative efficiency), and as competition induces the remaining enterprises in a sector to improve their productivity (enterprise efficiency). Other important sources of TFP growth are economies of scale and, in the long run, technological progress, managerial know-how, human capital, and improvements in basic infrastructure.

Unfortunately, no recent data on TFP are available from Kazakh authorities, whether in the aggregate, by sector, or by individual SEZ. So attention in this study is focused on certain proxies for TFP, specifically, the extent to which the SEZs have increased and/or diversified exports; attracted investment, especially FDI; and created highly paid jobs. These proxies were among the explicit economic objectives and related numerical targets of the SEZs, which is not surprising, given that export- and FDI-oriented firms tend to be more productive, and therefore to pay higher wages. It follows that Kazakhstan's Trade Policy Strategy should be aimed primarily at facilitating export orientation (rather than import substitution) and inward FDI.

3. Facilitation Measures versus Incentives

In evaluating Kazakhstan's SEZs (and IZs), a clear distinction is made in this study between measures that facilitate trade and FDI by removing domestic market distortions that affect competition and more proactive measures, such as incentives that promote certain activities, possibly on the grounds that such activities are "strategic" or more vulnerable to market failure. Facilitation involves the removal of impediments to the reallocation of domestic resources and to competition in reasonably well-functioning markets, in accordance with Kazakhstan's comparative advantage. Incentives involve the more challenging task of having the government successfully pick potential "winners" consistently. The danger is that political pressure or favoritism, rather than the firms' competitive potential, will drive the selection process.

4. Market Failure

Nonetheless, incentives may be justified as a means of correcting market failure, which arises when markets do not fully reflect the social costs and benefits of private economic activities. For example, research and development (R&D) is a major determinant of technological progress, and thus of TFP growth, but the social benefits tend to exceed the private benefits. Consequently, too little R&D would be undertaken if markets were left to their own devices. In such circumstances, it may be legitimate for the government to intervene, provided that the magnitude of the gap between the private and social benefits of R&D can be measured accurately, and that a cost-effective incentive can be designed to stimulate sufficient R&D to bridge that gap without any substantial adverse consequences. Interestingly, almost every technology that made the iPhone smart was funded by the government. Even in the case of R&D, however, governments are seldom capable of correcting market failure in a cost-effective way.

A related source of market failure concerns basic infrastructure (especially transport, energy, water, sewage and waste disposal, telecommunications and internet facilities, security, health, and education), which can often be characterized as a “public good.” By definition, public goods generate positive “externalities” in the sense that they deliver social benefits over and above what individuals or businesses would find it profitable to provide; so public goods tend to be undersupplied in a competitive market. Needless to say, few goods are purely “public,” a fact that provides a rationale for the use of public–private partnerships (PPPs) to provide quasi-public goods. In Kazakhstan, the envisaged basic infrastructure has been completed for six SEZs [Burabay, Ontustik, Saryarka, Seaport Aktau, Khorgos-East Gate, and Park of Innovative Technologies (PIT)]; the lack of infrastructure investment in the other four SEZs has thereby reduced, if not vitiated, the effects of the other SEZ features. Hitherto, the government has invested roughly T275 billion in basic infrastructure. Although no data on the internal rate of return of infrastructure investment were available in Kazakhstan, this reduction of the effects of the SEZs seems to have also been the case for investment in certain types of infrastructure in the Kyrgyz Republic where feasibility studies carried out for the Kyrgyz authorities found internal rates of return in the range of 14%–39%. This suggests that public investment in basic infrastructure, whether in or around SEZs and IZs or elsewhere in Kazakhstan, would be arguably more cost-effective than tax incentives [especially corporate income tax (CIT) holidays] for investments whose incremental effects are highly dubious—except perhaps in the case of R&D. This is partly because tax incentives are, in any event, seldom the main determinant of investment.

Tax Preferences for Special Economic Zones

Type of Tax	Inside Special Economic Zones (%)	Outside Special Economic Zones
Import tariff	0	6.9% ^a
Export duty	0 ^b	various rates ^c
VAT (standard rate)	0	12.0%
Corporate income tax	0	20.0%
Property tax	0	1.5%
Land tax	0	\$0.26–\$31.30/ha

ha = hectare, MFN = most favored nation, VAT = value-added tax.

^a Simple average applied MFN tariff rate (2016).

^b This preference was applicable until 1 January 2017 only for participants registered before 1 January 2012.

^c Export duty rates varied from 10% to 30% in 2015.

Source: Government of Kazakhstan, World Trade Organization, International Trade Centre, and the United Nations Conference on Trade and Development. 2017. *World Tariff Profiles 2017*. Geneva. https://www.wto.org/english/res_e/booksp_e/tariff_profiles17_e.pdf.

D. The Main Features of Kazakhstan's Special Economic Zones

Tax preferences are among the main features of Kazakhstan's SEZs (see the table above). Some of these preferences are arguably intended to facilitate trade, while others are meant to be incentives for investment. Whereas the former do not generally infringe WTO or EAEU rules, the latter may do so if they constitute "prohibited" subsidies (because they are contingent upon import substitution or exports) or "actionable" subsidies (if they are "specific" and have "adverse effects" on Kazakhstan's trading partners). In order to qualify for these tax preferences, a company must be registered as a SEZ resident and as a taxpayer in the SEZ, with no structural subdivisions outside the SEZ. Furthermore, at least 90% of the company's annual income (70% in the case of the PIT must be derived from the sales of goods produced as a result of the SEZ's priority activities. In addition, businesses operating in the PIT are exempt from any social taxation for 5 years on condition that their payroll amounts to at least 50% of their annual revenue, and that 90% of that payroll goes to residents of Kazakhstan. This requirement may infringe WTO (and perhaps EAEU) rules concerning subsidies contingent upon import substitution (or local content). As of 1 January 2017, firms registered and operating in SEZs are no longer subject to WTO-inconsistent requirements concerning local content or export performance, either in law or in practice. However, insofar as exports involve *targets* for 3 of the 10 SEZs (details in Chapter IV), rather than *requirements* (as in the case of local content rules), they apparently do not infringe WTO (or EAEU) rules.

Goods produced in the SEZs and sold in the domestic market are subject to the full value-added tax (VAT) and relevant tariffs. This treatment, which is in accordance with the Agreement on Free (Special) Economic Zones on the Customs Territory of the Customs Union and the Customs Procedures of the Free Customs Zones,² and thus places firms supplying the domestic market from inside and outside the zones on substantially the same footing with regard to the VAT. In the case of an inverted tariff, however, producers supplying goods to the domestic and EAEU markets from the zones are allowed to choose either the tariff rate that applies to the imported inputs or the rate that applies to the finished goods. There are no rules preventing Kazakhstan from granting full tariff drawbacks and rebates of indirect internal taxes to domestic firms supplying goods and services to zone-based enterprises, and such drawbacks and rebates could facilitate the development of value chains linking firms located inside and outside the zones. Tariff drawbacks would be especially beneficial in view of the fact that Kazakhstan's simple-average-applied most-favored-nation (MFN) tariff increased from 5.9% in 2009 to 7.8% in 2015, but then fell to 6.9% in 2016, as a consequence of the country's adoption of the EAEU's common external tariff (CET). The simple average of CET rate is expected to approach 8.4% in 2020.

The other main features of the SEZs are as follows:

- (i) The operating costs of SEZ management companies and the provision of infrastructure facilities are funded largely by the central government, especially the Ministry for Investments and Development (MID); the Samruk-Kazyna National Welfare Fund; Baiterek National Management Holding; and, to some extent, by local governments (*akimats*).
- (ii) Two SEZs (Burabay and PIT) managed by the MID also receive funding from the MID (as well as the IZ in Almaty), and the PIT receives additional funding from a 1% levy on the total annual revenue of subsoil companies, for the purpose of R&D.
- (iii) The local government provides a free plot of land to each SEZ for the entire period of the SEZ's existence, with the right to purchase once the SEZ regime expires.
- (iv) The SEZs have "positive," rather than "negative," lists of eligible activities, confined mainly to manufacturing.
- (v) Each SEZ has a "single window" for dealing with customs and tax matters.
- (vi) The SEZs have simplified procedures for recruiting foreign workers.
- (vii) The PIT receives some preferential treatment from the Samruk-Kazyna National Welfare Fund with regard to procurement.

² Decree of the President of the Republic of Kazakhstan No. 1003 (dated 17 June 2010).

E. Empirical Evidence concerning the Performance of Kazakhstan's Special Economic Zones

Although the Astana–New City, PIT, and Aktau Seaport SEZs have arguably met with some success, accounting for most of the goods produced in Kazakhstan's 10 SEZs, it would appear that the other seven have yet to take off (partly because of the lack of basic infrastructure in all but the Burabay, Ontustik, and Saryarka SEZs up to 2014). Judging from the most recent comprehensive data available (for 2015), the three relatively successful SEZs, as well as Saryarka, have more or less achieved their specific targets concerning production, investment, and employment. However, whereas FDI accounted for more than half of total investment in the Aktau Seaport and Saryarka SEZs, it was a mere 6% of total investment in the Astana–New City SEZ. In the case of the PIT, although investment has exceeded its target, this SEZ had apparently attracted no FDI, which would have potentially been a major source of technological progress, and thus of TFP growth. Despite its name, however, not much R&D is done in the PIT. Burabay has achieved its targets regarding production, investment, and employment, but it has also attracted little FDI, and so has failed to meet this particular target. Among the other five SEZs, Ontustik has exceeded its export as well as its production and modest FDI targets, but it has failed to meet its overall investment and employment targets. The remaining four SEZs have, by and large, failed to meet their targets. However, both the National Industrial Petrochemical Technopark and Pavlodar SEZs have substantially exceeded their employment targets. The total number of jobs in the SEZs was a mere 11,527 in December 2016, down from 12,650 in December 2015, well below the target of 19,108. Thus, the SEZs' shares of the country's total production, investment (including FDI), and employment are negligible. Interestingly, with T275 billion having already been spent on infrastructure in the 10 SEZs since 2003, the associated fiscal cost per job is almost T24 million (approximately \$70,000), which is roughly 14 times the average annual wage in Kazakhstan.

While there is little data on exports from the SEZs, it would appear that they accounted for only 0.08% of total exports in 2016. Astana–New City accounts for more than half of all the SEZs' total production, and its production is oriented entirely toward the domestic market, particularly the new capital city's construction and development. The much smaller production in the PIT is also apparently oriented largely toward the domestic market. To the extent that the domestic market is not large enough to enable competing producers to exploit economies of scale (or economies of agglomeration), and thus reduce their costs per unit of output, an orientation toward the domestic market is an impediment to the improvement of TFP.

The SEZs' strong orientation toward the domestic market may be partly due to the various tax preferences that enterprises have enjoyed in the zones. These preferences can place domestic producers operating outside the SEZs at a significant competitive disadvantage, compared with those operating inside the zones, to the extent that firms operating inside the SEZs maintain part of their preferential tax treatment when producing for the domestic market, both implicitly (because the payment of some taxes may be deferred until the goods are "imported into Kazakhstan's customs territory," thereby improving cash flow) and, more importantly, explicitly (because some taxes, notably the CIT, are not paid at all). It follows that firms supplying the domestic market from inside and outside the SEZs should, as far as possible, be placed on a more similar tax footing.

Firms producing outside the SEZs but wishing to integrate their operations into the GVCs of SEZ firms producing goods for export (and thus benefit from technology transfers and other spillovers) should be eligible for the same full and prompt tariff drawbacks and rebates of indirect internal taxes on their sales of goods to SEZ firms, as if they were also exporting (provided that leakages from the zones back into the domestic market can be contained). Otherwise, intermediate goods produced by non-SEZ firms will be more expensive than those imported into the zones from abroad (insofar as tariffs and the VAT are shifted forward), thereby deterring purchases by SEZ-based enterprises from firms based in the domestic market. Such eligibility, which is consistent with WTO rules, would be particularly beneficial to small and medium-sized enterprises, and would facilitate the formation of clusters around the SEZs, thereby contributing to more inclusive economic development.

One of the main objectives of the SEZs is to attract new investment, especially FDI, together with the technological progress and managerial know-how that FDI would bring (and which are major sources of TFP growth). Unfortunately, the SEZs have not attracted much FDI, which accounted for a mere 8% of total investment in all the SEZs by 2015. Apparently, the PIT has attracted no FDI at all, so it is not surprising that little R&D is being done there, notwithstanding this SEZ's name.

However, as mentioned above, whether or not any of the SEZs' production, export, investment (including FDI), or employment targets have been achieved, there is no convincing empirical evidence that any of these achievements have been substantially *incremental*. Indeed, tax preferences and other SEZ features (such as nontax incentives and the provision of infrastructure) may have merely induced domestic and multinational enterprises to establish operations in the SEZs instead of in the domestic market.

The SEZs' orientation toward the domestic market may also be partly due to local content requirements aimed at encouraging import substitution. In fact, all the SEZs except for Taraz Chemical Park have local-content targets ranging from 18% to 100%; these have largely been accomplished, and in six cases considerably exceeded. Although it is unclear how the targets were reached, it may have been due to local-content rules, to tax relief, or to other forms of financial assistance that were contingent on local-content rules. But these rules may be considered prohibited subsidies by the WTO and EAEU.

F. Lessons from Abroad

An obvious success story concerning SEZs has been the PRC, although not in the case of all of its zones (apparently, some 70% have been unsuccessful). The PRC's experience with SEZs is perhaps of particular relevance to Kazakhstan because the Chinese SEZs were successfully used as instruments to enable the PRC's transition from a centrally planned to a market economy, one highly oriented toward exports and toward attracting FDI (and technology) in order to create opportunities for more highly skilled (and thus better-paid) jobs. In contrast, India's SEZs are generally considered to have been far less successful than the PRC's, largely because they have not met their export, investment, or employment targets. In India, SEZs have often been used as devices to avoid, if not evade, taxes. According to a recent study by ADB, however, Cambodia's SEZs appear to have met with some success.

G. Some General and Specific Guidelines concerning the Role and Design of Special Economic Zones and Industrial Zones

Overall, SEZs and IZs should be an integral part of a coherent economic development strategy, with the full cooperation of the relevant ministries and other bodies at various levels of government, along with clear objectives and viable numerical targets, including the goal of improving TFP. Policies concerning SEZs, if not IZs, should be coordinated with (but also distinguished from) other policies, notably those involving priority and strategic investment projects. The latter policies also provide tax and nontax preferences (notably grants amounting to 30% of qualifying investments), which may reduce the attractiveness of SEZs and IZs.

As export- and FDI-oriented firms tend to have higher TFP, and therefore pay relatively high wages, SEZs should be oriented largely toward exports, rather than toward the domestic market; and they should aim to attract FDI (and the new technologies and managerial know-how that usually come with it) as a means of incorporating Kazakh enterprises into regional value chains and GVCs. In order to ensure the transparency of the SEZs and IZs with regard to their cost-effectiveness in achieving their objectives—especially improving TFP, facilitating exports, attracting FDI, and creating well-paid jobs—the zones and their specific features should be regularly monitored and evaluated using cost-benefit analysis.

The SEZs and IZs should focus on facilitating trade and attracting FDI in accordance with the WTO's Trade Facilitation Agreement (which Kazakhstan has ratified), rather than on providing incentives, unless the latter can be justified on grounds of market failure (as in the case of R&D, for example), and are in accordance with the WTO and EAEU rules on subsidies. Whereas facilitation measures are generally consistent with these international rules, incentives might not be.

Although the SEZs and IZs should be outward-oriented, linkages should nonetheless be made with the domestic economy to ensure that the SEZs and IZs do not become mere enclaves, with little spillover of benefits into the domestic economy. Therefore, enterprises outside the zones should be placed, as much as possible, on an equal footing with the enterprises inside the zones, especially as far as taxation is concerned. This would enable all enterprises to participate in GVCs. Indeed, the government should facilitate forward and backward

linkages between enterprises in the SEZs and enterprises outside, and with research and educational or training institutions outside the zones, thereby enabling the SEZs to become centers of excellence (something that the PIT is attempting to do). Links with educational or training institutions are especially important for ensuring the availability of a sufficiently educated and skilled labor force that would be receptive to new technologies and management methods.

In accordance with the foregoing general guidelines, SEZs and IZs should have the following main specific features:

- (i) Border taxes and associated adjustments should be the same for firms inside and outside the zones; that is, sales by firms inside the zones to the “internal” EAEU market should be fully taxed, and sales by firms in the “internal” market to zone-based enterprises should be eligible for full and immediate tariff drawbacks and VAT rebates.
- (ii) As CIT holidays are widely regarded as a relatively ineffective tax incentive, enabling tax avoidance, if not evasion, they should be abolished for the sake of economic efficiency and fiscal prudence. Insofar as CIT holidays are used, in order to prevent tax avoidance or evasion, any company operating in a SEZ should not be allowed to have structural subdivisions outside its SEZ (as is apparently the practice in Kazakhstan).
- (iii) Financial incentives should not be contingent on exports or import substitution, as that would involve subsidies prohibited under WTO rules. Nor should they be too selective, as such measures could be considered “specific” under WTO rules, and thus “actionable” inasmuch as they have “adverse effects” on Kazakhstan’s trading partners. Subsidies for R&D used to be considered nonactionable under WTO rules, possibly on the grounds of market failure, but this is no longer the case.
- (iv) Instead of attempting to “pick winners,” eligibility to invest and operate in the SEZs (or IZs) should be based mainly on “negative” lists; these lists should be as short as possible so as to permit a wide range of activities, especially services, which accounted for the bulk of world trade growth in 2014.
- (v) SEZs and IZs should have access to high-quality basic infrastructure (notably electricity; water; waste disposal; transportation facilities and corridors; and telecommunications, including internet facilities). To the extent that basic infrastructure constitutes a “public good,” it should be provided by the state, possibly with some private involvement, including PPPs and financing, based on an appropriate user-pays model.
- (vi) Irrespective of whether they are privately or publicly owned or developed, SEZs and IZs should be autonomous and self-financing, with full cost recovery if not-for-profit. Experiences in other countries suggest that this tends to minimize the large and sometimes wasteful costs incurred by the public sector when setting up such zones. It would also introduce greater market discipline into the management of the zones, thereby contributing to their long-term viability.
- (vii) SEZs and IZs should be sufficiently large to enable the enterprises operating in them to exploit economies of scale and agglomeration.
- (viii) Necessary regulations should be streamlined and consolidated, with “single window” or “one-stop” arrangements, to enable compliance by enterprises and the prompt approval of their investments and operations in the zones.
- (ix) Labor standards (including health and safety) and environmental standards in the SEZs and IZs should be in line with international norms and national laws.
- (x) Not only should SEZs and IZs be integrated into the national and regional economic development strategies to ensure coordination among zones, government bodies, and the private sector within each country, cross-border cooperation should be encouraged among zones in different member countries of the CAREC Program.

H. Concluding Remarks

While legislative stability is desirable, Kazakhstan's SEZs and IZs—and, indeed, its economic development strategy—should nonetheless be sufficiently flexible to adapt to domestic, regional, and global economic developments, including changes in global and regional trade. The zones could also possibly play a useful role in, among other things, paving the way for the implementation of the WTO's Trade Facilitation Agreement and in helping the country cope with the intensified competition and changes in the pattern of trade resulting from its accession to the WTO and membership of the EAEU. As the economic environment and consequent fundamentals determining the structure of global trade evolve, Kazakhstan's SEZs and IZs will need to adapt accordingly (and in the light periodic evaluations of their performance). They can also serve a useful purpose to the extent that they enable experimentation in the country's otherwise insufficiently market-oriented economy. The failure of some zones may be a price worth paying if others are successful. But the zones will require patience, planning, monitoring, and evaluation to ensure their cost-effectiveness. In any event, such zones are always likely to be inferior to economy-wide reforms that reduce impediments to trade and FDI and thus improve productivity and competitiveness of Kazakh enterprises.

Chapter I. Introduction and Background

1. Special economic zones have long been an important feature of national economic-development strategies, especially for facilitating export-led growth. Special economic zones (SEZs) around the world have a number of different names, depending on the country in which they are located and their particular type; and the same name could mean different things in different countries. Special economic zones in Ireland, for instance, are called “industrial free zones” or “export free zones,” while in the United States (US) they are called “foreign-trade zones,” and all goods produced there can theoretically be sold in the domestic market.³ In developing countries that produce specifically for export, they are typically called “export processing zones” (EPZs). Those in the People’s Republic of China (PRC), which tend to be less export-oriented than EPZs, are often called “special economic zones,” although the most recent one established in Shanghai is called a “free trade zone” (FTZ).

2. These zones have proliferated to such an extent that there are now more than 4,000 of them in some 130 countries. Of the 66 million workers employed in the zones worldwide, the PRC accounted for over 60%, and the rest of Asia, 22%. By and large, these zones have been aimed at facilitating manufacturing rather than services, although that is now changing. For example, in the Shanghai Pilot Free Trade Zone, which was launched in September 2013 in order to test and refine economic reforms before their

potential rollout nationwide, restrictions on foreign investment in 23 service sectors will be loosened, including those in banking, financial services, health care, and technology. SEZs are generally viewed as a useful tool for enhancing total factor productivity (TFP), which is key to unlocking Central Asia’s higher growth potential;⁴ attracting foreign direct investment (FDI), as well as associated technology transfers and managerial know-how; developing and diversifying exports, while maintaining trade barriers elsewhere in the economy; creating employment and improving on-the-job training; and piloting new policies. In the case of Kazakhstan, SEZs may also be used to mitigate the adverse trade effects of the Eurasian Economic Union’s (EAEU) customs union, including the substantial increase in tariff protection owing to Kazakhstan’s adoption of the common external tariff (CET), first of the Eurasian Economic Community in 2010, and then of the EAEU in 2015.

3. SEZs are broadly defined by the Asian Development Bank (ADB) as “clearly defined geographically, with a single management or administration and separate customs area (often duty free), where streamlined business procedures are applied, and where physically located firms qualify for more liberal and effective rules than those in the national territory (covering, for example, investment conditions, international trade and customs, tariffs, and taxation).”⁵ The features of such zones can vary widely from one country and zone to another.⁶

³ M. J. Bolle and B. R. Williams. 2013. US Foreign-Trade Zones: Background and Issues for Congress. 7-5700. Washington, DC: Congressional Research Service. <https://fas.org/sgp/crs/misc/R42686.pdf>.

⁴ P. Mitra et al. 2015. *Estimating Potential Growth in the Middle East and Central Asia*. International Monetary Fund (IMF) Working Paper No. 15/62. Washington, DC. <https://www.imf.org/external/pubs/ft/wp/2015/wp1562.pdf>.

⁵ ADB. 2014. Economic Zones: Instruments for Regional Production Networks and Supply Chains. Background paper for RCI Roundtable Conference. Manila. 17–18 November. Similarly, Claude Baissac observed that SEZs share two structural characteristics: they are formally delimited portions of the national territory and they are legal spaces with a set of investment, trade, and operating rules that are more liberal and administratively efficient than those prevailing in the rest of the national territory. The administration of the zone regime usually requires a dedicated governance structure, whether centralized or decentralized. The attributes of this structure vary according to the nature of the zone regime, the prevalent administrative culture, the number of existing zones, the role of the private sector in developing and operating zones, and other factors. In addition, zones are usually provided with a physical infrastructure supporting the activities of the firms and economic agents operating within them. See: C. Baissac. 2011. Brief History of SEZs and Overview of Policy Debates. In T. Farole, ed. *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences*. Washington, DC: World Bank. <http://elibrary.worldbank.org/doi/pdf/10.1596/978-0-8213-8638-5>.

⁶ EPZs, for example, are usually enclaves where foreign companies engaged in the manufacture of products for exports enjoy preferential tax treatment compared with the rest of the economy. SEZs have more flexibility with regard to location and have a wider application than EPZs because they also grant such treatment to domestic economic sectors. Several other types of zones exist, each with its particular features. Incentives in those zones generally involve nontax benefits such as good infrastructure and cheap utilities, as well as reduced customs duties, income taxes, local taxes, and fees. See: Organisation for Economic Co-operation and Development (OECD). Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment. <http://www.oecd.org/tax/tax-global/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment-call-for-input.pdf>.

4. However, SEZs—for which land is often set aside and where exporters and other investors receive tariff, tax, and regulatory incentives—create distortions within economies. They also incur other costs, including expenditure on infrastructure investment and forgone tax revenues. While it is hoped that these economic distortions and costs are outweighed by increased trade, investment, and employment, in reality that does not always happen, and many SEZs fail. According to *The Economist*, “Performance data are elusive because the effects of zones are hard to disentangle from other economic forces. But anecdotal evidence suggests they fall into three broad categories: a few runaway successes; a larger number that come out marginally positive in cost–benefit assessments; and a long tail of failed zones that either never got going, were poorly run, or where investors gladly took tax breaks without producing substantial employment or export earnings.”⁷ For example, whereas the Shenzhen SEZ, established by the PRC in 1980 near Hong Kong, China, attracted thousands of foreign investors, and the policies tested there have spread to other cities, India has had hundreds of zones that failed to get going, including more than 60 in Maharashtra state alone.

A. Background

5. As approved by ADB in December 2014, the Regional Policy and Advisory Technical Assistance for Supporting Industrial Park Development in the Central Asia Regional Economic Cooperation (CAREC) region is intended to improve the policy framework for planning, developing, and upgrading industrial parks in member countries of the CAREC Program, in order to increase the region’s productivity and international competitiveness. It focuses on two pilot countries, Kazakhstan and the Kyrgyz Republic, which best represent the different levels of progress among the CAREC developing member countries with regard to their industrial parks and other special types of economic zones. Indeed, the 13th CAREC Ministerial Conference, held in Bishkek, Kyrgyz Republic, on 5–6

November 2014, endorsed a framework for economic corridor development and the operationalization of this framework through a memorandum of understanding on the Almaty–Bishkek Corridor Initiative, the first effort to promote cooperation between Kazakhstan and the Kyrgyz Republic at the city level.

6. It was envisaged that this technical assistance (TA) would consist of two components. The first involves a pilot diagnostic study of each of these two countries, whose zones do not appear to have met with much success. The purpose of each diagnostic study is to evaluate the zones’ performance and, in the light of this evaluation, suggest general and specific guidelines as to how the zones might be overhauled (if not abolished in some instances). The second component of this TA entails outlining a strategic framework for each of the two countries’ zones, with the ultimate goal of driving both countries’ industrial development. It was also envisaged that the two diagnostic studies together with the strategic frameworks would provide useful lessons for other CAREC countries.

7. The key question, therefore, is whether economic zones can serve as cost-effective catalysts for inclusive economic growth and development—rather than as mere enclaves—in two quite different countries, given the evolving regional and global economic environments. For example, whereas the Kyrgyz Republic’s main export is labor, whose remittances account for around 30% of its gross domestic product (GDP),⁸ Kazakhstan is well endowed with natural resources, particularly oil and gas, which account for over 60% of its exports and nearly 25% of its GDP. Moreover, the Kyrgyz Republic’s per capita GDP is roughly 10% that of Kazakhstan’s.⁹ As both countries are located in Central Asia, however, neither has direct access to seaports, so both share certain market disadvantages—for instance, long distances and, for some destinations, multiple border crossings to reach main logistics hubs and global markets.

⁷ *The Economist*. 2015. Special Economic Zones: Political Priority, Economic Gamble. 4 April. <http://www.economist.com/news/finance-and-economics/21647630-free-trade-zones-are-more-popular-everwith-politicians-if-not>. See also: *The Economist*. 2015. Special Economic Zones: Not So Special. 4 April. <http://www.economist.com/news/leaders/21647615-world-awash-free-trade-zones-and-their-offshoots-many-are-not-worth-effort-not>.

⁸ Remittances from abroad, mostly from the Russian Federation, accounted for roughly 30% of the Kyrgyz Republic’s GDP in 2014. See International Monetary Fund (IMF). IMF Survey: Kyrgyz Republic Gets Loan to Boost Economy Amid Regional Slump. <http://www.imf.org/external/pubs/ft/survey/so/2015/car051415a.htm>. Remittances are also important for other Central Asian countries, notably Tajikistan and Uzbekistan.

⁹ The World Bank. GDP Per Capita (Current US\$). <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>.

B. Purpose

8. This diagnostic study provides an overview of the features, functions, and effectiveness of Kazakhstan's 10 existing SEZs and, to a much lesser extent, its 42 industrial zones, in order to identify and correct their shortcomings and formulate guidelines in accordance with international rules and best practices, so as to enhance their contributions to the success of the country's economic development strategy. Attention is focused primarily on the SEZs, as few of the industrial zones are as yet operational. The main purpose is to highlight the principal characteristics of the SEZs and IZs; in the case of the SEZs, it also evaluates performance with reference to specific numerical targets (no such targets exist for the IZs). These targets pertain especially to the SEZs' objectives of increasing employment, and attracting export-oriented activities (in three of the SEZs), as well as investment, including foreign direct investment (FDI), along with the resulting acquisition of new technologies.

9. However, overly ambitious objectives, limited factor endowments, and other economic conditions may have hindered the success of Kazakhstan's SEZs. The Government of Kazakhstan introduced its first SEZ law in the 1990s, and during that decade nine SEZs were created. These had to be scrapped by 2000, however, because they were not cost-effective owing to shortcomings in the legal and regulatory framework, lack of transparency and consequent corruption, mistakes in spatial planning, and poor site selection.¹⁰ Three of Kazakhstan's existing SEZs—Astana–New City; Aktau Seaport, which is essentially a trade and logistics SEZ; and the Park of Innovative Technologies (PIT)—appear to have met with some success, accounting for most of the goods produced in the country's 10 SEZs. As we shall see in Chapter V, the other seven SEZs have yet to take off. Pavlodar SEZ, for example, opened with fanfare in 2011, only to sink into a bureaucratic quagmire and fail to attract much FDI.¹¹ Indeed, the 10 SEZs' share of Kazakhstan's total production, exports, investment (including FDI), and employment is apparently minuscule.

10. In light of its evaluation of the effectiveness of Kazakhstan's SEZs in achieving their objectives

and targets, this diagnostic study recommends some general and specific guidelines regarding how the existing SEZs (and IZs) might be modified to improve their cost-effectiveness. These guidelines take into account, among other things, the need to adapt these zones to the evolving international trade environment, most notably Kazakhstan's recent accession to the World Trade Organization (WTO) and membership in the EAEU; the PRC's new "One Belt, One Road" initiative; and multilateral and regional trade agreements to which Kazakhstan is party. Such an adaptation will facilitate Kazakhstan's integration into regional and global value chains (GVCs). Participation in GVCs, which account for 80% of world trade, presents Kazakhstan with opportunities to gain access to international markets and thereby exploit not only its comparative advantage, but also to benefit from scale economies together with transfers of new technology and know-how, all of which are major sources of improved TFP, and thus living standards.¹²

C. Main Aspects of Special Economic Zones and Industrial Zones

11. In this diagnostic study, attention is focused on the following main features of SEZs (as well as IZs), with a view to recommending guidelines in accordance with international rules and best practices:

- (i) transparency regarding the benefits of zones in relation to their costs;
- (ii) the extent to which SEZs have attracted export- and FDI-oriented firms, which tend to be more productive and, therefore, to pay relatively high wages;
- (iii) reliance on the facilitation of trade and investment, instead of on tax and nontax incentives;
- (iv) facilitation of linkages with the local and regional economies, rather than the development of SEZ and IZs as mere enclaves;
- (v) fostering of centers of technological excellence in collaboration with local firms and with educational and research institutions;
- (vi) streamlining the regulatory framework and

¹⁰ ADB. 2015. *Asian Economic Integration Report 2015: How Can Special Economic Zones Catalyze Economic Development*. Manila. p. 30; and A. Karzhaubayeva. 2013. *Special Economic Zones in Kazakhstan. SEZ World Tracker*. October. pp. 58–62.

¹¹ *Financial Times*. 2015. *Kazakhstan Runs Economic Risks with Its Hyperactivity*. 5 November.

¹² See: UNCTAD. 2013. *World Investment Report 2013, Global Value Chains: Investment and Trade for Development*. Geneva. http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf.

procedures pertaining to business registration, investment approval, taxes and customs, land use, utility services, expatriate work permits, etc. (by means of one-stop or single-window facilities, for example);

- (vii) the use of short “negative” lists, rather than “positive” lists, to determine the eligibility of particular economic activities;
- (viii) permitting a wide range of service enterprises, as well as manufacturing, in the zones and park;
- (ix) improved governance on the part of management companies—whether public, private, or public–private partnership (PPP)—and an improvement in their ability to contribute to zone development;
- (x) fee-based management and other services, with full cost recovery, if not-for-profit;
- (xi) public provision of general (off-site) infrastructure and the private provision of specific (on-site) infrastructure, including utility services;
- (xii) the achievement of high environmental, labor, safety, health, and other standards; and
- (xiii) coordination among the zones within Kazakhstan and with zones in other CAREC countries.

D. Economic Environment

12. The appropriate design and role of SEZs and IZs cannot be considered in isolation from the prevailing economic environment, especially the deteriorating macroeconomic situation in Kazakhstan. Monetary policies, exchange rates, (especially) fiscal policies, as well as the structural features of Kazakhstan's economy, can all have implications for the design and functioning of the country's SEZs and IZs.

13. This diagnostic study of Kazakhstan is being undertaken in the context of two major adverse external shocks. The first involves the weaker demand from the Russian Federation, partly owing to sanctions and to the depreciation of the ruble,¹³ both of which have reduced the competitiveness of Kazakhstan's exports to the Russian Federation and boosted imports from the Russian Federation (further enabled by Kazakhstan's membership in the EAEU) and from the PRC, although this loss in competitiveness has been somewhat mitigated by the depreciation of the tenge by about one-half since the decision by the government in August 2015 to allow the currency to float freely. This weaker demand has been compounded by the second external shock: the collapse in the prices of oil and gas,¹⁴ which account for nearly a quarter of Kazakhstan's GDP, more than 60% of its exports, and roughly 50% of the government's tax revenues.¹⁵ The outcome has been reduced income and profitability, and thus lower private consumption and domestic investment. These twin external shocks, and the continuing delays in the second stage of a mega project involving the development of the Kashagan oil field, as well as deteriorating confidence,¹⁶ are the main reasons for the sharp slowdown in economic growth, tightening monetary and financial conditions, emerging external imbalances, and the serious deterioration of the government's fiscal position owing to the steep fall in tax revenues. The sharp depreciation of the tenge also means that the government will likely be called upon to provide further support to Kazakhstan's banking sector and potentially to major companies in other sectors with large external debts in US dollars.

14. Real GDP growth slowed to 1.0% in 2016, down from 6.0% in 2013 and 4.3% in 2014, though the IMF

¹³ The Russian ruble lost more than half of its value relative to the US dollar in 2014.

¹⁴ Since June 2014, the price of a barrel of oil has plummeted from \$115 to around \$50. This drop resulted in the postponement of the second phase of the development of Kazakhstan's Kashagan oil field, a megaproject run by an international consortium and accounting for some 600,000 barrels a day at peak production. During the same period, the oil price fall has also resulted in a 16% drop in Kazakhstan's sovereign wealth fund, which, according to the central bank, will be depleted by 2026 if the price of oil remains low and the government continues to withdraw cash to prop up the country's weak economy. See: A. Mooney. 2016. Kazakh Sovereign Wealth Fund Is Latest Victim of Oil Price Fall. *Financial Times*. 8 January. <https://www.ft.com/content/1ff29990-b5fe-11e5-b147-e5e5bba42e51#axzz3wGFLofn5>. The cost of producing a barrel of crude oil in Kazakhstan was \$10.70 in 2014. See: Knoema. Cost of Producing a Barrel of Crude Oil by Country. <http://knoema.com/rqaebad/cost-of-producing-a-barrel-of-crude-oil-by-country>. In 2014, however, the fiscal break-even oil price (i.e., the average oil price needed for an oil-exporting country to balance its budget in a given year) for Kazakhstan was \$65.50 per barrel. See: IMF, Middle East and Central Asia Department. Statistical Appendix. <https://www.imf.org/external/pubs/ft/req/2015/mcd/eng/pdf/mreost0115.pdf>. KazMunaiGas Exploration Production, the listed subsidiary of the state oil company, said that its main production unit needs an oil price of \$65 per barrel to break even. See: *Financial Times*. 2016. Falling Oil Price Raises Prospect of Bailouts for Crude Producers. 28 January.

¹⁵ The export duty on crude oil was reduced from \$60 to \$40 per ton as of 1 January 2016. Moreover, since 1 March 2016, the export-duty rate levied on crude oil has been tied to world prices. In fact, it is a floating rate, so that if the oil price dips below \$24 per barrel, the export duty will be zero.

¹⁶ Apparently, the Kashagan oil field ceased to be profitable in 2015, when oil prices fell below \$80 per barrel. See: D. Urazova. 2014. Dropping Oil Prices Cast a Shadow of Unprofitability over Kashagan. *Tengrinews*. 7 November. http://en.tengrinews.kz/politics_sub/Dropping-oil-prices-cast-a-shadow-of-unprofitability-over-257308/. Nevertheless, Kashagan started production again in October 2016, thereby pouring more oil into a heavily oversupplied market.

expects it to recover in 2017 and 2018. Tightened monetary policy and slower economic activity have markedly slowed lending. The external position has deteriorated largely due to the drop in the price of oil, with the current account balance having shifted from a surplus equivalent to 2.8% of GDP in 2014 to a deficit equivalent to 6.4% of GDP in 2016 according to the National Bank's data. The overall fiscal surplus dropped from 5.0% of GDP in 2013 to 1.7% of GDP in 2014; and became a deficit of 1.6% of GDP in 2016.

15. While no recent data concerning TFP are available from the Kazakh authorities, according to estimates by the Conference Board, Kazakhstan

experienced a sharp slowdown in TFP growth, which fell from an average of 7.4% in 1999–2006 to an average of 2.5% in 2007–2013 (Table 1). Kazakhstan's average TFP growth in 2007–2013 was lower than that of Tajikistan (5.3%), Turkmenistan (4.0%), and Uzbekistan (2.6%), but higher than that of the Kyrgyz Republic (2.2%), the Russian Federation (2.1%), and Belarus (–0.2%).¹⁷ Kazakhstan's productivity deteriorated in 2014, when TFP growth was negative (–1.4%). Negative TFP growth in 2014 was also experienced by the Kyrgyz Republic (–0.1%), the Russian Federation (–4.0%), and Belarus (–5.0%), but not by Tajikistan (4.3%), Turkmenistan (0.1%), or Uzbekistan (4.3%). Another recent study suggests that, as is the case with other former Soviet

Table 1: Total Factor Productivity Growth in Member Countries of the CAREC Program and Eurasian Economic Union, 1999–2014

Country	1999–2006	2007–2013	2012	2013	2014	2015
Armenia	10.6	0.9	2.8	4.0	1.8	...
Azerbaijan ^a	6.4	0.1	(0.2)	(2.2)	(4.7)	...
Belarus	4.7	(0.2)	(2.3)	(0.2)	(5.0)	...
PRC ^a	2.3	1.3	...	0.2	0.1	(1.3)
Georgia ^a	4.4	3.0	2.0	1.2	(0.4)	...
Kazakhstan^a	7.4	2.5	3.2	2.4	(1.4)	...
Kyrgyz Republic ^a	1.6	2.2	7.9	0.2	(0.1)	...
Pakistan ^a	2.0	0.5	2.8	3.1	2.4	...
Russian Federation	5.6	2.1	1.3	0.5	(4.0)	...
Tajikistan ^a	7.4	5.3	7.2	6.2	4.3	...
Turkmenistan ^a	4.7	4.0	2.7	3.1	0.1	...
Uzbekistan ^a	3.0	2.6	2.3	4.4	4.3	...
Other						
United States	0.5	(0.2)	...	(0.5)	0.1	0.1
Europe	0.4	(0.6)	...	(0.2)	(0.1)	0.3
Japan	0.1	0.1	...	0.7	(0.8)	(0.1)
India	0.1	0.6	...	0.9	1.6	1.9
World	0.9	0.1	...	0.0	0.0	(0.3)

... = data not available, () = negative, CAREC = Central Asia Regional Economic Cooperation, PRC = People's Republic of China.

^a Member countries of the CAREC Program.

Notes: The growth of total factor productivity (TFP) refers to the growth of GDP over the combined contributions of total hours, workforce skills, machinery and structures, and information-technology capital. Growth rates are calculated as log differences; those in this table for 1999–2006 and 2007–2013 are the averages of yearly growth rates.

Source: The Conference Board Total Economy Database™ (adjusted version), November 2016. <https://www.conference-board.org/retrievefile.cfm>

¹⁷ The Conference Board. Total Economy Database. Table 12. <http://www.conference-board.org/data/economydatabase/> (accessed January 2017).

republics (such as Armenia, Azerbaijan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan), Kazakhstan's TFP growth is slow due to a lack of technical progress.¹⁸ Kazakhstan ranked 47th out of 61 economies in the *World Competitiveness Yearbook 2016* (down from 34th in 2015 and 32nd in 2014), 53rd among 138 economies in the World Economic Forum's Global Competitiveness Index for 2016–2017, and 35th out of 190 economies in the World Bank's "ease of doing business" ranking in 2017 (up from 51st in 2016).¹⁹ Needless to say, Kazakhstan's economic development strategy can succeed in achieving sustained and inclusive growth only insofar as it improves TFP, and thus its international competitiveness.

16. The main aim of taxation is to finance government expenditures, including those on "public goods" such as essential infrastructure. An efficient tax system will yield revenues sufficient for financing government expenditure on basic development needs, and such expenditure in accordance with value for money is the other side of the same coin, as far as fiscal prudence is concerned. Fiscal sustainability now requires credible medium-term consolidation and greater transparency, especially on

the tax-revenue side of the coin. In particular, there is scope for raising tax collection by strengthening enforcement and curtailing various forms of tax relief, including incentives for resident companies in SEZs and IZs. Fiscal transparency, and thus public accountability, can be improved by expanding budgetary reporting in order to encompass all fiscal measures, including tax revenues forgone as a consequence of various types of tax relief accorded to the SEZs and IZs. The authorities can then evaluate the benefits of these types of tax relief to the SEZs and IZs, but balance the benefits against the costs of these measures in terms of forgone tax revenue. Likewise, the benefits of any public expenditure on zone-related infrastructure need to be evaluated in relation to the budgetary costs, which, in the case of the 10 existing SEZs, already amount to T275 billion (with an additional T200 billion still needed, but delayed due to the sharp fall in budget revenues). For example, the tax revenues forgone as a result of the tax incentives provided to SEZ-based companies could perhaps be better spent on essential development needs, including education and vocational training,²⁰ as well as basic infrastructure, especially electric power, water,

¹⁸ F. Saliola and M. Seker. 2011. Total Factor Productivity Across the Developing World. *Enterprise Surveys: Enterprise Note Series*. No. 23. Washington, DC: World Bank Group; and V. Shahabinejad, M. R. Z. Mehrjerdi, and M. Yaghoubi. 2013. Total Factor Productivity Growth, Technical Change and Technical Efficiency Change in Asian Economies: Decomposition Analysis. *Iranian Journal of Economic Studies*. 2 (2). pp. 47–69.

¹⁹ IMD World Competitiveness Center. 2015. *The World Competitiveness Yearbook 2015*. Lausanne, Switzerland, and Singapore. <http://www.imd.org/news/IMD-releases-its-2015-World-Competitiveness-Ranking.cfm>; 2014. *World Competitiveness Yearbook 2014*. Lausanne, Switzerland, and Singapore. <http://www.imd.org/news/2014-World-Competitiveness-Ranking.cfm>; World Economic Forum. Global Competitiveness Index for 2015. <http://reports.weforum.org/global-competitiveness-report-2015-2016/competitiveness-rankings/>; The World Bank. 2014 *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. <http://www.doingbusiness.org/-/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB16-Full-Report.pdf>; Ease of Doing Business in Kazakhstan. <http://www.doingbusiness.org/data/exploreconomies/kazakhstan>. *Doing Business 2017: Equal Opportunity for All*. <http://www.doingbusiness.org/Reports/-/media/WBG/DoingBusiness/Documents/Profiles/Country/KAZ.pdf>.

²⁰ Although public expenditure on education has been on the rise in Kazakhstan, reaching 3.4% of GNP during 2013–2014, it is still much lower than the average Organisation for Economic Co-operation and Development (OECD) benchmarks of 6.0%–7.0%. See: World Bank Group. 2015. *World Bank Group–Kazakhstan Partnership Program Snapshot: October 2015*. Astana. <http://pubdocs.worldbank.org/pubdocs/publicdoc/2015/10/527371446024973025/Kazakhstan-Snapshot.pdf>. While no data are available on the rates of return on investment in education in Kazakhstan, evidence from abroad suggests that the returns are relatively high. According to the OECD, for example, the rates of return for upper secondary and post-secondary non-tertiary education range 6.1%–18.0% for men and 5.4%–18.5% for women; and in the case of tertiary education, the average rate of return across 19 OECD member countries is 12% for men and 11% for women. See: OECD. 2008. *Education at a Glance 2008: OECD Indicators*. Paris. Chart A10.4. p. 191. <http://www.oecd.org/education/skills-beyond-school/41284038.pdf>. The rates of return on investment in higher education in Brazil, the PRC, India, and the Russian Federation are also high. See: M. Carnoy et al. 2013. The Economic Returns to Higher Education in the BRIC Countries and Their Implications for Higher Education Expansion. Working Paper No. 253. Rural Education Action Program. Palo Alto, CA: Stanford University. http://reap.fsi.stanford.edu/sites/default/files/Economic_returns_to_higher_education_in_the_BRIC_countries2.pdf. Moreover, estimates from the United States show that inflation-adjusted annual rates of return on investment in early childhood educational programs are 10% or higher. See: J. Heckman, R. Grunewald, and A. Reynolds. 2006. The Dollars and Cents of Investing Early: Cost–Benefit Analysis in Early Care and Education. *Zero to Three*. 26 (6). pp. 10–17; and J. Heckman et al. 2010. The Rate of Return to the High/Scope Perry Preschool Program. *Journal of Public Economics*. 94 (1–2). pp. 114–128. The rates of return on investment in a bachelor's degree in the United States average 15%, with those for degrees in engineering, math, and computer science as much as 18%–21%. See: J. R. Abel and R. Deitz. 2014. Do the Benefits of College Still Outweigh the Costs? *Current Issues in Economics and Finance*. 20 (3). https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci20-3.pdf. Very few alternative investments can yield such high rates of return. For example, in the US, the long-term annual rate of return on investments in stocks is 7%, and on investments in bonds it is 3%.

transportation, and telecommunications (including internet access), all of which are essential for exporters connected to GVCs.

