ICR Review

Operations Evaluation Department

Report Number: ICRR11373

1. Project Data:		Date Posted: 08/15/2002		
PROJ ID:	P050780		Appraisal	Actual
Project Name:	Pension Reform Sal	Project Costs (US$M)	300	200
Country:	Kazakhstan	Loan/Credit (US$M)	300	200
Sector(s):	Board: SP - Compulsory pension and unemployment insurance (65%), Central government administration (22%), General finance sector (9%), Non-compulsory pensions insurance and contractual (4%)	Cofinancing (US$M)		
L/C Number:	L4359			
		Board Approval (FY)		98
Partners involved :		Closing Date	07/01/2000	06/30/2001

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2. Project Objectives and Components

a. Objectives

A. Support the Kazak adoption of a fully funded pension system as part of the Bank's support to a successful transition to a market economy. The move to a fully-funded system would contribute to a successful transition by : (1) encouraging savings; (2) creating an attitude of self-reliance among the population; (3) reducing the public sector; and (4) deepening capital markets. B. More specifically, the development objectives were: (1) Provide adequate retirement income for pensioners; (2) Provide a minimum income standard for old-age pensioners; (3) Ensure that pensions are fiscally sustainable; (4) Develop capital markets through funded pensions; (5) foster individual responsibility for social protection; (6) reduce social demands on enterprises; and (7) improve the regulation of financial institutions. C. As acknowledged in the ICR, the Government of Kazakhstan took the initiative for the reform and decided on a specific new pension model centered on a fully -funded system before Bank involvement. The Bank's objective was to assist the government, improve proposals where possible, and reduce implementation risks.

b. Components

The PRAL comprised three tranches of US $100 million each.

c. Comments on Project Cost, Financing and Dates

The third tranche of the project was cancelled (because the government did not meet two tranche release conditions, including an audit for 1999) leaving the project cost at US $200 million which was financed by the Bank loan. The loan was appraised in February, 1998, approved by the Board on June 25, 1998, made effective on June 29, 1998, and closed on June 30, 2001, one year behind schedule.

3. Achievement of Relevant Objectives:

1. A new pension system has been instituted comprising a minimum pension financed through the budget and a new, fully-funded, privately managed, defined contribution, second pillar. Baseline assumptions indicate that the new system will be able to achieve higher benefits for the same level of contributions, which indicate a gain in efficiency. However, given the decline in contributions from 25% to 10% to finance future benefits, average future benefits may be lower than in the previous system, and subject to more variability due to capital market fluctuations. Disability and survivor benefits are only defined as flat rates, which is not satisfactory. In addition, people in the informal and rural sectors may have been left behind. 2. The minimum pension is a desirable feature of the new system, although it does not seem to be defined in terms of a percent of the average wage or a consumption basket. 3. The new pension system has operated under a sound fiscal framework in the first years of implementation. The revenue losses of 1.7% to 2% of GDP from the introduction of the second pillar were more than offset by a turnaround in fiscal policy. The transition has been so far tax-financed, with positive consequences for savings. However, Kazakhstan's

fiscal performance hinges to a large extent on oil prices, and sustainability in the future will depend on diversification of exports and output. 4. There have been some positive developments with corporate bonds. However, privatization of blue chip companies has lagged, so that the pension funds have a less diversified menu of assets than originally envisaged. In general, the development of capital markets is difficult to evaluate because of insufficient data, and because it is too early to make an informed judgment. 5. The key issue is the response of voluntary savings to the new system. 6. The burden of payroll taxes declines under the new system, although moderately at first. In the first stage, the 10 percentage point reduction in business taxes may imply less distortion of labor markets if the contributions to the funded pillar are not perceived as a tax. In the second stage, as the ratio of pension payments to GDP declines, this allows over time a reduction of the 15 percent tax to lower levels. 7. The regulatory framework has been improved somewhat, although much more needs to be done (see shortcomings below).

