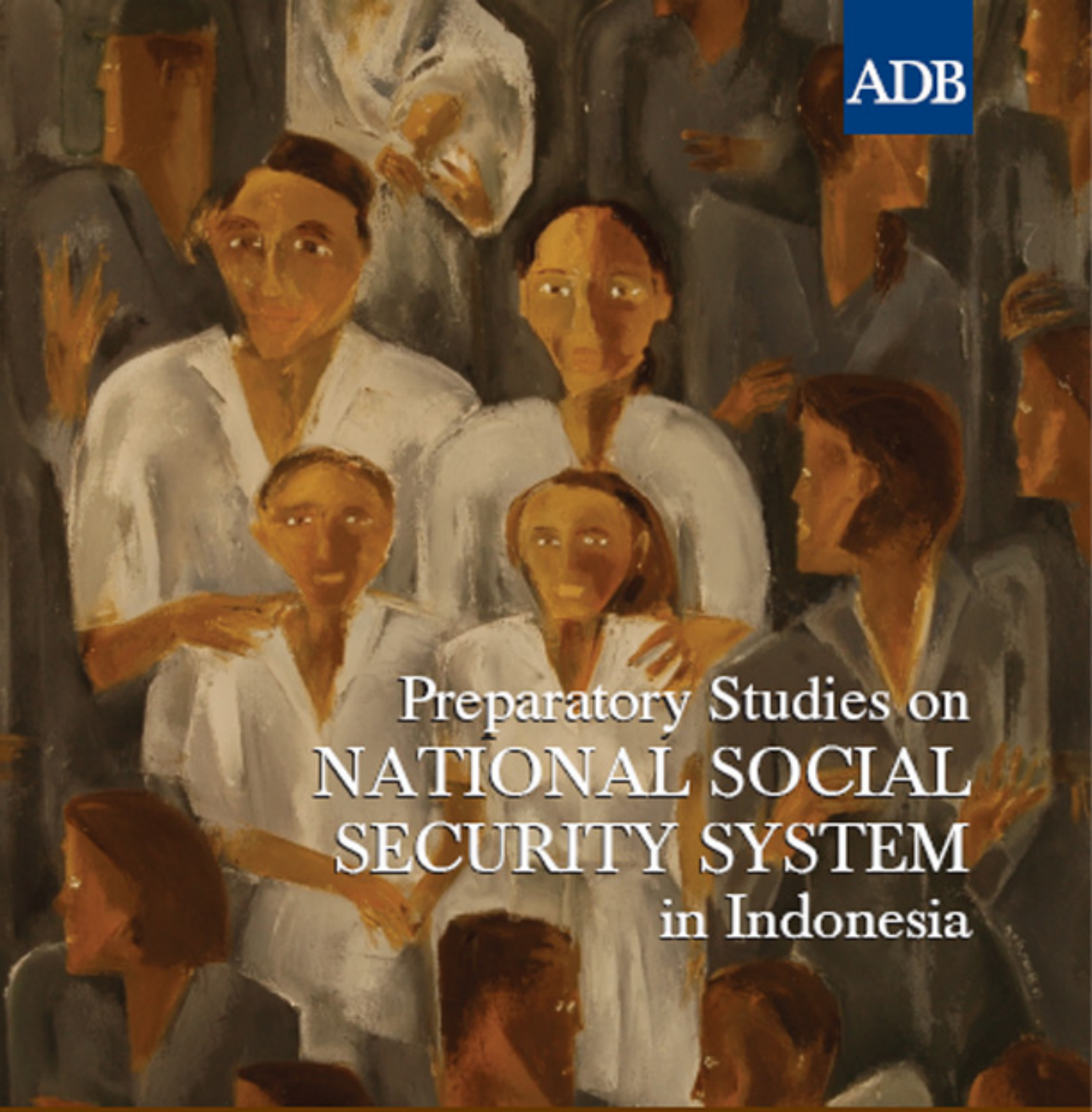

ADB

Preparatory Studies on NATIONAL SOCIAL SECURITY SYSTEM in Indonesia

Asian Development Bank

ADB

Financial Governance and Social Security Reform

Preparatory Studies on NATIONAL SOCIAL SECURITY SYSTEM in Indonesia

Asian Development Bank

The studies are prepared under TA 4024-INO: Financial Governance and Social Security Reform. The aim of the technical assistance (TA) is to support the implementation of key financial reforms, including insurance sector restructuring and the development of a national social security system. The TA is part of a broader loan program: Financial Governance and Social Security Reform Program, approved on 10 December 2002, aimed to support a broad framework for the overall strengthening of the financial sector and the social security system in order to facilitate broad-based economic growth, while reducing the vulnerability to crises.

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Cover Painting "Di Jalan Yang Benar" ("On The Right Path") by Firman Ichsan

Foreword

Most human beings place a very high value on security of income and work: we all seek the comfort of recourse to some form of support if calamitous events occur, such as work injury, ill health, or poverty in old age. It is important to reflect these human priorities in national policy objectives. In Indonesia, these issues have been debated for several decades, going back to the 1960s when the various national development plans laid out a vision of sharing the gains from rapid economic growth with the wider population. The ideas have taken root and were enshrined in an amendment to the Constitution in 2002. But the institutions for social security remain rudimentary, if not at a crossroad.

In terms of ideas, or rather ideals, Indonesia's National Social Security System Law of 2004 represents a social aspiration—namely, to provide all Indonesians with coverage under a comprehensive system of insurance and assistance spanning pensions, work injury, health insurance, old-age savings, and death benefit. The challenge is to transform this aspiration into a framework that judiciously and fairly embodies the principles of assistance for the needy and insurance for those who are able to pay. To be sustainable, the system, as a whole, must be cost effective, with the collected contributions sufficient to pay promised benefits. The precise combination of insurance and assistance will reflect, of course, the social values and goals of nation and society.

As the studies in this report detail, the existing social-security-related programs are costly and provide only limited protection to those covered. There are also issues related to their governance and management. Together, these features pose formidable challenges to the successful implementation of the National Social Security System Law. Relatively low-income levels and labor productivity constrain contribution rates and argue for redistributive policies. Yet such policies would place possibly intolerable pressures on the budget while preventing the emergence of a sustainable social security system. The administrative capacity for managing an integrated system needs to be built as does a public accountability mechanism that will ensure transparency in the management of the system.

These remain difficult issues. From this perspective, this report seeks to illuminate the nature of the challenges in terms of the expected fiscal costs of alternative arrangements assuming a variety of macroeconomic, indexing, and demographic scenarios. The report also suggests how existing schemes could be integrated under the National Social Security System Law. The goal is not to offer settled answers to all the issues, but rather to support the informed debate needed to establish a key national institution—one that has profound implications for intergenerational equity and fiscal balance.

The Asian Development Bank (ADB) has supported social security reform in Indonesia though technical assistance and adjustment loans since 1999. In continuation of this support, the studies in this report were prepared by the Southeast Asia Department of ADB under the supervision of Jaseem Ahmed, Director, Governance, Finance and Trade Division (SEGF). The Task Leader was Michiel Van der Auwera, Social Security Specialist (SEGF), who is also a co-author of some of the studies. The bulk of the analysis, and all of the fiscal and actuarial work, was carried out by Mitchell Wiener, Consultant. A major role was also played by the Indonesia Resident Mission of ADB, especially by Ramesh Subramaniam, who supported the SEGF team through his extensive knowledge of Indonesia and this sector. Sukanya Wignaraja edited the report in its entirety. I am grateful for the secretarial assistance provided by Jenelyn Mendez.

The preparation of this report involved discussions with many Indonesians. We owe a special thanks to Bapak Henry Toruan, Assistant to the Deputy Minister, Coordinating Ministry of Economic Affairs, who engaged actively in the analysis. We would also like to thank the Ministry of Finance and, in particular, Bapak Rakhmat, Director, Budget Systems, Directorate General Budget, Ministry of Finance, who provided the counterpart to the ADB team.

Finally, I would like to express my appreciation to the notable Indonesian artist, Firman Ichsan, who composed the front cover of this report.

Arjun Thapan
Director General
Southeast Asia Department

Executive Summary

Introduction

The Government of Indonesia faces a challenging period in reforming its national social security system. Currently, social security is provided through a series of programs that have developed separately from each other. The Asian financial crisis that hit the region in 1997 revealed the weaknesses of the existing system, leaving a large part of the population unprotected and providing only limited protection to those who were covered.

In response to the crisis, legislative reforms have been introduced to be better prepared in the future. In 2002, the Government of Indonesia amended the Constitution regarding the extension of social security to the entire population. The 1945 Constitution (Second Amendment) Article 28H, Subsection 3, states: "Every person shall have the right to social security in order to develop oneself as a dignified human being", and Article 34, Subsection 2, states: "The state shall develop a social security system for all the people and shall empower the vulnerable and poor people in accordance with human dignity".

On 19 October 2004, Indonesia enacted the National Social Security System Law (*Sistem Jaminan Sosial Nasional*/ SJSN law). This law will create a social security system covering all Indonesian workers and their dependents in both the formal and informal economy. Implementation of this law will be a major challenge. These programs will affect all Indonesians, involve multiple government ministries and institutions, create new permanent fiscal obligations for the State budget, and require the strengthening of existing institutions and IT systems.

Until the system proposed under the SJSN law is implemented, it is fair to say that Indonesia does not have a real social security system, although a number of workers are covered by health and old-age programs. The coverage, however, is very limited and, most of the time, the schemes do not deliver a sufficient level of income protection or quality of services.

Current social security system in Indonesia

The provision of social security is a shared responsibility between the State, employers, individuals, and families. In Indonesia, as in most other Asian countries, there is a strong reliance on the extended family and the community to provide support in case of illness, loss of income, or other unforeseen events. About two thirds of the population work in the informal sector and rely almost entirely on these informal mechanisms.

For the private sector, there is a strong reliance on employer's liability provisions and, to a lesser extent, on social insurance programs organized on a public and/or private basis. Private sector employers pay between 21% and 27% of the total cost of employees on social security programs, severance pay, and private health insurance. In exchange, private sector workers receive limited protection, especially in old age. This is because the lump sum payments that are provided by the severance pay and the old-age savings benefit are consumed early on and do not provide any form of financial security in retirement.

The public sector can fall back on an integrated package of benefits. While the level of protection provided under the public sector pension scheme is high, the concerns are of a different nature. The government allocates close to 5% of the central government budget to finance social security programs for the civil servants, a share that is increasing every year. One of the main concerns is the unfunded pension liability that was already accrued and is growing every year. On 1 January 2000, the unfunded liability of the public servants' pensions program was estimated at Indonesian rupiah (Rp)342 trillion.

The social health insurance programs for both civil servants and private sector workers are perceived as providing poor-quality services, resulting in members paying out-of-pocket for health services outside the system. In the case of private sector workers, many opt out and purchase private health insurance. Askeskin, the health

insurance program for the poor and near-poor, does make a difference for the target group, but still has considerable problems with targeting and with the quality of service delivery. In addition, it is underfunded on per capita basis.

Overall, social security coverage is rather limited. Only about 12% of the total workforce is entitled to pension and/or old-age benefits, while about 40% of the population is currently entitled to health insurance, covering formal sector workers under compulsory health programs and poor informal sector workers under the Askeskin program.

The social security institutions managing these programs face problems in almost all operational areas, including poor compliance; expensive and ineffective administration; poor governance structure lacking transparency, accountability, and focus on members' interests; complex and ineffective supervisory structure; and poor member service.

The SJSN Law

The SJSN law is a framework law. It outlines the basic structure of the reformed social security system, but does not specify details. Major strategic policy options, amounts of benefits, and contribution rates still need to be determined by regulations. The SJSN law provides for coverage of the entire Indonesian population with five separate programs: (i) pensions, (ii) old-age savings, (iii) health insurance, (iv) employment injury, and (v) death benefit. All these programs are to be administered by the four existing social security institutions. In addition, the law provides for the creation of a SJSN Council as the policy-making body responsible for running the SJSN system. There is a different contribution structure for formal and informal sector workers, with the government paying for the poor.

The ADB project prepared an initial fiscal analysis based on reasonable assumptions to illustrate the order of magnitude of program costs. In the case of pensions, the assumptions are that the pensioner would be entitled to a flat-rate pension equivalent to Rp200,000 per month in 2007, from age 60 onwards, with wage indexing following the retirement. In case of old-age savings, the contribution is set at 5.7% of income. The health program follows the benefit package for civil servants.

The total cost of these three programs is projected to grow from 2.88% of gross domestic product (GDP) in 2010 to 11.02% of GDP in 2070. The primary factors affecting the increase in costs as percentage of GDP are (i) the 15 years qualifying period for pensions, meaning that pensions will only be paid from 2022 onwards; (ii) the gradual phasing in of the health care costs; and (iii) the population aging that will affect both the number of pensioners and the cost of health care. The government contribution for the poor and the financially disabled is projected to grow from 0.53% in 2010 to 3% in 2070.

SJSN Implementation Issues

The SJSN law describes a new concept for social security in Indonesia. For fiscal and administrative reasons, it will take a considerable period of time to fully introduce the new social security structure. Coverage must be gradually expanded in a way that is fiscally affordable. In addition the legal structure, administrative systems, health care infrastructure, and institutions necessary to manage the SJSN system are not yet in place. Indonesia also needs to change the legal structure of the existing social insurance administrators and improve overall governance to protect the interests of fund members.

The improvement of the existing system and the gradual implementation of SJSN is a long-term process, covering different phases. The first phase, taking place during the initial years of reform, includes the policy debate and the preparation of the system design. During the second phase, taking place over the medium term, the focus is on institutional development, capacity building, and construction of new administrative systems. In the long run, SJSN coverage can be gradually extended to the entire population. Based on worldwide experiences, this phase lasts the longest and can take up to 25 years for full implementation.

The first step in any social security reform is to fix the current system before making other changes. The four existing social security institutions—PT Jamsostek, PT Taspen, PT Asabri, and PT Askes—are the foundation of the current system and retain a critical role under SJSN. If these institutions are weak, the current system will continue to function poorly and the new system will not function well either. The legal structure of the four administrators has to be changed from *perseros* (for-profit entities responsible to their shareholders [the government]) into trust funds (not-for-profit entities managing the funds in the best interest of the participants). The overall governance structure of the administrators needs to be improved, including a more effective regulatory and supervisory structure.

In order to introduce the new SJSN, the SJSN Council will have to be created, and the role of the existing social security institutions in the new setting will have to be determined. The law does not provide the required details needed to evaluate the fiscal costs of any of the proposed programs. The benefit programs and contribution levels

will have to be determined based on fiscal projections. In addition, other strategic policy options will have to be specified. As the last step in the process, the regulations and decrees will have to be drafted, reflecting the decisions reached during the preparatory design period. All reform will need to be clearly communicated to the different groups involved, so that the benefits and administrative structure of the new system are fully understood and appreciated.

The project prepared an SJSN implementation road map as a guideline for the Government of Indonesia to sequence the actions to reform the existing social security system and to gradually introduce SJSN. The road map requires discussions with the government in order that it can be further refined and adjusted to the institutional and political reality.

Conclusion

SJSN is a progressive law providing the entire Indonesian population with social protection through social security funds. It is a complex undertaking that will have a significant impact on every Indonesian. It will also affect a wide range of government ministries and institutions and will create significant coordination challenges. It is essential to involve all stakeholders and build maximum possible consensus on how to move forward.

Experience from other countries shows that one of the keys to successful social security reform is political support from the highest levels and the presence of a reform champion to lead and sustain the effort on a daily basis. In Indonesia, the key first steps for successful SJSN design and implementation include

- creation of the SJSN Council,
- appointment of a coordinator in the Ministry of Finance and other key ministries, and
- identification of a champion to lead reform on a daily basis.

We look forward to assisting the government with the design of SJSN that will truly meet the needs of all Indonesians at an acceptable cost and developing a road map for staged implementation of the reformed system.

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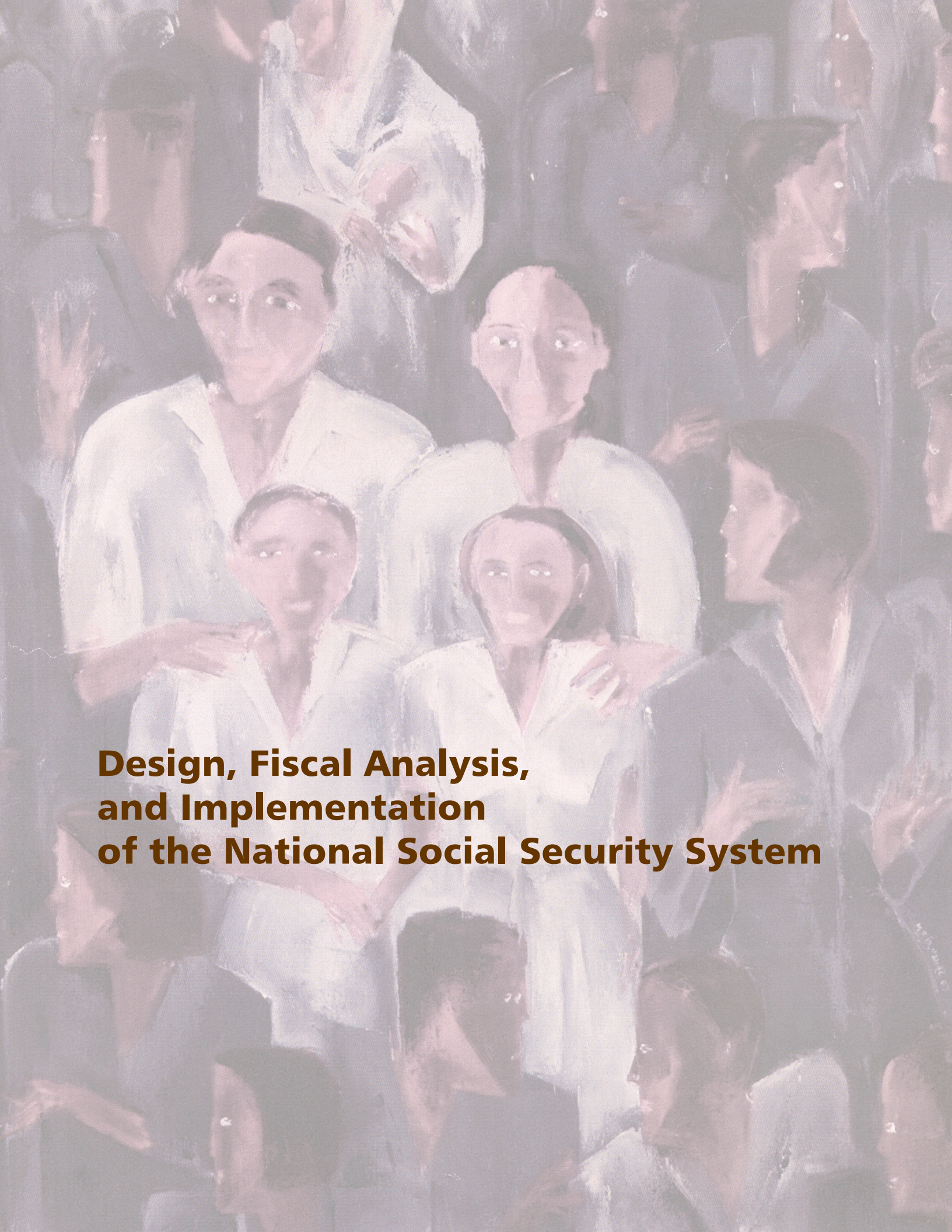
Abbreviations

ADB	–	Asian Development Bank
APBN	–	State Budget (Anggaran Pendapatan Belanja Negara)
Asabri	–	Pension Scheme for the Armed Forces (Asuransi Angkatan Bersenjata Republik Indonesia)
Askes	–	Indonesia Health Insurance (Asuransi Kesehatan Indonesia)
Askeskin	–	Health Care Scheme for the Poor (Asuransi Kesehatan untuk Keluarga Miskin)
Bapepam LK	–	Capital Market Supervisory Agency and Financial Institutions
BI	–	Central bank (Bank Indonesia)
BLU	–	non-profit organization (Bayan Layanaan Umum)
BPJS	–	Social Security Administrative Body (Badan Penyelenggara Jaminan Sosial)
CMPM	–	Cost per member per month
CPF	–	Central Provident Fund
CPP	–	Canada Pension Plan
CPPIB	–	Canada Pension Plan Investment Board
DJSN	–	National Social Security Council (Dewan Jaminan Sosial Nasional)
DPLK	–	Financial Institution Pension Fund (Dana Pensiun Lembaga Keuangan)
DPPK	–	Occupational Employer Pension Fund (Dana Pensiun Pencari Kerja)
EPF	–	Employee Provident Fund
EPS	–	Employee Pension Scheme
GMOP	–	General Meeting of Participants
GPF	–	Government Pension Fund
HMO	–	Health Maintenance Organization
ILO	–	International Labour Organization
Jamsostek	–	Private Sector Social Security System (Jaminam Sosial Tenaga Kerja)
JHT	–	Jamsostek Old-Age Program (Jaminan Hari Tua)
JKK	–	Jamsostek Employment Injury Program (Jaminan Kecelakaan Kerja)
JKM	–	Jamsostek Death Grant Program (Jaminan Kematian)
JPK	–	Basic health care package (Jaminan Pemeliharaan Kesehatan)
JPKM	–	Community Health Maintenance Protection (Jaminan Pemeliharaan Kesehata Masyarakat)
JPS	–	Social Safety Net Program (Jaringan Pengaman Sosial)
MOF	–	Ministry of Finance
MOH	–	Ministry of Health

MOM	–	Ministry of Manpower
MPFA	–	Mandatory provident fund authority
MSA	–	Ministry of State Apparatus
MSOE	–	Ministry of State-Owned Enterprises
NBFI	–	Non-bank financial institutions
NPS	–	New Pension Scheme
OAP	–	Old-age pension
OJK	–	Financial Services Authority (Otoritas Jasa Keuangan)
Persero (PT)	–	State-owned limited liability company (Perseoan Terbatas)
PKPS-BBM	–	Compensation for Fuel Subsidy Reduction Programs (Program Kompensasi Pengurangan Subsidi Bahan Bakar)
PMPM	–	Premium per member per month
PPI	–	Investment management guidelines (Pedoman Pelaksanaan Investasi)
ROI	–	Rate of return
SJSN	–	National Social Security System (Sistem Jaminan Sosial Nasional)
SSO	–	Social Security Office
Taspen	–	Pension Scheme for Civil Servants (Tabungan dan Asuransi Pegwai Negeri)
THT	–	Taspen Old-Age Savings Program (Tabungan Hari Tua)
TSP	–	Thrift Savings Plan



Design, Fiscal Analysis, and Implementation of the National Social Security System

March 2007

Prepared by Mitchell Wiener, Social Security Policy Expert, under the supervision of Jaseem Ahmed, Director, Governance, Finance and Trade Division, Southeast Asia Department, Asian Development Bank

I. Introduction

On 19 October 2004, Indonesia enacted the National Social Security Law (*Sistem Jaminan Sosial* Nasional/SJSN law). This law will create a social insurance system covering all Indonesian workers and their dependents in both the formal and informal economy. Implementation of this law will be one of the biggest challenges ever undertaken by the Government of Indonesia. These programs will affect all Indonesians, involve multiple government ministries and institutions, create new permanent fiscal obligations for the State budget, and require the strengthening of existing institutions and IT systems.

SJSN implementation will not take place in a vacuum. Indonesia's economic growth and politics will have a significant impact on the successful implementation of the SJSN law. Without economic growth, Indonesia will not have the necessary resources to pay for the cost of the planned social insurance programs. Without sustained support from all political parties, it will be difficult to maintain the required level of effort over many years to fully implement SJSN.

Experience from other countries shows that one of the keys to successful social insurance reform is political support from the highest levels and the presence of a reform champion to lead and sustain the effort on a daily basis. In Indonesia, the key first steps for successful SJSN design and implementation include

- creation of SJSN Council,
- appointment of a coordinator in the Ministry of Finance and other key ministries, and
- identification of a champion to lead reform on a daily basis.

The structure of Indonesia's population and labor force will also have a significant impact on the final design and cost of the SJSN programs. The benefit program design must take into account population aging and the large informal labor sector, as well as the time required to develop the institutions and administrative systems necessary to support the SJSN programs. The trends and issues that will impact the SJSN design and implementation process are briefly discussed below.

- *Political issues*. Indonesia has been making steady progress toward democracy and decentralization. This has resulted in a greater number of political parties and a more important role for the Parliament and regional governments. These changes mean the new SJSN law and implementation process will require broad political support from a wide range of political parties in order to succeed. The election cycle will also influence the SJSN implementation process. The next legislative elections will take place in April 2009 and the Presidential elections will be held in September 2009. The SJSN program and its implementation are likely to be an issue in these elections.

- *Population*. The total population of Indonesia is about 225 million. It is a young country. The estimated distribution of the population by age categories in 2007 is shown in Table 1.

Table 1: Population by Age Categories

Age	Percent (%)
0–14	28.5
15–54	59.8
55+	11.7

Source: World Bank projections for 2005 and author's projections

Life expectancy at birth is about 70 years for the total population (67 for men and 72 for women). The total fertility rate is about 2.2 children born per woman. Over the next 40 years, the population will continue to grow, with a dramatic increase in the number of elderly. Life expectancy will also increase, but the fertility rate is likely to stay the same or decline further.

- *Economic issues*. The Indonesian economy is steadily recovering from the slump following the Asian financial crisis. In 2005, economic growth reached a 9-year high of 5.6%. At the same time, the overall budget deficit declined from 4.0% in 1999 to 0.5% and the outstanding debt from more than 100% to 46.2% of GDP. Growth is expected to remain at high levels for the foreseeable future. The level of economic growth will have a significant impact on Indonesia's ability to afford the fiscal cost of the SJSN system. The SJSN law will create permanent new financial obligations for the government budget in perpetuity. It will need the financial resources to pay for those programs without causing large budget deficits or cutbacks in other critical government services, such as education and infrastructure.

- *Labor force issues.* In 2005, Indonesia had a workforce of about 105 million, of which 95 million were employed and 10 million were looking for work. Of the 95 million workers, approximately 30 million

were in the formal sector (including civil servants) and 65 million in the informal sector. The informal sector can be further subdivided by those who are poor or near-poor and other informal sector workers.

Assuming wages and income of workers is equal to 35% of GDP (International Labour Organization estimate), the average wage for the entire economy is about Indonesian rupiah (Rp)1 million per month. Based on anecdotal evidence and discussions with government officials, we estimate the average wage of the formal sector, including civil servants, to be about Rp2 million per month. The estimated average wage for the informal poor and near-poor is Rp300,000 per month and Rp750,000 for other informal sector workers. Table 2 summarizes this information, which we have used later in this report for our fiscal analysis of the SJSN law.

- *State budget*. The revised central government budget for 2006 (see Table 1 in *Assessment of Fiscal Cost of Social Security Related Programs in Indonesia*) recorded a deficit of approximately 1.3% of GDP. State revenues reached Rp654.9 trillion, with state expenditures recorded at Rp699.1 trillion (about 20% of GDP), producing a Rp40 trillion deficit. Two thirds of the revenue income came from taxation and the remaining non-tax revenues came mainly from oil and gas revenue. The SJSN implementation will create an additional burden on the State budget from two sources. The government must make contributions to all five social insurance funds for the poor and financially disabled, and also contributions to SJSN in its role as employer of civil servants and military personnel. In addition, the State budget will need to support any supplementary benefit programs for civil servants above and beyond what is provided by SJSN.

Successful SJSN design and implementation will require the government to focus on political, economic, and demographic issues. All must be coordinated to create a social insurance system that is politically and fiscally sustainable and that protects all Indonesians against poverty throughout their lives.

Table 2: Average Wage by Labor Force Category

	Number (millions)	Average Wage (million Rp)
Formal sector	30	2.00
Informal poor and near-poor	30	0.75
Informal, other	35	0.30
Total Employed	95	1.00
Unemployed	10	
Total Labor Force	**105**	

Source: Author's estimates based on conversations with government officials and ILO statistics regarding wages as a % of GDP

The balance of this report will

- describe the current social security system and institutions in Indonesia and identify their shortcomings;
- discuss the provisions of the SJSN law;
- identify changes needed to harmonize the SJSN law benefits with existing benefits; and
- discuss the required implementation phases, steps, and timing.

II. Current Social Security System in Indonesia

The provision of social security is a shared responsibility between the State, employers, individuals, and families. In Indonesia, as in most other Asian countries, there is a strong reliance on the extended family and the community to provide support in case of illness, loss of income, or other unforeseen events. About two thirds of the population work in the informal sector and rely almost entirely on these informal mechanisms.

For the private sector, there is a strong reliance on the employer's liability provisions and, to a lesser extent, on social insurance programs organized on a public and/or private basis. The nature of the social security systems for civil servants differs considerably from the system for the private sector. Public servants can fall back on an integrated package of conditions of service and social benefits while benefits for formal sector workers are much more limited.

Table 3 briefly summarizes the type of programs available to different segments of the population.

The percentage of workers entitled to pension and/or old-age benefits is quite low. Only about 12% of the total workforce is entitled to pension benefits. However, about 40% of the population is currently entitled to health insurance, thanks to the government's health insurance program for the poor.

Tables 4 and 5 provide the details regarding benefit coverage. Table 4 shows the percentage of the workforce entitled to pension or old-age savings benefits following retirement. For the purposes of this table, termination pay benefits for formal sector workers are not treated as a pension or savings program.

Table 3: Existing Social Insurance Program Summary

	Formal Wage Employment		Informal Wage Employment	
	Civil Servants	Private Sector	Non-poor	Poor
Health	x	x	x	
Pensions (monthly)	x			
Old-age (lump sum)		x		
Termination/ endowment benefits	x	x		
Death, workers compensa-tion	In pension program	x		

Source: Indonesian laws

Table 4: Number and Percentage of Workforce Entitled to Pensions

	Pension/Old-age Savings	As % of Workforce
Formal sector	7,000,000	7.4
Civil servants	4,100,000	4.3
Military	500,000	0.5
Covered Workforce	11,600,000	12.2
Formal sector, evading	18,400,000	19.4
Informal sector workers	65,000,000	68.4
Total Workforce/Population	95,000,000	100.0

Source: Jamsostek data, discussion with government officials, government labor statistics

Table 5: Number and Percentage of Workforce Entitled to Health Insurance

	Health	As % of Population
Formal sector	14,200,000	6.4
Civil servants	12,400,000	5.6
Military	1,400,000	0.6
Informal poor	60,000,000	27.3
Covered Population	**88,000,000**	**40.0**
Formal, evading	52,000,000	23.6
Informal, not poor	80,000,000	36.4
Total Workforce/ Population	**220,000,000**	**100.0**

Source: Jamsostek data, Askes, Taspen, Ministry of Finance, discussion with government officials, government labor statistics

Table 5 shows the percentage of the population entitled to health insurance. This table includes covered workers and dependents.

Social-security-related programs in Indonesia are managed by four social security administrators, which are all state-owned limited liability companies or *perseros* (PT): PT Jamsostek, PT Taspen, PT Askes, and PT Asabri. In accordance with Company Law No. 1 of 1985, a *persero* has the following characteristics:

- It is a legal commercial entity, expected to generate profits for its stakeholders. The dividends are determined by shareholders at the general meeting of shareholders.
- Corporate income tax treatment for social security administrators is similar to the private insurance and private pension funds.
- It has a two-board system, with a Board of Directors, responsible for the daily management and fully accountable for the performance and legal compliance of the corporation, and a Board of Commissioners, responsible for the oversight of the policy making and performance of the Board of Directors.
- The Ministry of State-Owned Enterprises is the sole shareholder and has controlling voting rights in the general meeting of shareholders and can appoint or dismiss the members of the Board of Directors and the Board of Commissioners, as well as determine their remuneration.

Various government agencies are responsible for the oversight of the *perseros.*

- The Ministry of Manpower is responsible for the labor legislation, for the supervision of PT Jamsostek, and the enforcement of compliance of its related legislation.
- The Ministry of Finance is responsible for the supervision of PT Taspen, private insurance companies, and private pension schemes. It has also some regulatory duties regarding the investment management activities of PTs.
- The Ministry of Health is responsible for the supervision of PT Askes.
- The Ministry of Defense is responsible for the social security provisions of the armed forces, with PT Asabri administering the scheme.

A. Civil servant benefits and contributions

Civil servants are entitled to the following benefit programs:

- *Health insurance*. The coverage is available during civil servants' active careers, as well as after retirement.

- *Pension program*. This pays a monthly pension benefit of 2.5% of the final month's pay for each year of civil service to a maximum of 80%. The benefit is indexed each year for changes in wages. The retirement age varies from 56 to 60, depending on position. However, a civil servant who reaches age 50 with at least 20 years of government service can retire early. The pension program also includes workers' compensation and death benefits.

- *Endowment program (Taspen Old-Age Savings Program [THT])*. Pays a lump-sum benefit at retirement age equal to 60% of final monthly salary for each year of service.

Contributions to finance these programs are shared between civil servants and the government in its role as employer. Table 6 shows the current required contributions.

The government's contributions to the pension and endowment programs are shown as "open". These are defined benefit programs and an actuarial valuation is required to determine the cost of the programs. Costs will also vary depending on the method of financing—pay-as-you-go, partially funded, or fully funded.

Table 6: Current Required Contributions (in %) for Civil Servants

Program	Civil Servants	Government
Health insurance (Askes)	2.00	2.00 (2007)
Pensions (monthly) (Taspen)	4.75	20.00 (est.)
Old-Age benefit (lump sum) (Taspen)	3.25	Open
Total	10.00	Open

Source: Laws, government decrees, information from government officials

B. Civil servants and institutions

Benefits for civil servants are provided through several social security institutions. All of these institutions are *perseros*, or state-owned enterprises that are required to make a profit, pay dividends to the government as its stockholder, and pay corporate income tax. The key institutions are briefly described in the following section.

1. PT Taspen

PT Taspen is responsible for both the pension and THT programs for civil servants and has a special legal status. Although PT Taspen's old-age pension benefits program is a type of insurance program, it is not subject to the Insurance Law or to the Pension Law. It is also not subject to the usual regulatory framework and does not need to comply with obligations imposed on other pension programs, such as the use of a custodian, the segregation of assets, and the appointment of an administrator distinct from the sponsor, that is, the government itself. It also is not subject to any particular funding and solvency requirements. Although exempt from the normal regulatory framework, PT Taspen is subject to an ad hoc combination of regulations, decrees, decisions, and instructions from the Ministry of Finance. The Ministry of Manpower stipulates the minimum retirement age.

PT Taspen acts only as the government's payment agent for the pension program and is not legally responsible for the liabilities under that program. It also accumulates employee contributions to the pension program in a special account and uses this money to meet a portion of the government's benefit payment obligations.

However, PT Taspen is legally responsible for the liabilities created under the THT program. In theory, employee contributions are supposed to be sufficient to fully fund benefits under this program. However, recent pay increases have created unfunded liabilities. The government is currently making contributions to PT Taspen to amortize these unfunded liabilities over a period of 15 years.

2. PT Askes

PT Askes sponsors a compulsory health insurance scheme for active and retired civil servants, retired military and police officers, veterans and national patriots, and their families. PT Askes manages three different programs, each with its own regulations:

- health insurance for government officials (social health insurance),
- commercial health insurance, and
- Askeskin, a health insurance for poor families. This program is discussed in a later section of this report covering benefits for the informal sector.

The program's beneficiaries enjoy comprehensive benefits through a structured health services mechanism and can get medical treatment all over Indonesia.

3. PT Asabri

PT Asabri is responsible for providing social insurance benefits to the military. Benefits are similar to those provided to civil servants by PT Taspen. A detailed description of PT Asabri is not included in this report because the issues are very similar to those of PT Taspen and its programs cover only 0.5 million active military personnel.

C. Formal sector, benefits and contributions

Formal sector workers are entitled to a variety of benefits through social insurance institutes and directly from employers. The primary benefit programs are

- *Old-age savings*. The Jamsostek Old-Age Program (JHT) for private sector workers is a provident fund where members get contributions and declared interest refunded in a lump sum under certain conditions. The conditions for the withdrawal are retirement at age of 55 years; total and permanent disability; death of the employee before retirement age; and unemployment for 6 months provided the employee has contributed for at least 5 years. Workers contribute 2% of wages and employers contribute 3.7% of wages to the provident fund.

- *Health insurance.* JHT provides health insurance for some formal sector workers. Coverage is limited due to an opt-out provision for private sector employers who purchase private health insurance providing better benefits, and due to evasion.

- *Employment injury*. Employment injury includes three separate elements: accident at work, occupational disease arising out of employment, and travel accidents that occur while traveling to work following the usual route.

- *Death gran*t. The death grant for the private sector covered by the JHT program is paid as a lump sum to the relatives of a deceased employee irrespective of the cause of death. The death must occur while the worker is in active employment. The amount paid is a flat rate equal to Rp3 million. In addition, a funeral grant amounting to Rp600,000 is given to the family.

- *Termination pay*. Upon termination of employment, regardless of the reason, the employer is obligated to provide severance pay and long-service pay in a lump sum. Benefits vary depending on the cause of separation.

- *Sickness and maternity*. The employer will pay employees in case they are absent because of sickness. Employees cannot be terminated because of sickness unless they are absent for at least 12 months. The employer will pay the employee in case of pregnancy or childbirth. Employers are prohibited from terminating the employment of female employees because of pregnancy or childbirth.

Table 7 shows the required employer and employee contributions to the various social insurance programs. As is evident, the vast majority of the costs are paid by employers. And workers are only required to contribute to the JHT program. This differs substantially from the contribution requirements for civil servants.

