

# **Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance**

## ***Background Paper*** **Kyrgyz Country Study**

**Edward Palmer**

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## **Acronyms and Abbreviations**

ADB	Asian Development Bank
CIS	Confederation of Independent States
EU	European Union
FSU	Former Soviet Union
GDP	Gross Domestic Product
IEG	Independent Evaluation Group (formerly Operations Evaluation Department)
IMF	International Monetary Fund
ILO	International Labour Organization
MHIF	Mandatory Health Insurance Fund
MLSP	Ministry of Labour and Social Protection
MOF	Ministry of Finance
NDC	Notional Defined Contribution
NGO	Non-governmental Organization
OED	Operations Evaluation Department (changed its name to IEG in December 2005)
PAYG	Pay-As-You-Go
PRGF	Poverty Reduction Growth Facility
PROST	Pension Reform Simulation Toolkit
SF	Social Fund
SOSAC	Social Sector Adjustment Credit
SSNP	Social Safety Net Project
VAT	Value Added Tax

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## **Preface**

This paper belongs to series of 19 country and regional case studies commissioned as background research for the World Bank's Independent Evaluation Group (IEG) report "Pension Reform and the Development of Pension Systems." The findings are based on consultant missions to the country or region, interviews with government, Bank, donor, and private sector representatives involved in the pension reform, and analysis of relevant Bank and external documents.

This case study was authored by Edward Palmer in 2004. Edward Palmer is a professor of social insurance economics at Uppsala University and head of the Division for Research at the Swedish Social Insurance Agency.



## **1. Introduction**

1.1 This document is an evaluation of the World Bank's support in pension reform to the Kyrgyz Republic during the period following the break-up of the Former Soviet Union (FSU) in 1991. The major reform work was undertaken in 1996-1998. The report discusses key issues in the process, the actual legislation and the process following the legislation.

1.2 The evaluation begins with a general country background and overview of pension data, followed by a summary of the Kyrgyz's pension reform and a discussion of the World Bank's technical assistance in this process. The final sections contain the evaluation of the Bank's and country performance and lessons and recommendations.

1.3 The evaluation is based on World Bank documents and interviews with World Bank staff, other available reports of relevance and interviews with Government officials involved in formulating and implementing reform policy in the Kyrgyz Republic, as well as persons outside the policy circle, such as representatives of NGO's and journalists. There is a Statistical Annex (Annex A) at the end of the report that provides a statistical overview of the country's economy and demography and key pension data. A list of persons interviewed in performing the evaluation is provided in Annex B.

## 2. Background

### Overview of the Economy

2.1 The Kyrgyz Republic is a landlocked country, with an area of 200,000 square kilometres, most of which is mountainous. It was one of the poorest republics of the former Soviet Union, and is still one of the poorest CIS countries. The level of literacy and skills is high, and the Kyrgyz Republic is generally regarded as being among the leaders in the CIS in the process of institutional transition and in development of a market economy. Overall, considerable progress was made during the first decade of transition.

2.2 Since gaining independence from the FSU the Kyrgyz Republic has been more or less self-sufficient and diversified in food production. Hydropower, agriculture and mining (gold) are key economic sectors, with the weather being a crucial risk for two of these. Another is trade barriers erected by its neighbours, over which the country has little leverage.<sup>1</sup>

2.3 For example, a wave of protectionism followed the Russian crisis that flared up in mid-1998. Uzbekistan unilaterally suspended traffic along a number of regular trade routes, and then levied heavy excise taxes of 35-100 percent on exports from the Kyrgyz Republic. Kazakhstan imposed a 200 percent tariff on foodstuffs from the Kyrgyz Republic, which it later replaced with high transit fees.<sup>2</sup>

2.4 In 2002, the country's population was about 5.0 million persons.<sup>3</sup> Around 1.7 million persons have been in employment during the 1990s. In 2001, 53 percent worked in agriculture, 33 percent in services and the remaining 14 percent in industry, construction, transportation and communications.<sup>4</sup> In 1998-2002, around 82 percent of the population 20-59 were in the labour force, and 75-77 percent of this working age population were employed. Registered unemployment has been, thus, around 5-7 percent (Annex A: Statistical Annex).

2.5 From 1991 to 1996, GDP dropped by over 50 percent. The economy turned up in 1996 and from 1996 through 2002 real growth per annum was on average five percent. Growth slowed considerably on two occasions, however. The first was in 1998 in response to the Russian crisis – which also triggered a domestic banking crisis. The second was in 2002, when the international economy turned down. Growth of 4-5 percent per annum is projected for the medium term from 2002 to 2010.<sup>5</sup>

2.6 On the basis of head count data, around half the population lives in poverty. With the Russian crisis, poverty increased slightly from 52 to 55 percent of the population in

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<sup>1</sup> Kyrgyz Republic: Joint Staff Assessment of the Poverty Reduction Strategy Paper, IMF, 2003. According to this report GDP was 65 percent of its 1990 level in the year 2000, which with the real growth figures in the Annex gives about 70 percent in 2002.

<sup>2</sup> Kyrgyz Republic: Selected Issues and Statistical Appendix, IMF, 2000.

<sup>3</sup> Key statistics for the Kyrgyz Republic are presented in a Statistical Annex to this paper.

<sup>4</sup> Kyrgyz Republic: Selected Issues and Statistical Appendix, IMF 2003.

<sup>5</sup> Poverty Reduction Strategy Concept Paper, World Bank, 2003.

1999, with 23 percent living in extreme (food) poverty.<sup>6</sup> In 2001, the last year for which figures were available at the time of this writing, general poverty had fallen to 47.6 percent and extreme poverty was at 13.5 percent.<sup>7</sup> Apparently, economic growth has succeeded in reducing poverty in a relatively short period.

2.7 Although the prevalence of poverty is high, poverty among old-age pensioners is lower than poverty among non-pensioners. However, the prevalence of poverty among the younger disabled and survivors is much higher than the prevalence of overall poverty in the country.<sup>8</sup>

2.8 Land reform in the early years of privatization created a large number of small plots that were distributed among persons previously working the same land in collectives. Two-thirds of the poor are engaged in agriculture, and about 80 percent of the self-employed in agriculture are among the poor.<sup>9</sup> Much of the rural economy is informal, and most farmers produce mainly for their own consumption.

2.9 A major dilemma for the development of state revenues in general, and, of particular interest in the present context, contributions for pensions, health and other social insurance, is the fact that taxes and contributions from agriculture, which employees over 50 percent of the workforce, are based on land area under cultivation rather than income. As a consequence, although agriculture employees over 50 percent of the labor force and constitutes about 35 percent of GDP, it contributes to only about four percent of state revenues.<sup>10</sup> For this reason, growth in GDP does not yield proportionate growth in revenues for the social sector.

### **Overview of Pension Data**

2.10 The pension system is solely pay-as-you-go financed. Table 1 provides an overview of some key pension statistics for 1995 and 2002. There were 6.4 working age persons (20-59 years old) to persons 60 and older in 2002, which is an improvement over 5.7 in 1995. Although the ratio of the working age population to the population 60 plus is high, since only about half of the 1.7 million persons registered as employed pay contributions on a regular basis, the ratio of contributors to persons 60 and older is much smaller. In 2002 it was 2.4 percent, which was slightly better than in 1995.

2.11 The number of contributors expressed either as a ratio to old age or old age plus disability pensioners improved considerably from 1995 to 2002. In 2002 the ratio of contributors to old age pensioners was in fact only a little higher than the ratio of contributors to persons 60 plus. The improvement is explained in part by the relative increase in contributors, in part by a decline in beneficiaries. The latter reflects the reform policy to be discussed in the next section, with the gradual abolishment of about a third of

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<sup>6</sup> Kyrgyz Republic: Poverty in the 1990s in the Kyrgyz Republic, 2001.

<sup>7</sup> Ibid.

<sup>8</sup> Report from the Kyrgyz Pensions Policy Update. The World Bank, June 2002.

<sup>9</sup> Poverty Reduction Strategy Concept Paper, World Bank, 2003.

<sup>10</sup> Kyrgyz Republic: Selected Issues and Statistical Appendix, IMF, 2000.

special privileges inherited from the old Soviet system and an increase in the pension age for both men and women beginning in 1998.

**Table 1: Kyrgyz Republic - Key Pension Ratios**

	<i>1995</i>	<i>2002</i>
(1) Ratio of Working age Population (20-59) to Population 60 +	5.7	6.4
(2) Ratio of Persons in Employment to Population 60 +	3.7	4.6
(3) Ratio of Contributors to Population 60 +	2.2	2.4
(4) Ratio of Contributors to Old Age Pensioners	1.8	2.3
(5) Ratio of Contributors to Old Age and Disability Pensioners	1.6	2.1
(6) Average Old Age Benefit/ Average Wage	66 %	40 %

2.12 Until 2003 contributions were not sufficient to cover expenditures. Payments were often not on time, and until recently a significant percent were made in kind. To cover pension payments revenues were regularly diverted from contributions earmarked for health and employment services,<sup>11</sup> with the consequence that debts were built up to health providers and the employment services could not operate as intended.

2.13 Considerable yearly deficits remained even after the diversion of health and employment funds to pay pension benefits, and through 1999 substantial sums of money were transferred from the Republican budget in order to cover these payments.<sup>12</sup> These budgetary transfers added to the overall and increasing indebtedness of the country.

2.14 Contribution growth has lagged far behind wage growth. Money contributions per contributor grew by 260 percent during 1995-2002, while the nominal wage rate grew by 413 percent (Statistical Annex). Certainly part of the reason why contributions per contributor lagged behind the growth in the per capita wage was the high degree of underreporting of smaller and medium-sized employers, as a study by the Social Fund in 2001 indicated. Another reason why contribution revenues have grown so slowly is the fact that taxes and social insurance contributions from small entities in the agricultural sector are based on land area rather than income.

2.15 Up to 2000, the total contribution rate was 39 percent. Employers paid a rate of 33 percent and employees six percent. The overall rate is divided between separate funds for old age and disability pensions, health, employment and other social insurance benefits. Due to increased revenue collections the overall rate was reduced in a series of steps from 2000, as is shown in Table 2. For the first time since 1991, in 2003 contributions are

<sup>11</sup> The practices of accepting payment in kind from farmers and covering pension payments with funds diverted from already slim health and employment budgets were recurring criticisms forwarded to the government by the World Bank and other international organizations.

