The State of Kazakstan's Pension Reform

by Heiner Flassbeck [1] and Rudolf Zwiener [2]

The comprehensive reform of old-age pensions that Kazakstan's government implemented at the start of 1998 has provoked a rather critical response. On the one hand, the reform has been unable to solve the difficulties created by the delays in the actual payment of benefits in principle. This caused considerable dissatisfaction on the part of pensioners who had expected the reform to rectify precisely this problem. Also, great confusion abounds concerning the question of who is to cough up the 10% of wages that employees have to pay into pension funds now. On the other hand, the government currently finds it even more difficult than before to rein in the public debt. Now, pension funds receive substantial revenue from contributions that would earlier have gone straight to the government. The latter now has to borrow this money from the funds at higher interest rates in order to cover its current pension liabilities. At the same time, the real value of government pensions continues to fall. Another problem arose from the government's decision to bail out the pension funds generously when the tenge's value dropped sharply in the spring of 1999. This protection of the funds from the risk of devaluation imposed an additional burden on the public budget.

In this situation, the government is seriously considering a complete suspension of the reform or, at least, a significant reduction of the mandatory contributions to pension funds. This shows that the reform cannot live up to the great expectations it gave rise to, as was predicted two years ago.[3] Nonetheless, the government should not react too hastily. Certainly, the reform of the pension system was never likely to achieve all that some of its proponents had hoped for. But neither is it responsible for all the negative developments it is now being blamed for. Therefore, the rash abandonment of the reform, or the poorly designed revision of its regulations, would only excite new irritations, again without easing any of the system's immediate difficulties.

Even before the reform started, some commentators unequivocally pointed out that the switch from a pay-as-you-go system to a fully funded one would not solve the acute problems that bedevilled Kazakstan's old-age insurance in 1997. Clearly, the

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[3] Spiecker, F; Zwiener. R.: Are Funded Pensions better than a Pay-As-You-Go System? - A critical View on Kazakstan's Pension Reform, in: KET, October-December 1997.

old system was no longer adequate. For one thing, it suffered from generally poor economic conditions, just like any other insurance system in the world. For another, like many old-age insurance systems in transition economies, it was charged with the task of redistribution, which properly should have been financed through the public budget, rather than through a system designed to insure workers' retirement. Both factors combined to open up a huge gap between revenues and outlays in the pension system.

The move from a pay-as-you-go approach to a fully funded scheme will do nothing for solving these difficulties. By now, even the reform's proponents unequivocally admit as much. Even so, they must face the criticism of those who point out that, in 1997, the reform's supporters, to say the least, led people to believe that it would do exactly this. Why else would Kazakstan have taken such a big leap towards reform so hastily – only a few months elapsed between the basic decision for reform and its implementation – if, according to the project's initiators, it was the sole purpose of the exercise to make sure that pensions would still be safe in 2030? Be that as it may, the current situation and the widespread dissatisfaction of Kazakstan's population clearly show that the reform made things worse rather than better.

In fact, the problems caused by the government's non-payment of pension benefits were aggravated by the transition from one economic system to another. This transition imposed an additional burden on the government, because the latter must continue to pay the regular amount of benefits for many years to come, while its share of contributions has dropped to three fifths of its former level. It is true that the government managed to pay out benefits more punctually, thus reducing its overall arrears. However, this „achievement" occurred only because policy-makers wanted to show their good faith, now that they had pushed through the reform. It can therefore not be attributed to any alleged „success" of the switch to a funded system. After all, the government could have demonstrated the same „good faith" much more easily under the old system.

The same goes for an objection frequently voiced by the new system's proponents who say that the old system had been totally wrecked, and that reform had therefore been inevitable. This is fair enough, as reform was indeed inevitable. It is, however, quite another matter whether a fundamental reform of the pay-as-you-go system would not have been better than the large-scale adoption of a new approach. A meaningful comparison of the two systems is only possible if, in both cases, one assumes the same ratio of income replacement and the same extent of the politically determined redistribution of income as, for example, from people with a reasonable income to the poor. As early as two years ago it was shown that the burden imposed on public budgets by the payment of retirement benefits could be reduced to roughly 2% of GDP by 2026 if the framework of the old system were subjected to the same kind of reforms as the new one. According to this scenario, the difference between the respective effects of each approach on the State Benefit Payment Centre's fiscal resources amounts to as much as 2% of GDP after a few years, while in 2026 it is still 0.8% of GDP.4 In addition, interest payments increase each year as the national budget has to absorb larger annual deficits under the funded system. This, in turn, makes the reform even more expensive for the public purse. Over the next 27 years, the additional cost averages nearly 2% of GDP each year. Even in the long run, funded pensions are clearly inferior to a reformed version of the pay-as-you-go system, as far as the financial impact on the republic's budget is concerned. The alleged superiority of the funded approach is merely an artefact of the decision to raise the age of retirement and to abolish early retirement and preferential pensions. Assuming comparable circumstances then, the pay-as-you-go model is superior to funded pensions in the short as well as the long term.