Table 7: Employer and Employee Contributions for Private Sector

Program	Employers (%)	Workers (%)	Total (%)
JHT contributions	7.24–11.74	2	9.24 –13.74
Health insurance	3–6	–	3–6
Old-age benefit (lump sum)	3.70	2	5.70
Employment Injury	0.24–1.74 (5 classes)	–	0.24–1.74
Death grant	0.30	–	0.30
Severance pay	8–14 (est.)		8–14 (est.)

Source: Jamsostek, Taspen, Indonesian Society of Actuaries' estimates of severance pay

D. Formal sector and institutions

The primary institution responsible for providing social insurance benefits to formal sector workers is PT Jamsostek, a for-profit, state-owned enterprise. The investment of provident fund assets is one of the core activities of PT Jamsostek. In the case of the JHT old-age benefit program, which is a defined contribution plan, the main goal of the investment function is to generate returns that accrue to individual member accounts in accordance with members' investment goals and risk tolerances. This contrasts with the goal of the health care benefit scheme, the employment injury program, and the death grant scheme, where the objective is to provide insurance through a risk-pooling

mechanism. PT Jamsostek currently pays both corporate income tax and dividends to the government.

E. Informal sector

For the most part, social insurance programs do not exist for the informal sector. The exception to this rule is the Askeskin health program for the poorest Indonesians. Indonesia has had a series of targeted health insurance programs since the mid-1990s, starting with the health card program in 1994. This program came to a close in 1998, and was replaced by social safety net programs that included subsidized health services.

In 2005, this program was converted into the Askeskin health care program for low-income people. The program now provides (i) free-of-charge health care services at public health centers and (ii) in-patient treatment in third-class hospital beds. The program is run by PT Askes, which distributes individual health cards to the poor and reimburses hospitals and public health centers for their services on a fee-for-service basis. The program targets 60 million people and is budgeted at Rp5,000 per capita per month.

The Askeskin program uses a 'managed care' approach. Health service providers receive a fixed amount to cover a certain number of people for a specified period of time, regardless of the actual number who fall ill during that period. This system is intended to stimulate the health service providers not only to provide the best in curative and rehabilitative services but also to provide preventive services, such as socialization and consultation.

F. Problems with current systems and institutions

This section highlights the primary problems with the existing social security systems and institutions. When implementing the SJSN law, the government needs to focus on correcting these shortcomings. The first step in any pension reform is to fix the existing system. The four social security institutes will be the foundation of the SJSN pension system. All these institutes will have significant additional responsibilities under the new system that they are not yet ready to handle. Consequently, much work is needed to strengthen these institutions before SJSN can be fully implemented.

1. PT Jamsostek

Improvement is needed in almost all operational areas.

- There are only about 7 million active PT Jamsostek members. The formal labor force, excluding civil servants, is about 25 million, so the number of members should be much higher.
- Rates of return, net of expenses, should certainly exceed returns on bank time deposits and the rate of real wage growth. To earn a reasonable benefit at retirement, the real rate of return must exceed the real wage growth by at least 2–3%. Until recently, real rates of return were negative.
- The current investment portfolio is not adequately diversified. It consists mostly of bank deposits and government bonds.
- Benefits at retirement will be inadequate because of early retirement ages, substantial withdrawals prior to retirement age, low contribution rates, inadequate investment returns, and high administrative costs. Benefits are also paid as a lump sum so they provide no protection against outliving assets following retirement.
- PT Jamsostek must pay dividends to the government in its role as shareholder and also corporate income tax on its profits from insurance operations. This is highly unusual for a social security institute.
- Investment returns to member accounts are not based on actual returns but rather on the amount declared by the government.

An analysis of PT Jamsostek's financial statements shows that only 71.4% and 66.1% of investment earnings were actually credited to participant accounts in 2004 and 2005, respectively. The remainder was retained by PT Jamsostek for administrative expenses, taxes and dividends, and retained earnings. Table 8 summarizes PT Jamsostek's financial statements for 2004 and 2005. This information was taken from PT Jamsostek's web site.

Governance procedures are also inadequate in many areas and must be improved if the system is to be operated in the best interests of members.

- *Fiduciary duty is to the government and not members*. Since the social security institutes are perseros, the management must make decisions in the best interests of its stockholder, the government. This is contrary to international best practice, which specifies that the social security institute must make all decisions in the best interests of its members.

- *Boards appointed by the Ministry of State-Owned Enterprises*. Since the Ministry appoints both the Board of Commissioners and the Board of Directors,

it effectively controls the persero and dictates its policies.

- *Board appointment process not transparent*. A transparent process is necessary for appointing Board members with specified requirements in education, training, and experience, as well as in moral conduct. Selection of Board members should be determined by their expertise in social insurance and related fields and not based on political considerations.

- *Investment rules give broad discretion to the Board and do not meet international norms*. There is no prudent person standard and the investment rules in the Ministry of Finance's regulations are too broad. These regulations do not require all investment decisions to be based on the best interests of members and to take into account the purpose of the fund. There should be more limits by asset class, permitted and prohibited investments, guidelines on asset quality, requirements for diversification, etc. in the law or regulations.

- *Investment portfolio of the insurance and provident funds is backward*. The investment portfolio of the provident fund consists mostly of government bonds and bank deposits and contains little equity investments. By contrast, the insurance portfolio has a significant equity component. This is contrary to international best practice. Normally, the portfolio of an insurance company consists primarily of bonds in order to match the duration of assets and liabilities and immunize the insurance company's surplus against changes in interest rates. By contrast, the investment portfolio for a mandatory defined contribution system is normally well diversified among asset classes and includes a significant equity component in order to increase expected rate of return and diversify investments.

Table 8: Financial Statements of PT Jamsostek 2004 and 2005

		2005 Audited (million Rp)	2004 Audited (million Rp)
1.	Premium Income (JKK,JKM,JPK,JAKONS, TKI)	1,390,985	1,200,598
2.	Income from Subsidiaries	11,462	6,279
3.	Claim payment (JKK,JKM,JPK,JAKONS, TKI)	(658,155)	(547,683)
4.	Additional technical reserves	(483,741)	(430,943)
	Net Premium Income	260,551	228,251
5.	Net Investment Income	3,518,510	3,269,141
6.	Operating and other costs	(654,991)	(527,605)
	Profit before the member's portion from the investment income from retirement benefit	3,124,070	2,969,787
7.	Members portion from the investment income of retirement benefit	(2,324,272)	(2,335,047)
8.	Estimated corporate tax	(166,610)	(179,916)
9.	Deferred Income (cost) of corporate tax	(3,585)	(33,760)
	Net Income after tax	**629,603**	**421,064**
	Percentage of investment income credited to members (%)	66.1	71.4

Source: Web site of Jamsostek

- *Actual investment return not credited*. As a general rule, the actual investment income earned should be allocated among plan members. Under Indonesia's current system, a rate of return is declared and is not necessarily directly related to actual investment earnings.

- *Management results are poor for registration, contribution collection, and benefits*. Many members have multiple accounts, and there are more than 20 million inactive accounts. The contribution collection process is not efficient. Many employers do not register, contributions are not made for all workers, and contributions are often not based on actual earnings. The historical database of wages and contributions is also not as accurate as it should be.

2. PT Taspen

The programs managed by PT Taspen also have significant problems, but the challenges are different from those facing PT Jamsostek. The pension and THT programs for civil servants are defined benefit programs financed from the State budget, mostly on a pay-as-you-go basis. These programs provide a much better benefit than the PT Jamsostek provident fund. The PT Taspen pension program provides benefits in the form of a lifetime annuity while the THT program provides a lump sum benefit. Consequently, benefit adequacy is less of an issue, assuming the budget has sufficient resources to pay benefits when due.

The primary problems and challenges in the PT Taspen system include

- *Fiscal sustainability, pension program*. The pension program is financed on a pay-as-you-go basis and fiscal management is the government's responsibility. PT Taspen is a payment agent only. Currently, about

85% of benefit payments are financed from the State budget and the remaining payments are financed from a special investment account created from employee contributions. Actuarial analysis indicates that this special investment account will soon be exhausted if there is no decrease in the percentage financed by employee contributions. It is almost inevitable that the government will eventually pay 100% of the cost of this program. Actuarial analysis also indicates a dramatic increase in the number of civil servant pensioners over the next 30 years. If Indonesia continues to experience strong GDP growth, the government will probably be able to afford the fiscal cost of this program. If not, the program may become fiscally unsustainable.

- *Fiscal sustainability, THT program*. The THT program is also a defined benefit program, and PT Taspen is legally responsible for financing and paying promised benefits. In theory, the benefit is fully financed by a 3.25% contribution from members. However, in reality, this contribution is insufficient to pay promised benefits, and the government is currently subsidizing the system. Program liabilities increase dramatically each time the Presidential pay matrix is increased because benefits are based on pay in the month prior to retirement rather than on pay throughout workers' careers. Currently, the government is contributing Rp250 billion per year for 15 years to the THT program in order to help finance its unfunded liabilities. It is very likely additional unfunded liabilities will be created in the future as well; the government and PT Taspen will continue to struggle to keep the THT program on a sound financial footing.

- *Lack of modeling capability*. The government does not have an Office of the Actuary or an equivalent institution capable of preparing short- and long-term actuarial forecasts of the current system and proposed changes to the system. Currently, these tasks are performed by outside consultants. However, it is important for the government to receive unbiased analysis of the current system and policy options. This could be done by a government institution, an outside research organization, or an academic institution. Regardless of the location, the analysis unit must create or purchase and maintain its own computer models and have staff with appropriate professional qualifications. This unit will have to employ actuaries and, most probably, also need to hire economists, demographers, accountants, labor force experts, and other professionals with appropriate skills.

- *Lack of transparency in financial reporting*. All financial statements should be prepared on the basis of accrual accounting using international financial reporting standards. The results of PT Taspen's operations and finances should be clearly and concisely reported to plan members and the government. Substantial improvements are needed in these areas.

In order to improve the long-term fiscal sustainability of the pension and THT programs, certain design changes will likely be required. These include

- *Changes in the mandatory retirement ages requiring or encouraging workers to retire at older ages*. As the number of pensioners increases and life expectancy following retirement increases, it will become nearly impossible to maintain fiscal balance without increasing retirement ages.

- *Changes in the way pensions are indexed following retirement*. Pensions are currently indexed to wages for the position the individual occupied prior to retirement. Benefits will probably have to be indexed to inflation in the future.

- *Change in the pay basis used to calculate benefits*. Currently, benefits are based on the last month's pay. To prevent misuse of the system, most social security systems base benefits on pay over the worker's entire career or on average pay over the last 3–10 years of the worker's career.

It appears that neither the pension nor the THT systems are sustainable in their current form in the long run. They require close actuarial scrutiny and reform. Benefits are high, the retirement age is low, and the number of pensioners will increase dramatically over the next 30 years. Introduction of SJSN should offer an opportunity to redesign and harmonize benefit programs for civil servants with the SJSN pension and old-age savings benefits.

III. Trends Affecting Social Security

Before discussing the SJSN law and its implementation, it is important to understand the global trends that are affecting social security systems. Any SJSN implementation plan must recognize and address these trends in order to be successful. The most important trend is the rapid aging of the population in most countries due to increasing life expectancy and declining birth rates. Other important trends include increasing urbanization and the decline in the family support system that has served as the primary source of retirement protection in Indonesia.

A. Population aging

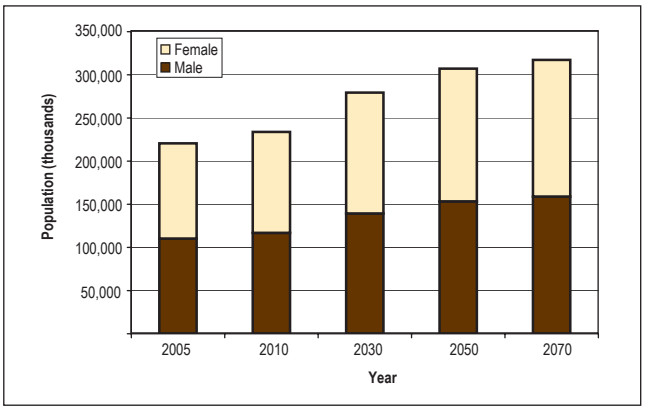
The two primary factors affecting population are fertility and mortality—the number of births and deaths. The other factors are immigration and emigration. Many developing countries are experiencing significant net emigration, especially among its best educated citizens.

- *Fertility*. The fertility rate is the number of babies that a woman will have during her lifetime. Indonesia's fertility rate has been steadily declining over the last 30 years from a high of about 5.5 to 2.2 today. In our projections, we assumed it would decline to 2.1 by 2020 and then remain at that level throughout the analysis period. Fewer births means the population will grow at a slower rate and the average age will increase over time.

- *Mortality*. The Government of Indonesia does not publish mortality statistics but statistics on life expectancy are available from the World Bank, the United Nations, and the International Labour Organization. Consequently, we used mortality rates from other countries in the region with similar life expectancies to estimate Indonesian mortality. Throughout most parts of the world, mortality rates are declining by 1–2% per year. Lower mortality means longer life expectancy and a greater number of years paying pensions.

Our projections indicate that the population of Indonesia is likely to continue increasing over the next 75 years. However, the rate of growth will decline steadily, particularly after 2050, as shown in Figure 1.

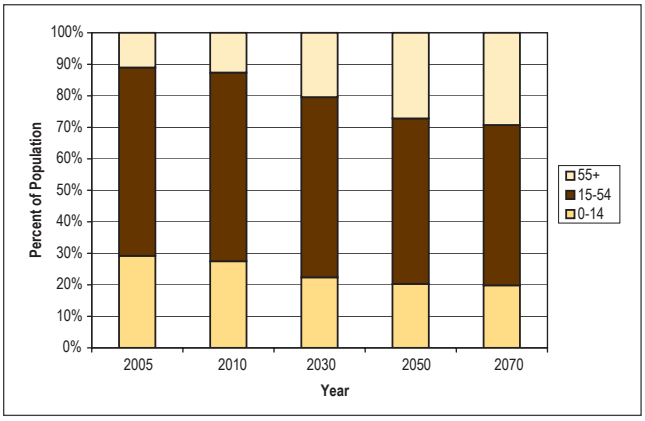
Figure 1: Population Projection



Source: Author's calculations

Although the population will grow throughout the analysis period, the age composition of the population will change dramatically. Because today's birth rates are much lower than in the past, the average age of the population will increase. Figure 2 shows the percentage of the population that are children (ages 0–14), working age (15–54), and retirement age (55+) now and in the future.

Figure 2: Percent of Population by Age Groups



Source: Author's calculations

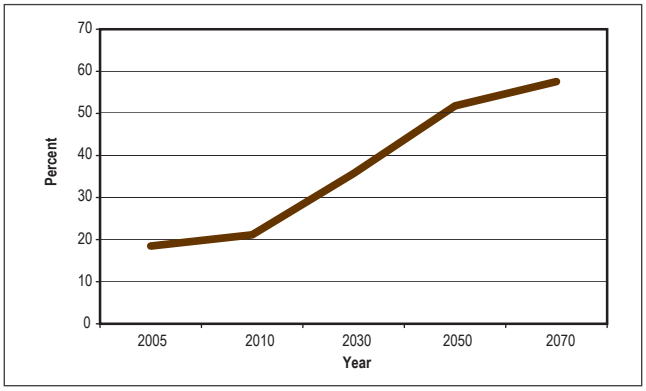
The percentage of the total population made up of children declines throughout the analysis period as does the percentage of working ages. There is a dramatic increase in the percentage of the population above retirement age. Today, the percentage of the population over age 55 is less than 12%. However, this will increase to 20.4% by 2030 and 29% by 2060.

When establishing pension insurance programs, population dependency ratio is the most important variable. This is the ratio of the number over retirement age to the number of working age. This is because workers

must make contributions to the social insurance fund that are sufficient to pay promised benefits to those who are retired. The greater the number of pensioners relative to workers, the higher the required tax rate to keep the fund solvent. Figure 3 shows this dependency ratio.

Figure 3 shows that there are more than five people of working age for each worker over age 55 today (dependency ratio is less than 20%). However, by 2047, this ratio will decline to just two workers for each pensioner and, by the end of the analysis period, the ratio will only be 1.7 workers for each pensioner and the dependency ratio will be close to 60%. The ratios can be decreased by raising the retirement age, but the dependency ratio will still increase sharply over the course of the 75-year period.

Figure 3: Population Dependency Ratio



Source: Author's calculations

Table 9 shows the pattern of population dependency ratios as a function of assumed retirement age and year. The higher the ratio, the greater the burden on the pension insurance system.

Table 9: Population Dependency Ratios by Retirement Age and Year of Retirement

Retirement Age	Population Dependency Ratio (%)			
	2010	2030	2050	2070
55	21.1	35.7	51.8	57.6
60	13.4	23.7	36.8	41.5
65	8.7	15.4	25.4	29.2

Source: Author's calculations

All pension reforms must deal with the issue of population aging. If programs are funded on a pay-as-you-go basis and retirement ages and benefits are left unchanged, the cost of the programs will increase dramatically. In order to deal with this issue, one or more of the following strategies are required:

- retirement ages must be increased so that life expectancy after retirement is controlled,
- benefits must be reduced,
- contributions must be increased,
- benefits must be fully or partially prefunded,
- spending on other government programs must be reduced.

Each country will have to decide the best combination of strategies to deal with its particular circumstances.

B. Societal changes

The SJSN law indicates an understanding by the government that the traditional support methods in old age are no longer as effective as they once were. In most Asian societies, children bear the responsibility of caring for their parents. In the past, the majority of the population lived in rural areas. Couples had five or more children who generally remained in the village where they were born for most of their lives. In this situation, the burden of caring for elderly parents was manageable.

However, over the last 30 years, fertility rates have declined dramatically and most families have only two children. Many more of these children choose to leave the region where they were born and move to larger cities seeking better job opportunities and a more prosperous life. With fewer children, the burden per child of caring for elderly parents increases, and children who leave home are less likely to help their parents. Consequently, the traditional old-age support methods are no longer as effective as they once were, and there is a great deal of pressure for the State to assume a more prominent role and create formal programs for supporting elderly Indonesians.

IV. The SJSN Law

The SJSN law is designed to provide all Indonesians with basic social insurance in order to protect them against adverse macroeconomic or life circumstances. The 1998 fiscal crisis revealed the fragility of the current system. Many Indonesians found themselves living in poverty and without support. Once the SJSN law is fully implemented, all Indonesians will have social protection programs to keep them from living in poverty in childhood, during their working years, and following retirement.

A. Basic structure

The SJSN law is a framework law. It outlines the basic structure of the reformed social security system, but does not specify the benefits and contribution rates for each of the programs. All details are left to government regulations and Presidential decrees. The basic features of the new social insurance system are

- *Entire Indonesian population covered*. Both the formal and informal labor sectors and their dependents would be required to make contributions to the program.

- *Five separate programs*. Five separate social insurance programs would be established. Each of these is described in more detail in the next subsection.

- *Four administrators*. The four existing perseros would be responsible for administering the five new social insurance funds. However, the law does not specify the exact responsibilities of each persero. In addition, the legal structure of the four perseros must be changed within 5 years after enactment of the SJSN law.

- *National Social Security Council*. The Council has 15 members—five represent government ministries, two represent employers, two represent workers, and the remaining six are appointed experts. The Council is a policy-making body responsible for running the SJSN system.

- *Contribution structure differs between formal and informal sector*. Contributions for formal sector workers are a percentage of wages. Contributions are evenly split between workers and employers. For the informal sector, contributions are a nominal amount in rupiah.

- *Government pays for poor*. The government makes contributions on behalf of those who are poor or financially disabled.

B. Benefit programs

The SJSN law requires the establishment of five separate social insurance programs.

- *Pensions*. This program will pay a lifetime pension to workers following their retirement.

- *Old-age savings*. Workers will make contributions to individual accounts throughout their working career. These contributions will be invested and the account balance will be paid out as a lump sum at retirement.

- *Health*. This program will provide comprehensive medical benefits to all Indonesians based on medical need.

- *Employment accident insurance*. This program pays benefits for those who are injured or die as a consequence of their employment.

- *Life insurance*. This program pays a death benefit to the family of a deceased worker.

Details regarding the benefit levels and cost are left to regulations and Presidential decrees. Substantial policy discussions and actuarial analysis will be needed to finalize the benefits and contributions and to integrate the SJSN programs with existing benefit programs for civil servants and formal sector workers.

C. Institutional structure

The four existing perseros—Jamsostek, Taspen, Asabri, and Askes—will collectively form the Social Security Administering Body. The exact role of each institution in the new system has not yet been determined. Discussions have centered on either

- assigning each of the five SJSN programs to one of the four institutions, or
- assigning the health program only to PT Askes and then allow each of the other institutions to provide all four remaining funds to its current constituency.

Ultimately, the Social Security Council will need to decide on the final structure. In either case, the legal structure of the four institutions will be changed in two stages. In the first stage, the social security institutions will no longer be obligated to pay corporate income tax or dividends to the government. Instead, they will become non-profit institutions and their fiduciary obligation will be to members rather than the government.

In the second stage, the social insurance funds will become "trust funds". The assets of the contributors will be legally separated from the assets of the social

security institutions. This will further protect participant assets against misuse or possible social security institute bankruptcy.

We understand there is currently a law in Parliament that would change the governance structure of PT Jamsostek. The law would establish a Board of Trustees on a tripartite basis. The Ministry of Labor would represent the government and the Board would also include employer and worker representatives. This Board would take over responsibility from the Ministry of State-Owned Enterprises for the appointment of the Board of Directors and Board of Commissioners. This would be a step in the right direction for improving overall governance.

Another question that must be addressed is what institution(s) will be responsible for technical oversight of the operations of the four social security institutions and for overseeing the actions of the Council. The Council will have a Secretariat, but it will not have the required expertise and staff to properly oversee the social security institutions' technical operations. The same is true of the Board of Trustees. Bapepam LK would be a logical choice for this role because it has the experience and professional staff to manage the SJSN pension, savings, and insurance programs. If Bapepam LK were responsible for the public pension and savings programs, it would also allow better integration of the supervision of public and private pensions, and savings and insurance programs. Another organization, most probably the Ministry of Health, would have to take responsibility for the technical supervision of PT Askes.

It is also important for the stakeholders to have an organization with responsibility for overseeing the Council. Stakeholders will want to make sure the Council is acting in their best interests and is protecting their rights. The SJSN law does not specify such a body. This function must be performed, to a certain extent, by the Office of the President, since he is the one that appoints the Council members. A process that allows stakeholders to nominate the members of the Council and send them to the President for formal appointment would also help assure Council members to act in their best interests. It might also be possible to create a special oversight board composed of stakeholder representatives to review Council performance and make recommendations for further improvement.

D. Fiscal analysis

The Government of Indonesia asked us to analyze the short- and long-term fiscal implication of the SJSN law. Unfortunately, the law does not specify the benefit amounts, retirement ages, or required contributions. Consequently, we had to make reasonable assumptions about these variables based on the language of the law and discussions with government officials. Our analysis illustrates the order of magnitude of program costs but is not intended to be a recommendation regarding the final program design. Rather, it is meant to stimulate discussion and illustrate the fiscal impact of alternative program designs.

In our analysis, we focused on both the design of each individual program and the interrelationship among the programs. It is important for all of the programs to fit together into a package that supports the government's overall policy and fiscal objectives. Each individual program must have a clear role and rationale within the country's overall social protection scheme.

Under the SJSN law, the burden of financing the various social insurance programs is allocated among workers, employers, and the government.

- Formal sector workers and their employers pay for the social insurance programs by making contributions as a percentage of wages. Costs are shared equally between employers and workers.
- Contributions for informal sector workers are a nominal amount in local currency rather than a percentage of wages.
- Contributions on behalf of the informal poor must be paid by the government. Those in the informal sector who are not poor must pay their own contributions.

1. Assumed program benefits

For purposes of our analysis, we made the following assumptions regarding pension and health insurance benefits and the required contributions to the old-age savings program. We did not prepare analysis for the life insurance and employment accident programs.

- *Pension*. Rp200,000 per month in 2007, retirement at age 60, wage indexing following retirement. This pension is roughly equivalent to US$2 per month on a purchasing power parity (PPP) basis. This is the Millennium Challenge target for Indonesia in 2015. This amount would be paid to anyone with 15 or more years of contributions, regardless of the number of years of service or salary level.

- *Old-Age Savings*. 5.7% of income. This is the current contribution rate to the PT Jamsostek JHT program. If a higher contribution rate is used, all results will increase proportionately.

- *Health*. PT Askes benefit package for civil servants. Currently, civil servants pay out-of-pocket for about 40% of the total cost of their health care. Also, many civil servants go outside the PT Askes program for outpatient primary physician services. When calculating the expected cost of the PT Askes benefit package, we assumed no co-pays would be required and a higher standard of care.

As previously stated, these benefits were selected solely for the purpose of illustrating the likely cost of the SJSN program. We are not recommending these benefit levels for the SJSN program. The purpose of this exercise is to illustrate the need to balance the level of benefits with short- and long-term fiscal sustainability.

2. Projected fiscal cost

We calculated the cost of the programs on three different bases:

- cost to the economy as a percentage of GDP,
- estimated cost to the State budget for the poor and financially disabled on a pay-as-you-go basis, and
- estimated contribution rate for formal sector workers on a pay-as-you-go and level funding basis.

Results on each of these bases are shown in Tables 10 and 11. More technical information regarding these projections is available in Estimated Cost of Pension, Old-Age Savings and Health Insurance under the National Social Security System Law. All projections were prepared over a 75-year period beginning in 2005 and ending in 2080.

Table 10 shows the cost of the pension, old-age savings, and health programs for everyone as a percentage of GDP. This table can be conceptualized in one of two ways—as the cost of the SJSN programs if the government paid the full cost for everyone, or as the burden of the SJSN programs on the overall economy. Economists often look at the cost of national pension or health systems as a percentage of GDP when comparing the cost of programs across countries or measuring the total portion of a country's GDP devoted to social insurance programs.

Table 10: Cost of Pensions as Percentage of GDP (%)

	2010	2030	2050	2070
Pension	0.13	1.84	3.23	3.69
Old-age savings	2.00	2.00	2.00	2.00
Health	0.75	3.19	4.25	5.33
Total	2.88	7.03	9.48	11.02

Source: Author's calculations

As can be seen, the cost of these three social insurance programs grows over time, even though real GDP is assumed to grow at a rapid rate for the next 20 years. Overall, the burdens of these programs on the economy seem reasonable compared with those in other developing countries. The primary reasons for the increase in costs as a percentage of GDP are

- *Pension program pays nothing in the first 15 years*. According to the SJSN law, only those with 15 or more years of contributions are entitled to a lifetime pension. Even if the pension portion of SJSN were started today, the first pensions would be paid to those retiring in 2022.

- *Health coverage phased-in through 2020*. We assumed health care coverage would be phased in over time and full coverage of the entire population would be achieved in 2020. If the health program were made available to all Indonesians immediately, there would be insufficient providers and facilities to meet the demand for health services. Consequently, we assumed the health insurance program would have to be phased in gradually.

- *Population aging increases the number of pensioners and cost of health care*. As mentioned earlier in this report, the Indonesian population will age rapidly over the next 30 years and the percentage of the elderly population will have doubled in that time period. Pension costs are directly related to the number of elderly, and health costs are also greater for older people than younger people.

Table 11 shows the government's cost for the poor and financially disabled under the SJSN program as a percentage of GDP. Note that these figures do not include the cost of contributions made to SJSN by the government for civil servants. Based on our assumptions, there are 30 million poor workers. They constitute about 31% of employed workers but only 9.5% of national wages and income.

Table 11: Government Cost as Percentage of GDP (%)

	2010	2030	2050	2070
Pension	0.04	0.58	1.02	1.17
Old-age savings	0.20	0.20	0.20	0.20
Health	0.29	0.97	1.30	1.63
Total	0.53	1.75	2.52	3.00

Source: Author's calculations

The pattern of costs as a percentage of GDP is similar to those shown in the previous table. Costs increase over time due to the phase-in of the pension and health insurance program and population aging. In the early years of the SJSN system, the government's cost for the poor is only about 0.5% of GDP. However, when the system matures, the cost will be closer to 3% of GDP for the pension, savings, and health programs combined.

Finally, we estimated the cost as a percentage of wages for formal sector workers and their employers. For these calculations, we calculated the level cost as a percentage of wages required to fund each benefit over the entire 75-year analysis period. The results are shown in Table 12.

Table 12: Cost as a Percentage of Wages, Formal Sector Workers

Program	% of Wages
Pension	3.9
Old-age Savings	5.7
Health	3.0
Total	12.6

Source: Author's calculations

These costs would be evenly shared between workers and employers, so each would make contributions of 6.3% of wages.

In reality, costs start out as a lower percentage of payroll and increase over time for the pension and health programs. The government has a choice between

- requiring employers and workers to finance these programs on a pay-as-you-go basis and regularly increasing required contribution rates; or
- requiring employers and workers to finance these programs by paying a contribution rate that is expected to remain level. In this case, contributions will be more than is needed to pay benefits in the early years of the system. The excess contributions must be saved and invested to create a reserve that can be used to supplement contributions in later years when contributions alone are insufficient to pay benefits.

On a pay-as-you-go basis, the cost of the pension program starts out at about 0.2% of wages and, ultimately, increases to 5.6% of wages. The comparable numbers for the health program are 1.8% and 4.1%. The cost of the old-age savings program remains level at 5.7% throughout the analysis period since this is a defined contribution plan.

V. SJSN Harmonization Issues

The Government of Indonesia currently sponsors a wide array of different pension and old-age savings programs. Separate programs are available for civil servants and formal sector workers. In addition, a variety of ways exists to voluntarily save for retirement through occupational pension funds, financial institutions pension funds, mutual funds, and certain types of insurance contracts. Each of these programs has its own contribution requirements, investment rules, payout options, regulatory structure, and tax schemes. The introduction of SJSN will create the need to review all existing pension and old-age savings schemes and make changes to integrate and harmonize them with the new SJSN programs and with each other.

A. Current Programs Comparison

As discussed earlier, the pension and savings programs for civil servants and formal sector workers are very different from each other and both differ significantly from the benefit package under the SJSN law. There are differences in retirement ages, benefit levels, and contribution requirements. Table 13 summarizes the features of the different programs.

The implementation of the SJSN law will require the government to restructure existing benefit programs for civil servants and the formal sector to fit within the SJSN framework. The THT program for civil servants is not a pension or old-age savings program. There are many good reasons to restructure the program to fit into one of these two components.

The termination pay program under Article 156 of Labor Law 13/2003 also does not fit the SJSN structure. It has both severance pay and reward pay components and has been serving as the main source of both termination and retirement benefits for formal sector workers. With the introduction of SJSN, private sector workers will now have a true pension program, as well as an old-age savings program that is focused on providing benefits at retirement. The termination pay program should be redesigned with these changes.

In addition, consideration should be given to how the SJSN program integrates with the existing voluntary pension system. Careful consideration should be given to the respective roles of the mandatory and voluntary pension systems after SJSN implementation. Various design elements of the two systems should be harmonized, as

Table 13: Pensions and Savings Programs Summary

	Servants	Formal Sector Workers	SJSN
Retirement Age	Mandatory age is generally either 56 or 60, depending on position. Early retirement permitted without reduction at age 50, with 20 years of service	Retirement age is 55. Mandatory formal sector retirement age is 60	Retirement age to be based on current legislation (probably age 60)
Contributions	Employee pays 4.75% to pension program and 3.25% to the endowment program. The government pays the balance of the cost of the pension program, which is currently about 20% of wages and is also making payments to the endowment program	Employee pays 2% to savings program. Employer pays other 3.7% of savings program. The employer cost for the severance pay program is estimated at 8–12% of pay	Cost of pension and savings programs for formal sector are % of wages and shared equally by employers and workers. Total contribution of about 10% for these two programs is likely
Pension Benefits	Rich defined benefit program providing benefit of up to 75% of final base pay, including family allowances, plus a rice allowance	None	Program allowing for a decent level of living (poverty prevention)
Savings Benefits	None	5.7% contribution to individual savings account. Money often withdrawn prior to retirement due to change of jobs or unemployment of more than 6 months	Percent of wages will be contributed to individual savings account and will be paid as a lump sum at retirement
Termination Benefits	The THT program is more analogous to termination pay than savings. The benefit is equal to 60% of final monthly salary for each year of service, payable as lump sum	Benefits are based on final salary and years of service and are payable as a lump sum. The benefit is composed of severance pay and long-service pay components	None

Source: Indonesian laws, Jamsostek, Taspen, Ministry of Finance, conversations with other government officials

well as such issues as tax schemes, regulatory provisions, payout options, and supervisory framework. The mandatory and voluntary systems should be two components of one national pension strategy rather the present arrangement of two independent pension systems, each operating as if the other did not exist.

B. SJSN Integration with Existing Programs

The SJSN pension and old-age savings programs have not yet been designed, so the benefit levels and cost are unknown.

- The primary purpose of the SJSN pension benefit is poverty reduction. It will probably be a defined benefit program providing a basic lifetime pension that is a uniform amount for everyone, regardless of salary level. Benefits should be tied to the poverty level or minimum subsistence level.
- The old-age savings benefit will operate on a defined contribution basis. By definition, this program will always be fully funded, and the benefit will be based on each individual's contributions and rate of investment return. The income from this program will supplement the benefits from the pension program and help workers maintain their standard of living following retirement.

Currently, civil servants have the pension benefit, but not the old-age savings benefit. On the other hand, formal sector workers have the savings program but not the pension benefits. Both sectors have a termination pay/endowment benefit that is not required by the SJSN law. Table 14 illustrates the current and SJSN program structures.

Table 14: Current versus SJSN Program Structures

	Civil Servants	Formal Sector	SJSN
Pension (DB)	X		X
Old-Age Savings (DC)		X	X
Termination/Endowment(DB)	X	X	

Source: Indonesian laws, author's interpretation

The SJSN law also requires the cost of the pension and old-age programs to be shared equally between workers and their employer. Current cost-sharing arrangements also differ between the two sectors as shown in Table 15.

Table 15: Current Cost-Sharing Arrangements

	Employee Contribution as % of Wages		
Civil Servants	**Pension**	**Savings**	**THT**
Employee	4.25	None	3.75
Government	20 (est.)	None	Open
Formal Sector	**Pension**	**Savings**	**Severance**
Employee	None	2.00	0
Employer	None	3.70	8–12 (est.)

THT is an abbreviation (in Bahasa Indonesian) for a pension endowment program for civil servants
Source: Indonesian laws, Jamsostek, Taspen, Ministry of Finance, other government officials

The programs for both civil servants and formal sector workers must be adjusted to fit into the SJSN framework. The end result will be a true national multipillar pension system with consistent methods of providing benefits to all workers. However, each sector may need to provide supplementary benefits outside the framework of SJSN as well.

- Civil servants may need additional pension benefits, since the SJSN pension benefit will almost certainly have much lower benefits than the current civil service program. The government can continue to provide additional pension benefits to civil servants from the budget, if it so chooses.
- The rationale and need for the THT program must be reconsidered. Civil servants will now have an old-age savings program, though the size of the required contribution has yet to be determined. Introduction of SJSN will give the government alternative and more stable methods of financing benefits now provided by the THT program.
- The termination pay program under Labor Law 13/2003 should be redesigned. The benefits from the pension and old-age savings schemes should be set at a level that is sufficient to provide for formal sector retirement needs without the need for payments from the termination pay program. This termination pay program should then be adjusted so it becomes a true severance pay program.

There are several ways the THT and termination pay programs could be restructured to fit within the framework of SJSN. Options include financing THT and the retirement portion of the termination pay program by

- increasing the size of the planned benefit payable from the SJSN pension program,
- requiring a higher contribution to the SJSN old-age savings program,
- a combination of the first two approaches, and
- financing the benefits through voluntary pension funds (modified Financial Institution Pension Fund [DPLK] program).

C. Restructuring Civil Servant Benefits

The SJSN package will provide lower pension benefits than the current civil servant package, but the SJSN old-age savings program will probably finance the benefits currently provided by the THT program. Key transition design issues for civil servants include

- What benefits should civil servants receive after SJSN introduction?
- Should benefits be the same for both current civil servants and civil servants hired after SJSN introduction?
- To the extent additional benefits are needed, should the supplementary benefits be determined on a defined benefit and/or defined contribution basis?
- How should the mandatory and normal retirement ages be adjusted in the future?

Several options are listed below.

1. *Civil servants get current benefits plus SJSN*. This option is not recommended as the government would have all the fiscal problems associated with managing the current programs, plus the additional cost of SJSN. It would also require the government to maintain a wide array of different programs on a permanent basis.

2. *Leave existing civil servants in the current program and put future civil servants in a new program consisting of SJSN and supplemental benefits*. Under this option, any civil servant hired prior to the effective date of the SJSN pension and old-age savings programs would keep the benefit package they currently have. They would not enter the SJSN program at all. However, civil servants hired after the effective date of SJSN would not be eligible for the current benefits package. They would receive benefits under the SJSN programs plus any supplementary programs the government may wish to provide.

This approach has the advantage of not needing to integrate existing programs for civil servants and SJSN benefits. However, it also has the following drawbacks:

- The government would have to maintain the existing civil service programs and structure for many years. Although there would be no new entrants to the civil service pension and THT programs, all existing workers would remain in the program for life.
- Newly hired civil servants would not make any contributions to the current civil service pension or THT programs, as they are not participating. This would eventually require these programs to be fully budget financed. However, the budget would only have to cover existing pensioners and a closed group of workers, and the government already pays more than 85% of the cost of civil service pensions today.
- There would be two categories of civil servants—those with rich benefits and those with lesser benefits. Two workers doing essentially similar work and with similar pay could have very different benefit packages.

3. *Provide everyone with SJSN plus supplemental benefits prospectively*. Under this approach, existing civil servants would keep benefits earned under the current pension and THT programs through the date of SJSN pension and old-age savings program introduction. However, they would accrue no further benefits under these programs after the SJSN program begins. Of course, accrued benefits in the existing programs would have to be protected and financed.