4. Significant Outcomes/Impacts:

The initial results of the reform appear to be satisfactory, but it is too early to make any meaningful judgment about the performance of the new system in the longer-run.

5. Significant Shortcomings (including non-compliance with safeguard policies):

A. 1. Disability/survivor benefits are given as flat rates which is unsatisfactory. 2. Annuity regulations are yet to be developed. 3. Capital markets have not developed at the expected pace because of the lack of privatization of blue chip companies. 4. Beyond the lack of blue chip stocks for investment, the financial structure of pension funds has been further limited with a reduction in allowable investments in deposit certificates and second level banks. While promulgated to prevent improper use of pension funds assets, this is unnecessary since improper investments should be investigated on an individual basis without reducing the opportunity to design constructive portfolio strategies. The requirement that 50 percent of investments must be held in Government securities is unduly restrictive. Asset valuation rules on a market-to-market basis need to be established. Risk rating services need to be developed. 5. Further steps are needed to improve the regulatory structure. The development of an independent regulatory agency, similar to the NBK, would reduce the possibility of actual or perceived government interference.The issue of provision of banking services by custodian banks of the NSAFs and AMCs needs to be addressed. The Central Depository is the custodian for assets other than Eurobonds, and banks involved in Eurobond transactions are the de facto custodians of the Eurobonds. B. The third tranche was cancelled because two conditions were not met: (1) Annual unqualified audits were required under the loan for SPPC but only one audit (for 1998) was produced, skipping 1999 as noted in the ICR, and also, apparently, 2000; and (2) the Government was to issue bonds of maturity of 3 years or more, but with the increase in oil prices, these were simply not needed. C. The project contained no monitorable indicators, so that it is difficult to assess progress. Perhaps to compensate for the lack of monitorable indicators, there were 28 tranche release conditions (11 conditions for first tranche release, 8 conditions for second tranche release, and 9 conditions for third tranche release), which may also suggest a lack of trust between the Bank and the Government of Kazakhstan.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Satisfactory	It must be stressed that the loan supported a reform that was essentially designed by the Government of Kazakhstan. The Bank's role involved improving some aspects of the basic design and minimizing implementation risks. Although there are several shortcomings as presented in section 5 above, the new system seems to be operating reasonably well in the first years of implementation. The main evaluation issue is related to the sustainability of the new system, not the initial outcomes.
Institutional Dev .:	Substantial	Substantial	
Sustainability:	Likely	Non-evaluable	It is too early to judge the sustainability of the new system. While Kazakhstan's fiscal situation is currently favorable, this is heavily dependent on petroleum prices, and the country will need to diversify to reduce risk. A number of issues related specifically to the pension reform still need to be addressed: it is not clear whether the minimum pension will remain

			appropriate in the future; survivor and disability benefits need to be improved; securities markets and the regulatory framework also need to be improved, an annuity market needs to be developed, and the underlying financial strength of the pension funds needs to be improved. Further, questions on sustainability arise because an audit for 1999 was not prepared, which was a key factor in leading to the cancellation of the third tranche of the loan.
Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Satisfactory	Satisfactory	
Quality of ICR :		Satisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

1. Project conditionality should focus on outcomes. PRAL conditionality focussed on a large number of studies and plans, but a few monitorable indicators of outcomes would have been more useful. 2. Monitorable indicators should be incorporated in project design, especially for complex adjustment operations such as pension reform.

8. Assessment Recommended? ● Yes ○ No

Why? OED finds that this project's sustainability is non-evaluable on the basis of evidence available to date. Since the real value of pension reform is its sustainability, further work would be desirable to explore this issue in more detail. This could be part of a planned thematic review of pension reforms in a number of countries.

9. Comments on Quality of ICR:

The ICR discusses the project clearly and thoughtfully, and presents a reasonable amount of evidence to support its conclusions, except on the issue of sustainability.