# KAZAKHSTAN: PROBLEMS OF DEVELOPING THE OIL AND GAS SECTOR AND IMPROVING THE SYSTEM FOR TAXING SUBSURFACE USERS

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In recent decades, the role of the oil and gas industry in the economic development of many states has significantly grown. This also stands true for our republic. The increase in its oil production and export, the country's main source of revenue, is prompting it to put up an increasingly active fight to conquer energy markets.

According to the Ministry of Energy and Mineral Resources, the proven reserves of oil and gas condensate in the republic amount to 4 billion tonnes. In terms of these indices, Kazakhstan is currently one of the leading oil and gas states in the world. But this does not guarantee the country prosperity. It still needs to find its niche on the world markets offering the best operating performance and political dividends.

At present, the oil and gas sector accounts for approximately 14% of the gross domestic product (GDP). This is essentially the same as the total contribution of the republic's transportation and construction sectors to the GDP, whereby in the past five years the share of the oil and gas industry in the GDP grew 2.1-fold (see Table 1). Throughout industry as a whole, it amounts to 10.2%, increasing in these same years by 2.4-fold, and in construction it has risen by more than 1.5-fold, which shows the intensive introduction of new facilities in this sector.

Whereas in 2003, total oil production in Europe and Eurasia amounted to 101.3% of the 1985 level (in 2002—97.2%) and in Russia to 78%, in Kazakhstan it increased by 230%. This clearly confirms that the republic is steering toward intensive development of the oil and gas industry, particularly oil production. Since 1996, the production of oil and gas condensate in the country has been rising steadily (in the first half of the 1990s, particularly in 1994-1995, these indices were perceptibly lower than in 1985-1990).

Today, Kazakhstan occupies 18th place among over 60 oil producing states in the world in terms of raw hydrocarbon production, and fourth among the European and Eurasian countries (after Russia, Great Britain, and Norway). And whereas in 1985 its share in the total oil production volume of Europe and Eurasia was equal to 2.8%, in 2003 it was on the order of 6.5% (in Russia, 67.2% and 51.5%, in Norway, 4.9% and 18.7%, and in Great Britain, 15.8% and 12.9%, respectively). In 2003, compared with 2002, the oil production growth rates in Kazakhstan rose to 8.3%.

A comparative analysis of the changes in GDP dynamics and oil production in the republic for the past ten years shows that the development rates in this sphere are much faster than similar indices for the economy as a whole. The growth in GDP for this period amounted to 123.4%, and the oil production

*Table 1*

**The Oil and Gas Sector in the Republic's GDP, 1998-2002 *(%)***

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| **Gross domestic product** | **100** | **100** | **100** | **100** | **100** |
| **Oil and gas sector** | **6.5** | **9.5** | **13.7** | **12.8** | **13.8** |
| **Other sectors** | **93.5** | **90.5** | **86.3** | **87.2** | **86.2** |
| ***Industry*** | ***24.4*** | ***28.2*** | ***32.6*** | ***30.6*** | ***29.5*** |
| **Oil and gas sector** | **4.3** | **7.0** | **10.3** | **9.3** | **10.2** |
| **Crude oil and natural gas production, oil- and gas-production-related services** | **3.4** | **6.2** | **9.3** | **8.0** | **9.1** |
| **Oil refining** | **0.8** | **0.8** | **1.0** | **1.3** | **1.1** |
| **Other sectors** | **20.1** | **21.2** | **22.3** | **21.3** | **19.3** |
| ***Construction*** | ***4.9*** | ***4.7*** | ***5.2*** | ***5.5*** | ***6.3*** |
| **Oil and gas sector** | **1.6** | **1.8** | **2.4** | **2.6** | **2.5** |
| **Other sectors** | **3.3** | **2.9** | **2.8** | **2.9** | **3.9** |
| ***Transportation*** | ***12.3*** | ***10.5*** | ***10.0*** | ***9.7*** | ***10.2*** |
| **Oil and gas sector** | **0.6** | **0.7** | **1.1** | **0.9** | **1.2** |
| **Rail** | **0.2** | **0.3** | **0.4** | **0.3** | **0.4** |
| **Pipeline** | **0.4** | **0.4** | **0.6** | **0.5** | **0.8** |
| **Other sectors** | **11.7** | **9.8** | **9.0** | **8.8** | **9.0** |

*Source:* Republic of Kazakhstan Statistics Agency (RKSA), 2003.

growth rates (including for gas condensate) to 227.0%, which had a significant impact on raising industrial production and economic volumes as a whole. This is confirmed by the rather high value of the correlation coefficient (0.942), which indicates that these indices are closely related.