Following the SJSN pension and old-age savings program effective dates, benefits and contributions would be based on SJSN plus any supplemental benefits the government provides. This approach has the advantage, when compared with the previous one, of treating all civil servants equally. Whether they were hired before or after the SJSN effective date, they receive the same benefits package going forward. Older civil servants get to keep the benefits earned prior to SJSN, but they do not continue to participate in those programs afterwards. Under this approach, the government would need to carefully study the total projected retirement benefits for different cohorts of workers to ensure there are no unintended significant benefit cutbacks for some groups of workers, particularly those who are currently close to retirement age.

Table 16 briefly summarizes the impact of these three options on current and future civil servants.

Table 16: Civil Servant Program Restructuring Options Summary

	Current Benefits Package		Future Benefits Package	
	Current Workers	Future Workers	Current Workers	Future Workers
Option 1	x	x	x	x
Option 2	x			x
Option 3			x	x

Source: Author

D. Restructuring Benefits for Formal Sector Workers

The introduction of SJSN should be a positive factor for private sector workers.

- Workers will receive a pension benefit that they did not previously have.
- The old-age savings program is unlikely to have a lower contribution rate than the 5.7% rate under the current system. It is likely to be the same or higher.
- The structure of the administrators will be changed to a trust fund arrangement by October 2009 and in the interim, the legal structure should be changed to eliminate the need for the administrators to pay taxes and/or dividends to the government and to create a fiduciary obligation to members.
- All investment income will be distributed to individual accounts and a more transparent fee structure will be established.

All of these should be significant improvements to the current program.

The main controversy is likely to be over the redesign of the termination pay program. Folding the benefits into SJSN will give workers more benefit security because the benefit will be properly financed. Under the current structure, an employer could declare bankruptcy and benefits might never be received. Some restructuring and benefit reduction in the termination pay program can easily be justified based on the introduction of the SJSN pension program and any enhancements to the old-age savings program. As with the THT program for civil servants, supplementary pension benefits and/or old-age savings contributions can be substituted for the retirement benefits previously paid from the termination pay program. This structure is consistent with the SJSN philosophy and offers an opportunity for diversification of benefit financing between the public and private sector.

Even under this arrangement, it is likely some type of severance pay program will have to remain. The current termination pay program is the only source of unemployment benefits for those who are terminated and have not yet found a new job.

E. Restructuring the Voluntary Pension System

The voluntary pension system (DPPK and DPLK) must also be adjusted to harmonize with the SJSN system and the reformed benefits packages for civil servants and formal sector workers. Key issues that should be addressed as part of the private sector reform include

- *Payout options*. Currently, workers who participate in voluntary defined contribution plans can take up to 20% of their account balance as a lump sum at retirement. The balance must be used to purchase an annuity. In the absence of SJSN, there is a stronger argument for an annuity purchase requirement in voluntary plans, since formal sector workers currently have no pension program and an old-age savings program that permits lump sums. However, after SJSN introduction, formal sector workers will have a pension program and we recommend that at least a portion of the benefits from the SJSN old-age savings program be used to buy an annuity or to pay monthly installments. To the extent the SJSN pension and old-age savings programs provide lifetime benefits, consideration should be given to increasing the percentage that can be taken as a lump sum in the voluntary system. Also, payout options should be enhanced to include monthly withdrawals over an extended time period and other more flexible types of annuities, such as variable annuities and participating (for-profit) annuities.

- *Investment regime*. Currently, the same investment rules apply to both defined benefit and defined contribution programs. The regulations allow a very wide range of investments, and each plan is required to adopt its own investment guidelines. Compared to similar legislation in other developing countries, the Indonesian law and regulations permit far more investment in illiquid assets and allow the investment manager much greater investment discretion. This much discretion may not be appropriate at this stage in the development of Indonesia's asset management industry.

  Basic principles of investing, particularly for individual account plans, are safety, liquidity, diversification, and maximizing investment income. This means only high-quality assets should be purchased and it should be possible to buy and sell the assets quickly with a small bid-ask spread. This means illiquid assets, such as property, privately negotiated loans, non-exchange traded securities, and collectibles, should be a very small portion of total assets or should be completely prohibited. Only securities traded on an organized exchange should be permitted.

  Assets should also be diversified as much as possible among different asset classes, types of securities, and among different geographic regions, industries, companies, currencies, etc. The goal is to invest in assets that are negatively correlated with each other so that all assets do not tend to go up or down in tandem in response to macroeconomic changes. Assets should also be selected to maximize expected rate of return while limiting risk to an acceptable level.

  The current investment rules for voluntary pension schemes will not necessarily result in portfolios meeting these criteria. Up to 30% of total assets can be invested in illiquid instruments, overseas investments are prohibited, and there are virtually no limits on the percentage of assets that can be invested in other asset classes. These investment rules should be changed to impose additional portfolio limits, permit foreign investment, and reduce the percentage in illiquid assets. A time period should be specified to bring portfolios into conformity with the new rules.

- *Tax regime.* In a country with relatively high personal income tax rates and a progressive tax structure, voluntary pension programs are unlikely to flourish without tax concessions. The general taxation principle is that long-term savings programs with strict limits on withdrawals prior to retirement should receive favorable tax treatment, while savings that can be withdrawn at any time should have no special tax treatment.

  In theory, the voluntary pension system has an EET tax structure. This means contributions to the voluntary pension system are exempt (E) from tax, investment income in the pension fund is exempt (E) from tax, and benefits are taxed (T) as received. In reality, however, the scheme does not work that way. Taxes for the self-employed, for example, are based on gross revenue; thus, there is no tax deduction for contributions to a

voluntary pension plan. Certain types of investment income are taxed, whether inside or outside of a pension fund, because the tax and pension laws have not been properly harmonized, and the accumulated account balance in voluntary defined contribution plans is taxed at the time an annuity is purchased rather than at the time the annuity benefits are received even though the annuity purchase is compulsory. The taxation of annuity purchases is also an impediment for defined benefit plans that would like to purchase annuity contracts from an insurance company.

- *Harmonization with other contractual savings instruments.* As financial markets develop, it is inevitable that different financial instruments and types of financial institutions will be used to fund pension benefits. In most countries, pension benefits are funded through pension funds, insurance contracts, mutual funds, and brokerage accounts. The competition and variety of products is healthy for the pension industry. However, it is most important that the same rules apply to all institutions and pension products. Fundamental features, such as contribution limits, permitted investments, tax rules, and available payout options, should be the same for all types of pension products so competition is on a level playing field. The rules must be the same for everyone. Currently, these rules tend to favor mutual funds and insurance contracts over voluntary pension funds. For example, there are various "pension insurance" products that permit lump sum distributions on attainment of a specified age while voluntary pension plans cannot offer this option. Consequently, voluntary defined contribution pension programs are at a competitive disadvantage. This situation should be corrected by defining permitted pension investment vehicles and subjecting all to the same rules. The presence of a non-bank financial institutions (NBFI) regulator should help facilitate this integration of different financial products. Passage of the Financial Services Authority (OJK) laws is an important step for the proper regulation of non-bank financial products and services, though a certain amount of integration should be possible today under the current Bapepam LK.

F. Other Integration Issues – Asset Management and Payout Options

Payout options available at retirement are one area that should receive close scrutiny as part of SJSN implementation. The SJSN pension benefit will be a life annuity. Payments will be made from the moment of retirement until death. This is "longevity insurance", protection against the risk of living too long. The current formal sector old-age savings program financed through PT Jamsostek pays a lump sum at retirement. There is also an option for monthly payments over a period of years, but this option is rarely, if ever, used.

The primary purpose of a pension program is to make sure workers have income from retirement until death. The SJSN pension benefit will be a relatively modest amount; its purpose being to prevent poverty. The SJSN old-age savings program will provide additional income to help workers maintain their standard of living following retirement. Consideration should be given to allowing only a portion of this benefit to be taken as a lump sum. For example, it might be reasonable to allow 50% to be taken as a lump sum and require the rest to be used either to purchase an annuity from an insurance company or to be withdrawn in monthly installments over an extended period to provide life income. This would give workers both a lifetime income and financial flexibility.

As part of this adjustment, the private pension law could also be changed to add the option for withdrawals in monthly installments and other more flexible annuity options, such as variable and participating (for-profit) annuities. Larger lump sums than under the current law could also be permitted to the extent the SJSN pension and old-age savings programs already provide a reasonable level of lifetime income. Indonesian practice is the opposite of standard practice in most of the world where the mandatory old-age savings program generally prohibits lump sums and the voluntary program permits lump sums.

The mix of public and private asset management in the SJSN old-age savings program is another area that should be carefully considered. Currently, civil servants have no old-age savings program and PT Jamsostek manages the assets in the old-age savings program for formal sector workers. Assets in private pension funds (DPPK and DPLK) are invested by the private sector. Throughout the world, different models are used for managing the assets in public mandatory old-age savings programs.

- *Public management*. This is the model used in the current old-age savings program for formal sector workers. All assets are managed by the PT Jamsostek. This is also the model used in Thailand's savings program for government workers and is the dominant asset management model in the provident funds in Malaysia and Singapore.

- *Private asset management*. This is the model used for mandatory old-age savings programs in Hong Kong, Australia, Chile, most of the rest of Latin America, and Eastern Europe. Under this model, private pension companies establish pension funds and workers choose the pension fund they want. The pension company either has investment experts on staff or outsources investment management to private asset management firms. The government is not directly involved in asset management decisions. Rather, the government regulates and supervises the system by establishing investment rules. The rules specify permitted and prohibited investments and limit the amounts that can be invested in different assets classes, in any one company and as a percentage of any one issue of securities. The government monitors compliance on a regular basis and, in many cases, even daily.

- *Public/private partnership*. This is the model that will be used by India's New Pension System (NPS) for government workers. It is also the model used by America's Thrift Savings Plan for government workers; by CALPERS, the pension plan for California's public employees and for many other large public sector pension plans in the United States and Canada. To a minor extent, it is also used by the Malaysian and Singaporean provident funds and Thailand's government pension fund. Under this model, a public entity, such as PT Jamsostek, hires private sector asset managers who are responsible for all investment decisions. However, the basic investment policy, any tender process, and the review and oversight of the actions of the private managers are the responsibility of a public entity. For example, in India's NPS system, workers will have a choice of investing in a pension fund with a conservative, aggressive, or moderate investment policy. Workers will have a choice of three or more pension funds for each type of investment policy. The pension fund managers will be selected by the government through an international tender. In Malaysia and Singapore, the vast majority of the provident fund assets are managed by the government. However, under some circumstances, workers can choose to have a portion of their assets managed by private asset managers. In Thailand's government pension fund, the government has the option (but is not required) to have some portion of plan assets managed by private pension fund managers.

Different models could also be used for different "components" of the old-age savings program. For example, we suggested earlier in this memorandum that it is possible to have a basic SJSN old-age savings contribution and also a supplemental contribution as a partial or total replacement for the existing THT and the retirement portion of the formal sector termination pay programs. The basic portion could be managed by a public institution or through a public/private partnership and the supplemental contributions could be managed by private asset managers selected by workers.

VI. SJSN Implementation Steps and Timeline

The SJSN law describes a new concept for social insurance in Indonesia. It creates five social insurance funds covering the entire Indonesian population. However, for fiscal and administrative reasons, it will take a considerable period of time to fully introduce the new social insurance structure.

Coverage must be gradually expanded in a way that is fiscally affordable. In addition to the legal structure, administrative systems, health care infrastructure, and institutions necessary to manage the SJSN system are not yet in place. Indonesia also needs to change the legal structure of the existing social insurance administrators and improve overall governance to protect the interests of fund members.

The steps required to implement the SJSN law can be divided into two broad categories: (i) changes required regardless of the SJSN law, and (ii) changes that are specifically needed for SJSN implementation. The first step in any pension reform is to fix the current system before making other changes. The four existing administrators (PT Jamsostek, PT Taspen, PT Asabri, and PT Askes) are the foundation of the current system and retain a critical role under SJSN. If these institutions are weak, the current system will continue to function poorly and the new system will not function well either.

Changes needed to improve the current system in the absence of SJSN introduction include

- *Changes in the legal structure of the four administrators*. They should not be *perseros*. It is important to establish an interim legal structure and, ultimately, to have a trust fund approach that allows fund assets to be legally segregated from the assets of the administrators

- *Improvements in the overall governance structure of the administrators, including a more effective regulatory and supervisory structure.* The current regulatory structure involves too many institutions and their responsibilities are not clearly defined. The creation of an independent Bapepam LK and abolition of the *persero* structure will give Indonesia an opportunity to simplify the supervisory and regulatory structure. There should be Memoranda of Understanding that clearly define (i) how the various government institutions will work together and (ii) the responsibilities of each organization.

- *Improvements in the contribution and data collection system.* The current system is not effective. In the formal sector, only 7 million out of 25 million workers are making contributions to the system. Historical records are not accurate. Many individuals have more than one ID and more than one account, and the enforcement procedures are ineffective. The contribution and data collection business processes and the supporting IT systems need significant improvement. If PT Jamsostek cannot properly collect data and contributions from the formal sector, how will it perform the far more complicated task of collecting from the informal sector?

- *Creation of a computer modeling center and the purchase or development of appropriate forecasting models for the social insurance programs.* The Government of Indonesia needs to have sophisticated computer models and professional staff to prepare short- and long-term projections for its existing and future social insurance programs.

Other implementation steps are specifically required to support introduction of the SJSN system. These include

- *Creation of the SJSN Council*. The Council should be the lead policy-making body for the new social insurance system. If the government is serious about SJSN implementation, a critical first step is the establishment of the Council.

- *Determine the role of the existing social insurance administrators.* The SJSN law specifies that the four existing *perseros* will collectively be the social insurance administrators for the new system. However, the SJSN law does not state the role of each institution under the new structure.

- *Design of the benefit programs*. The SJSN law is only a framework law. It requires the establishment of five social insurance funds, but the law does not specify (i) the benefits to be provided by any of the programs, or (ii) the contributions required to finance those programs.

- *Detailed short- and long-term fiscal projections for the five social insurance funds*. The benefits under the SJSN program must be sufficient to provide protection for the population at an affordable cost. For the formal sector, the contribution rates must be low enough to be affordable for workers and employers but high enough to provide meaningful benefits. For the poor and near poor, the fiscal cost to the budget to finance their benefits must be acceptable, and for informal sector workers who are not poor, the required contributions must be affordable. Determining the proper level of benefits and cost is both a technical and a political task, and it will take significant time to reach consensus among stakeholders

- *Drafting of all required government regulations and Presidential decrees*. The government must understand that the drafting of regulations and decrees is the last and easiest step in the design process. The analysis and decisions regarding legal structure, governance, regulation, benefit design, and fiscal cost must all be completed first. The decrees and regulations are merely final documentation of the decisions reached during the analysis period. Creating artificial deadlines for drafting legal documents will not speed up the decision process and instead will focus attention on the wrong issues.

- *Major public education program to explain the reformed social insurance structure*. Many different groups need to understand the benefits and administrative structure of the new system. Employers need to understand changes in contribution payment procedures and data reporting. Employees need to understand the benefits and costs of the new programs and how to enforce their rights. Journalists need to understand the new system so they can provide accurate information to the public. Government officials and institutions need to understand their roles in managing the new system. All of this requires a well-planned public education effort.

Improvement to the existing system and SJSN implementation can be thought of in two different ways—

by type of activity and by time frame. We envision the following three time frames, each with its own focus:

- *Short-term*. The activities in this phase are those primarily related to SJSN program design and changes in the legal and governance structure. These activities will require 1–2 years and the end result should be a series of government regulations and decrees that clearly define the benefits, required contributions, legal structure, and governance of the new system. Even if SJSN is never implemented, the legal and governance changes should be made to improve the functioning of the four administrators.

- *Medium-term*. These activities will take place over the next 2–3 years, with the primary focus on institutional development, capacity building, and construction of new administrative systems. The method of collecting and storing contributions and data will need to be significantly redesigned. A regulatory agency will have to oversee the activities of the four administrators and an off-site supervision system will need to be developed to help the regulator gather and analyze data from the administrators on a regular basis. An efficient modeling unit will be required to prepare actuarial reports, financial projections, and analysis of proposed changes to the system. All of these changes are necessary to improve current system operations even if SJSN is never implemented.

- *Long-term.* These are activities that will probably occur more than 3 years from now. The expansion of the SJSN social insurance funds to the entire population will have to be managed in a way that is fiscally affordable. Expansion of the health program will also have to be coordinated with the development of health infrastructure and with the expansion in the number of clinics, primary care providers, and specialists.

Another way to think about the implementation is by type of activity. There are six primary areas that must be addressed in the implementation process.

- *Legal and governance*. Key activities include appointment of the Social Security Council, interim and final legal structure of the four administrators, appointment of regulators, improvement in the enforcement power of regulators and administrators, and drafting of Memoranda of Understanding clearly outlining the responsibilities for system oversight among the various government institutions.

- *Program design*. The most fundamental element is to specify the benefits and required contributions for each of the five social insurance funds. Decisions must also be made regarding integration of the SJSN program with the existing pension programs for civil servants and the severance pay program under Labor Law #13 for formal sector workers. Contributions must be separately specified for the formal sector (as a percentage of wages) and for the informal sector (nominal amount in rupiah).

- *Institutional strengthening and capacity building*. The four administrators need to make significant improvements in their contribution and data collection, investment management procedures and processes, reporting and disclosure procedures, customer service and communication, and overall operational efficiency. A modeling capability must be established in the government or private sector and that unit must prepare regular actuarial analysis of the social insurance programs and analysis of any proposed changes to the programs.

- *Regulatory framework*. The Social Security Council is a policy-making body, but it does not have the staff or expertise to regulate the technical activities of the four administrators. This task needs to be delegated to institutions with the expertise to manage these programs. For most programs, the logical institution is Bapepam LK. The pension directorate has experience of supervising and regulating private sector defined contribution and defined benefit plans. The insurance directorate of Bapepam LK has the expertise to oversee the death grant and workers compensation programs. The Ministry of Health is the logical institution to oversee and regulate the national health insurance program and the activities of the administrators in this area.

- *Administrative systems*. In order to collect contributions from Indonesia's entire formal and informal sector workforce, the contribution and data collection systems and procedures will have to be significantly improved. Unique identification numbers must be assigned and an accurate database for storing historical personified information will be needed. The entire process must be automated so all information

is submitted and verified electronically. Standardized software is needed for employer monthly reporting. This software must have built-in validation procedures to eliminate many types of reporting errors and inconsistencies. The regulatory agencies must receive information from the administrators regularly and must have computer systems to search for and identify potential operational and compliance issues. The government will be unable to efficiently manage and regulate the SJSN system without significant upgrades in administrative systems and a focus on off-site supervision.

- *Public education*. Any major change in government-sponsored programs must be communicated to a wide array of audiences. The public must understand the new benefits they are entitled to and how to access those benefits and enforce their rights. Employers must understand their obligations and how to submit information under the upgraded administrative structure. They must also be able to respond to questions from their workers. Workers must understand how to use the new system to get the benefits to which they are entitled. Government institutions must clearly understand their roles under the new system and how those responsibilities are allocated and coordinated among various institutions. Journalists must be educated so they can provide accurate information to the public and give a positive image to the new system.

The SJSN implementation road map shown on the next few pages combines both of these perspectives into a single chart organized by type of activity and also by time frame. It also identifies those activities that are needed to improve the current system and those that are needed specifically for SJSN implementation.

VII. Conclusion

SJSN is a progressive law providing the entire Indonesian population with social protection through social insurance funds. It is one of the most complex projects the government is ever likely to undertake and will have a significant impact on every Indonesian. It will also affect a wide range of government ministries and institutions and will create significant coordination challenges.

The government will need the discipline to maintain the required level of effort for full implementation over a period of many years and many political cycles. Members of all political parties need to be committed to the new social insurance system to assure continued support for the implementation effort. It is well worth the time it takes to involve all stakeholders and build maximum possible consensus on how to move forward.

We offer the following observations and advice to the government as it undertakes this project:

- The government needs to start with an initial system design phase of 1–2 years, during which the SJSN program design and the initial changes in the legal and governance structure will be prepared. By the end of this phase, the benefits, required contributions, legal structure, and governance of the new system should be clearly defined in a series of government regulations. The preparation of the regulations should be the last step in the system design phase.
- The first step in any kind of pension reform is to fix the existing system. The four perseros will be the foundation of the SJSN system, and it is important to improve their legal and governance structure, administrative efficiency, and government regulation and oversight. In particular, the legal structure needs to be changed so the administrators are not-for-profit, with no dividends or corporate taxes payable to the government. Participant assets in the pension and old-age savings components also need to be legally separated from the administrators' assets. The governance structure of the SJSN system and the individual programs must clearly separate the policy, management, and oversight functions and must have clear accountability and transparency. The employer and worker registration process and the contribution and data collection and enforcement processes must be improved so that everyone who is required to participate makes contributions on the proper salary. These changes should be made regardless of whether or how quickly SJSN is introduced.
- The SJSN implementation project will not be successful without support from the highest levels of government. The reform needs a champion to lead the effort on a day-to-day basis and clear support from the office of the President to give it needed political support and urgency. The SJSN program

Table 17: Proposed Road Map for Social Insurance Reform in Indonesia

	Phase I (1–2 years)	Phase II (2–3 years)	Phase III (3+ years)
	Pension System Design	**Administrative System Implementation and Capacity Building**	**System Expansion**
I. Legal Framework and Governance	Current System • Decide on interim legal structure of perseros • Develop strategy for improving enforcement of registration and contribution payment requirements • Review of laws related to electronic signatures and legality of electronically submitted information SJSN System • Role of existing social insurance administrators and the Council • Decide if any amendments to SJSN are required • Finalize appointment of Council members	Current System • Reform asset management process to improve governance and assure decisions are made based in best interests of members. Need separation of management and oversight responsibilities • Implement changes to governance procedures to assure transparency, accountability and proper division of responsibilities for policy, day-to-day management and oversight • Draft all required regulations changing the interim legal structure of perseros to make the administrators not-for-profit and eliminate dividends to the government • Implement strategy for effective enforcement of contribution payments requirement SJSN System • Prepare key regulations for implementation of SJSN system • Change regulations and decrees governing PT Taspen to improve efficiency and clarity	Current System • Draft trust fund and other laws and change legal form of social insurance administrators SJSN System • Final legal structure of Social Security Organizing Body
II. Program Design	SJSN System • Options for benefits and contributions for pensions and old-age savings • Finalize health benefits package • Definition of "poor and financially disabled" • SJSN transition strategy for civil servants and military • SJSN integration with severance pay program	SJSN and Current System • Benefits, contributions, and retirement age for pensions and old-age savings • Contracting negotiations with regional health insurance provider associations • Develop computer systems and methods for measurement of outcomes, performance, and efficiency for health institutions and providers • Develop plan for health infrastructure expansion	SJSN and Current System • Expand access to health care by constructing needed clinics, hospitals, laboratories • Implement strategy for assuring sufficient supply of primary care physicians and specialists • Continue to expand SJSN system coverage based on fiscal sustainability
III. Institutional Strengthening and Capacity Building	Current System • Plan for development of modeling capability for social insurance programs within the Government of Indonesia or in an external research or academic institution	Current System • Select and staff organization responsible for financial modeling. • Conduct tender to purchase computer model. Train appropriate personnel in use of model	Current System • Prepare regular annual actuarial reports on the social insurance system • Periodic outside audits and performance evaluation of social insurance administrators

Table 17: Road Map for Social Insurance Reform in Indonesia

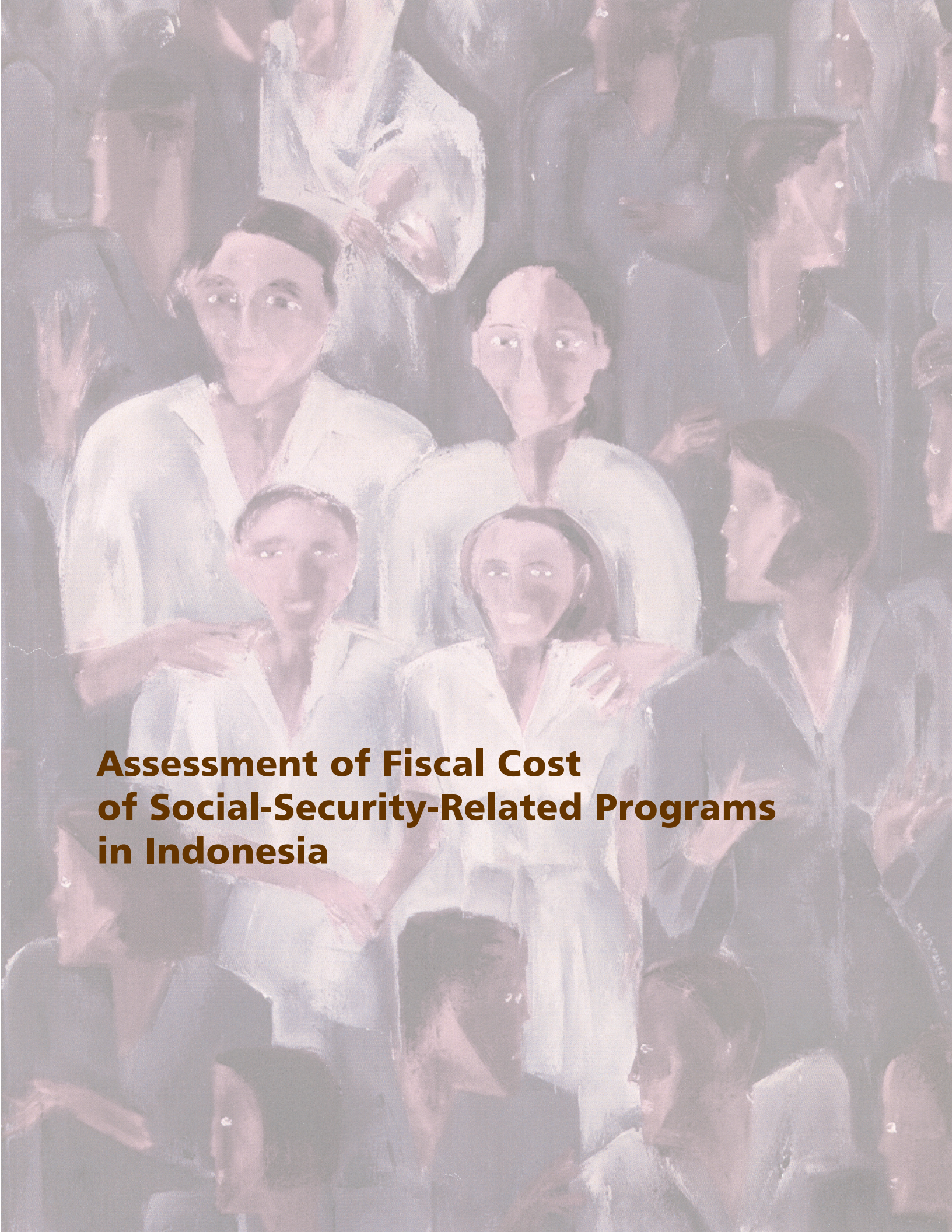
	Phase I (1–2 years)	Phase II (2–3 years)	Phase III (3+ years)
	Pension System Design	**Administrative System Implementation and Capacity Building**	**System Expansion**
III. Institutional Strengthening and Capacity Building	Current System • Strategy for reform of PT Jamsostek and PT Taspen to improve efficiency, member service, and asset management process	Current System • Implement changes in PT Jamsostek and PT Taspen to improve administrative efficiency and customer service, investment policy and process, oversight role of Board of Commissioners, compliance improvement	
IV. Regulatory Framework	Current and SJSN System • Strategy for simplified supervision and regulation, including role of Bapepam LK • Clear separation of policy-making and oversight responsibility	Current and SJSN System • Draft required regulations relating to pension accounting, asset valuation, reporting and disclosure • Memoranda of Understanding among government agencies clarifying precise role of each organization in the regulation of social insurance system	Current and SJSN System • Final supervision and regulatory structure
V. Administrative Systems and Procedures	Current System • Strategy for issuance of unique ID numbers to all Indonesians • Strategy for improvement and automation of contribution and data collection process SJSN System • Decision whether collection will be centralized with a single institution	Current System • Assignment of unique ID numbers to all Indonesians • Registration of all employers and workers • Development of standardized software for employer submission of electronic data • Business processes for collection and reconciliation of contributions and data • Creation of personified electronic database of wages and contributions history SJSN System • Track eligibility for government contributions subsidy, refine criteria as necessary to assure benefits go to intended recipients	Current System • Distribute software for standardized electronic data reporting. Train employers and accountants in use of software • Implement reformed contribution and data collection paradigm
VI. Public Education and Training	SJSN System • Strategy for educating public, workers, employers, journalists, Parliament, etc. about SJSN programs	SJSN System • Implement public education strategy o Publications o Study tours o Seminars o Town hall meetings o TV and radio infomercials, etc.	SJSN System • Evaluate results of public education programs • Modify and continue programs on an ongoing basis

Source: Author's proposals

will impact the life of every Indonesian and will cut across multiple Ministries with naturally conflicting interests. It will take considerable political will to involve and reconcile the interests of all stakeholders in the design and implementation process.

- The initial steps to be taken should include the (i) appointment of a coordinator in the Ministry of Finance (MOF), a major stakeholder, since the budget will finance benefits for the poor; (ii) creation of the SJSN Council, the organization that is supposed to set policy and lead the implementation effort; and (iii) creation of computer modeling capability and an office of the actuary within the government or in an outside research or academic institution. The government must have the ability to model the short- and long-term fiscal impact of proposed benefits under the SJSN system.
- The SJSN legislation creates two areas of cost for the State budget. The government is obligated to pay social insurance contributions to all five social insurance funds for the poor and financially disabled citizens. In addition, the government is required to make contributions under SJSN in its role as an employer. The introduction of SJSN will also require the government to review all of Indonesia's existing pension arrangements—civil servant benefits, formal sector benefits, and voluntary pension savings programs—and integrate them with the benefits provided by SJSN. The introduction of SJSN is a great opportunity for the government to consolidate and harmonize all of the country's pension and savings programs and create a true multipillar system for Indonesian workers.
- Once the government has decided on a range of possible options for integrating SJSN and other pension schemes, it will need to prepare detailed analysis for each option. This should include projections of benefits under the current and proposed schemes for different cohorts of workers, and the short- and long-term fiscal costs of each option. The impact of any change will probably vary with the current age and pay level of workers. It is important to understand who will win and who will lose under any proposed changes and consider ways of easing the burden of changes, particularly for workers who are close to retirement.

We look forward to assisting the government with any and all aspects of the SJSN implementation process.



Assessment of Fiscal Cost of Social-Security-Related Programs in Indonesia

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I. Introduction

The Government of Indonesia faces a challenging period in reforming its national social security system. Currently, social security protection is provided through a series of programs and initiatives that have developed separately from each other. The 1997 Asian financial crisis revealed the weaknesses of the existing system, leaving a large part of the population unprotected and providing only limited protection to those who were covered.

In response to the crisis, reforms have been introduced to be better prepared in the future. In 2002, the Government of Indonesia amended the Constitution extending social security to the entire population.[1] Subsequently, a national Task Force was established under Presidential Decree No. 22 of 2002 to design a social security system that would provide sufficient protection to the entire population. On 19 October 2004, the National Social Security System (Sistem Jaminan Sosial Nasional/SJSN) Law No. 40/2004, which calls for the establishment of a comprehensive national social security system, was enacted.

There are, however, concerns about the scope, content, and direction of the SJSN Law. The law is very general, with critical details on the program mode, implementation, and the associated costs left to implementing regulations to be passed at some future date. Cost escalations for the employers or the fiscal costs of coverage expansion were not considered. Actuarial analysis for possible schemes and their projected costs has not been done. In anticipation of more detailed modeling, an initial assessment of the fiscal implications of the existing social security system is prepared, to support the debate on the future reform of social security in Indonesia.

II. Update of Indonesia's Economic Situation

The Indonesian economy is steadily recovering from the slump following the Asian financial crisis. In 2005, economic growth reached a 9-year high of 5.6%. At the same time, the overall budget deficit declined from 4% in 1999 to 0.5% and the outstanding debt from over 100% to 46.2% of gross domestic product (GDP). A major concern, however, is that the gradual post-crisis recovery has largely been consumption-driven, without significant impact on either investment or job creation.[2]

Since 2000, the labor force has expanded by an average of 1.5% per year, or about 1.5 million new entrants each year. Total employment grew by an average of 1% per year. As a consequence of slow employment creation, open unemployment has steadily increased from an average rate of 4% in the 1990s to 7.7% by 2006. Within the same period, formal wage employment (defined as regular and casual wage employment) expanded by 0.8% per year with regular wage employment actually declining by 0.7% per year. In contrast, informal wage employment (including self-employed workers, casual wageworkers in the nonagriculture sector, and unpaid family workers) has expanded by an average 1.9% per year.[3]

In 2005, Indonesia had a workforce of 105.8 million, of which 94.9 million were employed and 10.3 million were looking for work. Based on the above definitions, 25.7 million were in formal wage employment and 66.1 million in informal wage employment. In addition, employers totaled 3 million.

The revised central government budget for 2006 (Table 1) recorded a deficit of about 1.3% of GDP. State revenues reached 654.9 trillion Indonesian rupiah (Rp), with state expenditures recorded at Rp699.1 trillion, producing a Rp40 trillion deficit. Two thirds of revenue income came from taxation. The tax ratio is equal to 13.6% of GDP, as

Table 1: Revised Central Government Budget, 2006

	Trillion Rp	Expenditure	Trillion Rp
A. Domestic Receipt	654.9	A. Central Government	478.2
1. Tax	425.1	1. Personnel expenditure	79.1
2. Nontax	229.8	2. Material expenditure	56.0
B. Grant	4.2	3. Capital expenditure	69.8
		4. Interest payment on debt	82.5
Deficit	40.0	5. Subsidy	107.6
% of GDP	1.3	i. Fuel subsidy	64.2
		ii. Nonfuel subsidy	43.4
		6. Social	41.0
		7. Other expenditures	42.3
		B. For Regions	220.8
Total	**699.1**	**Total**	**699.1**

GDP = gross domestic product, Rp = Indonesian rupiah, % = percent.
Source: Indonesian Ministry of Finance. 2007.

[1] The 1945 Constitution (Second Amendment) Article 28H, Subsection 3, states: "Every person shall have the right to social security to develop oneself as a dignified human being;" and Article 34, Subsection 2, states: "The state shall develop a social security system for all the people and shall empower the vulnerable and poor people in accordance with human dignity."

[2] Asian Development Bank (ADB). 2006. Country Strategy and Program. Indonesia 2006–09. Jakarta.

[3] ADB. 2007. Indonesia: Labor Market Policies and Employment. Manila.

targeted in the planned budget. Nontax revenues, mainly coming from oil and gas, were on target despite lower than expected lifting of oil and the appreciation of the rupiah that diminished nontax revenues from the oil and gas industry.[4]

III. Overview of Existing Social-Security-Related Programs

Providing social security is a shared responsibility between the state, employers, individuals, and families. In Indonesia, as in most other Asian countries, people greatly rely on the extended family and the communities to provide support in case of illness, loss of income, or other unforeseen events. About two thirds of the population, working in the informal sector, relies almost entirely on these informal mechanisms. In the private sector, employees largely rely on employer's liability provisions and, to a lesser extent, on social insurance programs, organized on a public and/or private basis. The nature of the social security system for the public sector differs considerably from that of the private sector. Public servants can fall back on an integrated package of conditions of service and social benefits, while private sector workers receive only very limited protection. The Government runs large subsidy programs to provide access to energy, food, health services, and education for all. In 2005, the Government reduced the fuel subsidies and used part of the freed-up resources to finance targeted programs, the Compensation for Fuel Subsidy Reductions Programs (PKPS-BBM/Program Kompensasi Pengurangan Subsidi Bakar Minyak), with components on health care, education, and rural infrastructure programs for the poor and near poor (Table 2).

Table 2: Existing Social-Security-Related Programs

	Formal wage employment		Informal wage employment	
	Public sector	Private sector	Non-poor	Poor and near-poor
Health	x	x		x
Pensions (monthly)	x			
Old-age (lump sum)	x	x		
Labor law (severance)		x		
Other programs	x	x		

x: these programs are covered under the pension program
Source: Indonesian laws, Jamsostek, Askes, Taspen

[4] Bank Indonesia. 2007. Press Statement: Revised 2006 Budget Outcome on Target. Jakarta.

A. Health Insurance

The existing health-care programs in Indonesia have some elements of a three-tiered health insurance system. Under the first, basic tier, the Ministry of Health and the provincial authorities (since the introduction of the Decentralization Law) run public health-care systems for the uninsured. In addition, the Government is funding the health program for the 60 million poorest Indonesians through the Askeskin program.

Under the second tier, social health insurance is provided through PT Askes and PT Jamsostek.

- Askes is a compulsory health insurance scheme for active and retired civil servants, retired military and police officers, veterans and national patriots, and their families. It is also available as a commercial health insurance product on a voluntary basis to employees of state-owned enterprises and private corporations;
- Jamsostek is the social security scheme for private sector workers and includes a health component. It provides health insurance for some formal sector workers. Coverage is limited because of an opt-out provision for private sector employers that purchase private health insurance providing better benefits, and because of evasion.

The third tier covers the private health insurances, provided through private insurance companies, and other initiatives, such as the Community Health Maintenance Protection Program (JPKM/Jaminan Pemeliharaan Kesehatan Masyarakat), and village health funds.