17. Kazakhstan does have some symptoms of the “Dutch disease,” which is a variation of the “natural resource curse” (the tendency of resource-rich countries to have slower economic growth than countries not rich in natural resources), and these symptoms have undoubtedly impeded the country’s efforts to diversify its exports away from oil and gas. When oil and gas prices were high, large inflows of FDI, which were concentrated in oil- and gas-related companies and accounted for over 80% of the total FDI in Central Asia, pushed up the value of the tenge, thus rendering Kazakhstan’s other exports less competitive. At the same time, the fact that investment flowed mainly to oil and gas firms meant that other industries were too weak to pick up the slack when the once-soaring tenge halved in value in 2015. As a consequence, non-energy exporters appear to be struggling despite the tenge’s recent plunge. Indeed, over the first half of 2015, as the volume of energy exports increased, non-energy exports fell.²¹ While the depreciation of the tenge presents an opportunity for industries that already export (e.g., iron and steel, inorganic chemicals, ores, and copper), any effort to increase exports in such areas as agribusiness, chemicals, fertilizers, logistics, business services, and information technology requires investment in new production, which takes time.

18. Another possible explanation for the weak performance of exports by countries with falling currencies involves the prevalence of GVCs, although the slowdown in annual global trade growth since 2010 to just 1.7% in 2016 suggests that businesses are less inclined to build cross-border supply chains. Globalization has turned many countries into way stations in the manufacturing process in which components are imported, assembled, and reexported. This means that much of what a country gains through currency devaluation in terms of the competitiveness of its exports is lost through the higher costs of imported components. According to

the World Bank, this may explain about 40% of the diminished impact of devaluations globally.

19. It follows that macroeconomic policies pertaining to exchange rates and related monetary policies, as well as fiscal policies, have important implications for other policies aimed at achieving export-led growth. While the recent depreciation of the tenge will help facilitate Kazakhstan’s recovery from the Dutch disease, full recovery combined with sustainable and inclusive growth in the future will require not just macroeconomic stability, but far-reaching structural reforms in order to diversify the economy away from such a heavy reliance on oil and gas. Falling oil prices underscore the need to diversify Kazakhstan’s economy away from the oil industry. In spite of the efforts to restructure the economy in response to the 2008–2009 drop in oil prices, dependence on oil has increased. Investment growth has lagged, and expenditure on research and development (R&D) as a proportion of GDP has declined to only a quarter of the average in middle-income countries. While the immediate challenge is to reverse the loss in competitiveness caused by the tenge’s appreciation against the ruble in the first half of 2015, in the longer term comprehensive structural reforms will be necessary to improve TFP and to facilitate the diversification of the economy into agriculture, manufacturing, and services.

20. According to Kazakhstan’s minister for investments and Development, “We want to change the structure of our economy. But in order to achieve this task, we need foreign investment. And in order to achieve that goal, we need to drastically change not just the image of the country, but legislation, norms — the very essence of it.”²² Among the government’s priorities in this regard, therefore, are increasing investment in human capital; improving the business climate; supporting R&D; and enhancing financial intermediation, thereby improving the functioning of capital markets, strengthening the rule of law (including the enforcement of property rights), and building institutions. Furthermore, with Kazakhstan heavily dependent on foreign trade and investment,

²¹ On 23 September 2015, the Ministry of Energy said that oil production would miss the target of 80.5 million tons in 2015. This marked the second consecutive year of decreases in oil output in Kazakhstan, as the output in 2014 had fallen slightly to 80.8 million tons. On 1 October 2015, the independent PRIX index forecasted a fall in oil exports for Kazakhstan in the fourth quarter of 2015, highlighting the impact that low oil prices were having on Kazakhstan’s oil sector. See: P. Sorbello. 2015. Ominous Outlook for Kazakhstan’s Oil Exports. *The Diplomat*. 1 October. <http://thediplomat.com/2015/10/ominous-outlook-for-kazakhstans-oil-exports/>.

²² H. Foy. 2017. Investors welcome push to prise open Kazakhstan. *Financial Times*. 19 June.

both of which have often been undermined by the Soviet legacy of an overbearing state role in the economy, privatization is also now a big item on the agenda. The unveiling in December 2015 of an ambitious privatization program 2016–2020 that included the Khorgos International Centre of Boundary Cooperation, an inland dry port, on the border with Xinjiang, the autonomous region in northwest PRC will, if implemented, not only help improve the fiscal situation, but also reduce the role of the state in the economy, thereby clearing the way for a broader growth strategy led by the private sector.²³ Indeed, Chinese companies bought 49% of this inland port in May 2017. Thus, if properly designed, SEZs and IZs could constitute an integral part of this economic development strategy.

E. Contribution and Organization of this Diagnostic Study

21. This diagnostic study adds value to existing technical assistance (TA) projects provided by other donors in the following ways:

- (i) stressing the importance of transparency concerning the objectives, features, functioning, and effectiveness of Kazakhstan's SEZs and IZs, including the crucial role of transparency in improving evidence-based policy making and public accountability, as far as these zones are concerned;
- (ii) throwing light on the legislative and institutional framework, and on the administrative procedures concerning SEZs and IZs;
- (iii) providing a valid methodology for evaluating the benefits and cost-effectiveness of SEZs and IZs;
- (iv) providing empirical evidence concerning the performance of SEZs (and IZs);
- (v) in light of this evaluation, making

recommendations as to how the SEZs (and IZs) might be modified to improve their cost-effectiveness, or replaced by more effective alternatives; and

- (vi) recommending guidelines regarding the use of SEZs and IZs and their specific features, taking into account international best practices, including those embodied in WTO and EAEU rules.

22. The rest of this diagnostic study is organized as follows. The methodology used to evaluate SEZs and IZs and related policies are discussed in Chapter II. Chapter III describes both the global and regional economic landscapes, most notably the impacts of Kazakhstan's membership in the WTO, EAEU, and the CAREC Program, and the implications for its SEZs and IZs. In view of Kazakhstan's recent accession to the WTO and membership of the EAEU, Chapter III also provides an overview of the resulting constraints on these zones. Given the importance of good governance and a strong institutional framework (possibly free from the institutional constraints prevalent in the rest of the economy) for the success of these zones and their contribution to economic development, the legislative, regulatory, and institutional framework and administrative procedures are summarized in Chapter IV. That chapter also contains the rationale for the existing SEZs and IZs and their main features. Chapter V examines the evidence concerning the effectiveness of the SEZs in achieving their explicit and implicit objectives. Some lessons from the failures and successes of zones in other countries, especially the PRC and India, are found in Chapter VI. In the light of the evidence regarding their effectiveness and lessons from abroad, Chapter VII suggests some general principles and specific guidelines concerning the design and use of SEZs and IZs.

²³ J. Kynge and J. Farchy. 2015. Crisis-Hit Kazakhstan Unveils Ambitious Privatisation Plan. *Financial Times*. 3 November; Khorgos. The First Kazakh-Chinese Project Presentation "Establishment of the International Center for Border Cooperation 'Khorgos' to Attract Investment and the Trade Partners. <http://www.mcps-khorgos.kz/en/smi-review/first-kazakh-chinese-project-presentation-%E2%80%9CEstablishment-international-center-border-coop>. In addition, Samruk-Kazyna, the Kazakh sovereign-wealth fund, is planning to sell shares in the firms it controls. See: *The Economist*. 2017. Kazakhstan: The Crossroads of the New Silk Road. 1 July.

Chapter II. Methodology and Key Concepts

A. The Crucial Role and Essence of Transparency concerning Special Economic Zones and Industrial Zones

23. The continual process of structural reform, including unilateral trade liberalization, can be greatly facilitated by a high degree of domestic transparency regarding the formulation, implementation, and evaluation of economic policies, including policies relating to the special economic zones (SEZs) and IZs. Ideally, such transparency should concern the nature of and rationale for these policies, and should involve an independent evaluation of their cost-effectiveness (i.e., their costs in relation to their benefits for consumers and producers). Such cost-benefit analyses, *ex ante* as well as *ex post*, should be the foundation for the evaluation of all government policies—not just those concerning SEZs and IZs, but also those concerning regulations and public expenditure on infrastructure. The institutionalization of transparency, particularly in the form of a rigorous, evidence-based approach to public policy, would enhance government accountability, public understanding, and thus the debate on the merits of policies.²⁴ It would also reduce the scope for rent-seeking and discretion in the implementation of policy measures, thereby helping to prevent corruption.²⁵ Unfortunately, the institutionalization of transparency is not a common practice in Kazakhstan, or elsewhere in Central Asia and much of the Asia and Pacific region.

24. No doubt, this lack of transparency in government institutions is partly due to the fact that high-quality transparency involving cost-benefit analyses of government policies takes time to establish, and is not cheap. Indeed, transparency measures may

be considered prohibitively costly by less-developed countries such as Kazakhstan, which also lack the institutional capacity to implement them. However, the costs of achieving transparency pale in comparison with other costs, including forgone tax revenues due to tax incentives; expenditure on infrastructure; and the possible “dead weight losses” (in terms of economic efficiency),²⁶ which are associated with such measures (or, indeed, with the taxes themselves).²⁷ In a worst-case scenario, transparency measures may even be counterproductive. While a cost-benefit analysis of transparency measures implemented in other countries can be enlightening in the absence of any analysis of similar measures implemented domestically, they are not a substitute. After all, economic, political, and social circumstances, as well as levels of development and institutional capacity, differ widely from one country to another. One size does not necessarily fit all, although positive experiences in other countries can provide some guidance. Among the countries of the former Soviet Union, for instance, Georgia is especially noteworthy for the remarkable progress it has made in the areas of public sector reforms and transparency.²⁸ It should be pointed that, in Kazakhstan, of the 100 concrete steps set out by President Nursultan Nazarbayev on 20 May 2015 for implementing the government’s five institutional reforms, 10 are aimed at improving the transparency and accountability of the state. Clearly, Kazakhstan would need technical and financial support in order to institutionalize transparency; this would have to include the gathering of reliable statistics, the lack of which inhibits evidence-based analyses of trade and trade-related policy measures, and thus the formulation of optimal policies, among them those involving SEZs and IZs (which is one of the purposes of this diagnostic study).²⁹

²⁴ Sunshine is said to be “the best disinfectant” against ill-conceived economic policies.

²⁵ Opacity may be considered necessary for concealing the features of the SEZs and IZs that may infringe World Trade Organization (WTO) regulations. Furthermore, a lack of transparency and oversight, as well as softened customs controls and enforcement of other laws and regulations, may render the SEZs and IZs more vulnerable to criminal activities, including money laundering and the production and distribution of counterfeit currencies. See: International Chamber of Commerce. 2013. *Controlling the Zones: Balancing Facilitation and Control to Combat Illicit Trade in the World’s Free Trade Zones*. Paris.

²⁶ A “deadweight loss” is the waste that results from the loss of economic efficiency for reasons such as taxes, tariffs, poorly designed regulations, and monopoly power.

²⁷ In Thailand, for example, a 1999 study by the Foreign Investment Advisory Service found that, for each industry-sector job created, investment incentives cost the government per year about 16 times the average annual wage of an industrial worker. Investments by General Motors in Hungary cost \$300,000 per job created. A package of tax incentives offered by India to Ford in 1997 cost an estimated \$200,000–\$420,000 per job. See: I. Gill and H. Kharas. 2007. *An East Asian Renaissance: Ideas for Economic Growth*. Washington, DC: The International Bank for Reconstruction and Development/The World Bank. p. 181. http://siteresources.worldbank.org/INTEASTASIAPACIFIC/Resources/226262-158536715202/EA_Renaissance_full.pdf.

²⁸ For example, see Georgia’s trade policy reviews by the WTO, including the latest one: WTO. 2016. *Trade Policy Review: Georgia*. Geneva. https://www.wto.org/english/tratop_e/tp_r_e/s328_e.pdf.

²⁹ Apparently, no studies have been done to estimate the tax revenues forgone due to individual tax preferences, including those granted to firms operating within SEZs and IZs.

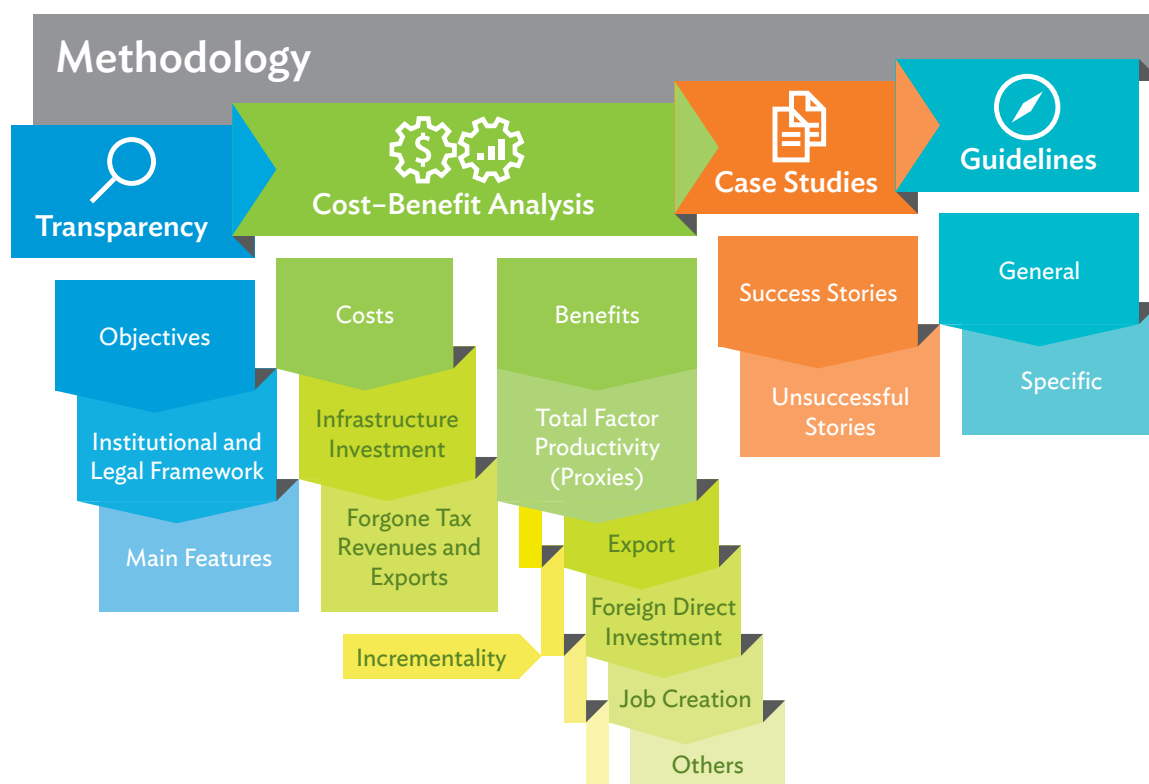
25. This diagnostic study is essentially an exercise in transparency aimed at evaluating, by means of cost-benefit analysis, the cost-effectiveness of Kazakhstan's SEZs (and, to a lesser extent, IZs) as instruments of economic policy. For the purposes of this study, transparency is deemed to consist of the following key elements:

- (i) a clarification of the stated objectives of its existing SEZs and IZs;
- (ii) a description of the legal and institutional framework concerning SEZs and IZs, and the SEZs' and industrial zones' main features;
- (iii) a computation of the costs of the existing SEZs and IZs, including associated spending on infrastructure, tax revenues forgone due to tax preferences, the administrative costs of operating the zones, compliance costs borne by enterprises operating in the SEZs and IZs, and undesirable and possibly unintended side effects (including deadweight losses);

- (iv) the benefits of existing SEZs and IZs, including the extent to which they have increased and diversified exports, attracted foreign direct investment (FDI), and created more highly paid employment;
- (v) an assessment of the cost-effectiveness of SEZs and IZs in achieving those benefits; and
- (vi) the provision of advice on how SEZs and IZs might be modified to improve their effectiveness or, indeed, whether they should be replaced by alternative policy instruments that would likely be more cost-effective.

26. Such an evaluation (or cost-benefit analysis) attempts to throw light on the effectiveness of SEZs and IZs (and of their particular features) in achieving their explicit and implicit objectives, notably: increasing and diversifying exports; attracting FDI (and associated technologies); integrating local enterprises into global value chains (GVCs); and creating more highly paid employment.

Figure 1: Methodology of the Diagnostic Study on Kazakhstan



Source: Asian Development Bank.

27. Transparency is necessary not only for ensuring the cost-effectiveness of SEZs and IZs, it is also an essential part of the institutional and legal framework of these zones. Moreover, transparency is important for ensuring that the various features of the SEZs and IZs (e.g., tax preferences, criteria for eligibility to operate in SEZs and IZs, and the role and financing of their management companies), as well as the government's spending on infrastructure, are all cost-effective. For example, the tax revenues forgone as a consequence of tax incentives might have been better spent on basic infrastructure, whether in or around SEZs and IZs or elsewhere in the economy. Given the inevitability of trial and error, the various features of SEZs and IZs, as well as the SEZs and IZs overall, should be closely monitored and evaluated in a timely manner.

28. Whereas the objectives and the legal and institutional framework concerning SEZs and IZs in Kazakhstan, as well as their main features, are reasonably clear, little data were available on fiscal and other costs of the various features of the SEZs and IZs, especially the costs of individual tax preferences and administration. This lack of data hampered the cost-benefit analysis,³⁰ and has meant that policies concerning SEZs and IZs are, to some extent, being made in the dark.

B. The Vital Concept of “Incrementality”

29. The most challenging part of this diagnostic study involves the evaluation of the benefits and costs of the various features of SEZs and IZs and of viable alternatives. In particular, a formidable methodological hurdle encountered by policy makers conducting economic evaluations of the cost-effectiveness of

SEZs and IZs in Kazakhstan (and elsewhere) is the difficulty of determining the extent to which such instruments are *incremental*.³¹ For example, it is important to determine whether exports from the SEZs and IZs are incremental or not. Some exporting firms may have relocated their operations to the zones, thereby creating the false impression that the zones have been successful in stimulating exports, whereas, in reality, the additional exports from the SEZs and IZs have merely displaced exports from the rest of the country.³² In the case of investment incentives, which are among the main features of SEZs and IZs, it is important to identify the incremental investments, and the additional employment, that would *not* have occurred without such incentives. (Thus, in the case of tax incentives, “incrementality” and forgone tax revenues are closely related.) The lack of incrementality reduces the benefits of SEZs and IZs relative to their costs, thereby reducing their cost-effectiveness.

30. In the absence of econometric analysis, this diagnostic study relied largely on the ADB team's interviews with enterprises in Kazakhstan's SEZs. While these interviews may throw some light on this matter, econometric analysis would have been far more reliable and credible. The interviews were based on a short oral questionnaire (in addition to anecdotal evidence), which allowed for follow-up questioning. They focused on the extent to which the enterprises' investments in the SEZs had turned out to be incremental (Chapter V) and on studies done in other countries (Chapter VI).³³ In connection with the SEZs, such analysis also requires data on government expenditures, including the costs of administration and forgone tax revenues, as well as the cost of capital in the case of infrastructure. However, the absence of any underlying SEZ model

³⁰ Some data are available regarding government expenditure on infrastructure in each SEZ and on total revenues forgone owing to tax preferences (T27.2 billion in 2014).

³¹ The Ministry for Investments and Development (MID) has recently developed a methodology to assess the performance of Kazakh SEZs. However, it is doubtful whether it would throw much, if any, light on the extent of “incrementality.”

³² To the extent that foreign importers prefer to import more from firms located in SEZs or IZs, whose costs are lower due to tariff and other preferences, these imports would be at the expense of the rest of the country, thus constituting trade “diversion.”

³³ The experiences of countries that have evaluated the impact of tax incentives for investment indicate that these incentives are seldom cost-effective. Most econometric studies show that forgone tax revenues tend to exceed the incremental investment they were meant to induce. Even in the case of R&D, which is widely considered to be especially susceptible to market failure, a study by Australia's Productivity Commission, for example, found that the general tax concession for R&D acted mainly as a “reward” for research the firms would have done anyway, rather than stimulating much additional R&D. See: Government of Australia, Productivity Commission. 2007. *Public Support for Science and Innovation*. Research Report. Canberra. However, recent empirical evidence from the United Kingdom shows that tax incentives for R&D not only spurred innovation by the firms that were its direct beneficiaries, but also had positive spillover into technologically related firms. As a consequence, each £1 of tax relief induced £1.7 in R&D spending. See: A. Dechezleprêtre et al. 2016. Do Tax Incentives for Research Increase Firm Innovation? An RD Design for R&D. *NBER Working Papers*. No. 22405. Cambridge, MA: National Bureau of Economic Research (NBER).

and of the data necessary for econometric analysis precluded any rigorous cost–benefit analysis of the SEZs.³⁴ Therefore, any data that might be available concerning, for example, exports, investments, technology transfers, and employment generated by the SEZs (or IZs), must be interpreted very carefully.

C. The Importance of Total Factor Productivity and Its Proxies

31. If not the stated goal, the ultimate test of the success of Kazakhstan's SEZs and IZs (and, indeed, of its overall economic development strategy) is the extent to which they

- (i) improve total factor productivity (TFP), and thus the international competitiveness of Kazakh enterprises, thereby enabling domestically produced goods and services to compete against imports and paving the way for economic diversification and export-led growth;³⁵
- (ii) facilitate the efficient reallocation of resources in accordance with comparative advantage (as reflected in TFP, for example), thus boosting exports despite Kazakhstan's remote location and small domestic market;
- (iii) attract FDI, which not only contributes to the domestic stock of capital, but also serves as a conduit for the diffusion of new technologies and expertise, and can induce local supplier linkages by providing improved access to GVCs, which account for 80% of world trade, and, through them, to international markets;³⁶ and
- (iv) create more productive (and thus more highly paid) employment.

32. The TFP of sectors and enterprises reflects the efficiency with which all the factors of production are used, including capital and labor. It is therefore a key determinant of Kazakhstan's economic performance.

TFP should be distinguished from labor productivity, which is the amount of output per employee or per hour worked, and thus affects wages, salaries, and living standards. Among the main sources of improvement in labor productivity are changes in the volume of investment and growth in TFP. Increased investment contributes to improvements in labor productivity by increasing the amount of capital that employees have to work with. In the absence of TFP growth, however, higher labor productivity based on increased investment can only be achieved at the expense of lower capital productivity.

33. In the early stages of development, the efficient reallocation of resources from low-productivity sectors, such as subsistence agriculture, toward more productive manufacturing and service sectors, in accordance with Kazakhstan's comparative advantage, would obviously improve overall TFP. However, TFP growth can also be the result of improved TFP *within* sectors or firms, as the most efficient enterprises gain market shares at the expense of those lagging behind (allocative efficiency), and as competition induces the remaining enterprises in a sector to improve their productivity (enterprise efficiency). Other important sources of TFP growth are economies of scale and, in the long run, technological progress, managerial know-how; education, vocational training, and learning-by-doing; and improvements in basic infrastructure (including electric power; telecommunications, especially internet access; and transportation, which is essential for improving the connectivity of Kazakhstan's otherwise remote economy, especially for trade in goods).

34. Trade liberalization, including a greater commercial presence in the form of FDI, contributes to improved TFP by expanding the markets in which firms can operate and by increasing the degree of competition among firms.³⁷ As a result, TFP growth is generated in four major ways. First, there is a

³⁴ Rigorous cost–benefit analysis of infrastructure investment requires not only data concerning the appropriate capital costs, but also estimates of the likely lifetime of such infrastructure.

³⁵ One of the objectives mentioned in the Law of the Republic of Kazakhstan dated 21 July 2011 “On Special Economic Zones in the Republic of Kazakhstan” (i.e., the current law) is the “development of modern high productive, competitive industries.”

³⁶ In order to be part of a GVC, firms must be as efficient as possible; otherwise, competitors will overtake them. Thus, the expansion of world trade in the late 1990s and early 2000s, as GVCs were formed, went hand-in-hand with improved TFP. So it is perhaps no coincidence that the recent slowdown in global trade has been accompanied by a worldwide slowdown in productivity growth. According to the United Nations Conference on Trade and Development (UNCTAD), as much as 80% of international trade takes place via GVCs linked to transnational companies. See: UNCTAD. 2013. *Global Value Chains and Development: Investment and Value Added Trade in the Global Economy*. Geneva. http://unctad.org/en/PublicationsLibrary/diae2013d1_en.pdf.

³⁷ A recent study of advanced countries, most of whose average most-favored nation (MFN) tariff rates are less than that of the Kyrgyz Republic, found that a 1 percentage point reduction in import tariffs levied on inputs raises TFP by 2% (see E. Dabla-Norris and R. Duval. 2016. “How Lowering Trade Barriers Can Revive Global Productivity and Growth.” <https://blog-imfdirect.imf.org/2016/06/20/how-lowering-trade-barriers-can-revive-global-productivity-and-growth/>).

more efficient allocation of domestic resources in accordance with comparative advantage, thereby inducing a specialization of production, which paves the way to participation in GVCs. Second, the expanded markets enable firms to take advantage of economies of scale, which are difficult to achieve within the confines of a small domestic market, so unit production costs are reduced. Third, market conditions are created in which the more productive firms can expand, while the less productive firms contract or even go out of business. Finally, in expanded markets there is more access to new ideas and greater rewards for innovation and for the adoption of new technologies.³⁸

35. Unfortunately, no recent data on TFP are available from the Kazakh authorities, whether in the aggregate, by sector, or by individual SEZ or industrial zone. Therefore, certain proxies for TFP are used as indicators of economic performance, specifically, the extent to which SEZs have increased and/or diversified exports; attracted investment, especially FDI; and created more highly paid employment.³⁹ These proxies are among the initial economic objectives of SEZs (summarized in Chapter IV), which is not surprising, given that export- and FDI-oriented firms tend to be more productive, and therefore pay relatively high wages, according to international empirical evidence

(referred to in Chapter V).⁴⁰ Other possible criteria for judging the success of SEZs include technology transfers, linkages with the domestic economy, and profitability (insofar as it is not due to tax avoidance or evasion).

D. The Role of Industrial Policy in Economic Development

36. The overriding objective of industrial policy and, indeed, of any economic development strategy, is arguably to prioritize the removal of the principal obstacles to TFP growth. In fact, the rapid economic growth of East Asian countries was largely due to the success of their economic development strategies in paving the way to improved TFP, which, in turn, has enabled their enterprises to compete not only against imports in their domestic markets but also in export markets. When implementing their development strategies in the early stages of their development, these countries deployed fairly active industrial policies that entailed various degrees and forms of direct or indirect government intervention.⁴¹ These policies ranged from relatively little intervention involving few instruments, as in Hong Kong, China, (in accordance with its principles of “market leads, government facilitates” and “big market, small government”), to

³⁸ International trade and FDI are the two main channels through which technology transfers take place. In the case of trade, firms can acquire technological knowledge by importing intermediate goods and capital equipment that include foreign technology. Firms can also “learn by exporting,” through direct interactions with their foreign customers, although the results are weaker than those associated with imports. Regarding FDI, the extent and speed of technology diffusion can depend on firm ownership and the linkages among firms. Multinational firms usually transfer technologies to their affiliates abroad through FDI in order to realize the full gains from their inventions. In the receiving country, inbound FDI may generate positive productivity spillovers into other firms through interactions between the multinational affiliate and local firms, worker turnover, or improved organization and management practices. FDI is therefore widely considered to be important for economic growth in emerging markets and developing economies.

Technology diffusion through trade and investment is not automatic, however. Productivity spillovers from FDI are more prevalent in countries with more highly qualified human capital. In addition, trade and investment often require an adequate level of infrastructure, such as well-developed ground transportation and ports. Public investment in human and physical capital is therefore essential for the achievement of the productivity gains associated with innovation. Some emerging markets and middle-income economies have successfully created well-trained pools of scientists and engineers who are now facilitating technology adoption and innovation. See: IMF. 2016. *Fiscal Monitor: Acting Now, Acting Together*. Washington, DC. <https://www.imf.org/external/pubs/ft/fm/2016/01/pdf/fm1601.pdf>.

³⁹ Interestingly, the presidential decrees providing for the creation of each of the SEZs specify numerical targets corresponding to each of the zones’ objectives, including some of these proxies for TFP. In the case of the Astana–New City SEZ, for example, the objectives and targets pertain to the volumes of foreign and domestic investment, production of goods and services in the SEZ, number of participants, number of jobs created, local content share of total production, and the level of innovative activity of enterprises in the SEZ.

⁴⁰ See, for example: B. Baltabaev. 2014. Foreign Direct Investment and Total Factor Productivity Growth: New Macro-Evidence. *World Economy*. 37, pp. 311–334; and D. Riker. 2015. Export-Intensive Industries Pay More on Average: An Update. Office of Economics Research Note No. 2015-04 A. Washington, DC: US International Trade Commission. While neither exports nor FDIs are mentioned as explicit objectives in the 2011 SEZ Law, the legal documents establishing individual SEZs do contain numerical targets for exports in three cases (Ontustik, Pavlodar, and Taraz) and for FDI in all of the SEZs. Besides, in the course of Kazakhstan’s accession to the WTO, its representative stated explicitly that the Kazakh SEZs were aimed at attracting FDI, among other goals. See: WTO. 2015. Report of the Working Party on the Accession of the Republic of Kazakhstan. WT/ACC/KAZ/93. Geneva. 23 June. p. 212.

⁴¹ There is no consensus regarding what exactly constitutes “industrial policy.” The World Bank has defined it broadly as “government efforts to alter industrial structure to promote productivity based growth.” See: World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press.

a high degree of intervention or “guidance” involving a wide range of instruments, as in the PRC, whose economy had previously been centrally planned. Most of these economies were originally developing countries whose factor markets, especially capital markets,⁴² were much less advanced. They were therefore arguably more susceptible to “market failure” than the industrialized economies. This higher degree of susceptibility to market failure provided some rationale for government intervention (e.g., on “infant” or “strategic” industry grounds),⁴³ although the correction of market failure was not the only driving force behind industrial policy. In any event, there is some doubt as to whether governments can allocate resources better than even imperfect markets. When influencing the allocation of domestic resources, however, the governments of East Asian countries did not generally ignore their economies’ comparative advantages.⁴⁴ As circumstances changed over time, including those regarding comparative advantage, these countries increasingly liberalized their economies by lowering their barriers to trade and FDI and by changing their regulatory frameworks, so as to promote competition and thus a more efficient allocation of resources.

37. Industrial policy in East Asia and elsewhere has consisted of a wide variety of policy measures, depending on the extent to which they have involved targets (and to which they intended to “pick winners”), especially for “infant” or “strategic” industries. A broad distinction can be made between “selective” and “functional” measures. Whereas the latter are available to all firms, or to all firms in a particular line of activity (such as innovation), the former target specific industries or even firms within industries. They include: selective tariffs and nontariff barriers to imports (often aimed at import substitution), SEZs or export processing zones (EPZs) to mitigate the anti-export bias arising from such import protection,⁴⁵ export restraints on raw materials or partially processed goods (to encourage downstream processing, for example), export incentives (including credits), tax and nontax incentives for investment (including subsidized interest rates), government procurement policies favoring domestic suppliers, and exemptions from competition laws (if such laws exist). Other forms of intervention have included government-owned or government-linked companies;⁴⁶ a broad, sound base of physical infrastructure (e.g., power supplies, ports,

⁴² In the Republic of Korea, for example, *chaebols* (corporate conglomerates) have been a driving force behind that country’s rapid industrialization, which was based on strong export-led growth. Given the scarcity of entrepreneurial talent during the early stages of the Republic of Korea’s economic development, resources became concentrated in the hands of the founders of these enterprises. The *chaebols*’ success reflected not only their ability to overcome imperfections in factor markets, such as those involving labor, capital, and technology, but also the benefits they derived from the synergies and economies of scope that are possible within large enterprises. The *chaebols* had the added advantage of close links with the Government of the Republic of Korea during a period when a large part of the Republic of Korea’s economy was regulated, a situation that led many to oppose the *chaebols*’ dominant position. In particular, given that part of its industrial policy was aimed at promoting heavy industry and chemicals during the 1970s, the government encouraged the growth of the *chaebols*. The close ties between the *chaebols* and the government, and with the banks (which were government-owned until the mid-1970s) have allegedly impeded access to the Republic of Korea’s market and distorted competition in other markets.

⁴³ Temporary government assistance may enable firms to achieve economies of scale and associated lower costs.

⁴⁴ Since 1990, one of the main sources of productivity growth, and thus development, in Asia has been the structural change caused by the movement of labor from low- to high-productivity sectors. The poorer productivity of Africa and Latin America is apparently due largely to the movement of labor in the opposite direction: from high- to low-productivity sectors. See: M.S. McMillan and D. Rodrik. 2011. Globalization, Structural Change and Productivity Growth. *NBER Working Papers*. No. 17143. Cambridge, MA: NBER. <http://www.nber.org/papers/w17143>.

⁴⁵ Tariffs are not only a barrier to imports. Insofar as they are levied on imported inputs and are reflected in the prices of final goods (and services) produced in the importing country, they also constitute export taxes to the extent that those final goods (and services) are tradable. Based on 2001 data, for example, import tariffs in the Asia and Pacific region were equivalent to export taxes of 5% in Malaysia, 10.4% in Sri Lanka, 12.1% in the PRC, 18.2% in Bangladesh, and as much as 31% in India. See: S. Tokarick. 2007. How Large Is the Bias against Exports from Import Tariffs? *World Trade Review*. 6 (2). pp. 193–212. <http://www.dartmouth.edu/~rstaiger/lerner.symmetry.theorem.evidence.pdf>. The best way to ensure that tariffs (and other indirect taxes) do not effectively end up as taxes on exports would probably be to use free economic zones, rather than tariff exemptions or more complicated drawbacks, as the latter can be costly to administer (although free economic zones can and do add to the complexity of border taxation). Interestingly, even though Moldova has had low formal barriers to trade (e.g., an average import tariff of 5.2%, a rate substantially less than Kazakhstan’s existing average applied MFN rate), another study has shown that Moldova’s informal barriers in 2002 were equivalent to a tax on exports of around 25%. The study also showed that reducing these costs would result in a substantial reduction in poverty in Moldova. See: G. G. Porto. 2005. Informal Export Barriers and Poverty. *Journal of International Economics*. 66 (2). pp. 447–470.

⁴⁶ Even in Singapore, where government-linked companies ostensibly compete on a commercial basis with private companies, their links to the government can result in capital markets valuing these companies more highly than private firms, thus giving them an advantage over the latter in the form of a lower cost of capital.

roads) and social infrastructure (e.g., an educated labor force); subsidized infrastructure supplies and factory space (as part of EPZs, for example); provision of research and development (R&D) facilities at government institutions, as well as tax incentives for private R&D; and, in some instances, the repression of interest rates (and thus of the cost of capital) and real wages (through restrictions on collective bargaining and trade union activity).

E. Facilitation Measures versus Incentives

38. In evaluating Kazakhstan's SEZs and IZs, a clear distinction is made in this study between measures that facilitate trade and FDI by removing domestic market distortions that affect competition and more proactive measures, such as incentives that promote certain activities, possibly on the grounds that such activities are "strategic" or more vulnerable to market failure. Facilitation involves the removal of impediments to the reallocation of domestic resources and to competition in reasonably well-functioning markets, in accordance with Kazakhstan's comparative advantage and improved productivity. At the same time, given the remoteness of the country, facilitation could be aimed at reducing logistics costs, both in the domestic and international markets.⁴⁷ Incentives involve the more challenging task of having the government successfully pick potential "winners" consistently. However, the danger is that political pressure or favoritism, rather than the firms' competitive potential, will drive the selection process, causing the government to pick "losers."

39. For example, with various types of indirect tax measures, which are among the most prominent features of SEZs and IZs, the elimination of tariffs and/or value-added tax (VAT) on imports used in the manufacture of products and services for export obviates the need for deferred and more complex

border-tax adjustments involving tariff drawbacks and VAT refunds upon exportation. Such relief from tariffs, the VAT, and other indirect taxes in accordance with the destination principle of international taxation can therefore be considered a means of facilitating international trade, and thus an export-oriented investment. In contrast, relief from corporate or personal income taxes otherwise levied on enterprises operating in SEZs or IZs (as in the case of tax holidays) constitutes a tax incentive, which is usually more difficult to justify.⁴⁸ Indeed, while the trade-facilitating tax measures mentioned above are consistent with WTO and Eurasian Economic Union (EAEU) rules, tax incentives run the risk of contravening these rules.

F. "Second-Best" Considerations

40. Policies that might appear to distort markets may nonetheless be beneficial if the markets are already distorted by other factors. Under such circumstances, the nationwide economic benefits from SEZs or IZs could be large enough to outweigh the fiscal and other costs, including the deadweight losses associated with the distortions in competition caused by the zones. For example, if a developing country's poorly functioning capital market is failing to channel savings into investment in manufacturing, even though this activity is highly profitable, SEZs or IZs could conceivably stimulate investment, and thereby improve economic welfare.

41. However, it is preferable to address existing distortions directly wherever feasible, and as soon as possible, especially as second-best policies generally have undesirable side effects. For example, preferential tax treatment of firms operating in SEZs might not only place other firms in the domestic market at a competitive disadvantage, but also encourage firms located in the SEZs to import their inputs rather than purchase them from domestic suppliers located outside the SEZs, thereby preventing the integration of the non-SEZ firms into GVCs.

⁴⁷ Depending on the industry sector, supply-chain logistics costs account for between 5% and 50% of a product's total landed cost. See: Material Handling & Logistics. 10 Tips for Reducing Supply Chain Logistics Costs. <http://mhlnews.com/transportation-and-distribution/10-tips-reducing-supply-chain-logistics-costs>. Logistics costs are among the main determinants of competitiveness. See: K. Rantasila and L. Ojala. 2012. Measurement of National-Level Logistics Costs and Performance. Discussion Paper No. 2012-04. Turku, Finland: Turku School of Economics, University of Turku. Background paper for the 2012 Summit of the International Transport Forum on Seamless Transport: Making Connections. Leipzig, Germany. 2-4 May. <https://www.oecd.org/tad/events/global-forum-trade-2012-reliability-measuring-logistics-costs.pdf>.

⁴⁸ Tax incentives may, in any event, be relatively cost-ineffective for the reasons mentioned in Chapter V.

Besides, in a complicated world, a second-best rationale can be found for practically any policy. It follows that second-best policies should be only temporary, used as a stepping-stone to full trade liberalization.

G. Market Failure and Public Goods

42. Market failure arises when markets do not fully reflect the social costs and benefits of private economic activities.⁴⁹ For example, in the case of R&D, which is a major determinant of technological progress, and thus of long-term TFP growth, the social benefits tend to exceed the private benefits (Annex). Consequently, too little R&D would be undertaken if markets were left to their own devices. In these cases, it may be legitimate for the government to intervene, provided that the magnitude of the gap between the private and social benefits of R&D can be measured accurately and that a cost-effective incentive can be designed to stimulate sufficient R&D to bridge that gap without any substantial adverse consequences. Market failure may partly explain why subsidies for R&D used to be permitted under WTO rules. This is no longer the case. Unfortunately, governments are seldom capable of correcting market failure in a cost-effective way, so they would be well advised to be careful about providing incentives, even in the case of R&D.

43. Nonetheless, in many countries, including the People's Republic of China (PRC), Finland, Israel, the Republic of Korea, and the United States, the state has played an active role in increasing innovation.⁵⁰ Indeed, almost every technology that makes the

iPhone smart was reportedly funded by government.⁵¹ Besides, several indicators point to the need to enhance the contribution of science and technology to Kazakhstan's economic development. In particular, the country's expenditure on R&D amounts to only 0.2% of gross domestic product (GDP), which is well below the 1.0%–1.5% levels generally recommended for countries at a similar stage of economic development, and also lower than the levels in neighboring countries, such as the Russian Federation (roughly 1%).⁵² Moreover, according to the World Bank's Knowledge Economy Index, Kazakhstan ranked 73rd among 146 countries in 2012 (up from 78th in 2000).⁵³

44. A related source of market failure concerns basic infrastructure (especially transport, energy, water, sewage and waste disposal, telecommunications and internet facilities, health, and education), which can often be characterized as “public goods.” By definition, public goods (and services) generate positive “externalities” in the sense that they provide social benefits over and above what individuals or businesses would be willing to pay for. They tend to be undersupplied in a competitive market because they are “non-excludable” and “non-rival,” that is, consumption by one individual or business does not preclude consumption by others.⁵⁴

45. Public investment in basic infrastructure is an indispensable source of TFP, and thus of economic growth in the long run. Furthermore, it creates employment in the short run. Indeed, it was these potential benefits that largely motivated the establishment of the new Asian Infrastructure Investment Bank, which aims to fill the region's

⁴⁹ A frequently mentioned example of market failure pertaining to trade involves export financing, which has prompted many countries to establish export–import banks. These banks are essentially government credit agencies. Their role is to provide export financing (i) when the private sector is unwilling or unable to do so alone on commercially viable terms, and/or (ii) to counteract foreign competition arising from government-backed financing by other countries for their companies. Proponents assert that these banks can facilitate exports by addressing financial market failures that impede exports, and thereby help exporters to compete internationally. However, critics contend that the private sector is nonetheless more efficient than the government's use of taxpayer funds for financing exports, irrespective of whether the beneficiaries are large or small businesses. The Organisation for Economic Co-operation and Development (OECD) has established international rules for such government-backed export credit agencies.

⁵⁰ M. Mazzucato. 2016. *Financial Times*. A Strong Industrial Strategy Has Many Benefits. *Financial Times*. 3 August.

⁵¹ The world's first touch screen, for example, the forerunner to the screens on the latest handsets, was invented in 1976 at the European Organization for Nuclear Research (CERN) in order to master the controls of a new big accelerator. See: *Cern Courier*. 2010. The First Capacitive Touch Screens at CERN. 31 March. <http://cerncourier.com/cws/article/cern/42092>.

⁵² OECD iLibrary. 2012. OECD Investment Policy Reviews: Kazakhstan 2012. <http://dx.doi.org/10.1787/9789264121812-en>.

⁵³ Knoema. Knowledge Economy Index (World Bank). 2012. <https://knoema.com/WBKEI2013/knowledge-economy-index-world-bank-2012>.

⁵⁴ The combination of high fixed costs and zero marginal costs of distribution makes certain types of basic infrastructure, such as electric power, water, and telecommunication grids, as well as transportation networks, natural monopolies.

infrastructure gap. As long as the return on investment in infrastructure exceeds the cost of finance, public investment strengthens the government's fiscal balance sheet. Although no data on the internal rates of return of such investments were available in Kazakhstan, this appears to be the case in the Kyrgyz Republic for investments in electricity generation and paved roads. Feasibility studies carried out on behalf of the Kyrgyz authorities suggest that the internal rates of return on investment in certain types of infrastructure would be in the range of 14%–39%.⁵⁵ This suggests that public investment in basic infrastructure (in SEZs, IZs, or elsewhere in the economy) would arguably be more cost-effective than tax incentives, especially corporate income tax (CIT) holidays, for investments whose incremental effects are uncertain.⁵⁶ The benchmark interest rate of Kazakhstan's Central Bank is currently 10.5%. Rather than relying exclusively on tax breaks to fund investment in infrastructure, a “user-pays” model would create an incentive for the efficient use of infrastructure, and would generate revenue to support maintenance and eventual renewal. All of this further helps to maximize the benefits derived from public infrastructure, including that in or near SEZs and IZs. The infrastructure has still not been completed in four of the SEZs, however, owing to the sharp reductions in the government budget. Moreover, it would appear that, in some cases, the infrastructure does not correspond to the needs of the enterprises operating in the zones.

H. Trade Liberalization, Structural Reform, and Trade Adjustment Assistance

46. The potential economic gains from trade liberalization—whether multilateral, regional, bilateral, or unilateral—are well-known.⁵⁷ Trade liberalization benefits those who produce exports or consume imports (including producers who use imported goods as inputs). At the same time, however, trade liberalization hurts the domestic producers (and their employees) of goods and services that are made better and/or more cheaply abroad. Nonetheless, the overall gains from trade liberalization and consequent structural adjustments are such that the winners could, in principle, compensate the losers, so that everyone is better off. Insofar as the winners are not willing or able to compensate the losers, the conventional case for trade liberalization and associated structural reform of the economy relies, in practice, on the role of government in facilitating the necessary reallocation of domestic resources in accordance with comparative advantage by means of structural assistance (to increase the efficiency of the adjustment process) and redistributive measures (to ensure that the gains from trade liberalization are spread more equally).

47. In the United States, for example, trade adjustment assistance (TAA) has helped support workers who have been adversely affected by

⁵⁵ See: IMF. 2015. Kyrgyz Republic: Request for a Three-Year Arrangement under the Extended Credit Facility. Country Report No. 15/113. Washington, DC. p. 33. The McKinsey Global Institute has estimated a 20% rate of return on investment in infrastructure. See: J. Woetzel et al. 2016. *Bridging Global Infrastructure Gaps*. Shanghai, Abu Dhabi, Zurich, Stockholm, and Toronto: McKinsey Global Institute. p. 12. http://www.iberglobal.com/files/2016-2/Bridging-Global-Infrastructure-Gaps_mckinsey.pdf.

⁵⁶ Judging from the experiences of countries that do evaluate the cost-effectiveness of their tax incentives, the forgone tax revenues generally exceed the increases in investment induced by these incentives, with the possible exception of suitably designed incentives for R&D.

