KAZAKHSTAN SNAPSHOT: INCENTIVES FOR INVESTORS AFTER COVID-19

Proposed introduction of Investment Tax Credit

October 5, 2020

As it has everywhere, the year 2020 has already left an indelible mark on Kazakhstan. The COVID-19 pandemic has brought a raft of new and critical challenges to an oil-dependent country already reeling from low oil prices and struggling to attract significant inward investment. From both an economic and a human perspective, this crisis will have a prolonged and severe effect on the future of Kazakhstan, and indeed on that of its neighbours across Central Asia. This memo looks in particular at how the Kazakh Government is responding to the macroeconomic impact of the pandemic, as it looks to stimulate a recovery, via a range of new and pre-existing incentives that critics say fall well short of what is required to reduce oil dependency and kickstart a new wave of incoming investment.

KAZAKHSTAN & COVID-19

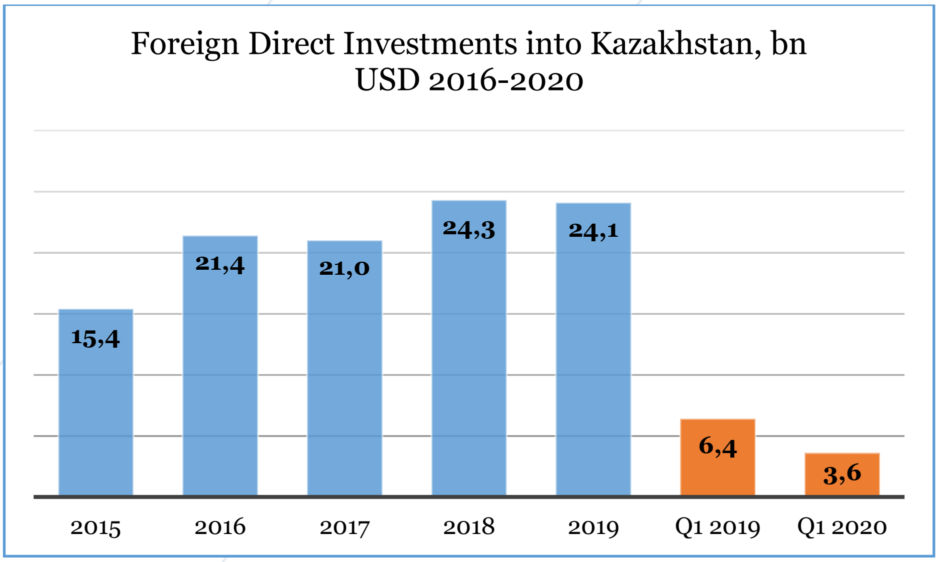
Initially, Kazakhstan, the largest country in Central Asia both by size and economy, managed to contain the pandemic by deploying early and strict country-wide quarantine measures. From March to May just 10,000 cases of the virus (less than 0.06% per 1,000,000 of the population) were recorded, with 38 deaths. The economic downside of this early and widespread lockdown, however, was devastating - and further compounded by the drastic decrease in oil prices and productions cuts in the first half of 2020. As a result, national GDP actually contracted during this period - for detailed information please see the Appendix.

According to Fitch Rating forecasts, the fall in oil prices due to the global oversupply, worsened by a plunge in demand caused by the pandemic and subsequent OPEC+ supply cuts, **will almost halve Kazakhstan's oil revenues in 2020**[1]. Even though the official

[1] https://www.fitchratings.com/research/sovereigns/fitch-affirms-kazakhstan-at-bbb-outlook-stable-21-08-2020

GDP drop looks less dramatic relative to neighbouring countries[2], **it is still the worst indicator in Kazakhstan since 1998**[3], showing a drop of 1.8% in the first half of 2020, and so far showing few signs of a fast recovery.

The economic crisis severely has impacted foreign direct investments (FDI) into Kazakhstan. After a harsh fall in 2015 (-35.5%, 15.4 bn USD) caused by an earlier plunge in oil prices, Kazakhstan had managed to maintain a level of US$ 21-24 bn for four consecutive years (see table below). However, preliminary data for the first quarter of 2020 show that **FDI volume is down by 43.8%** when compared to Q1 2019 (3.6 bn USD vs 6.4 bn USD)[4].



