

PENSION REFORM IN KAZAKHSTAN. COST-BENEFIT ANALYSIS.

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Abstract.

A bankruptcy of state-run pension system is haunting the world.

Setting pension reform as one of its primary goals, the government of Kazakhstan has begun transforming its pension system from joint into savings pension funds system. Initial estimates by Government suggested that a 10% contribution would provide a replacement rate of around 60 percent for career workers. For the first few years, the distribution from the new pension system will be quite small and will be provided as lump-sum benefits. Regulations on the payment of the pensions from individual accounts are to be promulgated in the future.

The purpose of the paper is to estimate the costs and benefits of Pension reform in Kazakhstan. While the cost of pension reform was estimated at 1.7 percent of GDP in 1998, it was projected to rise to 2.4 percent of GDP in 2008. The steady rise in the cost of reform was due to government's assumptions of further reduction in the payroll tax rate by one percent by annum to 5 percent in 2008. The method for estimating costs is a Cost-Benefit Analysis.

The progress of pension system can be expected.

The Pension System' Reform in Kazakhstan.

Introduction.

A bankruptcy of state-run pension system is haunting the world. The pay-as-you-go system that has reigned through most of 20 century has a fundamental flaw, one rooted in a false conception of how human beings behave: it destroys, at the individual level, the essential link between effort and reward-in other words, between personal responsibilities and personal rights. Whenever that happens on a massive scale and for a long period, the result is disaster.

Two factors aggravate the results of that flaw: 1) the global demographic trend toward decreasing fertility rates, 2) medical advances that are lengthening life. As a result, fewer and fewer workers are supporting more and more retirees. Since the raising of both the retirement age and payroll taxes has an upper limit, sooner or later the system has to reduce the promised benefits. A sign of bankrupt system.

Whether this reduction of benefits is done through inflation, as in most developing countries, or through legislation, the final result for the retired workers is the same: anguish in old age created by the inherent insecurity of the "social security" system.

After collapse of USSR, the Pension System of Kazakhstan was needed to make cardinal changes in its structure as any other sector of economics. A demographic situation when a whole burden of social payments was laid on small group of working people is one of the factors that led to the decision of Kazakhstan Government to transfer a pay-as-you-go system to Pension Savings Accounts (PSA). The Government has decided to copy a successful Chilean experience

that can be instructive to the countries around the world. It is a fact that the Chilean savings rate has increased to 27 percent of GNP and the unemployment rate has decreased to 5.0 percent since the reform was undertaken.

In 19 years, Chile's program has almost completely privatized the country's pension system, creating a huge source of domestic savings and investment for the country's financial markets. But in the case of Kazakhstan, where emigration has reduced the population by 2m since independence, the pension fund has been consistently in arrears, partly because of this imbalance in contributors and recipients. Implementing a Chile-type pension reform system was the natural alternative to a pay-as-you-go program. It is implemented gradually, over a period of decades, by diverting a percentage of pension contributions by workers into private or state-run pension funds, which invest the money, and then pay pensions to the contributor when he or she retires.

The research considers the reforms in pension system of Kazakhstan. It shows economical, social and political factors that lead to unsuccessful implementation of innovations. The paper defines the consequences of pension funds' activities on the development of Kazakhstan capital market.

The first paragraph presents the idea of old pension system, its characteristics and shortfalls. The reasons of reforms in pension system and some analytical reasons about the essence of pay-as-you-go system are given.

The second chapter concerns the process of reform and considers such details as the features of an accumulative pension system, reasons for its undertaking, main parts of new system, how does it fit with new requirements. In such framework the analysis of this problem is given. The publications of different specialists in the mass media field will help to consider the problem from various viewpoints.

The third chapter considers the influence of pension system on the capital market of Kazakhstan. The brief characteristics of accumulative Pension Funds as the main elements of pension reform are given. The problem with further development of accumulative pension system is investigated.

The fourth chapter of the research gives a cost analysis of an undertaking of pension reform in Republic of Kazakhstan. Here, the statistics of closed newspapers, magazines, electronic media are summarized in order to evaluate and assess the total costs both the undertaking of the pension reform and in the absence of it.

The fifth chapter presents the analysis of pension reform from the benefit side with giving all appropriate information.