<sup>12</sup> Yearly transfers of 0.7–1.5 percent of GDP were required through 1999. Kyrgyz Republic: Selected Issues and Statistical Appendix, IMF, 2000.

projected to cover expenses, excluding the costs of remaining special rights from the Soviet legislation, which are financed from general Republican budget revenues in accordance with the 1997 reform legislation.<sup>13</sup>

**Table 2: Development of the Contribution Rate (percent)**

	2000	2001	2002	2003
Total	39	38	37	34.5
Of which for: Old age and disability	32	32	32	29.5
Health	2	2	2	2
Employment services	2	2	2	2
Other insurance	3	2	1	1
Employer contribution rate	33	32	30	27.5
Employee contribution rate	6	6	7	7

2.16 The Social Fund<sup>14</sup> is responsible for collecting contributions. Better collection administration and two changes in the law in 2002 - originating from an initiative of the Fund - explain why it was possible to further decrease the contribution rate.<sup>15</sup> The first is a (protested) requirement that employers pay a minimum contribution per employee based on a wage of at least 1000 Som per month for all registered employees. The second empowers the Social Fund to prosecute employers with arrears.

2.17 In spite of real growth in GDP since 1996 of five percent per annum, an average pension fell from about 53 percent of the average wage in 1995 to around 38 percent in 2000-2002 (Statistical Annex). An average old age pension fell by even more, from 66 to 40 percent of an average wage (Table 1). According to more recent Bank calculations performed in the autumn of 2002, the average pension benefit will drop even further to 35 percent of the average wage in 2005.

2.18 There is no legislated adjustment mechanism for pensions. Instead, the legislation gives the Cabinet of Ministers the discretionary power to change benefits. As a result, adjustments in benefits have been *ad hoc*. The data (Statistical Annex) reveal that after 1995 the relative value of benefits was deflated substantially on two occasions by *not* indexing benefits from 1995/1996 (~ 32 percent inflation) and 1998/1999 (~ 36 percent inflation). In addition, in accordance with the new legislation, from 1998 the base pension was allowed to depreciate to a minimum of 12 percent of the average wage.

2.19 Nominal benefits increased by about half the increase in GDP from 1995 to 2002. Consequently, the share of pensioners' benefits (old age, disability and survivors) in GDP fell from 9.3 percent in 1995 to 4.5 percent in 2002. Total contributions fell from 7.4 to 4.6 percent of GDP, with financial balance finally being achieved at this lower level.

<sup>13</sup> Data on revenues collected show that in practice payments have corresponded to 35-36 percent of the contribution base through 2002 (Statistical Annex).

<sup>14</sup> The Social Fund was created in 1994 by merging three previously independent extra-budgetary funds, the Pension Fund, the Employment Fund and the Social Insurance Fund. The Social Fund administers the payment of old age, disability and survivor benefits; sickness and unemployment benefits and family allowances.

<sup>15</sup> Also, the administration of tax collection was improved in 2002, and the government now sees an extension of the VAT to large agricultural producers as a means for gathering higher tax revenues.

With a decline of around 7 percent in the number of beneficiaries, most of the decline in the ratio of benefits to GDP is due to the drop in the relative value of pensions – with the two largest measures being the absence of price indexation in 1995-96 and 1998-99.

2.20 Bad business practices led to the banking crisis in 1998-99, and as a consequence public confidence in financial institutions fell. It was still regarded as being low in 2003, at the time of this evaluation.<sup>16</sup> As a part of the IMF Poverty Reduction Growth Facility the country will undertake a banking reform with a new initiative to ensure better bank supervision and improve governance.<sup>17</sup> Hopefully this will help reduce the risk of corruption and improve confidence in the financial sector. To date the private insurance market is undeveloped. In 2003, there was only one private insurance company in operation, and the scale of its operations was very small.

2.21 In sum, in order to achieve balance without increasing the contribution rate or creating additional strain on the already deficit-ridden Republican budget, pension payments have been kept in line with the development of contributions by reducing the real purchasing value of benefits. In spite of considerable growth in GDP since 1995, growth of contributions has lagged behind, due to underreporting and the high reliance of growth in the economy on agriculture, mining and hydropower. Growth in these sectors provides only a relatively small boost for formal contributions. At the same time the key pension ratios indicate an improvement in the system dependency ratios, relating the number of contributors to beneficiaries. The latter reflects the impact of the reform package implemented in 1998 – in particular the increase in the pension age of men and women and the abolishment of some of the pre-reform special privileges.

### **The Pension Reform of 1997-1998**

2.22 The Kyrgyz Republic inherited the FSU's pension system. Pensions were calculated as a fixed component and a component based on service years. Service years consisted of years of employment, child care and a host of special rights. To create affordability, benefits had been flattened during the first half of the 1990s so that actual benefits no longer reflected previous individual wage differences. Persons with a right to a higher pension under the old (pre-reform) law are still lobbying to regain their higher pensions, perhaps encouraged by recent legislation to this effect in neighbouring Kazakhstan. However, there is no indication that this issue has been on the policy agenda.

2.23 Large yearly deficits in the pension budget were the prime driving force for reform. The overview in Table 1 shows that at the time reform was being considered in 1996, there were too many pensioners per contributor, while at the same time individual benefits were high compared to an average wage. In 1996, the deficit in the Social Fund's budget was 1.7 percent of GDP,<sup>18</sup> contributing considerably to the country's overall budget deficit that year - of 5.6 percent of GDP. The Social Fund's failing finances was a

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<sup>16</sup> Kyrgyz Republic: Second Review under the Poverty Reduction and Growth Facility. IMF Country Report No. 03/51, February 2003.

<sup>17</sup> Ibid.

<sup>18</sup> Kyrgyz Republic: Selected Issues and Statistical Appendix, IMF, 2000.

recurring topic in IMF documents during the 1990s, and reducing the overall cost of pensions was viewed as important for bringing country finances into balance.

2.24 In 1996 around 18 percent of pensioners (100,000 persons) enjoyed “special privileges”, typically a benefit received prior to the normal pension age of 55 for women and 60 for men. Generally, for persons with special privileges, it was possible to obtain a “special” benefit and continue working.<sup>19</sup> Early grants of benefits were not subject to an actuarial reduction, nor did postponed retirement give an enhanced lifetime benefit. In addition, the pension age of women was low, not the least given the life expectancy of women compared to men.

2.25 The government’s goal for the 1997 reform legislation was to create a financially sustainable pension scheme. The short-term focus was on cutting costs while the long-term focus was on creating a new scheme with a strong link between contributions and benefits. The short-term goal would be accomplished by increasing the pension age and abolishing immediately some of the existing special rights. To achieve the long-term goal, the Director and staff of the Social Fund began to design the Kyrgyz notional defined contribution (NDC) scheme.

2.26 Legislation was enacted in two stages. In the first stage two laws were drafted in 1996-97 and passed by Parliament in October 1997, the Law on State Social Insurance and the Law on Public Pension Social Insurance. The second stage was an amendment, prepared in 1997 and enacted in June 1998, to increase the pension age by three years by June 2004, and cut benefits to working pensioners – largely those with special privileges - by 50 percent. Parliament drafted and passed an alternative version of the law with a pension age increase of four months per year and limiting the reduction of pensions to those earning a wage above the average.

2.27 The legislation increasing the pension age and reducing benefits for persons with special privileges became the main point of public debate, whereas - perhaps because it didn’t have an immediate effect on benefits - the NDC scheme passed with little attention. The increase in the pension age and the reduction in pensions were challenged in the Constitutional Court in 1998, and the Court ruled that the amendments were unconstitutional. In January 1999, the Court amended its ruling allowing the parliament to pass legislation increasing the pension age, a process already begun in 1998. A new law was passed in February 1999 stipulating an increase in the pension age by three years by 2007. The ruling on the reduction in pensions was not reversed, however.<sup>20</sup>

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<sup>19</sup> Examples of circumstances giving entitlement to an early benefit were listed occupations such as cotton-growers, tobacco-growers, milkmaids, bus drivers, aviation employees and theatre performers; persons working in hazardous working conditions – *e.g.* in chemical, metallurgical and mining industries; and persons working in climatically extreme conditions. In addition persons unemployed one year prior to the normal pension age, dwarfs, and several other listed categories were entitled to benefits prior to the normal pension age.

<sup>20</sup> Kyrgyz Republic: Selected Issues and Statistical Appendix. IMF Staff Country Report No. 00/131, 2000.

2.28 The 1997 legislation combines a universal base pension with an NDC pension, inspired by the NDC reform in Latvia in 1995, and a transition benefit covering service years prior to 1996. The three components of the new system are summarized in the following.

2.29 ***The Base Component.*** Based on residency, everyone is entitled to the *base pension* of 12 percent of the average wage. In principle, this preserved the base component of the old system, but at a lower level. The strategy chosen to get to 12 percent was to let the amount deflate with normal inflation until it reached 12 percent of the average wage, which it had done by 2002.

2.30 ***The Transition Component.*** The *transition benefit* is calculated as one percent of the individual's best average wage for five consecutive years times the number of service years registered prior to 1996. There is a cap on this benefit of 15 times the minimum wage.

2.31 ***The NDC Component.*** The Kyrgyz Republic's *NDC scheme* follows many of the principles of a full-fledged notional defined contribution scheme, but not all. In the Kyrgyz system, contributions based on 23 percent of the participant's earnings are noted on an individual account beginning in January 1996. Account values are indexed annually to 75 (instead of 100) percent of the growth of contribution wages registered in the previous year.

2.32 The benefit in the NDC scheme is an annuity calculated by applying a "k" coefficient based on cohort life expectancy at the year of retirement to the sum of capital on the individual account at the time of retirement.

2.33 Unlike in the Latvian (1995) and Swedish reform (1994), rights earned prior to implementation were not converted into NDC "initial" capital. Instead, only new entrants would be covered fully by the NDC scheme. Persons already working at the time of implementation would receive the transition benefit based on rights earned up through 1995, with NDC rights beginning in 1996. In this respect the Kyrgyz reform resembled the Italian reform (1995), with the consequence that the transition is very long.<sup>21</sup>

2.34 In principle, the NDC scheme should encourage payment of contributions. However, unlike in Latvia and Sweden, where initial capital was created on the basis of acquired rights and a full transition was implemented, the Kyrgyz Republic's less dramatic introduction of NDC may have detracted from the potential "psychological" policy message of NDC – that benefits are based on contributions, and by not contributing, people are jeopardizing their own future pensions. Nevertheless, the Social Fund has worked hard on promoting this central message of the reform, and with a prolonged effort this should help to create higher compliance.