One problem, which might have been predicted, is the long-term burden imposed by higher public deficits. Even if the funded system works optimally, this just means that the 10% of payroll handed over to the funds still go to the government in the end, albeit in a rather roundabout way. Thus, the money is merely recycled, while the overall amount of available capital does not change at all. The public deficit must therefore be higher than it would have been otherwise. In Kazakstan, the resulting difference in the deficit was estimated to be 2% of GDP. This would not be so bad if all the parties involved were willing to accept it as inevitable, and if the pressure for cutting the deficit were no stronger than without the reform. However, it seems that neither international organisations nor private investors are ready to acknowledge as much. It follows that the reform is bound to create losses somewhere else, as for example, in public investment. In this case, the reform would indeed hamper future economic development rather than encourage it.

In addition, another effect must be taken into consideration. Even if the government maintains its previous expenditures and investment, it has now to pay interest on the funds it must borrow in order to cover current pension benefits. Before the reform, however, it had received those funds as contributions to old-age insurance. To this must be added the 1% of payments that the pension funds charge for managing the money they receive, as well as the dividends paid out to the funds' owners. Because the government has no more resources at its disposal than before, all it can do is either to reduce spending further or to raise taxes. These two policies

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[4] In the summer of 1997, the World Bank arrived at the same figure.

certainly affect the distribution of income differently. Yet, they both completely undo the benefit-increasing effect of the interest earned on the savings in these funds. As a consequence, a new wage tax of 5% was introduced last year. This tax can also be seen as rise in contributions, which must now cover even bigger deficits in the old pension system. But workers, and society as a whole, do not benefit at all from these developments. Even though they actually earn interest on the money they put into pension funds, they, as a matter of fact, pay for this interest themselves in the form of higher taxes or reduced government services. In the end, pension-fund operators are the only ones who benefit from this scheme in the form of the 1% service charge and the payout of dividends.

In 1999 great confusion arose in Kazakstan concerning the question of whether employers or their employees should have to pay the 10% contribution to the pension funds. Basically, it would have sufficed from the very beginning to have companies pay the contributions for their employees into the pension funds now, just as they had paid them into the government-operated system before. Payrolls would have remained exactly the same, while wage compensation would have been unnecessary. At the same time, the government would have had to make sure that the claims of individual workers were clearly and lucidly documented. As in the case of wages due, workers would then have been able to enforce their claims against their employers through the courts. Thus, non-payment of contributions would at least have been made visible.

At the start of 1999, the government reduced the overall social-insurance contributions paid by companies from 31% (25.5% for old-age insurance and health as well as diverse other programmes) to 21%. Apparently, this move was inspired by the idea that, under the new pension system, workers were to pay their own contributions. Accordingly, firms were to raise wages by 10% in order to keep workers' incomes from falling by the amount of their contributions, as such a cut could in no way be justified by the adoption of a new pension system .Yet, apart from a few appeals and the corresponding rise of public-sector wages, the government did nothing actually to enforce such a wage rise in the private sector. As expected, many businesses either did not pass on the reduction in labour costs to their workers at all, or they „figured them in" with wage increases that were due anyway. According to some estimates, wage rises corresponded to the cuts in contributions only in 20-25% of all firms. The workers, on their part, largely appear to have accepted this. At the same time they have not been paying their full contributions either. Thus, the first gaps in their future retirement incomes may already have been opened up. The continuing non-payment of wages and salaries will widen any such gaps. Later, the government will have to provide for these workers, even though its burden is already heavier now than it was under the pay-as-you-go approach. These developments reinforce the distrust of the new system. They also confirm the warnings we issued in 1997.

This must be seen against the backdrop of very low expected replacement ratios for significant categories of workers under the fully funded system. The decisive factor here is the low mandatory contribution of 10% of wages. Even in the case of uninterrupted lifelong employment and contribution payments, the replacement ratio may drop below 50%. If the period of covered employment is shorter, as must be expected especially for women, who average between 33 and 38 years of employment, the replacement ratio drops to 30-40%, even if otherwise favourable conditions are assumed, for instance, with regard to the growth of real wages and the expected rate of return on capital employed.[5]