Finally, the main ideas and findings are summarized in the last chapter. According to the above-mentioned results some useful recommendations are elaborated in this chapter for determination the possible ways for solving the problem with the lack of financial instruments for investment the pension assets.

I. The reforms in pension system.

Presence of Pension funds is most significant at the market of state securities, because the latter related to the instruments least of are subjected to financial risks. The brief history of development of accumulative pension system indicates that pension funds became the main investors at this market, and pressed the secondary banks.

Kazakhstan pension reform law was enacted in 1997 and begin to work in 1998. The reform immediately transformed the pay-as-you-go system to one, defined contribution accounts.

A. Old pension system.

In old pension system payments were defined by formula that based on salary size and amount of years of deductions. Pension assets were not invested anywhere.

1. Characteristics of pay-as-you-go system.

There are some *characteristics of pay-as-you-go system* as follows:

- A big scope.
- Lower pension age

- Privilege on earlier entrance on pension for social groups lead to non-equality of distribution of resources (average pension age 52 years) (World Bank:1998)

2.Environment.

1.Problems of old system:

2.Retirement age were low (55 years for women, 60 years for men)

3.Normal pension formula was generous at 60% of highest wages averaged over 12 months for workers with full service (20 years for women, 25 years for men)

4.Base was increased by 10% for each year above minimum.

- Theoretical replacement rates were generous. Inflation indexing did not keep up with wage growth, actual average replacement rates were much lower than in the formula.

- Demographic situation

Ratio of persons age 60 and over to the working age (from 20 to 59 years).(World Bank:1998)

In 1995 in Kazakhstan this ratio was 0.18 when in US it was 0.3.

Only 1.8 working people for 1 retired person-low ratio compared to the demographics of population.

Tax burden affected by several reasons:

1. High payroll tax (25%)

2. Early retirement ages

3. Increasing employment in informal sector

- Ineffective system of collection and payment

- Arrears in collection in Oblasts.

Collections only amounted to 45-52% of potential revenues. As a result government needed to transfer money from state budget to pension funds to cover payments (1997) and paying for administrative expenses.

- Macro-economic situation

B. Reasons for reforms:

- High sensitivity to economic crisis

- Decreasing in employment in official sector

- Faster growing old of population

- Tax evasion in non-official sector

- No relationship between fee and payment

- Demographic indicator (the ratio that defined as size of population which retired divided on to size of population with age between 16-63 years old) (Statistical Agency:1999)

Tab.1. Demographic indicator in Kazakhstan in 2000-2030

Year	Demographic indicator
2000	16.5%
2010	15.9%
2020	21.7%
2030	27.1%

Excess burden falls on small working groups.

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- 2) World Bank, 1994, "Averting the old age crisis: Policies to protect the old and promote growth", Oxford University Press
- 3) World Bank, 1998, "Kazakhstan: Living standards during the transition", Report # 17520-KZ (March 23)

II. The process of reform.

The new system based on investments is intended to promote self-sufficiency instead of government dependence, to reduce government expenditures, to encourage savings and promote development of capital market. Starting in 1 January 1998, pension system was transformed into one of fully funded, individual defined contribution accounts mandated for all workers on an immediate basis.

Pensions under new system are based on contributions of 10% of earnings allocated to individual accounts and invested in financial instruments in accumulation funds. These accumulation funds, including one managed by state, have been established. There is a safety-net legislation which provides social allowances for disability, old-age and loss of a wage-earner.

Government provide information about reformat the highest level. Government prepared a plan for public information campaign with a timetable for implementation of the public information strategy, which is supported by technical assistance from Asian Development Bank and World Bank.

The *main parts* of pension system are follows:

- Asset Management Companies (AMC)
- Custodian Banks (CB)
- Pension Funds (PF)
- New regulatory offices: 1) National Pension Agency (NPA), 2) Regulatory Office of National Securities Commission (NSC), 3) Regulatory Office of National Bank of Kazakhstan (NBK).

1. AMC is in charge of making day-to-day transaction decisions. It is in form of joint stock Company with chart capital 80-mln tenge. Any citizen can be a manager of AMC if he has a special certificate. AMC has right to sign contracts with one or more non-state accumulative funds.