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<sup>21</sup> See Palmer 2003 ("Conversion to NDC – Issues and Models". Paper presented at the World Bank and RFV Conference on Notional Defined Contribution Pensions, 28-30 September 2003, Sandhamn, Sweden. <http://www.rfv.se/konferens/index.htm>) for a discussion of different transition models.

2.35 Due to the transition rule, it will take until 2038 for the whole benefit to be based on the NDC formula, *e.g.* for a person born in 1975 and retiring at age 63. It takes even longer (to around 2060) until *all* living pensioners have a benefit determined solely by the NDC formula. This long transition occurs because acquired rights were not transformed into NDC rights ("initial" capital).

2.36 There is no legislated mechanism for indexation. In accordance with the original parliamentary amendment to the pension law, the minimum pension age has been increasing by four months per year, beginning with 1998, and will continue to do so until the minimum age reaches 58 for women and 63 for men at the end of 2006.

2.37 The 1997 legislation also reduced special privileges for about one third of those previously entitled to them, which took effect in 2000. Not all special rights have been abolished, however. As a component of the reform, remaining special rights are financed with general budget revenues – through the Republican budget.

2.38 The amount of the overall benefit can be illustrated as follows. For an individual whose average wage happens to be the same as the national average wage when he/she retires, and who had a record of 30 service years by 1996, the transition component is 30 percent of the average wage. The base component and transition components together would give, then, 12 plus 30 percent of an average wage the first year of retirement. If in addition, this person has contributed after 1996, the benefit will be enhanced by an NDC component.

2.39 The NDC benefit is based on a contribution rate of 23 percent of an individual's wage. The Kyrgyz rules provide, however, for only 75 percent of full indexation of notional capital. Assuming the individual earns the average wage, then the NDC benefit can be calculated as  $[0.23 \times \text{average wage} \times \text{number of years of contributions} \times \text{effect of reduced index}^{22}] / [\text{cohort life expectancy at retirement}]$ . Unisex life expectancy from age 60 is presently 17.5. Calculations are presented in Table 3, taking into consideration the fact that life expectancy at 58 and 63 is longer, respectively shorter than at 60.

**Table 3: Benefits in the Initial Years after the Reform (percent of average wage)**

	<i>Base Benefit</i>	<i>Transition Benefit</i>	<i>NDC Benefit</i>	<i>Total</i>
1. 30 years in pre-reform system + 10 years in post-reform, retirement at age 63	12 %	30 %	14%	56%
2. 30 years in pre-reform system + 10 years in post-reform, retirement at age 58	12 %	30 %	11%	53%
3. 30 years in pre-reform system + 5 years in post-reform, retirement at age 63	12 %	30 %	7 %	49 %
4. 30 years in pre-reform system + 5 years in post-reform, retirement at age 58	12 %	30 %	4%	46 %

<sup>22</sup> The effect of 75 percent indexation is to reduce benefits increasingly the longer capital is accumulated. After 10 years the reduction is ca 4 percent but it is 17 percent for full career accumulation of 40 years.

2.40 Presently about half the working population is not contributing regularly. Consequently, as the transition benefit, which is based on service years, is gradually replaced by the NDC benefit, which requires actual contributions, benefits will fall – unless the degree of formality increases dramatically in the coming decade. Two groups will be affected. The first, persons working in small and medium-sized enterprises and contributing on the basis of a minimum wage, could improve their fate by increasing compliance. The second is small farmers, who now pay small or no contributions. Hence, average newly granted benefits are likely to fall.

2.41 The individual results in Table 3 are much higher than the macro results for yet another reason. Because benefits are not indexed to wages, the ratio of a benefit to an average wage falls as the average wage in the economy increases. Assuming annual real wage growth of five percent, in line with the official growth forecast for GDP for the coming decade, the ratio of an average benefit to the average wage becomes about 67 percent of its newly granted value after only eight years and a little over 56 percent after 12 years. This means that the *macro* ratio of the average of all old age benefits to an average wage will be around the 35 percent, in spite of the relatively higher rates in the table. This agrees with the 2002 Bank calculations of macro rates for the coming years.

2.42 The low pension age of women means that they will have a lower benefit than the table indicates as the NDC benefit begins to dominate. Assuming an increase in the life expectancy of women by two years by 2020 and a pension age of 58, contribution careers of 30 and 40 years will give an NDC replacement rate of around 28 and 36 percent, respectively, and an overall replacement rate of 40 and 48 percent, respectively, assuming an average wage. It will be difficult to work 40 years with a retirement age of 58, however, especially with years of child care taken into account. So an overall replacement rate of 40 percent - or lower - is more likely.

2.43 In sum, the immediate effects of the new pension legislation were, first, to bring expenditures in line with contribution revenues, and, second, to enable a decrease in the overall contribution rate. These are short-term effects that derive mainly from the partial abolishment of special privileges, the transfer of the remaining costs for special privileges to budgetary means from the Republican budget, the gradual increase in the pension age and incomplete price indexation and the fall in the value of the base benefit to 12 percent of the average wage, in accordance with the legislation. As the NDC formula becomes more prominent, pension expenditures are likely to first fall due low contributions and holes in coverage, and then, hopefully, rise as formality and compliance increase.

2.44 Since all increases in rights are, by definition, accompanied by contributions to pay for them in NDC, as total benefit commitments increase in the long run, they will always be preceded by commensurate increases in contributions. This is why the generic NDC scheme needs to have a reserve fund (that earns at least the rate of return of notional accounts), *i.e.* in order to move money over time.

2.45 The demographic outlook for the country is move in a favourable direction in the nearest decades due to a high past and present fertility rate (2.2 and more). With normal net migration from the country, an increase in the working age population is likely during

the coming two decades, which creates more degrees of freedom for renewed thinking in formulating a long-term strategy for pension policy.

2.46 Finally, in summing up it is also important to mention that whatever interest there was in the development of a mandatory financial scheme, not the least spurred by the pension reform in neighbouring Kazakhstan, was cooled by the banking crisis of 1998. This issue didn't emerge until 2002, when the Social Fund presented a proposal for a mandatory financial individual account scheme, with suggested implementation in 2003. This schedule was not supported by the World Bank, because of the underdeveloped financial market environment, and the proposal is still under discussion. Financial market development is also now in focus in the under the IMF Poverty Reduction and Growth Facility.<sup>23</sup>

### **Development of the Pension Administration**

2.47 In 1991, the government created the Social Fund (SF), under the Ministry of Labour and Social Protection (MLSP). The SF administers pensions and other social insurance, and is responsible for collecting the contributions for pensions, unemployment (training is part of active labour market programs, which is responsibility of Employment Fund), health insurance and other social insurance, *i.e.* all payroll taxes. In 1998, the SF was granted complete autonomy and given a seat in the government. It was made fully responsible for formulating pension policy. From 2000 the SF was made responsible to the President, alone, putting it outside the governance of the government.

2.48 In 1997-98 the SF centralized accounts, previously kept at the local level, enabling:

- Daily receipt of information from servicing banks on the sum of money collected on a regional basis.
- Creation of daily accounts on pension payments and debts on a regional basis.
- Introduction of a new accounting system, based on an electronic database, and meeting international standards.
- Introduction of new principles of budget planning. Training of personnel in new standards of accounting and financing.

2.49 In 2003, the SF's information and payment systems have been further developed to enable the direct electronic transfer of cash through servicing banks from all registered employers. This eliminates the possibility of mismanagement of funds at the local level. At the same time information on individual employee contributions is transferred electronically from the employer to the SF. The SF can produce electronic account statements for all registered participants, over 2 million persons. The SF does not presently have the IT capacity to produce individual statements to send out by mail to participants, but development of this facility was under consideration at the time of this evaluation. Pensions are still delivered through the mail service.

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<sup>23</sup> Kyrgyz Republic: 2002. Article IV Consultation, Second Review under the Poverty Reduction and Growth Facility. IMF Country Report No. 03/51. February 2003.

2.50 The Social Fund examined contributions by type of employer in 2001. This study showed that large enterprises and the civil service were generally paying contributions of a reasonable amount, given employment figures, but small and medium-size enterprises were not. This led to the changes already discussed, first, that employers are required to pay contributions based on a minimum wage of 1000 Som, and, second, the right for the Fund to prosecute evasion. According to the Director of the Social Fund, these changes led to an increase in the *contribution base* by about 20 percent in 2002, and at least this much in the first half of 2003, on a year-on-year basis.

2.51 A schedule was prepared in 2003 to repay the money owed the Mandatory Health Insurance Fund (MHIF), which was not fully compensated in previous years, when fund money was used to meet pension commitments. To date in 2003, the SF has improved transfers to MHIF in order to meet IMF PRGF conditions.

2.52 If the measures implemented to cope with underreporting and arrears remain successful, then the decrease in the contribution rate applying for employers can become sustainable. The main threat to this is the lobbying of small and medium-sized employers to remove the legislation requiring a contribution based on the minimum wage of 1000 Som. Long-term calculations of the SF actuarial staff, as well as Bank calculations in late 2002, point towards an increasing surplus in the future.

### 3. The Bank's Country Assistance Strategy

3.1 The Bank's country assistance strategy in the early 1990s stressed the importance of an effective social safety net and infrastructure reform.<sup>24</sup> In 1994, IDA's first investment project in the Kyrgyz Republic, the Social Safety Net Project (SSNP), and was formulated and supported by a loan of 12 million SDR. The 1994 SSNP was a four-year project closing in the end of 1998. The project had four components

- social assistance reform,
- poverty and unemployment monitoring,
- employment services and
- training.

3.2 The bank policy regarding pensions at this stage was:

- a) To "simplify the benefit formula" for pension calculations and delivery in order "to free up staff time" [at the local level of administration] "to focus more on targeted forms of social assistance".<sup>25</sup> The problem was that benefit calculations, which were made by hand, were complicated and for this reason time consuming. The complications arose from the numerous special privileges.
- b) To "implement moves towards a flat-rate social insurance scheme" with the "finalization and implementation of a plan for the simplification of benefit calculations and recalculations".<sup>26</sup>

3.3 The SSNP was coordinated with an EU/TACIS project, which focused on the revenue and record maintenance of the recently created Social Fund. According to the SSNP, the main purpose of the reorganization of public administration, encouraged by the Bank, was to support a clear separation between social assistance and social insurance, and to put social assistance within the control of the state, rather than the local authorities. Means-tested benefits would then replace a general allowance to families, which was viewed as an unnecessary use of scarce public funds.