⁵⁷ Trade liberalization has been an integral part of broad ongoing market-based domestic economic reforms aimed at improving productivity and thus competitiveness, raising living standards, and reducing poverty, especially in the Asia and Pacific region. These reforms, including trade and FDI liberalization, have been primarily unilateral, both in large countries, such as the PRC and India, and in small countries. See: The World Bank. 2005. *Global Economic Prospects: Trade, Regionalism, and Development*. Washington, DC. <http://siteresources.worldbank.org/INTGEP2005/Resources/gep2005.pdf>. For example, of the 21% fall in the average weighted tariffs of all developing countries between 1983 and 2003, unilateral reductions accounted for two-thirds of the fall. Unilateral reform of trade and trade-related policies reflects the recognition that impediments to improved productivity, growth, and development are mainly homegrown. In particular, the PRC's unilateral “open door” policy, introduced in 1978, was an integral part of its strategy to achieve a gradual transition from a virtually closed centrally planned economy into a more market-based one. This “open door” policy culminated in the PRC's accession to the WTO in 2001.

globalization by providing job-training support, career counselling, wage supplements for older workers, job search and reallocation allowances, and income support for workers undergoing training.⁵⁸ The TAA program was established in connection with the launching in 1962 of the Kennedy Round of multilateral trade negotiations under the auspices of the General Agreement on Tariffs and Trade, the WTO's predecessor. The program has since been extended and revised in connection with subsequent trade agreements.⁵⁹ In 2006, the European Union introduced a similar program, the European Globalisation Adjustment Fund.⁶⁰

48. However, the slow growth of Kazakhstan's economy, as well as the fiscal constraints (notably, the lack of tax revenues), may preclude TAA or more far-reaching redistributive measures sufficient for ensuring that everyone gains from trade liberalization and the associated structural reforms. These measures might involve, among other things, more progressive taxation, employment tax credits for low-income workers, higher minimum wages, more government assistance to poor families, better training for unskilled workers, and a greater provision of free education and health care.

⁵⁸ J. Zients. 2015. Trade Adjustment Assistance: What You Need to Know. The White House: President Barack Obama. 11 June. <https://www.whitehouse.gov/blog/2015/06/11/trade-adjustment-assistance-what-you-need-know>.

⁵⁹ For example, President Clinton expanded TAA in 1993, when the US acceded to the North American Free Trade Agreement, as did President Bush when he received fast-track authority in 2002. The 2009 stimulus bill expanded TAA, which was extended in 2011 when President Obama signed legislation to approve three bilateral trade deals. Some of the enhancements to TAA expired at the end of 2013; the program was set to lapse in full at the end of 2015, when Congress extended it through September 2016. This last bill also included an expansion of TAA through mid-2021.

⁶⁰ See: European Commission. Employment, Social Affairs & Inclusion. <http://ec.europa.eu/social/main.jsp?catId=326&langId=en>.

Chapter III. Global and Regional Developments and Their Implications for the Special Economic Zones and Industrial Zones

49. The evolution of the global trade environment, including developments in the multilateral rules-based system under the auspices of the World Trade Organization (WTO) (including the 2013 Trade Facilitation Agreement), together with regional arrangements, has implications for Kazakhstan's economic development strategy and the role of its special economic zones (SEZs) and industrial zones in that strategy. While WTO agreements do not have any specific provisions concerning SEZs and IZs *per se*, as shown in Chapter V, SEZs and IZs are nonetheless subject to its rules. In contrast, the Treaty on the Eurasian Economic Union has specific provisions regarding the establishment and functioning of such zones. Therefore, Kazakhstan needs to adapt its SEZs and IZs to changes in the global trade landscape, including international regulations. It is also important to adapt the SEZs and IZs to take advantage of changes in the regional landscape, such as the One Belt, One Road" strategy of the People's Republic of China (PRC), which was initiated in 2013.

50. The dismantling of barriers to trade as a consequence of multilateral liberalization under the auspices of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) (and, to a lesser extent, of regional trade arrangements), and the resulting integration of the world economy, including the emergence of GVCs, will have far-reaching implications for the Central Asian countries' economic development strategies and for the use of the SEZs and IZs as instruments of economic policy. The emergence of GVCs, for example, has effectively precluded import substitution (and associated protectionist tariff and nontariff measures) as a means of economic diversification and as a basis for sustained economic growth. Instead, countries must now clear the way for their enterprises' participation in GVCs by further exposing them to competition, thereby inducing them to improve their TFP and thus their export competitiveness.

A. Kazakhstan's Membership in the World Trade Organization

51. In view of the key role of trade in contributing to economic growth and productivity, Kazakhstan

became the 162nd member of the WTO on 2 November 2015, after 20 years of negotiations. Accession to the WTO involved reducing barriers to trade and investment, as well as other distortions to competition (such as subsidies), as specified in the various agreements, notably GATT, the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights, and Kazakhstan's ratification of the WTO's Trade Facilitation Agreement, concluded in December 2013.

52. Membership in the WTO entails a package of obligations with respect to the basic principles of nondiscrimination (involving most-favored-nation [MFN] and national treatment), certainty (i.e., "bindings") concerning various obligations, and transparency in trade and trade-related policies and measures. WTO membership also involves obligations regarding preferential trade agreements, including those in connection with Kazakhstan's membership in the Eurasian Economic Union (EAEU). As highlighted in Box 1, these WTO obligations do curtail the scope of Kazakhstan's trade and trade-related policy measures, including those concerned with the use of SEZs and IZs as instruments of policies supporting the government's economic development strategy. At the same time, however, by imposing similar obligations on Kazakhstan's trading partners, the WTO provides Kazakh enterprises with easier access to export markets, thereby facilitating access to GVCs and enabling export-led growth.

53. Kazakhstan's package for accession to the WTO provided significant improvements in market-access opportunities for all WTO members, in accordance with the MFN principle, which prohibits discrimination against trading partners. Taken together, the package commits Kazakhstan to further liberalization of its trade regime and provides an impetus for its continued integration into the global economy. The deal also offers a more transparent and predictable environment for trade and foreign investment, ensuring fair competition and increased consumer welfare. The following are among Kazakhstan's main commitments.

Box 1: The World Trade Organization's Rules Pertaining to Special Economic Zones and Industrial Zones

There are no World Trade Organization (WTO) rules that deal with special economic zones (SEZs) or industrial zones per se. In fact, SEZs and industrial zones have not been challenged by the WTO until very recently. Nonetheless, some aspects of these zones, especially the relief they offer from various internal and border taxes, may infringe WTO rules, including the conditions attached to the authorization to operate in a SEZ or industrial zone, and thereby qualify for tax relief (one of the main features of SEZs and industrial zones), as well as other financial benefits. Such conditions might include, for example, an obligation to export a certain proportion of the goods produced, a restriction on the proportion of goods that can be sold in the domestic market, or a requirement to use a minimum percentage of local inputs.

In the case of trade in goods, the General Agreement on Tariffs and Trade (GATT) and related agreements, especially the Agreement on Subsidies and Countervailing Measures (ASCM) and the Agreement on Trade-Related Investment Measures (TRIMs), do apply to tax and nontax measures. Such measures are prohibited if they are contingent on export performance or local content, and they are considered “actionable” if they are “specific” and have “adverse effects” on the interests of another WTO member. Prohibited and actionable subsidies may be challenged, either through the WTO’s dispute-settlement mechanism or through the imposition of countervailing duties.

The concepts of “subsidy” (Article 1 of the ASCM), “specificity” (Article 2), and “prohibited subsidies” (Article 3), are the key to the ASCM. Article 1 (“Definition of a Subsidy”) holds that a subsidy is deemed to exist when there is a “financial contribution by a government or any public body within the territory of a Member” and “a benefit is thereby conferred.” Such financial contributions include (i) direct transfers of funds, whether actual (e.g., grants, loans, and equity infusion) or potential (e.g., loan guarantees); (ii) forgone tax revenues (e.g., via tax incentives); and (iii) the provision of goods and services other than general infrastructure or goods obtained through purchases. They also include the cases in which a government makes payments via a funding mechanism or entrusts or directs a private body (such as a SEZ or industrial zone managing company) to carry out one or more of the functions specified in (i), (ii), and (iii) above.

However, the ASCM provides that the exemption from or remission of import tariffs or indirect taxes on an exported product, typically a main feature of SEZs and industrial zones, does not constitute a subsidy. More specifically, tariff exemptions (as well as drawbacks and other similar schemes) for imported raw materials and intermediate inputs used in the production of goods for export are exempted from the ASCM definition of a subsidy. The same applies to exemptions from or remissions of internal *indirect* taxes (especially the value-added tax) on “inputs that are consumed in the production of the exported product” under certain conditions, including the requirement that these exemptions or remissions of indirect taxes not be “in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.” In contrast, any relief from *direct* taxes on exports constitutes an export subsidy, and is therefore prohibited.

The ASCM divides subsidies (as defined in Article 1) into those that are prohibited and those that are permissible. Subsidies that are “contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance” or on the “use of domestic over imported goods” are prohibited by Article 3 on the grounds that they are presumed to distort trade. Tax relief would probably be considered a prohibited subsidy if, for example, the firms based in zones or parks had to export a minimum percentage of the goods they produce, or if the tax relief were contingent on a quota of goods produced in the SEZ or industrial zone that could be sold in the domestic market (in which case it would be deemed an export subsidy). Tax relief would also be considered a prohibited subsidy if it required firms in zones to use a certain percentage of local rather than imported inputs.

continued on next page

Box 1 *continued*

The ASCM originally distinguished between two categories of permissible subsidies: those that were “actionable” (permitted, but potentially subject to action) and those that were non-actionable (permitted and shielded from action). However, the latter category no longer exists, so now all subsidies are actionable. Although other subsidies—particularly some for environmental measures, research and development, and regional development—were for a time non-actionable under Article 8 of the ASCM, that provision expired at the end of 1999.

According to Article 2 of the ASCM, a subsidy is “specific” if it is accorded to “certain enterprises,” that is, to an enterprise, industry, or to a group of enterprises or industries. A subsidy is also specific if it is “limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority.” In this regard, a “positive” list of activities permitted in SEZs and industrial zones is arguably more likely to be deemed specific than a “negative” list. Specificity may also be the outcome of the authorization process if, for example, the government decides which industries or enterprises are allowed to operate in the zone.

Article 3.1(a) of the ASCM prohibits “subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I.” Of the 12 examples of export subsidies illustrated in Annex I of the ASCM, 5 involve tax measures, that is, tariffs, indirect taxes, or direct taxes. In addition, Article 3.1(b) of the ASCM prohibits subsidies for import substitution, defined as “subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported products.”

Tax and nontax measures for SEZs or industrial zones that are neither contingent on export performance nor on the use of domestic (instead of imported) inputs could still be considered actionable subsidies if they are “specific” and the complaining WTO member can demonstrate that they have “adverse effects.” Adverse effects may take the form of (i) injury to the complaining member’s domestic industry, (ii) nullification or impairment of benefits from WTO tariff concessions, or (iii) or “serious prejudice.”

As in the case of the ASCM, there are no explicit references to SEZs or industrial zones in the TRIMs Agreement, even though these zones are trade-related and can involve investment measures intended to attract foreign direct investment (FDI) and promote exports. Like the ASCM, the TRIMs Agreement provides an illustrative list of measures that are inconsistent with GATT Articles III (“National Treatment”) and XI (“General Elimination of Quantitative Restrictions”). The list includes local-content and trade-balancing requirements, as well as foreign exchange restrictions. Therefore, any SEZ- or industrial zone-related measure that imposes such requirements or restrictions would infringe the TRIMs Agreement (unless the WTO had been notified, in accordance with Article 5.1). Interestingly, no such notifications related to SEZs or IZs have been made to the WTO.

Insofar as SEZs and industrial zones are involved in trade in services, they are covered by neither GATT nor by the related ASCM and TRIMs Agreement. Services are instead subject to the General Agreement on Trade in Services (GATS), particularly with regard to most-favored-nation treatment and, to the extent that WTO members have made commitments regarding specific service sectors, national treatment as well. Consequently, in contrast to the ASCM, tax and nontax measures contingent on export performance or import substitution are permitted as long as they are nondiscriminatory within SEZs and industrial zones. However, SEZs and industrial zones cannot accord preferential treatment to a subset of services or service suppliers from foreign countries. Nor can they treat foreign services and service suppliers less favorably than domestic services and service suppliers, insofar as they have made national-treatment commitments regarding specific service sectors.

- (i) In the case of goods, Kazakhstan has made tariff concessions and commitments that bind tariff rates for all products to an average of 6.1%. (For agricultural products the average is 7.6%, while for nonagricultural products it is 5.9%.)
 - (ii) If and when a common EAEU policy on export duties is implemented, Kazakhstan will be bound by the Russian Federation's list of commitments on export duties. This list consists of 556 tariff lines, of which 81.3% are set at zero.
 - (iii) In the case of services, Kazakhstan has made specific commitments regarding 10 service sectors (including telecommunications, banking, insurance, transport, tourism, and distribution), involving 116 subsectors.
 - (iv) Kazakhstan is committed to eliminating all of its industrial subsidies (including those specified in provisions of its development programs) or to modifying them, so that no subsidy is contingent on exportation or on the use of domestic over imported goods. The WTO will be notified about any subsidies within 120 days after accession, and none of the provisions of Articles 27 and 28 of the WTO's ASCM.
 - (v) All laws, regulations, and other measures pertaining to the Agreement on TRIMs shall be consistent with the WTO provisions upon accession. Existing WTO-inconsistent measures, including local-content provisions in investment contracts in the oil and gas sector and preferential tariffs and tariff exemptions in industrial-assembly agreements in the automotive sector, must be eliminated: the local-content provisions by 1 January 2021 and the preferential tariffs and tariff exemptions by 1 July 2018.
 - (vi) Internal taxes (e.g., the VAT and excise taxes) as well as other charges on imports will be applied in compliance with WTO agreements, including Articles I and III of GATT 1994.
 - (vii) Quantitative restrictions on imports, such as quotas, bans, permits, prior-authorization requirements, licensing requirements, or other requirements or restrictions that cannot be justified under the WTO agreement will be eliminated and not (re)introduced, whether by Kazakhstan or by the competent bodies of the EAEU.
 - (viii) Transit-related laws, regulations, and other measures governing the transit of goods (including energy) will be applied pursuant to Article V of GATT 1994. Kazakhstan will provide members, upon request, with information on the revenues collected from customs fees and charges and on the costs of providing the associated services.
 - (ix) Kazakhstan will fully implement the Agreement on Trade-Related Aspects of Intellectual Property Rights as of the date of accession.
 - (x) Within 4 years of its accession, Kazakhstan is committed to initiating negotiations for its accession to the Government Procurement Agreement, a WTO plurilateral agreement covering the procurement of goods, services, and capital infrastructure by governments and other public authorities. In the meantime, the procurement of goods and services, including by state-owned or state-controlled enterprises, will be conducted in a WTO-consistent, transparent manner.
54. In order to ensure transparency, all laws, regulations, decrees, decisions, and administrative rulings regarding intellectual property rights and trade in goods and services, whether adopted or issued by Kazakhstan or by the competent bodies of the EAEU, will be published promptly, with notifications as required by WTO agreements. Kazakhstan will also provide annual reports to WTO members on developments in its privatization program, as long as the program continues. Lists of goods and services subject to price controls will be published in the official journal from the date of accession. Laws and regulations on the application of charges and customs fees imposed in connection with transit will be duly published. Kazakhstan will send notifications and copies of its free trade agreements to the WTO's Committee on Regional Trading Agreements.
55. Interestingly, the accession package also contained explicit commitments regarding SEZs. Kazakhstan must apply WTO provisions, including its Protocol of Accession, uniformly throughout the entire customs territory, including its SEZs and other areas where special regimes for tariffs, taxes, and regulations are established. Moreover, upon accession the WTO agreement applied to Kazakhstan's SEZs and free warehouses,⁶¹ except the goods of firms that had been registered in SEZs or that had been using free warehouses prior to 1 January 2012, as their

⁶¹ A "free warehouse" is a building locked and guarded by the government customs service that anyone can use to store goods.

exemptions from customs duties and export duties were set to end on 1 January 2017. Since the expiry of this transitional period, firms registered in and operating in SEZs and/or using free warehouses have not been subject to WTO-inconsistent requirements for export performance, trade balancing, or local-content requirements—either in law or in practice. When non-EAEU goods are imported into the SEZs without any payments of customs duties or taxes, but subsequently released into Kazakhstan or another EAEU country, they will be subject to those duties and taxes. If those imports are reprocessed (i.e., substantially transformed) within a SEZ or free warehouse, the duties and taxes will be paid when the final products enter the rest of Kazakh territory or another EAEU country.

56. Regarding its participation in preferential trade agreements, Kazakhstan will observe the relevant WTO provisions, including Article XXIV of GATT 1994 and Article V of GATS. A unique aspect of Kazakhstan's rules and commitments in connection with such agreements is the extent of the accession-specific commitments "accepted" by Kazakhstan, which shall be applicable to all EAEU-member states on matters falling under the competence of the EAEU. There are 23 commitments that contain measures to be undertaken by "Kazakhstan and/or the competent bodies of the EAEU." Moreover, as part of the EAEU, Kazakhstan has accepted commitments to aligning its tariff concessions (import and export duties), including through post-accession compensatory adjustments.

B. Kazakhstan's Membership in the Eurasian Economic Union

57. Kazakhstan's accession to the EAEU (joining Armenia, Belarus, the Kyrgyz Republic, and the

Russian Federation), on 1 January 2015, marked a major change in the regional economic environment. Membership in the EAEU opens up new economic opportunities for Kazakhstan by removing barriers to the free movement of goods, services, labor, and capital (as well as technology). These new opportunities involve increased integration of these countries' economies by means of trade and investment, including the development of major infrastructure projects, primarily in the energy, transportation, and agricultural sectors. Kazakh citizens now enjoy the right to national treatment with regard to employment in any state of the EAEU. Likewise, citizens of its EAEU partners now enjoy the right to national treatment with regard to employment in Kazakhstan. Access to the larger EAEU market may well attract additional FDI to Kazakhstan.

58. Needless to say, membership in the EAEU has potentially far-reaching implications for Kazakhstan's trade and trade-related policies, especially its use of SEZs and IZs (Box 2). Although Kazakh enterprises now have improved access to the markets of other EAEU countries, membership in the EAEU will undoubtedly intensify competition from enterprises based in those countries, including in the domestic market. Accordingly, in order to take advantage of this greater access, the government will need to adapt its economic development strategy by removing obstacles to improved TFP, thereby enabling Kazakh enterprises to compete, not only in the domestic market, but also in the markets of its EAEU partners and markets outside the EAEU.

59. WTO rules do permit departures from the MFN principle in regional and bilateral free trade agreements, provided that these preferential

Box 2: Eurasian Economic Union Rules Pertaining to Free (Special) Economic Zones

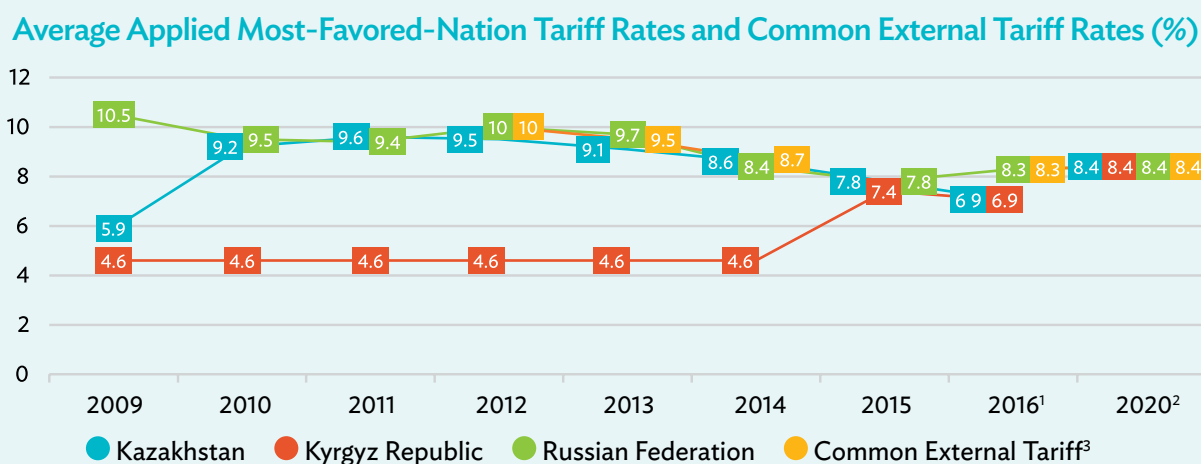
Unlike the rules of the World Trade Organization (WTO), those of the Eurasian Economic Union (EAEU) specifically mention free (special) economic areas. In many important respects, the EAEU rules concerning tax incentives and other forms of subsidies resemble those of the WTO summarized above, particularly the rules concerning prohibited and actionable subsidies, so there is no need to summarize them here. Suffice it to say, however, that as a consequence of Kazakhstan's accession to the EAEU, its special economic zones (SEZs) and industrial zones are now regulated by the Treaty on the Eurasian Economic Union, Article 27 ("Establishment and Functioning of Free [Special] Economic Zones and Free Warehouses") and by the Agreement on Free (Special) Economic Zones on the Customs Territory of the Customs Union and the Customs Procedures of the Free Customs Zone of 18 June 2010 (hereafter "Customs Union Agreement"), as well as by the Treaty on the Customs Code of the Customs Union of 27 November 2009. Since 6 August 2015, the provisions of the EAEU Treaty and the Customs Union Agreement regarding free (special) economic areas or zones have provided the general framework under the EAEU for rules concerning the establishment and operation of new SEZs and industrial zones and for the application of the relevant provisions to existing SEZs and industrial zones, including those on the customs regime of the free customs zone within the SEZs and industrial zones. The main objective of this general framework is to unify the laws of the member states of the Customs Union regulating the activities of free (special) economic zones, including the laws on taxation.

Accordingly, the rules concerning the payment of tariffs and indirect taxes are of special interest. In particular, Article 9 of the Customs Union Agreement considers such zones to be located outside the customs territory of the Customs Union for the purposes of tariffs and indirect taxes (and nontariff measures). Hence, goods imported into such zones may be exempt from tariffs and indirect taxes. Moreover, Article 13 allows tariff- and tax-free transit from a zone in one EAEU member to a zone in another member, thereby providing an opportunity for cooperation between EAEU countries' free (special) economic zones, with a view to coordinating their trade and economic development strategies. However, Article 17 of the Customs Union Agreement requires that goods that are exempted from tariffs and indirect taxes when imported into such zones be subject to those tariffs and taxes when entering the rest of the territory of Kazakhstan or the territory of any other member of the EAEU. If those imported goods are substantially transformed in the zone in accordance with any of the conditions listed in Article 19, the tariffs and taxes that would otherwise have been levied on those goods must be paid when the final products enter the rest of the territory of Kazakhstan or the territory of another EAEU member. Since the transition period ended, on 1 January 2017, Article 17 has placed firms supplying the domestic market from inside and outside the zones on the same tax footing. In the case of an inverted tariff, producers from the zones supplying goods to the domestic market or to the markets of other EAEU states are allowed to choose either the tariff rate that applies to the imported inputs or the rate that applies to the finished goods.

As in the case of WTO rules, there is nothing to prevent Kazakhstan from granting full tariff drawbacks and rebates of indirect internal taxes, such as the value-added tax (VAT), to domestic firms supplying goods and services to zone-based enterprises, thereby facilitating the development of value chains linking firms located inside and outside the zones. Tariff drawbacks would be especially beneficial in view of the fact that Kazakhstan's simple average applied most-favored-nation (MFN) tariff increased initially from 5.9% in 2009 to 9.2% in 2010 as a consequence of the country's adoption of the common external tariff (CET) of the Eurasian Customs Union (ECU) in 2010 (see figure). By joining the ECU, Kazakhstan essentially adopted the Russian Federation's customs tariff, with some exceptions that were supposed to be eliminated by 2015, when it adopted the EAEU's CET. In 2016, the simple average CET was 8.3%, in accordance with the Russian Federation's scheduled tariff-reduction commitments under the WTO.

continued on next page

Box 2 continued



CET = common external tariff, MFN = most favored nation, WTO = World Trade Organization.

Note: Data are not available for the years where figures are absent.

¹ Simple average applied tariff rates for 2016 are based on the assumption that the rates for the Russian Federation and CET are the same and taken from WTO. 2016. Trade Policy Review – Russian Federation. Geneva (Table 3.3).

² WTO-bound MFN rates to be implemented by 2020 are also taken from WTO. 2016. Trade Policy Review – Russian Federation. Geneva (Table 3.3).

³ CET rates from 2012 to 2014 are taken from https://www.wto.org/english/thewto_e/acc_e/Session1AndreyTochinEurasianEconomicIntegration.pdf.

Source: World Trade Organization. Statistics. www.wto.org/statistics.

The Agreement on the Free (Special) Economic Zones introduced the concept of port or logistics zones. Clause 11 of the Agreement states that in the port or logistics zones, not only residents of the SEZ but also other legal entities may place their goods under the free customs regime, provided they have a service agreement with SEZ residents. Service agreements may include, for example: storage of goods, loading (unloading) of goods and other cargo operations related to storage, to ensure the safety of goods, as well as for the preparation of goods for transportation; sorting, packaging, repackaging, marking, provided that such services do not change the characteristics of goods (and associated classification code).

A further amendment of Eurasian Economic Union Rules involved the signing in Moscow on 11 April 2017 of the corresponding agreement on the Customs Code of the EAEU (hereinafter the EAEU CC), which unified customs regulations in the territory of the EAEU and terminated the Customs Code of the Customs Union. The EAEU CC is expected to enter into force from January 2018. Customs procedures for free customs zones are specified in Chapter 27 of the EAEU CC. In addition, special conditions for selected free (special) economic zones of member states are described in the Code's Article 455 "Peculiarities of the application of the customs procedure of a free customs zone in individual SEZs of member states". Article 455 also stipulates that, in some cases, the peculiarities of customs procedures for port or logistics zones may be used in the territory of those zones that fall within the scope of Article 455. In other words, not only residents of these SEZs but also other legal entities may place their goods under the free customs regime if they have a service agreement with SEZ residents. Article 455 thus provides opportunities for duty and tax free trade as well as logistics operations on the territory of such SEZs. The zones that fall under the scope of Article 455 are determined by the national legislation of the member states, provided they satisfy the above mentioned conditions. Article 455 will apply to only one zone in Kazakhstan. It would appear that the Kazakhstan government has not yet made its final decision on the selection of the zone to which Article 455 will be applied.

Source: Asian Development Bank.

(and, therefore, discriminatory) agreements cover “substantially all” trade between the parties.⁶²

The rationale would appear to be that preferential agreements should *create* more trade than they *divert*. Whereas trade *creation* occurs when domestic production is replaced by imports from lower-cost and more efficient producers within the EAEU, trade *diversion* arises when higher-cost suppliers from within the EAEU replace imports from lower-cost, more efficient producers outside the trading bloc, contrary to the MFN principle. Unlike in the case of MFN tariffs, imports into Kazakhstan will not necessarily be produced by the lowest-cost (and most efficient) foreign producers.⁶³ The higher the EAEU's common external tariff (CET) and nontariff barriers to imports, the greater the likelihood of trade diversion, which undermines the economic welfare gains from trade creation for new members of the EAEU, including Kazakhstan. Insofar as essential inputs required by Kazakh enterprises are imported from outside the EAEU, and the tariffs levied on these imported inputs are reflected in the prices of the final goods (and services) produced by these enterprises, such tariffs also constitute export taxes to the extent that tariffs on such imports are not refunded promptly and in full once the final goods (and services) are exported.⁶⁴ Under such circumstances, tariffs on imported inputs will be detrimental to the export competitiveness of Kazakhstan's enterprises.

60. The question arises as to the appropriate role, if any, of Kazakhstan's SEZs and IZs in this new economic environment, and whether they divert more trade and investment from the domestic market than they create. It may be that, in the case of Kazakhstan, whose average level of MFN tariff protection increased considerably as a result of the need to bring it into line with the EAEU's CET, these zones (and particularly their tariff preferences) might

conceivably assume a more important role, especially in facilitating local suppliers' linkages to GVCs and, through them, to international markets. The value of deferred payments of tariffs and other taxes by zone enterprises, notably the VAT, is directly related to the tariff and tax rates, the interest rate, and the length of the deferral period.⁶⁵

C. The Central Asia Regional Economic Cooperation Program Corridor, the People's Republic of China's New Silk Road Initiative, and National Infrastructure Plans

61. While the EAEU and WTO agreements together constitute the essential software for trade facilitation (and thus for export-led growth), basic infrastructure, including transport corridors and logistics, is the necessary hardware. Considerable investment in basic infrastructure is clearly necessary to pave the way to deeper economic integration in the region, including the free movement of goods, services, labor, and capital (as well as technology). In order to enable deeper regional integration, CAREC 2020 introduces three new priorities into the agenda of the CAREC Program.⁶⁶ One of these priorities is economic corridor development, which focuses on how physical infrastructure can be used to catalyze the spatial organization of activities in the region so as to generate growth and improved productivity. A segment of the CAREC corridors network is involved in the pilot Almaty–Bishkek Corridor Initiative.

62. Another important recent development in the economic landscape, with potentially far-reaching implications for Kazakhstan and other countries in the region, is the “One Belt, One Road” initiative of

⁶² More specifically, see GATT Article XXIV (“Territorial Application—Frontier Traffic—Customs Unions and Free-trade Areas”) and GATS Article V (“Economic Integration”).

⁶³ Further costs arise because the origin of imports must be established and the necessary rules of origin must be enforced.

⁶⁴ It would appear that such refunds (as well as drawbacks) are made neither promptly nor in full owing to fiscal constraints.

⁶⁵ In effect, deferral of taxation constitutes an interest-free loan. The main monetary policy interest rate of the National Bank of Kazakhstan is currently 10.5%. See: Focus Economics. Interest Rate in Kazakhstan. <https://www.focus-economics.com/country-indicator/kazakhstan/interest-rate>.

⁶⁶ ADB. 2012. CAREC 2020: A Strategic Framework for the Central Asia Regional Economic Cooperation Program 2011–2020. Manila. <http://www.carecprogram.org/uploads/docs/CAREC-Publications/2012/CAREC-2020-Strategic-Framework.pdf>.

the PRC,⁶⁷ which aims to make Central Asia more connected to the world.⁶⁸ It comprises plans to build roads, railways, ports, natural gas pipelines, and other infrastructure stretching through Central Asia (including along the Almaty–Bishkek Corridor) into South Asia, Southeast Asia, the Middle East, and Europe. This initiative will not only enable the PRC to export infrastructure, but will also create a demand for Chinese manufactured exports. The Silk Road countries apparently account for roughly one-quarter of the PRC's foreign trade. Moreover, as rising wages erode the PRC's comparative advantage in labor-intensive manufacturing industries, lower-income countries, including those linked by the Silk Road, most of which have a per capita gross domestic product (GDP) less than half of the PRC's, are becoming more attractive locations for these industries. With improved infrastructure and, as a result, better connectivity to global markets, the Central Asian countries will be well-placed to absorb the migration of the PRC's labor-intensive industries. The PRC's manufacturing industry employs 125 million workers, with 85 million of them in low-skilled jobs. That is enough to enable virtually all of the developing economies along the new Silk Road to achieve industrialization and modernization simultaneously.⁶⁹

63. In addition, the newly established \$100 billion Asian Infrastructure Investment Bank, which has attracted much attention, can be expected to supplement the financing of infrastructure in the region by existing multilateral development institutions. The Asian Infrastructure Investment Bank will operate within the global economic and financial framework, and will follow established international practices.

64. Public and private investment in infrastructure—especially transportation, telecommunications and fiber optics, energy, and water (as well as education

and health)—can further facilitate trade and economic growth in Kazakhstan and elsewhere in Central Asia. Such investment in the region appears likely to grow considerably. In addition to the traditional donors, such as ADB and the World Bank, the Eurasian Development Bank is now providing a grant for a pre-feasibility study of the construction of the Russian Federation–Kazakhstan–Kyrgyz Republic–Tajikistan railway line. This transport artery is expected to link up with the Afghanistan–Turkmenistan–Tajikistan railway, whose construction will be funded entirely by the CAREC Program.

65. Kazakhstan can also be expected to benefit from the \$40 billion Silk Road Fund, established on 29 December 2014 by the PRC. This fund is aimed at providing investment and financial support for trade and economic cooperation and connectivity within the framework of the Belt and Road Initiative.⁷⁰ Among the projects supported by the fund is the start of the construction of a gas pipeline linking Central Asia and the PRC. Line D of this pipeline, which connects western PRC to Turkmenistan's large gas fields via Uzbekistan, Tajikistan, and the Kyrgyz Republic, is the main Chinese-funded project currently under development. Furthermore, a series of fresh projects, such as the Khorgos “dry port” on the Kazakh–Chinese border and a railway link connecting Kazakhstan with Iran, is helping to increase trade across Central Asia. The Khorgos dry port, which began operations in August 2015, is seen as a key cargo hub on the new Silk Road. Furthermore, PRC's Jiangsu province has agreed to invest more than \$600 million over 5 years to build logistics and industrial zones around Khorgos. And in May 2015, the President of Kazakhstan announced a plan to build, with the PRC, a railway from Khorgos to the Caspian Sea port of Aktau. The scheme dovetails with a \$2.7 billion Kazakh project to modernize its locomotives and freight and passenger cars and to repair 450 miles of railroad tracks.

⁶⁷ This initiative, which was proposed by the President of the PRC during a visit to Kazakhstan in 2013, has become the centerpiece of the PRC's foreign policy and international economic strategy. It involves economic development along two land and maritime routes—from western PRC to Eastern Europe and from Southeast Asia to East Africa—thereby linking Asia and Europe. The initiative is part of the PRC's strategy for rebalancing its economy. Such rebalancing involves reducing reliance on debt-financed investment in construction and heavy industry, and boosting consumption, high technology industries, and the service sector. Furthermore, reallocation of the PRC's large foreign-exchange assets away from low-yield US Treasury bonds to higher-yield infrastructure investment makes economic sense, and creates alternative markets for Chinese goods. With Chinese steel and cement firms suffering from overcapacity, Chinese construction firms will profit from the new investment. And as Chinese manufacturing moves to less accessible provinces, improved infrastructure connections to international markets fits the PRC's development needs.

⁶⁸ J. Farchy and J. Kyngé. 2016. Map: Connecting Central Asia. *Financial Times*. 9 May. <https://www.ft.com/content/ee5cf40a-15e5-11e6-9d98-00386a18e39d>.

⁶⁹ J. Y. Lin. 2016. China's Silk Road Vision. *Project Syndicate*. 21 January. <https://www.project-syndicate.org/commentary/china-maritime-silk-road-economic-belt-by-justin-yifu-lin-2016-01>.

⁷⁰ See Silk Road Fund. <http://www.silkroadfund.com.cn/enweb/23773/index.html>.

66. In addition, the Government of the PRC and private investors have pledged to invest in the construction of a road that will start from Xi'an, in central PRC, and pass through Xinjiang, Kazakhstan, Uzbekistan, Tajikistan, Iran, Turkey, and the Russian Federation, and then farther into Europe. The PRC is also building a Chongqing–Xinjiang–Europe railway that will reduce the time it takes for Chinese goods to reach Europe by 20 days. At present, the PRC trades with Europe mainly via the Indian Ocean–Gulf of Aden–Suez Canal route, which takes 36 days or even more, given the time needed to reach Chinese ports from central and western PRC. However, Kazakhstan and its Central Asian neighbors may wish to encourage the participation of other Asian countries, thereby providing such countries as India, Japan, the Republic of Korea, and Turkey with an opportunity to increase their economic presence in Central Asia as far as trade and FDI are concerned.

67. However, while the new Silk Road initiative can help to diversify Kazakhstan's trade by reviving the east-west trading route between Europe and Asia, and thereby supplement the country's Soviet-era web of transport links, which were mainly built north to south with Moscow at its center, the initiative's success is threatened by largely one-way traffic owing to the PRC's big balance of trade surplus. For example, five trains full of cargo leave Chongqing for Germany every week, but only one full train returns.⁷¹ Trade must flow both ways between east and west to make the route and related infrastructure economically viable and politically acceptable to the countries through which it passes. Moreover, sending goods overland from the PRC to Europe remains twice as expensive as shipping them by sea.⁷²

⁷¹ J. Wuttke. 2017. Xi Jinping's Silk Road is under threat from one-way traffic. *Financial Times*. 9 May.

⁷² J. S. Nye. 2017. Xi Jinping's Marco Polo Strategy. *Project Syndicate*. 12 June.

Chapter IV. A Legislative and Institutional Framework for— and the Main Features of—Special Economic Zones and Industrial Zones

68. This chapter provides a summary of the legislative, regulatory, and institutional framework, and of the administrative procedures, concerning Kazakhstan's special economic zones (SEZs) and industrial zones. It also provides a summary of the main features of these zones.

A. Special Economic Zones

1. The Rationale for Special Economic Zones

69. The idea of creating what were initially called “free economic zones” in Kazakhstan occurred under Soviet rule. The Law “On Free Economic Zones in Kazakh SSR” was approved on 30 November 1990.⁷³ The goal of creating such zones was to attract foreign investment, technology, and managerial experience in order to accelerate Kazakhstan's socioeconomic development. The law resulted in the creation of several free economic zones, such as Zhairim-Atasuiskaya, Lisakovskaya, Vostochno-Kazakhstanskaya, Alakulskaya, Zharkentskaya, Karagandinskaya, Mangistauskaya, and Atakent (in Almaty city).

70. In January 1996, the Law “On Special Economic Zones in the Republic of Kazakhstan” was approved, with following goals:

- (i) accelerate the development of regions,
- (ii) enhance the access of the national economy to the global economic system,
- (iii) develop new technologies,
- (iv) generate highly efficient production,
- (v) develop new products,
- (vi) attract investments,

- (vii) follow the legal norms of market relations,
- (viii) introduce modern management, and
- (ix) address social problems.⁷⁴

71. The free economic zones were transformed into “special economic zones” (SEZs), and the new SEZs, such as Akmolinskaya (in Akmola) and Kyzylordinskaya (in Kyzylorda), were established in October 1996.⁷⁵ However, by the end of the 1990s shrinking budgets had led to the cutting of the SEZ tax exemption and, subsequently, to the abolition of most of the SEZs in 1999 through a presidential decree.⁷⁶ The one exception was Astana SEZ, which would be abolished the following year.⁷⁷

72. In 2001, the government approved a new law, this one reestablishing Akmolinskaya SEZ as “Astana–New City SEZ.”⁷⁸ Between 1996 and 2000, Akmolinskaya SEZ had been a driver of the intensive construction of new buildings, such as the Ministry of Finance and Kazakhstan Sports Complex, and of Samal Microdistrict, and the ninth microdistrict. The law establishing Astana–New City SEZ focused on (i) accelerating the city's development by attracting investment and new construction technologies, as well as building new infrastructure; and (ii) establishing competitive advanced technologies and industries creating new products.

73. The Law “On Special Economic Zones in the Republic of Kazakhstan” that was approved in July 2007 declared that SEZs would be created to (i) develop and support various sectors of the economy; (ii) accelerate the development of regions and address social problems; and (iii) improve business efficiency, attract investments, and introduce

⁷³ Adilet, Information system of legal acts of the Republic of Kazakhstan. The law of the Kazakh Soviet Socialist Republic “On free economic zones in the Kazakh SSR,” dated 30 November 1990 (content in Russian only). <http://adilet.zan.kz/rus/docs/Z900001200...>

⁷⁴ Adilet, Information system of legal acts of the Republic of Kazakhstan. Law of the Republic of Kazakhstan “On Special Economic Zones in the Republic of Kazakhstan,” dated 26 January 1996, No. 2823 (content in Kazakh and Russian only). <http://adilet.zan.kz/kaz/docs/Z960002823...>

⁷⁵ The city of Akmola became the capital in 1997, and was renamed “Astana” in 1998.

⁷⁶ Adilet, Information system of legal acts of the Republic of Kazakhstan. Decree of the President of the Republic of Kazakhstan “Some Issues of the Special Economic Zones in the Republic of Kazakhstan,” dated 31 March 1999, No. 104 (content in Kazakh and Russian only). <http://adilet.zan.kz/kaz/docs/U990000104...>

⁷⁷ Astana SEZ was abolished in 2000 by the Decree of the President of the Republic of Kazakhstan “On the abolition of the special economic zone of the city of Astana,” dated 28 July 2000, No. 421.

⁷⁸ Decree of the President of the Republic of Kazakhstan “On the Establishment of SEZ Astana–New City,” dated 29 June 2001, No. 645.

new technologies and modern management, thereby generating highly competitive industries.

74. The current Law “On Special Economic Zones in the Republic of Kazakhstan,” approved on 21 July 2011, lists the following objectives for establishing SEZs:

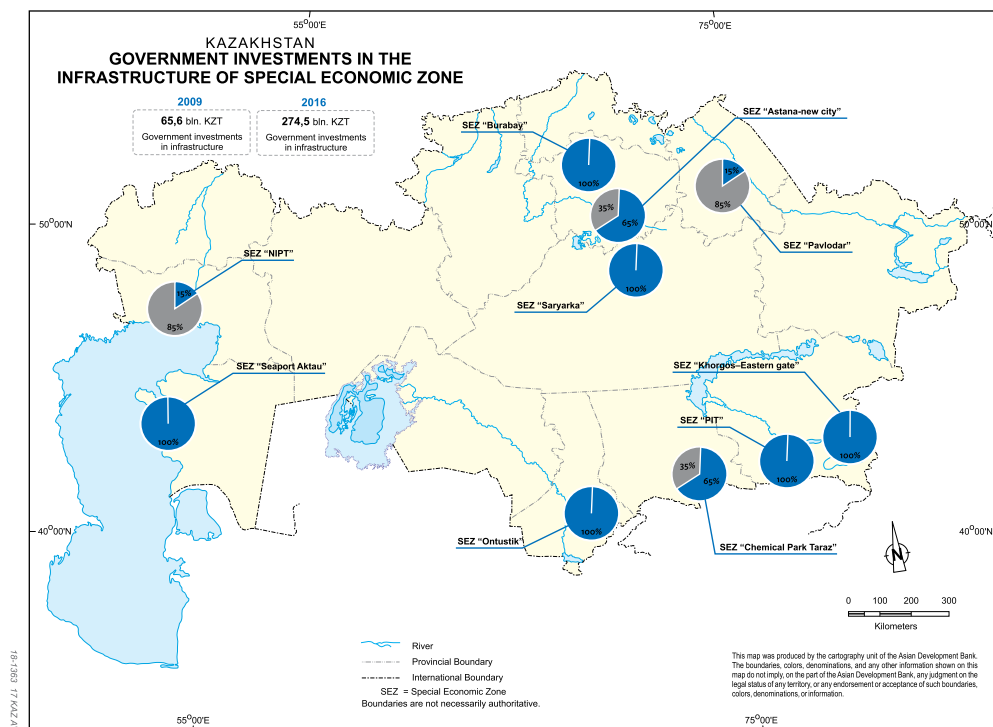
- (i) accelerating the development of modern, highly productive, and competitive industries;
- (ii) attracting investments;
- (iii) introducing new technologies into regions and into sectors of the economy; and
- (iv) increasing employment.⁷⁹

75. There are 10 SEZs in Kazakhstan, and each one is regulated by its own special decree of the President of the Republic of Kazakhstan, which states the objectives of its creation. According to these decrees, the SEZs have the following goals:

- (i) Taraz Chemical Park SEZ is to produce new chemical goods;

- (ii) Pavlodar SEZ is to develop chemical and petrochemical sectors, with a focus on the production of export-oriented products;
- (iii) The Park of Innovative Technologies (PIT) is to develop information technology (IT) and new technologies in other fields;
- (iv) Khorgos–East Gate SEZ is to become an effective transport, logistics, and industrial hub;
- (v) Ontustik SEZ is to develop enterprises that process cotton for the textile and garment industries;
- (vi) The National Industrial Petrochemical Park SEZ is to develop investment projects in the petrochemical industry, specifically for hydrocarbon processing and the production of high-value-added competitive petrochemical products;
- (vii) Aktau Seaport SEZ is to accelerate the development of the region by enhancing Kazakhstan's access to the global market;
- (viii) Burabay SEZ is to develop a competitive tourism infrastructure;

Figure 2: Government Investments in the Infrastructure of Special Economic Zones



SEZ = special economic zone, NIPT = National Industrial Petrochemical Technopark, PIT = Park of Innovative Technologies.
 Source: Kazakh Invest.

⁷⁹ Law of the Republic of Kazakhstan “On Special Economic Zones in the Republic of Kazakhstan,” dated 21 July 2011, No. 469-IV.

- (ix) Saryarka SEZ is to develop the country's metallurgical and metal-processing industries; and
- (x) Astana – New City SEZ is to help accelerate the development of Astana city, including the creation of modern infrastructure, by attracting investment and advanced technologies in the construction field.

76. More details about the specific objectives, features, and functions of each SEZ are highlighted in Table 3.

77. The Decree for each SEZ contains the following key statistical indicators for zone performance: investment, including domestic and foreign direct investment (FDI); production; the number of SEZ

members; jobs created; and local content. Details are in Table 6.

78. The Nurly Zhol State Program of Infrastructure Development for 2015–2019 points out that the national government had spent a total of T175.4 billion for SEZ infrastructure up to 2014, but only three of the SEZs—Burabay, Ontustik, and Saryarka—had infrastructure that was 100% ready, while the infrastructure development of the other SEZs was at different stages.⁸⁰ According to the most recent data, during 2003–2016 government investment in SEZ infrastructure from the national budget and the National Fund of the Republic of Kazakhstan amounted to T274.5 billion, and three more of the SEZs—Aktau Seaport, Khorgos–East Gate, and Park of Innovation Technologies—had infrastructure that was 100% ready.