Tab. 2. The amount of AMCs in Kazakhstan in 1998-2001

Month	Year	# of AMC
June	1998	4
February	1999	6
August	2001	7

AMC provides high rates of return from investments with interest rate 23-25%. (NBK:1998)

2. CB is the bank that accounts for and reports on all transactions, portfolio allocation and investment returns. It is a broker of transactions. CB was established because AMC and NASF (non-state accumulative funds) can not use assets in the accounts of plan participants. National Bank of Kazakhstan licensed 7 CB that they are credible institutions. NB monitors their activities. NSAF, AMC, and CB are independent of each other.

3. SAF (state accumulative fund) is in form of Joint Stock Company. The founder is Government. It guarantees safety of contributions. The charter capital –10-mln tenge allocated by Ministry of Finance. NB is functioning as AMC and CB. At the beginning of 1999, about 76% of total pension assets were in SAF and at the beginning of 2000 only 70% were there. (World Bank:1994) This decreasing in shares of SAF caused by the higher competition between pension

funds SAF can be privatized when it would not be predominant in market. SAF has a cost-advantage comparing with NSAF: subsidize by government in forms of salaries of staff and expenses on office space.

NSAF direct overall allocation of assets. It is in form of joint stock company with charter capital 180-mln for open NSAF and 50-mln for closed NSAF. The legal entities and individuals who passed qualification test can be shareholders and founders. Pension funds obliged to contract with one AMC. In this contract the distribution of commission between NSAF and AMC for management and methods of transferring grants are drawn up. The brilliant example of corporate pension fund is Phillip Morris APF where all contributors are internal.

The allocation of investments by the SAF and the NSAF are closely controlled. Both types of funds must invest a minimum of 50% of their assets in government securities. The SAF, by law, can invest up to 40% of assets in designated national banks deposits and up to 10% in the issues of international institutions such as IMF and IBRD. The NSAFs have greater flexibility in their investment portfolios as they may invest a maximum of up to 30% in class A corporate securities. Class A are listed on the Kazakhstan Stock Exchange and have had at least one year of financial statements audited in accordance with international standards. (World Bank:1994)

Three government authorities are responsible for regulating the various elements of the pension system: 1) the NSC for the asset management companies, 2) the NPA for the pension funds, reporting to the Ministry of Labor and Social Protection (MOLSP), 3) the NBK for the custodian Banks. The state pension payments center (SPPC), also reporting to the MOLSP, is the key administrative institution for the residual state system.(Anderson, J.M.:1997)

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1. Anderson,J.M., Kolberg, J.E., 1997, "*The pension system in Kazakhstan: policy, structure, operations and reform*" Final report to the Ministry of Labor and Social Protection, Republic of Kazakhstan, (April)
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III. The influence of the pension assets on the capital market.

Considering the question about influence of accumulative pension system on capital market' development it is necessary to give the brief characteristic of accumulative pension system as the main element of the pension reform in Kazakhstan.

A. Institutional infrastructure.

The basic infrastructure of accumulative pension system was formed during the period of realization of pension reform.

- The class of institutional investors as APF was created. (on present there are 14 NSAF and 1 SAF)
- The forming of APS results in the development of institute of capital market' participants. Where appearance of AMC affected on increasing number of brokers-dealers. Now there are 6 AMC.
- The development process of APS leads to active process to give a custodian services of second level' banks. Today 10 banks have a license of National Commission on implementation of custodian activity.

There are more than 50 legislative acts, where the directions of pension assets' investment are established: the principle of maximum exception of risks and the principle of providing appropriate profitability.

The situation with institutional and legislative infrastructure talks about sustainable development of pension system and the transformation of it into one of key' elements which are influencing on capital market.

In condition of decreasing interest of investors to developing markets only APFs are valuable institutional investors on stock market caused by lack of insurance companies and investment' funds. The bank' institutions can be concern as valuable institutional investors because the term of investment bank is absent in Kazakhstan lows.

B. Pension assets.

The dynamics of finance accumulation in APFs is described in the table (Moldachmetov N:1999)

Tab.3. Dynamics of finance accumulation in APFs.

Year	Value (Tenge)
First half of 1998	9 bln 53,5 mln
Second half of 1998	23 bln 527,7 mln
1999	46 bln 449 mln
2000	56 bln 674 mln

The growth of pension assets will have a stable trend due to legislative regulations about 10% mandatory contributions into accumulative system. It will result to increasing influence of APS on capital market affected by continually rising value of investments.