3.4 In the mid-1990's country assistance strategy, the social sector discussion continued to focus on the problems of poverty and employment, and the need to target support schemes. The mid-1990's country assistance strategy only has an indirect reference to pensions, to the above mentioned EU-TACIS project. Administrative efficiency in delivering benefits was still seen as the number one priority. Although the Bank was on record earlier as recommending a flat-rate pension, there was no mention of a pension reform strategy in the country assistance strategy.

3.5 In late 1995 and 1996 the government began work on the new pension reform, mainly with the aid of the TACIS advisers. This work resulted in the 1997 legislation discussed above – the base pension, the transition benefit based on service years and the

<sup>24</sup> Kyrgyzstan: Social Protection in a Reforming Economy, 1993.

<sup>25</sup> Social Safety Net Project (SAS), 1994, p. 4.

<sup>26</sup> *Ibid.*, p. 22.

average wage and the NDC scheme, stimulated by the Latvian reform, already formulated and legislated 1995. When the Bank entered the scene, the concept had already been adopted, including the proposed increase in the retirement age. The role taken on by the Bank was to help with the technical aspects of the reform and to provide modelling support. Both were important contributions in the overall process of formulating and evaluating the new legislation.

3.6 In the initial stages of the reform discussion, the government was considering abolishing the base pension altogether, and according to discussions in conjunction with this appraisal it was the Bank that persuaded the government to retain at least a small base pension. Hence, in the late 1990's, when a new country assistance strategy was formulated, the pension reform had taken a considerably different course than the flat-rate benefit promoted by the Bank.

3.7 The late 1990's country assistance strategy was formulated to support the new legislation. It established that the bank group lending program would be supported by a social sector adjustment credit (SOSAC). The primary objective of the SOSAC would be to achieve financial viability of the existing pay-as-you-go pension legislation, including creating timely payment of public pensions, which at the time was still a problem. Financial viability would be achieved through rationalization of special rights, an increase in the pension age and better linkage of benefits to contributions, *i.e.* the country assistance strategy supported the reform legislation already enacted. The Bank also recommended a decrease in the contribution rate as soon as this became financially feasible.

3.8 The Bank interpreted the new legislation as an innovative reform of the state pay-as-you-go pension system based on the best practice approaches similar to those being implemented in Latvia, Poland and Sweden. The new system was considered a way to improve fiscal sustainability and provide incentives to defer retirement when combined with aggressive cost cutting measures, such as a recently enacted increase in the retirement age. Further, the system was considered a flexible approach to pave the way for future reforms after the state scheme was sufficiently scaled back, and the country's capital markets were suitably developed.

3.9 Yet, the SOSAC pointed to a number of outstanding issues, still to be addressed in the NDC scheme. These were: 1) the approach taken to compute individual accounts, crediting NDC accounts with the overall contribution, including costs for disability and the minimum benefit, 2) the *ad hoc* indexation of current pensions, instead of using a legislated rule, and 3) the need to establish an actuarially fair value of the "k coefficient" used to compute NDC benefits. The SOSAC also supported the legislation of the base pension to help keep pensioners out of extreme poverty. Other problems were an increase in disability take-up, and the need for the Social Fund to manage and administer pensions efficiently. The SOSAC supported a thorough review of the disability certification procedures.

3.10 The institutional development under the heading of the social sector reform program supported the move of the Social Fund to international accounting standards. In

fact, this is the only project where financial support for development of the pension system and its administration was scheduled. The SOSAC also supported coordination of the Social Fund's collection procedures with the Tax Inspectorate through the implementation of a plan to introduce a single identification number.

3.11 The identification and appraisal phases for the 1998 SOSAC included the provision of technical assistance to adapt and use the Bank's PROST pension model for calculations. Calculations in support of the SOSAC showed that with the old rules, in the long run the system would have become increasingly in debt, *i.e.* there would have been a need to increase the contribution rate from the existing level of 39 percent. Calculations suggested that the reform legislation would turn this around by 2003. The increase in the pension age and reduction in special privileges provided the most immediate impact on the development of costs, while the gradual transition to the NDC formula strengthened the long-term outcome.

3.12 The SOSAC credit amount was 35 million USD. Additional financial assistance was provided by the Netherlands (5 million USD) and Switzerland (5 million USD). Table 2 in the Statistical Annex itemizes the activities within the program relating to pensions. The first tranche conditions were fulfilled at the time of issuance. The conditions for pensions for the second tranche of the SOSAC, to be released at the end of 1999 were:

- a) Provision of satisfactory evidence that the retirement age was being increased.
- b) Provision of satisfactory evidence that the expected non-mandatory transfers for pensions for 1999 to the Social Fund for 1999 amount to less than 300 Som.
- c) The Borrower has taken satisfactory measures providing changes in the pension formula regarding the contribution rate used to calculate pension capital and the calculation of "k", and the implementation of a rule providing a minimum pension.
- d) The Borrower's government has submitted a draft law to the Parliament specifying, first, an appropriate mechanism for pension indexation; secondly, the reduction of non-contributory periods for pensions and early retirement privileges; and thirdly the principle that any remaining privileges be financed from the Republican budget.
- e) The Borrower has provided documents for a tender to convert to international accounting standards and submitted a satisfactory audit of the accounts of the Social Fund.
- f) The Borrower has submitted to the lenders an assessment of the fiscal and social impact of pension policy options, using a technical model that is satisfactory to the lenders, and including the option of a gradual transition to a mandatory system with financial accounts.

3.13 Overall, the Bank supported the government in its goal of raising the pension age and abolishing some special rights, helped identify problems in the initial construction and proposed solutions for the nascent NDC scheme. The conditions attached to the SOSAC were fulfilled. Legislating indexation turned out to be a difficult issue, however. The government submitted an amendment to the Pension Law on indexation in

accordance with the SOSAC, however, indexation was made conditional on the development of arrears, and, to date, the government has increased pensions on an *ad hoc* basis.

3.14 A main focus of the technical assistance under the SOSAC was the implementation of international accounting standards and the institutionalization of a regular audit of the Social Fund. The technical assistance provided under the SOSAC led to the introduction of international standards and the training of personnel. The process went through two stages of development, however, as the IT-system first installed to support the accounting department (using an international bidding process) proved to be inadequate and was eventually replaced by an in-house IT product.

3.15 In the Bank's country assistance strategy of the early 2000s, there is only one indirect reference to pension policy and implementation. The country assistance strategy calls for a pension and social safety net update will reassess the financial sustainability of the Pension Fund, and begin to assess options for further modifying social protection strategy. Work would build on the completed SOSAC, ongoing CSAC and the FY01 Kyrgyz Social Sector Finances Study.

3.16 The policy dialogue was reinitiated between the Bank and the government in late 2002, after having remained on low burner since 1998. The dialogue was a reaction to the government's draft legislation for a new mandatory financial account system. According to the initial proposal, this was to go into effect in January 2003 with a contribution rate of 1 percent, increasing to 10 percent in 2012.

3.17 The government's new legislation presupposed that the additional financial costs, in addition to contributions needed to support the existing legislation, would be borne by the Republican Budget, by transferring to it the costs of financing the basic guarantee. Since the modelling capacity built up under the SOSAC had not been sustained, the technical capacity needed to evaluate the long-term consequences of the proposal did not and still does not exist, and therefore the proposal has not been accompanied by an adequate long-term financial analysis.

3.18 The 2002 pension policy dialogue primarily dealt with the government's proposal to introduce a new mandatory financial account scheme. Firstly, in its response, the Bank recognized the achievements of the Social Fund, including improved contribution collection and a substantial reduction in contributions paid in kind. Secondly, the Bank opposed the Fund's proposal that the new financial scheme could be financed initially by decreasing the health care contribution rate from two to 1.5 percent. Thirdly, the Bank points out that the proposal does not include a discussion of where the Ministry of Finance (MOF) would find new revenues to finance the proposed transfer of the flat-rate benefit commitments to the Republican budget (the equivalent of a contribution rate of 6-7 percentage points).

3.19 Finally, the Bank lists and discusses a number of other preconditions for the introduction of an individual financial account scheme, which, according to the Bank's analysis, were not fulfilled. For example, trust in financial institutions was low, and still

was even in 2003 according to this evaluation. In fact, a part of the focus under the IMF Poverty Reduction and Growth Facility is on “banking reform and a new initiative to improve governance.”<sup>27</sup> Corruption is perceived as being high, according to this evaluation, and in 2003 there is still no well-established supervisory agency and regulatory environment.

3.20 In conjunction with the 2002 pension policy dialogue, the Social Fund and the MLSP requested technical assistance and grants to aid in developing legislation and to improve the capacity to perform pension and actuarial analyses, including analyzing the impact of moving in the direction of a financial account scheme. To date this assistance has not been forthcoming. However, according to the Bank, the assistance has not been forthcoming, because it was not discussed with the Bank during the preparation of the country assistance strategy. This was because the MOF had not supported this request.

3.21 In sum, the Bank was not a part of the initial reform discussion in 1995-96, and the reform concept differed considerably from that recommended by the Bank in earlier discussions. The Bank supported the reform with technical assistance in formulating the legislation and performing the financial analysis. The Bank’s financial support began with the SOSAC, which provided some technical assistance in 1998-99, focused mainly on administration (developing accounting, audits and cooperation with the Tax Inspectorate). Until late 2002, there was no follow-up with technical assistance to support further development of institutions and policy, including the capability to provide competent technical long-term analysis of potential reform-completion strategies. Neither did the government find the means to develop its own capacity in this area in the absence of Bank support.

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<sup>27</sup> Kyrgyz Republic: 2002 Article IV Consultation, Second Review under the Poverty Reduction and Growth Facility. IMF Country Report No. 03/51. February 2003.