1. Health Insurance for the Poor and Near-Poor

Indonesia has had a series of targeted health insurance programs since the mid-1990s, starting with the health card (kartu sehat) program in 1994. The program ended in 1998, and was replaced by social safety net programs (JPS/jaringan pengaman social), with one program providing subsidized health services by giving block grants to health providers through district post offices in a way that was proportional to the number of poor families residing in an area. In 2005, this program was converted into the Askeskin health-care program, a health insurance program for low-income people. The program now provides: (i) free-of-charge health-care services at Puskesmas (public health centers) and (ii) inpatient treatment in third-class hospital beds for the poor. The program is run by PT Askes, which distributes individual health cards to the poor, and

reimburses hospitals and Puskesmas for their services on a fee-for-service basis. The program targets 60 million people and is budgeted at Rp5,000 per capita per month. The allocation is considered insufficient to finance the program. Early assessments point to improving the design of this program in numerous areas, such as the targeting of the program, the quality of service delivery, and the selection of the provider.[5]

2. Health Insurance for Formal Wage Employment (Government and Private Sector)

Under the Askes program, civil servants are entitled to a comprehensive package of benefits, including both outpatient and inpatient services. The benefits are provided through a provider network that mainly consists of public health centers and public hospitals. PT Askes pays the providers using prospective payments, mostly on per-case and per-day basis. The insured persons share between 30% and 60% of the health-care costs. In general, members are satisfied with the provided services. For catastrophic medical care, almost all members use the services. Nevertheless, Askes has a problem with the perceived poor quality of health services. In addition, coverage is only provided for two children per family. Those who can afford it prefer to look for services outside the network and pay out-of-pocket. More than two thirds of the beneficiaries used their insurance for inpatient care, while slightly less then half of the beneficiaries use their insurance for outpatient care.[6]

Under the Jamsostek program, the insured members and their families (up to three children) are entitled to a basic health-care package (JPK/Jaminan Pemeliharaan Kesehatan). PT Jamsostek is contracting the providers directly with few exceptions. Several regions contract outpatient services to private providers only, while others use a mix of public and private providers. Several regions use public health centers as primary health-care providers resulting in poor quality perception by the members. Given the limitation of benefits and the restricted choice of providers, many employers believe that joining the scheme is not worthwhile. Although health insurance is compulsory under Jamsostek, self-insured persons and employers that purchased more generous health packages than the one provided by Jamsostek may possibly opt out. The opt-out provision has resulted in adverse selection to Jamsostek. Workers with higher salaries obtain health coverage from private health insurance while those with low salaries choose to join Jamsostek.

3. Coverage

Health insurance coverage is still very low. Only about 15–16% of the population is insured against health hazards. About half of the insured Indonesians (around 7% of the total population) are covered under Askes, covering about 13.8 million members comprising about 4.5 million employees and 9.3 million dependents. Jamsostek covers about 1.3% of the population (of a potential 40–50% of the population in case the Jamsostek law were to be implemented consistently).[7] Only small employers enroll their employees in Jamsostek, while larger employers opt out and another 75% are evading all social insurance schemes completely. About 7–8% of the insured opted out from Jamsostek and are covered under private health insurance. In September 2005, Askes covered 60 million poor and near-poor people, or 30% of the population under the Askeskin health-care scheme.[8] There is a huge gap of uncovered workers in the middle.

B. Pensions

No unified program provides pensions for Indonesian citizens. Instead, several schemes provide monthly pensions and lump-sum benefits to various segments of the working population. Civil servants receive the most complete protection with access to a defined benefit scheme, where a monthly retirement payment is calculated based on a prescribed formula. In addition, the public servants receive another, partially funded defined-benefit old-age payment that provides them with a lump sum upon leaving government service. The private sector workers are only covered by a compulsory defined-contribution savings scheme, in which the periodic contribution is prescribed and the benefit depends on the contributions paid plus the declared rate of investment return. The benefit is paid out in a one-off payment (lump sum). A small fraction of the private sector workers are contributing to a private pension voluntarily. The voluntary programs can be either defined benefit or defined contribution. The vast majority of Indonesians have no pension provisions at all, and rely on the extended family for support in old age.

[5] World Bank. 2006. Making the New Indonesia Work for the Poor. Jakarta.

[6] Thabrany, H., et al. 2003. Social Health Insurance: Current Status and the Plan for National Health Insurance. Presented during Social Health Insurance Workshop, WHO SEARO, New Delhi, 13–15 March.

[7] Legislation mandates that all employers, regardless of the legal status of the entities, who employ 10 or more workers, or who pay more than Rp 1 million a month on salaries, register with *Jamsostek*. If this law were enforced and no opt-out option were possible, the health insurance coverage could increase up to 100 million people.

[8] Coordinating Ministry of People's Welfare and Ministry of Health. 2005. *Social Health Insurance Development as an Integral Part of the National Health Policy: Recent Reform in Indonesian Health Insurance System*. Paper presented in Berlin.

1. Pension (Monthly Payment)

Under the Taspen scheme, the standard retirement age varies from 56 to 60 depending on position. However, a civil servant who reaches age 50 with at least 20 years of government service can retire early. Pensioners receive a basic pension payable for life equal to 2.5% of the last basic salary for each year of service. The benefit is also indexed to increases in wages following retirement. In case of disability, civil servants are entitled to 75% of the last basic salary, given that they have at least 4 years of service. A civil servant's beneficiaries are entitled to a basic pension of 72% of the last basic salary if the cause of death is work-related; otherwise, the benefit is equal to 36% of the last basic salary. In addition to the basic pension, a number of allowances are paid. Some allowances are expressed as a percentage of the basic pension, others as monetary amounts. These allowances provide two thirds of the total payments made. Pensions for civil servants are generous and reach up to 80% of pre-retirement earnings.[9]

2. Old-Age Benefit (Lump Sum)

Under the Taspen pension scheme for civil servants, a lump sum is paid to employees who leave government service, or to survivors of employees who die before reaching the pensionable age. This amount is determined by the length of service, the final salary, and a factor determined by the Minister of Finance, currently set at 0.6. After a career of 30 years, the lump sum is equal to 18 months of salary.

The Jamsostek old-age program (JHT/Jaminan Hari Tua) for private sector workers is a provident fund where the members get the contributions and declared interest refunded in a lump sum under certain conditions. The conditions for withdrawal are: (i) retirement at the age of 55 years, (ii) total and permanent disability, (iii) death of the employee before retirement age, and (iv) unemployment for 6 months provided the employee has contributed for at least 5 years.

The level of the old-age benefit is not sufficient for adequate economic protection for life after retirement. In 2000, the average old-age benefit at age 55 was Rp2.1 million, or 5.5 month's average contributory salary, equal to 8.5 months of minimum wage.[10] Even for those who participate in the program for many years, the projected retirement benefit is very small relative to the final earnings. In 2000, the finding was that low contribution requirements, liberal withdrawal provisions, high costs, below-market investment earnings, and taxes and dividends payable by PT Jamsostek to the Government all contribute to this problem.[11] PT Jamsostek is a for-profit state-owned enterprise (persero) and pays corporate taxes and dividends to its shareholder (the Government). An analysis of PT Jamsostek's financial statements shows that only 71.4% and 66.1% of investment earnings were actually credited to participant accounts in 2004 and 2005, respectively. The remainder was retained by PT Jamsostek for administrative expenses, taxes and dividends, and retained earnings. The JHT scheme cannot really be called a pension. It is more of a compulsory savings program where resources can be withdrawn prior to retirement. In addition, it is paid as a lump sum, providing close to no old-age protection, as benefits are so low and are not paid as an annuity.

3. Private Pension Plans

Either the employer (DPPK/Dana Pensiun Pencari Kerja) or financial institutions (DPLK/Dana Pensiun Lembaga Keuangan) organize voluntary private pensions. These can be a defined benefit or defined contribution program. The maximum limit for a defined benefit program is 2.5% of the salary per year of service and an overall maximum of 80%. In case of a defined contribution program, the contributions cannot be higher than 20% of the employee's salary, with the employee's contribution not exceeding 7.5%.

The employer pension funds are the most popular form of private pension saving. The vast majority of these plans (88%) are defined benefit schemes, while all financial institution pension plans are defined contribution schemes. While the legislation governing private pension funds is a modern approach to providing retirement benefits, it cannot realistically be seen as the basis for adequate protection for the vast majority of workers in the private sector.

4. Coverage

Pension coverage is still very limited. Currently, about 12% of the total population has some kind of old-age protection. All civil servants are entitled to a monthly pension and a lump-sum benefit upon retirement. About one fourth of the formal private sector workers are paying into the Jamsostek provident fund program, and are entitled to a lump-sum payment upon retirement. About 6% of the formal private sector workers pay voluntarily into private pension schemes.

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[9] ADB. 2000. *Final Report. Reform of Pension and Provident Funds in Indonesia*. TA 3116-INO. Manila.

[10] International Labour Organization (ILO). 2002. *Social Security and Coverage for All. Restructuring Social Security Scheme in Indonesia – Issues and Options*. Jakarta.

[11] ADB. 2000. *Final Report. Reform of Pension and Provident Funds in Indonesia*. TA 3116-INO. Manila.

C. Employer-Liability or Statutory Provisions

A range of statutory provisions were established under the Labor Law No. 13, enacted in 2003. These impose an obligation directly on employers to meet prescribed working conditions and to provide prescribed benefits to employees. In principle, all private sector workers, about one third of the total workforce, are entitled to a severance pay upon terminating employment.

1. Severance Pay

Upon termination of employment, regardless of the reason, the employer is obliged to provide a severance payment in the form of a lump sum to the employees. Severance pay regulation has been an integral part of Indonesia's labor policies for a long time. Depending on the cause of separation, a distinction is made in the rights to severance and rates of severance and long service payments. Different coverage is mandated for quits and dismissals. The latter category differentiates between dismissals for economic reasons (including downsizing and bankruptcy), minor violations of company regulations, or, lastly, major violations or offenses.

Labor Law No. 13 increased the mandatory severance pay considerably compared to previous labor legislation. A study on employment protection legislation found that the cumulative changes since 1996 have doubled the cost of severance benefits and made Indonesia one of the most expensive countries in the region in that respect.[12] An employee who has worked for 4 years in Indonesia is entitled to a severance pay equal to 12 months salary (10 months of severance pay and 2 months of long service pay). In Thailand, the severance pay for a similar period of work is 6 months of salary. In Singapore, it is 4 months of salary, and in Malaysia, 2 months of salary.[13]

The purpose of severance pay is to improve job and income security for workers in the formal sector by making it difficult and expensive for employers to dismiss workers. Severance pay also provides workers a social safety net during the first months after they are laid off. However, the increases in severance pay since 1996 have gone beyond providing a social safety net for workers during periods of joblessness. The severance pay has become the main form of retirement-income support for formal sector workers, providing for unemployment-type benefits during economically active periods and lump-sum payments upon retirement.

2. Sickness and Maternity Benefits

Based on the Law on Manpower Affairs No. 25, enacted in 1997, the employer will pay the employees in case of absence because of sickness, 100% of pay for the first 3 months, 75% for the next 3 months, 50% for the next 3 months, and 25% for the next 3 months. Employees cannot be terminated because of sickness unless they have been absent for at least 12 months.

Based on Act No. 1 of 1951 and Government Regulation No. 4 of 1951, the employer will pay the employee, in case of pregnancy or childbirth, 100% of pay for 3 months with an additional 3 months, subject to medical certification. Employers are prohibited from terminating the employment of female employees because of pregnancy or childbirth.

3. Comments

Earlier this year the Coordinating Ministry of Economic Affairs started a series of measures to improve the investment climate. One of the planned measures is the amendment of Labor Law No 13/2003. The Government would like to make labor legislation more flexible and drastically reduce the severance pay to make the Indonesian labor market more attractive for investors. For employers, the revision of the labor law is vital to provide a more stable labor system that would lead to more jobs from the expected inflow of labor-intensive investment. Labor leaders believe that while Indonesian severance payouts are high compared to elsewhere, most other countries have adequate social security cover, which is not the case for Indonesia.

Severance pay and the Jamsostek old-age savings benefit are highly similar. Both provide protection in case of retirement and unemployment. Both, however, have the same deficiencies. They provide lump-sum payments, which are often consumed early on and do not provide any form of financial security in retirement. Both programs should be revised together to avoid duplication and to find a balance between labor market flexibility, job protection, and old-age protection.

D. Other Social Security Programs

PT Jamsostek is managing two additional, compulsory schemes: the employment injury scheme (JKK/Jaminan Kecelakaan Kerja) and the death grant scheme (JKM/ Jaminan Kematian) for private sector workers.

1. Employment Injury Benefits

Employment injury is defined as an "accident arising out of and in the course of employment, including diseases

[12] Universitas Padjajaran. 2004. *Indonesia's Employment Protection Legislation: Swimming Against the Tide*. Jakarta.

[13] Asher, M., and Muhkopadhaya P. 2004. *Severance Pay in Selected Asian Countries*: A Survey. Singapore.

arising out of employment and accidents on the way from the residence to the place of work and back to residence." Based on this definition, employment injury includes three separate elements: accident at work, occupational disease arising out of employment, and accidents that occur while traveling to work following the usual route.

The reimbursements include the cost of transportation (with a maximum of Rp400,000), the cost of medical examination, treatment and/or hospital care (with a maximum of Rp8 million), and the cost of rehabilitation (purchase of artificial limbs and other devices are reimbursed once). The victim of employment injury is entitled to cash payments which consist of:

- a temporary disability allowance, paid for a maximum period of 12 months, of which the first 4 months are paid at 100% of the monthly wage, the next 4 months at 75%, and the last 4 at 50%;
- a permanent disability allowance is paid in case of partial and total disability, the maximum rate of permanent total disability set at 70% of 70 monthly wages, and a monthly benefit of Rp25,000 for 24 months; and
- a death allowance, paid to the widow(er) or other relatives of the deceased employee in the event of an employment injury, which is equivalent to 60% of 70 monthly wages, and a monthly benefit of Rp25,000 for 24 months.

There is considerable anecdotal evidence supported by inference of statistics that employment accidents are underreported and that claims are not made in respect of entitlement. As a result, the protection provided is limited to a small proportion of the labor force and is seen as irrelevant to the needs of the injured employees and their dependents.

Employment injury provisions for civil servants are included in the Taspen scheme. The scheme provides for a disability pension equal to 75% of the last basic pension payable for life, subject to the condition that the member has at least 4 years of service, and an increased pension to the survivors in case the death of the public servant is work related. The surviving spouse and children are entitled to 72% of the last basic salary. In addition, they are entitled to a lump-sum payment under the old-age savings program.

2. Death Grant

The death grant for the private sector covered by the Jamsostek program is paid as a lump sum to the relatives of a deceased employee irrespective of the cause of death. The death must occur while the worker is in active employment. The amount paid is a flat rate equal to Rp3 million. In addition, a funeral grant, equal to Rp600,000 is given to the family.

The death grant for the public sector in the Taspen program is covered by the THT program and is equal to 16.5 months of salary in the event of death in-service of the civil servants and members of the armed forces.

IV. Cost of Existing Social-Security-Related Programs

A. Share of Labor Cost

1. Private Sector

A considerable share of the labor cost goes to the financing of a number of compulsory and voluntary social security-related programs. According to the Indonesian Employers Association, employers pay between 21 and 27% of the total cost of employees on social security programs, health insurance, and severance pay.[14]

Table 3: Contribution Rates for Private Sector Workers

Programs	Employers (in %)	Workers (in %)	Total (in %)
Jamsostek contributions	7.24–11.74	2	9.24–13.74
Health insurance	3–6	–	3–6
Old-age benefit (lump sum)	3.7	2	5.7
Employment injury	0.24 –0.74 (5 classes)	–	0.24–0.74
Death grant	0.3	–	0.3
Severance pay	8–14*		8–14
Private pension insurance (voluntary)	12.5	7.5	20 (max.)
Private health insurance (opting-out)			Rp100,000+

* estimates
Jamsostek = Jaminam sosial tenaga kerja or private sector social security system, % = percent, – = not available.
Source: Jamsostek, Taspen, Indonesian Society of Actuaries estimates for severance pay

[14] The Jakarta Post. *2004. Apindo asks the government to revise the Social Security Bill. 5 February.*

Employers with 10 or more workers or with a gross payroll of Rp1 million per month or more are required by law to register themselves and their employees with PT Jamsostek, and to pay contributions as a percentage of the monthly wage. The employers are liable to pay the contributions. While the contribution rates for retirement and death benefits are fixed, they vary for the other two programs. The contribution rate for the health-care benefits program is 3% for single employees and 6% for married employees, with a wage ceiling of Rp1 million per month. The employment injury program charges differential rates according to risk, classified in five occupational groups. The total contribution cost varies between 9.24% and 13.74%, with most programs being funded by the employer.

In line with the labor law, the employer also has the obligation to pay out a severance benefit to dismissed or retiring workers. The severance pay is paid as a lump sum upon termination of employment. The severance pay, in combination with long service leave, can add up to 25 months of salary after 20 years of service. Actuaries in Indonesia generally agree that the cost of the benefit varies between 8% and 14%, depending on the assumptions and the rate of pre-funding. The high severance pay is a tremendous burden on a company, as funds need to be reserved in the company's financial statement as debt. The employer can partly offset the obligation of paying the full severance pay by buying private pension plans for its employees or by paying the monthly contributions for the retirement pension.[15] However, there are no clear regulations stating the method of calculating the offset to severance pay for contributions to Jamsostek or private pension plans.

Privately managed, voluntary pension schemes have a maximum contribution rate of 20% of salaries, usually about 12.5% employer contribution and about 7.5% employee contribution. While the contribution for health care under PT Jamsostek is only Rp10,000–20,000 per person per month, a commercial product sold by PT Askes costs Rp20,500 per person per month. Many employers, who opted out from the Jamsostek health insurance scheme, pay premiums higher than Rp100,000 per employee.[16]

The total share of the labor cost going to financing of social-security-related programs is high but the impact of the high total contribution rate on employment generation is not clear. However, it is a fact that since 2001, formal wage employment has declined by 0.7% per year, while informal employment has grown by an average of 1.9% per year.

2. Public Sector

The public sector workers are contributing to a number of schemes, to the Askes program in exchange for health-care services, and to Taspen for their pensions and their old-age savings. Employee contributions during active service are only based on the basic salary.

Table 4: Contribution Rates for Civil Servants

Programs	Civil servants (%)	Government (%)
Health insurance (Askes)	2	2 (2007)
Pensions (monthly) (Taspen)	4.75	open[17]
Old-age benefit (lump sum) (Taspen)	3.25	open
Total	**10**	**open**

Askes = Asuransi Kesehatan Indonesia or Indonesia Health Insurance, Taspen = Tabungan dan Asuransi Pegwai Negeri or pension scheme for civil servants, % = percent.
Source: Indonesian laws, Taspen, Jamsostek

The Askes program is funded through a 2% payroll deduction from civil servants' basic monthly salary. The charge does not vary for individual and family coverage as it does in the Jamsostek scheme. Since 2004, the central government has started to contribute the equivalent of 0.25% of the basic monthly salary to be increased annually to reach the matching of 2% by 2007. The contribution payments are considered to be too low and affect the quality of health services for the program's beneficiaries. Hospitals and clinics that become service providers for PT Askes are required to cover a large portion of the health services, as the Ministry of Health has set the reimbursement levels by Askes below the published charges. The providers charge the remaining balance to the members. In 2002, Askes members paid 30–60% of the total out-of-pocket costs.

The contribution to the Taspen pensions program is 4.75% of the basic monthly salary. PT Taspen accumulates employee contributions for the pension program into a fund that initially was to cover 25% of the pension cost. The Government meets the balance of the payments from general revenue. The financial situation of this fund is not

[15] Act of The Republic Of Indonesia, Number 13 Year 2003, Concerning Manpower, Article 167.

[16] Thabrany, H., et al. 2003. *Social Health Insurance: Current Status and the Plan for National Health Insurance*. Presented during Social Health Insurance Workshop, WHO SEARO, New Delhi, 13–15 March.

[17] The FIRST report estimates a total contribution rate of 37.2% of the basic monthly salary, assuming that the 4.75% contribution by the civil servant represents 14% of the total contribution. Based on the 2000 actuarial valuation of Taspen, financed by ADB TA 3116-INO, the total contribution rate is much more dramatic, with the cost of the benefit accruing to about 65% of basic salary.

good. The contributions collected and the accumulated interest earned are not sufficient to pay the planned share. Over time, government share has been increasing. In 2007, Taspen will cover 15.5% and the Government, 85.5%.

The Government has limited choices to change this in case the basic design of the benefit structure were to remain the same. One option could be to increase the contributions of active civil servants. Currently, they pay 4.75% of basic salary. As an indication, to fund 25% of the benefits, contributions from active civil servants need to be about 17% of basic salary.[18] Given the aging population in Indonesia and the increasing age dependency ratios, especially for the segment of civil servants, the obligations of the Government are expected to increase significantly over the next decades. The Government will undoubtedly have to make major changes in the design of this program in the future to maintain its fiscal viability.

The old-age savings scheme is a compulsory savings program. The program is only funded by member contributions, 3.25% of the basic monthly salary. The benefit is determined by length of service, final salary, and a factor, currently set at 0.6. This factor is theoretically determined on an actuarial basis but, in practice, the MOF minister determines this based on political considerations. The result is that the program may result in losses. An actuarial valuation is needed to determine the required contribution rate for long term actuarial balance. Alternatively, the government should guarantee to underwrite the shortfall. This program is presented as a defined contribution scheme, but it is really a defined benefit scheme since benefits are determined by a formula and not by the account balance at retirement.

B. Government Budget

Following the financial crisis, fuel subsidies played a major role in determining levels of central spending. The fuel subsidy reached Rp69 trillion in 2004 and peaked at Rp96 trillion in 2005, despite reductions in the subsidy that year. The increase in fuel subsidies was mainly attributed to the fixed fuel-price mechanism introduced in January 2003 and subsequent international oil price increases. The large share of the government budget allocated to fuel subsidies, 15% of total government expenditures, took away resources from important development sectors in health, education, and infrastructure.

In 2005, the Government decided to reduce fuel subsidies. In March 2005, it raised fuel prices by 29%, followed by another, more dramatic, increase in October 2005 by 114%. Fuel subsidy reductions in 2005 provided a gross savings of Rp50.1 trillion. For 2006, the savings are estimated to be Rp91.6 trillion. In 2005, the Government reallocated about Rp15.4 trillion of these savings into Compensation for Fuel Subsidy Reductions Programs (PKPS-BBM/Program Kompensasi Pengurangan Subsidi Bahan Bakar Minyak), including an unconditional cash transfer program, a compensation package in the education sector, a rural infrastructure program and a targeted health-care program.[19]

Good progress has been made over the past 2 years in reallocating spending from inefficient subsidies toward pro-poor programs. However, Indonesia is still under spending in infrastructure and key social sectors.

1. Health

Overall, the access and quality of health care in Indonesia remains low and the health outcomes remain poor compared to neighboring countries, in particular, the infant and maternal mortality rates. These differences in outcomes hold even when per capita GNP is accounted for. Viet Nam, despite having a lower per capita GNP, fares better for all health indicators, while the Philippines, a country with a slightly higher per capita GNP, scores better for most health indicators (Table 5).

Public health expenditure in Indonesia has been increasing from 2.6% of total government expenditure in 2001 to 4.5% in 2006. However, public health spending as share of GDP remains low at 0.95% in 2006.

Table 5: Comparison of Health Indicators across Countries, 2004

	GNP per capita (US$)	Births attended by skilled health staff (% of total)	Infant mortality rate (per 1,000 live births)	Maternal mortality rate (per 100,000 births)
Indonesia	906	72	30	310
Malaysia	4,290	97	10	30
Philippines	502	60	26	170
Thailand	2,356	99	18	24
Viet Nam	1,085	90	17	170

Source: World Development Indicators. 2006.

[18] ADB. 2000. *Final Report. Reform of Pension and Provident Funds in Indonesia*. (TA 3116-INO). Manila.

[19] World Bank. 2006. *Making the New Indonesia Work for the Poor.* Jakarta.

The recent increase in overall public health spending is mainly driven by development expenditure, which increased from 28% of total national expenditure in 2001 to 39% in 2004, with routine expenditure staying essentially the same in absolute terms over the same period.

The majority of total health expenditures still come from household out-of-pocket expenditures. In 2004, Indonesian households covered 55% of total health expenditures. About 75% of private health spending comes from out-of-pocket payments. Private employers cover almost 20% of household health spending through reimbursement of medical expenses and direct payment for providing health care to their employees. The remaining 5% comes from household prepayments. Out-of-pocket payments increase the vulnerability of households and individuals and can result in pushing them below the poverty line, especially when they face catastrophic health.[20]

In 2005, the Government introduced the PKPS-BBM health-care program to finance the Askeskin program. The program was budgeted at Rp2.3 trillion in 2005 targeting 36 million poor, and Rp3.7 trillion in 2006 targeting 60 million poor and near-poor, equivalent to, 23% and 29%, respectively of the central government expenditure on health in 2005 and 2006. The pro-poor distribution of health cards has decreased inequality in access to health care. It reduces the risk of catastrophic expenditure, but does not necessarily imply adequate protection. Notwithstanding the progress made in expanding the public health-care system, access and quality of health care remain low, and the poor in particular rely heavily on private sector provision.

In the longer term, the Government should consider allocating more resources to health expenditure, as public health expenditure is still low compared to other countries in the region. However, the Government should first focus on improving the allocation efficiency and equality. Inequalities should be reduced by increasing access to and quality of health services for the poor. At the same time, priority should be given to identifying the right mix of investment to improve the effectiveness of the health sector.[21]

2. Pensions

As part of the bureaucracy reform program, the budget for personnel will increase in 2007 by 23% from Rp79.9 trillion to Rp98.5 trillion. Personnel expenditure will include (i) an increase in the base salary of civil servants, members of the armed forces, and basic pensions of 15%, (ii) the payment of a 13th month of salary and pensions, (iii) the revision of cost-sharing for pensions between the state budget and PT Taspen from 82.5–17.5% to 85.5–14.5%, and an increase of government contribution to PT Askes to finance increasing health services to civil servants and retirees. The share of government budget allocation for the Taspen pension program will reach Rp23.2 trillion in 2007, or around 4.7% of the central government expenditure (total amount of government expenditure was Rp496 trillion). In addition, the Government will allocate Rp0.25 trillion for the Taspen old-age benefit program, and Rp0.66 trillion for the Askes health insurance program (Table 6).

Table 6: Central Government Budget 2006 and 2007 (planned)

	2006		2007 (planned)	
	Rp (in billion)	% of Central Government budget	Rp (in billion)	% of Central Government budget
Employee spending	79,896,131	18.7	98,472,946	19.9
a. Wages and allowances	43,661,717	10.2	54,556,141	11.0
b. Honorarium, vacations	11,998,822	2.8	14,087,234	2.9
c. Social contributions	24,235,591	5.7	29,829,571	6.0
1. Pensions	18,581,459	4.3	23,239,812	4.7
2. Old-age saving	250,179	0.1	250,179	0.1
3. Health insurance	424,521	0.1	657,348	0.1

Rp = Indonesian rupiah, % = percent.
Source: Ministry of Finance. 2007.

[20] World Bank. 2007. *Spending for Development. Making the Most of Indonesia's New Opportunities. Indonesia Public Expenditure Review 2007.* Jakarta.

[21] Footnote 20.

3. Comments

The decrease in fuel subsidies, together with the increase in revenue, is driving the expansion of Indonesia's fiscal space.[22] The fiscal space was estimated at 8.3% in 2005 and projected to exceed 10% in 2006 and 2007. [23]

The current spending mix is still less than optimal with a large share of the total budget spent on core government administration (20%) and subsidies (15%). Indonesia's fiscal position could be further improved by reducing the spending on core government administration and by removing subsidies that still place a heavy burden on its budget. A more appropriate level of spending on government administration seen in other similar countries is around 5–10%. The further reallocation of spending would allow Indonesia to increase spending in key sectors, such as infrastructure and social sectors.

The medium-term fiscal framework forecasted that the central government, given high projected revenues and secure financing, could increase the development expenditures (the sum of capital spending and social assistance) from 3.1% of GDP in 2006 to 3.9% in 2010, without jeopardizing fiscal sustainability, given that subsidies would be reduced from 1.9% in 2006 to 1.2% in 2010.[24]

V. Financial Performance of the Pension Funds

Financial performance measurement varies according to the type of scheme. In a defined contribution scheme, such as the Jamsostek provident fund, efficient contribution collection, annual rates of investment return, and administrative expenses are important as these will determine the individual's pension entitlement. In defined benefit pension programs, such as the Taspen pension scheme, the capability of the available assets to back the liabilities is the most significant aspect to measure, as this will determine whether the administrator is able to stick to its pension promise.

A regular actuarial valuation is needed to evaluate the assets and the liabilities of the social security programs to determine whether the schemes remain solvent, and to adjust the rates of benefits and contributions based on actuarial estimates.

A. Private Sector

The investment performance of Jamsostek has been extremely poor in the past. From 1978 to 2000, the cumulative interest rate credited by Jamsostek was 38% less than inflation, indicating a negative real rate of return (ROR) over that period. The cumulative index was 63% less than the cumulative index of the average market interest rate. Because of poor investment performance in the past, the Jamsostek's provident fund accounts have lost their real value substantially.[25] Under the current investment regulation and improved investment management, a fair ROR is expected for the future. There is still, however, a serious problem with administrative expenses, which are about 2% of assets per year. The expense ratios for pension funds are in general much lower.

The figures shown in this table for rates of return are rough estimates. More accurate information is needed to properly compute rates of return.

Investment allocation by pension fund managers continues to be heavily skewed toward time deposits. Investments in Bank Indonesia Certificates also account for a significant portion of pension fund portfolios. At the end of 2003, 95% of PT Jamsostek's investments were in bank deposits, bonds, or shares listed on the Jakarta Stock Exchange. For private pension plans, unpublished statistics indicate that the corresponding figure is 83%. Around 55% of the investments were in bank time deposits.[26]

Private pension programs have been growing steadily, despite the Asian economic crisis of 1997. Several employers had to stop their pension programs because of financial problems that they had to solve, but the total assets of the pension programs keeps growing. This is due to the Pension Law that requires liquidated assets and liabilities to be transferred to other pension funds and not returned to the participants prior to their retirement. The figures shown in the Table 7 are an aggregate. Performance of individual pension funds varies from one to the other.[27]

Private pension funds have to adhere to strict regulations on transparency and prudential supervision:

- Pension funds will provide annual reports to participants, describing the financial condition of the funds and changes made in the pension regulations;

[22] The Public Expenditure Review defines fiscal space as discretionary expenditures that Indonesia can undertake without impairing its solvency. Fiscal space is defined as total expenditure minus personnel expenditures, interest payments, subsidies, and transfers to the regions.

[23] Footnote 20.

[24] Footnote 20.

[25] ILO. 2002. *Social Security and Coverage for All. Restructuring the Social Security Scheme in Indonesia – Issues and Options*. Jakarta.

[26] FIRST. 2005. Implementing an Indonesian National Social Security System. SJSN Law No. 40 of 2004. Jakarta.

[27] Rachmatarwata I. 2004. *Indonesia Pension System. Where to go?* International Conference on Pensions in Asia: Incentives, Compliance and their Role in Retirement. Tokyo, Japan. 23–24 February.

Table 7: Financial Performance of Private Sector Pension Funds, 2002 (in million Rp)[28]

	Jamsostek	DPPKs		DPLKs
		Defined benefit	Defined contribution	
Assets	21,317,262	36,835,568	1,884,234	2,486,672
As % of GDP*	1.32	2.29	0.12	0.09
Liabilities to participants	19,605,687	39,384,007	1,909,704	2,483,126
Contributions	945,770	2,667,252	313,165	818,169
Benefits paid	403,343	2,453,723	32,784	69,926
Investment returns	1,092,950	4,757,687	256,034	241,026
% ROI	5.96	14.38	15.98	12.40

*GDP for 2002 is Rp1,610,016 billion.
DPLK = Dana Pensiun Lembaga Keuangan or financial institution pension fund, DPPK = Dana Pensiun Pencari Kerja or occupational employer pension fund, GDP = gross domestic product, Jamsostek = Jaminam sosial tenaga kerja or private sector social security system, ROI = rate on return, Rp = Indonesian rupiah, % = percent.
Source: See footnote 26 on prior page.

- Pension funds will file financial and investment reports with the Minister of Finance every trimester;
- DPPKs providing defined benefit programs will submit an actuarial report every 3 years;
- DPLKs will need to publish audited financial statements to be published in a nationwide newspaper;
- DPLKs will provide fund accumulation statements to individual participants at least once a year.

Anecdotal evidence still indicates that performance is variable. Further improvement in the supervisory framework is needed. There is no formal licensing or training requirements for private fund managers. Supervision needs improvement and industry disclosure is slow.

B. Public Sector

One of the main concerns for government pension plans is the liability that these plans have already accrued but are unfunded. This is called the implicit pension debt (IPD). On 1 January 2000, the unfunded liability of the Taspen pensions program was estimated at Rp342 trillion. In 2000, the liability was backed by assets of Rp9.4 trillion, leaving an unfunded IPD of Rp332.6 trillion.[29]

Table 8: Financial Performance of Public Sector Pension Funds, 2002 (in million Rp)[30]

	Programs for civil servants		Armed forces
	Pension	Old-age savings	Old-age savings
Assets	10,410,249	9,851,358	1,863,745
As % of GDP*	0.64	0.61	0.12
Liabilities to participants	342,000,000**	9,363,338	1,611,043
Contributions	1,958,050	1,391,363	219,738
Government share	11,437,118	0	0
Benefits paid	14,831,869	929,340	91,579
Investment returns	1,518,063	1,451,943	274,086
% ROI	15.13%	16.15%	16.77%

* GDP for 2002 is Rp 1,610,016 billion.
** Based on Taspen valuation 2000.
GDP = gross domestic product, ROI = return on investment, Rp = Indonesian rupiah, Taspen = Tabungan dan Asuransi Pegwai Negeri or pension scheme for civil servants, % = percent
Source: Rachmatarwa I. 2004.

28 Rachmatarwata I. 2004.
29 Footnote 18.
30 Footnote 27.

The Taspen valuation report recommended that the Government recognize the unfunded liabilities in its accounts. The main reason for recognizing the liability is to help planning. Proposed changes to the civil service basic salary levels would have an immediate impact on the liabilities of the pension plan, not only for the short-term but also for the foreseeable future. Without recognizing the liability that the Government has with respect to the pension plans, no formal mechanism assesses the long-term costs of the changes.

C. Comments

Similar regulations on transparency and prudential supervision to the ones applicable to the private pension funds should be introduced for the social security administrators. This would promote consistency in a number of areas including participants' rights, vesting, portability, disclosure, asset valuation, and reporting requirements.

By their very nature, funded national pension schemes generate huge asset accumulations. These assets must be invested safely and productively. To be effective, pre-funding requires that assets consistently produce returns in excess of the increase in wages over a long period. In general, to achieve a reasonable pension, equal to 40–50% of the final wage, the ROR should be 2–3% higher than the rate of wage growth. This is difficult to achieve even in the best circumstances. Indonesia's conditions are far from the best. It has limited financial instruments available domestically. Investors must choose between bank deposits and government bonds, which pay low returns, and the stock market, which is very volatile. In these circumstances, pension funds could gain from resorting to international investment, which offers the opportunity to diversify across countries, and securities. The decision to move into this direction is always politically sensitive but economically desirable. It reduces risk while increasing yield. Risk diversification is especially important given the long time periods involved. International diversification opens up the possibility of investing in less volatile, more efficient stock markets abroad, and hedges against unforeseen economic crises that may hit Indonesia in the future.[31]

Further to the investment regulations on portfolio, equally important questions are how to organize efficient fund supervision and how to design the institutional structure that enables effective monitoring and inspection. Neutrality, transparency, and accountability are crucial elements for achieving sound fund governance. Only by efficiently monitoring and supervising the investment management process can one ensure sound fund governance in the end. The internal and external audits will serve as important tools for this purpose. Disclosure of key information on fund operations is also important not only because it is a prerequisite for auditing but also because it provides an opportunity for a wider surveillance.[32]

VI. Fiscal Analysis of Existing Pension Programs

This section analyzes the fiscal status of Indonesia's existing pension systems for formal sector workers and civil servants.

A. Jamsostek

Jamsostek is a fully funded defined contribution program; thus, by definition, it does not have any unfunded liabilities. When analyzing the performance of such a program, the focus should be on ROR, administrative efficiency, and payout options. The primary questions are:

- Is the contribution collection method efficient and effective? Are all employers who are required to pay registered? Do employers pay the correct amount on time each month? Is the contribution collection process electronic and automated? Is an effective mechanism in place to enforce compliance?
- Is the composition of the investment portfolio appropriate? Are assets invested in accordance with modern portfolio theory and in the best interest of members? Is the level of risk appropriate for a pension fund? Are assets well diversified to reduce the risk of large losses and protect against macroeconomic shocks? Are all assets valued at market value in accordance with international standards? Are there benchmarks for measuring ROR and is the ROR adequate to provide meaningful retirement benefits?
- Is the contribution rate high enough to provide a meaningful benefit at retirement? Is there a mechanism for providing adequate benefits to vulnerable groups who may have inadequate account

[31] James. E. 2004. *Reforming Social Security: What can Indonesia learn from other countries?* Paper prepared for USAID. Jakarta.

[32] ILO. 2003. *Report to the Government on the financing and investment of Jamsostek and social budgeting. Restructuring of the social security system*. ILO/TF/Indonesia/R.21. Geneva.

balances at retirement, such as the unemployed, underemployed, disabled, those who are out of the workforce, to raise children and others?