Table 2: Summaries of the Decrees on the Special Economic Zones in Kazakhstan

Special Economic Zone	Law
Astana–New City	Decree of the President of the Republic of Kazakhstan “On the Establishment of SEZ Astana–New City,” dated 29 June 2001, No. 645
Aktau Seaport	Decree of the President of the Republic of Kazakhstan “On the Establishment of SEZ Aktau Seaport,” dated 26 April 2002, No. 853
Burabay	Decree of the President of the Republic of Kazakhstan “On the Establishment of SEZ Burabay,” dated 15 January 2008, No. 512
Khorgos–East Gate	Decree of the President of the Republic of Kazakhstan “On the Establishment of the SEZ Khorgos–East Gate,” dated 29 November 2011, No. 187
National Industrial Petrochemical Park	Decree of the President of the Republic of Kazakhstan “On the Establishment of the National Industrial Petrochemical Park,” dated 19 December 2007, No. 495
Saryarka	Decree of the President of the Republic of Kazakhstan “On the Establishment of the SEZ Saryarka,” dated 24 November 2011, No. 181
Taraz Chemical Park	Decree of the President of the Republic of Kazakhstan “On the Establishment the SEZ Chemical Park Taraz,” dated 13 November 2012, No. 426
Pavlodar	Decree of the President of the Republic of Kazakhstan “On the Establishment of the SEZ Pavlodar,” dated 29 November 2011, No. 186
Park of Innovation Technologies	Decree of the President of the Republic of Kazakhstan “On the Establishment of the SEZ Park of Innovation Technologies,” dated 18 August 2003, No. 1166
Ontustik	Decree of the President of the Republic of Kazakhstan “On the Establishment of the SEZ Ontustik,” dated 6 July 2005, No. 1605

SEZ = special economic zone.

Source: Adilet, Information system of legal acts of the Republic of Kazakhstan. <http://adilet.zan.kz/>.

⁸⁰ Decree of the President of the Republic of Kazakhstan “On the Approval of the Nurly Zhol State Program of Infrastructure Development for 2015–2019,” dated 6 April 2015, No. 1030.

Table 3: Summaries of the Goals of the Special Economic Zones in Kazakhstan

Special Economic Zone	Goals
Astana–New City	The goals of Astana–New City SEZ are to accelerate the city's development by attracting investment and using advanced technologies in construction, build modern infrastructure, create high-tech competitive industries, and invent new products.
Aktau Seaport	Aktau Seaport SEZ's goals are to accelerate development in the region, preparing the country's economy for entry into the global economic system, create high-tech and competitive industries, invent new products, attract investment, improve the legal regulations on market relations, introduce modern management, and address social problems.
Burabay	Burabay SEZ was created for developing a highly competitive tourism infrastructure to accommodate domestic and foreign tourists; promoting the use of environmentally friendly transport, including small aircraft, to access all recreation facilities; creating a common information base for tourist services; fostering a favorable investment climate to attract domestic and foreign investment; and addressing social problems.
Khorgos–East Gate	Khorgos–East Gate's goal is to become an effective transport, logistics, and industrial hub.
National Industrial Petrochemical Park	The National Industrial Petrochemical Park was created to develop projects in the petrochemical industry for hydrocarbon processing; attract investment in petrochemical plant construction on the basis of public–private partnerships; help integrate Kazakhstan into the global petrochemical production and marketing system; create innovative, competitive domestic petrochemical products in accordance with ISO standards; conduct research and undertake innovative scientific and technological projects; and train or retrain specialists at petrochemical plants.
Saryarka	Saryarka SEZ was created to develop the metallurgical and metal-processing industries, in particular the production of finished products, by attracting manufacturers from around the world; develop competitive, high-value-added products in these industries; help integrate Kazakh products into the worldwide production and marketing system; create innovative, competitive domestic products in accordance with international standards; develop highly innovative industries, including high-tech and other competitive sectors; invent new products; conduct research and undertake innovative scientific and technological projects to support the production and deep processing of raw materials; foster a favorable investment climate to attract domestic and foreign investment; attract investments in construction projects and in the comprehensive development of the steel industry on the basis of public–private partnerships; help accelerate the development of the region; work to improve the legal norms of market relations; introduce modern management; solve social problems; and increase employment.
Taraz Chemical Park	The main aim of Taraz Chemical Park is the formation of new chemical-production facilities that apply highly effective technologies.
Pavlodar	Pavlodar SEZ's goal is to develop the country's chemical and petrochemical sectors, with a focus on the production of export-oriented, high-valued-added products, using high-tech, environment-friendly, and safe modern technologies.
Park of Innovative Technologies	The Park of Innovative Technologies was created to develop IT and other new technologies.
Ontustik	The aims of Ontustik SEZ are to accelerate the development of the region; to promote the growth of cotton-processing enterprises, and of the textile and garment industries in general; to attract investment from international brands in Kazakh textile products; create high-tech industries; and to improve the quality and expand the variety of manufactured textile products.

ISO = International Organization for Standardization, IT = information technology, SEZ = special economic zone.

Source: Adilet, Information system of legal acts of the Republic of Kazakhstan. <http://adilet.zan.kz/>.

Table 4: Profiles of the Special Economic Zones in Kazakhstan

Special Economic Zone	Year Created	Area (ha)	Management Company	Eligible Activities
Astana–New City	2001	7,634	Public Institution “Department of investment and development of Astana city” serves as the management company of SEZ Astana – New City.	<ul style="list-style-type: none"> (i) Manufacturing of other nonmetallic mineral products; (ii) production of machinery and equipment; (iii) manufacturing of household electrical appliances; (iv) manufacturing of rubber and plastic products; (v) production of chemical products; (vi) metallurgical industry; (vii) manufacturing of electrical equipment, including electric lighting equipment; (viii) manufacturing of glass components for lighting equipment; (ix) food production; (x) production of wood pulp and cellulose, paper and paperboard; (xi) furniture production; (xii) manufacturing of motor vehicles, trailers and semitrailers; (xiii) manufacturing of railway locomotives and rolling stock; (xiv) manufacturing of air and space aircraft; (xv) production of basic pharmaceutical products and preparations; (xvi) manufacturing of electronic parts; (xvii) warehousing and transportation-support activities; (xviii) construction and commissioning of infrastructure, administrative and residential complexes in accordance with the design and cost-estimate documentation; (xix) construction and commissioning of hospitals, polyclinics, schools, kindergartens, museums, theatres, higher and secondary educational institutions, libraries, palaces of schoolchildren, sports complexes in accordance with the design and cost-estimate documentation; (xx) construction and commissioning of facilities designed specifically for the implementation of priority activities, in accordance with the design and cost-estimate documentation.
Aktau Seaport	2002	2,000	Akimat of Mangistau Oblast is shareholder of JSC Management Company of SEZ Aktau Seaport.	<ul style="list-style-type: none"> (i) Manufacturing of household electrical appliances; (ii) manufacturing of leather and related products; (iii) production of chemical products; (iv) manufacturing of rubber and plastic products; (v) production of other nonmetallic mineral products; (vi) metallurgical industry; (vii) manufacturing of finished metal products; (viii) manufacturing of machinery and equipment; (ix) production of petrochemical products; (x) production of basic pharmaceutical products and preparations; (xi) warehousing and auxiliary transport activities; (xii) manufacturing of electric motors, generators, transformers, electric distribution, and control equipment; (xiii) manufacturing of electrical wiring and electrically conductive devices; (xiv) construction and commissioning of facilities intended for implementation of priority activities in accordance with the design and cost-estimate documentation.

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Table 4 continued

Special Economic Zone	Year Created	Area (ha)	Management Company	Eligible Activities
Burabay	2008	370	Territorial body of the Investment Committee of MID serves as the management company of SEZ "Burabay".	(i) Tourist services; and (ii) construction and commissioning of tourist accommodations, sanatoriums, and recreational facilities, provided that the following conditions are met: the facilities must not be connected with any gambling businesses, and they must be constructed and commissioned in accordance with design specifications and cost estimates.
Khorgos-East Gate	2011	5,740	JSC "Management company of SEZ Khorgos-East Gate" is 100% owned by the Kazakhstan Railways Company (KTZH), which is fully owned by Samruk-Kazyna, a state-owned company.	(i) Warehousing and transportation support activities; (ii) food production; (iii) manufacturing of leather and related products; (iv) manufacturing of textiles; (v) production of other nonmetallic mineral products; (vi) production of chemical products; (vii) manufacturing of finished metal products, except machinery and equipment; (viii) manufacturing of machinery and equipment not elsewhere classified; (ix) construction of buildings for the exhibitions, museum, warehouse and administrative buildings in accordance with the design and cost-estimate documentation; and (x) construction and commissioning of facilities intended for implementation of priority activities in accordance with the design and cost-estimate documentation
National Industrial Petrochemical Park	2007	3,475	JSC "The management company of SEZ National Industrial Petrochemical Park" is 97.5% owned by the Ministry of Energy, and 2.5% belongs to the United Chemical Company, which is fully owned by Samruk-Kazyna, a state-owned company. The Ministry of Energy is expected to transfer 46.5% of its shares to the United Chemical Company, bringing its total of shares to 49%; and the Ministry of Energy will transfer the rest of its shares	(i) Manufacturing of chemical products; (ii) production of petrochemical products; (iii) construction and commissioning of facilities intended for implementation of priority activities in accordance with the design and cost-estimate documentation.

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Table 4 continued

Special Economic Zone	Year Created	Area (ha)	Management Company	Eligible Activities
			to Kazakh Invest, single coordination center.	
Saryarka	2011	535	Akimat of Karaganda Oblast is shareholder of JSC Karaganda Invest, the management company of SEZ “Saryarka”.	<ul style="list-style-type: none"> (i) The metallurgical industry; (ii) manufacturing of finished metal products, except machinery and equipment; (iii) manufacturing of engines and turbines, except aircraft, automobile and motorcycle engines; (iv) production of motor vehicles, trailers and semitrailers; (v) manufacturing of computers, electronic and optical products; (vi) manufacturing of electrical equipment; (vii) production of chemical products; (viii) manufacturing of rubber and plastic products; (ix) production of other nonmetallic mineral products; (x) production of hydraulic equipment; (xi) manufacturing of other pumps, compressors, stoppers and valves; (xii) manufacturing of other valves and valves; (xiii) production of bearings, gears, gear elements and drives; (xiv) manufacturing of plates, furnaces and furnace burners; (xv) manufacturing of lifting and transportation equipment; (xvi) manufacturing of hand-held electrical tools; (xvii) production of industrial refrigeration and ventilation equipment; (xviii) manufacturing of purification apparatus for liquid minerals; (xix) manufacturing of equipment for the production, dispersion or dispersion of liquid minerals or powders; (xx) manufacturing of cleaning equipment for oil refining, chemical industry, the beverage industry; (xxi) the production of centrifuges (except for drains and dryers); (xxii) production of water cooling risers for direct cooling by means of water recycling; (xxiii) production of agricultural and forestry machinery; (xxiv) manufacturing of equipment for metal forming; (xxv) manufacturing of other metalworking machines; (xxvi) manufacturing of machinery and equipment for metallurgy; (xxvii) manufacturing of machinery for the mining industry, underground mining and construction; (xxviii) manufacturing of equipment for the production and processing of food, beverages and tobacco products; (xxix) manufacturing of equipment for textiles, sewing, fur and leather products; (xxx) manufacturing of machinery for paper and paperboard; (xxxi) manufacturing of equipment for the processing of rubber, plastics and other polymeric materials; (xxxii) construction and commissioning of facilities intended for implementation of priority activities, within the design estimates in accordance with the design and cost-estimate documentation.

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Table 4 continued

Special Economic Zone	Year Created	Area (ha)	Management Company	Eligible Activities
Taraz Chemical Park	2012	505	JSC «The management company of SEZ Chemical Park Taraz» 100% owned by United Chemical Company. United Chemical Company is expected to transfer 26% of its shares to the state.	(i) Manufacturing of chemical products; (ii) production of rubber and plastic products; (iii) production of other nonmetallic mineral products; (iv) production of machinery and equipment for chemical production; (v) construction and commissioning of facilities intended for implementation of priority activities in accordance with the design and cost-estimate documentation.
Pavlodar	2012	3,300	Akimat of Pavlodar Oblast is a shareholder of JSC «The management company of SEZ Pavlodar»	(i) Manufacturing of chemical products; (ii) production of petrochemical products; (iii) construction and commissioning of facilities intended for implementation of priority activities in accordance with the design and cost-estimate documentation.
Park of Innovative Technologies	2003	163	The management company is the Autonomous Cluster Fund, a not-for-profit organization funded by the government.	(i) Design, development, implementation and production of databases and hardware, (ii) Design, development, implementation and production of software (including prototypes); (iii) services for storing and processing information in electronic form using server info-communication equipment (data center services); (iv) creation of new information technologies on the basis of artificial immune and neural systems; (v) carrying out research and development work in the field of information technology, telecommunications and communications, electronics, instrumentation, renewable energy sources, resource saving and nature management, creation and application of new materials, production, transportation and processing of oil and gas in the presence of a conclusion, issued by the authorized body in the field of science, on the conduct of such works; (vi) manufacturing of machines for word processing, copying and duplicating equipment, address machines, calculators, cash registers, marking machines, ticket offices machines, production of other office machines and equipment, electronic computers and other equipment for information processing; (vii) production of electric and radio elements, transmitting equipment, receiving equipment, recording and playback of sound and image;

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Table 4 continued

Special Economic Zone	Year Created	Area (ha)	Management Company	Eligible Activities
				(viii) design, development, implementation and production of electronic, measuring, optical, lighting devices; (ix) educational activities in the field of innovative technologies according to the list of specialties determined by the Government of the Republic of Kazakhstan; (x) design, development, implementation and production of new materials (including prototypes); (xi) manufacturing of household electrical appliances: refrigerators, freezers, washing machines; (xii) construction and commissioning of facilities intended for implementation of priority activities in accordance with the design and cost-estimate documentation.
Ontustik	2005	200	Akimat of South Kazakhstan oblast is shareholder of JSC «The management company of SEZ Ontustik.»	(i) Manufacturing of finished textile products, except apparel; (ii) manufacturing of other knitted and knitwear; (iii) the production of clothing, except clothes made of fur and leather; (iv) spinning, weaving and finishing production; (v) production of nonwovens, except clothing; (vi) manufacturing of carpets and rugs; (vii) production of wood pulp and cellulose; (viii) manufacturing of paper and paperboard; (ix) manufacturing of leather products, except for tanning and dressing of leather, dressing and fur staining; (x) manufacturing of stationeries; (xi) construction and commissioning of facilities intended for implementation of priority activities in accordance with the design and cost-estimate documentation

ha² = square hectare, MID = Ministry for Investments and Development, SEZ = special economic zone.

Source: Resolution of the Government of the Republic of Kazakhstan “On approval of the lists of priority activities of SEZ and facilities, the construction of which is designed for implementation of priority activities of SEZ, and also, the Rules for including priority activities in the list of priority activities of SEZ and construction projects in the list of objects for which construction is intended for implementation priority activities of SEZ,” dated by 20 January 2017, No. 10.

2. Laws, Decrees, and Other Legislation Pertaining to Special Economic Zones

79. The SEZs are regulated by the Law “On Special Economic Zones in the Republic of Kazakhstan,”⁸¹ the Entrepreneurial Code of the Republic of Kazakhstan,⁸² the Land Code of the Republic of Kazakhstan,⁸³

the Code of the Republic of Kazakhstan “On Taxes and Other Obligatory Payments to the Budget” (Tax Code),⁸⁴ the Republic of Kazakhstan Code on Customs Affairs in the Republic of Kazakhstan,⁸⁵ and the laws of the Republic of Kazakhstan relating to employment and immigration. The customs duties were approved by Resolution No. 24 of the

⁸¹ Law of the Republic of Kazakhstan “On Special Economic Zones in the Republic of Kazakhstan,” dated 21 July 2011, No. 469-IV, with the latest amendments added in October 2015. <http://invest.mid.gov.kz/en/pages/law-republic-kazakhstan-special-economic-zones-republic-kazakhstan>.

⁸² Entrepreneurial Code of the Republic of Kazakhstan, dated 29 October 2015, No. 375-V.

⁸³ The Land Code of the Republic of Kazakhstan, dated 20 June 2003, No. 442.

⁸⁴ Code of the Republic of Kazakhstan “On Taxes and Other Obligatory Payments to the Budget” (Tax Code), dated 10 December 2008, No. 99-IV.

⁸⁵ The Code of the Republic of Kazakhstan “On Customs Affairs in the Republic of Kazakhstan,” dated 30 June 2010, No. 296-IV.

Government of the Republic of Kazakhstan on 21 January 2011. As noted, each SEZ has its own Decree of the President of the Republic of Kazakhstan besides these general laws.

80. The State Program of Industrial-Innovative Development of Kazakhstan for 2015–2019 listed constraints relating to SEZ development such as quotas and permits to attract foreign labor needed by companies operating in the SEZs, and suggested ways to improve the efficiency of SEZ development.⁸⁶ One way was to ensure the stability of the legislation, including tax preferences in the Tax Code during the period of SEZ operation, as well as the establishment of a single operator to oversee SEZ management and development. The program listed the tax benefits available for all participants of SEZs, including exemptions from the corporate income tax (CIT), land tax, property tax, and the value-added tax (VAT) on goods sold to a SEZ and completely consumed during the manufacturing process.

81. The objective of the program is to stimulate the diversification and competitiveness of Kazakhstan's manufacturing industry. The program is expected to establish two innovation clusters—Nazarbayev University, in Astana, focusing on the development of basic and applied science; and the Park of Innovation Technologies (PIT), in Almaty, focusing on the transfer of advanced technologies. The PIT innovation cluster joins participating enterprises of the PIT SEZ, large research and education institutes in Almaty, and other legal entities. Research and education institutes act as a platform for the generation and development of ideas that are then tested and pilot-run in the PIT. The PIT innovation cluster's development priorities will be, *inter alia*, space technology and information and communications technology, including mobile and multimedia technologies. It is managed by the Trusteeship Council, headed by the President of the Republic of Kazakhstan. To support the cluster fund's initiatives and the implementation of its strategy, the program recommended the establishment of the Autonomous Cluster Fund management company, which was created on 10 April 2015.

82. The program also aims to improve the Entrepreneurial Code, amendments of the Code on Customs Affairs, the Tax Code, the Law “On Commercialization of Scientific and (or) Technical Activities,” and the Law “On SEZs,” in order to provide stability and guarantee the preservation of tax preferences for SEZ participants during the entire SEZ operating period. In September 2016, the program was further reviewed because the decrease in oil prices after it had first been approved (in 2014) was adversely affecting the government's ability to achieve the program's targets, due to shrinking funds.

83. On 20 May 2015, the President's Decree “On the National Plan—100 Concrete Steps” was issued. It calls for five institutional reforms: (i) the formation of a professional state apparatus; (ii) enforcement of the rule of law; (iii) industrialization and economic growth; (iv) a unified nation facing the future; and (v) governmental transparency and accountability. Step 63 of the National Plan specifies that two innovative clusters should be developed as a foundation for a knowledge-based economy. The “Astana Business Campus,” at Nazarbayev University, will have research centers and laboratories to carry out joint research projects and development activities, as well as the commercialization of technologies they develop. The PIT will seek to attract local and foreign high-tech companies for the implementation of specific industrial projects. And financing from the National Oil Fund for the development of the infrastructure of the SEZs and industrial zones is possible under the Nurly Zhol State Program of Infrastructure Development for 2015–2019.⁸⁷

84. The objective of the Nurly Zhol State Program is to connect the regions of Kazakhstan by modernizing the country's logistical, social, and industrial infrastructure. The program emphasizes that industrial infrastructure is a prerequisite for the efficient operation of SEZs and IZs as sources of economic growth in the regions, and notes that the underdevelopment of Kazakhstan's infrastructure has had a negative impact on the implementation of government programs aimed at diversifying the national economy. The priority of the Nurly Zhol

⁸⁶ Decree of the President of the Republic of Kazakhstan “On Approval of the State Program of Industrial-Innovative Development of Kazakhstan for 2015–2019,” dated 1 August 2014, No. 874.

⁸⁷ Decree of the President of the Republic of Kazakhstan “On the Approval of the Nurly Zhol State Program of Infrastructure Development for 2015–2019,” dated 6 April 2015, No. 1030.

State Program is to complete the construction of infrastructure at the National Industrial Petrochemical Park and Khorgos-East Gate, as it is believed that development of both these SEZs will promote the development of the petrochemical industry and increase the transit potential. The National Industrial Petrochemical Park consequently received funding of T68.5 billion from the National Fund of the Republic of Kazakhstan in 2015, and T10 billion in 2016. The government project Integrated Gas and Chemical Complex-Phase 1, in the National Industrial Petrochemical Park, will get T35 billion from a single accumulative pension fund created through the issuance of bonds by the Samruk-Kazyna National Welfare Fund. In 2015, the National Fund of the Republic of Kazakhstan allocated T12.35 billion to the completion of the infrastructure of Khorgos-East Gate SEZ. Kazakhstan Temir Zholy, the national railway company, is cofinancing the completion of Khorgos-East Gate's infrastructure under the Nurly Zhol State Program, contributing T23.7 billion during 2015–2019.

3. The Definition of “Special Economic Zones”

85. The 2011 Law “On Special Economic Zones in the Republic of Kazakhstan” defines SEZs as part of the territory of the Republic of Kazakhstan, but possessing strict borders within which a special legal regime exists for the implementation of priority activities.⁸⁸

4. Corporate Governance

86. After the Decree of the President regarding the creation of a particular SEZ, the central government or *akimat* (local government) makes a decision on whether to establish or participate in the establishment of a management company for the SEZ. The central government, *akimats*, nongovernmental legal entities, and foreign legal entities with experience in SEZ operations may become founders of the management company.

87. If a SEZ is created on the initiative of the central government or *akimat*, over 50% of the voting shares of the management company are owned by the state, unless otherwise stipulated in the decree of the President on the creation of the SEZ. When a SEZ is created on the initiative of a nongovernmental legal entity, at least 26% of the voting shares will be owned by the state.

88. The first meeting of the founders of a SEZ is then held within 30 days after the government's decision regarding the extent of its own participation in the creation of the management company. The board of directors of the management company then elects two independent directors from a group of candidates recommended by the Single Coordination Center and by the National Chamber of Entrepreneurs of the Republic of Kazakhstan.⁸⁹ The National Chamber of Entrepreneurs serves as the head of the strategic planning committee of the management company's board of directors. Next there is the process of dividing up the voting rights among the management company's current shareholders.

89. Each SEZ is managed by a joint stock company that is owned by a government body or a state-owned enterprise. The management companies of three SEZs are overseen by government ministries: those of Burabay and the PIT by the Ministry for Investments and Development (MID), and that of the National Industrial Petrochemical Park by the Ministry of Energy. The Republican State Institution “Territorial Department of the Investment Committee of MID is serving as the management company of Burabay SEZ until 1 December 2017.⁹⁰ The PIT is managed by the Autonomous Cluster Fund,” which was created on 10 April 2015. Its activities are regulated by the Law “On Innovation Cluster–Park of Innovation Technologies.”⁹¹ The purpose of the innovation clusters is to create self-sufficient science and technology complexes, each with two or three high-tech companies, as a means of diversifying Kazakhstan's economy and developing industries

⁸⁸ Law of the Republic of Kazakhstan “On Special Economic Zones in the Republic of Kazakhstan,” dated 21 July 2011, No. 469-IV.

⁸⁹ Kazakh Invest serves as the single coordination center, in accordance with the Resolution of the Government of the Republic of Kazakhstan “On the Determination of a Single Coordination Center for the Special Economic Zones in the Republic of Kazakhstan,” dated 31 May 2016, No. 310.

⁹⁰ In accordance with the Decree of the President, Burabay SEZ will be abolished on 1 December 2017.

⁹¹ Law of the Republic of Kazakhstan “On the Park of Innovative Technologies innovation cluster,” dated 10 June 2016, No. 207-V.

that can provide high-value-added products and services.⁹²

90. Taraz Chemical Park is managed by United Chemical Company. The Ministry of Energy holds 97.5% of the shares of the National Industrial Petroleum Park's management company (Table 4), with the United Chemical Company possessing the remaining 2.5%. The Ministry of Energy is expected to transfer 46.5% to the United Chemical Company, which will then own 49% of the total shares.⁹³ The Ministry of Energy will transfer the rest of its shares to Kazakh Invest which serves as coordination center.

91. Kazakhstan Temir Zholy and its subsidiary company, KTZH Express, have created a management company to oversee the Khorgos–East Gate SEZ. The United Chemical Company and Kazakhstan Temir Zholy are both owned by Samruk-Kazyna, a state-owned company. Five SEZs are managed by management companies owned by regional *akimats*: Astana–New City, Aktau Seaport, Pavlodar, Ontustik, and Saryarka. Top government officials also supervise the SEZs, along with the management companies.

92. Under the Nurdy Zhol State Program, an international company will also be involved in the management of the SEZs to enhance their operations and make them attractive to investors. DP World was invited to provide consulting services to Khorgos–East Gate on management issues. In 2013, Kazakhstan Temir Zholy and DP World signed an agreement to cooperate in the management of Khorgos–East Gate.⁹⁴

5. Administrative Procedures

a. The Special Legal Regime of the Special Economic Zones

93. A special legal regime applies to participants operating within the territory of any SEZ.⁹⁵ There is an exemption in the case of the PIT, which applies the principle of extraterritoriality until 1 January 2018,⁹⁶

for companies located outside of the PIT territory engaged in the following activities:

- (i) the design, development, implementation, and production of databases; hardware design; and the development, implementation, and production of software (including prototypes);
- (ii) the storage and processing of information in electronic form using server-info-communication equipment (i.e., data center services); and
- (iii) research and development on the creation and implementation of information-and-communication technology projects.

94. In 2016, 47 companies under the PIT were located outside of this SEZ's territory. Of these companies, 2 were in Semey, 11 in Astana, 1 in Karaganda, and the remaining 33 were in Almaty. The special legal regime for SEZs entails a combination of terms and conditions regarding the operation of SEZs, in accordance with the national laws on SEZs, taxes, customs, and land, as well as the legislation on employment.

95. Each SEZ has a detailed list of permitted activities. The current scope of activities reflects the government's targeted sectors and priority areas. The special legal regime is applicable only when a SEZ participant engages in the priority activities defined for that particular SEZ (and consistent with the objectives of that SEZ's creation). If the SEZ participant derives more than 10% of its revenue from any activity that has not been specified for that SEZ, then it loses all its investment incentives, including the exemption from export duties and the CIT (with the exception of the PIT, whose companies are allowed to earn up to 30% of their revenues from activities that have not been specified). Consequently, a "positive" list of permitted activities limits the number of possible investors, as not all the activities of a SEZ-based company can be foreseen.

96. A SEZ's term of validity is set by the decree of the President on the creation of that SEZ, and the

⁹² Law of the Republic of Kazakhstan "On the Park of Innovative Technologies innovation cluster," dated 10 June 2016, No. 207-V.

⁹³ The United Chemical Company is expected to pay about \$12 million for its shares by 2022.

⁹⁴ DP World. DP World to use global expertise to assist Kazakhstan in expanding port and logistic capacity. http://web.dpworld.com/wp-content/uploads/2014/01/7_11_Press_Release_Global_Expertise_to_Assist_Kazakhstan.pdf.

⁹⁵ The "participants" of a SEZ include both residents and related nonresidents.

⁹⁶ At present, it is proposed to extend this exemption until 1 January 2028.

SEZ is expected to be abolished upon the decree's expiration. The SEZs in Kazakhstan were created for a period of 25 years, except for Burabay, which was created in January 2008, and is slated to expire by 1 December 2017. SEZ-participant firms that are leasing parcels of land in a SEZ have the right to purchase their parcels in accordance with the procedure established by the Land Code of the Republic of Kazakhstan. Chapter 17 in the Kazakhstan Tax Code specifies tax incentives for SEZ participants. The tax exemptions for SEZs are listed in Table 5.

97. Public service centers provide SEZ participants with all the services they need, in accordance with the “one-stop-shop” principle. These services include registration of businesses, licensing, and permission to export and import, among others. The purpose is to facilitate the collection and preparation of the required documents.⁹⁷ The one-stop shop is also part of the government's effort to promote e-governance.

b. The Roles of Key Stakeholders

98. SEZs are overseen at the national or regional level, depending on their affiliation. The Law “On Special Economic Zones in the Republic of Kazakhstan” defines the roles and responsibilities of the relevant government agencies. At the national level, MID implements the state's policies on SEZs, coordinating government agencies and management companies in the creation, operation, and abolition of SEZs—except for Astana–New City. MID develops laws and regulations on the activities of SEZs, keeps a unified register of SEZ participants based on the data provided by the management company of each SEZ, approves the requirements for a feasibility study on the establishment of a SEZ, and develops the model contracts for the lease or sublease of privately or state-owned land on which a SEZ will be built. It also sets the regulations for the “expert council,” a multiagency consultative and advisory body under

MID that considers issues related to the creation or abolition of SEZs.

99. The municipal government (*akimat*) of Astana coordinates the relevant state agencies and SEZ “Astana–New City” regarding the operation and abolition of that SEZ; it also works to attract new participants to the SEZ and maintains records of the SEZ's participants.

100. MID is the budget administrator for the PIT and Burabay SEZ, and allocates government funding to cover operational costs and infrastructure construction.⁹⁸ In 2016, MID approved a SEZ performance-evaluation methodology in coordination with the Ministry of National Economy (MNE).⁹⁹ The methodology was, however, criticized by SEZ representatives for not including consultations with SEZ management companies and for not reflecting typical practices in Kazakhstan.

101. The MNE is in charge of developing the government's budget, tax and customs policies, and the State Revenue Committee of the Ministry of Finance implements the tax and customs policies. During 2003–2016, the government's cumulative investments in SEZ infrastructure (with allocations from the national budget and the National Fund) amounted to T274.5 billion. There is a total of 152 projects in the SEZs, with 30 of them benefiting from foreign investments. The SEZs have created a total of 11,527 jobs, with the average cost of creating one job at about T16.1 million.

102. According to amendments to the Law “On Special Economic Zones” and the Resolution of the Republic of Kazakhstan “On Defining the Single Coordination Center of Special Economic Zones in the Republic of Kazakhstan” (approved in May 2016),¹⁰⁰ Kazakh Invest is to be the single coordination center for the SEZs, with the mission of raising the attractiveness of the SEZs to investors.¹⁰¹

⁹⁷ There are 271 public service centers, which provide 215 services to individuals and legal entities in Kazakhstan.

⁹⁸ Budget Programs for the Ministry for Investments and Development of the Republic of Kazakhstan for 2016–2018, Budget Pod Programs 101, 102, 103, and 104. <http://www.mid.gov.kz/en/pages/budget-programs-ministry-investment-and-development-republic-kazakhstan-2016-2018>.

⁹⁹ Order of the Minister of Investments and Development of the Republic of Kazakhstan “On Methodology of Assessment of Efficiency of Special Economic Zone Activity,” dated 29 January 2016, No. 136.

¹⁰⁰ Resolution of the Government of the Republic of Kazakhstan, “On Defining the Single Coordination Center of Special Economic Zones in the Republic of Kazakhstan,” dated 31 May 2016, No. 130.

¹⁰¹ Kaznex Invest was renamed as Kazakh Invest according to Resolution of the Government of the Republic of Kazakhstan “On renaming the joint stock company National Agency for Export and Investment Kaznex Invest,” dated 1 March 2017, No. 100.

103. Kazakh Invest is responsible for

- (i) interacting with public authorities, SEZ management company shareholders, other SEZ management bodies, and SEZ participants on registration of participants, distribution of land plots in the SEZ, financing and developing the infrastructure of the SEZs; interacting with public authorities, SEZ management company shareholders, other SEZ management bodies and SEZ participants;
- (ii) submitting proposals to the public authority on improving the legislation on SEZs;
- (iii) trust management of the management companies' shares owned by the state; and
- (iv) providing services for the development and promotion of SEZs, including monitoring the condition of SEZ infrastructure; and offering recommendations regarding the preparation of SEZ plans and project selection criteria, planning the financing of SEZ management bodies, developing financing plans of the SEZ, developing and introducing management models, internal business processes and corporate documents, improving the management of the SEZ; conducting market analysis and consulting with the management of the SEZ regarding the marketing strategy; target marketing; assisting in attracting potential investors in the SEZ; providing information support for the activities of potential participants of special economic zones, including the organization of meetings of potential participants of the SEZ with representatives of public authorities, management of special economic zones, as well as associations of private entrepreneurs, holding business forums, exhibitions, conferences and seminars on SEZ topics; conducting analysis of projects; monitoring the implementation of the terms of the contracts

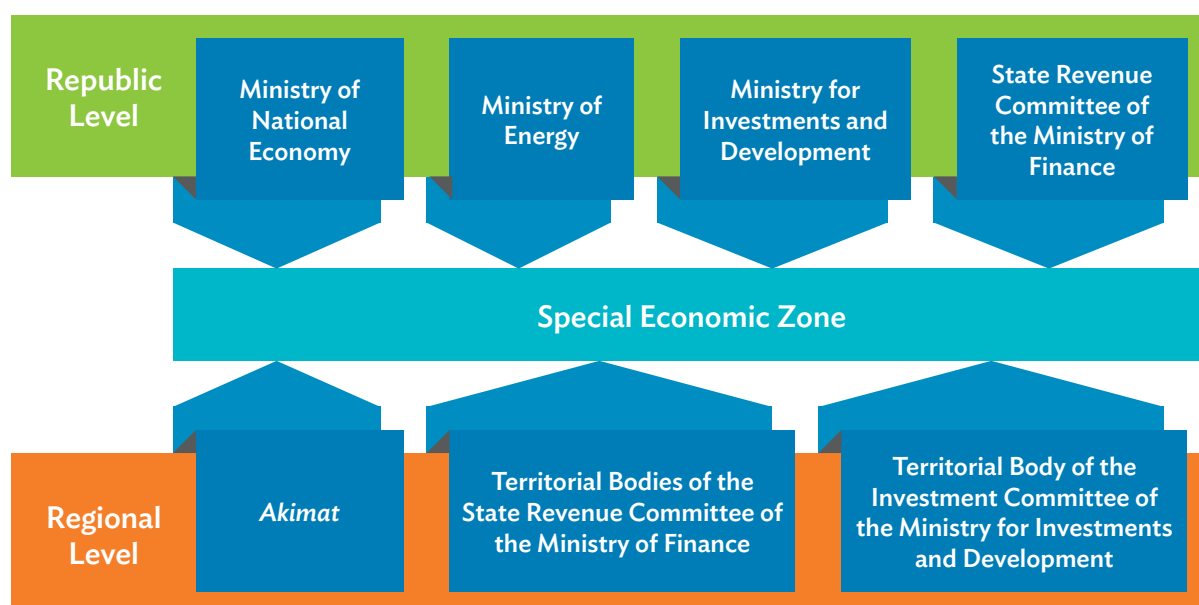
for the implementation of activities; and assisting in achieving the target indicators.

104. The Autonomous Cluster Fund's functions include providing funds for project participants; attracting potential investors; participating in the creation, management, and coordination of joint ventures in the form of technological development centers of transnational corporations; and participating in foreign investment funds.¹⁰²

105. Each SEZ management company undertakes the overall development, promotion, and monitoring of its SEZ. The management companies interact with state bodies and SEZ participants, provide land parcels for secondary land use, collect information on the key SEZ performance indicators, analyze possible ways to improve SEZ operations in terms of legal and institutional frameworks, elaborate development plans and marketing strategies for their SEZs, confirm the actual consumption of imported inputs during the activities corresponding to the SEZs' objectives, report to MID, attract investments for the construction of infrastructure and other activities, construct infrastructure facilities (in accordance with an approved feasibility study) on land plots that have not been transferred to any SEZ participants, and manage a public services center based on the "one-stop-shop" principle. They also ensure the provision of public utilities and logistical and maintenance services, and participation in public-private partnership (PPP) projects. *Akimats* implement state policy in the regions with regard to the operation of SEZs. They can initiate the establishment of SEZs. They participate in the management companies of the SEZs, provide funds for the management company budgets, provide land plots for SEZs, facilitate the development of infrastructure, monitor the activities of participants for compliance with the terms of agreements, and analyze monitoring data.

¹⁰² Law of the Republic of Kazakhstan "On the Park of Innovative Technologies innovation cluster," dated 10 June 2016, No. 207-V.

Figure 3: The Current Institutional Structure for the Development of Special Economic Zones



Source: Asian Development Bank.

Table 5: The Main Preferential Features of Special Economic Zones, Industrial Zones, and Priority and Strategic Investment Projects

Feature	Special Economic Zones	Industrial Zones	Priority Investment Projects ^a	Strategic Investment Projects ^b
1. Tax measures				
Import tariffs ^c	There is a tariff exemption for imported goods when they are (i) reexported to another SEZ in an EAEU-member country, or (ii) used in the production in the SEZ of goods for export. ^d	n.a.	There is a tariff exemption for imports of equipment and spare parts associated with the implementation of a 5-year investment contract (Entrepreneurship Code, Article 287).	There is a tariff exemption for imports of equipment and spare parts associated with the implementation of a 5-year investment contract (Entrepreneurship Code, Article 287).

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Table 5 continued

Feature	Special Economic Zones	Industrial Zones	Priority Investment Projects ^a	Strategic Investment Projects ^b
Export tariffs	n.p.	n.p.	n.p.	n.p.
Other customs fees	n.p.	n.p.	n.p.	n.p.
VAT (standard rate 12%) ^e	There is an exemption for goods fully consumed during activities corresponding to reasons for the creation of the SEZ and included in the list of goods established by the government. ^f The one exemption is the Astana–New City SEZ, specifically regarding its goods that are fully consumed during the process of construction.	n.p.	n.p.	n.p.
CIT (statutory rate 20%)	There is an exemption for the duration of a company's residence in a SEZ.	n.p.	There is an exemption for 10 years.	There is an exemption for 10 years.
Property tax ^g	There is an exemption for the duration of a company's residence in a SEZ.	n.p.	There is an exemption for 8 years.	There is an exemption for 7 years.
Land tax ^h	There is an exemption for the duration of a company's residence in a SEZ.	n.p.	There is an exemption for 10 years.	There is an exemption for 7 years.
Land utilization payment	There is an exemption for the duration of a company's residence in a SEZ.	n.p.	There is an exemption for 10 years.	There is an exemption for 7 years.
PIT (flat rate 10%)	n.p.	n.p.	n.p.	n.p.
Social charges to employers	Companies in the Park of Innovative Technologies (PIT) have an exemption from the social tax for 5 years. The exemption is given on the condition that payroll expenses comprise at least 50% of annual revenues and that 90% of the payroll budget be spent on Kazakhstan residents.	n.p.	n.p.	n.p.
2. Import and export quotas and other nontariff regulations	n.p.	n.p.	n.p.	n.p.

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Table 5 continued

Feature	Special Economic Zones	Industrial Zones	Priority Investment Projects ^a	Strategic Investment Projects ^b
3. Nontax incentives				
Financial contributions by government bodies	Yes	There is a business road map that includes financial contributions for (i) the development of the terms of reference, and (ii) infrastructure.	Investment subsidies cover up to 30% of the costs of construction, installation, and procurement of equipment (excluding the VAT and excise duties).	
Nonfinancial contributions by government bodies	Free land is provided with infrastructure, with right to purchase the land after abolishing the SEZ.	Leases of land are allowed for up to 49 years, with the right to purchase the land afterward.	Free land is provided for up to 10 years. The government can provide grants covering up to 30% of the costs of land, buildings, machinery and equipment, computers, instruments for measurement and control, vehicles (except passenger cars), and industrial furniture.	
Government procurement preferences	n.p. The PIT has a preference for procurement from the Samruk-Kazyna National Welfare Fund. Under the preference, no deposit is required for tenders.	n.p.	n.p.	n.p.
4. Linkages to the domestic economy (including businesses, as well as educational and research institutions)	Most of the products and services created by the SEZs are destined for the domestic market. Also, the PIT has ties to educational institutions in Kazakhstan.	Most of the linkages of industrial zones are currently with businesses, rather than with educational or research institutions.	n.p.	n.p.

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Table 5 continued

Feature	Special Economic Zones	Industrial Zones	Priority Investment Projects ^a	Strategic Investment Projects ^b
5. Streamlined regulations and procedures (pertaining to business registration, investment approval, taxes and customs, land use, utility services, expatriate work permits, etc.)	<p>For every SEZ, there is a territorial body under the State Revenue Committee of the Ministry of Finance that deals with customs and tax questions.</p> <p>There is a simplified procedure for recruiting foreign workers.</p>	The regulations are focused on land use.	<p>There is a “one-stop shop” for dealing with matters concerning investors’ questions for the Committee on Investments, under the Ministry of Industry and New Technologies.</p> <p>There is a simplified regime for visas and work permits for foreign employees.</p>	<p>There is a “one-stop shop” for dealing with matters concerning investors’ questions for the Committee on Investments, under the Ministry of Industry and New Technologies.</p> <p>There is a simplified regime for visas and work permits for foreign employees.</p>
6. Eligible activities: positive or negative lists	The lists of SEZ activities are positive.	The lists of the industrial zones’ activities are negative.	The lists of priority investment projects are positive.	The lists of strategic investment projects are positive.
Manufacturing vs. services	The lists mainly concern manufacturing.	The lists mainly concern manufacturing.	The lists focus on manufacturing.	The lists focus on manufacturing.
7. Management company: public vs. private	The management company is private however shareholder is public.	The management company is public.	n.a.	n.a.
8. Provision of infrastructure	The government provides the infrastructure facilities.	The government provides the infrastructure facilities (power, heat, water).	n.p.	n.p.
9. Environmental and labor standards	The Labor Code and Environmental Code, as well as every Decree of the President of the Republic of Kazakhstan on SEZs, have requirements regarding environmental protection.	The government’s Labor Code and Environmental Code both apply.	The government’s Labor Code and Environmental Code both apply.	The government’s Labor Code and Environmental Code both apply.

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Table 5 continued

Feature	Special Economic Zones	Industrial Zones	Priority Investment Projects ^a	Strategic Investment Projects ^b
10. Conditions attached to residence				
Export requirements	There are export requirements only for Ontustik, Pavlodar, and Taraz Chemical Park SEZs.	n.a.	n.a.	n.a.
Local content rules	Yes	n.a.	n.a.	n.a.

CIT = corporate income tax, EAEU = Eurasian Economic Union, n.a. = not applicable, n.p. = no preferential treatment, SEZ = special economic zone, VAT = value-added tax.

^a In order to qualify for tax and other preferences, a company must (i) be newly established (not more than 2 years old); (ii) have signed an investment contract; and (iii) have investments totaling no less than T4.24 trillion (or T2 million monthly calculation index equal to the 2121 tenge fixed in 2016 national budget). The law notes that investment must not be less than 4,242 billion KZT (or 2000000 monthly calculation index equal to 2121 KZT in 2016) established by the law on the national budget at the date of filing application for investment preferences. Monthly calculation index is an index used in Kazakhstan to determine social allowances, penalties, and taxes and other payments to the government budget. It is approved by the Law “On the Republican Budget” each year.

^b In order to qualify for tax and other preferences, a company’s investment must be (i) included in the list of strategic investment projects approved by the government, and (ii) the company itself must have concluded an investment contract before 1 January 2015. The list of strategic investment projects was approved by the Resolution of the Government of the Republic of Kazakhstan “On approving the list of strategic investment projects” No. 1293, dated 1 September 2009.

^c The latest (2016) simple average applied most-favored-nation tariff rate is 6.9%.

^d Customs duties need to reflect the provisions of the Eurasian Economic Union.

^e Goods sold by enterprises based outside the zones to those inside the zones do not qualify for VAT rebates.

^f Goods produced in the SEZs are subject to the full VAT when sold in the domestic market. Resolution of the Government of the Republic of Kazakhstan “On the approval of the lists of goods subject to a zero VAT rate for companies within a SEZ applies to goods completely consumed activities that meet the objectives of the creation of that SEZ.” No. 1197, dated 14 September 2012.

^g The average property tax rate on premises used for business activities is otherwise 1.5%.

^h The tax rate varies between \$0.26 and \$31.30 per hectare, depending on the “Bonitet Grade” (a classification of soil based on quality and fertility).

Source: Asian Development Bank.

c. The Institutional and Legal Implications of Kazakhstan’s Accession to the Eurasian Economic Union for the Functioning of the Special Economic Zones

106. The territory of a SEZ is part of the customs territory of the Eurasian Economic Union (i.e., encompassing Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and the Russian Federation).¹⁰³ The customs procedures of free customs zones follow the regulations of the Eurasian Economic Union (EAEU) and/or the laws of Kazakhstan. The territory of a SEZ, within which the customs procedures of free customs zones apply, is supervised by Kazakh

customs authorities. Chapter III highlights the specific provisions of the EAEU Treaty regarding the establishment and operation of SEZs.

107. On 30 November 2015, Kazakhstan became a member of the World Trade Organization (WTO). As noted above, firms registered and operating in a SEZ and/or using a free warehouse are not subject to regulations that are inconsistent with the WTO rules with regard to export performance, trade balancing, or local-content requirements. If non-EAEU goods are imported into a SEZ without any customs-duty or tax payments, they will be subject to those duties and taxes when they are released into

¹⁰³ This has applied since the ratification of the Agreement on the Free (Special) Economic Zones in the Customs Territory of the Customs Union and the Free Customs Zone Procedure by the Law of the Republic of Kazakhstan No. 312-IV, dated 30 June 2010.

the Kazakh domestic market or into the territory of another EAEU-member state. If those imports are reprocessed (i.e., substantially transformed) within a SEZ or free warehouse, the duties and taxes will be paid when the final products enter the rest of Kazakh territory or into another EAEU-member state.¹⁰⁴ Chapter III provides details on the legal implications of the EAEU and WTO for SEZ operations.