## 4. Performance Evaluation

### Outcomes

#### *Objectives*

4.1 The revealed objectives for the pension policy strategy as seen over the entire period, 1991-2003, have been to:

- a) Create a universal minimum flat-rate pension supplemented by mean-tested social assistance to relieve extreme poverty among the elderly.
- b) Create a mandatory old age pension scheme with a tight link between contributions and benefits, to supplement the universal minimum benefit.
- c) Bring finances into balance in the short-term and create a system that maintains long-term financial stability.
- d) If possible lower the contribution rate.
- e) Develop an efficient administration of pensions, with transparency and accountability.
- f) Supplement the pay-as-you-go scheme(s) with a mandatory financial account scheme, if possible

4.2 In the early years of the 1990s, the pension scheme inherited from the FSU, which was based on a flat component and a service-year related component, was compressed into a near flat-rate benefit by putting a ceiling on the amount of a benefit paid. The Bank promoted the idea of a universal flat-rate benefit, at least at least through the formulation of the country assistance strategy of the mid 1990's.

4.3 Given this point of departure, a possible reform would have been to replace the old formula with a flat-rate and increase the retirement age. This path was not promoted by the Bank, judging from the country assistance strategy, nor was it the path considered by the government when the reform concept began to take form in 1996. Nevertheless, the reform legislation contains a flat-rate minimum-guarantee benefit level-so this criterion was met.

4.4 In 1996 the government began working on its concept for pension reform. The government's NDC reform of 1997-98 introduced a long-run framework with benefits linked strongly to contributions. The reform legislation achieves objectives a) – d). The Bank supported the new reform. Consistent with its earlier position, the Bank's strongest influence on the main structure of the legislation came through its insistence that the country retain at least a minimal flat-rate benefit as a minimum guarantee. Without the Bank's efforts in this respect the reform may have proceeded without a universal minimum guarantee benefit, implicitly with much greater reliance on social assistance for poverty alleviation among the elderly.

4.5 In the short term, the most important instrument applied to create financial balance was *not* to index benefits sufficiently to keep up with inflation. However, by the end of 2002, the increase in the pension age and the abolishment of a significant number

of special privileges began to contribute significantly to reducing expenditures. Legislation in 2002 requiring employers to pay a contribution based on a minimum wage also improved revenue collection significantly. With financial balance there was room for successive decreases in the contribution rate already from 2001. Decreases in the overall rate were also combined with a partial shift from the employer to the employee, most certainly leading to a decrease in labor costs.

4.6 The Social Fund developed an efficient administration, spurred by the reform, and aided by a loan through the SOSAC. The SOSAC supported the goal of creating an efficient administration. However, the main thrust of administrative development came from the Fund itself. The SOSAC was focused on introducing international accounting practices and unique identification numbers. The Social Fund made the investments and developed the information technology needed to create an efficient flow of money (contributions) and information on its own. This in-house development project succeeded well, and is still moving forward with considerable momentum.

4.7 In sum, all of the government's objectives except that of introducing a mandatory financial account scheme were fulfilled. This objective was – and still is – not supported by the Bank, as long as the financial infrastructure remains underdeveloped (lack of transparency and supervision) and the risk of corruption is high.

### **Relevance of Objectives**

4.8 Government policy evolved in a logical sequence. In the turbulent initial years of the transition the focus was on employment policy and redesigning social policy instruments so as to use dwindling resources efficiently. In the initial years, pension “policy” was focused on reducing pension expenditures by capping individual pension benefits, thereby promoting a drift towards a flat-rate pension. At the same time administrative resources were freed to move in the direction of developing a national social assistance program, with means-tested benefits replacing universal benefits to families. This vision was promoted in the country assistance strategy of the early 1990s, and became once again the theme in the country assistance strategy of the mid-1990s.

4.9 However, the structural issue of too many people receiving pension benefits compared to the number of contributors was not identified in the country assistance strategy of the early 1990s. By 1995 this problem had become acute, yet the mid-1990s country assistance strategy also failed to identify, discuss and provide a blueprint for dealing with this structural issue. In fact, there was little written about pensions in the country assistance strategy, even though the pension deficit was almost two percent of GDP, and at a time when the country's overall debt was about 5 percent of GDP.

4.10 The discussions in conjunction with this evaluation suggest that the Bank still favoured a flat-rate benefit in 1995. At the time this meant maintaining the *status quo*. One possible reform alternative at the time would have been to increase the pension age, abolish as many special rights as possible and design an affordable flat-rate benefit. There's no documented discussion to this effect, however.

4.11 In spite of the sanguine approach taken to pension policy in the mid-1990s country assistance strategy, formulation of the Kyrgyz Republic's new pension system began almost before strategy was formulated. The Bank reacted, once this process was under way, providing technical assistance in formulating the new legislation and performing technical calculations.

4.12 Although the objectives of the Kyrgyz reform are all relevant *per se*, they are in potential conflict with each other. With a given cost constraint the conflict is between:

- a) establishing the form of indexation of the benefits of current pensioners.
- b) providing a sufficient base benefit,
- c) finalizing the design and scale of the NDC pay-as-you-go scheme,
- d) introducing a financial account scheme, and
- e) reducing the employer contribution rate.

4.13 On each point greater generosity for that specific point reduces the degrees of freedom for developing the other points, within a given cost framework – for example a given target percent of GDP over the long run. In addition, a decrease in the contribution rate can be achieved by increasing the role of the general budget in financing the pension system, which can be argued to be the right course to take for financing the base benefit, not the least because it will be the main benefit for subsistence farmers for much time to come. Yet, this strategy must also be weighed against competing uses of scarce tax money.

4.14 When the mid-1990s country assistance strategy was being formulated, most of the legislation and analysis for the reform had already been passed. The main objective of the new reform was to achieve financial sustainability. The reform blueprint for increasing the minimum pension age and reducing special rights provided strong short-term instruments to this end, and the introduction of the NDC formula was a first step in creating a stronger long-term link between contributions and benefits.

4.15 At the time when the reform was being introduced, public opinion was focused on the increase in the pension age and reduction of some special rights. This was not popular. With the transition formula, newly granted benefits were not affected dramatically, so this did not arouse opposition. The public debate that did arise may, however, have subdued any remaining reform energy. The government appeared to reduce its focus on pensions, too, once the legislation had been passed. In fact, as has been argued here, there was a need for both the government and the Bank remain on the playing field and continue beyond the 1997-98 legislation.

4.16 Efficient administration of contribution collection and benefit payments is central to the success of any social insurance scheme. The SOSAC supported further development of the Pension Fund's administrative capability, including introduction of international accounting standards, auditing and coordination with the Tax Inspectorate, both in line with best practice. Both are clearly relevant. The Social Fund continued beyond this on its own, however, and developed modern information systems and

procedures to manage money and information flows, both of which are extremely relevant development activities.

4.17 The Bank provided technical assistance with actuarial calculations in 1997, in conjunction with the preparation and enactment of legislation. The model was transferred to the Social Fund, but it fell into disuse because the personnel were not sufficiently trained to work with it, and, perhaps because the demand for these services was not established, competence eroded through disuse. Neither did the government or the Social Fund develop an in-house model with similar capacity. As a result, there is presently no institutionalized actuarial model in the Kyrgyz Republic, and when the Bank renewed its engagement in pension policy in 2002, it performed the calculations. These calculations have an *ad hoc* nature, focusing on decreasing the contribution rate, but not within the overall setting of making the choices between alternatives available for the future. In addition, at the time of this evaluation, there was no evidence in the dialogue – on the part of the Bank or the government - of the remaining issues in the design of the NDC scheme, nor the need to evaluate whether the present base pension fulfils its purpose in the coming decades.

4.18 **The rating on relevance of objectives is *substantial*.** The development problems were properly diagnosed, and as circumstances in the Kyrgyz Republic changed, the design of strategy changed accordingly. The Bank provided technical support for the formulation and analysis in conjunction with the preparation of the 1997-98 reform legislation, but the technical support was too short-lived to have a permanent effect on capacity. The SOSAC provided a small input into the improvement of the Social Fund, which throughout improved its capacity much beyond the framework of the SOSAC.

4.19 The objectives of the reform are all relevant. However, too little attention was devoted to fitting all the pieces together to formulate a consistent overall strategy over time. This blueprint is necessary in order to move forward in a coherent and transparent manner, and the fact that it is lacking impedes the current dialogue. In fact the importance of such a blueprint in communicating the government's strategy to the general public and specific actors should not be underestimated, and once the blueprint has been drawn up public communication must become a part of the overall strategy.

### **Efficacy of Objectives**

4.20 The Kyrgyz Republic's pension reform was a major accomplishment, and the country is a leader in pension reform in the region. An increase in the pension age and reduction of special privileges was especially difficult to effectuate in any socio-political environment where a low pension age and pension privileges in lieu of higher wages and better working environments have been an institution. In addition, the Social Fund has developed into an efficient administration, and has developed technical systems and routines for the collection of contributions, the payment of benefits and the provision of individual information to participants. In addition, the introduction of an NDC scheme has set a foundation for linking benefits to contributions and attaining long-term financial stability in the pay-as-you-go system.

4.21 The Kyrgyz Republic has replaced a financially unsustainable pension system with a framework that is financially efficient. Three outstanding issues influence the efficacy of the objectives, however. These are:

- a) The extent to which the present design will provide *adequate coverage* for the large percentage of persons presently working, but who are not paying regular and/or normal sized contributions.
- b) The *design of the system*, namely the size of the base benefit, which has to do with the first point, the design of the NDC scheme, finally, the future course of indexation, which is presently not legislated.
- c) The development of a financial infrastructure sufficient to support the introduction of a mandatory financial account scheme.

#### *Adequate coverage*

4.22 The first point has to do with adequacy of benefits. There remains an important issue that is not dealt with in the country assistance strategy documents at all, nor in the discussions reflected in Bank documents in conjunction with the pension policy update, and discussions conducted in the course of this evaluation. The issue is that half of persons registered as engaged in employment do not pay contributions on a regular basis, or at all. A large percentage of these are probably in subsistence farming. One can hope that this is no longer the case in two or three decades, since it is not efficient to have a large percentage of the population employed in subsistence agriculture and since the transition in the Kyrgyz Republic will have to involve bringing a larger percent of the working age population into other economic activities.

4.23 The risk is high that a large percentage of the elderly population will remain in poverty even many decades after the reform. The period of transition will certainly take at least a decade, but it could also take several decades, and in the process a large group of persons may not have accumulated enough contribution-based rights to give them a sufficient pension.

