



Reforming Kazakhstan's Pension System

Kazakhstan was the last republic to declare its independence from the former Soviet Union in 1991. The severing of economic links led to a decrease in the real gross domestic product (GDP) of more than 50% from 1990 to 1995. The transition period was accompanied by declining average incomes, increasing unemployment, deteriorating social services, and decreasing standards of living. The impact had been most severe on vulnerable groups, such as families headed by women, the children, and the elderly.

As the country gradually recovered from the slump in 1996 with a real GDP growth of 1.4%, reforms were implemented to ensure macroeconomic stability and improvement in social services, including privatization of state enterprises, private sector development and banking sector reform, defining a labor market policy, and reforming social insurance and pension systems.¹

Deteriorating Pension System

Kazakhstan's pension system was inherited from the former Soviet Union, wherein the state financed social security and pension through general revenues. Participation rates were high because the majority of workers were in either state-owned industries or collective farms. Mandatory contributions to the pension fund amounted to 25.5% of the wage bill with no contributions from the employees. The pension fund financed four main components: old age, invalidity, survivors, and social pensions. Old-age pensioners comprised 80% of the fund's beneficiaries.² With the cessation of subsidies under the former Soviet Union and the shift to a market economy, the country's pension system was financially constrained, making it difficult to meet its obligations. Because of economic slowdown, a lot of enterprises defaulted in their contributions to the pension fund. Serious institutional

weaknesses and poor management resulted in shortfalls in the collection of contributions. Pension payment arrears were at \$398 million at the beginning of 1996 and peaked at \$474 million (about 2.5% of GDP) by the end of June 1996.³

By end-1996, Kazakhstan's pension system was close to breaking down. The build-up of back pensions had begun to be a focal point for social unrest. As an immediate response, in June 1997, the Government enacted the "Law on Pension Provision in the Republic of Kazakhstan" that became effective in 1998. The reform immediately transformed the pension system from an expensive pay-as-you-go (PAYG)⁴ system to one that was fully funded through defined contribution accounts where workers and/or employers periodically contribute specified amounts to a fund in each worker's individual account.⁵ Based on investments, the new funded system was intended to promote self-sufficiency instead of government dependence, reduce government expenditures, encourage savings, and promote the development of the capital market.⁶ The system was based on three pillars: a residual PAYG system funded by a 15% payroll tax paid by employers; a mandatory, defined-contribution scheme financed by employees' contributions of 10% of the wage accumulated in individual accounts maintained either

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with the State Accumulation Fund (SAF) or privately managed pension funds for investments; and a privately managed voluntary scheme for individuals who want to augment their pension benefits. For the new pension system to succeed, three principal issues had to be resolved: restoring the public's confidence in the pension schemes to ensure wider participation and compliance; introducing key investment instruments and market institutions for the system's sustainability; and further improving the system's legal, regulatory, and institutional framework.

Supporting the Pension Reform Program

The Asian Development Bank (ADB) initiated assistance on the Pension Reform Program⁷ to complement the Government's efforts in reforming the country's pension system, particularly the system's transition from PAYG to a fully funded, defined-contribution pension system. The program aimed to provide effective long-term social protection to the working population, while promoting savings, minimizing distortions in the labor market, and facilitating capital market development. It was specifically designed to:

- create an enabling legal, regulatory, and institutional framework;
- raise public awareness of the new pension system;
- enhance the administration and management capacity of agencies involved in the pension system;
- ensure financial sustainability, including establishing a sound fiscal basis for the pension system and developing key investment instruments and market institutions for support; and
- ensure social sustainability, including adequacy of pension payments and assessment of the distributional impact of the pension system.

Under the program, pension fund guidelines, rules and standards on license fees, commission structures, reporting and disclosure requirements, accounting and auditing, minimum capital requirements, and prudential norms were formulated and adopted by the regulatory agencies. Model pension contracts and custodial agreements were developed and have been used by the SAF and the private pension fund. After the completion of the program in 2000, several new institutions were established while others were charged with new responsibilities:⁸

- The State Pension Payment Center (SPPC) is responsible for pension and allowance payments, maintaining the database for the new personal

pension accounts, and assigning individual social identification codes (SICs) to citizens.

- The Committee for the Regulation of Activity of Accumulation Pension Funds (CRAAPF), under the Ministry of Labor and Social Protection (MLSP), regulates and supervises the activities of pension funds.
- Sixteen pension funds, including the SAF and 15 privately owned and operated funds, have been set up.
- Seven new asset management companies, which manage pension funds, have been established; and six commercial banks are currently operating as custodians of the assets.
- The National Commission on Securities (NSC) is charged with licensing, regulating, and supervising asset management companies.
- The National Bank of Kazakhstan (NBK) regulates and supervises custodian banks.

To ensure the pension system's financial sustainability, the program assisted the Government in developing measures to strengthen nationwide contribution collection, creating a fiscal adjustment plan to finance deficits in the pension system, amending existing legislation to establish greater participation by foreign insurance companies, and designing key investment instruments and market institutions in support of the new pension system.