B. Industrial Zones

1. The Rationale for Industrial Zones

108. An industrial zone is created to provide economic and structural conditions that are conducive to entrepreneurship. The specific objectives of industrial zones are to

- (i) accelerate the development of private entrepreneurship in industry,
- (ii) reduce the costs of building new infrastructure,
- (iii) improve the efficiency of production, and
- (iv) provide employment.

109. In 2016, there were 42 industrial zones in 13 oblasts, with a total of 332 projects, according to the MNE. However, only 15 of these IZs are operational; and they have a total of 93 registered companies, which are based in Astana City and in Almatinskaya, Kyzylordinskaya, and South Kazakhstan oblasts. There are three IZs that are privately owned, Damu IZ, in Almatinskaya Oblast, SGT Group Industrial Zone and JigerMunaiServis Industrial Zone in Atyrau oblast. The MNE acknowledges that only a few of the 42 IZs have generated tangible outcomes, Ontustik Industrial Zone is deemed to be the more successful.

110. According to MNE data, the government spent T99.6 billion on IZs in 2015, of which T39.8 billion came from the budgets of local governments; T8.7 billion came from the National Fund and local government budgets; T33.8 billion came from

the central government's budget and from local government budgets; and T17.3 billion came from the National Fund, the central government budget, and from local government budgets.

2. Laws, Decrees, and Other Legislation Pertaining to Industrial Zones

111. There is no special law on IZs in Kazakhstan. However, the Entrepreneurship Code provides a definition of "industrial zone" and lays out the goals and tasks of IZs.¹⁰⁵ According to the Nurly Zhol State Program of Infrastructure Development for 2015–2019,¹⁰⁶ IZs serve as regional infrastructure for the development of small and medium-sized businesses, and for the diversification of regional economies. The industrial zones are intended to consolidate the efforts of businesses and to foster partnerships among small, medium-sized, and large businesses, with the large businesses serving as engines of development in these zones. The creation of IZs depends on regional specialization, as defined by the State Program for Accelerated Industrial Innovative Development 2010–2014, and on the capacities of local businesses. The program introduced government-budget funding of IZs on a nonrepayable basis. The "Business Road Map 2020" defines the mechanism for establishing IZs.¹⁰⁷

112. Located within the territory of an industrial zone are industrial plants (factories, storage space, administrative offices), social services (catering, worker training, public services), and banking facilities. The national budget, with cofinancing from the local government budget, funds the infrastructure within the territory of an industrial zone. The authorized body within the central government funds the creation of an industrial zone, after the selection is made from among competing business proposals.

113. Public infrastructure projects related to the creation or development of IZs have to meet the following criteria:

¹⁰⁴ WTO. 2015. Overview of Kazakhstan's Commitments. https://www.wto.org/english/news_e/news15_e/kazakhannex_e.pdf.

¹⁰⁵ The Entrepreneurship Code of the Republic of Kazakhstan, dated 29 October 2015, No. 375-V.

¹⁰⁶ See: Decree of the President of the Republic of Kazakhstan, dated 6 April 2015, No. 1030, which, as mentioned above, approved the Nurly Zhol State Program of Infrastructure Development for 2015–2019; and the introduction of amendments to the Decree of the President of the Republic of Kazakhstan "On Approval of the List of Government Programs," dated 19 March 2010, No. 957.

¹⁰⁷ The introduction of amendments to the Decree of the President of the Republic of Kazakhstan "On approval of Unified Program for Support and Development of Business" ("Business Road Map 2020"), dated 10 June 2010, No. 556. The amendments included measures for the implementation of the Business Road Map 2020 and the repeal of certain government decisions. Also see: Resolution of the Government of the Republic of Kazakhstan No. 168 (dated 31 March 2015).

Figure 4: The Procedure for Creating an Industrial Zone



MID = Ministry for Investments and Development, MNE = Ministry of National Economy, SEC = social-entrepreneurial corporation.

^a An “*akimat*” is a local government in Kazakhstan.

^b A “social-entrepreneurial corporation” is an organization that operates an industrial zone.

Source: Asian Development Bank.

- (i) the amount of investment in the project must total at least T10 billion;
- (ii) the cost of construction (or reconstruction) of the infrastructure may not be less than T2 billion, but may not exceed 50% of the cost of the project or of the creation of the industrial zone; and
- (iii) the list of needed infrastructure must be confirmed by the local regional coordination council.

3. The Definition of Industrial Zones

114. The Entrepreneurship Code defines an IZ as nonagricultural land with utilities provided by the state for use by private enterprises to operate industrial facilities, as established by the Land Code and other laws of the Republic of Kazakhstan.¹⁰⁸

4. Corporate Governance and the Roles of Key Stakeholders

115. According to the Business Road Map 2020,¹⁰⁹ the body that operates an industrial zone is called a “social-entrepreneurial corporation” (SEC). In addition to operating an IZ, an SEC supports the small and medium-sized businesses in the zone and works to

attract investments there. According to Nurly Zhol State Program of Infrastructure Development for 2015–2019, *akimats* must select SECs on a competitive basis and later evaluate their effectiveness.

5. Administrative Procedures

a. Regarding a Special Legal Regime for International Zones

116. There is no special legal regime for IZs. Companies located in an IZ do not receive incentives in the form of tax benefits or special customs procedures. Industrial enterprises that are newly established in the territory of an IZ can receive a reimbursement of 30% of the amount invested in their new facilities. However, this reimbursement does not apply to existing businesses.

b. The Roles of Key Stakeholders

117. The responsibility for policy development concerning IZs was transferred to the Ministry for Investments and Development (MID) in 2015, while support for infrastructure development remained within the purview of the MNE, in accordance with the Business Road Map 2020. The MNE provides funding

¹⁰⁸ The Entrepreneurship Code of the Republic of Kazakhstan, dated 29 October 2015, No. 375-V.

¹⁰⁹ This refers to some measures regarding the implementation of the Decree of the President of the Republic of Kazakhstan “On approval of Unified Program for Support and Development of Business” (“Business Road Map 2020”), dated 10 June 2010, No. 556; the Resolution of the Government of the Republic of Kazakhstan, dated 31 March 2015, No. 168; and the repeal of certain decisions by the government.

based on the applications submitted by akimats and on the expert advice provided by MID. According to the Business Road Map 2020 (footnote 107), the functions of an social-entrepreneurial corporation include:

- (i) attracting industrial enterprises to the IZ;
- (ii) attracting infrastructure investments into the IZ;
- (iii) enabling the secondary use (i.e., subleases) of land and infrastructure;
- (iv) monitoring the implementation of industrial activities by contractors, and terminating their contracts when necessary; and
- (v) overseeing the operation and maintenance of the IZ.

118. To ensure the effective management of their IZs, SECs may create management companies, with the involvement of local and international organizations. The services of the SECs are funded by the local government budgets. Issues regarding the sources of revenues of the management companies and the scope of their services are still under discussion.

c. Institutional and Legal Implications of Accession to the Eurasian Economic Union for the Functioning of Current Industrial Zones

119. There are no special consequences of Kazakhstan's accession to the EAEU on the functioning of current IZs.

C. The Main Features of Kazakhstan's Special Economic Zones and Industrial Zones

1. Tax Preferences

120. SEZ participants enjoy an exemption from tariffs on goods imported into their SEZ territories and then exported. There is an exemption for imported goods when these are (i) reexported to another SEZ in Kazakhstan or another EAEU-

member country, or (ii) used in the production of SEZ goods for export.¹¹⁰

121. Kazakhstan levies export duties on only a few goods.¹¹¹ Prior to 1 January 2017, those SEZ participants registered before 1 January 2012 were exempt from such taxes. However, this is no longer the case. Goods exported from a SEZ to the rest of the customs territory of the EAEU are not subject to export duties. However, goods exported from a SEZ to a destination outside the customs territory of the EAEU are subject to export duties. When foreign goods do not have the status of EAEU-made products (e.g., in cases of easy assembly), they are subject to customs duties if exported from the SEZ to a destination within the customs territory of the EAEU. If foreign goods are not used or are not processed within the territory of a SEZ, upon re-exportation to third countries they are exempt from "reexport" customs duties. If foreign goods processed within the territory of a SEZ are exported, export duties must be paid according to the Agreement on Free (Special) Economic Zones on the Customs Territory of the Customs Union and the Customs Procedures of the Free Customs Zone of 18 June 2010.¹¹²

122. The VAT is zero for goods that are fully consumed during activities corresponding to the reasons for the SEZ's creation and that are included in the list of eligible goods established by the government.¹¹³ There was also a zero VAT for goods fully consumed in the process of building the Astana-New City SEZ. But goods produced in the SEZs are subject to the full VAT when sold in the domestic market.

123. Companies operating in a SEZ are exempt from corporate income tax (CIT), value-added tax (VAT), and property and land taxes (Table 5). There are several eligibility conditions for these tax incentives. The legal entity has to be registered as a SEZ participant and as a taxpayer in the SEZ, and should not have structural subdivisions outside the SEZ.

¹¹⁰ Customs duties need to reflect EAEU provisions.

¹¹¹ In 2015, export duties were levied on livestock raw skin and wool, ferrous and nonferrous metal scrap and waste, and oil products. The export duty rates for these goods varied from 10% (uncombed wool) to 30% (copper waste and scrap). Apparently, the government has been taking steps to narrow down the list of goods subject to export duties.

¹¹² Also see the Law of the Republic of Kazakhstan "On the ratification of the Agreement on the Free (Special) Economic Zones in the Customs Territory of the Customs Union and the Free Customs Zone Procedure" by No. 312-IV, dated 30 June 2010.

¹¹³ Resolution of the Government of the Republic of Kazakhstan "On Approval of Lists of Goods Subject to Value-Added Tax at the Zero Rate," dated 14 September 2012, No. 1197. This was implemented within SEZs, and applies to all activities that meet the objectives of the creation of SEZs.

The proportion of the annual income earned by the member from SEZ-priority activities should be at least 90%. For companies in the PIT, the income earned from the goods and services that they provide as a result of SEZ-priority activities should be at least 70%. This means that if a SEZ participant derives more than 10% of its revenue from any unspecified activities (30% for the PIT), it will lose all the tax benefits.

124. Participants of the PIT SEZ are also exempted from social taxes for 5 years, on the condition that payroll expenses comprise at least 50% of annual revenues and that 90% of the payroll budget be spent on Kazakhstan residents. In 2014, tax and customs preferences amounted to T27.2 billion,¹¹⁴ but tax payments amounted to only T8.3 billion.

2. Local Content and Export Requirements

125. Whereas all the SEZs except the Taraz Chemical Park are subject to local content requirements, only three zones—Taraz Chemical Park, Pavlodar, and Ontustik—have export requirements among the targets in the laws that created them.

3. Nontax Incentives

126. **The financial contribution.** According to MID's Strategic Plan for 2016–2018, two SEZs under the ministry's management (Burabay and the PIT), as well as the IZ in the Alatau District of Almaty city, receive funding from MID. In accordance with MNE data, in 2015, MID provided T4 billion for the creation of a new IZ in the Alatau district of Almaty city. It budgeted T2.5 billion for 2016 for the new IZ.¹¹⁵

127. The State Program of Industrial-Innovative Development of Kazakhstan for 2015–2019 suggests new mechanisms for funding the infrastructure of SEZs and IZs: Bayterek National Managing Holding is borrowing from the National Fund through the issuance of bonds to fund program activities. Public investment under the program is based on two approaches: repayable and nonrepayable. The nonrepayable approach is being used to finance infrastructure for SEZs and IZs, including allocations from the National Fund, and to finance SEZ development and management. *Akimats* can

get financial contributions for (i) the setting of the terms of reference for IZs, and (ii) the development of infrastructure for IZs as envisaged by the Business Road Map 2020.

128. **Procurement.** There are no general preferences regarding government procurement, except for the PIT. According to the procurement rules of Samruk-Kazyna, the tender documents provide mandatory criteria for the evaluation and comparison of bids of potential suppliers participating in the tender. For example, the potential supplier must be a member of the PIT SEZ and must deliver goods and provide services relating to the priority activities corresponding to the objectives of the PIT.

129. **Land issues.** According to its latest amendments, the Law “On Special Economic Zones in the Republic of Kazakhstan” allows the creation of SEZs not only on state-owned land, but also on land that is privately owned by citizens and/or non-state entities. Private landowners may transfer land to the SEZ's management company for temporary compensated use (rent) in accordance with their contracts.

130. A company based in a SEZ can get a free plot of land for the entire period of the SEZ's existence, with the right to purchase after the expiry of the SEZ regime. IZ members can lease land for up to 49 years, with a right to purchase afterward. These rights may have negative consequences because they provide an incentive for members to ask for more land than they need as a form of speculation in industrial real estate. As a result, valuable industrial land could remain unused for years.

4. Linkages to the Domestic Economy

131. Most of the products and services of SEZs and IZs are sold in the domestic market. Linkages between SEZ-or industrial zone-based companies and the domestic economy depend on the particular activities of the SEZs and IZs. The Astana–New City SEZ, for example, was involved in the construction of the city of Astana. The PIT conducts competitions for start-ups owned by youths and university students, and helps develop projects for local companies and banks

¹¹⁴ This is based on data from the National Entrepreneur Chamber Atameken Union.

¹¹⁵ Results of development of IZ in regions. MNE, 14 June 2016.

to further broaden the linkages between SEZ and IZ members and the domestic market.

5. Streamlined Procedures and Regulations

132. Every SEZ has a state revenue committee within the Ministry of Finance to deal with customs and tax issues. Companies in the SEZs can invite foreign workers without requiring work permits. There is simplified visa regime for citizens of 19 countries. The investor service centers in each region provide public services to investors.

6. Eligible Activities

133. The eligible activities are listed in every decree establishing a SEZ. Investment projects in SEZs and IZs are mostly focused on manufacturing. The lists of eligible activities were expanded for most SEZs by the Resolution of the Government No. 10, dated 20 January 2017 (Table 4).¹¹⁶

7. Management Companies

134. The government is keen to bring in experienced international companies to manage SEZs, as exemplified by DP World's consulting work for Khorgos-East Gate. Apart from this one instance, however, there has been little progress in attracting private management companies to SEZs and IZs. In the case of IZs, local authorities do not want to lose control over these zones' operations.

135. The Law "On Special Economic Zones" foresees the following sources of funding for the management companies of SEZs:

- (i) payment by the SEZ participants for the services provided by the management company;
- (ii) targeted debt financing;
- (iii) proceeds from leases and/or subleases of infrastructure facilities, plots of land, and other property;
- (iv) funding contributed as statutory capital; and
- (v) other proceeds from activities of the management company not prohibited under the national laws.

136. The most reliable source of financing for management companies at this stage is the funding contributed as statutory capital by the central or local governments, as well as by Samruk-Kazyna, which receives money from the National Fund. The management company of the PIT, Autonomous Cluster Fund "Almaty Tech Garden," is financed by MID. The national budget allocated T4 billion to the PIT in 2016, but the PIT is also funded by a compulsory 1% levy on the revenues of subsoil users, which goes to research and development (R&D). MID reported that it had accumulated T900 million from subsoil users in 2016. In addition, management companies are trying to generate their own revenues by supplying utilities (electricity, gas, water, logistical services) at competitive rates to SEZ members.

8. Environmental and Labor Standards

137. The decrees of the President of the Republic of Kazakhstan establishing the SEZs contain the stipulation that the "implementation of the SEZ activity regarding environmental regulation is carried out in compliance with environmental legislation of the Republic of Kazakhstan and is based on a rational and efficient use of natural resources through the creation of conditions for the transition to sustainable development and environmental protection based on a balance of economic, social, and environmental aspects of quality of life." There is no special requirement regarding labor standards. All companies based in SEZs and IZs have to follow the Labor Code and other legislation concerning labor rights and conditions.

9. Conditions Attached to Residence

138. A legal (including foreign) entity that plans to implement projects in a SEZ has to be a resident of that SEZ. The following types of legal entities are excluded from SEZ membership:

- (i) subsoil users;
- (ii) organizations producing excisable goods, except those engaged in the production and assembly of excisable goods under subparagraph 6 of Article 279 of the Tax Code of 10 December 2008;¹¹⁷

¹¹⁶ The Resolution of the Government of the Republic of Kazakhstan "On approval of the lists of priority activities of SEZ and facilities, the construction of which is intended for the implementation of priority activities of SEZ, as well as the Rules for including priority activities in the list of priority activities of SEZ and construction sites in the list of facilities for which the protection is intended for the implementation of priority activities of SEZ" dated 20 January 2017, No. 10.

¹¹⁷ Code of the Republic of Kazakhstan "On Taxes and Other Obligatory Payments to the Budget," dated 10 December 2008, No. 99-IV.

- (iii) organizations applying special tax regimes;
- (iv) organizations that apply (or have applied) investment tax preferences before the enactment of the Tax Code of 10 December 2008;
- (v) organizations that implement priority investment projects and strategic investment projects under national laws on investments; and
- (vi) organizers of gambling activities.

139. Every decree establishing a SEZ contains local content requirements. The term “Kazakhstan content” refers to the proportion of goods and services that are of Kazakh origin; purchased from Kazakhstan companies; and specified in investment contracts, subsoil usage contracts, or the law. “Kazakhstan content” also refers to the percentage of Kazakh employees that should be employed in a project. The Kazakhstan content requirements are divided into three categories:

- (i) for subsoil usage operations;
- (ii) for procurements by state authorities, state institutions, and legal entities in which the state owns 50% or more of the shares, and their affiliates; and
- (iii) for procurements by companies affiliated with Samruk-Kazyna.

D. Priority Investment Projects and Strategic Investment Projects

140. The advantages of operating in a SEZ are not entirely obvious, especially given that non-SEZ companies that sign contracts for priority investment projects or for strategic investment projects can also benefit from tax exemptions (Table 5).

1. Priority Investment Projects

141. Companies implementing a project included in the List of Priority Activities approved by the government enjoy tax and nontax preferences. In order to qualify for tax and other preferences, a company must (i) be newly established (not more than 2 years old), (ii) have signed an investment contract, and (iii) provide investments in the amount not less than the T2 million monthly calculation index established by the Law on Republican budget and

valid on the date of application for investment preferences. The monthly calculation index is an index used in Kazakhstan to determine social allowances, penalties, and taxes and other payments to the government budget. It is approved by the Law “On the Republican Budget” each year.

142. A company can get an exemption for duties on imports of equipment and spare parts associated with the implementation of the investment contract over a period of 5 years (Entrepreneurship Code, article 287). An exemption can be obtained from the CIT, land tax, and land utilization tax for 10 years, and from the property tax for 8 years.

143. Companies can receive financial contributions from the government in the form of investment subsidies of up to 30% of the costs of construction, installation, and procurement of equipment (excluding the VAT and excise duties). The government can also provide state grants of up to 30% for land, buildings, machinery and equipment, computers, instruments for measurement and control, vehicles (except passenger cars), and industrial furniture. There are also nonfinancial contributions, such as free land, for up to 10 years.

144. Companies can use a “one-stop-shop” to deal with matters concerning investors’ questions for the Committee on Investments (under MID), the simplified visa regime, and work permits for foreign employees.

2. Strategic Investment Projects

145. In order to qualify for tax and other preferences, a company’s investment must be (i) included in the list of strategic investment projects approved by government, and (ii) the company must have concluded an investment contract before 1 January 2015. Resolution No. 1293 (dated 1 September 2009) of the Government of the Republic of Kazakhstan approved the list of Strategic Investment Projects.

146. Companies implementing a strategic investment project receive an exemption from the CIT for 10 years. The provisions apply if the supplementary agreement to the investment contract for a strategic investment project provides a reduction in the CIT by 100%. There is also a zero rate for the property tax, land tax, and land utilization tax.

Chapter V. Evidence concerning the Effectiveness of Special Economic Zones and Industrial Zones

A. Theoretical Observations concerning the Effectiveness of Incentives

147. As mentioned earlier, tax and nontax incentives have traditionally been among the main instruments of industrial policy in Asia, including in various types of economic zones. In particular, tax incentives—including reduced corporate income tax (CIT) rates (if not complete tax holidays) and adjustments to the tax base (including accelerated depreciation allowances and investment tax credits)—have been widely used to attract foreign direct investment (FDI), especially from export-oriented multinational enterprises.¹¹⁸ They have also been used to boost the domestic production of goods and services in certain sectors (such as agriculture, manufacturing, and various services) and activities (such as research and development [R&D]). Not surprisingly, therefore, tax incentives are also among the most prominent features of Kazakhstan's special economic zones (SEZs) and IZs, even though there is little convincing evidence that such incentives are sufficiently cost-effective to justify their use.¹¹⁹

148. While taxation may not necessarily be one of the main determinants of investors' decisions (the overall investment climate is much more important), it would be surprising if it did not have at least some influence

on those decisions.¹²⁰ Nonetheless, the experience of countries that do evaluate tax incentives indicates that they are rarely cost-effective, irrespective of whether or not they are consistent with World Trade Organization (WTO) and Eurasian Economic Union (EAEU) rules. Indeed, as pointed out in Chapter II, most econometric studies show that forgone tax revenues exceed the increase in investment induced by tax incentives. Moreover, tax incentives run the risk of subsidizing good investments that might have been undertaken anyway. They also run the risk of turning intrinsically bad investments into profitable ones, thereby distorting the allocation of resources and causing deadweight losses, to the detriment of total factor productivity (TFP). In addition, administrative discretion in managing incentives can increase the risk of rent-seeking and corruption. And there is strong evidence that casts doubt on the effectiveness of certain tax incentives for investments in free trade zones due to the lack of transparency, the unclear provisions, and to issues regarding the administration and governance of tax incentives.¹²¹

149. Although still widely used in Central Asia and elsewhere, tax holidays are regarded as a particularly ineffective type of tax incentive compared with tax credits,¹²² or compared with accelerated depreciation

¹¹⁸ In the PRC, for example, "foreign-invested enterprises" exporting at least 70% of their output have, until recently, qualified for a 50% income tax reduction (or possibly more if they were located in special zones) and a full refund of the income tax paid on the amount of their profits that they reinvested in export-oriented businesses (for at least 5 consecutive years).

¹¹⁹ Other than the issue of transparency, one of the reasons that assistance delivered via the tax system is often preferred is that it can be made contingent upon the recipient enterprise being profit-making. However, unless they are refundable, tax incentives may be of little use to start-ups or fast-growing companies that are in a nontaxpaying position, due to their high investments in relation to income.

¹²⁰ A range of econometric studies and survey data since the 1980s show that incentives are only one among many determinants of investment decisions (see Box 3).

Incentives seem to influence the choice of location more *within* regional groupings, such as the Association of Southeast Asian Nations (ASEAN). (See: World Bank. 2007. *An East Asian Renaissance*. Washington, DC. p. 181.). While empirical evidence suggests that taxes matter for investments, including FDIs, this is less likely to be the case in developing countries. One reason could be that many low-income countries do not offer attractive general investment conditions for domestic or most multinational companies; this may be due, for instance, to deficient legislation, weak governance or judicial systems, unclear property rights, onerous regulations, macroeconomic instability, and poor infrastructure. In such circumstances, tax incentives do not effectively counterbalance such poor conditions, and so are largely ineffective. (See: T. Kinda. 2014. *The Quest for Non-Resource-Based FDI: Do Taxes Matter?* IMF Working Paper No. 14/15. Washington, DC: IMF.) At the same time, however, tax incentives might be one of the few (albeit second-best) instruments available to low-income countries for offsetting their disadvantaged circumstances, mitigating market failure (such as lack of financial access), and addressing regional disparities.

¹²¹ Organisation for Economic Co-operation and Development (OECD). Tax and Development. <https://www.oecd.org/tax/tax-global/transparency-and-governance-principles.pdf>.

¹²² Such credits could be refundable in the case of start-ups, as these often have negative profits, so they would not immediately benefit from tax credits that could only be used against a positive tax liability. A tax credit that is refunded if there is a negative tax liability would be more effective for them. Thirteen advanced economies use refundable R&D tax incentives—sometimes only for small and medium-sized enterprises. Tax incentives for R&D can also be used to provide relief from labor taxes, such as payroll taxes or employer social contributions. Firms benefit from those incentives whether or not they report positive taxable income. Belgium, France, Hungary, the Netherlands, and Spain provide such tax relief. See: IMF. 2016. *Fiscal Monitor: Acting Now, Acting Together*. Washington, DC. p. 36. <https://www.imf.org/external/pubs/ft/fm/2016/01/pdf/fm1601.pdf>.

allowances for investment.¹²³ In the absence of any credible empirical evidence to the contrary, therefore, the use of tax and nontax incentives in SEZs and IZs (or indeed, as an instrument of economic policy under Kazakhstan's broad economic development strategy) should be avoided.¹²⁴ Indeed, Kazakhstan's statutory corporate tax rate of 20% is pretty much in line with all of its EAEU partners' rates except the Kyrgyz Republic, whose rate is 10%, and not much higher than the "business-friendly" CIT rates of Hong Kong, China (16.5%) and Singapore (17%), each of whose entire territory is arguably a free trade zone (Figure 5).¹²⁵ In the long run, a low corporate tax rate and a broad tax base are thought to be more conducive to investment and an efficient allocation of domestic resources, and, therefore, to TFP.¹²⁶

150. International double taxation of income from capital is unlikely to be conducive to foreign investment, or to the transfer of associated

technologies and managerial know-how. It occurs most obviously when income from cross-border investments is taxed both in the country where the investment is made (the "source" country) and the country where the investor resides (the "residence" country). Bilateral tax treaties—based largely on the "model" of the Organisation for Economic Co-operation and Development (OECD)—number some 3,600 worldwide; they are designed to reduce, if not eliminate, international double taxation. Kazakhstan has signed tax treaties with 49 countries, including the Netherlands, the United States, France, Japan, the People's Republic of China (PRC), and the Russian Federation, which have been its main sources of FDI in 2015 (Figure 6).

151. Tax holidays and tax rate reductions may be used to encourage foreign investment,¹²⁷ particularly from countries that tax income from capital on a

¹²³ Tax holidays, such as those granted by the Kazakhstan government, are a particularly pernicious tax incentive because they offer tax breaks often far in excess of what is needed to induce investment; they also encourage transfer pricing, attract only short-term projects, are frequently extended, and their costs and benefits are difficult to measure. Reduced tax rates have many of these drawbacks in a milder form, except for the last. As companies benefiting from reduced rates must file tax returns, the revenue costs of this policy are at least transparent. Accelerated depreciation and investment allowances or credits, in contrast, are better targeted to increasing investment than are tax holidays or reduced rates, which alleviate taxes on economic rents as well. For example, see: H. H. Zee, J. G. Stotsky, and E. Ley. 2002. Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries. *World Development*. 30 (9). pp. 1497–1516.

However, more recent research exploring the continued popularity of tax holidays and reduced tax rates has illuminated why they may work better than accelerated depreciation or investment allowances or credits in attracting FDI in certain cases. The possession by the Ministry of National Economy of exclusive technologies enables them to earn substantial rents, so they are less sensitive to investment allowances than to the statutory CIT rate. Reduced CIT rates and/or tax holidays are thus possibly a more effective inducement for FDI than accelerated depreciation, especially for international mobile investment. Under such circumstances, a reduced flat CIT rate may be superior to a tax holiday at inducing investment, as the latter imposes a rising effective tax rate on investment when it expires. In order to attract FDI that does not exploit locational rents, host countries may find that the best policy is to offer a permanently reduced CIT rate. With respect to investment expansion, a reduced CIT rate also has the benefit of not requiring separate accounting, as is the case with newly initiated tax holidays. Compared with tax holidays, a reduced flat rate also facilitates the estimation of tax expenditures due to tax incentives, and is therefore more transparent. See: A. D. Klemm. 2009. Effective Average Tax Rates for Permanent Investment. IMF Working Paper 08/56. Washington, DC: IMF.

¹²⁴ This applies even in the case of R&D. A study by Australia's Productivity Commission found that the general tax concession for R&D acted mainly as a "reward" for research that firms would have undertaken anyway, rather than stimulating much additional research. See: Government of Australia, Productivity Commission. 2007. *Public Support for Science and Innovation*. Research Report. Canberra. <http://www.pc.gov.au/inquiries/completed/science/report/scienceoverview.pdf>.

On the other hand, in comparison with tax incentives that apply to all R&D expenses, incremental incentives (above some baseline amount) tend to be cheaper because they avoid any windfall gains for existing R&D below the baseline. Such incremental schemes are used by Italy, Japan, the Republic of Korea, Portugal, Spain, and the United States. However, incremental incentives can be more complex, and may influence the timing of R&D investments. They also have higher compliance costs as a percentage of total support, which can reduce take-up. Some countries have therefore moved away from incremental schemes or have simplified them. See: IMF. 2016. *Fiscal Monitor: Acting Now, Acting Together*. Washington, DC. p. 36. <https://www.imf.org/external/pubs/ft/fm/2016/01/pdf/fm1601.pdf>.

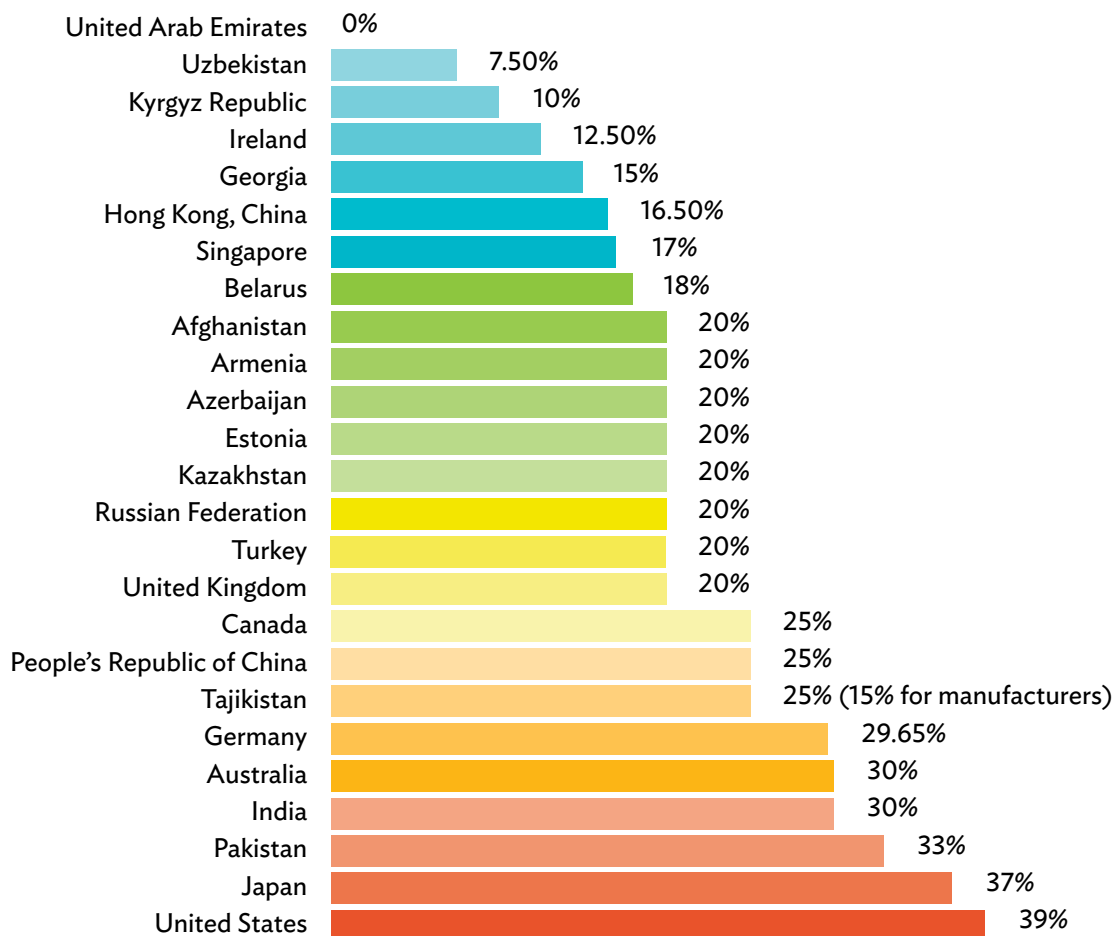
¹²⁵ EY (this refers to one or more of the member firms of Ernst & Young Global Limited). 2015. *Worldwide Corporate Tax Guide: 2015*. London: EYGM Limited. [http://www.ey.com/Publication/vwLUAssets/Worldwide_corporate_tax_guide_2015/\\$FILE/Worldwide%20Corporate%20Tax%20Guide%202015.pdf](http://www.ey.com/Publication/vwLUAssets/Worldwide_corporate_tax_guide_2015/$FILE/Worldwide%20Corporate%20Tax%20Guide%202015.pdf).

Regarding other CAREC members, Mongolia's corporate tax system is progressive, with an annual taxable income of up to MNT3 billion, subject to taxation at a rate of 10%, with taxable profits in excess of this amount taxed at a rate of 25%. In Turkmenistan, whereas legal entities are subject to a CIT rate of 8% (or 2% in cases where the company qualifies as a small or medium-sized enterprise), branches of foreign legal entities, as well as companies involved in oil and gas operations, are subject to a rate of 20%, irrespective of the company's legal status or ownership structure. See: PWC. *Worldwide Tax Summaries*. <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Turkmenistan-Corporate-Taxes-on-corporate-income>.

¹²⁶ During a 2015 Ernst & Young event attended by European tax directors, 92% said that they would prefer a low tax rate and low use of incentives, as opposed to a high tax rate and high use of incentives.

¹²⁷ In the PRC, for example, foreign-invested enterprises have been subject to a 15% corporate tax rate for 3 years following a 2-year tax holiday, instead of the standard 33% rate applied to purely domestic firms, thus according the foreign-invested enterprises better treatment than Kyrgyz companies.

Figure 5: Headline Corporate Tax Rates, 2015



Source: EY. 2015. Worldwide Corporate Tax Guide 2015. [http://www.ey.com/Publication/vwLUAssets/Worldwide_corporate_tax_guide_2015/\\$FILE/Worldwide%20Corporate%20Tax%20Guide%202015.pdf](http://www.ey.com/Publication/vwLUAssets/Worldwide_corporate_tax_guide_2015/$FILE/Worldwide%20Corporate%20Tax%20Guide%202015.pdf).

“source” or “territorial” basis.¹²⁸ But if the capital importing (“source”) country has a treaty with the country in which the foreign investor resides, to the extent that the capital-exporting country taxes income from capital on a “residence” (or “worldwide”) basis,¹²⁹ as in the cases of the PRC, the Republic of Korea, the Russian Federation and the United States, for example, with whom Kazakhstan

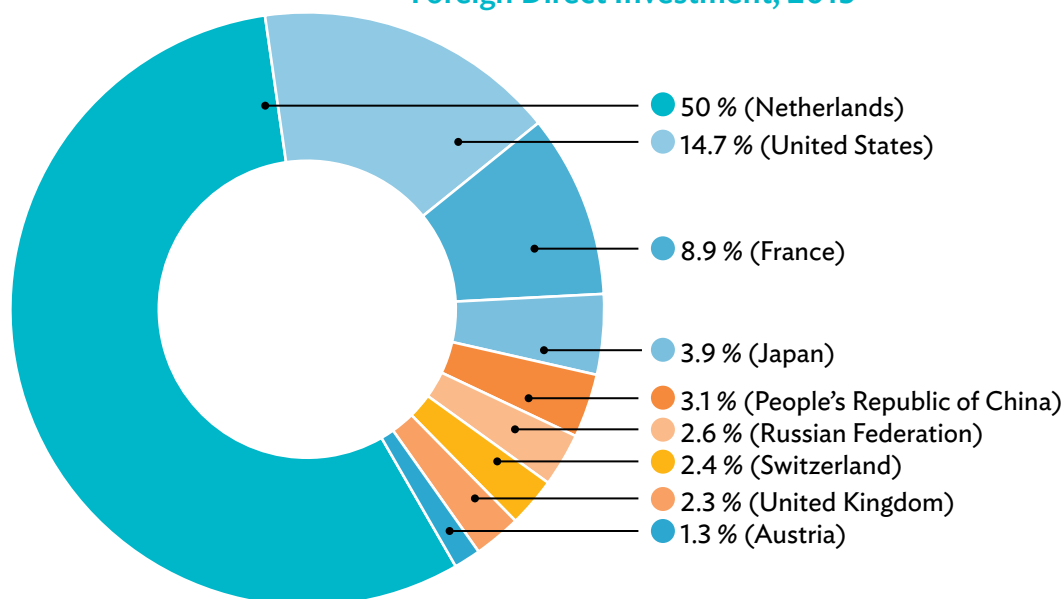
does have tax treaties, tax incentives accorded by capital-importing countries, such as Kazakhstan, may be ineffective. In these cases, the incentives merely result in a transfer from the state treasury of Kazakhstan to that of the capital-exporting country (Box 3), unless the treaty contains “tax sparing” provisions.¹³⁰ This situation does not arise if the capital-exporting country taxes income from capital

¹²⁸ Taxation on a “source” (or “territorial”) basis reflects the principle of capital import neutrality; that is, direct taxation should not influence who invests in a particular country. Capital import neutrality is therefore concerned with “competitive” neutrality. Few, if any, countries have a tax system based purely on the “source” (or “residence”) principle.

¹²⁹ Such taxation reflects the principle of capital export neutrality; that is, direct taxation ought not to influence the decisions of businesses or individuals residing in a country as to where to invest. It thus reduces the threat of tax competition for FDI among different locations. Capital export neutrality is thus concerned with “locational” neutrality, thus reducing the threat of tax competition among different jurisdictions for FDI. This is accomplished by ensuring that the same total amount of domestic and foreign taxes is paid on an identical investment, irrespective of the country in which that investment is undertaken or the amount of taxes levied by the foreign country.

¹³⁰ “Tax sparing” is a means of ensuring that the relief associated with tax incentives offered by developing countries to foreign investors is not offset by taxation in those investors’ country of residence owing to the latter’s use of the credit method for relieving international double taxation. The PRC, for example, generally insists on the inclusion of tax-sparing provisions in its tax treaties with developed countries. The only notable exception is the one with the US, which consistently refuses to grant such provisions to any country.

Figure 6: Countries' Shares of the Kazakhstan Stock of Inward Foreign Direct Investment, 2015



Source: International Monetary Fund. IMF Data Access to Macroeconomic & Financial Data. <http://data.imf.org/?sk=388DFA60-1D26-4ADE-B505-A05A558D9A42>.

on a “source” (or “territorial”) basis. Nor does it arise in the absence of a tax treaty between the capital-importing and capital-export country. In the case of the latter, tax incentives could reduce, if not remove, the obstacle to FDI posed by international double taxation. Tax incentives would be a second-best option, however, as they would have to respect the MFN principle, and would therefore be granted to treaty and non-treaty countries alike. Consequently, Kazakhstan would be well advised to negotiate tax treaties with all the countries that are potential sources of FDI, as such treaties mitigate, if not eliminate, international double taxation, and thus greatly facilitate an inward flow of FDI.¹³¹

152. Other countries in the region are using tax incentives, however, so it is understandable that Kazakhstan may feel compelled to compete with these countries for FDI by offering such incentives as well. National governments in Central Asia would be better off cooperating on a regional basis, so as to avoid a “race to the bottom” that would leave them collectively worse off, which is what would happen if they were to provide competing tax and nontax incentives to attract FDI. Besides, as pointed out above, Kazakhstan’s statutory CIT corporate tax rate is not out of line with international levels. Creating an environment that is more conducive to investment will involve much more than granting incentives whose cost-effectiveness is dubious.¹³²

¹³¹ These treaties should include not just “tax-sparing” provisions, but also most-favored-nation (MFN) provisions, whereby more generous relief from international double taxation negotiated by either party with a third country in a subsequent tax treaty are automatically extended to existing treaties.

¹³² The lack of carry-over of losses (with interest) for tax purposes constitutes a potential deterrent to investment, especially as far as start-up companies are concerned, and to the extent that interest rates are high. Such companies tend to have insufficient income to enable them to take advantage of tax provisions, including interest deductions and capital cost allowances (as well as incentives) associated with investment. Allowing a full carry-over of losses (including interest) is arguably not a tax incentive.

153. As mentioned earlier, however, the attractiveness of a country to FDI depends on much more than tax and nontax incentives. It also depends on the overall investment environment and on the extent to which tax revenues are spent by the

government in a cost-effective manner on essential “public goods,” including basic hard and soft infrastructure (outside as well as inside economic zones), and especially education, which is arguably the backbone of economic and social development.

Box 3: The Effectiveness of Tax Incentives in Attracting Foreign Direct Investment

Incentives for investment, most notably tax holidays, have long been widely used as instruments of industrial policy in Central and East Asia, as well as elsewhere. One of the main objectives of these incentives is to attract foreign direct investment (FDI), with a view to developing local industries that will be export-oriented. Although, without cost-benefit analysis, it is difficult to judge the extent to which incentives have actually attracted FDI, empirical evidence from economies elsewhere have provided grounds for doubting the effectiveness of such measures. In some instances the use of incentives may even be counterproductive.

In the first place, incentives are seldom among the main determinants of business decisions. This has been confirmed repeatedly by business surveys. Other determinants, which are usually more important, include the size of the domestic market and proximity to other markets; the availability of sufficiently skilled labor (or at least the available capacity to train workers) at competitive wage rates; labor market flexibility, including the ability to reduce the labor force or exit an industry without undue complications, the quality and reliability of essential infrastructure; protection of intellectual property rights; and a stable macroeconomic, political, and legal environment. The experiences of other countries with tax and nontax incentives suggest that the cost of such measures to the government (in terms of expenditure or tax revenue forgone) may exceed the investment generated. Moreover, it is difficult to determine the amount of *incremental* investment generated—that is, the amount of investment that would not have been made without the incentives.

Tax incentives for foreign multinational enterprises that are taxed in their home countries purely on a “residence” basis may have little, if any, effect on the incentive for those firms to invest in the country offering such relief. These incentives merely result in a transfer from the treasury of the capital-importing country offering the incentives to that of the capital-exporting country where the multinational enterprise is based. Such cuts would provide an effective incentive only insofar as (i) multinational enterprises are in an excess foreign credit position; (ii) taxes on repatriated income can be deferred; (iii) the multinational enterprise’s home country exempts foreign source income from domestic taxes; or (iv) if there is a treaty between the enterprise’s home country and the country where it has invested, and this treaty allows “tax sparing.”

To the extent that incentives do stimulate particular types of investment, they may result in a less efficient allocation of national resources than would be the case if the government had refrained from influencing private decisions. Any adverse effect of incentives on resource allocation would manifest itself as lower total factor productivity. The point that FDI should be assisted because it yields social benefits (externalities) that are not adequately taken into account by private investors appears to be overstated. Most benefits of FDI accrue privately, and hence do not need tax incentives. Moreover, it does not provide a justification for favoring foreign over domestic investment; and, as it is usually extremely difficult to measure such externalities precisely, there is always the likelihood that incentives will turn out to be excessive.

Tax incentives are usually expensive for the government, as they cause large losses in tax revenues. A tax system that features many special incentives is also much more susceptible to tax avoidance and evasion, which further contribute to losses in tax revenues. In this way, tax incentives tend to worsen the fiscal balance, reducing national savings and causing the deterioration of the current account.

continued on next page

Box 3 *continued*

Last, the use of investment incentives may provoke countermeasures by trading partners. Even when they do not contravene the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures, other countries may use them to justify countermeasures. In particular, countries may react by adopting incentives of their own, creating a beggar-thy-neighbor situation. The resulting “incentives race” and “incentives shopping” tends to be harmful to all countries concerned. It is also likely to disadvantage developing countries that need tax revenues to finance their essential developmental needs.

Instead of offering incentives to attract FDI, governments might instead focus on removing existing impediments to investment. Countries often have a mix of policies that simultaneously impede and encourage FDI. Rationalizing these policies to remove impediments is likely to be the best approach.

The most efficient means of removing the obstacle to FDI created by the international double taxation of profits earned by foreign companies would be for each capital-importing country to expand its network of double taxation treaties, focusing on the countries in which many of their foreign investors reside. The development of such a network would eliminate the need for tax incentives (especially tax holidays), and would be a more effective way to attract FDI.

Source: M. Daly. 2011. Evolution of Asia's Outward-Looking Economic Policies: Some Lessons from Trade Policy Reviews. *WTO Staff Working Papers*. No. ERSD-2011-12. Geneva: WTO. https://www.wto.org/english/res_e/reser_e/ersd201112_e.htm.

B. Empirical Evidence from Kazakhstan

1. Some Key Numerical Indicators for the Economic Performance of Special Economic Zones

154. Whereas the SEZs of Astana–New City, Aktau Seaport (essentially a trade and logistics SEZ), and the Park of Innovative Technologies (PIT) have arguably met with some success, with the first two accounting for most of the goods produced in Kazakhstan's 10 SEZs, it would appear that the other 7 have yet to take off. Judging from the most recent comprehensive data available (for 2015), which may or may not be reliable, these three SEZs, as well as Saryarka SEZ, have been relatively successful. For example, they have more or less achieved their targets concerning production, investment (including FDI), and employment. Targets relating to these economic performance indicators are used by all the SEZs, although the exact numerical targets

obviously differ. Saryarka has also achieved its targets regarding production, investment (including FDI), and employment. Whereas FDI accounted for over half of the total investment in Aktau Seaport and Saryarka, however, it was a mere 6% of total investment in Astana–New City.¹³³ And though the PIT has exceeded its target for investment, it has apparently attracted no FDI at all. It is worth noting that FDI is a potentially major source of technological progress, and thus of TFP. Burabay SEZ has also achieved its targets regarding production, investment, and employment; but it, too, has attracted little FDI, thus failing to meet that particular target.

155. Ontustik exceeded its export and production targets, as well as its modest FDI targets, but failed to reach its employment and overall investment targets. The remaining four SEZs have, by and large, failed to meet their targets. However, the National Industrial Petrochemical Park and Pavlodar SEZs have substantially exceeded their employment targets.