The vital importance of APFs is in state securities market that relates to instruments with less degree of financial risks. The factor of investment risk minimization of pension assets dominates on the factor of profit maximization caused by high social significance.

APFs became main investors on security market within short period of APS' development. They pressed another investor on this segment – the second level of banks. APFs take a first place on securities market by the volume of investments. Common volume of PF' investments is 70,25% of the whole of volume of state securities.

Tab.4. APF portfolio (state securities)

Tenge value(tenge):	
National middle-term securities	396,6 mln
NB notes	36,8 mln
Total in tenge:	455,1 mln
Percentage:	1,1%
Foreign currency value (tenge):	
Eurobonds	12317,6 mln
Special state bonds	31517,0 mln
Special state bonds on five years	824,7 mln
Total in foreign currency:	44659,3 mln
Percentage	98,9%
Total investments:	45114,40 mln

NSAF positive influence on the stabilization of Kazakhstan' eurobonds profit. Now 17,3% of the whole volume of issued eurobonds are in APF due to The Degree of National Commission (5 October 1998) that allowed AMC to purchase eurobonds as state securities.

The corporate stock market has not such developed as state securities market due to some reasons result in small shares of corporate issues (0.86%) in APF' portfolio.

The development of APS will connect with capital market because getting of investment profit on pension assets is possible in the framework of investment portfolio. The subjects of APS are the subjects of capital market since the AMC are professional participants of capital market, APF are main institutional investors.

Perspectives of accumulative system' development and its influence on the capital market connected with pension assets growth and increasing in volume of investments. This growth will have a permanent trend due to the legislative regulation on 10% of mandatory contributions into APS. Also increasing in pension assets is possible due to voluntary contributions into APS.

The main problem of further development of APS follows from this statement. This is the lack of financial instruments for investments except state securities. This problem can become more sharp in the nearest future when the volume of accumulative pension asset would be confront with the volume of issues on securities market.

National Commission allows investing to foreign corporate issues with rating no less than "AA". However, the question of financing the foreign economy through investment of foreign issues by APF is not a preferable.

Decision that is more appropriate is a creation of conditions for further development of national issuers' stocks. In this light, a Program on development Kazakhstan capital market on 1999-2001 years takes a special significance. In this Program the main moments of development of capital market are underlined. Different measures on increasing of attractiveness of investments into non-state securities and investment opportunities are considered here.

First of full an elaboration of opening an information about activities of securities' issuer by state organs is considered. Procedure of state registration should refer to the question of opening the information and a mechanism of providing information to interested investors.

The second point is increasing a discipline of joint stock companies in fee and payments by issues. The lack of upper class issuers caused by the absence of dividends on simple issues and therefore there is not the profit on investments.

The last point is that the realization of "blue chips" program and selling state issues of second echelon enlivens the capital market. In "blue chips" privatization shares of Kazakhstan companies in which majority blocks of shares were first to tender to strategic investors and then sold through stock exchange.

The process of issue of municipal securities has received legislative basis. Therefore, in 2000 the share of these issues has amounted 242,6-mln tenge or 0,22% of investment portfolio. (Umbetov A.-:2001).

Marchenko G., Chairman of NBK, says that "...the problem is unwillingness of management of potential investors to provide information on required level and we need a real measurements from the state by supporting the development of securities market". It is argued that government should press the management of big companies which are "blue chips" and must to make a requirements of listing "A".

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IV. The Benefit structure.

Initial estimates by Government suggested that a 10-percent contribution would provide a replacement rate of around 60 percent for career workers. For the first few years, the distributions from the new pension system will be quite small, however, and will be provided as lump-sum benefit. Regulations on the payment of pensions from individual accounts are to be published in the future, in conjunction with the development of the insurance industry. As Government expects the pension system to provide adequate future retirement income relative to earnings, ongoing analysis of the level of pensions by age cohort, gender and length of working life is to be instituted. Such analysis is essential as pensions that rely on personal savings will vary across cohorts depending on system returns and may lead to lower replacement rates for women or other groups in the population. (World Bank: 1998)

A. Normal Pensions.

Whether or not replacement rates meet the 60 percent rate target depends on the period over which the contributions are made, the rate of return to the participants' pension accounts, and the length of the contributory period. A simulation model using slightly different assumptions than those used by Government indicates that under reasonable assumptions, individual replacement rates may be less than 60 percent rate.