4.24 For the reasons mentioned here, average benefits, and with them total pension expenditures as a percent of GDP, may decrease for many years to come, even after the final effect of the increase in the pension age has worked itself through, as the contribution-based formula takes over and creates low pensions for many for the reasons discussed above. In the even longer run, as a larger percent of the working population have contributed normally during a lifetime working career, average benefits will begin to increase again.

4.25 This problem needs to be recognized, analyzed and dealt with in one way or another. Seen in this perspective, the issue of the size and source of financing of the base pension, or more generally the guarantee, is a key issue. This issue should also be examined in the overall perspective of the roles of social assistance and community based services (including health services).

### *System design*

4.26 The second point has to do with the design of the NDC scheme, and the overall issue of indexation. These are also interrelated. There is a need to review a) the indexation of NDC accounts (presently 75 percent of the growth in then covered wage), and in conjunction with this the contribution rate applied to create NDC capital, and b) the indexation of NDC benefits. The latter is a part of the more general issue of how to index all pension components in the future, including the “hang-over” of pensions granted under the old law.

4.27 Under the new law, it is possible to separate the question of the indexation of the base pension from the question of the indexation of transition and NDC benefits. There should be internal logic in the indexation of individual components, and the path chosen should be chosen as a component of the entire blueprint for the future, including the development of the overall contribution rate and the government’s goal of introducing a mandatory financial account scheme.

4.28 The Bank maintained a consistent position from 1997 on recommending legislation of an indexation rule, but did not promote development of this recommendation within the above broader context. The current legislation empowers the Cabinet of Ministers to determine indexation in accordance with the development of the pension budget. This united government’s short-term goal of creating financial balance, as *ad hoc* indexation is the only short-run tool available to government to “fine-tune” the pension system into balance.

4.29 The obvious risk of *ad hoc* indexation is that it will have an election cycle, with generous improvements in the period immediately preceding an election, and perhaps troughs thereafter, if this suits the government. The long-term risk is that, in the absence of an overall blueprint for the future including an indexation regime that is consistent within the overall picture, overly generous short-term indexation reduces the latitude for manoeuvre in the long-run. Conversely, inadequate indexation can create future poverty.

### *Financial infrastructure*

4.30 Finally, the financial infrastructure necessary to implement either private or mandatory financial account schemes did not evolve in the period up to mid-2003. It is likely that this situation would have been better had the government and the Bank focused more strongly on institution building in this area.

### *Overall rating for efficacy*

4.31 The Kyrgyz Republic’s pension reform was an important and major accomplishment, and in the region the Kyrgyz Republic is one of the leaders in this area. The reform has become established in the eyes of the public, thanks to both improvements in administrative collection, payment and information efficiency, as well as the routine PR of the Social Fund. However, because of remaining design problems,

and more importantly, the absence of a coherent overall strategy for finally fulfilling the objectives of the reform, the overall rating for efficacy is substantial.

### **Efficiency**

4.32 In accordance with the objectives of the country assistance strategy of the late 1990's the reform has already achieved the goal of financial viability, and pension rights are gradually becoming increasingly more contribution related. In addition, the Social Fund has made substantial administrative progress, as has already been noted.

4.33 The reform required relatively few resources during the implementation phase. The Bank's involvement piggy-backed on the work of an EU-TACIS project, and in doing so was able to accomplish much with relatively modest input from the Bank.

4.34 It would have been more efficient in terms of achieving the objectives effectively, however, to have continued with the provision of technical assistance even after 1998. The period 1998-2003 has the appearance of "time lost" in terms of reaching the ultimate goals.

4.35 Further progress requires the technical capacity to analyze alternative long-term strategies for indexation, possible cuts in contribution rates, the scale phasing in of a mandatory financial account scheme, etc. This work was begun in the preparation of the SOSAC, but progress stopped at this juncture. The Bank's support became dormant after 1998, with little local development emerging in its place. The first steps in filling this gap have been taken in 2003, with the initiation of a new dialogue. Technical assistance in performing policy analysis is still needed to move forward, however, and this was brought up by various experts and policy makers in the interviews performed in conjunction with this evaluation.

4.36 The overall rating for efficiency is, thus, substantial. The Bank's investment yielded a good return considering its modest size. However, what was needed was continuity after 1998 and this did not occur.

### **The Outcome Rating**

4.37 The objectives of the reform are achievable, however, the process is unfinished, and there are still important priorities to be set among them. The absence of a strategy to fit all the pieces of the puzzle together means that the blueprint for the future is unclear. This has led to ratings of substantial for relevance, efficacy and efficiency. The reform project accomplished a great deal, but there remain shortcomings, and the process itself has been dormant for several years, following a laudable start in 1996-98. The shortcomings in the reform are all possible to remedy. Overall, then, the rating is satisfactory for the outcome.

## **Institutional Development Impact**

4.38 The new legislation signals a change in values and practices compared with the old Soviet system. The conversion to a paradigm based on contribution-related benefits signifies a substantial change in norms. Government and other stakeholder ownership of the current legislation is substantial. Constant efforts are made through the Social Fund to communicate the new values and practices embodied in the 1997-98 legislation. For example the Social Fund communicates with the public regularly through mass media to improve ownership of the principle of contribution-linked benefits.

4.39 The reforms undertaken in 1997-98 changed the rules of the game. The changes in the law implemented signal a change in values, and a need to change practices. The development of efficient contribution collection by directing payments directly from employers to banks is an example of how efficiency has increased and the scope for corruption and misuse of funds has been reduced.

4.40 The new system makes a critical contribution to the country's ability to use its human resources effectively, because the focus is shifted from benefits to work. This is reinforced by the fact that the reform package has created an affordable overall system. Further improvements can build on the set of values and practices already established.

4.41 The separation of social insurance from other public benefits, accomplished early in the reform process signaled a change in values and practices and constituted a major institutional change. The principles of insurance are important for any market economy to embrace and understand, and it is important to distinguish what is insurance and what is general social policy. The shift in the financing of remaining special rights to the general budget – and out of the insurance scheme – is another example of the clear line established between social policy and social insurance. A final step in this direction would be to finance the base pension with general budget revenues.

4.42 The creation and development of the Social Fund, the most important single institution for the pension system, has also been a success. The Fund has continuously improved its use of technology in order to collect contributions, pay benefits, construct accounts following good international standards and provide information to participants.

4.43 The overall institutional impact rating is high. The objectives underlying the reform process must be considered to have made a critical contribution to the country's ability to use its human and financial resources effectively and to introduce market-oriented values. The objectives can be expected to have a high institutional development impact for decades to come.

## **Sustainability**

4.44 The most serious threat to the Kyrgyz reform was the attempt to declare the increase in the pension age unconstitutional. Since then, there appears to have been no other serious attempts to roll back the reform. All the major components of the reform have withstood the first five years after implementation. It is highly unlikely that the

structural changes introduced will be rolled back in the future, and many of the changes that remain to be implemented are of a nature that they are likely to be uncontroversial and for this reason will be regarded as improvements by the general public and major actors.

4.45 As has been noted in the discussion of the reform in the background to this report, system dependency had improved on its pre-reform values already by 2002. Calculations of the impact of the reform performed in conjunction with the late-1990s country assistance strategy indicated that there would be financial balance in 2003, which has occurred. By 2002 pensions cost about half what they cost in 1995 expressed as a percent of GDP. The continued increase in the pension age through 2006 will further improve the financial outcome, and as has been argued in this evaluation, it is likely that as the NDC scheme becomes a dominant part of newly granted pensions, the average benefit will decrease by even more, primarily due to the effects of poor contribution records for many informal and quasi-formal workers and the (likely) application of price indexation, while the contribution base is increasing at a real rate of growth of five percent. The other side of this is the development of pension adequacy.

4.46 Finally as the system matures and the NDC scheme is well established, it will provide long-term sustainability. Indeed with its present design, it is “over financed”. Calculations performed in the Bank’s pension policy update confirm this picture of financial sustainability. There are no independent calculations to check against the Bank calculations.

4.47 The large informal sector also presents a challenge. Many workers still take advantage of opportunities to evade making contribution payments. For this reason, there remains considerable work for the government and members of parliament to espouse the principles of the reform, and just as important to work on the improvements needed to make the system technically and socially resilient – in order to prevent a future backlash when earnings of workers will be considerably higher – and pensions are still low.

4.48 The institutional role provided by the Social Fund in the development of the administration has been strong, and there’s every reason to believe it will continue to develop even more and remain a strong bearer of the new culture in the future. This in itself speaks in favor of sustainability.

4.49 In sum, the general picture is that with the current legislation the system will become even cheaper with time, expressed as a percent of GDP, but at the expense of low benefits for a large segment of the population - mainly persons in “transition” from subsistence farming to the formal economy and women.

4.50 Overall sustainability is highly likely. Overall, the factors needed to create resilience are high. The remaining changes, with the exception of further increasing the pension age of women, should be readily acceptable. In fact, the most critical factors in the reform, the potentially low benefits of persons making the transition from farming to the formal economy and women, will not present an immediate threat to sustainability;

rather they will reveal themselves in a higher number of poor among the elderly in two to three decades, creating pressure on the social assistance budget.

## 5. Attribution of Results

### Bank Performance

5.1 Bank performance is evaluated in terms of quality at entry (project concept, technical aspects, poverty reduction and social aspects, institutional aspects, financial management aspects, readiness for implementation, and assessment of risk and supervision) and supervision (focus on development impact, adequacy of supervision of inputs and processes – here rated separately for pre and post 1999). These are presented separately below.

5.2 The quality at entry was overall unsatisfactory since the Bank's approach during identification was reactive, as has been discussed in the overview of the Bank's strategy. The Bank was active in promoting a flat rate within the framework of the Kyrgyz reform concept, and in aiding with determining the technical details and performing the financial analysis for the Kyrgyz NDC reform. The Bank's support added value to the process, and definitely led to technically better legislation. The impact on the results in the short term was substantial, since financial modeling was performed and the legislation was improved. Perhaps the most crucial short-run impact will be the positive impact on poverty of retaining a small flat-rate benefit, compared to the counterfactual of eliminating it altogether.

5.3 The technical design of the Kyrgyz reform leaves open many important long-term questions, and in this sense, the impact of the Bank has been only modest to date. Not enough effort has gone into getting all the technical aspects of the reform as right as possible. Perhaps there was too little time available at the point of entry, and from 1998 the ball stopped rolling for several years. The NDC scheme is incompletely formulated and the base pension will prove to be too small to alleviate poverty in old age among large groups in the (coming two to three) decades preceding the full transition from a rural subsistence to a formal economy.