¹³³ More recent data suggest that most of the investment in Seaport Aktau in 2016 involved FDI.

Table 6: Key Numerical Indicators of Special Economic Zones' Economic Performance, Actual to 31 December 2015

	SEZ Astana- New City	SEZ Sea Port Aktau	SEZ Burabay	SEZ Khorgos - East Gate	SEZ National Industrial Park	SEZ Saryarka	SEZ Chemical Park Taraz	SEZ Pavlodar	SEZ Park of Innovation Technologies	SEZ Ontustik	Total
Total Investment (T billion)											
target to 2015	1,170.2	26.5	5.0	211.11	567.0	7.0	82.5	67.4	7.0	32.8	2,176.51
actual to 31 Dec 2015	1,826.0	55.8	14,329	28.00	154.00	11.50	3.00	42.6	18.35	27.8	2,181.38
Including FDI target to 2015	101.6	9.16	2.50	1,946	58.05	4.9	41.2	12.5	0	2.3	234.16
Including FDI, actual to 31 Dec 2015	113.0	36.70	1,978	0	15.20	6.8	0	0.85	0	4.60	1,79.13
Including internal investment, target to 2015	1,068.4	17.34	2.5	209.16	508.95	2.10	41.20	54.9	7.0	30.5	1,942.05
Including internal investment, actual to 31 Dec 2015	1,713.0	19.10	12.35	28.0	138.80	4.7	3.00	41.75	18.35	23.20	2,002.25
	233.0 (differs from Decree - 58.2)	239.2	6,512	0	178.27	5.84	0	5.0	16.	9.8	693.63
Production, target to 2015											
Production, actual to 31 Dec 2015	545.3	229.00	24,794	0.088	0.158	9.6	0	4.3	73.10	14.6	900.94
Number of participants											
target to 2015	41	36	1	12	5	8	7	5	65	7	187
actual to 31 Dec 2015	94	30	3	68	14	9	5	6	155	10	394
Number of jobs											
target to 2015	2,650	1,164	1,970	7,200	264	500	172	500	1,688	3,000	1,9108

continued on next page

Table 6 continued

	SEZ Astana- New City	SEZ Sea Port Aktau	SEZ Borabay	SEZ Khorgos - East Gate	SEZ National Industrial Park	SEZ Saryarka	SEZ Chemical Park Taraz	SEZ Pavlodar	SEZ Park of Innovation Technologies	SEZ Ontustik	Total
actual to 31 Dec 2015	3,011	955	2,155	117	397	532	47	904	2,387	2,145	12,650
Share of export of production											
target to 2015	n/a	n/a	n/a	n/a	n/a	n/a	0	10	n/a	50	n/a
actual to 31 Dec 2015	n/a	n/a	n/a	n/a	n/a	n/a	0	10	n/a	55.0	n/a
Local Content											
		50% to 2017			30% to 2017	18% to 2015	0% to 2015				
target to 2015	35% to 2015	50% to 2015	100% to 2015	75% to 2015	18% to 2015			50% to 2015	50% to 2015	70% to 2015	n/a
actual to 31 Dec 2015	58.0%	85%	100%	100%	74.8%	66.3%	0	80%	50%	67.2%	n/a

FDI = foreign direct investment, n/a = not applicable, SEZ = special economic zone.

Source: Kazakh Invest.

156. Interestingly, all the SEZs except the Taraz Chemical Park have local-content targets (if not requirements) aimed at encouraging import substitution, ranging from 18% to 100%, which have largely been met, and in six cases considerably exceeded.

157. There are also some targets specific to the Astana and PIT SEZs. In the case of Astana, the target of 8% concerning the level of innovative activity of enterprises in the city of Astana has apparently been achieved. However, as regards the PIT's target involving the establishment of four scientific research laboratories and educational departments in the field of information and communication technology, it would appear that none of these has yet been established.¹³⁴

2. Export Performance and Linkages to the Domestic Economy

158. While only limited data are available regarding exports from the SEZs, considering that Astana–New City accounts for more than half of the SEZs' total production, and that it is oriented entirely toward the domestic market, it would appear that the 10 SEZs' overall share of Kazakhstan's exports is merely 0.08%. The much smaller amount of production in the PIT is also oriented largely toward the domestic market. However, regarding the only two SEZs for which some export data are available, Ontustik, one of the SEZs visited by the ADB team, exported 55% of its production, slightly more than its target of 50%, while Pavlodar exported 10%, which was the target.

159. One of the reasons for this orientation toward the domestic market is Kazakhstan's relatively low TFP and slow rate of TFP growth, owing to a lack of technical progress, as mentioned in Chapter I. This constitutes a major systemic impediment to the international competitiveness of the country's non-hydrocarbon exports. Hence, Kazakh firms may have little choice but to sell their products in the domestic market.

160. Another reason for the strong orientation of the SEZs toward the domestic market may be the various tax preferences that enterprises have enjoyed in these zones (see Table 5). While these tax preferences can facilitate production efficiency and thus improve these enterprises' international competitiveness, they can also place domestic producers operating outside the SEZs at a significant competitive disadvantage compared to those operating inside the FEZ, unless goods produced in the zones and sold in the domestic market are subject to the same tariffs and internal taxes. This competitive disadvantage arises insofar as firms operating in the zones maintain part of their preferential tax treatment when producing for the domestic market, both implicitly (because payment of some taxes may be deferred until the goods are "imported into the Kazakhstan's customs territory," thus improving cash flow)¹³⁵ and explicitly (because some taxes are not paid at all).

161. More specifically, while goods produced by companies in SEZs and sold in the domestic market are, in principle, currently subject to import tariffs and value-added tax (VAT), companies operating in the SEZs are exempt from the corporate income tax (CIT) and from property and land taxes. These exemptions put non-SEZ firms in the domestic market at a competitive disadvantage, so it follows that firms supplying the domestic market from inside and outside the zones should, as much as possible, be placed on a similar tax footing. This would involve ensuring not only that, upon entry into the domestic market, goods produced in the SEZs are subject to the same tariffs and VAT as goods produced and sold in the domestic market, but also the same CIT and other taxes. (SEZ firms would still enjoy the cash flow advantage arising from the deferral of tariff and VAT payments, however.) A unified CIT would place producers inside and outside the SEZs on an equal tax footing. It would also reduce the potential loss of corporate tax revenues owing to "creative" accounting practices by companies aimed at shifting profits from operations outside the zones (where the tax rate is

¹³⁴ In February 2016, however, the PIT together with Eltex Alatau, and the University of Turan signed an agreement on the establishment of an educational and training center, namely "Turan Alatau" <http://www.turan-edu.kz/en/novosti/podpisano-soglashenie-osozdani-uchebnoprakticheskogo-centra-turanalatau-na-baze-specialnoy-ekonomicheskoy-zony-park-innovacionnyh-tehnologiy/>. Kazakhtelecom is already building a new information technology center in the PIT, and the Oil and Gas Institute, Kazakh-British Technical University, and the International Institute of Information Technologies have also started to build new research facilities there. In addition, the Alatau PIT has negotiated a memorandum of cooperation with all national technical universities in Almaty to find new ideas from students and young scientists. In 2012, this led to three new patent applications from the International Institute of Information Technologies.

¹³⁵ The value of deferral is directly related to the import tariff rate (and interest rate, which, in the case of the central bank's main policy rate, is currently 10.5%).

20%) to those inside the zones (where the tax rate is zero), unless such practices can be prevented by prohibiting companies from structuring their group so as to operate both inside and outside the zones, as is currently the case in Kazakhstan.¹³⁶ This would help to ensure that SEZs are not used as tax avoidance, if not evasion, devices, as in India, for example (see case study in Chapter VI). Needless to say, any curtailment of the existing tax preferences offered to firms producing in the SEZs would tend to reduce the zones' attractiveness.

162. Firms operating outside the SEZs, but wishing to integrate their operations into the global value chains (and thus benefit from technology and other spillovers) of firms producing goods within the zone for export should be eligible for the same full and prompt tariff drawbacks and rebates of indirect internal taxes on their sales of good to firms inside the zones as if they were exporting themselves,¹³⁷ provided leakages from the zones back into the domestic market can be contained. Otherwise, intermediate goods produced by firms outside the SEZs will be more expensive than those imported into the zones from abroad (insofar as tariffs and VAT are shifted forward), thereby deterring purchases by SEZ enterprises from firms located in the domestic market. Such eligibility, which is consistent with WTO rules, would be particularly beneficial to small and medium-sized enterprises and facilitate the formation of clusters around the zone. The importance of tariff drawbacks is bound to increase owing to the rise in the average applied most-favored-nation (MFN) tariff rate from 5.9% in 2009 to 6.9% in 2016 as a consequence of Kazakhstan's adoption of the EAEU's common external tariff (CET), which is expected to reach 8.4% by 2020.

163. The SEZs' orientation toward the domestic market may also be partly due to local-content requirements aimed at encouraging import substitution. In fact, all the SEZs except Taraz Chemical Park do have local-content targets, ranging

from 18% to 100%. These targets have mostly been met, and in six cases considerably exceeded. Although it is unclear how the SEZs reached their targets, it may have been due to tax relief and other forms of financial assistance contingent on adherence to these local-content targets (as noted in Chapter III). But such financial assistance may be considered prohibited subsidies under the WTO and EAEU rules. In accordance with WTO rules, these requirements were supposed to end as of 1 January 2017.

164. Although there is no empirical evidence concerning the interaction between trade and economic performance in Kazakhstan, such evidence from other countries suggests that the lack of export orientation of Kazakhstan enterprises is likely to be detrimental to productivity and thus to wages. Data from the United States, for example, show that export-intensive manufacturing industries report 51% higher TFP growth, as well as 17% higher average wages and value-added per worker compared with non-export-intensive manufacturing industries, which is consistent with the findings of academic research.¹³⁸ Similarly, workers employed in export-intensive services earn 15.5% more than those in non-export intensive services.¹³⁹ To the extent that Kazakhstan's domestic market is not large enough to allow competing producers to exploit economies of scale (which enables reductions in costs per unit of output), an orientation toward the domestic market constitutes an impediment to the improvement of TFP, and thus to international competitiveness. Membership of the EAEU will increase the size of the "internal" market to encompass all the member countries of the Eurasian Customs Union, thus making Kazakhstan more attractive to foreign investors.

3. Investment, Foreign Direct Investment, Employment, and Productivity

165. One of the main goals of the SEZs (and the IZs) is to attract new investment, especially FDI, along with

¹³⁶ More specifically, according to Kazakhstan's Tax Code, CIT holidays are conditional upon the absence of structural subdivisions outside the SEZs.

¹³⁷ It would appear that such tariff drawbacks and VAT refunds are, in any event, made neither promptly nor in full possibly owing to fiscal constraints (see American Chamber of Commerce in Kazakhstan. 2015. Improving Kazakhstan's Investment Climate: Top Ten Barriers to Foreign Investment. AmCham White Paper 2014–2015).

¹³⁸ Council of Economic Advisors. 2015. Economic Report of the President. February. p. 307. https://www.whitehouse.gov/sites/default/files/docs/cea_2015_erp_complete.pdf. This evidence is based on data from the United States Census Bureau's Foreign Trade Statistics matched to the NBER's Manufacturing Industry Database (Council of Economic Advisors. 2015. The Economic Benefits of US Trade. May. pp. 14–15).

¹³⁹ D. Riker. 2015. Export-Intensive Industries Pay More on Average: An Update. Office of Economics Research Note No. 2015-04A. Washington, DC: US International Trade Commission.

the associated transfer of technologies and managerial know-how, which are major sources of improvement in TFP. Indeed, FDI is the key to enabling the transition from an industrial-based to a knowledge-based economy. During 1994–2015, cumulative inflows of FDI into Kazakhstan amounted to more than in any other country in the Commonwealth of Independent States, except for Georgia (Table 7). However, most of this FDI is concentrated in the oil and gas sector. Manufacturing and services have both failed to attract much FDI. By 2015, total FDI for all 10 SEZs amounted to only 8% of overall investment, falling considerably short of the overall target (by one-third). For this reason, the SEZs have experienced little benefit from any associated spillovers.¹⁴⁰

166. The SEZs' lack of success in attracting inward FDI constitutes a potentially serious impediment to their long-term viability given that FDI is a major source, not just of capital, but of technological progress and management know-how, and therefore of TFP. As discussed earlier in this chapter, there are various reasons for the failure of SEZs to attract significant FDI, including local-content targets and the lack of management expertise and sufficiently skilled labor. Although great importance has been attached to skill- and technology-intensive SEZs, management expertise and technical and marketing skills are all in short supply, with many large investors relying on foreign workers to meet demand. In the case of Saryarka, where FDI has considerably exceeded its (modest) FDI target, one of the foreign investors is addressing the lack of skilled labor by sending local employees abroad to the parent company for training, in this way effecting a transfer of technological and other skills.

167. Interestingly, the same foreign company said that it was unable to sufficiently exploit economies

of scale, and another foreign company in Saryarka revealed that its actual production was only at 40% of the optimal level necessary to achieve economies of scale. In both cases, the inability to benefit from economies of scale has been an impediment to improved TFP, and thus to these subsidiary companies' competitiveness in both the domestic and export markets. As mentioned above, however, Kazakhstan's membership in the EAEU will increase the size of its "internal" market, and this will likely solve the problem for the foreign firms at Saryarka and the other SEZs.

168. At the end of 2015, it would appear that all 10 SEZs accounted for 12,650 jobs, well short of the target of 19,108. According to more recent data, however, the total number of jobs in the SEZs was 11,527 in 2016 (and 9,278 in 2015).

4. Growth, Productivity, and High-Wage Employment

169. As no data were available concerning wage differences inside and outside the SEZs, it was not possible to ascertain whether or not wages were relatively high in the zones. To the extent that the various features of Kazakhstan's SEZs, and of its IZs, do induce incremental investment, employees in the zones will have more capital to work with, labor productivity will rise in the enterprises concerned, and so will wages. However, incremental investment will not improve TFP unless it (i) results in increased technological progress and managerial know-how (as well as learning by doing), (ii) enables the achievement of economies of scale, or (iii) prompts a reallocation of domestic resources in accordance with Kazakhstan's comparative advantage (as reflected in TFP). Low and slow TFP growth means that, even if increased investment raises labor productivity,

¹⁴⁰ A study using firm-level data and national input-output tables from 17 Central Asian and Eastern European countries, including Kazakhstan, over the 2002–2005 period concerning the impact of FDI on the efficiency of domestic firms in the host country (i.e., spillovers) show that (i) backward spillovers (stemming from supplying a foreign firm in the host country or exporting to a foreign firm) are consistently positive; (ii) horizontal spillovers are mostly insignificant, but positive for older firms and firms in the service sector; and (iii) forward spillovers (from purchasing from foreign firms or importing) are also positive only for old and service sector firms. The study found no support for the hypothesis that spillovers are greater for FDI with more advanced technology. As regards whether spillovers vary with the firm's "absorptive capacity," the study found that (i) distance from the efficiency frontier tends to dampen horizontal spillovers in manufacturing and backward spillovers among old firms; and (ii) whereas firms with a larger share of university-educated workforce are more productive, they do not enjoy greater FDI spillovers than firms with less educated workers. FDI spillovers hence vary by sectors and types of firms. (See Y. Gorodnichenko, J. Svejnar, and K. Terrell. 2007. When Does FDI Have Positive Spillovers: Evidence from 17 Emerging Market Economies. IZA Discussion Paper No. 3079., <http://ftp.iza.org/dp3079.pdf>). There is also some evidence of backward and forward vertical FDI spillovers in the PRC's strategic industries, thereby enhancing productivity growth in these industries, and also that these are induced especially by tariff reductions (particularly those associated with the PRC's accession to the WTO) and corporate tax holidays (L. Du, A. Harrison, and G. Jefferson. 2014. FDI Spillovers and Industrial Policy: The Role of Tariffs and Tax Holidays. *World Development*. Elsevier. 64 (C). pp. 366–383).

the latter is achieved at the expense of capital productivity, and this would not be conducive to investment.

C. Empirical Evidence from Other Countries

170. Few econometric studies were found regarding the possible impact of SEZs on other countries' economic performance, especially their TFP. However, as discussed in Chapter VI, there is some evidence from Chinese municipalities suggesting that their SEZs increased their per capita FDI by 58% in the form of foreign-invested and export-oriented industrial enterprises, thereby increasing local workers' earnings, as well).¹⁴¹ Most of this inflow of FDI into Chinese SEZs was apparently new, rather than merely investment diverted from Chinese companies outside the SEZs. These SEZs also increased the municipalities' TFP growth by 0.6 of a percentage point.

171. Another source of possibly relevant empirical evidence is an ADB study in 2015 that used a dynamic gravity model of trade flows based on bilateral trade data concerning manufactured goods.¹⁴² It involved a random-effects generalized least squares regression analysis with various dummy variables, including those pertaining to SEZs regarding each of several countries—Bangladesh, Cambodia, the PRC, India, Kazakhstan, the Philippines, and Sri Lanka—for which data were available on a number of SEZs for 1990–2014. The ADB study showed that the presence of SEZs has had a slightly negative effect on exports globally, which suggests that many zones had not been performing well. However, the analysis appears to be somewhat contradictory (and provides no insights on causation or any theoretical explanations.¹⁴³ For example, while the regression results indicate that the

level of exports from Asian economies with SEZs was not significantly different from the levels of exports from economies without SEZs, they suggest that a 10% increase in the number of SEZs will raise an economy's manufacturing exports by 1.1%.

172. The regressions also suggest that the presence of an independent SEZ authority and a national law on SEZs both have a positive effect on exports. As far as Asian economies are concerned, those with an independent SEZ authority export 27% more than those that do not; and those with a SEZ law export 40% more than those without such a law. Although the regressions support the view that an independent SEZ or IZ authority might have a positive impact on exports, this remains to be seen, as there are as yet no export data specifically on these zones. Judging from discussions during the study with their management companies, two of Kazakhstan's SEZs that are independent, Ontustik and Taraz Chemical Park, apparently export more of their production than the other eight.

173. In addition, the regressions also show that Asian developing countries with SEZs have 82.4% more FDI than Asian developing countries without SEZs.

174. Given the limitations of the gravity model and the somewhat contradictory results of the regressions (regarding the impact of these zones on exports) in the ADB study, together with the lack of any data for Kazakhstan (especially regarding exports from the zones), it is not clear how relevant the empirical evidence summarized in this section really is for this diagnostic study. Besides, one size does not necessarily fit all countries as far as the policy implications are concerned.

175. Another empirical study based on a gravity model of trade, in this case evaluating the impact

¹⁴¹ D. Riker. 2013. The Economic Impact of Special Economic Zones: Evidence from Chinese Municipalities. *Journal of Development Economics*. 101 (C). pp. 133–147.

¹⁴² ADB. 2015. Special Chapter: How Can Special Economic Zones Catalyze Economic Development? In ADB. *Asian Economic Integration Report 2015: How Can Special Economic Zones Catalyze Economic Development*. Manila. <https://www.adb.org/sites/default/files/publication/177205/asian-economic-integration-report-2015.pdf>.

¹⁴³ The gravity model attempts to explain trade patterns in terms of geography and the size of markets. It reflects the reality that large countries trade more, but that small ones appear more open, and that distance and borders impede trade, given relative country sizes. The model can also explain multi-country interactions; that is, the more country A trades with country B, the less is left over for trade with country C. Frictions between B and C thus affect A's trade with either B or C. However, the gravity model does not have any economic theory underlying it, and therefore can provide no explanation. See: J. E. Anderson. 2010. The Gravity Model. *NBER Working Paper Series*. No. 16576. Cambridge, MA. <http://www.nber.org/papers/w16576.pdf>; NBER. 2016. *Trade, Slides, and Friction: The Gravity Model*. Boston, MA: Boston College and NBER. <https://www2.bc.edu/~anderson/GravitySlides.pdf>.

of free-trade zones (FTZs), used trade data from 122 countries (not including Kazakhstan). The study suggested that the impact of FTZs on imports is greater and more robust than their impact on exports.¹⁴⁴ It also suggests that, regarding firms involved in global value chains (GVCs) that entail the importation of raw materials and components for processing before exporting them, FTZs in exporting countries increase trade by offsetting the negative impact of tariffs on imported inputs.¹⁴⁵

176. In the case of tariffs (and other taxes collected on imports), which raise the cost of imported inputs and thus undermine the competitiveness of exporting firms, FTZs can eliminate this adverse effect on competitiveness. (At the same time, they raise the rest of the world's exports.) In effect, FTZs remove the adverse effects that tariffs and other taxes on imports can have on the exports of a country, and on the exports of other countries that provide the intermediate goods and components. However, there is also the danger that FTZs may sometimes provide countries with an excuse to maintain protectionist barriers around the rest of their economies.

177. The simple average nominal applied MFN tariff rate of Kazakhstan was 6.9% in 2016; and given that the average CET of the EAEU is expected to reach 8.4% by 2020, the SEZs' role in offsetting the tariff's

adverse effects could assume greater importance. Moreover, the "effective" rate of tariff protection can be much higher than the nominal rate.¹⁴⁶

178. Interestingly, *The Economist* reported in April 2015 that SEZs often fail because they create distortions, require large investments in infrastructure, and entail forgone tax revenues.¹⁴⁷ Similarly, a 2011 World Bank study found that, while SEZs may attract foreign investment and create employment in the short term, they cease doing so when the initial favorable conditions no longer exist.¹⁴⁸ The study also found that (i) even when SEZs generate exports and employment, they fail to extend these benefits outside their enclaves, and (ii) multinational companies take advantage of tax breaks and other benefits without generating much employment or export revenues.

179. Some additional empirical evidence concerning the economic performance of SEZs in Cambodia, the PRC, and India is presented in the Chapter VI. The PRC, for instance, is often credited with having implemented tax incentives effectively. During its transition period, from the mid-1980s to the mid-2000s, it experimented with a wide range of industrial policy instruments, including tax incentives for SEZs, reduced tax rates for FDIs, and tax holidays for strategic industries. FDI inflows accelerated during this period, and the country became a top destination

¹⁴⁴ J. Siroën and A. Yücer. 2014. Trade Performance of Free Trade Zones. *Développement, Institutions et Mondialisation (DIAL) Working Paper Series*. No. DT/2014/09. Paris: Université Paris-Dauphine.

¹⁴⁵ Tariffs on imported intermediate goods not only reduce GVC participation, but also hamper an economy's ability to capture a higher share of value added along a GVC once the economy is a member of a GVC. This is because when intermediate inputs cross borders multiple times, they compound the detrimental effect of a given trade barrier. In fact, within a GVC, imports are essentially inputs into exports, and thus any trade barrier imposed by an economy on its imports of intermediate goods is effectively a tax on that economy's own exports. Therefore, removing tariffs and other forms of trade barriers would benefit all GVC participants. Reduced participation in GVCs would also inhibit technology and knowledge transfers, which have been shown to be higher across countries linked through GVCs. See: R. Piermartini and S. Rubínová. 2014. Knowledge Spillovers through International Supply Chains. *WTO Working Paper Series*. No. ERSD-2014-11. https://www.wto.org/english/res_e/reser_e/ersd201411_e.pdf.

¹⁴⁶ To the extent that the tariff is characterized by escalation, especially as far as semi-processed and fully processed goods are concerned, "effective" tariff rates can considerably exceed nominal tariff rates. The "effective rate of protection" (ERP) measures the protection provided by the entire structure of tariffs, taking into account those levied on inputs as well as those on final products. It is defined as $ERP = (V_D - V_W)/V_W$, where V_D is the value-added in the given sector at domestic prices, which includes tariffs, and V_W is value added at world prices. If the nominal tariff on the final product is t , the share of each imported input i in the total value of the final product is a_i , and the nominal tariff on each imported input is t_i , then the effective rate of protection can be written as: $ERP = (t - \sum a_i t_i)/(1 - \sum a_i)$. Thus, if $t = 5\%$, $t_i = 1\%$ for all inputs, and $\sum a_i = 0.6$, the ERP is 11%. According to the OECD, taking into account tariffs at all stages of the supply chain magnifies the effective tariff rate, especially in sectors such as communications and electronics, motor vehicles, basic metals, and textiles, which are characterized by long value chains and several production stages. See: Å. Johansson and E. Olaberria. 2014. Long-Term Patterns of Trade and Specialization. Economics Department Working Paper No. 1136. Paris: OECD.

¹⁴⁷ *The Economist*. 2015. Special Economic Zones: Not So Special. 4 April. <http://www.economist.com/news/leaders/21647615-world-awash-free-trade-zones-and-their-offshoots-many-are-not-worth-effort-not>

¹⁴⁸ T. Farole and G. Akinci, eds. 2011. *Special Economic Zones: Progress, Emerging Challenges, and Future Directions*. Washington, DC: World Bank. <http://documents.worldbank.org/curated/en/752011468203980987/pdf/638440PUB0Exto00Box0361527B0PUBLIC0.pdf>.

for many multinationals. Evidence suggests, for instance, that Chinese SEZs (which also enjoy some nontax benefits) located in various regions of the

country have systematically increased their FDI inflows.¹⁴⁹

Table 7: Flows of Foreign Direct Investment into the Countries of the Commonwealth of Independent States, 1994–2015 (% of GDP)

Country	1994	1999	2004	2009	2015
Armenia	6.3	22.8	29.1	43.2	40.4
Azerbaijan	3.7 ^a	78.7	132.3	16.0	41.0
Belarus	0.7	9.5	8.9	17.3	32.9
Georgia	3.2	22.5	37.2	69.3	89.4
Kazakhstan	16.3	47.3	51.9	62.3	69.2
Kyrgyz Republic	4.3	33.8	26.3	30.5	58.5
Moldova, Republic of	2.5	27.3	32.5	51.0	55.2
Russian Federation	1.2	9.3	20.7	31.0	19.5
Tajikistan	3.6	10.4	12.1	19.9	27.0
Turkmenistan	4.0	21.2	30.9	48.5	90.0
Uzbekistan	2.0	3.7	9.2	11.1	15.1
CIS countries	1.8	12.8	22.5	33.2	29.3
Landlocked countries	13.1	25.0	34.0	33.7	44.2

CIS = Commonwealth of Independent States, GDP = gross domestic product.

^a This percentage is for 1995.

Source: United Nations Conference on Trade and Development. World Investment Report 2016: Annex Tables. <http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx>.

¹⁴⁹ L. K. Cheng and Y. K. Kwan. 2000. What Are the Determinants of the Location of Foreign Direct Investment? The Chinese Experience. *Journal of International Economics*. 5 (2000). pp. 379–400. <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.630.4872&rep=rep1&type=pdf>.

Chapter VI. Lessons from Other Countries' Successes and Failures

A. Introduction

180. There has been a worldwide proliferation of special economic zones (SEZs), and while a few have undoubtedly been successful, many have not, including most of those in Kazakhstan and elsewhere in Central Asia. The jury is still out regarding the rest, as few have been rigorously evaluated to ascertain whether they are actually successful or not.

181. One obvious success story has been the SEZs of the People's Republic of China (PRC), although not all of them, as some have been much more successful than others. By contrast, those in India are generally considered failures. This chapter will try to throw light on the possible reasons for the successes and failures of such zones in other countries, and to draw some useful lessons in this regard, bearing in mind that it is not a question of "one size fits all" when considering different countries. It may be that the factors contributing to the successes in some countries cannot be replicated in others. Likewise, the factors that resulted in failure of SEZs in some countries may not do so in others.

182. The PRC's experience with SEZs is perhaps of particular relevance to Kazakhstan because they were successfully used as instruments for enabling the transition from a centrally planned to a market economy. The Chinese experience is also revealing in that its SEZs were inspired partly by Ireland's success with its Shannon Free Zone, which was established in 1959 as an "experiment" at Shannon Airport, and is widely regarded as the first modern zone (Box 4). Ireland's experience with its Shannon Free Zone may also be relevant for Kazakhstan because both countries are on the periphery of customs unions—one of the countries surrounded by sea, the other landlocked—and they have traditionally been characterized by large-scale emigration owing to the lack of employment opportunities at home. Like the PRC, both countries have needed to attract foreign direct investment (FDI) (together with the associated transfer of technologies and managerial know-how) in order to create opportunities for more highly skilled and thus better-paid jobs.

183. India's experience is also of particular interest because its so-called Chinese-style SEZs are widely considered to have been failures. Indeed, they have been characterized as primarily tax avoidance devices with the added sweetener of access to land. The other country selected for discussion in this chapter is Cambodia, whose zones were the subject of a recent study by ADB. Cambodia's SEZs appear to have met with some success. While lessons often travel poorly, even over short distances, from one country to another, they can still help identify the pitfalls to be avoided.

B. The Experience of the People's Republic of China with Its Special Economic Zones

1. The Genesis and Evolution of the People's Republic of China's Special Economic Zones

184. In the case of the PRC, the development of SEZs was, from the outset, an integral part of the government's unilateral "Open Door Policy," adopted by the 11th Congress of the Chinese Communist Party, in December 1978. This economic development strategy was aimed at enabling the country's gradual transition from a virtually closed, centrally planned economy to an outward-looking market economy, thereby paving the way for growth through export-based industrialization. The Open Door Policy, which culminated in the PRC's accession to the World Trade Organization (WTO) in 2001, involved the opening up of the economy to international trade and to inward flows of FDI, two of the main ingredients of the "East Asian miracle." Manufactured exports, together with investment, were initially seen as the main engines of growth. For that reason, the PRC largely eschewed policies aimed at import substitution, which had failed in countries such as India, partly because it was incompatible with the emergence of global value chains (GVCs). In July 1979, the government decided that Guangdong and Fujian provinces would take the lead in opening up to the outside world and in implementing "special and flexible

Box 4: The First Modern Special Economic Zone—Shannon Free Zone, Ireland

The Shannon Free Zone (SFZ) is one of the main instruments of Ireland's outward-oriented economic development strategy that have boosted the country's economy.^a Located at the most westerly point of Europe, Shannon had been the necessary airport refueling stop and transit point for long-haul flights to and from North America since the start of commercial trans-Atlantic aviation. By the end of the 1950s, however, advances in aeronautic technology meant that its days as a refueling stop were numbered, as commercial aircraft would soon have the range to bypass the airport, thus delivering a potentially devastating blow to the local economy. Responding to this crisis was a matter of great urgency. Consequently, Shannon Airport's director at the time submitted a proposal to the Government of Ireland recommending the establishment of a distinct manufacturing zone with special tax incentives. This zone would create much-needed jobs and specific air traffic to Shannon Airport.

The outcome was the creation of both the SFZ and a related independent managing company, the Shannon Free Airport Development Company (SFADCO), whose legal framework gave it considerable freedom of action. The SFADCO's mandate was broad enough to enable it to contribute to the development of Shannon Airport and its region. In its early days, the SFADCO was also a developer of tourist sites, with the aim of attracting tourists to replace the decline in transit passengers.

At the outset, the SFZ's development was based on airport-related services such as repairing and maintaining aircraft, as well as manufacturing and trading operations, all of which contributed to the use or development of the airport. Although many of the first operations failed, others were great successes. What made the difference this time was the "clustering" effect, which consists of the drawing power of a large concentration of successful companies and the presence of a pool of workers with experience in the tech sector and a familiarity with the cultures of large United States (US) multinational corporations. Indeed, within a short period of time, most US multinationals with an interest in entering the European market had a base in the SFZ.

Over the following decades, the continued success of the SFZ was ensured by (i) a highly integrated and coordinated approach to development, including cooperation with the Government of Ireland's Industrial Development Agency (IDA);^a (ii) a focus on learning, whereby vocational programs were provided by the SFADCO, including skills training at factories in Shannon, that generated a supply of trained labor for other areas of Irish industry and, most importantly, for projects such as the National Technology Park, in Limerick (which has close ties with the University of Limerick); (iii) a pragmatic approach, including trial and error as the norm when setting up new industries and companies; and (iv) rapid, but harmonious social and cultural changes at the local level. Thanks to its partnership with the University of Limerick, the SFZ also supports the National Technology Park.

Interestingly, in 1980, Jiang Zemin, then senior vice minister of the People's Republic of China (PRC) State Imports and Exports Administration, visited Shannon to study the SFZ. By that time, Shannon had long been regarded as a hub for innovation, including the world's first duty-free zone, and was an international example of a successful project developed by testing different models to see what worked. Jiang Zemin was followed by several other Chinese leaders, who also visited Shannon to study its model and adopt ideas suitable for the PRC. They included Premiers Zhu Rongji and Wen Jiabao; Vice-Premiers Huang Ju and Zeng Peiyan; and, most recently, President Xi Jinping. However, while Shannon's population has grown to almost 10,000, Shenzhen's is now well over 10 million.

After 50 years of the SFZ's existence, during which time Ireland became a member of the European Community (now the European Union), the zone continues to attract investors. Since 2014, the Shannon Group (successor to the SFADCO) has been responsible for managing and developing the SFZ. The Shannon Group is state-owned, but has a commercial mandate. Currently, some 100 companies are operating in the SFZ, including many US companies (e.g., Intel, GE, Symantec, and Xerox).

^a The IDA is an autonomous agency responsible for attracting foreign direct investment (FDI) from large global firms in the high-wage, high-tech manufacturing and service sectors, especially from the US. Due at least partly to the IDA, Ireland has become a magnet for internet and digital investments by industry leaders such as Adobe, Amazon, Apple, Facebook, Google, LinkedIn, Microsoft, Oracle, and Twitter, which have made Ireland a hub for their respective European operations. At the end of 2013, the stock of US FDI in Ireland amounted to \$240 billion, more than the US total FDI in the BRICS countries (Brazil, the Russian Federation, India, the PRC, and South Africa).

Source: T. Farole and G. Akinci, eds. 2011. *Special Economic Zones: Progress, Emerging Challenges, and Future Directions*. Washington, DC: World Bank. p. 186.

measures.”¹⁵⁰ By August 1980, Shenzhen, Zhuhai, and Shantou (all in Guangdong province) were designated as SEZs, followed by Xiamen (in Fujian province) in October 1980.

185. The objectives of the SEZs were primarily to attract FDI, expand Chinese exports, and accelerate the acquisition of new technologies and managerial know-how. The belief that SEZs could contribute to economic development was based on the assumptions that they would (i) overcome the common problem of limited resources by attracting large-scale investment; (ii) foster incremental experimentation and trade-based learning, supported by government policies; (iii) attract FDI to promote export-led economic growth and generate employment; and (iv) facilitate economic liberalization (including trade, financial, and institutional liberalization) through policy measures and in situ innovations.

186. The four Chinese SEZs were similar in that they comprised large areas of land and were located far from the center of power, Beijing, so as to minimize political interference,¹⁵¹ but close to basic infrastructure, such as the seaport and airport hubs of Hong Kong, China, and to potential investors in Hong Kong, China and Taipei, China. In line with the central government's Open Door Policy, the objective of these SEZs was to facilitate broadly based, comprehensive economic development. In order to achieve this, all the zones enjoyed special trade, investment, and financial privileges, as well as a high degree of autonomy, even though most were publicly owned; and some of them were involved in public-private partnerships (PPPs).¹⁵² They were encouraged to pursue pragmatic and outward-oriented economic policies that would serve as pilots for more innovative market-oriented policies aimed at overcoming development constraints—such as red tape, labor market rigidities, lack of protection of intellectual property, and restrictions on land use—all of which constituted impediments to investment. If proven successful, these policies could then be implemented more widely across the entire

country. Two key features of these policies were (i) the dismantling of barriers to trade and inward flows of FDI (and thus to the associated transfer of technologies and managerial know-how), and (ii) the PRC's accession to the WTO (after 15 years of negotiations) as a sign of its openness to the world economy and desire to foster the growth of its private sector. The zones thus served as testing grounds for institutional and policy reforms that enabled the PRC's transition to an open-market economy. The reforms involved, among other things, successful policies to facilitate exports and FDI (including the building of infrastructure) and to develop market-based transfer of land-use rights, planning, and zoning.

187. The fact that these manufacturing-oriented SEZs were established on land adjacent to transport hubs in regions with abundant cheap, albeit unskilled, labor for processing or assembling goods for export proved vital to the PRC's success with its zones, and paved the way to the country's industrialization. The combination of relevant government policies and the right mixture of factors of production in the SEZs contributed to unprecedented rates of growth in the PRC. Between 1980 and 1984, while the PRC's overall annual gross domestic product (GDP) growth averaged 10%, Shenzhen experienced average annual growth rate of 58%, followed by Zhuhai (32%), Xiamen (13%), and Shantou (9%). By 1986, Shenzhen had developed rudimentary markets in capital, labor, land, technology, communications, and other factors of production.¹⁵³ The success of this initial opening up of the PRC's economy to trade and investment prompted the central government to open the economy further and to deepen its reforms. For example, in 1984, under the SEZ program, the central government created economic and technological development zones (ETDZs), which had somewhat clearer geographic boundaries and an emphasis on industrial production.

188. The difference between the SEZs and ETDZs is mainly one of scale: a SEZ often consists of a much larger area than an ETDZ, sometimes encompassing an entire city or province. From 1984 to 1988, 14

¹⁵⁰ Y. Yeung, J. Lee, and G. Kee. 2009. China's Special Economic Zones at 30. *Eurasian Geography and Economics*. 50 (2). pp. 222–240.

¹⁵¹ D. Z. Zeng. 2015. Global Experiences with Special Economic Zones: Focus on China and Africa. *Policy Research Working Paper Series*. No. 7240. Washington, DC: World Bank Group. p. 4. <http://documents.worldbank.org/curated/en/810281468186872492/pdf/WPS7240.pdf>.

¹⁵² ADB. 2015. Special Chapter: How Can Special Economic Zones Catalyze Economic Development? In ADB. *Asian Economic Integration Report 2015: How Can Special Economic Zones Catalyze Economic Development*. Manila. p. 71. <https://www.adb.org/sites/default/files/publication/177205/asian-economic-integration-report-2015.pdf>.

¹⁵³ Y. Yeung, J. Lee, and G. Kee. 2009. China's Special Economic Zones at 30. *Eurasian Geography and Economics*. 50 (2). pp. 222–240.

ETDZs were established in additional coastal cities; and in the following years more were established in cities in the Pearl River Delta, the Yangtze River Delta, and the Min River Delta (in Fujian province). In 1988, the entire province of Hainan was designated as the fifth SEZ, and the Shanghai Pudong New Area was granted the same status in 1989. (Tianjin Binhai New Area became the seventh SEZ in 2006.)

189. Then, in 1992, the State Council created another 35 ETDZs. By the end of 2008, there were 54 national-level ETDZs, and by March 2013, that number had grown to 191. Within each ETDZ, an administrative committee, usually selected by the local government, oversees the economic and social management of the zone on the local government's behalf. In addition to the SEZs, there are many other types of zones in the PRC at various levels, such as high-tech industrial development zones (HIDZs), free trade zones (FTZs), and export-processing zones (EPZs), among others; and each type has a different focus.¹⁵⁴

190. The SEZs have undoubtedly played a crucial role in the PRC's successful economic development strategy. First and foremost, the zones—especially the earliest ones—successfully tested the market economy and new institutions, and established role models for the rest of the country. By 1992, the concept of openness had been extended to every coastal province and to all the capital cities of the provinces and autonomous regions in the interior; and various types of SEZs had begun to spring up throughout the country. Thus, by the time Deng Xiaoping made his famous southern tour that year, the program that had started with the creation of the first four SEZs was, in many respects, completed. The “special” economic zones were no longer so special.

191. SEZs have contributed significantly to the growth of GDP, employment, exports, and foreign investment in the PRC; to the adoption of new technologies and modern management practices; and to other improvements in the country's economic performance. Recent estimates indicate that the SEZs at the national level (including all types of zones and industrial parks) accounted for about 22% of the GDP, about 46% of FDI, and about 60% of exports; and that they generated in excess of 30 million jobs.¹⁵⁵ A study based on panel data from 270 cities at the prefecture level covering 23 years (during the reform period) found that the establishment of a major zone in a city led to an average 12% increase in the city's GDP. The long-term cumulative effect of a SEZ could be an increase in GDP of about 20%.¹⁵⁶ In addition, a study of 321 prefecture-level cities between 1978 and 2007 found that, on average, the government's SEZ program (i) increased the country's per capita FDI by 21.7% and the FDI growth rate by 6.9% per year; (ii) generated significant economies of agglomeration, increasing the technological progress of the cities with the earlier SEZs by 1.6% more than that of the cities with the later ones; and (iii) resulted in wages for workers in the cities with SEZs that were 8% higher than those in cities without SEZs.¹⁵⁷

192. These two studies did not evaluate the extent to which the SEZs had generated incremental investment, employment, etc. Nor did they assess the impact of the SEZs on total factor productivity (TFP). However, estimates derived from data on Chinese municipalities from 1978 to 2007 show that, by protecting private property rights and offering preferential treatment with respect to taxes and long-term land-use fees, the SEZs increased per capita FDI in the form of foreign-invested and export-oriented

¹⁵⁴ HIDZs, for example, were set up starting in 1998. They are concentrated zones aimed at promoting new local high-tech industries oriented to both the domestic and overseas markets, and based on the PRC's indigenous scientific and technological strengths. Currently, there are 219 national and 30 provincial HIDZs, mainly located near ETDZs. See: ADB. 2015. Special Chapter: How Can Special Economic Zones Catalyze Economic Development? In ADB. *Asian Economic Integration Report 2015: How Can Special Economic Zones Catalyze Economic Development*. Manila. p. 74. <https://www.adb.org/sites/default/files/publication/177205/asian-economic-integration-report-2015.pdf>.

¹⁵⁵ D. Z. Zeng, ed. 2010. *Building Engines for Growth and Competitiveness in China: Experience with Special Economic Zones and Industrial Clusters*. Washington, DC: World Bank. <https://openknowledge.worldbank.org/bitstream/handle/10986/2501/564470PUB0buil10Box349496B01PUBLIC1.pdf;sequence=1>.

¹⁵⁶ S. Alder, L. Shao, and F. Zilibotti. 2013. The Effect of Economic Reform and Industrial Policy in a Panel of Chinese Cities. *Working Paper Series*. No. 207. Zurich: Center for Institutions, Policy and Culture in the Development Process, University of Zurich. http://www.econ.uzh.ch/ipcdp/Papers/ipcdp_wp207.pdf.

¹⁵⁷ D. Z. Zeng. 2015. Global Experiences with Special Economic Zones: Focus on China and Africa. *Policy Research Working Paper* 7240. Washington, DC: World Bank Group. p. 5. <http://documents.worldbank.org/curated/en/810281468186872492/pdf/WPS7240.pdf>.

industrial enterprises by 58% (and increased local workers' earnings).¹⁵⁸ Most of the flow of FDI into the SEZs was new, rather than merely diverted from the domestic market. The SEZs also increased the municipalities' TFP growth by 0.6 of a percentage point.

193. Hence, it is probably no coincidence that the PRC's TFP growth more than quadrupled after the establishment of the SEZs in accordance with the Open Door Policy. Whereas the relatively slow economic growth experienced by the PRC during 1970–1980 (averaging 6.1% per year) was largely due to the slow rate of TFP growth (0.45% per year), the subsequent increase in economic growth to 9.4% during 1980–2014 can be attributed to an increase in TFP growth, which reached an annual rate of 4.2% (Figure 7). Consequently, the improvement in TFP growth of 3.7 percentage points was responsible for most of the post-1980 increase in economic growth. The reasons for this marked improvement in TFP growth are unclear, although it may have been partly due to economies of scale and agglomeration (or clustering), and to technological progress. Indeed, with rising labor costs, the PRC is noted for having shifted its SEZs and the larger economy away from labor-intensive toward skill- and technology-intensive production.¹⁵⁹ In any event, improved TFP growth has undoubtedly contributed to the PRC's export competitiveness.

194. The success of the national-level SEZs encouraged the speedy development of new ones by other levels of government. In 2004, there were nearly 7,000 such zones in the PRC. In order to curb the blind (and therefore possibly harmful) expansion of SEZs, the central government stepped up its efforts to clean up substandard zones. By the end of 2006, the number of SEZs had been drastically reduced to 1,568, of which 222 were national-level, and the total planned area had been reduced from 38,600 to 9,900 square kilometers (km²).¹⁶⁰

195. The PRC is currently exploring a new variation on SEZs involving cross-border economic zones, which will be especially relevant for the Khorgos–East Gate SEZ, located on the border with Kazakhstan. These zones will require greater policy coordination between two or more countries. For example, the Chinese provinces of Guangxi and Yunnan, which are connected by common mountain ranges and rivers to member countries of the Association of Southeast Asian Nations (ASEAN), have been constructing cross-border economic zones in order to promote the [People's Republic of] China–ASEAN Free Trade Agreement.¹⁶¹

196. By and large, the Chinese zones were intended to facilitate manufacturing, rather than services, but this appears to be changing. In accordance with the PRC's more recent economic development strategy, which seeks to rebalance the economy by shifting it away from a heavy reliance on manufacturing (together with savings and investment) and toward services (together with consumption), the PRC (Shanghai) Pilot Free Trade Zone (SHFTZ) was launched in September 2013. Built on four existing tariff-free zones and covering an area of 29 km², the SHFTZ is meant to test and refine further economic reforms before their potential rollout nationwide. With services accounting for only 14% of Chinese exports, the SHFTZ's main objective is to relax restrictions on foreign investment in 23 service sectors, including banking, financial services, health care, and technology, using a “negative” (albeit long) list, rather than a “positive” list, although the latter is customary elsewhere in the PRC. It might operate as a platform for easing capital controls and for testing the feasibility of a full convertibility of the yuan. Since the establishment of the SHFTZ, the central government has also approved 12 other FTZs, including those in the southern and eastern provinces of Guangdong and Fujian and in the northern port city of Tianjin. The rules in the latter zones are expected to be similar to those in the SHFTZ, although they may also reflect aspects of their respective regions. The success of this new group of zones remains to be seen.