- Is there a mechanism for converting accumulated account balances into a stream of income for life?
- Are overall administrative costs kept to a minimum? Are administrative processes electronic and automated?
- Is an effective governance structure in place? Are all aspects of system operations fully transparent? Is there full and complete disclosure of the investment policy, investment portfolio, performance, member rights, and methods of enforcement? Is an outside body responsible for reviewing the performance of the Board and system staff? Are there established performance benchmarks? In addition, is performance regularly reviewed against those benchmarks?
- While more data are needed for a thorough analysis, improvement appears to be needed in most areas.
- Only about 7 million are Jamsostek members. The formal labor force is about 30 million, so the number of members should be much higher.
- Rate of returns, net of expenses should certainly exceed returns on bank time deposits and the rate of real wage growth. To earn a reasonable benefit at retirement, the real ROR must exceed the real wage growth by at least 2–3%. Until recently, real rates of return were negative.
- The current investment portfolio is not adequately diversified. It consists mostly of bank deposits and government bonds.
- Benefits at retirement will be inadequate because of early retirement ages, substantial withdrawals prior to retirement age, low contribution rates, inadequate investment returns, and high administrative costs. Benefits are also paid as a lump sum so they provide no protection against outliving assets following retirement.
- Governance procedures are inadequate. Please see our report on governance for additional details.

If members' benefits at retirement are not adequate, then the system is not meeting its goals. Further analysis is needed in all areas to develop an effective road map for social security reform implementation.

B. Taspen and Asabri

These two programs differ sharply from Jamsostek. They are defined benefit programs financed from the state budget, mostly on a pay-as-you-go basis. Unlike Jamsostek, the benefit formulas provide a very rich benefit at retirement, so benefit adequacy is not an issue, assuming the budget has sufficient resources to pay benefits when due. Therefore, the key questions and required analysis are different.

- Is the system fiscally sustainable in the short and long term? If not, what changes are required to bring the system back into long-term balance? Benefit promises are meaningless if the financial resources to meet obligations are not available.
- Are actuarial models used to provide regular analysis of the system's financial status and to evaluate all proposed changes to the system? Is a unit within the Government capable of maintaining these models and responsible for preparing analysis?
- Are there actuaries with proper knowledge and training in the use of the models? Are they capable of modifying the models on their own?
- If the system is partially funded, is there an adequate reserve and is it invested properly to maximize returns within acceptable risk parameters? Is the investment policy consistent with the expected liability payments from the system?

Neither of these systems appear sustainable in the future. Benefits are very high, the retirement age is low, and the number of pensioners will increase dramatically over the next 30 years. These systems need close actuarial scrutiny and reform. An actuarial valuation is needed for both programs to develop an effective road map for social security reform implementation.

VII. Fiscal Management of Pension Programs: An International Perspective

A. Rationale for National Pension System(s)

A pension system is an important part of a nation's overall social protection and social insurance programs. The primary purpose of the national pension system is to prevent poverty among workers following retirement. If possible, the system should also provide sufficient benefits—along with other programs and personal savings – to allow a worker to maintain the same standard of living after retirement as before. During their working career, individuals receive a salary that allows them to purchase the necessities of life. Eventually, most workers reach an age where they are either unable to work, prefer not to work, or their productivity is significantly lower than earlier in their career. Once workers leave the labor force, they no longer earn a salary and need an income source for life's necessities.

Many individuals do not save during their working career to finance their retirement. Those with very low salaries are usually unable to save. All earnings are needed for basic necessities, such as food, clothing, shelter, and medical care. Others have higher salaries, but would not ordinarily save for retirement, preferring instead to spend all their money on current consumption. This is especially true if the country has welfare programs for destitute retirees.

Consequently, many governments decide to compel workers and their employers to set aside money to finance pensions following retirement. That way, all workers have at least enough income following retirement to meet their basic needs. This takes pressure off state-financed social assistance programs, since the government no longer needs to worry about how to care for destitute, elderly workers.

There are also other compelling labor market, demographic, and macroeconomic reasons for a national pension system or systems.

- *Allowing workers to retire when no longer productive*. Most workers' productivity declines as they get older. Eventually, many individuals are unable to work due to either physical or mental deterioration. However, without a retirement system, these individuals may have no choice but to remain in the workforce, since they would otherwise live in poverty. A retirement program provides a systematic way for employers to remove less productive individuals from the workforce with dignity.

- *Creating jobs for younger workers and promotion opportunities for older workers*. When older workers can retire and be financially secure, job openings for younger workers are created. Those graduating from universities will have a better chance of finding jobs, and those already in the workforce will have greater opportunities for promotion. This turnover in the workforce is beneficial for the country as a whole. It increases overall labor force productivity and promotes innovation and new ideas.

- *Relieving children from fully supporting their parents*. In a country with a national pension system, children do not need to bear the entire financial burden of caring for elderly parents. In societies with lower birth rates and increasing life expectancy, the burden per child of caring for parents is much greater when the birth rate is low and the elderly live longer. Children may not be able to afford children of their own when they have to support their parents. This results in further reducing the birth rates.

- *Facilitating labor mobility*: A true national pension system automatically provides full pension portability. When a worker changes jobs, no pension benefits are lost and the pension system gives credit for all years worked, regardless of the employer. Consequently, employees feel free to change jobs without fear of losing pension benefits. This increases overall labor force mobility, improves labor market efficiency, and reduces unemployment. Of course, in Indonesia, the national pension systems only cover a fraction of all workers. In theory, the entire salaried workforce is covered but, in practice, only about 25% is covered. Majority of government workers are covered through a separate program. However, no pension program exists for the 60 million informal sector workers.

While not all these reasons may apply in every country, taken together, they present a compelling argument for having a national pension system regardless of whether all workers are covered by a single scheme or multiple schemes cover different groups of workers with pension portability among schemes.

B. Pension System Goals

Pensions are the exact opposite of life insurance. The purpose of life insurance is to protect families against the risk of early death of the breadwinner. It is intended to

replace the income that would have been earned during the remainder of the insured's working career. By contrast, pensions are protection against living too long and exhausting all personal assets. Pensions protect against this risk by providing income for the balance of the pensioner's life after he or she is no longer able to work.

There are two main types of pension plans: defined benefit and defined contribution. Defined benefit plans have a formula that determines the monthly pension benefit payable each month. Often the formula is based on earnings history and years of contributions to the system, but sometimes the benefit is a flat amount or a combination of a flat amount plus an earnings-related benefit. The contributions to the system should ideally be determined by actuaries so they are sufficient to fund the promised benefits. However, the contributions collected and the promised benefits all too often have little or no connection.

National social security systems are typically unfunded (and are often referred to as pay-as-you-go systems). Under this model, contributions collected from current workers are used to pay benefits to current pensioners. The money is not saved to finance the worker's own retirement benefit. Instead, contributions from the next generation of workers are used to pay pensions to current workers. For this reason, these systems are often referred to as solidarity systems because each generation of workers finances the pensions of the generation that came before. Such systems function well when the ratio of contributors to pensioners is the same or increasing. However, when the opposite occurs, these systems often face financial difficulties.

Defined contribution plans are the opposite. The law defines the contribution that must be made to the system. Typically, the contribution is a percentage of earnings, but it may also be a flat amount or a combination. The contribution is invested and the balance in the individual's account at retirement is the pension benefit. Often, the accumulated balance at retirement is converted into an annuity to meet the primary goal of providing lifetime income following retirement. This system is often referred to as a fully funded system because each worker's contribution is saved in an individual account to finance that worker's benefit at retirement. This differs sharply from the social security system where contributions by current workers are immediately used to pay benefits to current pensioners.

Based on these definitions, Indonesia does not have a pension plan for formal sector workers at all. The Jamsostek program is a defined contribution system but it is not a pension system. Benefits are paid out in a lump sum and at a young age when many workers are still in the labor force. Consequently, Jamsostek is actually a special-purpose savings program and not a pension program. Any real pension will have to be provided by family, friends, or charity.

The Taspen system, on the other hand, is a defined benefit pension system. It provides benefits as a percentage of salary for life to government workers following retirement. Employees make contributions to the Taspen system, but these are not intended to be sufficient to finance all benefits. The primary source of funding is the state budget. In fact, the Taspen fund is likely to run out of money in the near future. At that time, the employee contributions will finance a very small portion of the total required benefit payments.

If a country wants to have a true pension system, it should meet the following primary goals regardless of whether the system is defined benefit or defined contribution or whether there is a single plan with universal coverage or multiple plans:

- *Prevent poverty among elderly workers.* At a minimum, benefits should be sufficient to allow system participants with long work histories to live above the poverty level at the moment of retirement and for the rest of their lives. This means pensions must also be indexed for inflation following retirement.

- *Provide adequate benefits*. Also to prevent poverty, the pension system should ideally provide benefits that replace a percentage of the worker's salary just prior to retirement. Workers need about 60–80% of their pre-retirement pay to maintain their living standards following retirement. The pension system cannot be expected to provide all of this income, but typically it will provide a replacement rate of at least 40% for workers with long work histories.

- *Financial stability*. The pension system must be financially stable in the short and long run. Contributions must be sufficient to pay promised benefits when due and provide an adequate replacement ratio. The system must be run efficiently so administrative costs are kept to a minimum and investment returns are maximized within acceptable risk parameters.

- *Efficient administration*. The administrative systems should provide maximum automation and efficiency, and limit the portion of contributions needed to cover administrative expenses. Ideally, all employee data should be transmitted electronically and be kept in electronic databases.

- *Protection of member rights*. Systems must be in place to make sure participants' rights and benefits are protected. This will require a combination of well-written laws, proper governance procedures, a strong regulator, and the ability to enforce rights through the judicial system.

- *Strong enforcement*. Employers who are required to pay must register. Employers must withhold and pay their own and workers' contributions on time and in the correct amount. The appropriate government organizations must have the authority to enforce payment.

C. Designing a National Pension System

National pension systems today often consist of a number of components or "pillars." The goal is to integrate all pillars into a single coherent pension system that best meets the country's needs. In current World Bank terminology, there are five possible pillars in typical national pension systems. Not every country has all the pillars and different countries choose different combinations of the pillars in designing their national pension programs. Countries may also choose to have multiple systems rather than a single universal system for all workers or citizens.

- *Pillar 0*. This is the country's social welfare programs. It generally provides benefits to the elderly who do not receive pensions from other sources or who have insufficient total benefits from other sources. It may also be used to provide a universal pension to all residents. However, it is usually based on need and is not a social insurance program. Support from family, friends, charities, nongovernment and other organizations are also considered part of this pillar.

- *Pillar 1*. This pillar is typically referred to as the country's social security system. Benefits are usually a flat amount and/or based on wage history and years of contributions. It is an insurance system for workers and is not means-tested. Those who make contributions and have sufficient work history are entitled to benefits at retirement. The primary purpose of this pillar is to prevent poverty among workers following retirement. This system is usually unfunded (pay-as-you-go) or partially funded. Current workers make payroll contributions to the system and most contributions are immediately used to pay benefits to current pensioners. In some systems, a portion of the contributions are set aside in a reserve. The reserve supplements contributions in years when contributions alone are insufficient to pay all benefits.

- *Pillar 2*. This is a mandatory pension system and can be defined benefit or defined contribution. In the vast majority of countries, it is a defined contribution system (often referred to as a mandatory accumulation system or a fully funded system) based on the principle of individual accounts. Workers contribute to their own accounts to save for their retirement. Typically, workers can choose among competing private pension funds. The accumulated individual account balance is converted into a pension upon retirement by either making periodic withdrawals from the investment account over an extended period or by purchasing a life annuity from an insurance company. In some countries, some or all benefits from this pillar can be taken as a lump sum.

- *Pillar 3.* These are voluntary pension systems and are often referred to as occupational or employer-sponsored pension plans or individual pension savings programs. These pension plans either are established by an employer for the benefit of its employees or are voluntary pension programs for individuals. Those employers who want to establish voluntary pension plans must comply with government rules for eligibility, funding, benefit formulas, nondiscrimination, and tax benefits. These plans may be defined benefit or defined contribution, but either way they usually must be fully funded at all times. Pay-as-you-go or partially funded systems are not permitted.

- *Pillar 4.* This consists of all other "savings" that can be used to provide income in retirement and might include personal savings, equity in homes, artwork, and jewelry or other hard assets. These items can be converted into cash to supplement retirement income.

Table 9 analyzes Indonesia's current pension programs:

Some classifications in the table may seem surprising.

- As previously mentioned, Jamsostek is not a pension system at all. If it were to be classified as a pension system, it would consist of pillar 2 only;

Table 9: Indonesia's Existing National Pension System

	Jamsostek	Taspen	Asabri	Private Plans
Pillar 1	None	The pension and lump-sum programs are partially funded defined benefit plans.	Unfunded defined benefit plan	None
Pillar 2	None	None	None	None
Pillar 3	None	None	None	Defined benefit or defined contribution
None of the above	Existing system is not a pension scheme. It is a defined contribution savings scheme.			

Asabri = Asuransi Angkatan Bersenjata Republik Indonesia or pension scheme for the armed forces, Jamsostek = Jaminam sosial tenaga kerja or private sector social security system, Taspen = Tabungan dan Asuransi Pegwai Negeri or pension scheme for civil servants.
Source: Author classification and comments.

- The Taspen lump-sum program is not a defined contribution program; it is defined benefit. The lump sum payable at retirement is a function of a factor set by the Government, final pay, and years of service. It is not equal to the account balance in an individual account at retirement.

The fundamental questions for Indonesia as it seeks to redesign its pension insurance schemes are:

- What is the maximum amount of payroll contributions that can be devoted to pensions?
- What is the minimum acceptable replacement ratio?
- Should there be a universal pension system or should there continue to be separate programs (or no programs) for different groups of workers?
- Should the prevention of poverty for workers following retirement be covered entirely by the pension system, the state budget, social welfare or a combination of some or all of these methods?
- What combination of pension systems, benefit formulas, retirement ages, and contribution rates will produce the best system for Indonesia?

D. Pension Systems in the Region

The countries in the Association of Southeast Asian Nations and Pacific region (and elsewhere in the world) have made very different decisions about:

- the pillars included in the national pension system,
- whether to have a universal pension system covering all workers or multiple systems covering different groups of workers, and
- whether to have a pension program for informal sector workers and how it should be designed.

Table 10 briefly summarizes the structure of the national pension systems in various countries in the region, Europe, and North America.

As can be seen, many countries have adopted a multi-pillar pension system consisting of:

- either a universal pension paid from the budget or an unfunded or partially funded social security system financed with payroll contributions (defined benefit basis), or
- a fully funded accumulation system (defined contribution basis).

The following are some reasons countries adopt a multi-pillar system rather than a system based only on social security or social assistance:

- *Diversifying pension system risk*. Traditional social security systems are subject to political and demographic risks. Accumulation systems are subject to capital market risk. This is the risk whereby rates of return, net of expenses will not be as high as assumed, and benefits will be less than expected, upon retirement. A system that includes both components helps make the overall system more robust. It is less vulnerable to macroeconomic shocks.

- *Protecting reserves from politicians*. Social security systems often accumulate substantial reserves to meet obligations when demographics deteriorate. By introducing an accumulation system, the Government can put some of these reserves into individual private accounts, beyond the reach of politicians.

- *Clear link between contributions and benefits*. In a traditional social security system, there is one formula for benefits and another for contributions, but the

Table 10: National Pension Systems in Selected Countries

Country	Description of national pension system
Hong Kong	Universal flat pension for all residents paid from the budget plus a mandatory defined contribution occupational pension system with private asset management. The universal pension is means-tested between ages 65 and 69 and is not means-tested on or after age 70 (Pillars 0 and 2).
Thailand	Earnings-related social security system for the formal sector (Pillar 1 only). For government workers, a combination of an earnings-related benefit paid by the State budget and a mandatory accumulation system with State asset management (Pillars 1 and 2).
India	Provident fund for the formal sector (Pillar 2 only). For government workers, the TCSP system is a defined benefit system payable from the budget (Pillar 1) and the new NPS system is a mandatory defined contribution scheme with private asset management (Pillar 2).
Philippines	Earnings-related social security system for private sector and some public sector workers (Pillar 1 only).
Malaysia	Central provident fund providing health, education, housing, and retirement benefits through a mandatory defined contribution arrangement with State asset management. Options to invest small amounts in private unit trusts for those with large account balances. (Pillar 2 only).
Australia	Means-tested universal pension for all residents paid from the budget plus a mandatory defined contribution occupational pension system with private asset management (Pillars 0 and 2).
Sweden	Earnings-related social security system based on the principle of notional accounts and a mandatory defined contribution pension system based on individual choice with private asset management (Pillars 1 and 2).
United States	Earnings-related social security system and a very large voluntary system consisting of both occupational and individual savings schemes (Pillars 1 and 3).
Canada	Universal flat pension for all residents paid from the budget plus an earnings-related pension paid through a social security system with reserves managed by the private sector through a quasi-governmental organization. Large voluntary pension system. (Pillars 0, 1, and 3).
Chile	Mandatory fully funded accumulation system for all workers based on private asset management, with a guaranteed minimum pension payable from the budget for those with long service (Pillars 0 and 2).

NPS = new pension scheme, TCSP = Training for Capacity Strengthening Program.
Source: .Author, pension laws in the various countries

relationship between the two is often not clear. It is difficult for workers to know whether they are getting good value for their money. In mandatory accumulation systems, contributions and benefits have a direct and obvious relationship.

- *More attractive to young workers*. Young workers usually understand that their parents' generation is much larger than their own. They understand that their own contributions are likely to increase and their benefits are likely to decrease. Consequently, they are usually opposed to the traditional social security system.

- *Greater potential for financial innovation*. Private pension funds (and life insurance companies) are two of the main institutional investors in any country. They also often purchase fixed-income assets with long maturities. The existence of pension funds will help create demand for products such as long-term government and corporate bonds, mortgage bonds, mortgage-backed securities, and other innovative products.

- *Positive impact on the macro economy*. The multi-pillar pension system may increase overall savings rates and create deeper and more liquid local capital markets.

- *Accumulation systems are a better model for the informal sector than social security systems*. Traditional social security systems are a good pension insurance vehicle for workers who receive wages. It does not work well for entrepreneurs or the self-employed because their earnings are irregular and more difficult to measure. It is also more difficult to collect contributions from these workers. An accumulation system is a better pension savings vehicle for the self-employed and can be adapted to the informal sector more easily than a social security system.

E. The Pension Reform Process in Thailand

Thailand's pension system consists of a variety of programs covering different groups. The various programs began at different times. Existing programs include:

- *Government Pension Fund (GPF)*: This system began in March 1997. Prior to that, the pension systems for government workers in Thailand and in Indonesia were very similar. They consisted of a rich-defined benefit pension payable directly from the state budget. In 1997, Thailand changed the benefits for new government workers and for existing government workers who voluntarily joined the new system. Under the reformed system, the benefit payable from the budget was reduced (but not by much) and a defined contribution pension fund was established. The GPF system is financed by a 6% contribution with half contributed by the Government and half by covered workers. This pension fund provides benefits only for retirement, disability, and death and does not provide medical, housing, or other benefits like other regional provident funds. This reform is not as dramatic as India's New Pension Scheme (NPS), where benefits for government workers will be based only on defined contributions and the old defined benefit schemes will be eliminated.

- *Voluntary provident funds (VPF)*: In December 1987, legislation was enacted allowing employers to establish voluntary provident funds for their workers on a defined contribution basis. Like the GPF, benefits are available for retirement, disability, and death only. Companies that want to be listed on the Thai stock exchange are required to establish a VPF for their workers and state-owned enterprises are "strongly encouraged" to establish VPFs. For these last two groups, benefits are arguably mandatory and not voluntary.

- *Retirement Mutual Funds*: In December 2001, a limited voluntary pension savings program was introduced for individuals.

- *Old-Age Pension (OAP)*: In 1999, a partially funded-defined-benefit social security system began for formal sector workers. It was the first government-mandated pension scheme for the formal sector. The Social Security Office (SSO) administers this program. SSO provides a variety of social insurance benefits such as disability, maternity, health, death, unemployment, and child-care allowances to formal sector workers.

OAP is a traditional defined-benefit social security insurance system and complements the other social insurance funds that SSO administers. It differs from the approach of neighboring countries such as Malaysia and Singapore where multipurpose provident funds are used to finance retirement benefits for the formal sector. Unfortunately, pay-as-you-go pension systems are very sensitive to demographics and the Thai population will age significantly over the next 20 years. Consequently, this system will come under intense financial pressures in the medium to long term.

While the OAP system began in 1999, coverage was phased-in over time. It initially covered only employers of 20 or more. In 2000, it was extended to employers of 10 or more. Finally, in 2002, it was extended to employers of one or more. This delay allowed smaller employers time to prepare for the additional required payroll contributions and to upgrade their information technology systems. SSO also had additional time to prepare for the more difficult task of collecting from small employers.

The OAP system provides a benefit of 15% of 5-year final average pay for a worker with 15 years of contributions at retirement. An additional 1% is provided for each additional year of contributions. Since the system began in 1999, the first workers will be eligible for pensions in 2014. Those retiring prior to 2014 will merely receive a refund of contributions with interest. Currently, contributions are far higher than needed to finance the limited lump-sum benefits. However, by 2027, contributions will no longer be sufficient and system reserves will rapidly be consumed.

To avoid this problem, the Government of Thailand has two options, neither of which is ideal.

- It can either increase the contribution requirement sharply over time. Under this method, contributions will eventually exceed 20% of pay for the OAP program alone.

- The contribution rate can be immediately doubled and the system can accumulate reserves of nearly 50% of GDP to pre-fund the coming demographic crisis. As shown in the next section, the Government of India chose not to establish a traditional social security system for precisely these reasons.

The design of Thailand's pension program for formal sector workers was perhaps over-influenced by the psychological impact of the 1997 Asian financial crisis. It was designed to delay the start of pension payments to allow time for economic recovery. It also avoided investments in capital markets as government officials feared another sharp decline and potential loss of pension assets. While the design may have accommodated short-term needs and fears, it created a pension system that was clearly not

fiscally sustainable in the medium to long term. Now, the Government of Thailand is already faced with the need to significantly reform the formal sector pension system.

The Government of Thailand is studying the option of introducing a mandatory accumulation system—known as the National Pension Fund—for formal sector workers, raising retirement ages, and reducing OAP benefits over time. The new system would be introduced on a mandatory basis for new workers and on a voluntary basis for existing workers. This strategy parallels the changes previously made for the government pension system. Recent political turmoil and the military coup have slowed the debate on pension system reform. The new scheme also faces stiff political opposition from the SSO, Ministry of Labor, International Labour Organization (ILO), and many employers.

F. The Pension Reform Process in India

India's pension reform is designed to create a fiscally sustainable pension system to prevent poverty among the elderly following retirement. As in other Asian countries, the system of family support is slowly breaking down as fertility rates decline and labor mobility increases. India's population is very young and demographic problems will begin later there than in other Asian countries. However, the population will eventually age, making unsustainable a system based on budget transfers or a pay-as-you-go social security system. This has led to the logical conclusion that today's workers need to save for their own retirement through a defined contribution system based on individual accounts.

Most Indians have no formal pension program today. Government workers are covered by a defined benefit scheme payable from the state budget (Training for Capacity Strengthening Program [TCSP]) and the organized or formal sector participates in programs sponsored by the Employee Provident Fund Office. TCSP pays a benefit of about 50% of final pay at retirement and is indexed to wages following retirement. This system will not be fiscally sustainable in the medium to long run.

The office sponsors the Employee Provident Fund (EPF) and the Employee Pension Scheme (EPS). EPF is a defined contribution scheme while EPS is a defined benefit scheme. EPF has a high contribution rate, yet delivers very low benefits at retirement for a variety of reasons. EPS began in 1995 and is supposed to be fully funded. However, its funded status is currently questionable. Both systems have serious problems with transparency, governance, administration, and availability of data for analysis.

India's pension reform goals were designed to correct these shortcomings by creating a reformed pension system for newly hired civil service workers. The new system is based entirely on a defined contribution model and eliminates TCSP for new hires. The primary goals are: improved coverage, fiscal sustainability, improved transparency, low cost, worker choice, and effective regulation.

India rejected the concept of a nationwide social security system because it would require constant increases in contribution rates and/or benefit rate decreases to remain solvent. If the system were pre-funded, it would require a massive asset accumulation, and poor RORs and ineffective governance procedures were feared to endanger system solvency. The Government also concluded it did not have the capability of collecting contributions from 365 million wage earners scattered over a wide geographic area or making benefit payouts efficiently on a regular monthly basis to pensioners.

The key components and concepts of the new Indian pension system were:

- Clear separation of the accumulation phase from the payout phase to avoid a system based on promises that might be difficult to keep;
- Use of fund managers in the accumulation phase and insurance company annuity products in the payout phase;
- Limiting sales expenses and avoiding high-pressure sales strategies, by hiring asset managers through a government-run open tender process and selecting managers primarily on lowest fees and expenses;
- Avoiding high asset management fees, by using index funds;
- Allowing limited participant choice by offering only three types of funds with conservative, moderate, and higher investment risks. Placing choices with individuals rather than employers;
- Reducing administrative costs by using a single centralized organization to collect contributions and data, process enrollments and transfers, and maintain individual accounts;
- Protecting against poverty among the elderly by establishing a retirement age of 60 and requiring at least 40% of the account balance to be annuitized. For those electing to leave the system prior to age 60, 80% must be annuitized;
- Introduction of an EET (exempt-exempt-taxed) tax regime. Current Indian programs use EEE (exempt-exempt-exempt);
- Enrollment through existing venues such as banks and post offices that serve all pension asset managers. Individual managers do not need to

create their own enrollment network; and
- Creation of a separate pension regulator.

This system is intended for Indian civil service employees, at least initially. It is mandatory for the central government and state governments have the option of joining the scheme voluntarily as do the self-employed and those in the informal sector. Many of the larger states have already chosen to join. For the moment, the new system is not replacing the existing EPF and EPS programs, but it has the potential to do so in the future.

This model is very similar to the one that the Government of the United States adopted for its mandatory thrift savings plan for federal workers. The thrift savings plan uses a tender process to hire a record keeper, an insurance company for annuities, and a limited number of investment managers to manage various index funds. In the US system, workers can allocate their money among the index funds as they wish, while in the Indian system, standardized balanced schemes will be made available to members.

VIII. National Health Insurance System

A national health insurance program raises many of the same issues and options as a national pension system. Fundamental questions include:

- Should there be universal coverage?
- Should all Indonesians participate in a single health system or should there be separate programs for different groups?
- What role should the Government and the private sector play in the health system?
- Should there be a defined benefit program, where the package of services is defined and contributions are determined using actuarial analysis? Alternatively, should there be a defined contribution program where account balances are used to finance health expenditures?
- What package of benefits should the mandatory health program cover? What types of voluntary health insurance programs should be permitted?
- Should contributions and benefits be based on the principle of social solidarity or individual equity?
- Should the reformed health-care system be based on existing institutions or are new methods and institutions needed?
- What administrative systems and procedures are needed to support the system?
- What governance procedures are needed to ensure that the system functions efficiently and effectively with proper oversight and protection of member rights?
- Should benefits be paid directly from the state budget or should a separate social insurance fund be established?
- Are there adequate computer models to analyze the long- and short-term financial solvency of the health system?

Other questions and issues are quite different from pensions. Important issues include:

- On what basis should providers be compensated for services rendered?
- How can proper incentives be built into the compensation arrangement so the system does not encourage over- or underutilization of medical services?
- How should providers be evaluated? How will outcomes and efficiency be measured? What criteria should be used for including or excluding providers from the program?

A. Purpose of National Health Insurance

The purpose of a national health insurance program is to provide all citizens with access to comprehensive health-care services at an affordable price. The health-care package should be available on an equitable basis regardless of geographic region or economic status. The health insurance system is normally based on the principle of solidarity. Within reason, contributions to finance the system should be based on ability to pay and benefits based on need.

In most countries, it is accepted that the ultimate goal should be universal coverage of all citizens, though this may take considerable time to achieve. The health insurance system is closely related to the goal of reducing poverty incidence. Catastrophic medical expenses are one of the primary events that can push poor and near-poor families into poverty.

If the health system were to be effective, it must be compulsory. It is very hard to design a financially viable system based on voluntary participation. If workers can choose whether to participate, those in good health may think that the price is too high and opt either not to have

health insurance or to buy insurance at a lower price from the private sector. The national program will then be left contributing with only those in poor health and will be forced to raise required contributions. This will make the national program too expensive for another group of members who will then choose to leave the system. This process, which is referred to as anti-selection, will eventually cause the failure of the health system. To get adequate risk pooling and keep the cost of the system reasonable for everyone, compulsory membership is required.

This is the problem with the current opt-out arrangement for Jamsostek health insurance. Large employers who wish to provide their workers with a better benefits package than the one offered under the Jamsostek program or who feel the price for existing coverage too high can choose to purchase health insurance from private insurers instead. This leaves Jamsostek with fewer members and primarily those with poor health. Ultimately, the Jamsostek program is left with insufficient revenue to finance quality care for its members, which encourages even more employers to opt out. Jamsostek's health program is unlikely to be financially viable unless the opt-out provision is repealed.

In most developing countries, access to health care is based on out-of-pocket payment for services received. Citizens pay for health care when services are provided. Under this system, a serious accident or illness can easily put a family in poverty for two reasons. If the primary breadwinner is unable to work because of illness or an accident, then the family has no income. In addition, the medical expenses may quickly exhaust whatever savings the family might have. To make ends meet, the family might have to eliminate expenditures for education, not receive necessary medical care, reduce their budget for food, sell their house, or take other actions that might make their immediate financial situation and future prospects even worse.

The national health insurance program solves this problem by creating a mechanism for pre-funding and pooling of health-care risks. Pre-funding means that the funds necessary to pay for medical services are accumulated well before the need for services arises. Money is saved in advance to pay for future medical expenses. The concept of pooling means that money is collected from all citizens To pay benefits only those who need medical care. Some citizens may receive far more in benefits than contributions made while others may contribute and receive little or no benefits. Pooling is the concept that underlies all types of insurance.

B. Defined Benefit and Defined Contribution Approaches to Health Care

The defined benefit approach for health-care benefits is the most prevalent method. Under this approach, the health scheme defines the covered health benefits. Actuarial techniques are then used to calculate the required contributions to fund those benefits. Funding health-care costs on a "defined contribution" basis is also possible. Under this arrangement, specified contributions are paid into an individual account and accumulate with investment income just like a defined contribution pension plan. When medical expenses are incurred, the money accumulated in the account can be used to pay for those expenses. The problem with a pure defined contribution arrangement is that it is unlikely to protect against catastrophic medical expenses, as the account probably will not have sufficient funds to cover the expense.

A mix of defined benefit and defined contribution approaches can also be used. For example, in the United States, it is common to have private health insurance policies that cover catastrophic expenses only. The insurance reimburses the individual for medical expenses in excess of $2,500 per individual, for example, in any 1 calendar year. This protects the individual against any catastrophic event but requires him or her to pay for all routine medical expenses out-of-pocket. As part of this arrangement, the individual can put money into a medical savings account on a tax-favored basis and these funds are used to pay for routine medical expenses below the $2,500 limit.

C. National Health Insurance Financing Methods

The concepts of pre-funding and pooling can be implemented implicitly or explicitly. The explicit method is generally referred to as social health insurance while the implicit method is referred to as tax-based health-care financing.

Under the explicit method of financing health care, all covered citizens make contribute to a health insurance fund regularly. The fund's rules define the package of health-care services covered, and the required contribution rate is calculated using actuarial principles and is based on the benefit package, expected utilization of services and the expected cost of those services. If a member requires covered health-care services, the money in the fund is used to reimburse service providers.

Contributions to the fund can be based on pay or can be a flat amount. Wage-based contributions are common for formal sector workers. For the self-employed or the

informal sector, contributions may be based on a different formula because it measuring income and calculating required contributions may be difficult. The Government may also have to make some or all contributions on behalf of the poor or near poor, as they may be unable to afford the required contributions.

The health fund administrator should be able to collect required contributions from all members efficiently. For this reason, social health insurance tends to work best in developed countries that have a small informal sector. If a country has a very large informal sector, efficiently administering the social insurance scheme may be difficult.

However, a social insurance fund does not usually pay 100% of health-care expenditures for several reasons.

- Certain procedures may not be part of the package of health-care benefits. For example, experimental procedures and drugs may be excluded or benefits for psychiatric services or alcohol and drug abuse may not be covered.
- Certain procedures may not be covered, especially for those who are very old. For example, heart transplants might not be covered for those over the age of 70. "Health-care rationing" is an inevitable part of almost all national health systems
- There may be maximum limits on covered expenses on an annual or lifetime basis, or there may be limits on service usage such as a maximum number of covered hospital days, outpatient psychiatric sessions, payments for transplants, etc.
- Usually some type of small payment (co-payment) is required at the time medical services are received to influence behavior patterns among patients and providers. This payment must be small enough that the poor and others can still afford needed services but it must be large enough to discourage citizens from using medical services unnecessarily.

In a well-designed system, about 70–90% of health expenditures should be pre-funded with 10–30% paid out-of-pocket.

The implicit method of financing health care uses general tax revenues to finance health care. Under this method, there is no separate social insurance fund. The country's legislation will define the package of health-care services provided. Like the social insurance fund method, there are generally small out-of-pocket payments are required when medical services are received. The Government reimburses medical providers from the state budget for services provided. The country's overall tax structure plus borrowing must raise sufficient revenue to cover all state budget expenditures, including those for health care, but no separate fund is established solely for payment of medical expenses, and the amount allocated to medical spending is established through the political process as with all other state spending.

Tax-based schemes are used in both developed and developing countries. In some cases, it may be a better scheme for developing countries with a large informal sector because it avoids the problem of calculating and collecting contributions for the social insurance fund. The manner in which the country's health-care burden is shared among the poorer and wealthier members of society in a tax-based system will depend on the structure of the overall tax system. Members of the formal sector may seem to pay for the health expenditures of the poor under this system because they are the primary payers of personal income taxes. However, the state budget in developing countries often receives only a small portion of total revenues from personal income tax. Often other taxes such as value-added tax, customs duties, and property taxes are the primary sources of revenue. These types of taxes may be distributed more equitably among the population than personal income tax. Even under a social insurance scheme, the Government may be paying contributions to the health fund for the poor from general tax revenues. So even under this method, the formal sector may be indirectly subsidizing the informal sector.

Table 11 shows the dominant type of schemes used in several countries today. In many cases, these funds or programs cover a limited portion of the population and may include significant out-of-pocket contributions as well.

Table 11: National Health Insurance Schemes in Selected Countries

Social insurance fund	Tax-based	Mixed
Japan	Britain	Thailand
Republic of Korea	Singapore	
Taipei,China	Malaysia	
India	Hong Kong	
Philippines	Sweden	

Source: World Health Organization (WHO)

Countries may have a single health insurance system covering all citizens or there may be a variety of health insurance systems covering different groups of citizens. For example, a tax-based system may cover the poorest members of society while one or more social health insurance funds cover the formal sector. It is also possible to set up different health funds or programs by geographic region, occupation, or other criteria or to allow citizens to

choose among competing national health insurance funds. Arrangements with multiple funds create a variety of risk management problems. Those funds that cover older citizens or those in poor health will inevitably have higher claims than funds covering those in better health. Smaller funds will also have higher administrative costs and less ability to withstand catastrophic claims than larger funds. A variety of risk-equalization measures are required to make a system based on multiple funds function effectively.

Indonesia uses a variety of schemes to cover different population groups. Table 12 summarizes the different health insurance schemes currently in place in Indonesia.

PT Jamsostek runs a health insurance fund for formal sector workers. PT Askes runs a health insurance fund for civil servants, a special program for the 60 million poorest Indonesians, and sells private health insurance to employees of state-owned enterprises and private employers. This still leaves about 150 million Indonesians with no health insurance program at all. This group remains vulnerable to being thrown into poverty by catastrophic medical expenditures.

Table 12: National Health Insurance Schemes in Indonesia

	Jamsostek	Askes	PKPS-BBM	JPKM
Social insurance fund	x	x		
Tax-based		x	x	
Private insurance		x		x

Askes = Asuransi Kesehatan Indonesia or Indonesia Health Insurance, Jamsostek = Jaminam sosial tenaga kerja or private sector social security system, JPKM = Jaminan Pemeliharaan Kesehata Masyarakat or community health maintenance protection, PKPS-BBM = Program Kompensasi Pengurangan Subsidi Bahan Bakar or compensation for fuel subsidy reduction programs.
Source: Author's classification. Indonesian laws

D. Role of Private Health Insurance

Private health insurance differs from the public health program because the former is based on the concept of individual equity rather than social solidarity. In the public program, required contributions are not based on each individual's age, sex, or health status. The contribution is based on a formula and is the same for all similarly situated citizens.

For private health insurance, the required premium is based on expected future claims. Someone who has a chronic health condition may not be able to buy coverage at all or will have to pay more for a health insurance policy than someone who is healthy. Older citizens will pay higher premiums than the young will. For this reason, systems based solely on private health insurance will normally leave large portions of the population uninsured.

For example, in the United States, a national health insurance program covers most retired workers. However, active workers normally receive health insurance through their place of employment. But the employer is not obligated to provide its workers with health insurance and each employer has its own scheme with different covered benefits and cost-sharing arrangements. Those who are self-employed or unemployed need to purchase their own individual health insurance policies. Not everyone will be able to get health insurance because they are in poor health or the premium is not affordable. As a result, about 40 million Americans do not have health insurance.

In countries with national health insurance programs, private medical insurance is often used to supplement the benefits payable from the public program. For example, private insurance might provide extended benefits for hospital stays beyond what is covered by the public program, or it might cover psychological care, cosmetic surgery, private hospital rooms, or other benefits excluded from the public program. The existence of a private insurance market may allow the Government to keep the cost of the public benefit package reasonable while still allowing those who want additional benefits to buy them with their own funds.

Private health insurance is well suited to supplementing a country's health insurance system because it does not create anti-selection problems. All citizens are required to participate in the state-run system so the cost of public health care is still broadly shared. This is a far better arrangement than Jamsostek's opt-out system.