# Oil Production Growth Factors

Two factors are responsible for oil production growth in the republic. First, the significant increase in the inflow of foreign capital, particularly foreign direct investments (FDI) into the industry. Second, the favorable situation on the world raw hydrocarbon markets is having a tangible impact on the situation in the sector.

Let us take a look at the first of these factors. An extremely important aspect of economic reform is creating a favorable investment climate for attracting domestic and foreign capital. In our country, it is

one of the most attractive, not only in the CIS republics, but also among the Central and Eastern European states and the Baltic countries. For example, in the last eight years, Kazakhstan has leapt ahead of the other CIS countries in terms of how attractive its economy is to potential investors, the stability of its political system, and its access to financial resources. This is particularly confirmed by the fact that the republic is the first among the Commonwealth states to obtain an investment credit rating.

As a rule, an increase in investments eventually leads to an increase in their yield, which, in turn, is vital for supporting high economic growth rates in the country. An analysis of the global and regional shifts in capital shows that in the last eight years Kazakhstan has surged ahead of many countries and regions of the world in terms of FDI dynamics (see Table 2).

*Table 2*

**Dynamics of the Change in FDI in the World, by Country Groups, and in Kazakhstan, 1995-2002 *(1995=100%)***

| *Region/Country* | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|---|
| Worldwide | 100 | 113.8 | 145.2 | 206.7 | 325.2 | 419.8 | 248.3 | 196.2 |
| Developed countries | 100 | 106.9 | 131.1 | 229.6 | 400.9 | 544.8 | 286.5 | 223.8 |
| Developing countries | 100 | 129.6 | 172.7 | 171.0 | 204.9 | 219.9 | 187.2 | 144.9 |
| Central Asia | 100 | 124.0 | 187.7 | 181.1 | 148.8 | 113.1 | 239.5 | 243.8 |
| *Kazakhstan* | *100* | *117.9* | *137.0* | *119.5* | *152.7* | *133.1* | *292.8* | *265.7* |
| Central and Eastern Europe | 100 | 89.0 | 133.4 | 157.6 | 176.2 | 184.9 | 175.3 | 201.2 |
| Russia | 100 | 123.0 | 241.3 | 137.0 | 164.1 | 134.6 | 122.5 | 120.1 |

*Sources:* *World Investment Report. Cross-border Mergers and Acquisitions and Development*, U.N., New York and Geneva, 2000, pp. 283-287; *World Investment Report. FDI Policies for Development National and International Perspectives*, U.N., New York and Geneva, 2003, pp. 249-252.

As of 1 April, 2004, the gross input of FDI into the republic's economy amounted to 27.103 million dollars. More than 58% of the total amount of these funds received in 1993-the first quarter of 2004 went to the mining industry. In so doing, more than 52% of the entire amount of outside investments went to the production of crude oil and natural gas (see Table 3) and in specific years (for example 2002), more than 70% was used for this purpose. It is no secret that foreign investors are very interested in the raw material industries, especially the production sectors of the oil and gas and metallurgical industry.

Attracting FDI has its positive and negative aspects. They have already been analyzed in enough depth,[1] so without focusing too much attention on them, we will note that investment in the development of only one industry could lead to dystrophy in other spheres of the national economy.

The second important factor influencing the dynamics of oil production and production growth in the oil and gas industry, as well as throughout the economy, is the favorable price situation on the world commercial raw material markets, primarily the price of oil, which encourages the companies in question to expand their production and export volumes.

[1] See: B.D. Khusainov, "The Development of Oil and Gas in Kazakhstan: Present and Future," *Caspian Research*, No. 4, Anglo-Caspian Publishing, London, October 2002, pp. 46-52.