For example, Table 1 present estimates of total pensions (state plus funded) as a function of age cohort and work history. In the model, the individual contributes 10 percent of his or her wage from the start of the reform until retirement and receives a price-indexed pension from retirement until death. Administrative costs are assumed to take

up 10 percent of contributions, savings earn a 3,5 percent rate of return, real wages grow at 2 percent while inflation is 0. Individuals start work at age 20 and retire at the official retirement age.(World Bank:1998)

Table 5 :Initial Replacement Rate(%) as a function of work history and starting age.

Work history (years)	Age at start of reform (years)		
	25	35	45
40	30 (2.50)	34 (2.82)	44 (3.65)
35	27 (2.24)	31 (2.58)	36 (3.00)
30	24 (2.02)	28 (2.35)	33 (2.76)
20	18 (1.48)	22 (1.80)	30 (2.50)

Note: the figure in brackets is the initial pension as a function of the minimum pension.

Two main points emerge from these simulations. First, under the specified assumptions, initial pensions will typically replace less than 60 percent of the final wage. If workers want to have a higher replacement rate, they will have to save more voluntarily. Second, those with short contribution histories (which are likely to include women) may not be able to accumulate enough in their pension accounts to support themselves adequately in their old age. The reform could put these groups at risk of old-age poverty.

While current rates of return to pensions are currently far higher than initial Government assumptions and much higher than the return assumed in the simulation model, these high rates are not likely to last in perpetuity. And, as the stock market emerges, funds can expect fluctuations in returns. Fluctuations in emerging markets are still likely to be greater than those in developed market economies. Two main policy implications emerge. First, it will be important not to raise false expectations about the level of pensions the reformed system will support. Second, it may be necessary to raise contribution levels and make other changes in order to achieve social protection outcomes to approach the 60 percent target.

B. Minimum pensions.

As part of pension reform, pensioners with full years of service (equal 25 years for men and 20 years for women) will be eligible to receive a minimum pension if their combined plan pensions fall below a minimum consumption standard. A minimum of 2,400 tenge was enacted under the 1998 budget law. That level is roughly equivalent to 70 percent of the 1997 survival minimum cited in the World bank's poverty assessment, "Kazakhstan: Living standards during the transition." Allowing for the fact that pensioners may have other sources of income, including self-production of food and assistance of relatives, a target of 70 percent of the survival minimum appears both adequate and reasonable. Such benefits should be indexed for inflation automatically to ensure pensioners that with a full working history are not at risk of poverty.(Anderson at all:1997)

C Disability and Survivors' Benefits

Under the new legislation for social allowances, disability and survivors' benefits have ceased to be insurance benefits and have become flat-rate allowances unrelated to service- or wage-history. These allowances are funded directly through the budget and are no longer a part of the pension system. Workers eligible for invalidity benefits, whose conditions preclude any possibility of work, face a sharp reduction in their income if they earn above the average wage. Similarly, low-wage earners in other categories may receive higher income from disability allowances than they did prior to disablement. For these reasons, these policies represent interim measures instituted to break with the former system. The longer-run goal for disability and survivor's benefits is the provision of annuities through private disability and life insurance.

The emergence of a strong insurance industry is thus necessary to support the funded pension system. As the system matures, the payment options approved by government for the funded system (such as fixed schedule of payments, single life annuities, joint and survivor annuities) will be in the hands of commercial insurers. Similarly, an extension of reform to mandate insurance-based disability and survivors' benefits must be predicated on the emergence of a well-regulated insurance industry.