According to Kazakstan's government agencies in charge of paying out pension benefits, about 3.5 million workers have, since early 1998, been assigned a social-security number that is used to document their contributions to pension funds. This means that by now nearly all employed persons have probably been registered. It is, however, far from clear how much individual workers have paid into these funds over the past two years, if anything at all. In the meantime, the number of persons who are covered by the programme, and who therefore are obliged to pay contributions, has been reduced to 3 million according to information from the Pension Fund Project. For one, a number of double counts had occurred at the start. For another, an actual drop in the number of covered persons is indeed quite possible, as employment has declined in the formal sector of the economy. The two major groups who remain effectively outside the funded system are up to 2.5 million self-employed persons and roughly half a million unemployed workers. At the same time, there is some evidence that a sizeable share of covered persons do not pay regular monthly contributions to the funds. This suggests that the performance of the new system is highly unsatisfactory. If this problem cannot be rectified, far too many people will in the future still depend on the government for all or part of their retirement income, even though the government-operated system of old-age insurance is to be gradually phased out. Based on current trends, poverty will be a serious problem for a large share of the elderly. In this case, the government may have to provide additional assistance. These prospects fundamentally call into question the whole purpose of the new system. So far, the tax authorities have been in charge of monitoring the punctual payment of contributions. However, in an econ-

[5] See Spiecker/Zwiener (1998), p. 43.

omy rife with tax evasion, particularly among private households, this does not seem like a good idea. A closely related issue is the question of how to get all those „self-employed" persons, that is, those who hold several jobs or sell things in outdoor markets, to pay their pension-fund contributions regularly.

The bail-out of all funds in connection with the tenge's devaluation in April 1999 must be seen as a grave violation of the principles underlying a private insurance system that is supposed to be free of government interference. Presumably as an attempt to fend off losses for the funds, or even some outright bankruptcies, the government swapped all tenge-denominated assets for dollar-denominated ones at an exchange rate of 88 tenge to the dollar. After the currency's devaluation, all funds registered enormous profits in tenge terms, because they were treated as if they had always held dollars. In doing this, it was at least implicitly assumed that the exchange was the result of „investment decisions" of the funds, which led to a big and justified leap in their profits. The swap was particularly favourable for the government's own fund, which, after all, was bound by law to take on by far the largest share of bonds denominated in tenge.

Such bail-outs fundamentally violate the rules of systems based on the strict separation of private business and government. In this connection, it is of no concern whether the government operates its own fund. By all means, let the government compete with other funds. However, strictly the same rules must apply to all parties, and the government must not come to the rescue of failing institutions. With Kazakstan's public deficits being as high as they are, the bail-out indirectly reduced the payment of benefits in the „old" pension system even further. At present, about 50% of pensioners receive only the minimum benefits of 3500 tenge a month. This means that – not least because of the reform – a decent standard of living will become less and less likely for the current and future generations of retired workers. At the same time, a fabulously high return on investment is being squandered in the funded system. It seems indeed possible that the government went ahead with this bail-out, because it got caught up in a situation where the initially short-term nature of its liabilities simply forced it to do so. Even though this action may have temporarily shored up the capital market after the tenge's devaluation, it sent quite the wrong long-term signals to all the parties involved. Thus, it will probably also be impossible in the future to induce private funds to make capital available for real investment in Kazakstan's economy, when they are offered completely risk-free government securities denominated in foreign currency. Yet, an important reason for introducing the funded system was the hope that this might make it easier to transform short-term private savings into long-term capital for financing investment. So far, these attempts have not been successful. And in view of current policies, they will probably not succeed in the future either.

The interest that the government pays to the funds also includes a risk premium for unforeseeable events, such as devaluation. Why else would the government pay interest on money it had previously collected directly in the form of contributions? If the government then assumes the risks of these pension funds, despite having paid interest to them, the basic idea of the fully funded approach is in fact perverted. The whole system thus deteriorates into a machine for redistributing money to a select few who profit from managing the funds. At this point, the funded system definitely has no longer anything to do with the much-hyped superiority of individuals providing for their own future needs as opposed to simply relying on the government to fork out what is necessary.

As we pointed out as early as 1997, the system of funded pensions will not live up to the expectations it has inspired. However, the shortcomings that cropped up over the past two years are not the only reason for this. Even if the fully funded system were to function perfectly, it would, from a macroeconomic point of view, differ only very little from its pay-as-you-go alternative. There is simply no way an economy as a whole can carry over its accumulated savings or financial assets to the future. As opposed to private households, it is impossible for an economy as a whole to save in this sense. The accumulation of financial assets by some must always be offset by a corresponding build-up of debt by others. Net financial assets in an economy are, by definition, zero. The future can only be secured by promoting real investment in order to create and efficiently employ as large a capital stock as possible. For this, a country like Kazakstan needs, above all, well-functioning and rapidly growing manufacturing industries. However, real investment is precisely the one thing that will not be promoted if everybody tries to accumulate large financial assets, that is, if they try to save in the microeconomic sense. A „pensions industry“, as the World Bank has called the newly established administrative departments of the funds, does not create any truly new income. Instead, it merely tries to manage savings from already existing income more efficiently. Whether such activities actually add any overall economic value, once all the costs have been figured in, remains an open question, as no one has, so far, produced any conclusive evidence to that effect.