*Table 3*

**FDI Attracted in Terms of Types of Economic Activity in 1993-2003**
**(*mill. doll.*)**

| | 1993-2000 | 2001 | 2002 | 2003 | 1st qtr. 2004 | 1993-1st qtr. 2004 | Structure (%) |
|---|---|---|---|---|---|---|---|
| **FDI—total** | **12,562.2** | **4,556.6** | **4,105.8** | **4,595.7** | **1,282.7** | **27,103.0** | **100** |
| **Including:** | | | | | | | |
| **Mining industry:** | **7,841.2** | **3,088.9** | **2,123.4** | **2,187.8** | **599.5** | **15,840.8** | **58.4** |
| ***Production of crude oil and natural gas*** | ***6,303.0*** | ***3,059.5*** | ***2,070.8*** | ***2,113.5*** | ***582.3*** | ***14,129.2*** | ***52.1*** |
| **Processing industry:** | **1,766.4** | **642.7** | **832.4** | **993.7** | **179.6** | **4,414.8** | **16.3** |
| **Processing of agricultural products** | **409.3** | **89.6** | **64.9** | **37.0** | **–0.9** | **599.9** | **2.2** |
| **Metallurgical industry** | **1,034.0** | **389.1** | **575.1** | **624.2** | **131.3** | **2,753.7** | **10.2** |
| **Transportation and communication** | **160.0** | **161.1** | **95.2** | **75.8** | **–9.7** | **482.4** | **1.8** |
| **Financial activity** | **206.4** | **44.8** | **11.8** | **52.7** | **3.9** | **319.6** | **1.2** |
| **Real estate transactions, rental, services to enterprises** | **1,432.8** | **454.5** | **845.7** | **987.1** | **437.5** | **4,157.6** | **15.3** |

*Source:* Compiled according to the data of *Vestnik natsional'nogo banka Kazakhstana,* Almaty, April 2003.

# Oil Export

Kazakhstan, like Russia, Azerbaijan, and Turkmenistan, depends heavily on the export of energy resources. Since 1995, the export of raw hydrocarbons in our country has been steadily rising. For example, oil production in 1995-2003 increased 2.5-fold, and export (in kind) almost quadrupled. During this time, the volumes of oil and gas condensate export in value terms increased 8.8-fold (entire export, 2.5-fold), and in terms of its overall volume (12.9 billion dollars) from 15% in 1995 to 54.4% in 2003 (cf. Table 4).

As can be seen from Table 4, during 1995-2003, the percentage of crude oil export (including gas condensate) in its total production volume increased from 55% to 83%. Whereby for the past five years, this index fluctuated around the 80% level. Along with the upswing in the economies of the world's lead-

*Table 4*

**Oil Export (Including Gas Condensate) for 1995-2003**

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|---|
| Export (*mill. tonnes*) | 11.3 | 14.5 | 16.4 | 20.4 | 23.8 | 29.3 | 32.4 | 39.1 | 43.5 |
| Percentage of export in the total production volume (%) | 54.9 | 63.0 | 63.6 | 78.8 | 79.1 | 83.0 | 81.6 | 82.8 | 83.3 |
| Percentage in the total export volume (%) | 15.1 | 21.3 | 25.7 | 30.4 | 36.5 | 49.3 | 49.3 | 49.9 | 54.4 |

*Source:* Calculated according to the data of the Republic of Kazakhstan Statistics Agency.

ing countries after the financial crisis of 1997-1998, the high world prices for raw hydrocarbons as a whole had an impact on the level of Kazakhstani oil production and export.

A particular characteristic of domestic hydrocarbon export is its geographical vector. Oil and gas condensate are mainly sent to countries outside the CIS, whereby their percentage is steadily rising. For example, in 1998 these indices in kind amounted to 49.5%, and in value terms to 59.1%, and in 2002, to 77.4% and 86.9%, respectively. What is more, offshore zones are at the top of the list of importers. For example, export to the Bermuda and Virgin Islands (both British) amounted to 6.1% in kind in 1998 and to 33.9% in 2002, and to 7.2% and 42.5% in value terms, respectively. (In 2003, approximately 16% of the total export of hydrocarbons went to the CIS republics, all the rest "seeps out" to the "far abroad," mainly to offshore zones, primarily the Bermuda Islands.)

