**Long-run growth barriers in Kazakhstan: Possible causes and repercussions**

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***Abstract:*** *In economics, endogenous growth theory emphasizes the ability to influence the national pace of technological development. Obstacles slowing the rate of innovation in Kazakhstan include low population density, deficient transportation, and income inequality. Solutions include economic diversification, equitable taxation, and regional and global integration.*

***Keywords:*** *Economic growth, infrastructure, institutions, natural resources, spillovers, trust*

**1. Introduction**

 Unlike exogenous neoclassical growth theory, endogenous growth theory argues that long-run economic growth is influenced by internal processes. So it is possible to finance innovations. Paul Romer (1994, pp. 20-2) emphasized policies that will affect discovery, diffusion and technological advance. Creating opportunities for spillovers becomes essential.

 In Kazakhstan, however, several factors can block technological advancement and long-run economic growth. One is the country’s vast territory; winter transportation is difficult. Air transportation can partly eliminate problems that are due to low population density; but in Kazakhstan, the state has a monopoly on domestic flights. A more important problem is income inequality, which permits a decent environment for innovations in only the two major cities, Almaty and Astana. The country needs policies and improvements in infrastructure, regional integration, and communication.

The political and social environment in Kazakhstan creates disincentives for investment in research, development and diversification. This creates space for profit-seizing techniques, which firms in Kazakhstan value more than innovations. Some business entities (especially small ventures) face costs in shielding themselves from the rent-seeking behavior of their competitors or even of their employees. Usually, this behavior is a consequence of the information available to firms. For example, a firm knows that its cashier may take advantage of it, so it adds monitoring devices. This cuts the resources available for research and development.Perhaps weak institutions account for this problem. So might another barrier: the lags in global integration that stem from the loss of intangible assets, from questionable trust, and from over-reliance on physical resources.

**2. Spillover effects**

 The vast territory of Kazakhstan may discourage spillovers that lead to long-run economic growth. With poor communication, roads and income distribution, Kazakhstan is left with only the two big cities where everything “boils.” Government investment in human capital and innovation becomes complicated because the income gap between big cities and small ones is huge. In addition, the lack of incentives to travel to small cities may prevent beneficial spillovers.

High inequality can reduce growth for several reasons. In an unequal society with imperfect capital markets, many talented people lack access to capital or education, resulting in individual poverty traps (Guriev et al., 2009, p. 9). The already small population, spread across an enormous territory, is trapped, as movement is not completely free. Rapid innovation occurs only when people can interact easily. As Romer pointed out, technological advance comes from the things people do. “When more people start prospecting for gold or experimenting with bacteria, more valuable discoveries will be found. There are monopoly rents on discoveries. People and firms have some control over the information produced by most discoveries; therefore they can charge prices higher than zero if they have a control over the access to a discovery. As information has no opportunity cost, the firm enjoys monopoly profits” (Romer, 1994, pp. 12-13). There are incentives to conduct research and organize development. In Kazakhstan, however, the incentives are obstructed and misguided.

**3. Impact of weak institutions**

 May poor countries eventually converge with rich ones in terms of per capita income? This depends on whether they can absorb technological advancements of rich countries and maintain higher returns to capital. These conditions depend in turn on political and economic institutions. If these are weak, investors will under-invest because they fear expropriation. But good institutions will raise the private return to investment and innovation. They are critical to long-term growth (Guriev et al., 2009, p.8).

 North (1990) stated that institutions are formal and informal constraints on political, economic and social interactions. In this respect, Kazakhstan could improve. The social aspects of doing business and of investing are far from ideal; the post-Soviet atmosphere and unreliable governance have created an economy in which trust plays a minor role.

 Inefficiency and disturbance of long-run growth are just one side of the coin. The other side, as Aghion et al.(2010) suggest, is that countries lacking trust and civic capital may produce businesses that do not consider themselves constrained by civic norms. Regulation restricts entry. The regulators do not consider themselves constrained, either; they allow entry in exchange for bribes, which are paid by businessmen who do not consider this a violation of a norm. The population knows of the corruption but demands regulation anyway since large bribes deter some businesses from entry. In such societies, not being civic pays off, and children learn this “optimal” behavioral strategy from their parents. If trust erodes, transaction costs for businesses will rise. People will spend more time choosing the person (or firm) with whom to do business, to avoid being taken advantage of. This blocks long-term growth and investment in innovation.