The reform of existing pay-as-you-go systems is also being debated in other countries, especially with a view to looming demographic developments. The case of Germany is as good an example as any. However, most German proposals for reform just recommend additions to the existing pay-as-you-go system rather than its replacement.[6] But even such additions come with certain problems of their own. From a macroeconomic perspective, it must be considered that the introduction of a significant funded-pension component would raise the savings-to-income ratio by several percentage points, with a corresponding weakening in consumer demand. The latter effect would then directly reduce the level of economic activity. The only force to head off such a development would be the uncertain stimulatory impact of falling interest rates due to a bigger supply of capital. It is by no means certain that the additional capital supply that would thus be generated by force, so to speak, would find enough investment opportunities at home in order to actually provide the expected growth impetus. Those who have to pay contributions can react in various ways to a policy of enforced saving. They may, for instance, reduce their voluntary saving, at least to the extent that it exists. And some of those affected will certainly reduce their consumption. The greater the effect on private consumption and the construction of housing, the larger the negative short-term effects on the overall economy will be. Even assuming that the ex ante planned savings of private households (voluntary plus forced saving) are higher than those under status quo conditions, the outcome in terms of ex post savings remains undetermined. Indeed, if the contractionary short-term effects on demand predominate, the actual level of savings in the economy may well decline. Lower interest rates, which might be expected to counter the negative effects on demand, will therefore not be an option in this situation. Econometric simulations have shown that the introduction of a significant funded component, such as might allow for stable overall contribution rates in the future, would shave 0.3-0.5 percentage points off the annual growth rate during the transitional period. The stimulus to growth that some expect from a move towards a funded system will be achieved only in the very long term, if at all. In all econometric simulations, lower growth leads to higher public deficits. If the government sought to counter this by reducing spending or raising taxes, the losses in terms of lower growth would be even greater.[7] In contrast to these considerations for a limited switch in Germany, the complete replacement of a pay-as-you-go system by a fully funded alternative, as it is now under way in Kazakstan, must be expected to reduce growth far more severely.

[6] See Möglichkeiten und Grenzen einer verstärkten Kapitaldeckung der gesetzlichen Alterssicherung in Deutschland, in: Monatsbericht der Deutschen Bundesbank, Dezember 1999.

[7] See Meinhardt, V.; Wagner, G.G.; Zwiener, R.: Introduction of a Funded Component of Old-Age Provision Reduces Economic Growth, in: Economic Bulletin of the German Institute for Economic Research, Vol.37, 1-2000.

Since Kazakstan's funded system has no long-term advantages that a reformed pay-as-you-go system would not have either, the question is indeed whether the country should perhaps hold on to its mixed system. However, this time the answer should not be given as hastily as when the transition to the new system was made. Rather, we recommend the involvement of the whole society in a thorough and comprehensive debate on the advantages and disadvantages of the various alternatives, before a decision is made. In any case, the government should not be swayed by the pressure of limited public resources to hollow out the old system and its terms (benefit levels, and, above all, replacement ratios) any further, even though some proponents of the funded system recommend this, and despite the fact that it is actually being done already.

The reform of 1998 established certain facts that will be very hard to get rid of again in the short term. The pension funds have already been set up with a considerable number of administrative offices all over the country. Also, the government's monitoring and oversight agencies are largely up and running. If the government is thinking about abandoning the funded system, it must not wait much longer. Instead, a commission should be set up as soon as possible in order to review the country's experience with the mixed system. This commission should, above all, review the macroeconomic effects of changing the system of old-age pensions. In particular, the following questions should be addressed:

- Has the new system helped to insure the punctual payment of benefits, as many had hoped it would do?
- How have public-sector budgets held up under the additional strain exerted by the change in the pension system? More specifically, have the international financial institutions, which had wholeheartedly recommended the new system, helped to prevent the distrust of the government's financial situation from growing when the public sector increased its borrowing?
- Has the new system enhanced investment activity in Kazakstan, as funded systems are often expected to do?
- What are the main obstacles to a swift return to the old system?
- Is there a way to reorganise the new system so as to reduce the burden on the government and to increase the contributions of workers to the funds?

The commission should submit a final report that might serve as a basis for a fundamental decision by Kazakstan's government on the country's pension system. Until then, the current system should be used and, whenever necessary, be improved within its existing framework.