E. Provider Compensation Arrangements

Health-care expenditures have proven notoriously difficult to control. The primary reason is that those who benefit from the system are the ones who also control the volume of services demanded. For example, doctors tell their patients what types of services and procedures they need and patients are reluctant to disagree with their doctors. Consequently, doctors are in a position to create demand for their own services and often recommend extra tests and procedures that may not be needed or perform surgery when another cheaper alternative might be better.

Consumers are also part of the problem. They usually demand high volumes of services, particularly when they are covered by insurance and out-of-pocket payments are minimal. In this instance, consumers have little incentive to restrict the volume of services requested. In addition, new medical technology continually creates demand for more sophisticated and expensive services.

Governments and private insurance companies have tried many different methods to control rising health-care costs by entering into different types of contractual arrangements with providers. None of them have proven particularly successful. All of them either create incentives for overutilization of services or create incentives for providers not to give needed care. Table 13 illustrates the different methods for the Government or health insurance funds to contract for services with providers.

IX. Indonesia's Decision Process and Road map for Reform

The SJSN Law lays out a proposed design for Indonesia's national social insurance system. However, there is far from universal agreement about this framework, system details, and the proper interpretation of the law. Either Indonesia can try to fit its reform within the restrictions imposed by the SJSN Law or it can choose to modify some elements of the national pension and health-reform design strategy.

The SJSN Law envisions the following structure:

- Introducing a defined benefit pension providing lifetime annuity benefits to everyone (pension scheme),
- Continuing something similar to the existing provident fund structure, but extended to the informal sector (old-age savings scheme),
- Creating a universal health insurance program,
- Introducing/continuing workers' compensation and death insurance programs for everyone, and
- Keeping all existing administrators, changing their legal structure, with a clause that provides for the establishment of a new administrator in case needed.

The law does not give required details to evaluate the fiscal costs of any of the proposed programs. Benefits, contribution levels, and other important design details are not specified.

Table 13: Provider Payment Systems

Method	Description	Advantages	Disadvantages
Fee for service	Providers are reimbursed for actual services provided.	Good service quality	Incentives for overproduction of services and high administrative costs.
Per diem	Providers are paid a flat amount per day. This method is often used for hospital care.	Simple and cheap to administer. Gives providers an incentive to control costs and be efficient.	Incentive to extend hospital stays artificially and increase admissions. Incentive to minimize services to increase profit.
Case payment	Provider receives a flat amount based on the diagnosis. This method is often referred to as diagnostic-related groups or DRG.	Gives providers an incentive to control costs and be efficient.	Encourages increased hospital admission, incentive to diagnose problems as more severe than they really are, incentive to avoid complicated cases that will likely cost more than the case payment.
Capitation	Provider receives a flat amount for each person in the covered population. This is often used with primary care physicians.	Eliminates incentives for excess services	Incentive to provide the least possible amount of services. Incentive to transfer complicated cases to a higher level not covered by the capitation agreement.
Budget	A fixed budget is established for all health-care services	Eliminates incentives for excess services	Budget may be insufficient to finance benefit package. Creates incentive to not provide needed services or creates waiting lists for voluntary procedures.
Salary	The health insurance system establishes its own providers and pays them a salary.	Controls personnel expenses	Only controls personnel costs. There may be provider dissatisfaction with income level, and difficulty getting appointments.

Source: WHO/ILO. Social Health Insurance. A guidebook for planning.

A. General Design Comments

We have a few general observations to make about these proposed plans. In making these comments, we are assuming Indonesia does have the option of amending the existing SJSN Law. Therefore, options that do not precisely fit the proposed structure can be considered.

- Do not put in a traditional pay-as-you-go social security system for formal sector workers. Thailand did it in 1999 and now they are facing a choice between rapidly escalating contributions in the future or accumulating a reserve of close to 50% of GDP to pre-fund the upcoming demographic crisis. Both are poor choices. Indonesia's future demographics will put pressure on any traditional social security system and subject the state budget to large contingent liabilities.
- If a universal pension is desired, consider a flat benefit payable from the budget to those over a specified age. First, determine how much money Indonesia can afford to spend. Then play with retirement age and amount options to find a combination with acceptable short- and long-term costs.
- To compel the self-employed, entrepreneurs, and the informal sector to contribute to social insurance funds is difficult. The Government may spend more on administration and enforcement than it will collect in contributions. Indonesia must carefully consider whether it can efficiently collect contributions from these groups. If not, it should not put them in the system on a mandatory basis. For health insurance, consider a tax-based scheme rather than a social insurance scheme for these groups or consider having the Government make contributions to the health insurance fund for the entire informal sector.
- Create a true defined contribution pension system. Set the contribution level to produce a target replacement ratio at the standard retirement age. The legal structure, governance, administration, and asset management must be improved. The retirement age should be at least 60 years, only a portion of the benefit should be taken as a lump sum, and annuity and periodic withdrawal options should be added. Consider India's NPS structure as one option to improve investment results, control expenses, and separate operational and oversight responsibilities for asset management. If the defined contribution program will only provide a 7–11% replacement ratio, there is no point in having this benefit. Consider making the defined contribution program mandatory for the formal sector and voluntary for the informal sector with some incentive for participation (like a matching government contribution, for example).
- Consider following the approaches of Thailand and India with the government workers plan. A plan for new (and possibly existing) workers should be set up with a modest or no benefit payable on a defined benefit basis from the budget plus a benefit from a new defined contribution system.
- Indonesia needs a system that can uniquely identify system members. This could be a unique identification number or it could be a system based on photographs and fingerprints such as the one India is implementing for its securities market participants.
- The data collection system must be automated. Electronic data submissions, an accurate electronic database, and effective enforcement are necessary. Indonesia should seriously consider a single centralized agency for collecting contributions and data for all social insurance funds like India has created for its NPS system. This agency would collect data and contributions for all social insurance funds and then distribute the data and money to the correct administrators and funds. This would streamline administration, produce economies of scale, and avoid unnecessary duplication of functions.
- Make sure that the Government and formal sector pension schemes are fully portable. It does not make sense to force workers to receive taxable distributions of account balances when they move from one sector to the other or even from one employer to another within the existing system.

B. Reform Road Map

Some guiding principles for structuring the reform road map should be:

Fix existing systems and institutions first. In our opinion, the first step in any pension reform is to fix the existing system—legal structure, governance, administration, and asset management—since this will serve as the foundation for any new system.

- Do not give more responsibilities to existing organizations that are not functioning well. These organizations must first prove that they can properly manage the functions already assigned to them.
- Finish implementing the formal sector pension structure before implementing the structure for the informal sector. The Government cannot afford additional budget spending now any way and any plan for the informal sector will involve budget subsidies in one form or another.
- Build modeling capability. To design properly the ultimate national social insurance schemes without reliable models to project short- and long-term costs and to evaluate potential risks is impossible.

The Government of Indonesia enacted a far-reaching social insurance reform law in 2004. However, this law lacked most necessary design details and articulated a concept that could take many years (or decades) to implement fully. The Government of Indonesia faces two key questions now:

- Is the system design in the SJSN Law the proper ultimate social insurance system for Indonesia? If not, what changes are needed to the legislation?
- What steps should be taken and in what order should the reformed social insurance system be implemented?

The social insurance reform decisions within the Government could take some time to resolve. However, this does not mean the reform process needs to be put on hold until all critical design decisions have been made. Regardless of the ultimate reform selected, there are certain required steps can and should be taken immediately. These will be needed to support any reform.

C. Pension System Reform

The following steps are needed to prepare for the implementation of any pension reform scheme, regardless of design.

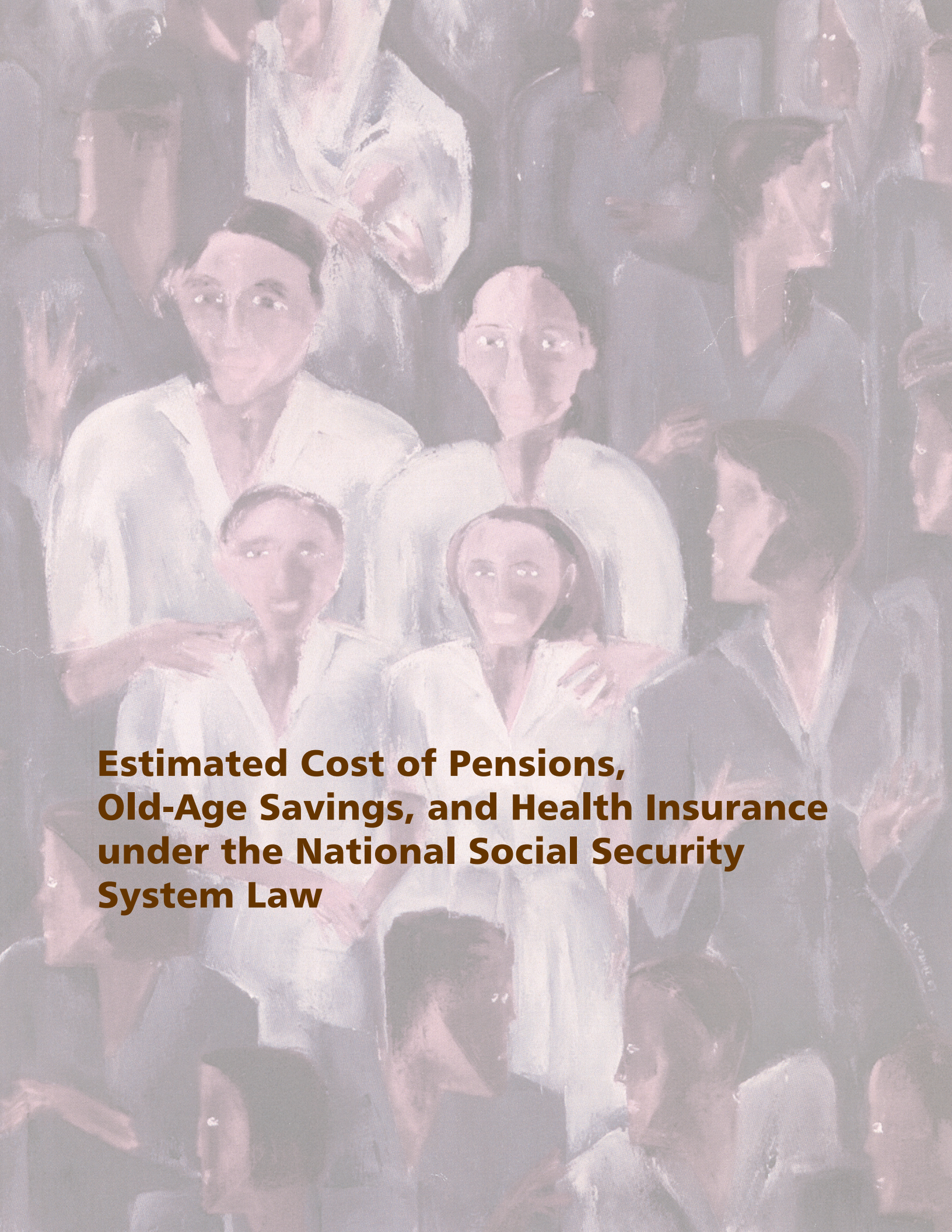
- Reform of PT Jamsostek to improve contribution, collection, compliance, investment policy, governance, and administrative efficiency. This includes some method of unique identification of members, collection of data electronically, and maintenance of an electronic database.
- Creation of pension system modeling capability within the government or an independent institution. Without long-term modeling capability, the fiscal impact of different pension reform proposals cannot be determined.
- Updated actuarial valuation of the Taspen pension and lump-sum programs. The factor for calculating lump-sum benefits was recently increased and government workers have recently received significant pay increases. The Taspen pension program's liabilities need to be reassessed in light of these factors and the decline in system reserves.

D. Health Insurance Reform

The following steps are needed to prepare for the implementation of any health insurance reform, regardless of design.

- Creation of health insurance modeling capability within the government or an independent institution. Without modeling capability, the true cost of the current health benefit packages and the fiscal impact of health reform proposals cannot be determined.
- Actuarial valuation to determine the true cost of various health insurance benefit packages under Jamsostek and Askes.
- Elimination of the employer opt-out program in Jamsostek. Increased compliance in the Jamsostek health insurance program so it includes all formal sector workers and their dependents.
- Review whether the provider network and compensation arrangements for both Jamsostek and Askes are adequate.
- Strategy for "filling the gap" in the health insurance system. Jamsostek compliance could solve much of this problem. By itself, this would eliminate a significant portion of the current uninsured population. However, many Indonesians in the informal sector would still be left without health insurance coverage.

We look forward to working with the Government to design social insurance programs that will truly meet the needs of all Indonesians at an acceptable cost and developing a road map for staged implementation of the reformed system.



Estimated Cost of Pensions, Old-Age Savings, and Health Insurance under the National Social Security System Law

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I. Introduction

The purpose of this paper is to estimate the required contributions to the pension, old-age savings and health insurance funds under the SJSN (Sistem Jaminan Sosial Nasional or National Social Security System) Law.[33] The law requires the establishment of five separate social insurance programs.

- *Pensions*: This program will pay a lifetime pension to workers following their retirement.
- *Old-age savings*: Under this program, workers will contribute to individual accounts throughout their working career. These contributions will be invested and the account balance will be paid out as a lump sum at retirement.
- *Health*: This program will provide comprehensive medical benefits to all Indonesians based on medical need.
- *Workers compensation*: This program pays benefits for those who are injured or die because of their employment.
- *Death benefits*: This program pays a death benefit to the family of a deceased worker.

This paper focuses on three of the above five programs: (i) pensions, (ii) old-age savings, and (iii) health insurance.

The SJSN Law is a framework law, which outlines the basic structure of the reformed social security system, but does not specify the benefits and contribution rates for each of the programs. Consequently, we had to make reasonable assumptions about these variables based on the language of the law and discussions with government officials.

In our analysis, we have focused on both the design of each individual program and the interrelationship among the programs. All the programs must fit together into a package that supports the Government's overall policy and fiscal objectives. Each individual program must have a clear role and rationale within the country's overall social protection scheme.

Under the SJSN Law, the burden of financing the various social insurance programs is allocated among workers, employers, and the Government.

- Formal sector workers and their employers pay for the pension, old-age, and health benefits by making contributions as a percentage of wages. Costs are shared equally between employers and workers.
- Contributions for informal sector workers are a nominal amount in local currency rather than a percentage of wages. Contributions on behalf of the informal poor must be paid by the Government. Those in the informal sector who are not poor must pay their own contributions.

In preparing these estimates, we focused only on the cost of the SJSN programs themselves. We did not estimate the offsetting savings that might occur from the reduction or elimination of other current government programs that may overlap with the coverage provided under the SJSN Law. The results of our analysis are shown in various ways:

- Cost of the program as a percentage of gross domestic product (GDP). This shows the burden of each social insurance program on the Indonesian economy as a whole
- Cost of the program to workers and employers. This shows the burden on employer labor costs and the reduction in workers' take-home pay
- Cost as a percent of the state budget. This shows the amount by which the government budget would have to increase to cover the cost of these programs, assuming there are no expenditure reductions elsewhere.

The remainder of this paper shows the estimated cost for each of the three main social insurance programs and the assumptions and data we used in preparing these estimates. It should be noted that these estimates were prepared within a short period and were based on readily available data. While they are a good indication of the magnitude of program costs, these estimates should be refined as additional data are gathered and as government decisions are made regarding the design of these benefit programs.

It should also be noted that Indonesia does not yet have the infrastructure to support the programs created under the SJSN Law. Significant time and expense will be needed to prepare the necessary administrative procedures, institutions, and information technology systems to support full implementation of the SJSN programs. A

[33] The Coordinating Ministry of Economic Affairs (Menko Ekuin) requested this analysis as part of the Asian Development Bank's (ADB's) technical assistance under TA-4024 (INO): Financial Governance and Social Security Reform.

full discussion of these preconditions is contained in the governance report.

II. Population and Labor Force Projections

To estimate the required contribution to the social insurance programs, we first prepared long-term projections of the Indonesian population, labor force, workers, and beneficiaries. We used a 75-year analysis period, beginning in 2005 and ending in 2080. We used 2005 as the starting year because reliable population data were available for that year.

A. Population Projections

The starting population by age and sex for our study was obtained from the World Bank web site. These values were compared with those from the Indonesian statistical yearbook, which gives information on the working age population by age and sex as of February 2005. Unfortunately, the yearbook does not give information about children by age and sex and groups everyone aged 60 years and over into a single category.

The two primary factors affecting population are fertility and mortality, affecting the number of births and deaths. The other factor affecting population is immigration and emigration, which we assumed netted to zero.

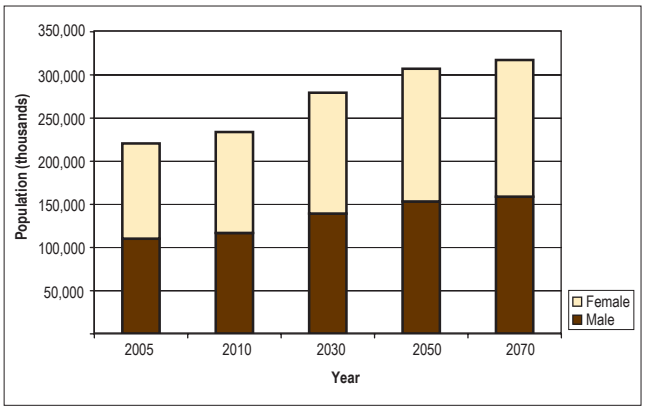
- *Fertility*: We assumed Indonesia's fertility rate to be 2.2 today, declining to 2.1 by 2020 and then remaining at that level throughout the analysis period. The fertility rate is the number of babies that a woman will have during her lifetime. This is consistent with the assumptions that the World Bank and International Labour Organization (ILO) used in their projections.

- *Mortality*: The Government of Indonesia does not publish mortality statistics. Consequently, we started with mortality rates in Thailand, a neighboring country with similar life expectancies. We input recent infant mortality and under-5 mortality rates from the World Bank. Then we calculated life expectancies at various ages and compared them with life expectancies based on the World Bank, United Nations (UN), and ILO projections. Based on this analysis, we adjusted the Thai mortality rates; female rates are higher than Thailand and male rates are roughly the same

- *Immigration and emigration*: As previously stated, we assumed no net immigration or emigration during the analysis period.

Our projections indicate that the population of Indonesia is likely to continue increasing throughout the 75-year analysis period. However, the rate of growth will decline steadily, particularly after 2050, as shown in Figure 1 below.

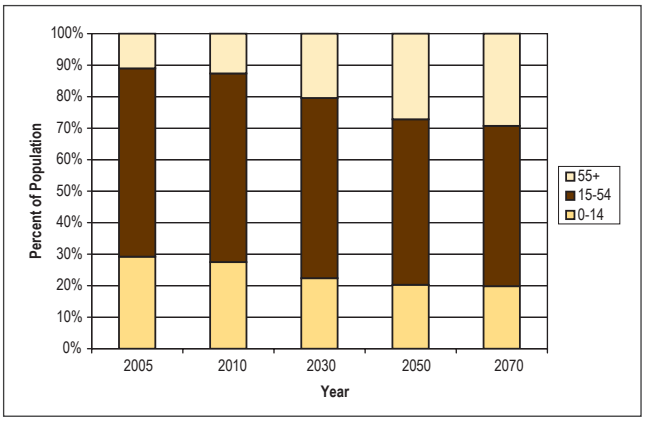
Figure 1: Population of Indonesia, According to Gender (2005–2070)



Source: Author's projections

Although the population grows throughout the analysis period, the age composition of the population will change dramatically. Because today's birth rates are much lower than in the past, the average age of the population will increase. Figure 2 shows the percentage of the population that are children (ages 0–14 years), people of working age (15–54 years) and retirement age (55+ years), both now and in the future.

Figure 2: Population of Indonesia, by Age Range (2005–2070)



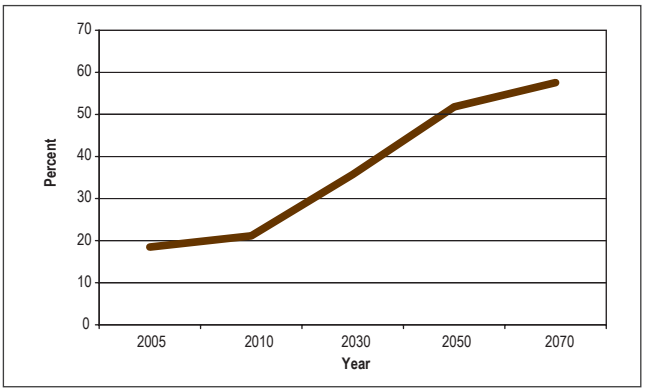
Source: Author's calculations

As can be seen, the percentage of children in the total population declines throughout the analysis period. The same applies to people of working age but the percentage of the population above retirement age dramatically increases. Today, the percentage of the population over age 55 years is less than 12%. However, by 2030 this will increase to 20.4%, and by 2060, it is 29%. A similar pattern is observed if 60 or 65 years is used as the age of retirement.

When establishing pension insurance programs, the most important variable is the population dependency ratio. This is the ratio of the number over retirement age to the number of working age. This is because workers must make sufficient contributions to the social insurance fund to pay promised benefits to those who are retired. The greater the number of pensioners relative to workers, the higher the required tax rate to keep the fund solvent. Figure 3 below illustrates this dependency ratio.

Figure 3 shows that there are more than 5 people of working age for each worker over age 55 years today (dependency ratio is less than 20%). However, by 2047, this ratio will decline to only two workers for each pensioner, and by the end of the analysis period, the ratio is only 1.7 workers for each pensioner and the dependency ratio is close to 60%. The ratios can be decreased by increasing the retirement age, but the dependency ratio will still increase sharply over the course of the 75-year period.

Figure 3: Population Dependency Ratio (2005–2070)



Source: Author's projections

Table 1 below shows the pattern of population dependency ratios as a function of assumed retirement age and year. The higher the ratio, the greater the burden will be on the pension insurance system.

Table 1: Population Dependency Ratio (2005–2070)

Retirement Age	Population Dependency Ratio (%)			
	2010	2030	2030	2030
55	21.1	35.7	51.8	57.6
60	13.4	23.7	36.8	41.5
65	8.7	15.4	25.4	29.2

Source: Author's projections

B. Labor Force and Contributors

Once the population projections have been completed, the next step is to project the size of the labor force and the number of workers. To calculate the cost of the pension insurance program, it is necessary to determine how many workers (formal and informal sector) contribute and how many will receive benefits. To project the labor force and number of workers, we need to know (i) the labor force participation rate (the percentage of the population that is able to work at each age), (ii) the number of unemployed, and (iii) the number of employed.

The Statistical Yearbook of Indonesia for 2005/2006 gives information on labor force participation and unemployment rates in 5-year age groups. The rates are shown in the Table 2 below.

Table 2 shows that 68.02% of the working age population is available to work and 10.26% of those who wish to work are unemployed. Those not part of the labor force include children, students, homemakers, and the disabled. Normally there are separate labor force participation and unemployment rates for men and women

Table 2: Labor Force Participation and Unemployment Rate (2005–2006)

	Labor force participation rate (%)	Unemployment rate (%)
15–19	38.79	34.88
20–24	69.97	25.24
25–29	73.10	11.41
30–34	73.50	4.90
35–39	77.63	3.00
40–44	79.78	2.00
45–59	80.88	2.22
50–54	79.33	2.97
55–59	74.70	4.24
60+	52.20	8.04
Total	**68.02**	**10.26**

% = percent
Source: Statistical Yearbook of Indonesia for 2005/2006

because male labor force participation rates are higher and unemployment rates are lower than for females. However, the yearbook did not include this information.

We kept these rates constant throughout the analysis period. This yields a labor force of about 105 million and employment of 95 million workers in 2007. Either all 95 million workers must contribute to the social insurance funds, or the Government must contribute on their behalf. Under the SJSN Law, the Government contributes for the poor or "financially disabled."

C. Beneficiaries

Next, we must estimate how many are eligible to receive benefits each year from the various social insurance funds. Those who are entitled to benefits vary by program.

- *Pension program*: Those over the specified retirement age can receive benefits for as long as they live.
- *Old-age program*: Upon reaching the retirement age, workers receive their accumulated account balance as a lump sum.
- *Health program*: Everyone in the population is entitled to benefits if they are in need of medical care.

Table 3 below shows the number of beneficiaries (in thousands) eligible to receive benefits from each of these social insurance programs in selected years, assuming a retirement age of 55 years. For the pension program, it shows the total number of pensioners receiving payments in the selected year. For the old-age program, it shows the number attaining age 55 in the given year, and for the health program, it show the population in the given year.

Table 3: Number of Beneficiaries Eligible to Receive Benefits (in thousands)

	2010	2030	2050	2070
Pension	0	25,579	77,632	92,345
Old-age	1,915	3,143	3,588	3,712
Health	233,868	279,382	307,122	317,258

Source: Author's projections

We assumed workers receive benefits when reaching retirement age even if they continue to work. As shown in the previous section, participation rates among the labor force remain high even after age 60. Many of these are likely informal sector workers who continue to work for their entire lives if they remain healthy.

There is one further observation regarding the number of beneficiaries in the pension program. Under the SJSN Law, only those who have contributed for 15 years are eligible for a pension benefit. If the pension program began in 2007, only those reaching age 55 in 2022 or later would be eligible to receive pension benefits. Others are only entitled to a return of contributions with interest. In effect, the pension program is a defined contribution plan for the first 15 years and a defined benefit plan thereafter. Moreover, those who retire prior to the time the system begins will receive no pension benefit at all. Under the SJSN Law, all existing pensioners plus another generation of retiring workers will not receive a pension.

D. Macroeconomic Assumptions

We wish to express the costs of the benefit programs as a percentage of GDP, a percentage of formal sector wages, and as percentage of the state budget. To do this, we must make assumptions about the growth rate of the economy, national wages, and the state budget. The macroeconomic assumptions used in our analysis are summarized in Table 4 below.

Table 4: Macroeconomic Assumptions (%)

	2005	2006	2007	2010	2040	2045	2080
Inflation rate	10.5	13.1	6.5	4.0	4.0	4.0	4.0
Real GDP growth	5.6	5.5	6.0	4.5	4.5	3.0	3.0
Real wage growth	0.0	0.0	4.0	3.5	3.5	3.0	3.0

GDP = gross domestic product, % = percent.
Source: Author's selected assumptions

The real wage assumption was selected to keep labor's portion of total output (national wages) approximately equal to 35% of GDP in all years. This assumption was used by ILO in its social budgeting models and is consistent with the other assumptions selected for this study.

Additional assumptions for this analysis include:

- National wages as a percentage of GDP: 35%
- Wages of the poor as a percentage of national wages: 10%
- Size of the state budget as a percentage of GDP: 20%
- Workforce segmentation: Formal sector (30 million), informal sector and poor or near poor (30 million), informal sector and not poor (35 million).

We used our estimate of national wages and employment to estimate the national average wage for the entire economy, formal and informal, in 2007. This method results in a national average wage of about Rp1 million per month. Based on this information and the assumption on workforce segmentation, we set the average wage for the three employment groups as follows:

- Formal sector: Rp2 million per month
- Informal sector, poor, and near poor: Rp300,000 per month
- Informal sector and not poor: Rp750,000 per month

Information was insufficient to calculate a national average wage separately by workforce segment, gender, or age range.

III. Pension Program

According to the SJSN Law, the pension program should pay a lifetime benefit to all contributors following their retirement. The benefit should be sufficient to "maintain a decent level of living standard." However, under the current system, no benefits are paid to those who retire prior to the start of the pension program and none are paid to those who retire in the first 15 years following the start of the program. The latter group receives only a refund of contribution with interest. To calculate the cost of this program, we must first decide at what age pension benefits will begin and what the benefit amount will be.

A. Retirement Age

The SJSN Law requires the pension age to be "according to valid laws and regulations." The existing retirement programs use a variety of retirement ages.

- Jamsostek pays out provident fund benefits at age 55.
- Taspen benefits for civil servants generally begin at age 56 or 60, depending on employment classification. Benefits can begin as early as 50 with 20 years of government service.
- In the private sector, age 60 is considered the standard retirement age and is the age when health insurance benefits normally stop.
- In the informal sector, since many citizens work throughout their entire lives, determining a true "retirement age" is difficult.

Nonetheless, retirement age is a key variable in the design of any pension scheme. It determines the age at which most workers will leave the labor force, the number of years workers are likely to contribute to the pension insurance fund, and the number of years for which workers are likely to receive benefits. In general, the Government has a choice between:

- having a low retirement age and paying low benefits or having a higher retirement age and paying higher benefits; or
- having a low retirement age and higher cost or higher retirement age and lower cost.

In our opinion, age 55 is too low as a general retirement age. Even today, life expectancy at age 55 is 20.9 years for men and 22.6 years for women and will increase to 23.5 and 25.5 by 2050 (author's estimates). The retirement age used for the pension insurance system should be at least 60 today, if not higher, and will undoubtedly have to be increased in the future to recognize higher life expectancies and to control the cost of the pension program. In some countries, benefits are paid from the state budget to only the very old (age 75 or older, for example) and not to all who have retired from the labor force. Nevertheless, based on the language of the SJSN Law, we have calculated costs based on retirement ages of 55, 60, and 65.

B. Pension Indexing

Another issue is how the pension benefits will be increased (indexed) following retirement. If pension benefits remain the same, they may be adequate to prevent poverty upon retirement, but can quickly become inadequate a few years later due to inflation. For this reason, pensions are normally indexed to either inflation or nominal wage growth following retirement. We have shown cost estimates on both bases.

C. Benefit Amount

The next step is to determine a reasonable target pension benefit meeting the requirements of the law. The Millennium Development Goal for Indonesia is to provide a benefit of $2 per day to all Indonesians on a purchasing power parity basis by 2015. This is equivalent to Rp194,439 in 2006. Consequently, we chose to use a benefit amount of Rp200,000 as the pension benefit level for 2007 and we assumed this amount would increase in proportion to wages each year. Based on our income assumptions, Rp200,000 is

10% of the average formal sector wage and 20% of the average income for the entire economy.

For purposes of this paper, we have valued only old-age benefits and have not included the disability and survivor benefits that the SJSN Law contemplated. The cost of these programs can be added to our analysis following further discussion and guidance from the Government. With these results, the Government can easily estimate the cost of different benefit amounts by increasing or decreasing our results proportionately.

D. Additional Assumptions

The SJSN Law requires 15 years of contributions to receive benefits. Those with less than 15 years' contributions at retirement are entitled to a refund of contributions made on their behalf with interest. If the pension program began in 2007 and the retirement age was 55, only those who are age 40 or younger would be entitled to a pension benefit, the first of which would be paid in 2022. Those retiring earlier would receive only a lump-sum payment and not a lifetime annuity.

We also assumed everyone begins receiving benefits at the stated retirement age even if they are still working. Labor force participation rates show that many continue working beyond age 60 or even 65. Yet, defining the retirement age in the informal sector is difficult since many continue to work full or part-time until they die or until their health fails.

For purposes of this paper, we assumed the benefit is a flat amount payable to anyone with 15 or more years of contributions. One problem with this proposed design is the lack of an incentive to contribute for more than 15 years if the benefit does not increase. If those with 15 years' contributions and those with 30 years' contributions are both entitled to the same benefit, why contribute after reaching the 15-year threshold? The solution to this problem is to have workers accrue the full benefit over a longer period,, such as 30 years. Those who contribute for 15 or more years but less than 30 years would receive a prorated benefit. Of course, this means those retiring with 15 years of service would only receive a benefit equal to half the poverty level. It also means that those retiring more than 30 years after the start of the new system would be eligible for a full pension. We will need additional guidance from the Government on this issue.

E. Cost of the Pension Insurance Program

The most basic measure of the cost of the pension program is the benefits as a percentage of GDP. This figure represents the overall burden of the pension insurance program on the economy. It also represents the cost to the state budget if the Government were to pay the entire cost of the program on a pay-as-you-go basis.

Table 5 below presents costs as a percentage of GDP for each of the six different plan designs we examined.

Table 5 Cost of Pension as Percentage of GDP

Retirement Age	Pension Indexing	(%) 2010	2030	2050	2070
55	Inflation	0.15	1.80	2.77	3.09
60	Inflation	0.11	1.47	2.37	2.67
65	Inflation	0.09	1.14	1.90	2.17
55	Wage	0.17	2.29	3.99	4.50
60	Wage	0.13	1.84	3.23	3.69
65	Wage	0.10	1.39	2.45	2.85

GDP = gross domestic product, % = percent.
Source: Author's projections

As can be seen, expenses in the early years of the pension system will be very low. However, as the population ages and life expectancy increases, the cost of the program escalates significantly.

These costs can also be expressed as a percentage of the state budget. Assuming the state budget remains 20% of GDP in the future, the cost as a percentage of the budget will be equal to five times the cost as a percentage of GDP. This would be the cost if the Government paid for the entire pension system from the budget.

Table 6: Cost of Pension as Percentage of State Budget

Retirement Age	Pension Indexing	(%) 2010	2030	2050	2070
55	Inflation	0.75	9.02	13.86	15.44
60	Inflation	0.55	7.33	11.85	13.34
65	Inflation	0.46	5.68	9.50	10.84
55	Wage	0.87	11.45	19.93	22.51
60	Wage	0.64	9.18	16.16	18.46
65	Wage	0.51	6.93	12.24	14.24

% = percent
Source: Author's projections

The next issue is the allocation of cost among the three labor force segments:

- formal sector workers,
- poor informal sector, and
- nonpoor informal sector.

Each workforce segment's benefits are financed in a different manner under the SJSN Law.

Formal sector workers

Benefits for formal sector workers are financed by contributions as a percentage of wages. For these calculations, we need to know:

- the size of the formal sector,
- the age/sex composition of the formal sector, and
- the average wage of all formal sector workers.

As discussed in an earlier section of this paper, we assumed there were 30 million formal sector workers out of 95 million workers (31.6% of the workforce). We also assumed the average wage of the formal sector in 1997 was Rp2 million per month.

No public information is available regarding the age/sex distribution of all formal sector workers so we have assumed the age/sex distribution is the same as the total labor force. This is unlikely to be correct. Experience from Thailand, for example, suggests that the formal sector workforce is younger than the entire workforce. They also tend to retire from the workforce at earlier ages than the informal sector where lifetime work is often the norm.

Using these assumptions, we then calculated the required contribution as a percentage of wages to finance the pension benefit. For these calculations, we assumed that throughout the analysis period:

- the retirement age does not change,
- formal sector workers remain 31.6% of the total work force, and
- national income remains 35% of GDP.

When calculating the cost as a percentage of wages, we also must decide whether the workers and employers should pay an amount that is expected to stay level for the near future or whether the contribution rate should start out low and grow over time. Both methods have advantages and disadvantages and neither is optimal.

Defined benefit pension insurance funds are difficult to finance properly when the population is aging and the ratio of pensioners to contributors (the system dependency ratio) is growing. These programs work best when the system dependency ratio is stable or declining. The government must choose between two financing methods:

- *Finance the program on a pay-as-you-go basis*. Contributions each year are sufficient to pay benefits and administrative expenses in that year. If the Government makes this choice, then the required contribution rate will increase sharply over time, assuming there is no change in benefits or the retirement age. In this instance, older workers will pay very little for their benefits, while younger workers and future work force entrants will pay far more for the same benefit.

- *Finance the program on a partially funded basis*. Contributions are a level percentage of pay in each year. Contributions in the early years are higher than needed to pay benefits and administrative costs. The excess contributions are used to accumulate a reserve. Investment income on the reserve and the reserve itself are used to supplement contributions in later years when they are insufficient to pay all benefits and administrative expenses. In this instance, costs are allocated more fairly between generations. However, the pension insurance fund will accumulate a very significant reserve that must be properly managed and protected.

Table 7 below shows the costs on both bases. These are the required contributions rates to finance benefits for the formal sector only. Informal sector workers (or the Government) will need to contribute on a nominal basis to finance their own benefits. These amounts are a function of the assumed average wage for formal sector workers. We assumed this amount is Rp2 million in 2007. If the actual average wage of formal sector workers is different, the amounts in Table 7 will be proportionately higher or lower.

The contribution rate for the formal sector should probably be somewhat higher. The rates in Table 7 are based on average mortality rates for the entire Indonesian population. The formal sector will more likely have lower mortality rates and longer life expectancy, so the contribution

Table 7: Contribution Rates as Percentage of Formal Sector Wages

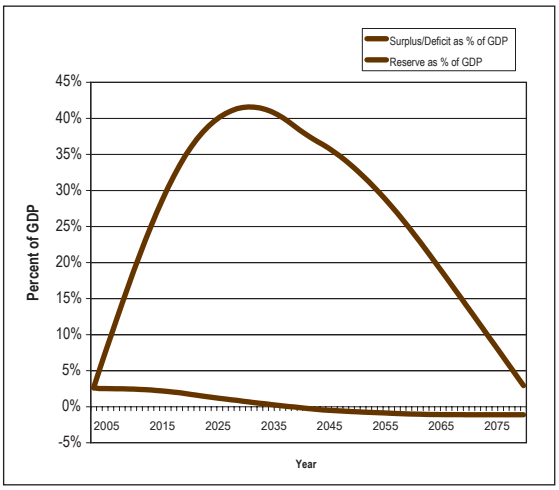
Retirement Age	Pension Indexing	PAYG cost (%)				Level Rate
		2010	2030	2050	2070	(%)
55	Inflation	0.22	2.59	4.21	4.66	3.40
60	Inflation	0.16	2.10	3.60	4.03	2.90
65	Inflation	0.14	1.63	2.89	3.27	2.30
55	Wage	0.26	3.29	6.06	6.79	4.80
60	Wage	0.19	2.64	4.91	5.57	3.90
65	Wage	0.15	1.99	3.72	4.30	2.90

PAYG = pay-as-you-go, % = percent.
Source: Author's projections

rate should be higher. We do not have the necessary data to calculate mortality rates by age and sex separately for the three population segments. With this caveat, all costs in this paper are calculated so that cross-subsidy between the three groups does not exist. However, there will still be subsidies within each workforce segment. For example, those in the formal sector with higher wages are subsidizing benefits for formal sector workers with lower wages.