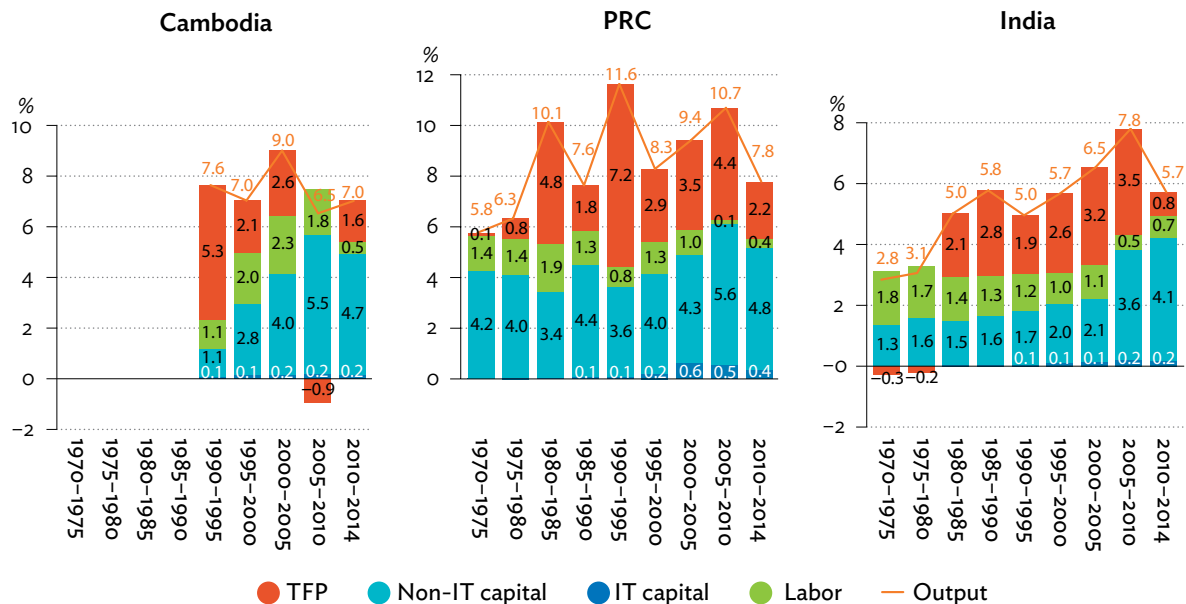
¹⁵⁸ J. Wang. 2013. The Economic Impact of Special Economic Zones: Evidence from Chinese Municipalities. *Journal of Development Economics*. 101 (C). pp. 133–147.

¹⁵⁹ In 2007, the 54 HIDZs hosted about half the nation's high-tech firms and science and technology incubators, registering a total of some 50,000 patents, more than 70% of which were registered by domestic firms. Between 1998 (when HIDZs started appearing) and 2013, these zones accounted for half of the PRC's high-tech gross industrial output and for one-third of its high-tech exports. In addition, the ETDZs were responsible for another one-third of the country's high-tech industrial output and exports. See: ADB, Special Chapter; Zeng, *Building Engines for Growth and Competitiveness in China*.

¹⁶⁰ D. Z. Zeng, ed. 2010. *Building Engines for Growth and Competitiveness in China: Experience with Special Economic Zones and Industrial Clusters*. Washington, DC: World Bank. <https://openknowledge.worldbank.org/bitstream/handle/10986/2501/564470PUB0buil10Box349496B01PUBLIC1.pdf;sequence=1>.

¹⁶¹ Some of these zones involved public–private partnerships. See: ADB, Special Chapter, p. 71.

Figure 7: Output Growth and Contribution of Labor, Capital, and Total Factor Productivity for Cambodia, the People's Republic of China, and India



IT = information technology, PRC = People's Republic of China, TFP = total factor productivity.

Source: Asian Productivity Organization. 2016. *APO Productivity Databook 2016*. Tokyo: Keio University Press Inc. <http://www.apo-tokyo.org/publications/wp-content/uploads/sites/5/APO-Productivity-Databook-2016.pdf>.

197. Since 1978, the transformation of the Chinese economy has been such that in 2010, the PRC replaced the United States (US) as the world's largest manufacturer of goods, and overtook Germany to become the world's largest exporter, with nearly 60% of its exports produced by foreign-invested enterprises (whose labor productivity was more than nine times that of the rest of the economy). It has become the world's second-largest importer (behind the US), as well as the third-largest recipient of FDI (after the US and the European Union). It has also displaced Japan as the world's second-largest economy. More importantly, the PRC's real GDP growth has averaged almost 10%, GDP per capita has increased almost 20-fold (from \$195 in 1978 to \$3,863 in 2014), and millions of Chinese have been lifted out of poverty, although there is increased inequality.¹⁶² The PRC's export-oriented development strategy has some key similarities to the successful approaches previously taken by other East Asian economies, notably Hong Kong, China; Japan; the

Republic of Korea; and Taipei, China; as well as ASEAN countries.

2. Lessons from the Experience of the People's Republic of China

198. While the PRC's successful use of SEZs as instruments of policy under its economic development strategy may well be difficult to replicate elsewhere, some of the features of the zones provide several lessons for Kazakhstan and other countries in Central Asia.

199. The most noteworthy lesson from the PRC's experience is the government's single-minded commitment to its Open Door Policy (with a view to eventual membership in the WTO). The overriding goal of this economic development strategy was the PRC's gradual transition from a closed centrally planned economy to an outward-looking market economy, thereby paving the way to growth through

¹⁶² According to the World Bank, the percentage of the PRC's population living below the \$1.90-a-day poverty line fell from 88% in 1981 to 6.5% in 2012, and the number of poor fell from 878 million to 87 million during this period. See: The World Bank. Poverty Headcount Ratio at \$1.90 a Day (2011 PPP) (% of Population). <http://data.worldbank.org/indicator/SI.POV.DDAY?page=6>. However, the PRC's Gini coefficient has worsened from 29.1 in 1981 to 42.1 in 2010, the latest year for which Gini data are available. See: The World Bank. GINI Index (World Bank Estimate). <http://data.worldbank.org/indicator/SI.POV.GINI?page=1>.

export-based industrialization. The role of the Chinese SEZs was to pilot the economic reforms necessary for achieving this goal. They were thus seen as an integral part of the PRC's economic development strategy, which had an effective monitoring-and-evaluation process, as well as a clear goal.

200. The government's strong commitment to this strategy has ensured a stable, supportive, and coordinated environment for the necessary economic reforms, and has resulted in a determination to prevent political opposition and temporary setbacks from undermining the economic experiment with the SEZs. At the same time, institutional reforms, especially the decentralization of power, have helped create a conducive legal and policy environment for the SEZs, enabling them to enjoy a high degree of political and economic autonomy¹⁶³ with support from the central and local governments; and they have contributed to the development of a sound business environment.

201. An effective legal framework with stable, transparent, and unambiguous rules is crucial for the success of SEZs. This framework should be sufficiently well-developed to specify the role of the SEZs in the national economic-development strategy, regulate the governing structure and operating procedures of the SEZs, and provide transparent guidance to investors concerning their eligibility for various tax and nontax incentives. While an effective legal framework may not be sufficient to ensure the success of a SEZ program, its absence almost inevitably leads to a SEZ program's failure, with a negative impact nationwide. In this regard, the Regulations on Special Economic Zones in Guangdong Province (where Shenzhen is located), promulgated in 1980, constituted the centerpiece of the PRC's legal framework for its SEZs. Approved by the National People's Congress, the SEZ Regulations followed the economic development strategy of opening up and attracting FDI into broad areas of the economy. Whereas other countries' SEZs were focused largely on labor-intensive manufacturing, Article 4 of the SEZ

Regulations invited foreign capital to participate in "industry, agriculture, animal husbandry, aquaculture, tourism, housing and construction, and research and manufacture involving high technology, as well as other businesses of common interest to investors and to our side."¹⁶⁴ It also provided a basic legislative framework for the establishment of SEZs in other areas of the country, although, as mentioned above, their number was eventually curbed.

202. Before 2008, SEZs in the PRC were normally set up in batches—initially four at a time, but then the number increased rapidly. There are now hundreds of SEZs, and most of them have clear goals and targets with regard to GDP growth, exports, FDI inflows, revenues, etc. These expectations have put a great deal of pressure on the management of each zone. Moreover, the SEZs are highly competitive among themselves, as each one strives to distinguish itself with regard to service, quality of infrastructure, the ability to attract new enterprises, and the achievement of development goals. This competition arguably has helped to make the SEZs more efficient and competitive.

203. In support of their SEZs, local governments put in place not only an efficient regulatory and administrative system, but also basic infrastructure for their zones, such as roads, water, electricity, gas, sewerage, telephones, and ports, which usually involved considerable public investment, especially in the initial stages. In addition, local governments provided or facilitated the provision of various business services to many SEZs, especially the HIDZs and ETDZs. These services included accounting, legal counseling, business planning, marketing, import-export assistance, skills training, and management consulting.

204. The large size of the Chinese SEZs was an important reason for their initial success. SEZs often encompassed a large area of land, sometimes an entire city or, indeed, a province (as in the case of Hainan). However, the ETDZs—which, after their initial establishment along the coast and in the Pearl,

¹⁶³ It would appear that most of the SEZs in the PRC are publicly owned. However, some are completely privately owned, while others involve PPP components, motivated by the potential synergies between the public sector's provision of infrastructure, land, and possibly financing, and the private sector's less-politicized management structure and superior business models. See: ADB, Special Chapter, p. 72.

¹⁶⁴ Government of the People's Republic of China. 1980. Regulations on Special Economic Zones in Guangdong Province. Beijing. pp. 1–2. https://www.wto.org/english/thewto_e/acc_e/chn_e/WTACCCHN46_LEG_8.pdf.

Yangtze, and the Min river deltas, were then extended to inland regions—are much smaller than the SEZs.¹⁶⁵ For example, the Shenzhen SEZ, the biggest and best-known of the original SEZs, covers 320 km². The more recently established SHFTZ originally encompassed around 28 km², but was expanded to 120 km² in 2015 so as to include Lujiazui, an area of Shanghai where major Chinese banks and multinationals are located, thereby allowing them access to the SHFTZ's incentives and benefits. Large-scale SEZs may be difficult to replicate in Kazakhstan, however, so ETDZs, which are aimed mainly at developing export-oriented technology-intensive industries, may be more appropriate.

205. Most of the SEZs in the PRC are located in the coastal regions or near major cities that have a tradition of foreign trade or business, and are thus better linked to international markets. These regions and cities also have good access to major infrastructure, such as seaports, airports, and railways. The locations of the SEZs in the Pearl River Delta were especially advantageous, as they were close to Hong Kong, China; and so were the locations of the SEZs in the Min River Delta, as they were close to Taipei, China. The Shenzhen SEZ's large size, together with its location on the border with Hong Kong, China—where imports enter free of tariffs and other taxes, and labor-intensive manufacturers seek to lower their costs—has enabled manufacturers in the SEZ to exploit the economies of scale and agglomeration, and to link with global value chains (GVCs). While Hong Kong, China provides capital, technology, management know-how, logistical support, and access to world markets, the adjacent Pearl River Delta region has provided labor, land, and natural resources. It is this interaction that allowed the Greater Pearl River Delta to emerge relatively quickly as one of the world's major manufacturing bases.

206. Not surprisingly, the strategic locations of the SEZs and the government's innovative policies, such as land reforms, were both crucial to the zones' success. Prior to 1981, all land in the urban areas

belonged to the state, while all land in the rural areas was “collectively” owned. The land reforms included land-use fees in the SEZs and an “open bidding” system for land allocation. The outcome was a modern land market that has transformed the PRC's urban landscape.

207. Inward FDI, particularly from the Chinese diaspora, has played a critical role in the success of the SEZs in the PRC¹⁶⁶ together with the associated transfer of technology and management skills learning-by-doing, and various spillovers. This FDI was instrumental in building local manufacturing capacity. At the same time that the government started setting up the SEZs, in the 1980s, Hong Kong, China and Macau, China, arguably the most open economies in the world, as well as Taipei, China, were also beginning to move up the value chain and reduce their reliance on labor-intensive manufacturing. The relatively cheap labor and good infrastructure in the SEZs, coupled with the government's “Open Door Policy” (which included various incentives), provided a great opportunity for the diaspora to invest in the PRC and to shift manufacturing operations there. Given the shared culture and language, as well as the advantages of the SEZs' locations, investments from the Chinese diaspora were dominant during the early stages of the SEZs.

208. In order to encourage domestic and especially foreign enterprises to invest in the zones, the government made various tax and nontax preferences, including financial and nonfinancial incentives (such as one-stop services), among the zones' main features. The tax preferences included depreciation allowances, exemptions from import and export taxes, and lower corporate income tax (CIT) rates. While some of these tax incentives were granted to all firms, many were accorded only to inward FDI. The reduction in the CIT rates for FDIs was especially generous: down to 15% from the 30% levied on domestic firms. And FDI was exempted from local income taxes altogether. But in 2007, the CIT rates

¹⁶⁵ National Economic and Technological Development Zones. A Brief Introduction of National Economic and Technological Development Zones in China. <http://www.china.org.cn/english/SPORT-c/76751.htm>.

¹⁶⁶ From the outset of the PRC's Open Door Policy, diaspora Chinese have provided the lion's share of FDIs, which have been concentrated in the export-oriented sectors. Not only were investors from the Chinese diaspora—living mostly in Hong Kong, China; Macau, China; Southeast Asia; and Taipei, China—the main source of FDI, they also influenced the conception and implementation of SEZs. Moreover, the technology and capital they sunk into these SEZs powered the takeoff of the PRC's export industries, weighing the political scales in favor of continued liberalization and openness. See: J. Lee. 2016. The Chinese Diaspora's Role in the Rise of China. *East Asia Forum*. 14 September. <http://www.eastasiaforum.org/2016/09/14/the-chinese-diasporas-role-in-the-rise-of-china/>.

for foreign and domestic firms were unified at 25%. Moreover, to support the PRC's underdeveloped capital market, development banks provided subsidized loans, especially to small and medium-sized enterprises (SMEs) based in the SEZs.

209. Tax preferences were gradually withdrawn, especially those pertaining to the CIT. Instead, zones started to grant their own subsidies, including income tax incentives, to highly skilled labor, reflecting a shift of strategy from attracting investments to attracting talent and knowledge. Corporate tax relief has become more prudent, and it is applied in very specific ways, depending on the type of business or production activity, with the clear purpose of supporting certain sectors (e.g., high technology) and encouraging SMEs.

210. The Shenzhen SEZ was the first to establish a functioning labor market. Companies operating inside the zone could enter into enforceable labor contracts with specific term limits; could dismiss unqualified or underperforming employees; and could adjust wage and compensation rates to attract skilled labor; for the state-owned enterprises, all this represented a break with the customary practice of offering guaranteed labor contracts. Among the other policies aimed at attracting skilled labor, including employees from the overseas Chinese diaspora, was the provision of housing, research funding, and subsidies for children's education. The Shenzhen SEZ also started offering a minimum wage and social insurance package that were superior to anything previously available in the PRC.

211. One of the main strengths of the Chinese SEZs is that they have a high concentration of very skilled workers, including many research and development (R&D) personnel, especially in the HIDZs and ETDZs. As a result, the zones have become centers of knowledge and technology generation, adaptation, diffusion, and innovation. The abundance of FDI provides good opportunities for technological learning. Local governments put a strong emphasis on technological learning and innovation, as well as on technology-intensive industries. For example, the Shenzhen SEZ set up an intellectual property office and issued a number of policies and regulations to protect intellectual property rights. It

also implemented various incentives to encourage high-tech industries, R&D spending, and venture capital investment, and to attract technology talent. In addition, the SEZs are closely linked to domestic enterprises and industrial clusters through supply or value chains. This connection not only helps achieve economies of scale and agglomeration, as well as business efficiency, but also stimulates synergistic learning and enhances international competitiveness.

212. In addition, most SEZs and industrial parks have attracted a large number of immigrants from across the country and, later on, from overseas, who hoped to find better jobs and new opportunities. Such a strongly motivated migrant community tends to generate an innovative and entrepreneurial culture. In Shenzhen, for instance, migrants account for 83% of the total population. Moreover, among Shenzhen's permanent residents, 21% are under the age of 16, and 62% are between the ages of 17 and 44.¹⁶⁷ Such a young and innovative culture makes Shenzhen one of the most dynamic SEZs in the PRC.

213. Regarding other reforms piloted by SEZs, it is noteworthy that Shenzhen was also the first city in the PRC to set up a center to monitor currency exchange rates; undertake the partial privatization of state-owned enterprises through stock-sharing plans; enable the entry of foreign banks; and, in 1990, to establish a stock exchange.

214. The development of SEZs in the PRC has always been aligned with the government's national economic strategy, institutional reform process, and/or territorial development programs. Due to this alignment, the SEZs have been provided with institutional support and essential infrastructure from the government. In return, the government can utilize the SEZs as instruments for achieving economic and institutional goals.

215. A coherent strategy that includes a well-designed industrial development policy, an appropriate land-use plan (which often includes zoning), and a business promotion plan would significantly contribute to the success of the SEZs. Such a strategy would normally address the objectives of each zone; identify the zone's strengths

¹⁶⁷ ADB, Pakistan Resident Mission. 2007. *Special Economic Zones and Competitiveness: A Case Study of Shenzhen, China*. Islamabad.

and weaknesses; exploit, create, or shape the comparative and competitive advantages of the zone; and consolidate a mechanism that takes industrial growth, land use, and infrastructure construction into account.¹⁶⁸ Recently, the planning of SEZs has become more sophisticated, as they have become a part of urban development, contributing to a better balance between industrial production and livability.¹⁶⁹

C. India's Experience with Its Special Economic Zones

1. The Genesis and Evolution of India's Special Economic Zones

216. Although it was the first country in Asia to establish EPZs, in 1965, India later attempted to replicate the PRC's success by abandoning its own failed economic development strategy, which had been based on import substitution (with an inherent anti-export bias). To replace the old strategy, the Government of India formulated its "Export-Import Policy" for 2000, which involved the conversion of the eight existing EPZs into SEZs. The goal of this policy was to make the SEZs an engine for economic growth supported by quality infrastructure and complemented by an attractive fiscal package, at both the national and the state levels, with the minimum required regulations.¹⁷⁰ This policy, which laid out a regulatory framework for the development of Chinese-style zones, was eventually formalized in the Special Economic Zones Act, 2005, with the associated rules added in 2006. This act was intended to stimulate investment (especially inward FDI), with the objectives of transforming India into a powerhouse for export manufacturing, reducing India's heavy reliance on services-led growth, creating employment opportunities, and developing infrastructure. These objectives were to be accomplished by "incentivizing" SEZ activities by means of tax preferences and other measures (Table 8). Success thus required cooperation among the Ministry of Commerce and Industry (overseeing

Table 8: Incentives Granted to Companies in India's Special Economic Zones

Exemption from import tariffs (from the DTA and from abroad)
Exemption from the national sales tax
Exemption from the tax on services
Exemption from the state sales tax and other levies (e.g., stamp and electricity duties), as provided by the respective state governments
An income tax exemption of 100% for SEZ-based companies for the first 5 years, 50% for the next 5 years, and 50% of the ploughed-back profit from exports for the next 5 years
External commercial borrowing by SEZ-based companies up to \$500 million in 1 year, without any maturity restrictions, through recognized banking channels
Automatic approval of investment involving 100% FDI
Single-window clearance for national- and state-level approval procedures

DTA = domestic tariff area, FDI = foreign direct investment, SEZ = special economic zone.

Source: World Trade Organization. 2015. Trade Policy Review: India. Table 3.14, p. 69. Geneva. https://www.wto.org/english/tratop_e/tpr_e/s313_e.pdf.

the SEZs), the Ministry of Finance (specifically, the Central Board of Excise and Customs and the Income Tax Department, both under the Department of Revenue), state governments, and public sector banks, among others. SEZs may be established by the central or state governments, or by private developers (including foreigners) through joint ventures with the state or through purely private partnerships.

217. As is often the case elsewhere, tax preferences are among the main features of India's SEZs. They include exemptions from import tariffs, national and state sales taxes, and taxes on services, plus a 5-year corporate tax holiday on income from exports.¹⁷¹ To qualify for these tax preferences, instead of having to specialize in exports, a SEZ-based manufacturer only has to be a net earner of foreign exchange for 5 years. So, firms could use a SEZ to supply some of

¹⁶⁸ Y. Zhenshan and C. Jianming. 2002. Industrial Clusters and Their Application in China: Progress and Implications for Urban Planning. *City Planning*. 36 (12). pp. 60–68.

¹⁶⁹ Y. Zhenshan et al. 2013. City Profile: Beijing. *Cities*. 31 (April 2013). pp. 491–506.

¹⁷⁰ In this section, "state" is not used as a synonym for "government," but rather for the equivalent of provincial or regional governments, as states in India are equivalent to provinces or regions in the PRC.

¹⁷¹ Special Economic Zones in India. Facilities and Incentives. <http://www.sezindia.nic.in/about-fi.asp>.

their domestic markets (i.e., the domestic tariff area [DTA] outside the SEZs), its export-oriented units (EOUs),¹⁷² and its operations in various technology parks.¹⁷³ (While there is no quantitative limit on the amount of SEZ production sold in the DTA, such sales are subject to the same tariffs and indirect taxes as any other imports into the DTA.) Hence, many economists, including some at the Ministry of Finance, have feared that rather than stimulating new investment, the SEZs would merely divert investments that would have been made anyway.¹⁷⁴ Instead of generating fresh sources of funding for the country's poor infrastructure, the government would only make things worse by depriving itself of tax revenues.

218. There are also exemptions from some of the requirements under India's "License Raj," a legacy of the country's earlier regime of central planning. The License Raj, which lasted from 1947 to 1990, involved an elaborate and pervasive system of licenses, regulations, and accompanying red tape that one had to navigate in order to set up and run a business in India. Industrial companies still need to get nearly 70 clearances a year to operate. Complying with the labor laws, for example, requires employers to maintain—and submit to the authorities—16 separate types of worker registries.¹⁷⁵

219. Not surprisingly, despite high expectations, the performance of India's SEZs has been disappointing. Indeed, two recent reports, one by the Comptroller

and Auditor General (CAG) of India in 2014,¹⁷⁶ and another published in 2016 by the Indian Council for Research on International Economic Relations (ICRIER)¹⁷⁷ both commissioned by the Ministry of Commerce and Industry, concluded that the SEZs had failed to meet their objectives. Indeed, the SEZs were characterized as primarily tax-avoidance devices with the added sweetener of access to land.

220. Since the SEZ policy was first announced, in 2000, 421 formal approvals have been granted, out of which 345 SEZs were notified as of 1 May 2016. By 31 March 2017, only 218 were operational.¹⁷⁸ Of these, 21 were multi-product, 2 were multi-services, and the rest sector-specific. Exports from the SEZs totaled Rs2,359 billion (almost \$37 billion) during the fiscal year (FY) 2017,¹⁷⁹ down from Rs3,416 billion (almost \$53 billion) in FY2016, from Rs4,638 billion (\$68 billion) in FY2015, and from Rs4,941 billion (almost \$77 billion) in FY2014. Whereas in February 2006 total employment in the SEZs stood at 134,704 and total investment at just over Rs57 billion (\$888 million), by 30 September 2016 total employment was almost 1.7 million and total investment was Rs4,067 billion (\$63 billion). The SEZs' share of India's total exports (including its exports of services) increased from about 3% in FY2006 to 19.5% in FY2013,¹⁸⁰ but the SEZs' share has declined substantially since then (to 16.1% in FY2015).¹⁸¹ However, as highlighted by the CAG report, there is no credible

¹⁷² The EOU scheme, which complements the SEZs, is regulated by India's foreign trade policy. EOUs are similar to SEZs, except that they may be located anywhere in the country. As in the case of the SEZs, the main objectives of the EOUs are to increase exports and foreign exchange earnings, promote the transfer of latest technologies, stimulate FDI, and generate additional employment. In principle, EOUs are established to export their entire production. However, subject to certain conditions, a specific percentage may be sold in the DTA upon payment of duties (including anti-dumping duties) and taxes, with some exceptions. In general, EOUs may sell up to 50% of the "free on board" (FOB) value of exports in the DTA. EOUs producing gems and jewelry, however, may sell only up to 10% of their FOB value of exports in the DTA.

¹⁷³ The various types of technology parks in India include electronic-hardware technology parks, software technology parks, and biotechnology parks.

¹⁷⁴ *The Economist*. 2006. India's Special Economic Zones: Cash Cows. 12 October. <http://www.economist.com/node/8031219>.

¹⁷⁵ A. Kazmin. 2014. Modi Tackles India's "Licence Raj" with a Thousand Cuts. *Financial Times*. 21 September. <https://www.ft.com/content/5badad82-3ff6-11e4-a381-00144feabdc0>.

¹⁷⁶ Government of India, Department of Revenue. 2014. *Performance of Special Economic Zones (SEZs): Report of the Comptroller and Auditor General of India*. No. 21. New Delhi. http://www.saiindia.gov.in/sites/default/files/audit_report_files/Union_Performance_Dept_Revenue_Indirect_Taxes_Special_Economic_Zones_SEZs_21_2014.pdf.

¹⁷⁷ A. Mukherjee et al. 2016. *Special Economic Zones in India: Status, Issues and Potential*. New Delhi: Indian Council for Research on International Economic Relations (ICRIER) and Springer India. <http://link.springer.com/book/10.1007/978-81-322-2806-6>.

¹⁷⁸ Government of India, Ministry of Commerce and Industry, Department of Commerce. Fact Sheet on Special Economic Zones. <http://sezindia.nic.in/writereaddata/pdf/factsheet.pdf>.

¹⁷⁹ The fiscal year in India is from 1 April to 31 March. As the fiscal year as notated is based on when the year ends, FY2017 refers to 1 April 2016 to 31 March 2017.

¹⁸⁰ A. Aggarwal. 2016. Special Economic Zones in India: Growth Engines or Missed Opportunity? *East Asia Forum*. 19 February. <http://www.eastasiaforum.org/2016/02/19/special-economic-zones-in-india-growth-engines-or-missed-opportunity/>.

¹⁸¹ WTO. 2016. *World Trade Statistical Review: 2016*. Geneva. https://www.wto.org/english/res_e/statis_e/wts2016_e/wts2016_e.pdf.

evidence that investment and employment in the SEZs and exports from the SEZs have been incremental.

221. In any event, a major finding of the CAG report was that the SEZs had failed to achieve any of the three most important objectives of the SEZ Act: increasing India's share of global exports, stimulating investment (both local and foreign), and creating employment. Actual gains from the SEZs fell short of the government's performance-indicator targets, amounting to 46% instead of 94% in the case of exports, 24% instead of 75% for investment, and 66% instead of 97% for employment. The CAG report concluded that "the achievements of SEZs in the country are contributed by a few SEZs located in some developed states, which were mostly established prior to enactment of the SEZ Act." Furthermore, the CAG report found that manufacturing activity in the SEZs had declined. Other targets missed included land use in the processing area of the SEZs (by a margin of 31% to 93%), overall operational land (38%), and net foreign exchange earnings (39% instead of 109%). Regarding the latter, the CAG report also highlighted the lack of timely foreign currency remittances. In addition, the CAG report found that a number of SEZs were operating without environmental clearance.

222. Notwithstanding the apparent failure of the SEZs to increase India's share of global exports,¹⁸² stimulate investment (both local and foreign), and boost employment as much as expected, the country has undergone a remarkable transformation, albeit not as spectacular as the PRC's.¹⁸³ Since 1991, the government has been undertaking unilateral economic reforms, including the progressive abandonment of its inward-looking strategy of import substitution, whose protectionist policies had an anti-export bias. Instead, India's economy has been opened up to international trade and FDI, with exports (of goods and services) now

considered one of the main engines of growth, alongside domestic consumption and investment. Real growth in the gross domestic product (GDP) accelerated from an average annual rate of 5.4% during 1990–1999 to 7.2% during 2000–2009, and slowed to 5.7% during 2010–2014. Roughly 2.6 percentage points of this growth during the latter two periods, was due to improved TFP (Figure 7). Concurrently, millions have been lifted out of poverty, even if there has also been a slight increase in inequality.¹⁸⁴

2. The Causes of Failure

a. The Lack of a Coherent and Coordinated Economic Development Strategy

223. The government's desire to make its SEZ policy serve *all* of its social and economic objectives, together with a lack of vision in its policy design and implementation, weak commitment, and lack of experimentation, among other problems, seriously jeopardized India's efforts to industrialize by means of its SEZs.¹⁸⁵ Furthermore, the SEZs have been involved in a wide range of activities that fall under various ministerial domains and different levels of government, but a lack of coordination among these ministries and levels of government has constituted a serious impediment to the success of those activities. Indeed, the government looked like a house divided, with bitter public turf wars between ministries and local governments. The lack of cooperation on the part of state governments, for example, discouraged investment in the SEZs. Furthermore, the CAG report found that gaps in the policies and inefficiencies in their implementation (typical of most social and developmental initiatives by the government) have cost the exchequer valuable revenue and reduced the effectiveness of the government's policies.

¹⁸² In 2015, India's share of world exports of *manufactured goods* was a mere 1.6%, compared with the PRC's 13.83%. By contrast, India's share of world exports of *services* was 3.3%, compared with the PRC's 6.0%. See: WTO, *World Trade Statistical Review*: 2016.

¹⁸³ Whereas in 1978, India's per capita GDP was \$303 and the PRC's was \$195, by 1991 India's per capita GDP had grown to \$398, compared with the PRC's \$501; and in 2014 India's per capita GDP was \$1,234, compared with the PRC's \$3,863. See: Knoema. GDP by Country: Statistics from the World Bank, 1960–2015. <http://knoema.com/mhrzolg/gdp-statistics-from-the-world-bank?country=China> and <http://knoema.com/mhrzolg/gdp-statistics-from-the-world-bank?country=India>.

¹⁸⁴ According to the World Bank, the proportion of India's population living below the \$1.90-a-day poverty line, for example, fell from 52.6% in 1983 to 21.3% in 2011. See: The World Bank. Poverty Headcount Ratio at \$1.90 a day. <http://data.worldbank.org/indicator/SI.POV.DDAY?page=6>. The PRC's Gini coefficient deteriorated slightly from 31.1 in 1983 to 33.9 in 2009, the latest year for which data are available. See: World Bank, GINI Index (World Bank Estimate). <http://data.worldbank.org/indicator/SI.POV.GINI?page=1>.

¹⁸⁵ *The Financial Express*. 2014. CAG Report on SEZs: Lessons from the SEZ Fiasco. 15 December. <http://www.financialexpress.com/article/fe-columnist/cag-report-on-sezs-lessons-from-the-sez-fiasco/19215/>.

224. As a consequence, there remains little, if anything, particularly special about the SEZs in India. And the government has done little to streamline the regulatory regime. On the contrary, firms in the SEZs face a far more restrictive environment than those in the domestic economy. They enjoy no special benefits, not even in terms of the basic facilities such as a single-window mechanism or high-quality infrastructure. As for the SEZ tax regime, it appears to be actually less attractive than the regime outside the SEZs.

225. An important lesson that emerges from the findings of the CAG report is that SEZ-related policies should be initiated with a proper understanding of the conditions necessary for their success. In view of the obvious uncertainty as to their eventual outcomes, major policies involving SEZs should be initiated on a pilot or experimental basis, and then expanded gradually based on the outcomes. Policy making should not be understood as a single once-and-for-all exercise. It should instead be a series of steps, with each step improving the policy and leading to a higher level of achievement. Monitoring and evaluation are two important components of this process that contribute to transparency, and thus should be institutionalized by being incorporated into the policy design itself. Having concluded that SEZ developers and enterprises had been left largely unmonitored, thereby posing a huge risk for revenue administration, the CAG report highlighted the need for such mechanisms, with an emphasis on monitoring and controls, largely as a means of preventing irregularities. More importantly, however, monitoring and evaluation should provide the foundation for evidence-based policy making.

b. Land Issues

226. Land laws are among the most formidable challenges for companies, which complain that these laws make the acquisition of land for industry virtually impossible. However, the CAG report found that 52% of the land allotted to SEZs remained idle, even though their approval had dated back to 2006. Given that only 35% of the land area of a SEZ had to be used for production, many of the SEZs may have simply been used for property deals, with developers seeking to acquire cheap land, put in a minimum of infrastructure,

and then sell it.¹⁸⁶ Real estate developers apparently had an initial advantage over industrial enterprises when it came to acquiring land and getting their SEZ approved. Indeed, even India's central bank, the Reserve Bank, seemed to have suspicions, classifying loans to SEZs as "real-estate" lending, which made them relatively expensive. Moreover, with farmers allegedly being forced to sell their land and lose their occupations, developers, together with state governments, were accused of profiteering.

227. Another reason for the failure of SEZs, mentioned by the ICRIER study, was the fact that India had opted for a large number of small SEZs without ensuring the provision of proper infrastructure outside the zones (whereas the PRC created a limited number of large SEZs near port facilities). The total area covered by India's SEZs is currently only 51,604 hectares, or 516 square kilometers (km²). By contrast, as mentioned above, the PRC's zone in Shenzhen alone covers 320 km². Along with its proximity to Hong Kong, China, the large size of Shenzhen SEZ has been a major factor in its success.

c. Infrastructure Problems

228. One of the main objectives of the SEZs was to fix India's "infrastructure deficit," which included problems such as potholed roads, clogged ports, and intermittent power. Indeed, the government hoped that, with the incentives available in the SEZs, the private sector would make a large contribution to the \$320 billion in infrastructure investments that India was looking to make during 2005–2010. The SEZs have been hampered notably by an absence of external infrastructure. In order to be successful, SEZs have to be connected with world-class roads, railways, seaports, and airports, and customs authorities have to adopt international best practices to promote trade facilitation. This is not the case at present. Deficiencies in the availability and quality of power are an equally important constraint, with state-owned companies such as Coal India unable to keep pace with the rising demand for coal for power generation. At the same time, private companies complain that the existing framework for public–private partnerships (PPPs) in infrastructure projects has them shouldering too much of the risk.

¹⁸⁶ Government of India, Department of Revenue. 2014. *Performance of Special Economic Zones (SEZs): Report of the Comptroller and Auditor General of India*. No. 21. New Delhi. p. 119. http://www.saiindia.gov.in/sites/default/files/audit_report_files/Union_Performance_Dept_Revenue_Indirect_Taxes_Special_Economic_Zones_SEZs_21_2014.pdf. Indeed, the CAG report found that land acquired for public purposes was subsequently diverted (up to 100% in some cases) after de-notification (i.e., the cancellation of a notification of intent to acquire a plot of land).

d. Taxation

229. Taxation policies have apparently played a key role in the failure of India's SEZs. As mentioned above, tax preferences—notably exemptions from import tariffs, national and state sales taxes, and service taxes, as well as a 5-year corporate tax holiday on income from exports—are among the main features of the SEZs in India.

230. Regarding import tariffs, the ICRIER study mentioned two additional important reasons for the failure of India's SEZs.¹⁸⁷ The first involved the incentives offered under the government's 2009 foreign trade policy concerning exporters based outside the zones. These measures involved, for example, a tariff drawback scheme that allowed manufacturers outside the SEZs to obtain a refund of tariffs paid on imported materials used in the manufacture of goods for export. The second was the consequence of India's free trade agreements with several countries, which resulted in the reduction, if not elimination, of the tariffs on many imported products. These two developments negated the considerable advantage provided by the tariff exemptions in the SEZs, given India's relatively high applied most-favored-nation (MFN) tariff rates (averaging 13.5% in 2014, though as high as 32% in 2001).

231. Under the original SEZ scheme, businesses and developers operating in the zones were also exempted from the dividend distribution tax and from the minimum alternate tax (MAT) on book profits.¹⁸⁸ One of the most common complaints against the SEZs is that they have failed to achieve their stated objective of encouraging the exportation of manufactured goods. Instead, they have become attractive centers for information technology (IT)

companies (whose activities are especially conducive to "creative accounting" for tax purposes), where they again benefited from the tax incentives they had lost when the Software Technology Parks of India scheme ended.¹⁸⁹ Indeed, the CAG report found that, whereas 57% of the country's SEZs were catering to the IT sector, only about 10% were catering to manufacturing.

232. There were also indications that companies were misusing the government's tax policy regarding real estate arbitrage. As a consequence, the MAT exemption was terminated in 2011, and the dividend-distribution-tax exemption was terminated in 2012. More importantly, the MAT was levied on book profits of SEZ enterprises at the rate of 20%, thereby rendering the SEZs much less attractive from a tax standpoint. While the withdrawal of these tax incentives was arguably necessary to combat tax avoidance, if not evasion, it nonetheless undermined the predictability of tax policy, a necessary condition for an environment conducive to investment, whether by multinational or domestic enterprises.

233. Another possible tax-related reason for the failure of India's SEZs mentioned in the ICRIER study was perception that the tax incentives granted to the SEZs might infringe WTO rules that prohibit financial contributions by a government body, particularly those contingent on exports. While enterprises operating in SEZs still enjoy income tax relief, there is the perceived threat that other countries may impose countervailing duties to negate the effects of that tax relief, thereby reducing the competitiveness of exports from the SEZs. Indeed, 33 countervailing-duty measures have been taken against India, surpassed in number only by the PRC (42).

¹⁸⁷ *iGovernment*. 2013. Why India's SEZ Policy Didn't Work: ICRIER Study. 12 December. <http://www.igovernment.in/articles/36851/why-indias-sez-policy-didnt-work-icrier-study>.

¹⁸⁸ The rationale for the MAT was that companies exempted from the CIT paid hefty dividends to their shareholders, many of whom paid no tax on those dividends. It was therefore felt that companies ought to pay some minimum income tax, irrespective of whether they were entitled to various tax deductions and exemptions. The MAT was initially levied at a low rate, but subsequently raised to 20% on book profits. This resulted in a substantial cash outflow that reduced the scope for retained profits to financial investments. Even infrastructure sectors such as power generation and water resources, as well as export-oriented industries that had previously been exempt from the CIT, were required to pay the MAT at 20%. Thus, the CIT exemption was largely vitiated by the MAT.

¹⁸⁹ When the government in 2000 removed its incentives for exporters, except for EPZ-based firms or other entities qualifying as export-oriented units, investment behavior hardly changed due to this reform. Indeed, firms that had lost their incentives maintained the same level of investment as before, despite the higher tax rates—roughly the same level as the control group, which had kept their incentives. However, reported profits did respond drastically to the loss of incentives. In particular, reported pretax profits dropped by half on average for the firms that had lost their incentives, despite only minimal changes in sales. By contrast, the pretax profits for firms that had kept their incentives showed an increase. Hence, companies seem to have diverted profits from affiliates facing higher taxes to those that were exempt from taxation due to the incentives. See: S. James. 2007. *The Effect of Tax Rates on Declared Income: An Analysis of Indian Taxpayer Response to Changes in Income Tax Rates*. PhD dissertation. Cambridge, MA: Harvard University.

e. The License Raj

234. The dense thicket of niggling rules, regulations, and reporting requirements have contributed to India's reputation as an extremely difficult place to do business. Therefore, making life easier for companies would be a logical first step toward the goal of attracting more investment to job-generating manufacturing industries. While the SEZs have streamlined their regulatory regimes in some respects,¹⁹⁰ it appears that firms operating within the SEZs face a far more restrictive regulatory environment than enterprises operating in the DTA. Indeed, the CAG report observed that before a SEZ could be established the developers had to obtain multiple approvals, and that only around 39% of the planned SEZs actually became operational after their notification. Moreover, 17 states were not on board when it came to passing state legislation to match the SEZ Act, and this reluctance has rendered India's single-window system ineffective.

f. Labor Laws

235. There are more than 140 overlapping labor laws in India, 44 at the national level and about 100 at the state level. As a consequence, the near impossibility of big companies firing permanent workers, for example, is a big disincentive to large-scale, labor-intensive manufacturing. Any hint of an intention to dilute the labor laws risks an immediate backlash, although the government does seem to want to make such changes as allowing longer overtime hours and letting women work factory night shifts.

g. Recent Developments

236. The government appears to have plans to revive the SEZs, this time on a much larger scale, as "coastal economic zones".¹⁹¹ Two are reportedly envisaged thus far, each to cover a land area of somewhere between 2,000 km² and 3,000 km², compared with a total of 516 km² for India's 329 SEZs, of which about 8% (i.e., 25 of them) exceed 2 km². It remains to be seen what the features of the coastal economic zones will be, and whether these zones will be any more successful than the SEZs.

D. Cambodia's Experience with Its Special Economic Zones

237. Cambodia's SEZs are relatively new, with the earliest one established in 2006, in accordance with the legal framework for SEZs set out in a government sub-decree issued in late 2005.¹⁹² In 2014, there were 9 such zones operating in the country, with a further 20 authorized to begin operations, all of which were small. The Government of Cambodia's purpose in establishing these SEZs was to promote diversification of the industrial base beyond garment manufacturing, to establish economic linkages between urban and rural areas, and to promote industrial investment outside of Phnom Penh.

238. The SEZs are almost entirely privately owned and managed.¹⁹³ This has minimized the large and sometimes wasteful costs incurred by the public sector when setting up zones in other countries. It also contributes greater market discipline to the running and management of the SEZs, adding to their long-term viability. To establish a SEZ, an operator needs at least 50 hectares (half a km²) of land and must install the necessary roads, electricity, and water supply to service the enterprises that will operate from there.

239. Cambodia's manufacturing sector is heavily dominated by the garment industry. This is less true inside the SEZs, where the industrial base is more diversified, including a higher proportion of firms producing electronics, electrical products, and household furnishings. Industrial diversification was one of the government's objectives in establishing the SEZs, and so this objective has been met to a degree. This diversification offers the advantage that, if the global garment industry suffers a downturn, employment in Cambodia's manufacturing sector will be less vulnerable.

240. Cambodia's experience to date indicates that its SEZ firms are *not* closely linked to the domestic economy. In fact, they are significantly *less* linked than similar firms operating outside the zones. Nonetheless, SEZs may have a significant demonstration effect, as they could show that

¹⁹⁰ Imports to and exports from SEZs are not subject to routine customs examinations; for example, "let export" orders are granted on the basis of self-certification by the SEZs. And exports of products manufactured in SEZs are not subject to compulsory pre-shipment inspections.

¹⁹¹ S. Ahluwalia. 2016. The A to Z of Coastal Economic Zones. *Deccan Chronicle*. 17 February. <http://www.deccanchronicle.com/opinion/columnists/170216/the-a-to-z-of-coastal-economic-zones.html>.

¹⁹² This case study is based on a recent ADB study. See: ADB. 2015. Special Chapter: How Can Special Economic Zones Drive Economic Development? In ADB. *Asian Economic Integration Report 2015*. Manila. pp. 118–121.

¹⁹³ A partial exception is the small Sihanoukville Port SEZ, which is a public-private joint venture financed by a loan from the Japan International Cooperation Agency.

investment in manufacturing beyond the garment sector can be successful, even though the preference-driven, labor-intensive garment industry still dominates manufacturing in Cambodia. And the development of SEZs may also indirectly promote FDI outside the zones, though that would, of course, take time.

241. The Asian Development Bank (ADB) has found that Cambodia's SEZs have attracted significant FDI that would not have otherwise occurred, thereby creating around 68,000 jobs with equal or better pay and with better prospects than the alternatives that would have existed without the FDI. The SEZs account for just under 1% of total employment (and 3.7% of total secondary industry employment), and at least 95% of the SEZ workers in the manufacturing sector are women.

242. Low labor costs and, in some cases, favorable tariff treatment by the European Union and the United States of goods produced in Cambodia are among the main reasons why many foreign firms were initially attracted to Cambodia. Although the employment conditions in the SEZs seem relatively good, however, wages seldom exceed the legal minimum, which is currently \$100 per month. By contrast, the average wage in Cambodia as a whole is between \$160 and \$180 per month. With the rise in real wages since 2010, the era of cheap labor in Cambodia may be approaching its end, but increased labor productivity could compensate for the rise in wages.

243. An ADB survey of SEZ firms in Cambodia was conducted to gauge firms' perceptions of various aspects of doing business in the zones.¹⁹⁴ Among other factors, as discussed below, this survey touched on the quality and availability of labor at the SEZ firms. Cambodian workers could reach satisfactory levels of productivity, but they would require higher levels of training and longer periods of adjustment than would workers in neighboring Thailand and Viet Nam. The average standard of literacy in Cambodia is not high, and 30% of new employees cannot read at all, apparently never having gone to school. As a

consequence, Cambodia has yet to achieve export competitiveness (beyond that due to low labor costs) by raising productivity or investing in innovation. Moreover, a World Bank Enterprise Survey in 2012 noted that there were no significant differences in labor productivity or TFP between SEZ and non-SEZ firms in Cambodia, although the value added per unit of output was slightly higher in the SEZs.¹⁹⁵ But in the economy as a whole, after deteriorating from an annual average rate of 2.6% in 2000–2005 to 0.9% in 2005–2010, TFP growth recovered to 1.6% in 2010–2014 (Figure 7).

244. To maintain the international competitiveness of firms operating in the SEZs, the Government of Cambodia must not only improve the quality of labor by investing more in human capital, it must also upgrade the country's infrastructure, so as to reduce the costs of electricity and transport, and improve their reliability. In the case of electricity, for example, firms choosing to locate in the zones are contractually required to purchase electricity from the zone operator, even when cheaper sources of power are available from sources outside the SEZ. (In the Phnom Penh SEZ, electricity costs \$0.20 per kilowatt-hour, compared with \$0.07 in Thailand and Viet Nam.). Furthermore, the government needs to facilitate trade by reducing the costs and delays involved in importing and exporting. And it needs to reduce corruption and to clarify the rules of payment to government agencies.

245. The ADB survey of the SEZs found that "one-stop" administrative services had generally reduced regulatory compliance costs, but not enough to satisfy firm managers. The responses of the SEZ-based firms to survey questions on the quality of infrastructure, public services, and government policies ranged from "average" to "good."

246. In light of the PRC's recent interest in developing cross-border zones in cooperation with member countries of the ASEAN, perhaps Cambodia will have an opportunity to establish strong links with value chains for rice, corn, and other agricultural products.