The reorientation to offshore zones was primarily caused by the following specifics in the development of the country's petroleum sector. The matter concerns the practice of transfer pricing adopted by oil companies (both foreign and domestic) when transporting raw hydrocarbons beyond the republic, which is essentially one of the ways to carry out "shadow" export of capital. Under Kazakhstan's conditions, as in other CIS countries, the transfer pricing mechanism intentionally adopted by large transnational corporations for exporting capital out of the country is acquiring increasingly refined forms. As a result of the manipulations carried out, it is very difficult to prove the affiliation of the sides participating in the transaction and consequently almost impossible to establish the fact that prices have been deliberately lowered. But a significant percentage of the republic's strategic resources is exported using precisely this method. By way of example, we will present a few calculations (see Table 5), which are very applicable to macroeconomic analysis.

According to our estimates, for 1998-2003, the potential losses from exporting oil using the transfer pricing mechanism amounted to 9,515,400 dollars. Taking into account the maximum marginal corporate tax rate of 30%, it can be maintained that during these years, the country's state budget lost 2,854,600 dollars in oil export revenue alone. If we add the losses induced by transfer prices in ferrous and non-ferrous metallurgy, this amount increases at least 1.5-fold.

In actual fact, the tax burden on oil producing companies is much lower. For example, according to the data of the republic's Ministry of Finance, in 2003 the net tax coefficient for the production of crude oil and natural gas, as well as for rendering services in these industries was an average of 17.2%. Contrary to elementary logic, this coefficient has been extremely low for large foreign oil companies in recent years. In particular, in 2002 for the Tengizchevroil Joint Venture, it dropped from 17.5% to 15%, and for CNPC-Aktobemunaigaz Open Joint-Stock Company from 22% to 15.4%. But as early as 2003, the net tax coefficient for these companies amounted to 21.5% and 29.6%, respectively. Nevertheless, the percentage of revenue from oil production in most countries of the world engaged in this industry is very high. For

*Table 5*

**Oil Export and Losses from Transfer Prices, 1998-2003**

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| **Export of crude oil, mill. tonnes** | **20.4** | **25.2** | **27.7** | **32.4** | **39.1** | **43.5** |
| **Average annual cost of export, doll./t** | **80.9** | **91.6** | **153.4** | **131.3** | **128.6** | **161.2** |
| **Average annual world price for Brent oil, doll./t** | **95.4** | **133.6** | **213.8** | **183.3** | **187.7** | **216.2** |
| ***Losses from transfer prices, mill. doll.*** | ***295.8*** | ***1,058.4*** | ***1,773.1*** | ***1,684.8*** | ***2,310.8*** | ***2,392.5*** |

Here: 1 t = 7.5 barrels.

*Source:* Calculated according to the OECD, RKSA.

example, in Indonesia, this index is equal to 88%, in Malaysia to 83%, in China to 60%, in Nigeria to 86%, in Angola to 85%, in Norway to 82%, in the U.S. to 52%, and in Great Britain to 33% (in the last two countries, this coefficient applies to fields with a production volume of up to one million tonnes a year).

In this way, despite the significant growth in oil export, a serious problem for the Kazakhstan economy is filling out the state budget. During the past nine years, the country's budget (in dollar terms) has swelled almost 1.9-fold. As we have already noted, in the same time, oil export in value terms increased almost 9-fold. Of course, an equals sign cannot be placed between these growth indices. But the budget is experiencing significant losses from tax and customs benefits, in particular, it is losing hundreds of millions of dollars from the use of the transfer pricing mechanism and the high percentage of the shadow economy in the GDP (23% in 2002).