Figure 4 shows the year-to-year surpluses or deficits and the reserves in the portion of the pension insurance fund for formal sector workers assuming benefits are financed with a contribution rate that remains level throughout the analysis period. This graph is based on a retirement age of 60 with wage indexing. The shape of the two curves is similar for all six options, although the maximum reserve as a percentage of GDP varies somewhat.

Figure 4: Surpluses/Deficits and Reserves of Pension Fund as percentage of GDP



GDP = gross domestic product, % = percent
Source: Author's projections

Figure 4 shows that contribution revenue exceeds expenditures until 2039. After this date, contribution revenue alone is insufficient to pay all benefits and expenses. Thereafter, reserves and interest on reserves must be used to supplement contributions and pay all benefits and expenses when due. Until 2067, the reserve continues to grow in absolute amounts, but it becomes a smaller and smaller percentage of GDP. After that date, the reserve shrinks rapidly and is fully exhausted in 2080, the end of the analysis period. It should be noted that the reserve reaches a maximum of 45.6% of GDP in 2032. The government will have to efficiently manage and protect this reserve. Otherwise, the Government's contingent liability could be substantially higher.

Informal sector

Funding for the other two groups will be based on nominal contributions rather than on contributions as a percentage of wages. Nevertheless, the basic issues are the same. For purposes of this discussion, assume the retirement age is 60 years and wage indexing is used. For the formal sector group, the cost is 3.9% of payroll on a level-funding basis. For 2007, the average contribution for the formal sector group would be Rp78,000 (3.9% of Rp2 million).

For the informal sector, the same contribution amount will be required from each individual, and this amount should be increased in proportion to the average wage of that group each year. While this amount is only 3.9% of wages for the formal sector, it will be 10.4% of income for the nonpoor informal sector, and 26% of income for the informal poor. This assumes, of course, that life expectancy is the same for all groups. Without proper statistics, it is difficult to say whether the mortality rates for the informal poor and nonpoor are higher or lower than the average mortality rates for the entire Indonesian population. To treat each population segment equitably and avoid cross-subsidies between segments, an effort should be made to develop separate mortality tables for each segment.

Of course, the Government will pay for the informal poor. The total required payment on a level-funding basis for 2007 would be Rp78,000 per month per person or Rp28.1 trillion for the year (78,000 * 12 * 30 million). The government could also finance the informal poor on a pay-as-you-go basis. In this instance, the required government contribution will be less in the early years and greater in the later years. In 2007, the cost would be virtually zero, but would increase to more than 37% of the average wage of this group by 2070. Since the Government is paying for the benefit, it makes sense to finance it on a pay-as-you-go basis since individual equity is not an issue and there is no reason purposely to accumulate a large reserve that will take money away from other needs such as education, health, and infrastructure.

The situation for the nonpoor informal sector is much more difficult. On a funded basis, the required nominal contribution is Rp78,000 per month. However, this is likely to be unaffordable for many members of this population segment. Once again, financing could be done on a pay-as-you-go basis. However, this would create the same problems as financing benefits for the formal sector on a pay-as-you-go basis. Required nominal contributions would increase rapidly over time and younger workers would be paying far too much in relation to benefits received. For this group, realistically, the Government will likely have to pay at least a portion of the required monthly contribution.

Even if the Government paid half the contribution, the burden as a percentage of the average wage of the group would be higher than for the formal sector.

F. Observations and Recommendations

In our opinion, establishing a defined benefit pension insurance fund financed by worker contributions is not a good idea. The contingent liability assumed by the budget is simply too high. Potential revenue shortfalls could be very high on either a pay-as-you-go or funded basis. The plan will be inequitable for young workers and future workers on a pay-as-you-go basis. On a funded basis, the required contributions may be too high for many workers, particularly in the informal sector, and the level of reserves will be extremely high.

If the Government truly wishes to provide a pension benefit sufficient "to maintain a decent level of living standard," it should do so through direct payments from the budget without any requirement for worker contributions. Although costs will still increase over time as a percentage of GDP and the budget, this will avoid the issues of individual equity. The government will not be required to collect contributions from the informal sector and will not have to deal with the time, expense, and governance issues associated with efficient and effective management of a very large reserve.

There is one other major advantage of paying benefits directly from the state budget. The government could significantly reduce costs by managing the program on a means-tested basis. Means testing is a powerful tool for controlling costs by targeting payments only to those who are in need. A social insurance program cannot use means testing. By definition, those who contribute and meet eligibility conditions receive benefits. However, if the Government pays benefits from the state budget, means testing is a viable alternative, either now or in the future.

IV. Old-Age (Savings) Benefit

According to the SJSN Law, the purpose of the old-age benefit scheme is to provide workers with a lump sum at the time they retire. The benefit must be a lump sum equal to the account balance and is generally paid at retirement, permanent disability, or death. The SJSN Law also includes a provision allowing some portion of the account balance to be withdrawn after contributing for 10 or more years. Like the pension program, formal sector workers are required to contribute a percentage of wages and those in the informal sector contribute a nominal amount. Although not explicitly stated, it appears that the Government is required to contribute for the poor, and we have assumed this is the case in preparing our analysis.

This benefit differs from the Jamsostek and Taspen lump-sum programs in several significant ways:

- Unlike Jamsostek, account balances are not paid-out due to termination of employment or unemployment for more than 6 months. The law does allow a portion of the account balance to be withdrawn after 10 years of participation, but the amount and conditions are not stated.
- The benefit is equal to the account balance based on actual investment earnings. In Jamsostek, the rate of return (ROR) credited to individual accounts is declared by the company and is not equal to actual investment earnings. In the Taspen lump-sum program, the lump-sum amount is determined by a formula related to final salary and years of service. Although employees are required to contribute 3.25% of pay, the Taspen program is actually defined benefit and not defined contribution. The obligation is to pay a lump sum based on the formula and not on any account balance.

The old-age savings program under the SJSN Law is a defined contribution scheme while the pension program is a defined benefit scheme. Under the pension program, the Government sets the benefits and actuarial calculations are required to determine the contribution rate. Under the old-age savings scheme, the opposite occurs. The government sets the contribution rate and the benefit is equal to the account balance at retirement. It is impossible to state in advance what the account balance will be as it depends on too many factors:

- wages and the pattern of wage changes,
- periods of absence from the labor force,
- contribution rate,
- investment management and administrative expenses, and
- ROR on investments.

However, it is possible to use reasonable assumptions to estimate the likely size of the account balance at retirement and the impact of changes in the variables listed above on the size of the benefit.

A. Contribution Requirement

The first step is to decide what the contribution rate will be for the formal sector and what the nominal contribution amount will be for the informal sector. The government's choice of contribution rate should depend on the following policy issues:

- The social purpose of the lump-sum payment upon retirement. What types of expenses is the lump sum supposed to provide for? How much money is required to meet those needs in relation to salary preceding retirement?
- The affordable level of contributions for employers. Contributions to the social insurance fund must be balanced against labor costs and the competitiveness of Indonesian products in the regional and global economies.
- The affordable level of contributions for workers. This is a trade-off between saving for a secure retirement and the need for current consumption.
- The size of the severance pay benefit. If the severance pay program makes large lump-sum payments at retirement, then the need for large lump sums from the old-age savings program will be less. Alternatively, a large old-age savings contribution could be used as a partial substitute for the severance pay program.
- The size of the pension benefit and the quality of the health insurance coverage. Following retirement, workers need both longevity insurance and savings for large purchases or emergencies. The longevity insurance is provided by the pension component. This component should assure sufficient monthly income to avoid poverty in retirement. One of the main financial emergencies for the elderly is the risk of large medical expenses. If national health insurance effectively controls this risk, then the need for large lump sums may be much less than if no medical insurance exists for the elderly as is the case for most of the population today.

A complete analysis of the required contribution rate for the old-age savings scheme is beyond the scope of this paper. Most countries with very modest defined benefit pension programs like the one anticipated in this SJSN Law tend to have higher contribution rates to their old-age savings programs. For example, Hong Kong's mandatory savings program requires a 10% contribution rate—5% from workers and 5% from employers. In Kazakhstan and Chile, both of which have very small or nonexistent national defined benefit pension schemes, the contribution rate is also 10%. In Australia, the required contribution rate is 9%. In European countries where defined benefit social security systems tend to provide higher benefits, contribution rates generally range from 5–8%.

Another policy issue that requires attention is required annuitization. In Southeast Asia, a strong bias toward lump-sum payments prevails. This is the case in both Hong Kong and Australia. Eastern Europe and Latin America have the opposite bias—limiting lump sums and requiring either periodic withdrawals from investment accounts over a long period or required annuitization. If Indonesia chooses to have a high contribution rate to the old-age savings system, it should consider requiring at least a portion of the account balance to be annuitized, especially since the defined benefit pension component will, by design and financial necessity, need to be kept small.

For purposes of illustration, we used a contribution rate to the old-age savings system of 5.7% of wages for the formal sector. We also used the same 5.7% rate and the average wage of the informal sector (poor and nonpoor separately) to calculate the required flat contribution for those population segments. This is the total contribution rate to Jamsostek's provident fund today. The accumulated account balance for any other contribution rate can easily be calculated from these results, since it will be proportional.

B. Cost of the Old-Age Savings Program

Based on this contribution rate and the assumptions outlined earlier in this paper, we calculated the total cost of the old-age savings program as a percent of GDP. If national wages are equal to 35% of GDP and the required contribution rate is 5.7% of wages, then the total cost of the program will be 2% of GDP (35% * 5.7%). Based on our estimated 2007 GDP of Rp3,533 trillion, the total cost would be Rp70 trillion. This amount would be allocated among the three population segments as follows:

- *Formal sector:* Total contribution is 5.7% of wages, split equally between workers and employers. Assuming an average wage of Rp2 million per month, the contribution for an individual worker would be Rp1,368,000 per year per worker (2 million * 12 * 5.7%) or Rp684,000 each for the worker and his or her employer. Assuming 30 million formal sector workers, the total contribution for the entire formal sector would be Rp41 trillion, paid entirely by employers and workers.

- *Informal sector, nonpoor*. We assumed the average wage for this group is Rp750,000 per month and the flat contribution amount for each member of this group is Rp42,750 per month (5.7% of 750,000). Assuming 35 million workers in this segment, the total required contribution would be Rp18 trillion.

- *Informal sector, poor*. With an average wage of Rp300,000 per month, the required contribution will be Rp17,100 per month. Presumably, the Government will be responsible for this contribution. The total required amount, assuming 30 million workers, would be Rp6.2 trillion or about 0.18% of GDP.

C. Benefits from the Old-Age Savings System

Next, we need to estimate the size of the lump sum at retirement that can be generated by a 5.7% contribution. As stated earlier, the benefit amount will depend on a wide range of different variables. Consequently, we need to make some reasonable assumptions to estimate the expected benefit and then study the consequences of variations in these factors.

In the literature we have studied, benefits from the current provident fund are often expressed as a multiple of monthly salary prior to retirement. For example, if the account balance at retirement is Rp5 million and monthly salary is Rp1 million, then the benefit ratio of the account balance to salary at retirement is 5; the account balance, without future investment earnings, can continue salary payments for 5 months. We will use the same method to express the results of our analysis—the number of months of salary provided by the account balance.

We made the following simplifying assumptions for our analysis:

- contribution rate: 5.7%,
- contribution payment frequency: all years,
- withdrawals prior to retirement: none,
- inflation: 4%,
- real rate of wage growth: 2%,
- real ROR on investments: 4%,
- expenses: none.

Based on these assumptions, Table 8 shows the ratio of the account balance to final monthly salary as a function of years of contributions.

Table 8: Account Balance, in Salary Multiples

Years of contributions	Salary multiple
5	3.7
10	7.8
15	12.2
20	17.2
25	22.7
30	28.7
35	35.3
40	42.6

Source: Author's calculations

The average working career in Indonesia today is about 30 years in the formal sector. Table 8 shows that a worker who contributed regularly would have an account balance sufficient to continue his or her last salary for 28.7 months. This assumes, of course, that contributions are made in all months for the entire 30-year period and the real ROR exceeds real wage growth by 2%. It also assumes no expenses, which is not realistic. Of course, higher multiples can be achieved by increasing the required contribution rate. A 10% contribution, for example, would produce a multiple of 50.4 months.

Table 9 illustrates the impact of ROR on the account balance. It shows the salary multiples with a 5.7% contribution and a real ROR on either 2%, 3%, or 4%, again with no expenses.

Table 9: Impact of Rate of Return on Account Balance

Years of contribution	Account Balance Multiple		
	2%	3%	4%
5	3.5	3.6	3.7
10	7.0	7.4	7.8
15	10.6	11.4	12.2
20	14.1	15.6	17.2
25	17.6	20.0	22.7
30	21.1	24.6	28.7
35	24.7	29.4	35.3
40	28.2	34.5	42.6

Source: Author's calculations

If the ROR, for example, is only 2%, then the account balance will be sufficient to continue salary for only 21.1 months rather than 28.7 months with 30 years of contributions. This is a reduction of 26%. The reduction is even larger if contributions are made for a longer period.

Next, we look at the impact of expense charges on account balances. Expenses are normally charged in one of two ways—as a percentage of assets or as a percentage of contributions. The charge as a percentage of assets

compensates the fund manager for its asset management function. The charges as a percentage of contributions compensates for administrative expenses such as contribution collection, individual account record keeping, participant enrollment, etc.

For a very large fund, such as the one anticipated by the SJSN Law, expense charges should be fairly low due to economies of scale. In general, expenses as a percentage of contribution have a bigger impact on individual account balances in the early years when total assets are smaller than in the later years. By contrast, fees as a percentage of assets are very small when individual account balances are low and are much higher in later years when account balances are large. Different patterns of expense charges create different incentives for the fund manager.

The next four tables (10–13) show the impact of different levels of expense charges. Table 10 looks at the impact of charges as a percentage of contribution.

Table 10 illustrates that charges as a percentage of contributions reduce salary multiples by an equal amount regardless of the number of years of contribution. If the charge is 6%, then only 94% of contributions are invested and the overall size of the account balance will be 6% lower than it would have been without the charge.

Table 10: Impact of Charges as Percentage of Contributions on Salary Multiples

Years of Contributions	Fee as % of Contributions		
	0%	3%	6%
5	3.7	3.6	3.5
10	7.8	7.6	7.3
15	12.2	11.9	11.6
20	17.2	16.7	16.2
25	22.7	22.0	21.4
30	28.7	27.9	27.0
35	35.3	34.3	33.3
40	42.6	41.4	40.2

Source: Author's calculations

Table 11 illustrates the impact of fees as a percent of assets. This is equivalent to a reduction in the real ROR. If the real ROR is 4% and the asset charge is 1% of assets, it will produce the same results as a fund with a 3% real ROR and no asset charge.

We do not recommend this method of charging members for services. Under the SJSN Law, the legal structure of Jamsostek will be changed so it becomes a nonprofit corporation. Under the new structure, the provident fund will be treated as a trust, which means the contributions and investment income will be the property of members and not the property of Jamsostek. Once these changes are implemented, Jamsostek must have a fixed schedule of fees that are charged to the fund for its services. These fees should be transparently tied to Jamsostek's business plan and operating expenses and should be justified to members and approved by the government regulator. A careful study should determine Jamsostek's fees under the SJSN old-age savings scheme .

Table 11: Impact of Charges, as Percentage of Assets on Salary Multiples

Years of Contributions	Fee as % of Contributions			
	0%	0.5%	1.0%	2.0%
5	3.7	3.7	3.6	3.5
10	7.8	7.6	7.4	7.0
15	12.2	11.8	11.4	10.6
20	17.2	16.4	15.6	14.1
25	22.7	21.3	20.0	17.6
30	28.7	26.5	24.6	21.1
35	35.3	32.2	29.4	24.7
40	42.6	38.3	34.5	28.2

Source: Author's calculations

Solely for purposes of illustration, Table 12 below shows the salary multiples based on a 4% real ROR and expenses equal to 2% of contributions and 0.6% of assets. Of course, the benefits are significantly lower than they would have been without expense charges.

Table 12: Account Balance, in Salary Multiples

Years of Contributions	Multiple
5	3.6
10	7.4
15	11.5
20	15.9
25	20.6
30	25.6
35	31.0
40	36.8

Source: Author's calculations

Unfortunately, the SJSN Law allows workers to withdraw a portion of their account balance after 10 years of participation. The permitted percent is not specified in the law and the law does not state whether multiple withdrawals can be made prior to retirement age. If the

old-age savings program's purpose is to save for retirement, then these early withdrawals should be severely restricted or prohibited. One primary reason for the tiny benefits payable from Jamsostek's provident fund at retirement is that most of the money is withdrawn prior to retirement age. It is important to understand the effect of "leakage" on the salary multiples available at retirement.

For purposes of our analysis, we assumed a 4% real ROR and no expenses. We then examined the impact on the salary multiple if 10–50% of the account balance is withdrawn after 20 years of participation. The results are shown in Table 13.

Table 13: Impact of Early Withdrawals on Salary Multiples

Years of Contributions	Percentage of account balance withdrawn			
	0%	10%	20%	50%
20	17.2	15.5	13.8	8.6
25	22.7	20.8	18.9	13.2
30	28.7	26.6	24.5	18.2
35	35.3	33	30.7	23.8
40	42.6	40.1	37.6	29.9

Source: Author's calculations

As can be seen, any withdrawal significantly reduces the lump sum available at retirement. We thus urge the Government of Indonesia to restrict in-service withdrawals as much as possible.

D. Old-age System Assets

Finally, we show the total amount of assets expected to accumulate in the old-age savings system during its first 20 years, assuming the system begins in 2007. For purposes of these projections, we used a 4% real ROR and expenses of 2% of contributions and 0.6% of assets.

The Government of Indonesia must seriously consider how and where it will invest such large amounts of assets and what governance procedures are necessary to protect these assets for the retirement security of its citizens.

Table 14: Accumulation of Assets in Old-Age Savings System

Year	% of GDP
2011	9.5
2016	17.7
2021	24 .5
2026	30.1

GDP = gross domestic product, % = percent.
Source: Author's calculations

V. Severance Pay Program

The severance pay program is based on Labor Law #13 and is outside the scope of the SJSN Law. However, it is impossible to design the pension and old-age savings programs without taking into account the severance pay program and any proposed changes to its design or financing. Now, the severance program—and not the Jamsostek provident fund—is the primary source of financial support for formal sector workers at retirement.

The severance pay program is an unfunded defined benefit scheme. The lump-sum benefit at employment termination is defined by a formula related to years of service and reason for termination. Setting aside funds in advance to meet this payment obligation is not required. However, employers are required to recognize an expense in their income statement and to establish a book reserve on their balance sheet. The Society of Actuaries of Indonesia estimates the cost of this benefit between 8% and 12% of wages.

We understand the Government is considering financing some or all of severance pay benefits through PT Jamsostek. The program could be structured in one of two ways:

- *Similar to the savings program under Taspen*. Under the Taspen program, the benefit is determined by formula and the contributions are set at 3.25% of contributions. Unfortunately, no actuarial study was used to set the contribution rate so it may not be sufficient to fund the promised benefit. Periodic actuarial valuations are needed to set the initial contribution rate and to adjust it over time to keep the benefit fully funded. Systems like the Taspen savings program can quickly become significantly underfunded if large pay increases are granted to all workers or if pay is significantly increased in the year just prior to retirement. Unlike Taspen, the Jamsostek program does not contain any defined benefit pension programs and we do not recommend changing the severance pay program into a funded defined benefit program

- *True defined contribution program*. In this instance, the severance pay program and old-age savings program under SJSN would have a similar structure. Both would require a fixed contribution as a percentage of wages and pay a lump sum based on individual account balances. However, the severance pay program pays benefits on termination of employment while the old-age program pays benefits

at retirement, permanent disability, death, and after 10 or more years' of participation. It might be possible to harmonize and merge these two programs into a single old-age savings program under SJSN that could largely replace both the severance pay plan for formal sector workers and the Taspen savings program. A smaller severance pay program might still be needed for those who become unemployed and are unable to find another job quickly or remain permanently unemployed. This would depend on the conditions for in-service withdrawals permitted in the old-age savings program.

Under any circumstances, the design of the SJSN pension and old-age savings programs must be coordinated with any decisions made regarding the severance pay program.

VI. Health Insurance Program

The health insurance program is designed to provide equal coverage to all Indonesian citizens. Like the other social insurance programs in the SJSN Law, the health insurance program requires contributions from the formal and informal sectors. The formal sector contributes a percentage of payroll, while the informal sector pays a nominal amount and the Government pays for poor citizens.

The benefit covers necessary medical care, including visits to primary and secondary care specialists, hospitalization, surgery, pharmacy, laboratory tests, and other types of care to ensure good health. The system is based on the managed care model. Each citizen has a primary care physician who serves as the focal point of the system. Except for emergencies, patients must first visit their primary care physician before seeing specialists or being admitted to hospitals. Health services will be provided through government-owned facilities or private facilities that have reached an agreement with the administrator of the health insurance fund. The administrators must negotiate rates with the association of health facilities in each region.

This program differs from the others in that it has arguably already begun. PT Askes already provides health insurance coverage to all civil servants and their families and to 60 million poor Indonesians. Coverage of the poor is expected to expand to 74 million by the end of 2007.

The financial management of the health insurance program will differ from the SJSN pension and savings programs for several reasons:

- All Indonesians are eligible for benefits, not only those who have retired. This is a national health insurance program and not just a postretirement medical program
- Required contributions are not impacted by the ratio of pensioners to workers. Rather, contributions are impacted by the total size of the population; the age/sex composition of the population; and the types, use, and cost of covered services. Ultimately, all Indonesians will be eligible to participate and someone will have to pay contributions for all participants.
- As the health sector develops, the availability and type of covered services and standard treatment methods will change dramatically. Therefore, making long-range projections on the future cost of the program is much more difficult (and less necessary).
- The required reserves will be much lower than in the pension system. In the old-age savings program, workers' contributions are saved in an individual account for many years until retirement. In the pension system, population aging and the increase in the number of pensioners relative to workers require the accumulation of a large reserve to prevent very large future increases in costs as a percentage of payroll. In health systems, accumulating very large reserves to pre-fund future increases in medical costs is unusual. Instead, contributions collected each year are designed to be sufficient to pay promised benefits, establish a claims reserve, and cover administrative expenses. Reserves are needed to cover the risk of higher-than-expected claims due to random statistical fluctuations. For proper accounting, reserves are also needed for settlement of open claims and to cover the costs of claims that have been incurred in a particular accounting period but not yet reported. However, these reserves do not contain a "savings" or "pre-funding" component like they the one for pensions.

For these reasons, the cost of the health insurance program is usually not projected for 75 years as was done with the pension programs. Instead, we have focused on the projections in the first 20 years of the new system. As will be discussed later in this section, we assumed the benefit program would be fully phased-in by 2020, so this projection period is sufficient to show the financial impact of the phase-in.

Two state-owned enterprises—PT Askes and PT Jamsostek—currently administer Indonesia's health insurance

programs. Of the two, the Askes program is by far the biggest. As of the end of 2006, Askes had about 76 million members while Jamsostek about 1.3 million members.

PT Askes also has a large professional staff. It has seven health insurance experts, 25 life insurance experts, and six actuaries. It also has more than 100 employees with masters degrees or higher in business and financial management, hospital management, health insurance management, actuarial science, and human resources management.

A. Benefits

The SJSN Law specifies the type of health services that are to be provided to all Indonesian citizens based on need. Citizens will go to public or private health care facilities, clinics, and hospitals to receive medically necessary care. Prescription drugs are also covered as part of the health insurance program. The health insurance fund is obligated to reimburse providers promptly for their services to health fund members at pre-negotiated prices.

B. Cost

Once the range of benefits and services has been specified, the required contributions for the program are calculated based on the expected utilization rate and cost for each service. Based on discussions with PT Askes and Indonesian health experts, we assumed the package of benefits currently provided by the Askes programs for civil servants and the poor (with the adjustments outlined below) will be the benefit package under the SJSN national health insurance program. To the extent the estimated cost of this program is too high or the required resources are not available, the program's benefits may have to be adjusted or phased in over time.

To determine the cost of the benefit package under SJSN, we first studied the health care expenditures under the current Askes programs for civil servants and the poor. Then we adjusted these costs for:

- out-of-pocket expenditures (according to PT Askes, 40% of total costs in the civil service program are paid by users),
- expected future improvements in service quality,
- gradual expansion of coverage to the entire population,
- medical expense inflation,
- increased utilization due to availability of insurance, expansion of facilities and increased citizen knowledge about the health insurance program.

The current Askes health program covers catastrophic health expenditures, but program participants are not satisfied with the quality of care received. Many go outside the program, particularly for outpatient medical care.

Table 15 shows the breakdown of claims costs among primary care, secondary care and hospital care for civil servants, the poor, and commercial insurance.

Table 15: Covered Health-Care Expenditures, in million Rp

	Amount	%
Primary Health-Care Service		
Civil Servants	92,431	9.6
Commercial	79,851	23.2
Poor	798,323	24.0
Total	1,070,605	18.8
Secondary Health-Care Service		
Civil Servants	781,576	39.0
Commercial	93,240	27.1
Poor	395,623	11.9
Total	1,270,439	22.4
Hospitalized Care Service		
Civil Servants	1,031,420	51.4
Commercial	171,239	49.7
Poor	2,137,331	64.2
Total	3,339,990	58.8
Total Health-Care Service		
Civil Servants	2,005,427	
Commercial	344,330	
Poor	3,331,277	
Total	**5,681,034**	

Source: Askes

This table shows that expenses for civil servants for primary health care are a far smaller percentage of total health care services than for commercial insurance or the poor. This shows the extent to which civil servants are going outside the program for primary health care. Not surprisingly, the poor have a higher percentage of total expenses for hospital and a lower percentage for secondary health care than the other two groups. According to PT Askes, Indonesia has a shortage of physicians, particularly specialist physicians in rural areas. As a result, the poor must rely on hospitals for services that might otherwise be provided by physicians in more urban areas.

Table 16 shows other key statistics for 2006 for the three Askes health insurance programs – civil servants, the poor and commercial insurance.

At first glance, these figures appear wildly inconsistent with each other since all three groups have essentially the same coverage. However, the figures are more consistent

Table 16: Key Statistics of Askes Health Insurance Programs for 2006

	Number of members	PMPM	CMPM	Loss ratio %
Civil servants	14,274,776	16,045	11,707	73.0
Poor	60,000,000	5,000	4,627	92.5
Commercial	1,909,662	23,382	16,331	69.8

CMPM = cost per member per month, PMPM = premium per member per month, % = percent.

than they appear and yield important information about the likely cost of the SJSN health program.

- The premium for civil servants is lower than for commercial insurance because the maximum amount Askes pays to providers is set by the Ministry of Health (MOH). Public hospitals and clinics are not permitted to charge Askes more than this amount and in some parts of the country, providers agree to accept less than the rates set by MOH. However, in other parts of the country, like Jakarta, privatized hospitals and private clinics refuse to accept the MOH maximum as payment in full. In this instance, the participant is required to pay the excess of the usual charge over the Askes maximum. According to PT Askes officials, about 40% of the cost of medical care is paid out-of-pocket by plan members. Therefore, the required premium for civil servants needs to be adjusted to reflect these out-of-pocket costs if the SJSN health plan were to provide comprehensive coverage and properly reimburse providers
- The premium per member per month (PMPM) for coverage of the poor is only Rp5,000; and surprisingly, the cost per member per month (CMPM) is only Rp4,627. This means the premium is sufficient to provide the coverage. The logical question is why the cost for the poor for the same coverage is so much less than for civil servants or commercial insurance. The explanation, according to PT Askes officials, is that utilization is quite low and economies of scale keep administrative costs per person lower than for the other two groups. Although 60 million poor Indonesians are covered, only about 60% are actually using the medical insurance. There are several reasons for this low utilization:
  - Many poor Indonesians live far from the nearest clinics or hospitals and cannot afford to travel there.
  - Many do not trust "modern medicine" and prefer to use traditional cures and remedies instead.
  - Many are not aware of the full range of services to which they are entitled.
  - Poor Indonesians tend not to have access to or use expensive medical procedures.
  - The type of care typically required by the poor is different than for wealthier Indonesians. For example, the poor require more care for infectious diseases, which are less expensive to cure than diseases linked to modern and affluent lifestyles.

Over time, as MOH constructs more clinics, hospitals, and other facilities in remote parts of the country, the program expands and citizens gain greater aware of their entitlements under the programs, many of the features that keep the cost lower for the poor than for the other two groups will disappear, leading to significantly higher overall costs.

Another reason for the relatively low costs of the current program is that the MOH is financing the construction of new facilities from the state budget. According to PT Askes, these costs are often not directly built into the overall pricing structure. The prices charged are sufficient to cover operating costs but, in many cases, are not sufficient to amortize the cost of facilities construction and the purchase of equipment. This leaves the burden of repairing or replacing existing facilities and the purchase of new equipment on the state budget. As the pace of facilities construction accelerates, the Government may need to increase its charges to amortize at least the costs of new construction and equipment purchases. The increased demand for primary and secondary medical care, x-rays and laboratory tests, and medical equipment and new technology are likely to cause medical costs to accelerate more rapidly.

Counteracting some of these increases will be the change in the legal structure of the health fund administrators and the increase in the number of members. Once the legal structure is changed, the health fund administrators will no longer need to pay taxes and dividends to the Government. This will reduce their overall expenses, leading to a reduction in required premiums. As the program grows larger, economies of scale will also lead to reductions in unit expenses and more predictable and stable claim patterns. This should reduce the required level of contingency or claim fluctuation reserves.

It will also take time for the health insurance system to cover all Indonesians. Prior to the Askes program for the poor, most health clinics and hospitals were operating well below capacity. Hospital beds were only about 50% full

and public clinics were open only about 2 hours per day. Now that the program for the poor has been implemented, hospitals are much closer to full capacity and clinics are remaining open more hours per day. As the program expands further, it will overload the existing health care infrastructure and create a higher demand for facilities and doctors, particularly in remote regions. The expansion of health coverage will have to be synchronized with the ability of the Government and private sector to provide needed infrastructure. The government's goal for full coverage is 2015, but PT Askes officials believe it might take until 2025 before the system can cover the entire population.

For purposes of our projections, we calculated the PMPM each year and multiplied by the assumed number of covered members of the population. We made the following assumptions when preparing these calculations:

- The percentage of the population covered will increase from 38.8% in 2007 to 100% by 2020. The increase in the covered percentage will be linear.
- The true cost of the insurance program for civil servants in 2006 is equal to the CMPM, adjusted for underutilization of primary care physician services and adjusted for the significant out-of-pocket expenses paid by civil servants for secondary physician and hospital services. The result is a PMPM of Rp31,397 per person per month. This was calculated by dividing the claim amount for secondary physicians and hospital by 0.6 to adjust for the 40% out-of-pocket expense. We then solved for adjusted claims for primary care physicians by assuming those costs will be 23% of total claims (the same percentage as the commercial insurance). Finally, we used the adjusted claims to calculate a revised CMPM and divided this by the current loss ratio to obtain a revised PMPM. These adjustments are shown in Table 17.
- The ultimate cost of coverage for the poor will be equal to 90% of the cost for the civil servants. In 2006, the CMPM for the poor is only 28.3% of the CMPM for commercial insurance. This percentage will increase linearly to 90% by 2020.
- Loss ratios for the health insurance program will gradually increase from an average of 83% in 2006 to 90% by 2020. This is due to the change in the legal structure of the administrators and economies of scale.
- The number of civil servants covered increases at the same rate as the population increases.
- Medical cost increases each year will be 1% larger than increases in GDP. This will slowly increase medical costs as a percentage of GDP and is intended to adjust for changes in medical care and technology as well as for the construction of new facilities and purchase of equipment.

Table 17: Adjusted Claims

(1) 2006 Claim costs for civil servants	(in million Rp)
(a) Primary health care	192,431
(b) Secondary health care and hospital	1,812,996
(c) Total	2,005,427
(2) Adjust for out-of-pocket expenses	(in million Rp)
(a) Primary health care	192,431
(b) Secondary health care and hospital: (1)(a) / 0.6	3,021,660
(c) Revised total	3,214,091
(3) Adjust primary care expenditures	(in million Rp)
(a) Primary health care: (2)(b)* 0.23 / 0.77	902,574
(b) Secondary health care and hospital	3,021,660
(c) Final total	3,924,234
(4) Calculate revised CMPM and PMPM	
(a) Membership	14,274,776
(b) CMPM: (3)(c) / (4)(a) / 12	22,909
(c) Loss ratio for 2006	73%
(d) PMPM: (4)(b) / (4)(c)	31,397

CMPM = cost per member per month, PMPM = premium per member per month, Rp = Indonesian rupiah,
Source: Author's calculations

Based on these assumptions, the cost of the health program as a percentage of GDP is shown in Table 18.

Table 18: Cost of Health Program as % of GDP

Year	Percent (%)
2010	0.7
2015	1.6
2020	2.7
2025	2.9

GDP = gross domestic product, % = percent.
Source: Author's calculations.

Costs in the early years are low because the entire population is not covered and there are insufficient facilities in many parts of the country. However, we have assumed that by 2020, the entire population is covered and facilities are sufficient to meet demand.

Despite all our adjustments and assumptions, the health insurance program still costs just 2.9% of GDP. By international standards, this appears slightly low. Most developing countries spend 3–4% of GDP on health while richer countries spend 8–10%. This implies that the health

insurance program is not covering all health spending. Users will probably have additional out-of-pocket expenses for services that the health program does not cover, and medical costs can be expected to continue to grow as a percentage of GDP after 2025.

This also means there will be (and should be) a role for private health insurance following introduction of the SJSN health insurance program. Those who want coverage for noncovered services, coverage beyond the maximum limits in the SJSN program, or who want to have first class beds in hospitals or more flexibility in choosing service providers, for example, may be able to purchase additional health coverage from private insurance companies. However, some individuals may find they cannot purchase private insurance or the cost may be prohibitively high. Insurance companies will check the health of potential policyholders and will deny coverage to those in very poor health. They may charge more for those whose health is somewhat impaired.

This arrangement is very different from the current Jamsostek health insurance program. Under this program, employers have the right to opt out of the Jamsostek health program if they provide their workers with equivalent or better coverage through a private insurance company. When an opt-out is offered, large employers and those who employ workers who are in good health will choose to leave the program. This leaves Jamsostek with small employers, and workers whose health is worse than average, such as minimum wage earners, workers in hazardous industries, etc. This will inevitably lead to continuing large cost increases and a decline in the number of covered members until the program ultimately collapses. This is a poor arrangement and should be prohibited under the SJSN program.

To get economies of scale and spread risk over as large a group as possible, it is critical for everyone to participate in the base SJSN insurance program. If projected premiums are higher than expected, the benefits can always be scaled back from those originally planned to make the premiums affordable. Those who want additional coverage can choose to purchase it from a private insurance company. A base plus supplemental approach will not cause the financial problems associated with Jamsostek's current opt-out approach.

VII. Summary

The benefits and contributions for the various social insurance programs under the SJSN Law must be defined by regulations. For the purposes of our analysis, we made reasonable assumptions regarding the benefits and contributions based on the language of the law and discussions with government officials. The results of our analysis are shown in the main body of this paper.

In this paper, we also pointed out the administrative tasks that must be completed prior to full implementation of the SJSN Law. Indonesia does not yet have the IT systems, health care infrastructure, financial management tools, and sufficiently effective and efficient institutions to support the SJSN Law. The success of the SJSN program will ultimately depend on both successful financial management and improvements in administrative support systems.

Finally, we have questioned whether the SJSN in its current form is the ideal structure for the Indonesian social security system. While we support the law and its goals, we believe that the Government should consider some modifications to make the program simpler to administer and more cost effective. We also pointed out the necessity of coordinating national social security design with modifications to the severance pay program under Labor Law No. 13.

We look forward to discussing the results of our study, preparing additional analysis, and working with the Government to finalize the overall structure of the national social security system.

Governance Assessment of the Social Security Organizations in Indonesia

April 2007

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I. Introduction

There are four social security organizations in Indonesia: PT Jamsostek, PT Taspen, PT Askes, and PT Asabri. All are state-owned enterprises (SOEs) with a legal structure as a limited liability firm, called *persero*. Each is expected to deliver specific products or services to a specific group of participants:

- PT Jamsostek (Jaminan Sosial Tenaga Kerja) provides two main services: social insurance and a provident fund. The social insurance is for workers in the formal sectors, working either for SOEs or for private firms. It covers work-related accidents, life, and health insurance. The provident fund, the old-age benefit program or JHT (Jaminan Hari Tua), is similar to a defined contribution pension plan. The retiree receives a lump-sum payment upon retirement.
- PT Taspen (Tabungan dan Asuransi Pegawai Negeri Sipil) has two main activities, a defined-benefit pension scheme and an old-age savings scheme for civil servants and senior-ranking government officers. The old-age savings program or THT (Tabungan Hari Tua) provides a lump sum upon retirement, while the pension fund pays monthly benefits for life.
- PT Asabri (Asuransi Angkatan Bersenjata Republik Indonesia) provides the same services as PT Taspen, but for military personnel and civil servants at the Ministry of Defense.
- PT Askes (Asuransi Kesehatan) provides health insurance services for active and retired civil servants, active and retired military personnel, active and retired government officers, and their covered family members (spouses and a maximum of two dependent children younger than 21 years). In addition, it provides a commercial health insurance— membership of which is on voluntary basis—and it manages the Askeskin (Asuransi Kesehatan untuk Keluarga Miskin) or health-care scheme for the poor.