¹⁹⁴ P. Warr and J. Menon. 2015. *Cambodia's Special Economic Zones*. Manila: ADB. <https://www.adb.org/sites/default/files/publication/175236/ewp-459.pdf>. This survey was based on field work in Cambodia in October 2014, which entailed visits by the ADB team to three SEZs. The visits included one-on-one interviews with firms operating in the SEZs, and with the managers and operators of the SEZs, followed by a questionnaire-based survey of SEZ-member firms that was conducted in October and November of 2014. The ADB team visited 11 SEZ firms—3 in Phnom Penh SEZ, 4 in Bavet SEZ, and 4 in Sihanoukville SEZ—in addition to the SEZ administrators.

¹⁹⁵ World Bank. 2012. *Enterprise Surveys: What Businesses Experience; Cambodia 2012 Country Profile*. Washington, DC: World Bank Group.

Chapter VII. Principles and Guidelines concerning the Design and Role of the Special Economic Zones and Industrial Zones

A. Introduction

247. The foregoing chapters of this diagnostic study highlighted and assessed the main features of Kazakhstan's special economic zones (SEZs) and industrial zones. In the case of SEZs, they evaluated performance with regard to the zones' explicit objectives, especially the attraction of export-oriented activities and investment (including foreign direct investment [FDI]) and the creation of employment.

248. The purpose of this evaluation is to address the various shortcomings in the features, functioning, and effectiveness of the SEZs and IZs with a view to formulating general guiding principles and specific guidelines in accordance with international rules and best practices. These principles and guidelines are intended to provide a sound fiscal and economic basis for modifying the zones in order to improve their performance and cost-effectiveness (if they are not replaced by more effective alternatives), and thereby enhancing the role of the zones in Kazakhstan's economic development strategy. Such principles and guidelines could help to establish what should be "special" about these zones and what should not. Clearly, both the SEZs and IZs need to adapt to the evolving international trade environment, especially Kazakhstan's recent accession to the World Trade Organization (WTO) and its membership in the Eurasian Economic Union (EAEU), the Central Asia Regional Economic Cooperation (CAREC) Program, and One Belt, One Road" initiative of the People's Republic of China (PRC), as well as its adherence to multilateral and regional trade rules.

B. Empirical Evidence concerning the Performance of Kazakhstan's Special Economic Zones and Industrial Zones

249. While the Park of Innovative Technologies (PIT), Astana–New City, and Aktau Seaport SEZs have arguably met with some success, accounting for most of the goods produced in Kazakhstan's 10 SEZs, the other 7 have yet to take off, partly because

of the lack of basic infrastructure. Judging from the most recent data available (for 2015), the three relatively successful SEZs and Saryarka have more or less achieved their specific targets concerning production, investment, and employment. However, whereas FDI accounted for more than half of total investment in the Aktau Seaport and Saryarka SEZs, it was a mere 6% of total investment in the Astana–New City SEZ.¹⁹⁶ In the case of the PIT SEZ, although investment has exceeded its target, there was apparently no FDI, which could have been a major source of technological progress, and thus of total factor productivity (TFP) growth. And despite its name, no research and development (R&D) has been occurring at the PIT, just manufacturing. Burabay has achieved its targets regarding production, investment, and employment. On the other hand, it has attracted little FDI, and as a result failed to meet this particular target. Among the other five SEZs, Ontustik exceeded its export, production, and modest FDI targets, but has failed to meet its overall investment and employment targets. The remaining four SEZs have, by and large, failed to meet most of their targets. However, both the National Industrial Petrochemical Park and Pavlodar SEZs have substantially exceeded their employment targets. The total number of jobs in the SEZs was a mere 11,527 in December 2016, down from 12,650 in December 2015. Consequently, their shares of the country's total production, investment (including FDI), and employment remain negligible. Interestingly, with T275 billion having been spent on infrastructure alone for the 10 SEZs since 2003, the associated fiscal cost per job is almost T24 million (approximately \$70,000), which is roughly 14 times the average annual wage in Kazakhstan.

250. While there is little data on exports from the SEZs, it would appear that they accounted for a mere 0.08% in 2016. Astana–New City accounts for more than half of the SEZs' total output, and its production is oriented entirely toward the domestic market, particularly toward the new capital city's construction and development. The much smaller production in the PIT is also apparently oriented mostly toward the domestic market. Given that the domestic market is not large enough to enable

¹⁹⁶ More recent data suggest that most of the investment in Seaport Aktau in 2016 involved FDI.

competing producers to exploit economies of scale (and of agglomeration), and thus reduce their costs per unit of output, an orientation toward the domestic market constitutes an impediment to the improvement of TFP.

251. The SEZs' strong orientation toward the domestic market may be partly due to the various tax preferences that enterprises have enjoyed in the zones. These preferences place domestic producers operating outside the SEZs at a significant competitive disadvantage vis-à-vis those operating inside the zones, to the extent that firms operating inside the SEZs maintain part of their preferential tax treatment when producing for the domestic market, both implicitly (because the payment of some taxes may be deferred until the goods are "imported into Kazakhstan's customs territory," thereby improving cash flow) and, more importantly, explicitly (because some taxes, notably the corporate income tax (CIT), are not paid at all). It follows that firms supplying the domestic market from inside and outside the SEZs should, as far as possible, be placed on a more equal tax footing.

252. Firms producing outside the SEZs, but wishing to integrate their operations into the global value chains (GVCs) of SEZ firms producing goods for export (and thus benefit from technology transfers and other spillovers), should be eligible for the same full and prompt tariff drawbacks and rebates of indirect internal taxes on their sales of goods to SEZ firms, as if they were also exporting (provided that leakages from the zones back into the domestic market can be contained). Otherwise, intermediate goods produced by non-SEZ firms will be more expensive than those imported into the zones from abroad (insofar as tariffs and the VAT are shifted forward), thereby deterring purchases by SEZ-based enterprises from firms based in the domestic market. Such eligibility, which is consistent with WTO rules, would be particularly beneficial to small and medium-sized enterprises, and would facilitate the formation of clusters around the SEZs, thereby contributing to more inclusive economic development.

253. One of the main objectives of the SEZs is to attract new investment, especially FDI, together with the technological progress and managerial know-how that FDI brings (and which are major sources of TFP growth). Unfortunately, the SEZs have not attracted much FDI, which accounted for a mere 8% of total investment in all the SEZs by 2015.

254. However, as noted above, there is no convincing evidence that any targets met by the SEZs with regard to production, exports, investment, and employment represent achievements that were substantially incremental. Indeed, tax preferences, nontax preferences, and the provision of infrastructure may have merely induced domestic and multinational enterprises to establish operations in the SEZs instead of in the domestic market, as demonstrated by the example of the firm that merely moved 90 of its 450 employees into the Astana–New City SEZ from elsewhere in Kazakhstan. However, in this case the tax relief did enable the firm to buy new equipment and provide better social benefits to its employees.

255. The SEZs' orientation toward the domestic market may also be partly due to local content requirements aimed at encouraging import substitution. In fact, all the SEZs except the Taraz Chemical Park have local content targets ranging from 18% to 100% percent, which have largely been accomplished and in six cases considerably exceeded. Although it is unclear how such targets have been achieved, if their achievement is, indeed, due to tax relief or other forms of financial assistance contingent upon local content rules, such assistance could possibly constitute prohibited subsidies under WTO and EAEU rules.

C. Lessons from Abroad

256. A well-known success story concerning SEZs has been the PRC, although not in the case of all of its zones (apparently, some 70% have been unsuccessful). The PRC's experience with SEZs is perhaps of particular relevance to Kazakhstan because the Chinese SEZs were successfully used to assist the PRC's transition from a centrally planned to a market economy, one highly oriented toward exports and toward attracting FDI (along with associated technology transfers) in order to create opportunities for more highly skilled (and thus better-paid) jobs. By contrast, India's SEZs are generally considered to have been far less successful than the PRC's, largely because they have not met their export, investment, or employment targets. In India, SEZs have often been used as devices for avoiding, if not evading, taxes. Cambodia's SEZs appear to have met with some success, according to a 2015 study by ADB. Although relatively new, they have managed to diversify the country's manufacturing sector to some extent.

D. General Principles

257. On the whole, (#1) the SEZs and IZs should be integral parts of a coherent economic development strategy that involves the full cooperation of the relevant ministries and other bodies at various levels of government, and includes clear objectives and viable numerical targets (as in the case of Kazakhstan) consistent with the goal of improving TFP, and thus the international competitiveness of Kazakh enterprises. Policies concerning the SEZs and IZs should be coordinated with (but distinguished from) other policies, notably those involving priority-investment and strategic-investment projects. These other policies also include tax and nontax preferences (notably grants amounting to 30% of qualifying investments), which may reduce the attractiveness of SEZs and IZs.

258. As export- and FDI-oriented firms tend to have higher TFP, and therefore pay relatively high wages, the SEZs and IZs should be oriented mainly toward exports, rather than toward the domestic market. And they should aim to attract FDI (and the new technologies and managerial know-how that usually come with it) in order to pave the way for the integration of domestic enterprises into regional as well as global value chains (GVCs). Accordingly, Kazakhstan's economic development strategy should eschew industrialization based on import substitution, which has failed elsewhere because it pays little attention to a country's comparative advantages, undermines economies of scale, and impedes the participation of domestic companies in GVCs.

259. In addition to an overall economic development strategy, (#2) there should be an effective institutional and legal framework specifically for the SEZs and IZs. That framework should be stable, rather than characterized by the frequent legislative changes experienced by Kazakhstan, as well as nondiscriminatory, unambiguous, and transparent. Such a framework would enhance public accountability and reduce the scope for administrative discretion, and thus corruption. The framework should be sufficiently well-developed to (i) specify the role of the SEZs and IZs in the national economic development strategy; (ii) define the rights and obligations of public and private parties, particularly concerning on-site and off-site infrastructure and other facilities; (iii) regulate the governing structures and operating procedures of the zones;

and (iv) provide transparent guidance to investors concerning their eligibility for various tax and nontax incentives, as well as other privileges.

260. Given that Kazakhstan is a member of the WTO and the EAEU, the legal framework concerning the SEZs and IZs and various related measures should not infringe implicit WTO rules or explicit EAEU rules, especially those concerning subsidies. In the case of WTO rules pertaining to *goods*, for example, (#3) no tax incentives or any other type of financial assistance for enterprises in the zones should be contingent on import substitution (due to local content requirements) or on export performance. Otherwise, they will likely be prohibited under the Agreement on Subsidies and Countervailing Measures (ASCM).

261. Irrespective of whether they infringe WTO and EAEU rules or not, fiscal prudence requires that the special features of the SEZs and IZs (including public expenditures on infrastructure, together with tax and nontax preferences), and the zones overall, deliver value for money. As the development of economic zones inevitably involves trial and error, the costs and benefits of the special features, as well as zone performance in general (especially with regard to cost-effectiveness), should also be transparent—in line with 10 of the 100 concrete steps set out by the President of Kazakhstan toward improving the transparency and accountability of the state. Accordingly, (#4) the SEZs and IZs should be closely monitored and periodically evaluated to ensure that they achieve their objectives, including numerical targets, in a cost-effective manner.

262. Such monitoring and evaluation are the foundation for evidence-based policy making and public accountability, so they naturally require the collection of data on the costs involved in pursuing the stated objectives of economic zones, and on the extent to which those objectives have actually been achieved, thereby paving the way for the zones' fine-tuning, their possible rollout on a national scale, or their elimination. Unfortunately, whereas the objectives and the legal and institutional framework for the SEZs and IZs, as well as their main features, are reasonably clear, there is little information on the fiscal and other costs of the various features of the SEZs and IZs—notably, the tax revenues forgone as a consequence of tax preferences, expenditures on infrastructure, and zone administration costs—or on exports from the SEZs and IZs, with the exception of

three that had specific export targets. The lack of data has meant that policy making with regard to the SEZs and IZs is to a large extent being done in the dark.¹⁹⁷

263. An additional formidable impediment to cost-benefit analysis, and thus to transparency, encountered by the ADB team was the difficulty of determining the extent to which the exports, investment, and employment generated by the SEZs and IZs were incremental. Hence, the data obtained from the authorities and the information obtained from interviews with SEZ or IZ officials and residents concerning exports, investments, and employment must be interpreted very cautiously. The exports, investments, and jobs generated by the zones may simply have displaced exports, investments, and jobs from the rest of the country. A lack of incrementality reduces the benefits of the SEZs and IZs relative to their costs, and thus diminishes their cost-effectiveness.

264. When evaluating zones, a clear distinction should be made between measures that facilitate trade and investment (by removing domestic market distortions that affect competition or by providing services in return for fees on a cost-recovery basis) and more proactive measures (such as incentives) that are intended to favor certain activities and may sometimes be justified on grounds of domestic market failure.

265. Facilitation involves the removal of impediments to competition and to the reallocation of domestic resources in reasonably well-functioning markets, in accordance with Kazakhstan's comparative advantage and improved competitiveness. By contrast, incentives involve the more challenging task of successfully identifying, measuring, and correcting market failure, as in cases pertaining to economies of scale or agglomeration, investment in R&D, learning by doing, and insufficiently developed financial markets. However, (#5) incentives should be used only if the exact nature of the market failure can be identified, a substantial gap exists between the private and social benefits due to the market failure, and if a viable cost-effective incentive is the best means of

bridging that gap without any substantial unintended adverse consequences. Insofar as they involve financial contributions by a government or any public body, (#6) incentives (including direct transfers of funds, actual or potential; forgone tax revenues; and the provision of goods and services) should be transparent and subject to "sunset provisions," as well as to periodic monitoring and rigorous analyses to ensure cost-effectiveness.

266. A related source of market failure concerns basic infrastructure which can often be characterized as a public good. As noted in Chapter II.G, public goods are those that deliver social benefits over and above what individuals or businesses would find it profitable to provide, and so tend to be undersupplied in a competitive market. Although few goods are purely "public" (#7), government investment in basic infrastructure (possibly in partnership with the private sector), including in or around SEZs and IZs, would clearly be an indispensable source of TFP, and thus of long-term economic growth. Indeed, the potential benefits of public investment have largely motivated the establishment of the new Asian Infrastructure Investment Bank, which aims to fill the region's infrastructure gap. As long as the return on investment in infrastructure exceeds the cost of finance, public investment will strengthen the government's fiscal balance sheet. For example, in the Kyrgyz Republic feasibility studies predicted that the internal rates of return for investments in electricity generation and paved roads would be in the range of 14%–39%. This suggests that public investment in basic infrastructure, whether in or around SEZs, IZs, or elsewhere in Kazakhstan, could arguably be more cost-effective than tax incentives (especially CIT holidays), whose incremental effects are highly dubious.¹⁹⁸ This is partly because tax incentives are rarely the main determinants of investment. As an alternative to relying exclusively on taxes to finance investments in infrastructure, a user-pays model would create an incentive for the efficient utilization of infrastructure, and would provide funding for its maintenance and eventual renewal. All of this would increase the benefits gained from public infrastructure, including the benefits to enterprises based in the zones.

¹⁹⁷ Some data do exist on the expenditures on infrastructure by each SEZ, also on the total government revenues forgone owing to tax preferences (T27.2 billion in 2014).

¹⁹⁸ Judging from the experiences of countries that evaluate the cost-effectiveness of their tax incentives, the forgone tax revenues generally exceed the increases in investment induced by these incentives, with the possible exception of suitably designed incentives for R&D.

267. While the SEZs and IZs should be outward-oriented, (#8), it is important that they also create linkages with firms and markets in the rest of the country, to ensure that the zones do not become mere enclaves, with little spillover of benefits—especially skills, know-how, and technology—into the domestic economy. Enterprises outside the SEZs and IZs should therefore be placed, as much as possible, on a more equal footing relative to the enterprises inside the zones, especially with regard to taxation. This would enable all Kazakh enterprises to participate in GVCs. Indeed, equalization should be encouraged by facilitating forward and backward linkages between enterprises in the zones and enterprises (as well as research, educational, and training institutions) outside the zones, as this would enable the SEZs and IZs to become centers of excellence. As such, the SEZs and IZs could help improve the capacity of local researchers, universities, and firms to integrate with foreign enterprises in local networks, thereby promoting Kazakhstan's transition to a more knowledge-based economy.¹⁹⁹ Links with educational and training institutions are especially important as a means of ensuring the availability of a sufficiently educated and skilled labor force, which would be more receptive to new technologies and management methods.

268. While no data were available on TFP or labor productivity in the SEZs and IZs, productivity is bound to be adversely affected if zone enterprises are not sufficiently export-oriented or have attracted insufficient FDI (and thus insufficient transfers of superior technology, management know-how, and learning by doing). Productivity will also be impaired if firms operating in the zones are unable to achieve a sufficiently high level of production to benefit from

economies of scale (as was the case for two foreign enterprises visited by the team in the Saryarka SEZ). Greater investment in human capital, especially in education and vocational training, would contribute to higher productivity, not just in the zones, but in the country as a whole, especially in the long run. A better-educated and skilled labor force would make the zones and the rest of the country more attractive to FDI. After all, education and training stimulates innovation and enables the adoption of new ideas and technologies. International empirical evidence suggests that the rates of return from investment in education are relatively high. Consequently, (#9) investment in human capital should be among the main features of Kazakhstan's economic development strategy, and should involve close collaboration between enterprises located in the zones and educational and/or vocational training institutions elsewhere in the country. In the meantime, the government should address the shortage of skilled labor by easing the issuance of residence permits for key personnel and skilled workers from abroad, including those from non-EAEU countries, as envisaged in Kazakhstan's new employment and immigration law.

269. In addition, the protection of intellectual property rights is essential for the transfer of technology and proprietary knowledge, usually in connection with inward FDI, and thus for the development of business linkages between multinational and local enterprises, including small and medium-sized enterprises (SMEs). Therefore, (#10) Kazakhstan should ensure that its laws concerning the protection of intellectual property rights are at least in line with, if not better than, international best practices, and that these laws are adequately enforced.

¹⁹⁹ Singapore provides one of the world's most obvious examples of successful FDI-driven economic development. Since the 1980s, the focus of FDI-promotion policies has been gradually moving away from lower-end manufacturing to knowledge-intensive activities. In addition to targeting innovative multinational enterprises, however, the Government of Singapore has launched new programs to attract foreign universities to the country, making it possible to build a competitive science hub. The "Global Schoolhouse" initiative, launched in 2002, aims to encourage foreign universities to establish branch campuses in Singapore as a means of improving the national education system and attracting international scholars and students. Complementing these efforts, the Campus for Research Excellence and Technological Enterprise program was set up in 2008 to induce foreign universities to fund local R&D centers. As a result, nine universities in six countries, including Cambridge University and the Massachusetts Institute of Technology, have established new research centers in Singapore, and are now collaborating closely with local universities and firms. In Chile too, a shift in FDI-promotion policies has occurred, starting in the early 2000s, with a stronger focus on using FDI as a lever for building national technological capabilities. In 2000, the Government of Chile established the InvestChile agency, providing grants of up to \$2 million, in an attempt to emulate Ireland's success in attracting high-technology FDI. In 2009, the government initiated a new scheme, this one seeking to create international centers of excellence in R&D by offering foreign universities and research institutes grants of up to \$19.5 million over a 10-year period to establish new R&D centers in Chile. A total of 13 R&D centers from seven countries have been established so far under this scheme. See: J. Guimon. 2016. From Export Processing to Knowledge Processing: Upgrading the FDI Promotion Toolkit. *Columbia FDI Perspectives*. No. 186. New York: Columbia Center on Sustainable Investment. <http://ccsi.columbia.edu/files/2016/10/No-186-Guimon-FINAL.pdf>.

270. The overall economic gains from trade liberalization and the consequent structural adjustments in accordance with comparative advantage are such that the winners could, in principle, compensate the losers, so that everyone in Kazakhstan is better off. Insofar as the winners are not willing or able to compensate the losers, however, the government may need to facilitate the necessary reallocation of domestic resources through redistributive measures, so as to increase the efficiency of the adjustment process and thereby ensure that the gains from trade liberalization are spread more equally. Consequently, some form of trade adjustment assistance (TAA) or more far-reaching income-redistribution measures should be an integral part of any economic development strategy, as they can ensure that the gains in TFP from trade liberalization—including the use of SEZs or IZs—and the resulting economic growth are inclusive.²⁰⁰

E. Specific Guidelines

1. Tax Preferences and Adjustments at the Borders

271. Tax preferences are among the most prominent features of Kazakhstan's SEZs and IZs. To preserve the integrity of the tax system, however, such preferences should be specified in the Tax Code (as is now the case in Kazakhstan), rather than in special legislation. Like the legal framework concerning the zones, tax preferences should be stable, nondiscriminatory, transparent, unambiguous, and consistent with WTO and EAEU rules.

272. In order to place the firms supplying the domestic market from inside and outside the zones on the same footing, and thus prevent distortions to competition, (#1) the sales of goods and services to the domestic market by firms located in zones should face full taxation as far as tariffs and indirect taxes are concerned. In the case of an inverted tariff, producers supplying goods to the domestic market from the zones should be allowed to choose either the tariff rate that would have applied to their imported inputs or the rate that applies to the finished goods. Such provisions are included in the EAEU rules concerning

economic zones, which are scheduled to enter into force in 2017, and are now seemingly in effect in Kazakhstan. At the same time, to facilitate exports by domestic firms (especially SMEs) located outside the SEZs and IZs, and thereby develop value chains linking firms located inside and outside the zones, (#2) the sales of goods and services by domestic firms to zone-based enterprises should be eligible for full tariff drawbacks and for rebates of indirect internal taxes²⁰¹ as a way to facilitate linkages between the zones and the domestic market.

273. In the absence of any credible empirical evidence to the contrary, the use of direct tax incentives (especially CIT holidays) in the SEZs and IZs should be avoided, as they are seldom cost-effective. Indeed, Kazakhstan's statutory CIT rate of 20% is not high by international standards, so there is no compelling rationale for additional incentives. However, to the extent that they are nevertheless deemed necessary for encouraging investment in the zones and elsewhere (and do not infringe WTO or EAEU rules), (#3) direct tax incentives should not include tax holidays, but should instead be confined mainly to accelerated depreciation, investment tax credits, or a more generous carryover of tax losses. Tax holidays tend to be less cost-effective and more susceptible to creative accounting (aimed at profit shifting), and thus to tax avoidance, especially in the case of high-tech firms. Needless to say, the SEZs and IZs should not be used primarily as devices for tax avoidance, as is frequently done in India. To ensure that this does not happen, (#4) direct taxes and tax incentives should be the same inside and outside the zones. A common system of tax preferences and/or incentives would avoid harmful tax competition among the zones. It would also ensure a more level playing field among the zones and between the zones and the rest of the country.

274. With regard to the tax treatment of multinational enterprises, (#5) Kazakhstan would be well advised to expand its network of tax treaties to encompass all the countries that are potential sources of inward FDI. Such treaties would mitigate, if not eliminate, international double taxation, and therefore greatly facilitate inward FDI.

²⁰⁰ A public forum addressing the question of how to make trade more inclusive was held at the WTO on 27–29 September 2016.

²⁰¹ Drawbacks or rebates should not exceed the taxes originally paid, as the excess could be considered a prohibited export subsidy under ASCM rules.

2. The Scope of Financial Incentives

275. To the extent that tax and nontax incentives are used to encourage certain activities in the zones involving the production of goods, insofar as these incentives are specific (as might be the case with “positive,” rather than “negative,” lists of eligible activities) and have adverse effects on Kazakhstan’s trading partners, they may be actionable under ASCM rules, and thus subject to countervailing measures. Hence, instead of attempting to pick “winners,” (#6) the government should determine eligibility to invest and operate in the zones mainly based on short negative lists, which are less likely to be specific (and therefore actionable), rather than on long positive lists. (The management company of the Ontustik SEZ noted that the narrow scope of eligible activities included in its positive list had been a deterrent to investors.) Irrespective of WTO and EAEU rules, a negative list would obviously be preferable because it would provide more flexibility in adapting to changes in the nature and structure of world trade, including increases in the cross-border flows of digital information and the introduction of new manufacturing technologies.²⁰²

276. Whatever the type of list used to define eligibility, given that services now account for a growing share of world trade, (#7) the government should allow into the SEZs and IZs the widest possible range of companies specializing in services. The WTO rules for services are much less onerous than those for goods. More specifically, the General Agreement on Trade in Services (GATS) does not include any requirements other than nondiscrimination and transparency.

277. When granting financial incentives, (#8) the governments of Kazakhstan and the other Central

Asian countries should cooperate on a regional basis, so as to avoid a “race to the bottom,” which would leave them collectively worse off from a fiscal standpoint as they competed with each other to offer more tax and nontax incentives to attract FDIs.

3. Access to Basic Infrastructure

278. Judging from the experience of the People’s Republic of China (PRC) with its zones, (#9) access to high-quality basic infrastructure is a prerequisite for the successful operation of the SEZs and IZs, as well as an important source of improved TFP. The zones need to have ready access to electricity and water supplies; ports, railways, roads, and other transport facilities (including the envisaged corridor between Almaty and Bishkek); telecommunications services, especially the internet; and waste disposal. However, the envisaged basic infrastructure has still not been completed for four SEZs (namely Astana, the National Industrial Petrochemical Technopark, Pavlodar, and Taraz), thereby reducing, if not vitiating, the effects of the other features of SEZs.

279. To the extent that basic infrastructure constitutes a public good, it should be publicly provided, possibly with some private involvement through public–private partnerships (PPPs), including financing based on an appropriate user-pays model.

4. The Management of the Zones

280. Regardless of whether it is publicly or privately owned, (#10) the management company in charge of a zone should be sufficiently autonomous, and should operate on a commercial basis. In either case, (#11) it should be self-financing as much as possible, charging

²⁰² According to the McKinsey Global Institute, cross-border flows of data and other information now generate more economic value than the global trade in goods. See: J. Woetzel et al. 2016. *People on the Move: Global Migration’s Impact and Opportunity*. London: McKinsey Global Institute. <http://www.mckinsey.com/global-themes/employment-and-growth/global-migrations-impact-and-opportunity>. An example of a new manufacturing technology is 3D printing, known in the business as “additive manufacturing,” whereby product design files are sent via the internet, and the goods are then “printed” locally, rather than manufactured in one country and then transported to another. Such new manufacturing technology could obviously have important implications for GVCs. Although 3D printing is still in its infancy and therefore has very little effect on cross-border trade, this could change once high-speed 3D printing makes mass production with such printers economically viable. The outcome could be a major disruption in the global flows of goods and thus value chains. According to a recent report, if the current growth of investment in 3D printers were to continue, 50% of manufactured goods would be printed by 2060. In this case, world trade would be expected to fall by one-quarter because 3D printers use much less labor, thereby reducing the need to import intermediate and final goods from relatively low wage countries. As automotive, industrial machinery, and consumer product industries are the top investors in 3D printers as well as large players in world trade, they are likely to take the lead in suppressing cross-border trade. Less trade means that countries with trade deficits in manufacturing will see deficits decline. This will be more pronounced for countries that import relatively many products from leading industries in 3D printing. By contrast, countries with a surplus in manufacturing trade will see their surpluses shrink, especially if they currently export many products that will be 3D printed in the near future. (See: Ing. 2017. *3D Printing: A Threat to Global Trade*. Amsterdam. <https://www.ingwb.com/media/2088633/3d-printing-report-031017.pdf>).

fees (if not market prices) that are commensurate with the services it provides (such as on-site infrastructure, facilities, and management), instead of relying on direct government funding or, in the case of the Park of Innovative Technologies (PIT), on a 1% levy on the total annual revenues of subsoil companies. Self-financing would help to ensure that the management companies provide their services on a cost-effective and competitive basis. Moreover, they should be more transparent and, therefore, more accountable.

281. However, in accordance with fiscal prudence, the experiences of other countries suggest that (#12) private, rather than public, ownership and management can help to contain the large wasteful costs that are sometimes incurred by the public sector when setting up such zones. Private ownership and management also introduce greater market discipline, and thus greater efficiency, into the operation of zones, thereby contributing to their long-term viability. In the case of PPPs, the rights and responsibilities of each of the public and private partners should be clearly defined, especially with regard to the financing and provision of off-site and on-site infrastructure and facilities (notably electricity, telecommunications, transport links, water, and waste disposal), regardless of whether a “build–operate–transfer” or “build–own–operate” approach is used for the development of such infrastructure and facilities.

282. Irrespective of whether the ownership and management of the SEZs and IZs are public or private, (#13) an independent board of directors—comprised of representatives of key government bodies, business executives, and other stakeholders—should be established to oversee the zones. In addition, (#14) both competition and coordination among the various zones should be encouraged. Competition should be based mainly on the facilities and services provided on a cost-recovery basis, rather than on the incentives offered. Furthermore, coordination could help to reduce the risk of harmful competition between zones.

283. With regard to services, (#15) management companies should be permitted to supply various utilities (including electricity, telecommunications, internet access, waste disposal, and water) to the enterprises located in their zones on a commercial basis, as is done in the Ontustik SEZ, for example.

5. Zone Size and Land Use

284. The size of a zone (as well as its location) is an important determinant of its success. As in the case of the PRC, (#16) zone sites should be large enough to accommodate enterprises, especially those involved in manufacturing, for which economies of scale and/or agglomeration are important sources of TFP growth and cost reduction. This will enable them to compete in export markets and in the domestic market without the tax advantages highlighted above. A sufficiently large site will also have enough room for a “clustering” of companies inside the zone and in close proximity to the zone.

285. Given the importance of transferring government-owned land from agricultural to industrial use, and the need to develop an efficient market for the allocation and use of land (including prices, rents, etc.), (#17) the government should engage in land-use planning, zoning, and development, along with the building of related basic infrastructure.

6. The Simplification and Streamlining of Regulations and Procedures

286. In addition to simplification and streamlining of regulations and procedures by the government whenever possible, (#18) a single-window or one-stop-shop system should be set up in each zone to facilitate compliance with domestic regulations (including those regarding investment approvals, business registration, taxation, customs, land use and ownership, buildings, access to basic infrastructure, licensing, health and safety, residence permits for key personnel and skilled workers from abroad, environmental and labor standards, and access to foreign exchange) and to provide assistance in obtaining the related authorizations, licenses, and permits. Moreover, (#19) the laws and regulations pertaining to labor (e.g., working conditions and health and safety) and environmental standards in the zones should be in line with, if not better than, the national laws and international best practices. Empirical evidence suggests that such standards tend to improve labor productivity.²⁰³

²⁰³ For example, see: T. Chang et al. 2016. The Effect of Pollution on Worker Productivity: Evidence from Call-Center Workers in China. *NBER Working Papers*. No. 22328. Cambridge, MA: NBER. <http://www.nber.org/papers/w22328>.

7. Domestic and Regional Cooperation between Zones

287. As there appears to be little cooperation among the SEZs and IZs in Kazakhstan, or between them and similar zones in neighboring countries, recent amendments to Kazakhstan's SEZ law envisage, among other things, the establishment of a unified coordination center for the development of all the SEZs (under the auspices of Kazakh Invest). Accordingly, the purpose of the ADB team's visit to Astana in June 2016 in connection with this diagnostic study was to initiate a forum for coordination, including not just the SEZs, but also the IZs and other major stakeholders from the public and private sectors.

288. In order to facilitate cooperation among the SEZs and IZs and similar zones in neighboring countries, the 13th Central Asia Regional Economic Cooperation (CAREC) Ministerial Conference, held in November 2014, endorsed a framework for economic corridor development, as well as the operationalization of this framework, in a memorandum of understanding on the Almaty–Bishkek Corridor Initiative, the first instance of regional cooperation at the city level between Kazakhstan and the Kyrgyz Republic. Such cooperation between the two countries could usefully involve collaboration between their respective economic zones, and with zones in other countries along the New Silk Road.

F. Concluding Remarks

289. While legislative stability is desirable, Kazakhstan's SEZs and IZs—and, indeed, its economic development strategy—should nonetheless be flexible

enough to adapt to changes in the regional and global economic environments, especially in international trade, and to changes in the domestic environment, such as Kazakhstan's shift to a more knowledge-based economy.²⁰⁴ Changes in international trade include the increasing role of the service sector; “digitization,” which has enabled emerging economies, small businesses, and individuals to participate directly in regional and global trade;²⁰⁵ a slowdown in the annual growth of international trade since 2010 to only 1.7% in 2016, a sign that businesses are becoming less inclined to build cross-border supply chains (which mainly involve manufacturing);²⁰⁶ a deepening of regional integration owing to the EAEU and the New Silk Road; and the recent stalling of global trade liberalization and growth, with the associated fall in FDI flows (from a peak of \$1.9 trillion in 2007 to \$1.2 trillion in 2014).²⁰⁷ The slowdown in the growth of global trade, together with the fall in FDI flows, has been accompanied by a global slowdown in TFP growth, which fell from an annual rate of 0.9% in 1999–2006 to 0.1% in 2007–2013, and disappeared altogether in 2013 and 2014 before recording a negative rate of 0.3% in 2015. As the economic environment and consequent fundamentals determining the structure of global trade evolve, the SEZs and IZs will need to adapt accordingly (also in response to the periodic evaluations of their performance).

290. The SEZs and IZs could play a useful role in paving the way for the implementation of the WTO's Trade Facilitation Agreement, given that it has been ratified by the government. This agreement will help further integrate Kazakhstan into the global trading system by reducing nontariff as well as tariff barriers to trade. The removal of nontariff barriers will be especially important in the case of services.

²⁰⁴ As mentioned in footnote 202, cross-border flows of data and other information now generate more economic value than trade in goods. Moreover, e-commerce has grown so rapidly that the Trans-Pacific Partnership agreement broke new ground when the negotiators agreed to comprehensive rules (in Chapter 14, which addresses e-commerce) that strongly advance the liberalization of internet trade flows and facilitate commerce and investment via cyberspace. It is worth noting that financial services are especially information-intensive.

²⁰⁵ J. Manyika and S. Lund. 2016. Globalization for the Little Guy. *McKinsey Global Institute*. January. <http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/globalization-for-the-little-guy>.

²⁰⁶ Chinese manufacturers, for example, are increasingly producing many of the intermediate parts that they once imported for assembly. Such developments, which are being replicated in the United States and elsewhere, are having a global impact, as car manufacturers and other companies begin to bring production closer to home or to concentrate it in larger markets. These developments are starting to show up in the data, with the global consumption of many finished products, such as cars and pharmaceuticals, outpacing the growth in trade in those goods in recent years, while the trade in many intermediate goods, like fabrics and electrical parts, has actually slowed down.

²⁰⁷ For example, see: G. C. Hufbauer and E. Jung. 2016. Why Has Trade Stopped Growing? Not Much Liberalization and Lots of Micro-Protection. *Peterson Institute for International Economics*. 23 March. <https://piie.com/blogs/trade-investment-policy-watch/why-has-trade-stopped-growing-not-much-liberalization-and-lots>.

It will require more coherent and less obstructive regulations, as well as a focus on the obstacles to FDI, which has been the main mode of boosting trade in services (although this situation appears to be changing with the increasing cross-border flows of digital information).

291. Kazakhstan's zones will also need to adapt to intensified competition and likely trade diversion resulting from the country's accession to the EAEU. For example, accession raised the Kazakhstan's average applied MFN tariff rate from 5.9% in 2009 to 6.9% in 2016, as a consequence of its adoption of the common external tariff (CET). Given that the average CET is expected to increase further to 8.4% by 2020, the possible role of the zones in offsetting the tariff's adverse effects could assume greater importance. Tariffs (and other taxes collected on imports) raise the cost of imported inputs, thus undermining the

competitiveness of exporting firms in Kazakhstan and impeding their integration into global value chains (GVCs). Tariff exemptions accorded to the SEZs and IZs, therefore, could mitigate the adverse effects that import tariffs have on exports to other countries within the EAEU (by deferring payment); they could also remove the adverse effects on exports to countries outside the EAEU.

292. Finally, the SEZs and IZs could help encourage experimentation in Kazakhstan's otherwise insufficiently market-oriented economy. The failure of some zones may be a price worth paying if others are successful. But it will require patience, planning, and monitoring and evaluation to ensure their cost-effectiveness. In any event, the zones are always likely to be an inferior option to economy-wide reforms that reduce impediments to trade and FDI, thereby improving the productivity and export competitiveness of Kazakh enterprises.

Figure 8. Guiding Principles and Specific Guidelines**Kazakhstan General Guiding Principles**

Kazakhstan Specific Guidelines



Tax preferences

1. Tax preferences should be specified in the tax code rather than in special SEZ legislation.
2. Tax preferences should be stable, nondiscriminatory, transparent, and unambiguous.
3. Tax incentives (or other types of subsidy) in the zones/parks should not be contingent upon export performance or local content requirements, in accordance with WTO rules.
4. (Short) “negative” lists are less likely to be “specific” and therefore “actionable” than (long) “positive” lists.
5. As wide a range of services as possible should be allowed in the zones/parks to place firms supplying the domestic market from inside and outside the zones/parks on the same footing.
6. Sales of goods and services to the domestic market by firms located in zones/parks should face full taxation as far as tariffs and indirect taxes are concerned.
7. Sales of goods and services by domestic firms to zone-based enterprises could be eligible for full tariff drawbacks and rebates of indirect internal taxes to facilitate linkages with the domestic market.
8. Tax incentives should be confined to accelerated depreciation or investment tax credits and not include tax holidays.
9. Direct taxes should be the same inside and outside zones/parks to ensure a level playing field.
10. Governments in the Central Asia region should cooperate on a regional basis to avoid a “race to the bottom.”
11. Expand network of tax treaties to all countries that are potential sources of inward FDI to eliminate international double taxation.



Management of zones/parks

12. The body overseeing zones/parks should be sufficiently autonomous and operate on a commercial basis, whether publicly or privately owned.
13. Zones/parks should be self-financing, charging fees, if not market prices, commensurate with the services rendered by the managing company to ensure that such services are provided on a cost-effective and competitive basis.
14. Private ownership and management help contain the wasteful costs sometimes incurred by the public sector in setting up such zones/parks in other countries.
15. An independent board of directors (comprised of representatives of key government bodies, business representatives, and other stakeholders) should be established to oversee the zones/parks.
16. Competition and coordination between various zones should be encouraged.
17. Managing companies should be permitted to supply various utility services to enterprises located in the zones/parks on a commercial basis.



Access to basic infrastructure

18. Access to high quality basic infrastructure (electricity, water supply, transport facilities, telecommunications, and waste disposal) is a prerequisite for the successful operation of the existing zones/parks.



Location, size, and land use

19. Zones/parks should be located close to high quality infrastructure.
20. Zone/park sites should be large enough to accommodate enterprises for which economies of scale are important sources of productivity growth and cost reductions.
21. Transforming government-owned land from agricultural into industrial use requires land-use planning, zoning, and development along with development of basic infrastructure.



Simplification and streamlining of regulations

22. “Single-windows” or “one-stop-shops” set up in each zone/park facilitate obtaining related authorizations, licenses, and permits and compliance with domestic regulations.
23. Labor laws and regulations (including work conditions, health, and safety) and environmental standards should be in line with national laws and international best practices.



New technology and intellectual property rights

24. Intellectual property rights laws should be in line with international best practices adequately enforced.



Human capital

25. Invest in human capital through close collaboration between enterprises located in the zones/parks and educational and/or vocational training institutions.
26. Ease the issuance of residence permits for key personnel and skilled expatriate workers to address skilled labor shortage.

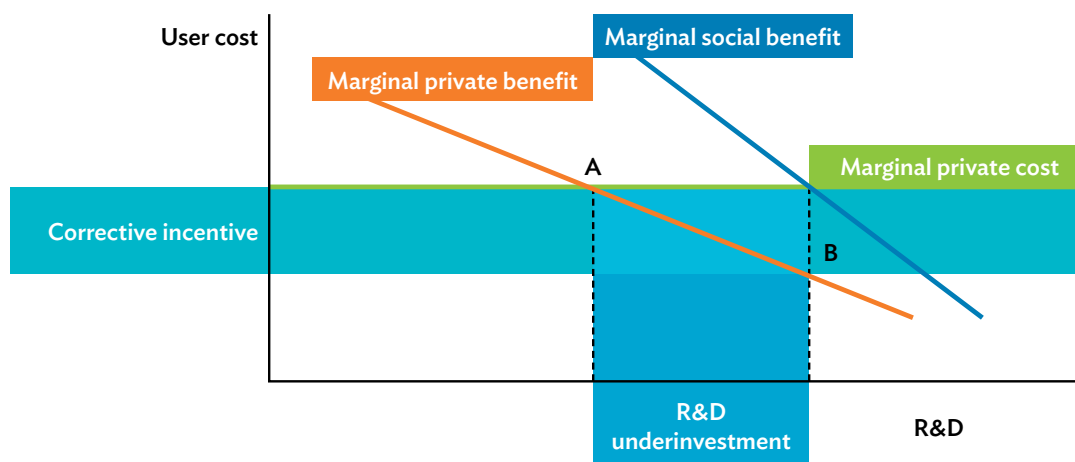


Regional cooperation and cross-border economic zones

27. Almaty-Bishkek Corridor Initiative framework should involve collaboration between the two countries' zones/parks.
28. Explore opportunities to develop cross-border SEZ arrangements not only with the People's Republic of China, but also with other neighboring countries located along the New Silk Road.

Annex: Corrective Fiscal Incentives for Research and Development

Underinvestment in Research and Development and the Efficient Corrective Incentive



Source: International Monetary Fund (IMF). 2016. *Fiscal Monitor: Acting Now, Acting Together*. Washington, DC. <https://www.imf.org/external/pubs/ft/fm/2016/01/pdf/fm1601.pdf>.

1. This annex provides an indicative estimate of possible underinvestment in private research and development (R&D). It combines a simple analytical framework with consensus estimates from the empirical literature.¹

2. Consider a neoclassical framework in which R&D investment of an individual firm is determined by the usual optimality condition that the marginal private cost (*mpc*) (or user cost, *u*) equals the marginal private benefit (*mpb*). Assuming a constant *u*, decreasing returns to scale with respect to R&D capital determines the optimal private R&D (point A). Assume further that the marginal social benefit (*msb*) is two times the *mpb*—as suggested by the empirical literature—and that the externality exhibits the same decreasing returns to scale as the *mpb*. The socially optimal outcome will then be: $mpc = msb = 2 \times mpb$, or $\frac{1}{2}u = mpb$. Firms should thus continue to conduct R&D until the *mpb* equals half the user cost (point B).

The government can encourage firms to achieve this level of R&D by adopting a corrective tax incentive that reduces the user cost by 50%.

3. The effective R&D subsidy rates for 36 countries for 2015 are available in the Organisation for Economic Co-operation and Development (OECD) Science, Technology and Industry Scoreboard 2015.² These rates are derived from the so-called B-index, which expresses the R&D subsidy as a percentage of the user cost. The unweighted average subsidy in the sample is 12%. An efficient corrective fiscal incentive (50% of the user cost) would therefore, on average, require the subsidy rate to be increased by 38% of the user cost. An extensive literature has estimated the sensitivity of private R&D to the user cost and, on average, reports a consensus elasticity in the long term of about -1 . These findings imply that, at current effective subsidy rates, the average underinvestment in R&D is 38%.

¹ This annex was adapted from Chapter 2 of: International Monetary Fund (IMF). 2016. *Fiscal Monitor: Acting Now, Acting Together*. Washington, DC. <https://www.imf.org/external/pubs/ft/fm/2016/01/pdf/fm1601.pdf>.

² OECD. OECD Science, Technology and Industry Scoreboard 2015. <http://www.oecd.org/sti/oecd-science-technology-and-industry-scoreboard-20725345.htm>.

4. The B-index is an experimental indicator that requires a number of assumptions. An alternative measure of the effective subsidy is based on government funding of business R&D as a ratio of R&D spending. The unweighted average for 37 countries in 2013 implies an effective subsidy rate of 14%, and is thus close to the 12% derived above. Average government spending on support for private R&D is 0.15% of GDP. Proportionately scaling up the effective subsidy to the efficient level of 50% would entail an increase in government support of 0.38% of gross domestic product (GDP).

5. Of course, these calculations rely on a number of simplifying assumptions—perfect market conditions, decreasing returns to scale to private R&D, externalities that vary proportionately with the private return, and the absence of distortionary taxation. The user cost of R&D is held constant, while researcher wages might rise in light of their inelastic supply (at least in the short term), thus driving up the user cost. The first-order approximations also take no account of possible nonlinearities, such as those with respect to the effectiveness of subsidies or the impact on GDP. The results should therefore be interpreted with caution and are for illustrative purposes only.

A Diagnostic Study of Kazakhstan's Special Economic Zones and Industrial Zones

This diagnostic study provides an overview of the features, functions, and effectiveness of Kazakhstan's existing special economic zones (SEZs) and, to a much lesser extent, its industrial zones (IZs), in order to identify and correct their shortcomings and formulate guidelines in accordance with international rules and best practices, so as to enhance their contributions to the success of the country's economic development strategy. Attention is focused primarily on the SEZs, as few of the IZs are as yet operational. The main purpose is to highlight the principal features of the SEZs and IZs; in the case of the SEZs, it also evaluates their performance with reference to specific numerical targets. These targets pertain especially to the SEZs' objectives of increasing employment, and attracting export-oriented activities, as well as investment, including foreign direct investment (FDI), along with the resulting acquisition of new technologies. At the same time, this diagnostic study provides some guidelines as to how the existing SEZs (and IZs) could be modified to improve their cost-effectiveness.

About the Central Asia Regional Economic Cooperation Program

The Central Asia Regional Economic Cooperation (CAREC) Program is a partnership of 11 member countries and development partners working together to promote development through cooperation, leading to accelerated economic growth and poverty reduction. It is guided by the overarching vision of "Good Neighbors, Good Partners, and Good Prospects." CAREC countries include: Afghanistan, Azerbaijan, the People's Republic of China, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan. ADB serves as the CAREC Secretariat.

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