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- 3) *Reports: World Bank, 1998, "Report on recommendation of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Proposed Reform Adjustment Loan in an Amount Equivalent to US\$300 million to the Republic of Kazakhstan." Report #P7242 KZ (July 3)*

V. The costs of pension reform.

The fiscal sustainability of the pension reform has been and is a crucial consideration. The fiscal framework developed by the authorities for 1998 after the passage of the pension reform legislation was to accommodate the increased budgetary expenditures incurred under pension reform through an overall deficit for 2009 of 5.5 percent. (The overall fiscal deficit, excluding privatization receipts, was estimated at 7.8 percent of GDP for 1998. The underlying adjustment in other recurrent revenues and expenditure items equaled a decline of 0.7 percent of GDP.). In terms of the cost of transition, projections based on government's actuarial model indicate that the implicit government debt would amount to 110 percent of 1997 GDP, which compares favorably to other countries in the world. (World Bank:1998)

When the reform was enacted, actuarial and economic projections indicated that the shift to a fully funded pension system would result in an additional fiscal cost of pension reform of 1.7 percent of GDP in 1998. The cost of moving to the new system using the results of the actuarial model are presented in the Table 1. In principle, government should borrow the full amount to finance the increase in the fiscal deficit from the domestic market without causing undue pressure on aggregate demand as losses in public revenue would be compensated by an increase in non-public sector savings. Further, the revenues from privatization were also intended to buffer the costs of the reform from the impact of the increased deficit stemming from the reduction in the payroll tax of the 10 percent that was transferred to the pension funds. (World Bank: 1998)

Table 6: Cost of Pension Reform according to Government's Actuarial Projection Model (billions of 1997 tenge)

<i>State Budget Plus pension Fund</i>	<i>1997 Former System</i>	<i>1998 No Change in Policies</i>	<i>1998 New System</i>	<i>Cost of Pension Reform</i>
Retirement Pensions	89.4	92.4	91.4	-1.0
Social pensions/ allowances	19.8	21.0	21.0	0.0
Military Pensions	5.1	5.2	5.2	0.0
Gov't contrib. to accum. Funds	0.0	0.0	10.9	10.9
Total Outlays	114.3	118.6	128.5	9.9
Net Payroll Tax	48.4	48.7	28.2	-20.5
Gross inflows to SPPC	70.2	70.5	41.0	-29.5
less, gov't contrib.- own employees	21.8	21.8	12.8	-9.0
Net Cost to Gov't	65.9	69.9	100.3	30.4
Percent of GDP	3.9%	4.0%	5.7%	1.7%

The actuarial model shows that in the absence of reform, the costs of the existing system would increase slightly in 1998, from 3.9 to 4.0 percent of GDP, mainly as a result of additional pensioners. With reform, the cost of the new system would be 5.7 percent of GDP, or an increase of 1.7 percent of GDP. The cost of reform is mainly due to the reduction in the payroll tax rate from 25.5 percent to 15 percent in 1998, which was estimated to reduce gross inflows to the PAYG system by 30 billion tenge. For the government, as for all other employers, the reduction in payroll tax

should be offset by the 10 percent cash contribution employers will be required to make on behalf of their employees to the private pension funds.

While the net cost of pension reform was estimated at 1.7 percent of GDP in 1998, it was projected to rise to 2.4 percent of GDP in 2008. The steady rise in the cost of reform was due to government's assumptions of further reduction in the payroll tax rate by one percent per annum to 5 percent in 2008. The incremental cost then began to decline to zero. In 2026, the gross cost of the new system was projected to be equivalent to 2 percent of GDP, considerably less than continuing with the former system. With the change in the financing of the system to general revenue financing, the projection of the costs of reform must be redone. The revenues stemming from the payroll tax will no longer be related to the reform. Nonetheless, it is possible to calculate the funds required if the system had not been reformed and the funds required funding both the funded system and the residual system. This difference represents the costs of the reform. It is also important to keep in mind that at the time of the reform, the 25.5 percent payroll tax did not cover the costs of the old system. Government is committed to estimating the annual costs of the public system as part of the fiscal planning process.

Further, government is committed to a program of fiscal adjustment, as is necessary, on a permanent base. Certainly, other factors could influence adversely fiscal expenditures and macroeconomic balance. In Kazakhstan were to suffer an economic collapse like Russian, both the pension reform and the entire economy would be in a state of turmoil. And the impact of the Asian crisis, Russia's financial crisis, and the collapse of commodity market prices, especially oil prices, have had an adverse exogenous impact on Kazakhstan's economy. While, it is unlikely that the pension reform could have, or would have been enacted initially under similar economic conditions, those were not the circumstances in 1997. At that time the economy looked strong and world conditions favorable. Hindsight notwithstanding, to date government has been taking prudent steps in both its fiscal and monetary policy to deal with projected reduction in revenues and in economic growth.