After the Asian and Russian financial crisis (1997-1998), Kazakhstan's state budget revenue rose 1.7-fold, from 3,952,700 dollars to 6,700,800 dollars (in Russia it rose five-fold, from 20 billion dollars to 100 billion dollars). Of course, the budget indices of these countries cannot be compared in absolute terms. But the economies of our states have one thing in common, they are both "addicted to oil." It is thought that the significant increase in the Russian budget is related to the very low personal income tax rate (13%). In our country, since 1 January, 2004, the upper personal income tax rate has been equal to 20%. But taking into account the 10% mandatory payments to the Pension Fund, the maximum sum of contributions amounts to 28%.

In the final analysis, the low rate at which the state budget is being filled is having an effect on the social sphere, which is not experiencing any drastic changes in development. In so doing, average wages and real personal incomes are rising with each passing year, but this growth could be much higher were it not for the problems with filling the state budget.

## Taxation of Subsurface Users

Since 1 January, 2004, certain changes have occurred in the system for taxing subsurface users. In general they are aimed at improving tax management and raising the transparency of relations between taxpayers and the state. The most significant innovations relate to the taxation of petroleum transactions,

which make it possible to increase the republic's budget revenue from subsurface users and at the same time introduce a more flexible and comprehensible taxation mechanism.

A major innovation is rent tax on exportable crude oil. What is more, the Tax Code sets forth a different procedure for calculating excess profits tax on subsurface users, as well as for calculating royalty rates (see Table 6). It is presumed that these measures will make it possible to significantly increase the country's revenue from the economy's raw material sector.

*Table 6*

**System for Taxing Subsurface Users**
**(*as of 1 January, 2004*)**

| Type of payment | Description |
|---|---|
| Bonus | Varies depending on the contract |
| Royalties | A sliding royalty rate scale is set for oil depending on the export volume—from 2% at an export volume of up to 2 million tonnes to 6% at an export volume of 5 million tonnes and up in the tax period under account |
| Corporate income tax | 30% |
| Compensation oil | PSA |
| Profit oil | PSA |
| State participation | PSA |
| Rent tax on oil export | Sliding-scale rate—from 1% at a price of 19 dollars a barrel to 33% at a price of 40 dollars a barrel and up |
| Profit distribution (excess profits tax) | Progressive rates based on internal rate of return (IRR): rates vary from 15% to 60% depending on the how much 20% of the IRR is exceeded |

*Source:* Compiled on the basis of the Republic of Kazakhstan Tax Code.

Let's take a look at these amendments and addenda to the Tax Code from the standpoint of both a deterioration in the working conditions of subsurface users and in terms of natural resource rent extraction in favor of the Kazakhstan people.

## *Royalties*

By nature, royalties are a way of extracting part of the natural resource rent. In international practice, the royalty rate reaches 20%, but it is more commonly applied within a range of 8-12%. Pursuant to Art 299 of the republic's Tax Code, the tax base for calculating royalties is the cost of the minerals. A sliding scale for these rates is set for oil producing companies depending on the accumulated production volume: from 2% at a production volume of up to 2 million tonnes and 6% for 5 million tonnes and higher for the current calendar year. In other words, the royalty rate in Kazakhstan is much lower than in other countries.

This rate is calculated depending on oil export sales and does not reflect the difference in production conditions at different fields. It is essentially simply a mineral production tax, that is, it does not have

anything to do with resource rent. In this respect, the new procedure for calculating royalties puts production companies at a disadvantage. The tax burden on these companies increases in reverse proportion to the field's profitability. For example, the burden increases on companies producing oil at difficult low-profit fields where there is no resource rent at all. There may even be cases when the oil production profitability is actually negative. So the development of small fields with high costs per production unit could be unprofitable, making it more advantageous to halt production on developed fields, whereby some of the oil is left in the ground.

To a significant extent, the Tax Code's shortcomings in calculating royalties are because the amendment writers do not understand (or are unwilling to understand) the gist of natural resource rent, or royalties as a way for extracting this rent. In our opinion, the royalty rate should essentially be determined on a different basis, proceeding from the rent assessment of the field. In the set of amendments and addenda adopted, there is no concept of field rent assessment at all. Instead, a concept of the cost of the minerals is introduced, which depends on price fluctuation. But the amount of rent does not depend on the sales price. If the rent of a certain field were three dollars a barrel, its amount would remain the same at any sales price and would still be equal to three dollars. In this respect, the royalty rate would ensure the extraction of three dollars of natural resource rent in favor of society.