Major investors cancelling well-advanced plans this year include Borealis (a projected USD 5 bn construction of a polyethene plant in the Atyrau region) and Xiamen Tungsten (a projected USD 750 mln construction of a tungsten processing plant in the Karaganda region), both of which withdrew from negotiations with the Government, citing worsened global market conditions, increased uncertainty and the effects of the COVID-19 pandemic.

This perfect storm has heightened the feeling among many commentators that Kazakhstan's flawed investment strategy and lack of progress towards economic diversification has been brutally exposed. Certainly, diversification and incentives to attract investment have become even more critical for the economy, leading to an initial round of tax incentives that the Government hopes will help it turn the corner, but which have been criticized for being insufficient. Below we look at the current incentives and proposed changes and how we expect them to be received by the international community.

[2] Kazakhstan: https://primeminister.kz/ru/news/pravitelstvo-podvelo-itogi-socialno-ekonomicheskogo-razvitiya-za-pervoe-polugodie-2020-goda-106416; Russia: https://rosstat.gov.ru/storage/mediabank/9t1WUjua/oper-07-2020.pdf; Uzbekistan: https://cbu.uz/ru/press_center/releases/367724/; Kyrgyzstan: http://mineconom.gov.kg/ru

[3] https://www.imf.org/external/pubs/ft/weo/2018/01/weodata/weorept.aspx?sy=1992&ey=2023&scsm=1&ssd=1&sort=country&ds=.&br=1&c=916&s=NGDP_RPCH%2CPPPGDP%2CPPPPC%2CPCPIPCH%2CLUR%2CGGXWDG_NGDP&grp=0&a=&pr.x=27&pr.y=19

[4] Data of the National Bank of Kazakhstan and from other sources

CURRENT TAX INCENTIVES FOR INVESTORS

After the oil price crisis in 2014, Kazakhstan adapted its investment strategy, **naming processing and manufacturing as its priority industries**. The introduction of the Entrepreneurship Code[5] and corresponding amendments to the Tax Code[6] in late 2015 provided tax incentives for investors into the priority non-oil & gas sectors of economy, the list of which currently includes 131 different business operations with relatively high initial capital expenditures, including metallurgy, manufacturing of machinery, medicine, clothes, producing food and beverage products.

For these industries, an investor may apply for an Investment Project Contract, under which specific tax preferences such as **full exemption** from **corporate income tax, property tax, import customs duties, and grants in nature** (land lots), or **state subsidies** (up to 30% of the project cost) may be applied to the investment project.

Requirements for an investment project to qualify for these incentives:

1. the projected investment is within one of the priority industries;
2. minimum investment amount for new production facilities – USD 13 mln;
3. minimum investment amount for expansion of existing facilities – USD 32 mln.

It is still possible to enter into an Investment Project Contract with lower investment, only with proportionately lower incentives. An investor looking to secure incentives under this option should undergo an **approval procedure with Government agencies** at both local and central levels.

While these incentives with this extended list of priority sectors have been in place since 2015, success has been visible, but limited. In 2019 KazInvest, the government agency promoting foreign investments in Kazakhstan, reported 40 projects put into operation (a tripling since 2017), with a total investment volume of USD 1 bn. One of the recent successful examples was ENI completing its 48 MW wind power station in Aktobe region, with a planned expansion this year suspended due to the pandemic.

Kazakhstan also progressed a range of other initiatives, such as establishing the **Astana International Financial Center (AIFC)**, an extraterritorial domain governed by UK law with a focus on capital markets; and the **Astana Hub**, a tax-free IT start-up incubator. Along with existing special economic zones' specific exemptions, these initiatives were intended to help invigorate and diversify a stagnating, oil-dependent economy.

[5] In Russian: http://adilet.zan.kz/rus/docs/K1500000375#z290
[6] In Russian: http://adilet.zan.kz/rus/docs/K1700000120#z274

Despite these efforts, in 2019 successful non-oil & gas projects constituted less than 5% of total FDI, showing just how much progress is needed to ensure a sustainable diversification away from the energy sector – and this was before the onset of the pandemic.

PROPOSED INVESTMENT TAX CREDITS

The Government clearly understands that existing tax incentives must be broadened to increase the country's attractiveness for investors, both domestic and international. As one of a number of further steps towards a more appealing investment climate, it has developed a draft law amending a range of important taxation and investment regulations, as it looks to simplify tax administering procedures and implement new instruments for potential inward investors.