5.4 An overall blueprint for how the flat rate, the transition benefit, the NDC scheme, future indexation, and the goals of phasing in a financial account scheme and even reducing contribution rates did – and still does not – exist. Since some of the choices that have to be made limit the scope of other choices, it's important to have a blueprint as legislation moves forward, even if the blueprint is revised along the way.

5.5 In addition, although the increase in the pension age of women was substantial, especially given strong public opposition, nevertheless the minimum pension age of women is still too low at 58. An NDC benefit, which is based on life expectancy at retirement will be too low for women retiring at age 58, and will generate poverty among older women in coming decades. The Bank acted to retain a minimum benefit for the lifetime poor, but the low pension age for women precluded providing a generous guarantee (flat-rate) benefit because it would have cost too much, given the other parameters of the reform.

5.6 The SOSAC supported and strengthened the legislative and administrative processes already begun. Stakeholders were involved in the project formulation and implementation, and Bank entrance helped to create more efficient legislation with respect to the immediate objectives of the reform project, even if more could have been done. The SOSAC loan itself was focused on developing administrative capacity. The impact of the loan on the development of the administration was only modest, however, although the Social Fund continued afterwards to develop the administration of benefits and contributions, more-or less in the absence of support from the international agencies.

5.7 Monitoring of individual outcomes was made possible through the yearly surveys on poverty and its composition, supported by the Bank. Transparent monitoring of financial outcomes was made possible through the introduction of international accounting and auditing standards at the Social Fund, spearheaded by the SOSAC. However, the overall project was not followed up after 1998. This was necessary in order to provide an environment for further improvements in existing legislation and for working on the pre-conditions necessary to introduce individual financial accounts at some point in the future.

5.8 Counterpart resources were strong in the areas of monitoring of individual outcomes and administration, but weaker in terms of policy analysis and the technical modeling capacity needed to continue with the reform work. Both the government and the Bank should have invested more in helping to build up and sustain this capacity.

5.9 The weakness in the development of the government's capacity to follow up the 1997-98 legislation meant that the process more-or-less stagnated from 1998. This risk was not recognized and, hence, there was no blueprint for managing it in the SOSAC. In this sense the SOSAC fell short of being an ideal support project. Nor was there a follow up devoted towards moving forward again until 2002-2003. At the time of this evaluation, there was still no program to build the necessary analytical capacity.

5.10 Supervision was modest to substantial in 1996-1998, but thereafter modest. When rated for the entire period, the Bank's performance was unsatisfactory. Bank involvement was high during the 1997-98 phase of the reform process, but dwindled thereafter. There is no evidence that milestones were set after 1998. The logical follow-up to the 1997-98 reform would have been to work with an appropriate indexation strategy and improvements in the base pension and the NDC benefit, coupled to consideration of the trade-offs between lowering the contribution rate and/or introducing a mandatory financial account scheme. The latter would have required stronger financial infrastructural evolution than that achieved during 1998-2003. In sum, it appears that the Bank dropped the ball for a lengthy period, and the government did not pick it up and move forward to a significant extent. The focus on development impact and monitoring was too weak after 1998.

5.11 *The overall quality of the Bank's performance was unsatisfactory.*

## **Borrower Performance**

5.12 Borrower performance is rated according to performance in project preparation and implementation, and Borrower compliance with the loan commitments. These are considered separately.

5.13 **Preparation.** The reform process through 1998 was much more ambitious and far-reaching than in most FSU countries. Much of the reform had been formulated prior to the explicit involvement of the Bank through the SOSAC. The Bank worked together with the client in preparing the financial calculations, although as it turned out there was little ownership of the tools of analysis (the PROST model), which put a damper on further progress in coming years. Performance in the preparation stage through 1997 must be judged as being **highly satisfactory**, as both the government and the implementing agency, the Social Fund, were the owners of a process that accomplished a significant first step in reform.

5.14 **Implementation.** Implementation is rated according to government performance and implementing agency performance.

5.15 The government made and implemented many tough decisions in the 1997-98 reform legislation. The most difficult decision taken was the legislated increase in the minimum pension age, which resulted in heated public debate and a court challenge of constitutionality.

5.16 During the majority of the period 1998-2002 the responsibility for the formulation of policy had been delegated to the Social Fund. Since the policy decisions needed in the pension area involve other areas beyond the responsibility of the Social Fund, this had disadvantageous repercussions. In the Kyrgyz Republic the Social Fund was accountable to the government until 2000. In 2000 the Social Fund itself initiated the Presidential decree, according to which it no longer is under the government. This causes problems, because in many cases the Social Fund does not coordinate its activities with relevant government bodies. Later on the government issued a decree moving pension policy to the MLSP, but there is still too little coordination between the MLSP and the Social Fund.

5.17 Three problems resulted from this way of pursuing policy:

- The first problem was that during years when contributions were insufficient to finance pensions, money from overall contributions including those earmarked for health and employment measures were used to pay pensions. As a result, the MHIF was not getting planned revenues for years. Since the MHIF is a main reform agent in the health sector, this procedure discredited overall health reforms. Transfers to the Unemployment Fund were also insufficient, which meant pensions were paid at the expense of unemployment benefits and implementation of active labour policy measures.
- The second problem is that the long term goal of the pension reform is to introduce mandatory financial accounts and/or private insurance needs to be

coordinated with the development of the financial infrastructure. This is outside the domain of the Social Fund.

- The third problem is that there are competing future policy goals that require difficult political decisions, with repercussions that affect both the overall economy and the distribution of the country's income among competing ends, and different generations of workers and pensioners. In the present context, these are the goals of indexation of pensions, the introduction of a mandated financial account scheme and reducing the contribution rate. These are decisions that need to be made at the government level, although an agency such as the Social Fund can provide valuable input into the process.

5.18 Because the government had delegated policy making to the Social Fund after 1998, it did not engage and develop its own staff in these policy issues to the extent necessary to drive the reform work forward.

5.19 The overall rating for the government is more than satisfactory if one bases the evaluation on the process through 1998, but the rating falls because the period from 1998 does not appear to have moved the process significantly forward – given the government's own objectives. Instead, the impetus gained through 1998 was lost and the reform process stagnated. **The government's performance was satisfactory**, on the basis of performance through 1998, but unsatisfactory thereafter.

5.20 The Social Fund has worked throughout on improving the collection of contributions, payment of benefits, the provision of information to participants and the implementation of international accounting standards. By mid-2003 administrative performance appears to be high at a low overall personnel cost, and in-house IT support has been developed, also at a relatively low cost. To a certain extent, the Social Fund filled the policy gap left by the government, but it did not fill the analytical gap by maintaining and developing the technical and analytical capacity needed to evaluate long-term policy alternatives. It is nevertheless the government that needs this tool to formulate and monitor the financial outcome of its policy, although the Social Fund could have been requested to develop this capacity to assist the government. **The Social Fund's performance is thus rated as highly satisfactory** based on its ongoing efforts to improve the administration of benefits and contributions.

5.21 Taking the Social Fund and the Government as a whole, **the overall performance of all official bodies of government was satisfactory with regard to implementation**, despite unsatisfactory performance by the Government during the second part of the period.

5.22 **Compliance.** The government complied with many but not all of the conditions of the SOSAC. An important condition not fulfilled was the institutionalization of analytical capacity for continued policy formulation and evaluation, and the indexation mechanism used in practice is based on *ad hoc* decisions. On the other hand, the government implemented the tough decision to increase the minimum pension age and reduce special privileges, both against popular opinion, both of which have proved to be major

stumbling blocks in transition countries. **The overall performance on compliance is, thus, satisfactory.**

5.23 **The summary rating for overall Borrower performance is satisfactory**, based on the strong performance through 1998, and the development of administrative capacity throughout the entire period. Weaker government performance after 1998 prevents the overall Borrower rating from being higher. Much more could have been done to move the reform process even farther after 1998.

## 6. Lessons and Recommendations

6.1 The 1997-98 legislation was an important first step in bringing the Kyrgyz pension system into financial balance. However, the government and the Bank dropped the reform-initiative ball for several years from 1998. In the late summer of 2003, when this evaluation was performed, the Bank and the government had reinitiated a dialogue on the introduction of a mandatory financial account scheme. However, this proposal was not being presented or discussed within the context of an overall strategy for the future.

6.2 **Role of Donors.** The initiative for developing NDC for the Kyrgyz Republic arose indigenously, with an initiative of the Social Fund. The country assistance strategy of the early 1990s mentions the presence of an EU/TACIS administrative project at the Social Fund, and initial discussions on the formulation of reform received support from this project. When the Bank entered the picture, in the preparation of the SOSAC, much ground had already been covered. However, the Bank was instrumental in providing advice that corrected some major flaws in the original formulation of the scheme. In addition, according to Bank sources, the original Kyrgyz reform had no guarantee level at all, and the Bank was instrumental in strongly recommending the retention of at least a small flat-rate benefit.

6.3 The IMF produced its own analysis of the Kyrgyz pension system in early 1998<sup>28</sup> with an inexplicable absence of references to either the developing Kyrgyz legislation, or the role of the Bank. The problem according to this report is not the level of benefits per se, since pensioners were extremely poor, but the large number of beneficiaries, specifically men and women with special privileges and women under 60. The IMF's main policy recommendation in this report was to increase the retirement age, and then to lower the contribution rate once financial balance in the Social Fund had been achieved.

6.4 Other international organizations, for example the ILO and ADB, were not important players in the area of pensions during this period. The ADB, however, has had a considerable presence in the areas of financial intermediation, corporate governance and enterprise reform, which all have bearing for the development of the financial sector and the prerequisites for financial account pension schemes.

6.5 **The Success of the Reform.** The 1997-98 reform was successful in taking a first step in raising the pension age, dealing with special rights and introducing the concept of contribution-linked pensions. However, many of the overall design issues still remain open because the reform was not steered by a more comprehensive blueprint for the future. Let us revisit the issues, placing them into the framework of a more comprehensive spate of options for the future.