The pension reform has already developed a new financial sector in Kazakhstan through the blossoming of private pension funds and asset management companies. While the reform appeared to get off to a slow start, the expertise being developed is already substantial and significant assets have started to flow to the private system. These assets will build the foundation for a transparent investment process that will provide a firm foundation for business practices that are not tainted with the type of corruption that is rampant in many transition economies with the emergence of strong mafias and others engaged questionable business practices. As a result of the pension reform, the regulation of financial institutions is being strengthened and that will reduce the scope for fraud and abuse. The NBK is known to have developed into one of the most credible institutions in Kazakhstan. Many of the new regulators of the pension system have benefited from initial NBL training.

Further, the reform sends a strong signal to the population that times have changed and that individual responsibility must be counted on to replace the state in the provision of social needs. Such a change in mentality is key if the transition to a market economy is to succeed. While the progress of the pension reform in terms of portfolio diversification is likely to be slower given current economic circumstances, the reform should not be rolled-back or rescinded on the basis of budgetary concerns as this would surely damage the potential for economic growth.

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VI. Conclusion.

Kazakhstan pension reform law was enacted in 1997 and began to work in 1998. The reform immediately transformed the pay-as-you-go system to one, defined contribution accounts.

The new system based on investments is intended to promote self-sufficiency instead of government dependence, to reduce government expenditures, to encourage savings and promote development of capital market. Starting in 1 January 1998, pension system was transformed into one of fully funded, individual defined contribution accounts mandated for all workers on an immediate basis.

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Initial estimates by government suggested that a 10-percent contribution would provide a replacement rate of around 60 percent for career workers. For the first few years, the distributions from the new pension system will be quite small, however, and will be provided as lump-sum benefits. Regulations on the payment of the pensions from individual accounts are to be promulgated in the future, in conjunction with the development of the insurance policy.

The emergence of a strong insurance industry is thus necessary to support the funded pension system. As the system matures, the payment options approved by government for the funded system will be in the hands of commercial insurers. The extension of reform to mandate insurance-based disability and survivors' benefits must be predicted on the emergence of a well-regulated insurance industry.

While the cost of pension reform was estimated at 1.7 percent of GDP in 1998, it was projected to rise to 2.4 percent of GDP in 2008. The steady rise in the cost of reform was due to government's assumptions of further reduction in the payroll tax rate by one percent per annum to 5 percent in 2008. The incremental cost then began to decline to zero. In 2026, the gross cost of the new system was projected to be equivalent to 2 percent of GDP, considerably less than continuing with the former system. With the change in the financing of the system to general revenue financing, the projection of the costs of the reform must be redone. The revenues stemming from the payroll tax will no longer be related to the reform. Nonetheless, it is possible to calculate the funds required if the system had not been reformed and the funds required funding both the funded system and the residual system. The difference represents the costs of the reform. It is also important to keep in mind that at the time of the reform, the 25.5 percent payroll tax did not cover the costs of the old system. Government is committed to estimating the annual costs of the public as part of the fiscal planning process.

The pension reform has already developed a new financial sector in Kazakhstan through the blossoming of private pension funds and asset management companies. While the reform appeared to get off to a slow start, the expertise being developed is already substantial and significant assets have started to flow to the private system. These assets will build the foundation for a transparent investment process that will provide a firm foundation for business practices that are not tainted with the type of corruption that is rampant in many transition economies with the emergence of strong mafias and others engaged questionable business practices. As a result of the pension reform, the regulation of financial institutions is being strengthened and that will reduce the scope for fraud and abuse. The NBK is known to have developed into one of the most credible institutions in Kazakhstan. Many of the pension system have benefited from initial NBK training.

Further, the reform sends a strong signal to the population that times have changed and that individual responsibility must be counted on to replace the state in the provision of social needs. Such a change in mentality is key if the transition to a market economy is to succeed. While the progress of the pension reform in terms of portfolio diversification is likely to be slower given current economic circumstances, the reform should not be rolled-back or rescinded on the basis of budgetary concerns as this would surely damage the potential for economic growth.

VII. Bibliography.

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