The draft law (full text in Russian) was officially submitted to the Parliament by the Resolution of the Government of the Republic of Kazakhstan no. 79. It has already passed the first reading by the lower chamber[7], and is likely to be adopted by the Parliament during its 2020 autumn session, coming into force in January 2021.

The draft introduces the option of an Investment Tax Credit for investors. This measure is aimed at attracting new investments by reducing the burden on investors in the initial period of activity, as well as stimulating the development of new industries, with an additional focus on mid-sized projects – something that was missing from Kazinvest's 2018 – 2027 priority projects strategy[8], which cited USD 45 mln as the average expected cost of an investment project.

Unlike the Investment Contract, **this option does not have any specific requirements**: the new tool is intended for all sectors of the economy, not just the priority ones. The Tax Credit would not require minimum investment commitments from an investor, significantly expanding its potential reach, and would allow investors to reduce their tax payments for a period of up to three years, followed by a phased repayment of the tax credit amount. The tax credit would be granted on **corporate income tax** (tax rate is 20%) and **property tax** (tax rate is 1.5%), so businesses would be free of obligations under these taxes for the period of the tax credit. Such incentives, as the government suggests, will help new investment projects find their feet in their initial start-up phase. Others argue that the measures fall short in a world competing even more fiercely for a dwindling pool of investors, given the pandemic-fueled crisis.

According to the draft, the specific tax credit provisions, including its rate and terms, will be determined by an Investment Tax Credit Agreement. Similarly to the Investment Project Contract, we expect that any Tax Credit Agreement will need to be approved by government

[7] https://www.inform.kz/ru/mazhilis-odobril-popravki-v-zakonodatel-stvo-po-voprosam-nalogooblozheniya_a3665382
[8] In Russian: https://invest.gov.kz/upload/Files/strategiya_-_rus_-_1807_26_1_formatirovanie.docx

agencies – the Committee on Investments under the Ministry of Foreign Affairs, divisions of the Ministry of the National Economy and the Ministry of Finance.

	Existing investor incentives (in force from January 2016)	**Proposed investor incentives in addition to existing (expected from January 1, 2021)**
	Investment contract	Tax credit
Sectors of economy	List approved by the government	All
Minimal investment requirements	New project – USD 13 mln Expansion – USD 32 mln	No minimal requirements
Type of incentive	Tax exemptions: • corporate income tax • property tax • import customs duties • land lots State subsidies • compensation up to 30% of the project costs	Postponed payment of taxes • corporate income tax • property tax
Duration	up to ten years	up to three years

FINAL NOTES

The new Tax Credit incentive is on the table for the Parliament discussion this Autumn and expected to be approved by the end of this year. While not being a unique invention of the Kazakh Government, is an interesting case of how the tax and fiscal authorities are trying to reconsider their approach towards businesses in such challenging times.

Certainly, to prove the value of this initiative, **the Government needs to streamline significantly the bureaucratic processes** involved, which it has committed to do. For instance, while there is a 'Single Window' principle declared to assist new and existing investors, currently there are, in fact, up to seven different governmental agencies involved at various stages of an investment project's approval and execution.

In the meantime, the existing investment regulatory instruments, such as Investment Contracts, should also be made more accessible for potential investors. **The Government must take significant steps** to make Investment contract actually attractive for investors. This can only be achieved by **lowering investment minimal limits, extending terms of incentives, increasing monetary value of incentives** and **nominating one governmental agency** that would have broader authority to simplify the application and negotiations process for an investor.

While it remains to be seen if these new measures can stimulate further significant investment into the country (critics have claimed the range of incentives do not go far enough), we may nevertheless, at last, be witnessing a small but significant new chapter in Kazakhstan's investment history, as it finally wakes up to the need to be more proactive, competitive and attractive to investors.

While still looking for big and lucrative projects, Kazakhstan is also turning its attention to smaller investors, a sector it has ignored for too long. With new and existing tools like **tax credits** and **investment contracts**, the strengthening of the **Astana International Financial Centre regulatory and investment status**, and other brand-new initiatives still under development (e.g. the **Strategic Investment Agreements, lowering the number of taxes and levies** and the forthcoming **2021-2025 Privatization Plan** announced by the President during his State to the Nation address on September 1, 2020), the Government is aiming to chart what we expect to be a long and rocky road back to growth in 2021.