In practice, specific royalty rates should be set by negotiations based on rent assessment, taking into account the oil production dynamics during the entire time the field was being developed and in operation. In world practice, subsurface user taxation systems make it possible to rake in 80% (and more) of the natural resource rent. At this juncture it should be noted that resource rent extraction should not be seen as an increase in the tax burden on production companies. This measure simply evens out the conditions of economic activity for all companies in this sphere, ensuring them a normal average profit. Minimum royalty rates can be set by legislation.

In this respect, it would be advisable to carry out rent assessment for each mineral field in order to determine royalty rates and bonuses; to view royalties as regular payments of natural resources, the rate of which is determined by assessing the potential or real rent revenue of the oil production companies; to set royalty rates for specific projects by means of negotiations; and to legislatively enforce the lowest level of these rates.

## Excess Profits Tax

A certain innovation is also the introduction of excess profits tax on production companies, and the taxation target is that part of net revenue over 20% of the amount of permitted deductions. Excess profits tax is imposed on highly profitable enterprises in many countries and helps to significantly augment budget revenue.

Based on the gist of natural resource rent, it should be noted that with respect to extraction of the latter, like royalties, this tax does not work since it is only paid after production companies have a profit of higher than 20%, and rent forms at a lower level of profitability. What is more, due to the lack of transparency in the bookkeeping of these companies, it is always possible to artificially raise the amount of permitted deductions, which significantly lowers the tax base. For example, according to the republic's Accounting Committee, some production companies manage to write off up to 80% of oil costs to permitted deductions by taking advantage of various bookkeeping loopholes and accounting gaps.

## Rent Tax on Exportable Crude Oil

All exporters of crude oil must pay rent tax on oil export (RTOE), with the exception of subsurface users working under Production Sharing Agreements. And its calculation is based on the cost of crude oil, which is determined from the actual export volume and market price of the raw material after with-

holding production and sales expenses and keeping in mind its quality. A sliding-scale rate is envisaged from 1% at a price of 19 dollars a barrel to 33% at a price of 40 dollars a barrel and higher.

RTOE is essentially a type of export duty aimed at fuller extraction of the excess profit which was obtained due to the increase in world oil prices. On the one hand, introduction of this tax solves the problem of transfer pricing, since the tax rate is determined on the basis of current world oil prices, and not on the actual sales price, which could be artificially lowered. On the other hand, rent tax makes it possible to extract that part of excess profit obtained due to an increase in world oil prices (compared with the prices adopted when drawing up the country's budget draft).

In this respect, RTOE actually replaces the mechanism of resource rent extraction with the export duty, which is a manipulation of public consciousness and another topic of discussion.

First of all, this is related to the fact that the new tax legislation only applies to new contracts. The old tax conditions still apply to companies working under contracts already in effect. On the one hand, this shows the government's firm intention to maintain stability in the tax sphere in order to ensure the country remains investment-attractive in the eyes of foreign investors. But on the other hand, all the advantages of the new system for taxing subsurface users, that is, significantly raising budget revenue from the raw material sector, are put off until the more distant future. If we keep in mind that contracts for developing most fields have already been signed, the amendments to the Tax Code are largely cosmetic and only serve to appease public opinion.

Second, if the definition of RTOE is carefully reviewed, not one of the characteristics defining the taxation target is rent-forming. In our case, natural resource rent itself vanishes as a taxation target, and the fiscal function moves into the foreground—the extraction of additional revenue obtained as a result of the change in world oil prices.

Let's take a look at two fields producing equal-quality oil but with different production costs. In our example (see Table 7), the rent at the first field amounts to three dollars a barrel. According to the amendments, the percentage of this tax in the rent amounts to 2% at a price of 19 dollars, 2.1% at 20 dollars, and a little more than 7% at 40 dollars. In this way, by introducing RTOE, natural resource rent remains at the disposal of the production company owners. Nor will the tax proposed resolve the problem of budget revenue stability, since at a price lower than 19 dollars a barrel (or a project profitability lower than 15%), there will be no budget revenues from this tax.