 To compensate for the lack of transparency, the state invests in “social happiness,” generated by such factors as entertainment, national identity and pride. This is easier to do than to completely restructure moral behavior by creating institutions.

Let’s turn to a related question. Kazakhstan survives on its revenues from natural resources. Is possessing resources a curse?

**4. Emergence of weak institutions and resource curse**

 Kazakhstan’s government relies on resource revenues rather than on conventional taxes. This reduces the incentives for governments to seek popular support for spending. In turn, this creates undemocratic conditions, corruption, and a lack of accountability (Pomfret, 2006, pp. 94-95; Pomfret, 2011, p. 148). Kazakhstan is a transition economy starting from scratch, with no initial institutions. Resources might have been a blessing had they been discovered while strong institutions were present. Williamson (1990) argued that it had been a huge blunder to fail to create economic institutions at the beginning of the transition. In addition, Guriev et al. (2009, p. 8) contended that weak initial institutions increased rent extraction, slowing economic growth.

 Natural resource exports may come at the expense of the manufacturing sector (Corden and Neary, 1982) -- the famous Dutch Disease.[[1]](#footnote-1) If manufacturing increases through “learning by doing,” product quality improvements, and through discovery of products, then the disease can depress long-term growth. Moreover, the presence of commodity resources may create disincentives to investment that create the resource curse (Guriev et al., 2009, p. 6).

 Is the curse impossible to defeat? “Resource booms can be harmful (Sachs and Warner, 1995), but this is not inevitable” (Pomfret, 2005, p. 863). The example of Georgia shows that Kazakhstan is not doomed. Guided by Kakha Bendukidze, Georgia managed a politically painful elimination of government regulation and introduction of economic freedom, creating a business environment with considerable trust (Sonin, 2012, p. 9).

**5. Conclusions**

 For steady economic growth and for convergence to a Western level of income per capita, reformers in Kazakhstan should target three issues: Diversification, taxation, and global and regional integration.

 Vertical diversification implies direct government investment or preferential treatment of firms, which shows willingness to create higher-value-added goods (that is, to expand the production chain). Studies suggest that the sophistication of export products predicts higher economic growth (Hausmann et al., 2007). If raw materials are used to create something more complicated, then the export based economy should shield the country from volatile commodity prices and boost long-run growth. Policies to improve the business environment and to direct the investment flows of micro firms in the right directioninclude improvements in property rights protection, contract enforcement and financial regulation, investment in education and infrastructure, and broad support for financial development.

 Guriev et al. (2009, p. 13) argued that infrastructure and education are feasible even with weak institutions. But these can be strengthened by growth of the middle class, better corporate governance, and by external sources (p. 38). By institutions, I mean the rules of the business game within the country. By changing the rules, the government can accelerate economic growth. Institutions may evolve more rapidly than before, due to pressure from a stronger middle class and from foreign firms that operate in Kazakhstan.

 Improvements in tax collection will increase demand for a responsible government, especially from the middle class. If the tax price of government services increases, citizens may demand better services. Tax increases may slow private investment by reducing the after-tax return; but they would also encourage public spending on human capital, infrastructure and financial development.

Guriev et al. (2009, p. 15) maintained that in developing countries progressive taxation does not work because the rich can avoid taxes. The quality of institutions plays a crucial role; for resource-rich Kazakhstan the need for higher taxes and better institutions (to reduce tax evasion) is low because the country enjoys export revenues from commodities.

 Regional integration can induce innovative spillovers.

Although reputation is an intangible asset, it can depreciate. For example, Kazakhstan’s attempts to seize profits from foreign oil companies have damaged the country’s reputation, discouraging foreign investment (Pomfret, 2005; Pomfret, 2011, p. 152). What should be targeted is improvement of the business environment for foreign firms. This will accelerate global integration, and it will set new innovative standards for firms.

*Rabat Mambekov**is an entrepreneur holding a bachelor’s degree in business economics and finance.*

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1. The term was coined in 1977 by *The Economist* to describe the decline of manufacturing in the Netherlands after the discovery of a large natural gas field in 1959. [↑](#footnote-ref-1)