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About Kesarev

Kesarev is the largest independent consultancy in Russia, the post-Soviet region, Central, Eastern Europe, Turkey, and Israel, covering 25 countries and specializing in government relations services, risk and corporate reputation management.
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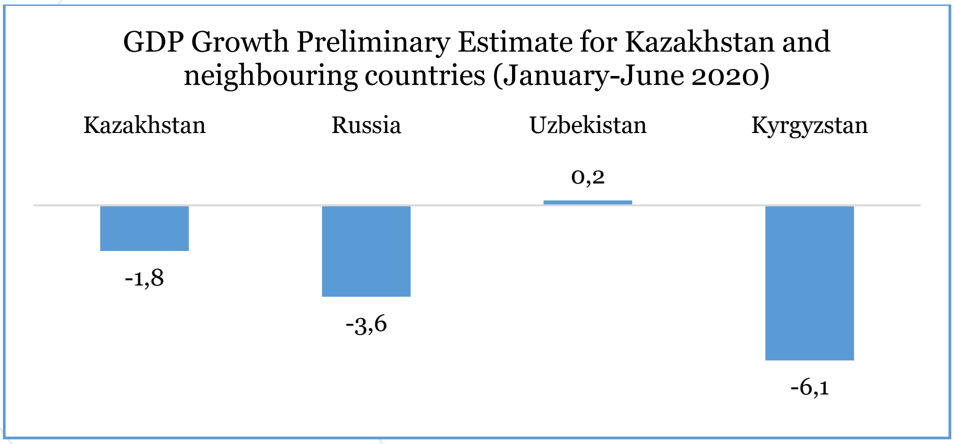
APPENDIX: ADDITIONAL INFORMATION

1. Initially, Kazakhstan, the largest country in Central Asia both by size and economy, managed to contain the pandemic by deploying early and strict country-wide quarantine measures. From March to May just 10,000 cases of the virus (less than 0.06% per 1,000,000 of population) were recorded, with 38 deaths. However, soon after controversially easing restrictions as far back as May 17, the Government had to re-introduce them a month later amidst a surge in both cases and fatalities. As of the end of September, the **number of officially confirmed COVID-19 cases including pneumonia reached 140,000, with more than 2,000 deaths**. Most commentators assume the actual figures are much higher.

2. For a country so reliant on energy sector revenues and foreign direct investment, the quarantine wrought severe economic damage to an already struggling economy and population. Virus outbreaks at workcamps at the country's largest oilfield (Tengiz), which contributes up to 20%[9] of the State budget, brought further shutdowns even as the rest of the country was emerging from the first, worsening economic forecasts even further. The ongoing volatility of global oil prices has added more uncertainty (Kazakhstan's three biggest oil projects account for 30%[10] of State revenues, and oil and gas together 45-50%[11]).

3. The April OPEC+ agreement, which Kazakhstan is obliged to execute, requires Kazakhstan to cut its 2020 oil production by no less than 4.5%, down to 86 mln tons[12] versus 90 mln tons in 2019.

4. GDP data for Kazakhstan and to neighbouring countries[13] for H1 2020:



[9] https://kursiv.kz/news/issledovaniya/2020-02/samye-platyozhesposobnye-kompanii-kazakhstana
[10] https://kursiv.kz/news/issledovaniya/2020-02/samye-platyozhesposobnye-kompanii-kazakhstana
[11] https://forbes.kz//process/energetics/44_gosudarstvennogo_byudjeta_kazahstana_formiruet_neftegazovyiy_sektor
[12] https://forbes.kz//news/2020/06/09/newsid_227105
[13] Kazakhstan: https://primeminister.kz/ru/news/pravitelstvo-podvelo-itogi-socialno-ekonomicheskogo-razvitiya-za-pervoe-polugodie-2020-goda-106416; Russia: https://rosstat.gov.ru/storage/mediabank/9t1WUjua/oper-07-2020.pdf; Uzbekistan: https://cbu.uz/ru/press_center/releases/367724/; Kyrgyzstan: http://mineconom.gov.kg/ru