Under the taxation model currently in use, the first company paid corporate income tax on rent, which is included in profit. After paying taxes and mandatory payments, this company assimilates a rent of 2.1 dollars for each barrel of produced and sold oil. The amendments on taxing oil transactions increase budget revenue. At 20 dollars a barrel, this company brings an additional 0.6 dollars in rent tax and 2.91 dollars in excess profits tax to the budget. The total increase in tax revenues amounts to 3.59 dollars a barrel of exported oil. Correspondingly, the second company adds 1.66 dollars to the budget, including 0.98 dollars in excess profits tax and 0.6 dollars in rent tax.

As can be seen from the calculations, rent tax for the first and second companies is the same, and its amount does not depend on the mining, geological, and other conditions, but on the sales price. In actual fact, all other things being equal, the difference in amount of net revenue of these companies is defined by the amount of natural resource rent assimilated. As noted above, in our example, the first company assimilated 2.1 dollars in natural resource rent. But after the amendments on taxing oil transactions, it assimilates a natural resource rent of 1.67 dollars (approximately 80% of the natural resource rent). In this respect, it can be maintained that all the amendments to the Tax Cod make it possible to extract no more than 20% of natural resource rent.

In this situation, rent tax, like royalties, raises the tax burden on less profitable fields. And companies that assimilate natural resource rent will continue to assimilate it, that is, be in a more privileged position. In other words, the problem of resource rent extraction has not been resolved. In so doing, it is important to note that resource rent is formed during oil production. It does not depend on where the oil is sold, in the country or beyond it. In the formulation proposed, companies operating on the domestic market are excluded from rent tax payers, or correspondingly the part of the oil produced that is sold on this market.

*Table 7*

**Provisional Calculation in Light of the Amendments to Tax Legislation on Taxing Oil Transactions at a World Price of 20 Dollars per Barrel (*mill. doll.*)**

| | *1st field** | | | *2nd field* | | |
|---|---|---|---|---|---|---|
| | With the model in effect | | With RTOE | With the model in effect | | With RTOE |
| 1. Total annual revenue | 16.0 | 20.0 | 20.0 | 16.0 | 20.0 | 20.0 |
| 2. Royalties | 0.39 | 0.52 | 0.9 | 0.39 | 0.52 | 0.9 |
| 3. Rent tax | | | 0.6 | | | 0.6 |
| 4. Transportation expenses | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| 5. Operational expenses | 2.84 | 2.84 | 2.84 | 5.84 | 5.84 | 5.84 |
| 6. Amortization | 0.82 | 0.82 | 0.82 | 0.82 | 0.82 | 0.82 |
| 7. *Total permitted deductions* | *9.05* | *9.18* | *10.16* | *12.05* | *12.18* | *13.16* |
| 8. Taxable revenue | 6.95 | 10.82 | 9.84 | 3.95 | 7.82 | 6.84 |
| 9. Corporate income tax | 2.09 | 3.25 | 2.95 | 1.19 | 2.35 | 2.05 |
| 10. *Total net revenue* | *4.86* | *7.57* | *6.89* | *2.76* | *5.47* | *4.79* |
| 11. Excess profits tax | | | 2.91 | | | 0.98 |
| 12. *Total tax revenues* | *2.48* | *3.77* | *7.36* | *1.58* | 2.87 | *4.53* |
| 13. *Difference due to introducing RTOE and the new method of calculating excess profits tax* | | | *3.59* | | | *1.66* |
| Net revenue after paying excess profits tax | 4.86 | 7.57 | 3.98 | 2.76 | 5.47 | 2.31 |
| Privatized rent | 2.1 | 2.1 | 1.67 | | | |
| Tax burden | 15.5 | 18.85 | 36.8 | 9.88 | 14.35 | 22.65 |

* For the first field, original data presented by the developers in documents prepared for the deputies of the republic's Majilis (parliament) are used.