A targeted public education and information campaign was undertaken through training, computerization, and staffing for monitoring and supervision functions. This led to enhanced administrative and management capacity of the pension system, all of which increased compliance and enrollment in the new system. Reporting mechanisms were improved to ensure adequate transparency and disclosure under the new system, and to monitor the financial stability of the various pension institutions.

Learning the Ropes in Pension Reform

ADB's Independent Evaluation Department (IED)⁹ in its review,¹⁰ cited the Pension Reform Program's key accomplishments:

- the successful creation of the legal, regulatory, and institutional framework required for the new pension system to operate effectively;
- the reasonable public understanding of the reform;
- the adequate capacity on the parts of the SPPC and the regulatory authorities to administer and oversee, respectively, the new system;

- the settlement of all outstanding pension arrears and the continued timely payment of benefits under the old PAYG system; and
- the strong progress in promoting the development of the capital markets. It also said that the program helped support the implementation of a reform that is unlikely to be reversed.

The IED review noted the following key lessons:

- Shifting from a PAYG pension system to a partially or fully-funded system contributes to capital market development in early-stage transition economies and creates institutional pressure to strengthen financial market regulation and oversight.
- Shifting from a PAYG pension system to a partially or fully-funded system also deprives the Government of resources for addressing social issues and should only be pursued if additional resources can be obtained to ease the cost of the transition.
- The success of a funded pension system in providing adequate income replacement depends upon the capital markets' capacity to absorb substantial inflows of investment capital and generate adequate returns to fund participants. In countries with nascent capital markets, the inflow of capital may exceed the absorption capacity of the markets and could expose invested assets to inappropriate risks.

- In the absence of other mechanisms to assure a minimum level of benefit adequacy and effect a reasonable degree of income redistribution from the comparatively well-off to the less fortunate, the introduction of a funded pension system may not provide effective long-term social insurance to the working population.

The IED review further noted that the pension reform was not only tremendously ambitious, it was designed and implemented more rapidly than virtually any other reforms in the former Soviet Union. The reform was complex to design and challenging to implement. It necessitated writing new laws and promulgating regulations to address issues that had never before been faced in Kazakhstan. Moreover, it was logistically demanding, as the administration of the new system required the issuance of social identification codes to millions of people and the computerization of existing social insurance records, which, itself, was a massive undertaking.

Kazakhstan's pension reform is a continuing process. Emerging issues challenge the new pension system, particularly the capacity of the capital markets to absorb all funds flowing into the SAF and private pension funds. A new set of measures and initiatives is needed for the pension reform to live up to its objectives. For sure, the improvement of the reform will continue for years.

Endnotes

- ¹ In general, a **pension** is an arrangement to provide people with an income when they are no longer earning a regular income from employment.
- ² Asian Development Bank (ADB). 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Republic of Kazakhstan for the Pension Reform Program*. Manila. [http://lnadbg1.asiandevbank.org/sec0025p.nsf/docbyno/4ef14d86939148b5482567fb002caa70/\\$file/r24397.pdf](http://lnadbg1.asiandevbank.org/sec0025p.nsf/docbyno/4ef14d86939148b5482567fb002caa70/$file/r24397.pdf)
- ³ Emily Andrews. 2001. *Social Protection Discussion Paper Series: Kazakhstan: An Ambitious Pension Reform*. World Bank, Washington D.C. <http://siteresources.worldbank.org/SOCIALPROTECTION/Resources/SP-Discussion-papers/Pensions-DP/0104.pdf>
- ⁴ "Pay-as-you-go" (PAYG) arrangement means that current workers pay contributions from their salaries, and this money is distributed among current retirees. A method of financing whereby current outlays on pension benefits are paid out of current revenues from an earmarked tax, often a payroll tax.
- ⁵ The term fully funded refers to the new accumulation system. Until the PAYG system is phased out in 2028, the two systems will operate in parallel and thus the pension system at large will be partially funded.
- ⁶ Emily Andrews. 2001. *Social Protection Discussion Paper Series: Kazakhstan: An Ambitious Pension Reform*. World Bank, Washington D.C. <http://siteresources.worldbank.org/SOCIALPROTECTION/Resources/SP-Discussion-papers/Pensions-DP/0104.pdf>
- ⁷ Loan 1589 KAZ Pension Reform Program. Approval Date: December 1997. Completion Date: March 2000. ADB Loan Amount: \$100 million. Executing Agency: Ministry of Finance.
- ⁸ ADB. 2000. *Program Completion Report on the Pension Reform Program (Loan 1589-KAZ) in the Republic of Kazakhstan*. www.adb.org/Documents/PCRs/KAZ/pcr_kaz31091.pdf
- ⁹ Operations Evaluation Department (OED) is renamed the Independent Evaluation Department (IED), as part of measures approved by ADB's Board of Directors to enhance the independence and effectiveness of ADB's operations evaluation function. www.adb.org/IED/default.asp
- ¹⁰ ADB. 2003. *Program Performance Audit Report on the Pension Reform Program in Kazakhstan*. (PPA: KAZ 31091). Manila. www.adb.org/Documents/PPARs/KAZ/ppar_kaz_31091.pdf

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