### *The construction, size and financing of a guarantee*

6.6 The minimum benefit has fallen to 12 percent of an average wage, in accordance with the design of the reform legislation. In the future, the compensation provided by the

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<sup>28</sup> IMF Staff Country Report. 1998/8.

transition benefit will become increasingly lower, while the earnings-related NDC benefit will be insufficient for the large percentage of the rural population that have been and will continue for some time to pay small or no contributions. Poverty among the elderly in the rural areas is likely to increase due to this. At the same time, the contribution-related benefits of younger workers migrating from the countryside may be small if informality remains high.

6.7 The first lesson is that too little thought and analysis was devoted to determining the level and means of financing the guarantee, and to determining its place in the overall strategy for the future, given the fact that around half of the country's labour force is employed in subsistence the farming. A recommendation is to pursue and analyze the idea of financing the guarantee (or flat-rate base benefit) using the broader tax base (and tax instruments) of the Republican budget, as was proposed by the Social Fund in the dialogue initiated in 2003.

*The minimum pension age and the pension age of women*

6.8 The minimum pension age is important in determining when the guarantee should be paid out. Generally speaking, a high minimum age makes it easier to finance an adequate minimum benefit. For this reason alone, the pension age of women, even after the legislated increase, is still too low at 58. In a system where benefits are contribution-linked and based on life expectancy at retirement, a low pension age is likely to create long-term poverty when women no longer share household income with a spouse.

6.9 The lesson here is that a more dramatic increase in the pension age of women, for example to age 63, as it will become for men, would have been the best policy to adopt from the outset, since it still remains on the list of things that should be done. The gains of increasing the pension age are twofold: First, the contribution-related benefit will be higher, even given the same lifetime income, because of a better life expectancy factor. Second, it is possible to provide a higher guarantee amount per person, at a more affordable cost to the government.

*The structure of the NDC scheme*

6.10 The design of the NDC scheme could have been closer to the "generic" model from the outset. Some technical improvements remain, which means the legislation should be revised. What remains is:

- a) to determine a desirable long-term scale (contribution rate), given 100 percent indexation of notional capital instead of 75 percent,
- b) to determine a desirable long-term strategy for indexation of NDC benefits when they have become more prominent,
- c) to consider budget financed non-contributory rights (for notional capital, but even financial capital accounts if and when they eventually are introduced), with child-care time being the most likely candidate, and
- d) to establish a reserve fund for the NDC scheme.

6.11 It is important to point out that “generic” NDC can afford indexation of both notional capital and benefits linked to the development of the contribution wage base, given an adequate methodology for computing life expectancy and the establishment of a reserve fund (mainly for demographic reasons). The financial requirement for the system is that the present value of assets, including a reserve fund, always be greater than the present value of liabilities.<sup>29</sup>

#### *Indexation of benefits*

6.12 A long-term strategy for indexation that is affordable is a part of the missing blueprint. Presently, benefit payments are dominated by benefits granted prior to the reform and transition benefits. An overall strategy for future indexation should be analyzed, given the other components of the blueprint, and legislated. At the very least, the present ambition of price indexation should be fixed in law, to avoid the temptation to use *ad hoc* indexation as a vote gathering political instrument.

#### *Financial individual account scheme(s)*

6.13 With or without a mandatory financial account scheme, it is important to stabilize the institutional pre-conditions for a transparent financial sector, with adequate governance and supervision. Considerable technical assistance has been devoted to this effort by both the ADB and the World Bank. Since the focus of this evaluation has not been on assessing the accomplishments of this assistance it would not be appropriate to attempt to discuss lessons.

6.14 The clear recommendation is that once the institutional environment is judged to be satisfactory, a long-term financial saving scheme (or schemes) for retirement purposes can be implemented. Looking around the world, there are many models from which to choose, all of which have pros and cons that are becoming increasingly well illuminated. The fact that the Kyrgyz Republic is coming into this arena later than some of the other transition countries could, in fact, prove to be an advantage, since it will be possible to assess and learn from the experiences of others.

#### *The overall blueprint*

6.15 The challenge remaining is to put the pieces together to form the *whole* strategy. Hindsight says that more effort should have been put into the overall blueprint in formulating the original legislation of 1997-98. Experience from many countries tells us that it is always difficult to reopen legislation. Lobby groups will put pressure on politicians to (re)gain special privileges. The risk is that some of the old battles will have to be re-fought. On the other hand, given the point of departure, the Kyrgyz Republic is

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<sup>29</sup> Transition questions, and with references to what countries have done, are discussed in Edward Palmer, “Conversion to NDC – Issues and Models”. Paper presented at the World Bank and RFV Conference on Notional Defined Contribution Pensions, 28-30 September 2003, Sandhamn, Sweden.  
<http://www.rfv.se/konferens/index.htm>.

in an ideal position to learn from the experience an assessment of its own previous record and from the experience of others.

### *Analytical capacity*

6.16 The in-house capacity to perform long-term technical analysis gradually fell by the wayside after 1998. In fact, the Bank analysis performed for the pension policy update in late 2002 provides an illustration of this, rather than a remedy, since the calculations were performed by the Bank, not the country experts, and they appear to have been performed in the absence of an articulated government strategy.

6.17 The lesson is that support in developing and maintaining technical modelling capacity must be built up gradually over several years, and that the government must decide whether the home for this capacity should be maintained at the ministerial level or within the administration. Neither the Bank nor the government commitment was sufficient in this respect.

6.18 ***Other Issues.*** An observation from the evaluation is that it could be useful to consider the development of a postal banking network to handle Social Fund payments, since this system offers ready outlets covering most of the country.<sup>30</sup>

### *Overall lessons and recommendations*

- 1) The interrelated and sometimes conflicting aims of pension reform require an overall blueprint, which constructed well in the beginning will set out the steps needed to achieve the goals. Without this it is more difficult to move coherently towards fulfilling the goals.
- 2) Pension reform takes time. Both the Bank and the government dropped the ball instead of diligently moving forward, following a blueprint. The 1997-98 work should have been followed up by next steps.
- 3) Developing the technical and analytical capacity to support both the reform process and the monitoring of outcomes after the reform is difficult. The small investment made in this capacity was too small to have a lasting effect. The investment in training must be large and sustained until the recipients have the capacity to move forward themselves.
- 4) As is frequently the case, much of the capacity to work with further development of the reform was at the Social Fund. An appropriate Bank strategy would have been to help develop this agency's capacity to assist the government in formulating policy, not the least through developing and maintaining relevant technical capacity and a technical model for analyzing and monitoring the medium and long-term outcome of policy.

6.19 ***The Counterfactual.*** What course would events have taken without the Bank's technical assistance in the process of formulating legislation? The mid-1990s country

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<sup>30</sup> This was suggested by one of the government officials in the course of this evaluation.

assistance strategy was extremely docile on pension issues. Nevertheless, the ideas of raising the pension age, dealing with special rights and introducing NDC proposal were already on the drawing board when the Bank re-entered the picture a year later. What the Bank's presence added to the process was the provision of financial modelling and expert assistance in formulating the details of the reform. The NDC legislation, with the adjustments specified in the SOSAC conditions, was a considerable improvement upon the proposal without these adjustments. In addition, the Bank's entrance in the discussions was instrumental in maintaining a minimum flat rate. Finally, the Bank provided technical assistance in financial modelling. This would not have otherwise been done with such a high level of quality.





**Annex Table 1: Kyrgyz Republic. Statistical Overview**

	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>
% GDP	9.2%	6.8%	6.5%	7.1%	5.1%	4.5%	4.7%	4.6%
29. Ratio of an average pension to an average wage	53.33	50.3	45.14	44.93	36.67	37.75	38.42	37.28

\*Estimated values for 1995-1996.

*Sources.* Kyrgyz Social Fund; Kyrgyz Republic: Selected Issues and Statistical Appendix, IMF, 2003; Comprehensive Development Framework of the Kyrgyz Republic to 2010, National Poverty Reduction Strategy: 2003-2005, IMF, 2003.

**Annex Table 2: Activities and Sources of Finance for the 1998 SOSAC**

<i>Activity</i>	<i>Preliminary Budget</i>	<i>Funding Source</i>
[Social fund IAS conversion (completed)]	(88 000 USD)	(FINSAC TA 2891-KG)
1. Social fund accounting preparation	72 000 USD	FINSAC TA 2891-KG
2. Social fund accounting	947 250 USD	SOSAC or appropriate donor
3. Social Fund audit	97 450 USD	ditto
4. Social Fund financial management	130 000 USD	ditto
5. Social Fund/Tax Inspectorate coordination	120 000 USD	ditto
6. Disability Certification	58 800 USD	ditto
7. Means testing assessment	157 800 USD	ditto
8. Active labour market assessment	85 200 USD	ditto
Total, financing to be identified	1 476 500 USD	(excluding IAS conversion)
Total, financing under FINSAC	192 200 USD	(excluding IAS conversion)
<b>TOTAL FINANCING</b>	<b>1 668 500 USD</b>	(excluding IAS conversion)

**Annex B: IEG Project Mission to the Kyrgyz Republic, July 7-10, 2003:  
List of Persons Interviewed**

Ms. Ainura Ibraimova	Deputy Minister of Health, General Director of the Health Insurance Fund
Ms. Roza Aknazarova	Minister of Labor and Social Protection
Ms. Marina Japarkulova	Lead Specialist of the Social and Pension Policy Department, Ministry of Labor and Social Protection
Mr. Chris Lovelace	World Bank Country Manager
Ms. Dinara Djoldosheva	World Bank Country Officer
Ms. Philip Goldman	World Bank
Mr. Tynybek Ormonbekov	Head, Social Protection Department, President's Administration
Mr. Asanbek Sarybaev	Head of the Social and Cultural Development Department, Prime Minister's Office
Ms. Cholpon Kalmurzaeva	Head of the Sector on Social Protection and Health, Social and Cultural Development Department, Prime Minister's Office
Mr. Achmatbek Keldibekov	Chairman of the Social Fund
Ms. Galina Voronina	Deputy Director, Employment Fund
Ms. Ainura Kypchakbaeva	Cluster Task Manager, UNDP Social Governance Programme
Mr. Kurmanbek Osmonov	First Vice Prime Minister, Minister of Justice
Mr. Emirlan Toromyrzaev	First Deputy Minister of Finance
Ms. Roza Uchkempirova	Director, Socium Consult
Ms. Sagyn Esenalieva	Socium Consult
Dr. Raymond Mogilevsky	
Dr. Marianna Abrahaminov	

Series of meetings at the Social Fund coordinated by Mr. Khalil Razaev

Meeting with NGOs

Meeting with journalists