In this respect, it would be advisable to change the name of the RTOE tax, so as not to confuse anyone, otherwise, when the question of resource rent extraction is put on the agenda, it can be said that this law

already exists; to draw up a draft law on Natural Resource Rent, envisaging fixed rates of rent tax which do not depend on the price of minerals; and based on the nature of resource rent, to ensure the rates are independent of the price level and the company's profitability. It is not advisable to set a profitability level of 15%, for the amount of rent does not depend on the profitability of the enterprise, but on natural conditions; rent tax should apply to the entire volume of minerals produced, not only to those exported; and a law on Natural Resource Rent should be adopted which enforces the lowest rate of this tax. Its specific rate should be determined by negotiations with subsurface users (while issuing licenses and entering contracts) and encourage the extraction of no less than 60-70% of natural resource rent.

On the whole, the amendments on taxing subsurface users will play a positive role in raising the country's revenue from the raw material sector of the economy. In so doing, the negative impact of the new taxes will mainly be felt by small companies which cannot minimize expenses due to the production scale effect, as well as companies developing low-debit field. So it is highly likely that due to the high costs per unit on production, the mineral extraction coefficient will decrease. What is more, projects for developing small fields will become less investment-attractive. And the tax innovations will have less of an impact on profitable fields (with a high natural resource rent), since its privatization will make the project profitability much higher than on average throughout the national economy or in the mining sector. So the claim by several investors that the investment climate in Kazakhstan has drastically deteriorated does not hold water.

In this way, the amendments and addenda to the system for taxing subsurface users, which came into force on 1 January, 2004, do not resolve the main problems of resource rent extraction, which at present is essentially the only resource in capital accumulation. Rent extraction will make it possible to raise the rate of accumulation without increasing foreign borrowing and lowering public consumption. In this respect, in the mining sector, it is important to transfer from taxing the profit and revenue of subsurface users to rent taxation principles.

# Development Prospects

For two (even three) decades now, domestic specialists have been talking about integrated oil refining. Of course, at the initial stage, the budget could accumulate significant funds from the export of crude oil too. But this stage is already drawing to a close, although perceptible shifts in the oil industry, apart from a simple increase in production, have not been forthcoming. It is clear that the raw material vector of the economy is heading into an impasse. It should not be forgotten that several years ago, the price of oil reached its lowest point—9 dollars a barrel.

We are justified in asking whether Kazakhstani oil refining products will be competitive on the world market. First of all, the domestic market will be fully provided for. What is more, the demand for polypropylene and polyethylene is rising in the world at an annual rate of 2-3%. According to the estimates, one ton of polypropylene currently costs 1,200 dollars and one ton polyethylene approximately 1,000 dollars. Countries which understand the profit this promises are actively (and successfully) finding their niche on this market. For example, China is building a 2.8-billion-dollar facility in Xinjiang for manufacturing these products. Beijing estimates that as early as the second year of operation, this enterprise will be able to put out 1.7-billion-dollars-worth of commercial product and saturate the Kazakhstani market.

Domestic specialists correctly believe that "we should take advantage of everything that can be gleaned from the production of oil, gas, and condensate." For example, the institutes of the republic's Academy of Sciences are making estimates taking a field approximately the size of Tengiz as the basis, that is, with an annual production of 12 million tonnes of oil and 6 billion of associated gas. Ten different

alternatives with respect to oil were analyzed: depending on the depth of refining, it will possible to receive between 847 and 982 million dollars in profit, and for gas, the "rawest" alternative presumes 362 million dollars in profit. The maximum alternative is up to 3 billion! So this is how budget revenues could be increased, oil will provide us with these possibilities.

It is obvious that natural resources and investments are having a definite impact on the dynamics of the republic's economic growth. But dependence on exogenous factors, particularly on the fluctuations in world prices on the commercial and raw material markets, is making the export-raw material development model vulnerable. In his Message to the people of Kazakhstan, President Nursultan Nazarbaev noted in this respect that "this could lead to a loss of economic independence." On the president's initiative, a strategy of industrial-innovative development until 2015 has been drawn up and approved in the republic, the main task of which is to raise the GDP 3.5-fold compared with 2000.