The governance structure of each social security organization follows the common format of a limited liability corporation in accordance with Company Law No. 1 of 1985. Their SOE status also requires them to comply with all prevailing laws and regulations regarding SOEs. The following are the key characteristics of a persero:

- The organization is a commercial legal entity in nature, which is expected to generate profits.
- The use of the corporation's after-tax profit is determined by shareholders at its general meeting of shareholders (GMOS). Either the profit is retained and added to capital or distributed to the shareholders as a dividend.
- As the sole shareholder, the Ministry of State-Owned Enterprises (MSOE) has controlling voting rights in the GMOS to appoint or dismiss the members of the corporate board of directors and the board of commissioners, as well as to determine their remuneration. Despite many expectations of greater transparency in appointing and dismissing directors and commissioners, the nomination and selection processes remain murky and subject to political interference.
- The board of directors and board of commissioners assume fiduciary duties to act in the best interests of the firm and not necessarily the best interests of its members. They must ensure their decisions and actions are taken on that basis.[34]

The roles and duties of the board of directors and the board of commissioners are articulated in the company law. The board of directors is the supreme executive body of the corporation; the only one that can enter into legal contracts for and on behalf of the corporation for all executive affairs. The exception to this are those contracts that require explicit approval from either the board of commissioners and/or GMOS, such as disposal of corporate assets, a decision on merger or acquisition, and remuneration of the board of directors. The board of directors is fully accountable for managing the entire corporation, from strategizing to operating it. Furthermore, the directors are fully accountable for the performance and legal compliance of the corporation.

As the Indonesian Company Law No. 1 of 1985 adopts a "two-board system," the position of the board of commissioners is neither higher nor lower than the board of directors. Both are equal in the governance structure but have different roles and functions. The board of commissioners is responsible for oversight of policy making and the performance of the board of directors to ensure that decisions are made and executed in the best interests of the firm. Law gives the commissioners access to all information and to the premises of the corporation to discharge their oversight role.

[34] Company Law No. 1 of 1985.

Some details of each organization, except PT Asabri, will be further described. PT Asabri is not described in detail for the following reasons:

- structure and process are the same as PT Taspen's, except that the target participants are not civil servants but military personnel;
- the fund is very small; and
- limited information is available.

II. Existing Institutional Structure

A. PT Jamsostek

1. Legal Framework and Corporate Governance

The Government of Indonesia (GOI), in implementing its mandate of providing social protection under the 1945 Constitution, as sponsor of Jamsostek Law No. 3 of 1992 and as shareholder of the executing agency—that is, PT Jamsostek—has delegated its rights and responsibilities to various government departments as follows:

- The Government owns 100% of PT Jamsostek's shares of stock. The Ministry of Finance (MOF) represented it until September 2001 when the role and authority of MOF in perseros were transferred to the minister of MSOEs. All strategic decisions requiring the approval of shareholders were made by MOF–MSOE through GMOS. Further, as a persero, PT Jamsostek reported its financial performance, work plan, and budget to the MOF–MSOE.
- As the designated administrator of Jamsostek programs, PT Jamsostek is supervised by a technical department of the Government, identified in the law to be the Ministry of Manpower (MOM). Under Government Regulation No. 36 of 1995, "guidance and supervision over the administration of the employees' social security scheme by the executing agency are to be provided by the minister in charge of manpower affairs."
- Enforcement of compliance with the Jamsostek Law is the responsibility of MOM. The labor inspection officers of MOM have been vested with this responsibility under Law No. 3 of 1951 on the "Enactment of Labor Inspection Act of 1948" and Law No. 1 of 1970 on "Work Safety."
- The distribution of annual profits as determined by the shareholder of PT Jamsostek, its taxation, and the use of PT Jamsostek resources to manage social and welfare activities, are not harmonized with the corporate mandate of PT Jamsostek as administrator of Jamsostek programs under Law No. 3 of 1992. As revealed in the Asian Development Bank (ADB) operational audit on PT Jamsostek,[35] these have the effect of making the benefits accruing to Jamsostek members dependent on arbitrary decisions of the shareholder or tax office that cannot be demonstrated as complying with Article 25 (3) of Law No. 3 of 1992 and, in some cases, effectively subsidize activities outside its mandated program.
- Certain regulatory duties have been delegated to MOF. PT Jamsostek and its programs are exempted from MOF supervisory and regulatory prudential framework applicable to other pension and insurance programs. However, under Government Regulation No. 28 on the management of PT Jamsostek funds, MOF has been tasked with:

  – Providing advice on the determination of the minimum rate of return (ROR) to be credited on Jamsostek's old-age program or Jaminan Hari Tua (JHT) contribution (Article 10, paragraph 3);
  – Determination of the implementing guidelines regarding Jamsostek's technical reserves (Article 11, paragraph 2); and
  – Determination of the form and content of the annual reports on solvency, audited financial statements, and investment portfolio to be submitted by PT Jamsostek to MOF (Article 18).

As persero, the current governance structure within PT Jamsostek follows the two-board system as suggested in Company Law No. 1 of 1985. It consists of a board of directors and a board of commissioners. While the board of directors is responsible for policy making, the board of commissioners is responsible for the oversight of activities and decisions by the board of directors.

2. Administration and Operational Activities

The administration of a social security scheme has three specific areas, which are critical to its success:

- registration,
- collection of contributions and data and their efficient and correct recording, and

[35] Ernst & Young. 2004. *PT Jamsostek. Performance Audit (1999–2003).* Final Report to the Ministry of Finance of the Republic of Indonesia. (ADB TA Loan 1620-INO Capacity Building for Financial Governance). Jakarta.

- management and payment of benefits.

The first process is divided into two parts: the registration of the employer and the registration of the employee. This process is crucial, and the remaining processes are dependent on the level of accuracy and comprehensiveness of the data collected and stored during registration. The second process—i.e., collection of contributions—is very important as the viability of the schemes is dependent on the correct and timely collection of due contributions. The third and final process, the management and payment of benefits, provides the promised benefits at the time of occurrence of the insured contingency. It alleviates the financial problem of the covered members or their dependents caused by the occurrence of the contingent event.

The ADB performance audit of PT Jamsostek's administration of the schemes indicated a number of weaknesses in the three functional areas. These weaknesses have affected how well the organization functions as an institution, tasked with providing social security coverage to the labor force in the formal sector.[36] The following is a summary of audit results in this particular matter:

- The registration system of employers for recording and administrative purposes is stable but has some limitations. An employer with an enterprise that has branches in different locations will be registered as a separate individual employer for each branch and receive different registration numbers. The employee registration is not managed well at all. A considerable number of employees are registered multiple times. Each time an employee changes employer, he is reregistered and allocated a new number.
- The recording of contributions is inefficient, inaccurate and, in most cases, not current. The principal cause of this weakness is that management has not focused on the need to use modern technologies to address the problem successfully. All attempts to solve the problem are, at best, poorly managed firefighting efforts that make matters worse.
- The weaknesses and shortcomings of the systems of registration and recording have affected the benefits payment system. Payments are delayed and are insufficient in providing the required protection for the contingency. This condition has resulted in poor management of payment to third parties providing services to the employees.

The weakness and shortcomings, together with deficiencies in enforcement and leakage upon early withdrawals after 5 years of participation, have resulted in low effective coverage of employers and employees, a high default rate, inadequate protection of the covered population, and a negative image of PT Jamsostek due to the nonachievement of the intended objectives for which the law was amended in 1992.

3. Financial Management

The investment of fund assets is one of the core activities of PT Jamsostek. In the case of the JHT old-age benefit program, which is a defined contribution plan, the main goal of the investment function is to generate returns that accrue to individual member accounts in accordance with members' investment goals and risk tolerances. This contrasts with the goal under a non-JHT-defined benefit plans, the health-care benefit scheme, the employment accident benefit program, and the death benefits scheme, where the objective is to generate the optimal risks/return combination in accordance with the liability and liquidity needs of the plan. In both cases, it is critical that the investment function be reasonably regulated, implemented, and managed.

The responsibility for regulating PT Jamsostek's investment activities lies with the Government, which issued Government Regulation No. 28 of 1996 (as amended by Government Regulations No. 45 of 1997 and 22 of 2004). The regulatory approach is the use of quantitative portfolio limitations, including portfolio limits and single-issuer limits. These were stipulated in the form of investment management guidelines, namely, Pedoman Pelaksanaan Investasi (PPI). PT Jamsostek developed its PPI in 2003. It set out the guidelines on organizational structures, investment policies, strategic asset allocation, and operating procedures in investment activities.

According to the performance audit conducted for the MOF in 2004 on PT Jamsostek, the developed PPI of 2003 was incomplete in that there were a number of unclear and undefined matters with regard to managing investment funds.

- There are no clear and defined policies on investment horizon, cash flows and liquidity needs, and risk tolerance.
- Other matters that had not been established included industry and geographical limits, guidelines on proper classification of the securities portfolio (i.e. trading, availability for sale, hold to maturity), guidelines regarding specific areas in

[36] Footnote 35.

direct lending activities, selection and retention of counter-party brokers and custodian bank.

- Although the long- and short-term strategic allocations have been developed through PPI of 2003, the policies did not clearly define the elements to be considered in developing a sound and prudent asset allocation strategy. Furthermore, these strategies did not address the different circumstances and requirements of JHT and non-JHT programs, anticipated demands for funds, long-term asset mix over the main investment categories, the maturity profiles required from the investment portfolio, and maximum and minimum limits within which the fund can deviate from a particular asset class allocation.[37]

The absence of complete policies resulted in inadequate diversification, write-down and write-offs of investments in medium-term notes, commercial papers, time deposits, shares of stocks, bonds, and direct investments in shares of stock of unlisted companies, unusual purchase agreements, and investment decisions that were not documented or based on political intervention.

In addition, there was no governing body to oversee the investment activities. While the investment committee was created in 2002, the appointment of the members happened much later. There was also a lack of communication and monitoring of the established investment policy guidelines.

The same audit also noted some concerns on the measurement of investment returns and asset-liability management:

- The basis of the calculation for ROR during the period 1999–2003 was inconsistent from year-to-year. Returns were calculated by dividing income by the average year-end balance in some years and the average month-end balance in more recent years. Such differences in calculation may be misleading and may not reflect the actual ROR attained by the funds. Moreover, the ROR cannot be compared with the trends and market rates as it is calculated differently. The generally accepted and suitable method of calculating ROR within the fund management industry is the time-weighted ROR. This method makes adjustments for the timing of cash flows, which could otherwise distort investment returns achieved by the funds. In addition, investment targets should stipulate both the asset mix and the benchmark so that variation between the expected and actual returns can be analyzed and attributed. Another issue that should be addressed is asset valuation. Are they valued at cost, market value, amortized value, or on some other basis? Who determined the asset valuation rules? What guidelines exist for determining market value of investments? What government institution is responsible for this issue?
- As the JHT fund matures, the matching of its assets and liabilities will become an increasingly important consideration. However, PT Jamsostek has not established a mechanism that determines effectively the maturity profiles of its JHT liabilities as a basis of the investment directorate in deciding the appropriate duration of its assets. Consequently, PT Jamsostek may not be able to anticipate accurately the fund's needs for cash in the coming years, and address how these needs will be provided for so that investment assets are not liquidated unexpectedly and at potentially unfavorable prices and so, the investment portfolio does not contain an excessive amount of cash or low-yielding liquid assets.

4. Tax Compliance

According to Indonesian tax authorities, PT Jamsostek is organized into two kinds of business activities: insurance (for non-JHT programs) and pension fund (for JHT programs).

The income tax treatment with respect to PT Jamsostek's non-JHT programs is similar to that of insurance companies. In the case of the JHT program, the investment income is not taxable for many of the investment types such as dividends—except dividends from their own direct subsidiary—coupons of obligation, and deposits. The expenses for managing this type of investment, such as administration and brokerage fee, are not tax-deductible items from its income on JHT's program. Net profits from both JHT and non-JHT programs are subject to corporate income tax and the net profits can be distributed to shareholders (government) based on a decision of GMOS.

In practice, according to the result of ADB Audit of 2004, PT Jamsostek is not able to determine the actual expenses incurred for the JHT program since there are common expenses for both JHT and non-JHT programs. To address this issue, PT Jamsostek allocates the total common expenses incurred using the ratio of contributions from the JHT program to contributions from non-JHT programs.

[37] Footnote 2.

According to a circular letter of the Indonesian tax authorities, PT Jamsostek is permitted to form reserve funds as follows:

- With respect to life insurance, the amount of premium reserves is in accordance with the computation of the actuary certified by the directorate general of financial institutions of MOF.
- With respect to work accident and health insurance, the amount of premium reserves is 40% of the premium received/earned during the year. The said amount is an income of the following year (unearned premium reserve).

5. Coordinating Mechanism

The existing legal framework provides no clear coordinating mechanism between the three involved government departments—i.e., MOF, MSOE, MOM, and PT Jamsostek—specifying their respective responsibilities and ensuring that all strategies objectives are covered.

B. PT Taspen

1. Legal Framework and Corporate Governance

PT Taspen (persero) was established on 17 April 1963 through Government Regulation No. 15 of 1963 as Perusahaan Negara or PN Taspen. It was changed to Perusahaan Umum (*perum*) or Perum Taspen with MOF Decision No. 749/MK/IV/11/1970 dated 18 November 1970. Subsequently, Perum Taspen was changed to PT Taspen (persero) on 30 July 1981 through Government Regulation (PP) No. 26 of 1981. PT Taspen (persero) has two programs: an old-age saving program or Tunjangan Hari Tua (THT) and a pension program.

The old-age saving program for civil servants was established by Government Regulation (PP) No. 9 of 1963 regarding Civil Servant Financing (Pembelanjaan Pegawai Negeri) and Government Regulation (PP) No. 10 of 1963 regarding Civil Servant Insurance Savings (Tabungan Asuransi). The pension program for civil servants was established through Law No. 11 of 1956 regarding Pension Financing (Pembelanjaan Pensiun) and Law No. 11 of 1969 regarding principles of employment for civil servants. Government Regulation (PP) No. 25 of 1981 regarding social insurance for civil servants, merged the welfare program for civil servants, the old-age saving program (Tabungan Hari Tua) and the pension program into a single program managed by PT Taspen.

PT Taspen has a special legal status. Although the old-age pension benefits program is a type of insurance program, neither is it subject to the Insurance Law nor to the Pension Law. PT Taspen was originally established as a state company under Ministerial Decision No. 380/MP/1960. Subsequently, its legal structure changed in 1982 to become a limited liability company based on Regulation No. 26 of 1981. It is not subject to the regular regulatory framework and does not need to comply with obligations imposed on other pension programs, like the use of a custodian, the segregation of assets, and the appointment of an administrator distinct from the sponsor—that is, the Government itself—or with any particular funding and solvency requirements. Although exempt from the normal regulatory framework, PT Taspen is subject to an ad hoc combination of regulations, decrees, decisions, and instructions from MOF. MOM stipulates the minimum retirement age.

2. Administration and Operational Activities

Clarification is needed on the role of PT Taspen in managing the program. A simpler administrative structure would require separating the responsibilities for policy, administration, and investment. This would eliminate major issues of control and supervision, allowing for a very light and simple approach to the remaining tasks that PT Taspen performs. Once the existing small base of assets is used up and the Government begins to pay all the benefits out of its budget, such segregation will be automatic, and the cost will borne by the government budget.

3. Financial Management

In 1997, the Government issued Government Regulation (PP) No. 30 of 1997 regarding the determination of basic pension scheme benefits for retired civil servants and their spouses. These rules are still being used as the basis for the pension amount calculation.

PT Taspen has two programs: an old-age benefits program or THT and a lifetime pension program. THT is an endowment program combining savings and life insurance, payable in a lump sum upon retirement or death. Employees contribute 3.25% of their salary. PT Taspen's lifetime pension program is a larger program covering all civil servants. Its generous formula can pay up to 75% of final salary for life, with survivor benefits, all indexed based on wage increases. Employees contribute 4.75% of their salary. It is a pay-as-you-go pension fund for civil servants, with the government contribution equal to the current benefit payments minus the employees' contributions. The Government is payer of last resort.

The Government plays a major role in the payment of benefits. Until 1993, pensions and other benefits were

paid from the central government budget, and employee contributions were accumulated to build up the fund. Starting in 1994, 25% of the payments were financed out of the accumulated assets, with the Government contributing the remainder of the cost on a pay-as-you-go basis. The Government's contribution is set at 79% of payments, and the remaining 21% is drawn from the fund. On that basis, the fund will be depleted by about 2008, and the Government will support the full pay-as-you-go cost minus the employee contributions.[38]

The Government faces two issues with regard to the civil service pension system: (i) management of the fiscal costs of the current scheme and the role and (ii) structure of PT Taspen in managing the scheme. The pension and old-age programs for civil servants entail significant costs and liabilities as well as financial risks for the Government. A performance audit completed for MOF in 2003 concluded that there were no reliable estimates for the costs and liabilities of the pension and savings programs. Rough estimates indicate that as of end 2002, liabilities were in the order of 400 trillion rupiah (Rp) (20% of GDP) and assets were only about Rp20 trillion.[39] The true financial state of both programs remains unclear, and there is no clear financing path. The programs have major implications for fiscal policy as well as for the budgets, the allocations to regional governments, and the management of government debt. As a part of the performance audit's recommendation, a thorough assessment of the financial and actuarial state of the civil service pension and savings program was suggested.

4. Coordinating Mechanism

MOF is the single institution responsible for the regulation and supervision of PT Taspen, although MSOE is its shareholder. Contrary to general perception, MOF plays a significant role in managing the pension fund, as the investment of assets is under the ultimate control of the ministry. PT Taspen provides certain management services, such as collecting contributions, maintaining the database, and paying benefits. A board of commissioners and a board of directors governs PT Taspen. The GOI appoints all members of both boards and approves the budget, the financial statements, and annual reports. The investment of assets is under the ultimate control of MOF.

[38] World Bank. 2006. Unlocking Indonesia's Domestic Financial Resources for Development: The Role of Nonbank Financial Institutions. Jakarta.

[39] Footnote 2. However, according to some actuarial experts and PT Taspen, it is now 14.5% and depletion is expected in 2016.

C. PT Askes

1. Legal Framework and Corporate Governance

Based on Presidential Decree No. 230 of 1968 regarding the arrangement of health-care services for civil servants and retired personnel (civil servants and army), the MOH minister established Badan Penyelenggara Dana Pemeliharaan Kesehatan or the provider for the health-care fund as the predecessor of PT Askes. It was changed to Perusahaan Umum Husada Bhakti in 1984 through Government Regulation (PP) No. 22 of 1984 regarding health care for civil servants, retired personnel (civil servants, military, and senior rank government officers), and their family members. Based on Government Regulation No. 69 of 1991, the membership was extended to veterans and their family members. In addition, the company was given a license to expand membership to commercial entities on a voluntary basis.

Through Government Regulation No. 6 of 1992, the status of perusahaan umum or perum was changed to persero, providing more flexibility in financial management and making management more independent.

PT Askes has a two-board system, consisting of a board of directors and a board of commissioners, in line with Company Law No. 1 of 1985. The board of directors is responsible for policy making, while the board of commissioners is responsible for oversight over the activities and decisions of the board of directors.

PT Askes manages three different programs, each with its own regulations, namely: social health insurance, commercial health insurance, and Askeskin or health insurance for poor families.

Social health insurance is a mandatory assignment for PT Askes, based on Government Regulation No. 69 of 1991 also known as "health insurance for government officials." The participants of social health insurance are civil servants, retired civil servants, retired military personnel, veterans, and their family members. The program's beneficiaries have enjoyed comprehensive benefits through a structured health services mechanism and can access medical treatments all over Indonesia that consist of (i) first-level health services (outpatient level one and inpatient level one); (ii) higher level of health services (higher-level outpatient services, 1-day-care health services, and higher-level inpatient services); (iii) inpatient treatment in standard and special; and (iv) other health services, such as blood tests, medication, and other health interventions.

Commercial health insurance is offered by PT Askes on the basis of Government Regulation No. 6 of 1992 where it was given an opportunity to expand its coverage

beyond government officials to other commercial entities. Since 1993, PT Askes has been offering commercial health insurance on a managed-care basis.

Askeskin was established through Ministerial Decree of MOH No. 1241/MENKES/SK/XI/2004. This program provides free health services for poor families. *Puskesmas* (Pusat kesehatan masyarakat) and its network (supporting puskesmas and village midwives) provide primary care. Secondary care is provided by public hospitals (in third-class hospital beds) and by several appointed private hospitals.

The government-appointed PT Askes as the operator of Askeskin program and paid the premium Rp5,000 per capita for poor citizens per month for the health services rendered by PT Askes. PT Askes is allowed to use the premium up to a maximum 5% of the cost of health services as administration cost. If the fund is not fully spent during the working year, the excess can be forwarded to the following year.

The Askeskin program is conducted through a "managed-care" approach that links the payment system to the provision of certain health services. This system has been used by many other countries, as it is effective in improving the health of society collectively while, at the same time, maintaining health costs at a manageable level. Under the "managed-care" approach, the health service providers receive a fixed amount to cover a certain number of people for a certain period regardless of the actual number of sick people at that time. This system is intended to stimulate the health service providers not only to provide the best in curative and rehabilitative services but also preventive services, such as socialization and consultation.

The Askeskin program uses two payment systems. The first is the capitation system, where a payment of Rp1,000 per capita (person) per month is made to Puskesmas for the primary health-care services. The payment is made up front (prepaid system) regardless of the number of participants who actually fall sick. The second payment system is the "package" managed-care system for hospitalization, where PT Askes pays daily package tariffs for the different services—such as the use of a room, medical consultation fee, basic laboratory tests—regardless of their costs as used per day. The use of this daily package tariff is also applied for consultation visits to the polyclinic, laboratory tests, radio-diagnostic tests, electro-medical tests, and medical operations.

Under the Askeskin program, participants use a reference system where a higher level of health services can be accessed only when referred by a lower level of health service provider such as puskesmas, except during emergencies. In August 2006, the Government introduced the use of a "formularium" system, where the use of generic drugs is mandatory for participants of Askeskin to control the cost of medicines and drugs that generally absorb 50–65% of the health service costs.[40]

2. Administration and Operational Activities

Membership to social health insurance is compulsory for civil servants, retired army personnel, veterans, and their families. Civil servants are automatically eligible upon issuance of a decision letter stating that the individual is eligible as a designated civil servant. The civil servant needs to report to the nearest PT Askes office with the decision letter to activate such membership.

The social health insurance program is funded through a 2% payroll deduction from the participant's salary. Payments are based on a capitation system,[41] budgeting system, and benefits package that are consistent with principles of community health maintenance. Health services are provided through a health maintenance organization (HMO) network[42] that is structured to provide preventive, curative, and rehabilitative treatments. The HMO also promotes health services.

However, PT Askes feels that the 2% premium is too low and affects the quality of health services for the program's beneficiaries. Hospitals and clinics that become service providers for PT Askes pay for a large portion of the health services because PT Askes only reimburses a small amount for the services provided for the program's beneficiaries. As a result, the number of services is often quite limited. For instance, most low-ranking civil servants receive the lowest level in inpatient care available (1D class) and it is very difficult for them to access a good referral system.

Membership to commercial health insurance is voluntary upon a cooperation agreement between two parties: PT Askes and the respective client organization or corporation (SOEs, provincial government-owned enterprises, private corporations, and foundations). Upon the signing of such cooperation agreements, the client organization provides the list of their employees who are registered participants.

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[40] Decision Letter of MOH No. 336 of 2006, which was renewed through Decision Letter of MOH No. 720 of 2006 (SK. Menkes No. 336 tahun 2006 yang diperbaharui dengan SK. Menkes No. 720 tahun 2006).

[41] A capitation-based reimbursement system is a health service reimbursement system under which health-care providers receive regular fixed payments for each patient in their care, regardless of the services actually provided to the patient.

[42] A health maintenance organization (HMO) is a health-care provider that offers comprehensive health care to an established panel of providers (doctors, midwives, etc.) that have signed a contract with this organization and who are paid using a capitation-based reimbursement scheme. Common features of HMOs include voluntary membership, comprehensive health services, community rating premiums, and closed system delivery (International Labour Organization, 2003).

The contribution or premium payment for commercial health insurance is determined per person per month. The premium is paid monthly as set out in the cooperation agreement and PT Askes receives premium payment only from the organization or corporation, and not from the individual participant. Whether or not the organization or corporation will deduct premium payment from the employee's salary is not PT Askes' concern.

Membership to PT Askeskin is the Government's responsibility, which determines the number and the name of prospective members. The program is funded from the government budget, paid through MOH in stages within a certain period. GOI determines the rate or premium and its allocation.

3. Financial Management

The financial management has been planned according to government regulations[43] to be invested mostly in term deposits. The investment portfolio is 85% to deposits and 15% to other securities such as stocks and obligations. The fund in PT Askes is around Rp1.7 trillion. Part of the resources is not invested as PT Askes may need the fund anytime to fulfill its obligation to pay claims or with hospitals.

4. Coordinating Mechanism

MOH is responsible for the regulation and supervision of PT Askes, whereas MSOE acts as the representative of the shareholder. PT Askes is governed by a board of commissioners and a board of directors. Representatives from MOH and MSOE sit in the board of commissioners. MSOE appoints all members of both boards and approves the budget, financial statements, and annual reports.

D. Indonesia's Private Pension Funds (Pension Law No. 11 of 1992)

There are two main types of private plans: employer pension funds ((dana pensiun pencari kerja [DPPK]) and financial institution pension funds (dana pensiun lembaga keuangan [DPLK]). DPPKs—also called as occupational pension plans, autonomous plans, and private plans—are funds established by the employer for the benefit of its employees. DPLK are pension plans offered by a bank or insurance company.

DPPK can be either defined-benefit or defined-contribution programs. There are more than 300 employer pension plans in Indonesia. These plans are the conventional way to enroll participants. Unlike some other countries, Indonesian Pension Law does not allow multiple-employer plans or association plans for self-employed professionals. However, the law recognizes that many employers are closely associated within conglomerates or within a certain circle, though not necessarily through affiliates or subsidiaries, and thus, allows employers to cosponsor a plan. Employees of cosponsors are enrolled as participants, and the cosponsor must delegate all its responsibilities to the main sponsor.

DPLKs are defined-contribution programs open to employees and the self-employed who wish to accumulate retirement savings through a supervised and regulated tax-sheltered fund offered by a bank or insurance company. The original intention of DPLKs was to cover individuals (employed or self-employed) who do not have access to an employer pension fund and to offer a vehicle for individuals to hold tax-deferred vested benefits between the termination of employment and normal retirement age. However, some employers have begun to enroll their employees in a DPLK as individual participants and to support their participation administratively through payroll deductions, often contributing on their behalf. There are around 30 DPLKs in Indonesia.

The structure of employer and financial institution pension funds is reasonably similar. Most of the regulatory setup applies to both types, including the mandatory annuitization upon retirement.

Pension Law No. 11 of 1992 is the basic legal framework for private pension funds in Indonesia. This law is based on the principle of "freedom to promise, obligation to deliver," that is, while the creation of a pension program is voluntary, the rights of beneficiaries have to be secured. The law lays out the duties, obligations, and authority of the supervisory board and the administrator; considers the administrator as one legal person; and makes the administrator personally liable for losses due to neglect of duty or obligations.

The regulatory framework for private pension funds in Indonesia addresses several key aspects, but tax issues remain a problem. The prudential framework operates under Law No. 11 of 1992 and two overarching government regulations—Regulations No. 76 for DPPKs and 77 for DPLKs. The framework is a series of decrees dealing with key issues such as funding and solvency requirements, investment regulations, tax treatments, and qualifications of fund administrators. A decree to protect the tax base from excessive erosion stipulates maximum contributions and benefits. One set of limits applies to defined contribution programs that can be offered both by

[43] MOF Decree No. 424. KMK.06/2003 regarding the Financial Health of Insurance and Reinsurance Companies.

employers and by financial institutions. Another set of limits applies to defined benefit programs that only employers can offer using either a monthly pension formula or a lump-sum formula. Despite further clarifications, tax issues remain a source of difficulty. A different tax treatment persists for the benefit of a defined contribution versus a defined benefit plan. Not all investments for pension funds are tax exempt.

The investment regime is a mixture of the "prudent person" rules prevalent in several developed economies and the "prescriptive" guidelines prevalent in developing countries. Detailed limits are not prescribed for each asset class, but overall limitations are applied to achieve diversification of risks. In particular, the regime imposes a maximum limit of 10% of pension assets in any party with an inner limit of 2% in any unit of land or buildings. The limit means that pension funds must have a flexible exit strategy and avoid being a majority owner of a business. Fund sponsors are required to file an annual investment directive defining the investment policy to be followed by the fund administrator. Also stipulated are minimum requirements for what constitutes investment guidelines, the need for an investment plan, categories of eligible investments (foreign investments are excluded), conflict of interest rules, and rules on the valuation of assets.

Private pension funds are considered a special entity according to Article 3 of the Pension Law. They are not a limited liability company and thus do not need a "two-board system." Their governance rests on the principle of a single-governing body that is held by the administrator of the pension fund fully accountable and separate from the sponsor. Furthermore, a supervisory board is assigned by the sponsor. Their respective roles are as follows:

- *Sponsor or founder or employer (Pendiri)*. The sponsor is the corporation that establishes the private pension fund. The employer usually registers the employees as participants in the private pension fund. If more than one sponsor establishes a private pension fund, then the principal originating corporation acts as the sponsor and the others act as cosponsors.

- *Administrator (Pengurus)*. The administrator, as governing body, has full responsibility and determines the overall strategy, plan of action, risk policy, annual budget, and performance objectives. It monitors implementation and performance and oversees major capital expenditures. Article 10 of Pension Law No. 11 of 1992 defines the governing body as an administrator distinct from the sponsor, properly qualified and fully responsible. The administrator is responsible to the sponsor and not to the supervisory board.

- *Supervisory board (Dewan pengawas)*. The supervisory board is a body that has only reporting and monitoring duties and is accountable to the sponsor. The board of supervisors is appointed by the sponsor and represents the employees and pensioners. It supervises the administrator, prepares annual reports, and appoints a public accountant to audit the fund and an actuary to provide an actuarial report. It has no legal responsibility, no accountability, and no executive or administrative responsibilities.

Neither the sponsor nor the supervisory board can interfere with the implementation of the plan. In particular, the sponsor can dictate neither the organizational structure nor the selection or appointment of managers.

The legislation should state clearly the relationship between the sponsor and the fund once established. At present, there are insufficient safeguards to prevent the founder from misusing the fund since the administrator and the supervisory board report to the founder, rather than to the members.[44]

DPPKs and DPLKs are supervised and regulated by the Directorate of Pension Funds (DoP), under the Bapepam LK (Capital Markets and Financial Institutions Supervisory Agency), within the MOF. A bank can obtain a license to run a DPLK after approval by the Bank Indonesia (Minister of Finance Decree No. 228/1993). In this case, on top of the MOF, Bank Indonesia can also examine the bank's DPLK operations as the supervisor of the banking sector. The bank itself is responsible for monitoring its subsidiary operations to ensure prudent implementation of principles as appropriate.

DoP requires pension funds to deliver an administrator's statement; a financial report; an investment report (including investment portfolio position, investment return, and analysis and disclosure); an actuarial report (only for defined-benefit employer pension funds); and a technical report semiannually. It also requires pension funds to publish their audited financial statement in newspapers and to provide a summary of their investment report to their contributors a month after submitting their reports to DoP.

[44] Mc Donald, O. *Review of the Private Pensions Law*. ADB TA 3850: The Establishment of a Financial Services Authority. Jakarta.

E. SJSN Law No. 40 of 2004

In 2004, GOI enacted the National Social Security System Law No. 40 of 2004 (Sistem Jaminan Sosial Nasional or SJSN). This law calls for a national pension plan, along with old-age, health-care, employment accident, and death benefits for Indonesians, for workers in both the formal and informal sectors. SJSN is to be administered by "trust fund" organizations.

1. Registration of Members and Collection of Contributions

It is mandatory for all Indonesians to join SJSN. Gradual registration will be stipulated by presidential regulation (SJSN, Art. 13). Social security organizations will issue a unique identification number for every member and for family members (SJSN, Art. 15).

All members are mandated to pay contributions. Formal sector workers will have to contribute a certain percentage of wages through their employers. Informal sector workers will have to pay a nominal amount. For the poor and the disabled, GOI is mandated to pay the contributions. This provision will be further stipulated by presidential regulation (SJSN, Art. 14).

The Government may conduct special interventions to ensure liquidity and solvency of the social security organizations (SJSN, Art. 48), which is interpreted as a guarantee of last resort.

2. Financial Management

The social security organizations will be responsible for the management and investment of the funds. The guidelines on the management of the fund, as well as on the technical reserves, will be further stipulated by government regulations (SJSN, Arts. 47 and 50).

The oversight of the financial management of the social security organizations shall be conducted by legal institutions as legislated by applicable law (SJSN, Art. 51).

3. Coordination Mechanism

The first step in the implementation of SJSN will be the establishment of a *Dewan Jaminan Sosial Nasional* (DJSN) or the National Social Security Council, which is accountable directly to the President of the Republic of Indonesia. The function of the council is to formulate general policies and to synchronize the implementation of SJSN. DJSN will be established by presidential decree (*peraturan presiden*). It will consist of 15 people representing the Government, employers' organizations, labor unions, and experts in social security.

Law No. 40 of 2004 has stipulated the four current administrators—PT Jamsostek, PT Taspen, PT Askes, and PT Asabri—as *Badan Penyelenggara Jaminan Sosial* (BPJS). The law, however, provides for a 5-year transition period after its enactment. This means that all regulations pertaining to BPJS must have been synchronized by 18 October 2009. Otherwise, the four current administrators would have no legal basis for their existence.

4. Tools for Monitoring

Every member has the right to receive the benefits and information concerning the implementation of the social security programs (SJSN, Art. 16).

The social security organizations shall conduct accounting practices according to prevailing accounting standards. Members have, at all times, the right to access information regarding the accumulation of contributions; related investment incomes; and estimated old-age, pension, and death benefits. In addition, the social security organization will provide information on the accumulation of contributions and its investment incomes to each member of the old-age benefit program at least once a year (SJSN, Art. 49).

5. Implementation of SJSN

The Government recognizes that the implementation of the SJSN Law still requires more guidance to be issued by the Government. Law No. 40 of 2004 needs further elaboration in the following key areas: (i) required regulations, (ii) organization of SJSN, (iii) building the role of stakeholders, (iv) extension of membership, and (v) benefits of the social security program.

a. Required Regulations

On the legal aspect, the implementation of Law No. 40 of 2004 still requires the preparation of a series of regulations, detailing the roles and functions, rights and obligations of each party involved, and how they should be exercised. The SJSN Law refers to nine presidential regulations and 11 government regulations that still need to be prepared. Some of the referred regulations can be merged into one. Presidential regulations can be issued directly under the authority of the President. The state secretariat, upon recommendation by the technical ministry involved and after consultation with relevant ministries, issues government regulations.

On 1 June 2006, the coordinating minister of people's welfare established a team to draft the implementing regulations pertaining to Law No. 40 of 2004 through

its decision letter No. 14A/Kep/Menko/Kesra/VI/2006. The team is chaired directly by the coordinating minister of people's welfare, assisted by three vice chairpersons (the ministers of Social Welfare, Health, and Manpower and Transmigration). Each concerned agency has two representatives in the working group. The implementation regulations for the SJSN Law must be ready, ratified, and implemented, at the latest, by 18 October 2009.

The team has identified the following tasks:

- Accelerating the completion of the implementing regulations of Law No. 40 of 2004.
- Mapping the harmonization of all laws and regulations related to the implementation of SJSN under Law No. 40 of 2004.
- Determining the respective authorities of the central and regional governments in developing SJSN, to be described in detail in the implementation regulation of Law No. 40 of 2004 and Law No. 32 of 2004 pertaining to regional governments.
- Accelerating the completion of the draft law for BPJS or the Social Security Administrative Body, which accommodates the regional governments' aspirations.

b. Organization of SJSN

The following key initiatives have been set:

- Accelerating the formation of DJSN (by presidential decree and presidential decision).
- Providing the legal framework for the establishment of BPJS.
- Preparing the transition of PT Askes, PT Jamsostek, PT Asabri, and PT Taspen to become BPJS.

c. Building the Role of Stakeholders

The following objectives have been set:

- Preparing the socialization module and carrying out training/s for SJSN trainer.
- Accelerating the public education of stakeholders with respect to their roles and responsibilities under Law No. 40 of 2004 (central–province–city government, business people, employers, employees, mass media, and the rest of society).
- Accommodating the aspirations of regional governments.
- Building information and management systems of social security.
- Building a positive public attitude toward the development of the system of National Social Security.

d. Extension of Membership and Benefits of the Social Security Program

The following objectives have been set:

- To build a design, strategy, and plan of expansion for the membership coverage and program benefits of social security in the short, medium, and longer term.
- To increase the role of regional governments in reaching universal membership in the social security program.
- To prepare the infrastructure and supporting facilities of the national social security program.
- To establish the role of regions in accelerating the implementation of the national social security program, including efforts to expand the membership with a regional approach; getting partnerships and harmonization with all stakeholders, including international organizations.
- Coordinating the Ministry of People's Welfare in determining the agenda and coordination of budgeting.

III. Alternative Institutional Structures

The current legal format of the four designated social security providers—PT Jamsostek, PT Taspen, PT Askes, and PT Asabri—is persero or a limited liability firm. As perseros, they must comply with Law No. 1 of 1985 regarding the Company Law. As SOEs, they must comply with all prevailing laws and regulations governing SOEs.

The objective of a persero is to make a profit which will be then be distributed either as a dividend to the shareholders or as retained earnings to add to the firm's capital. This structure is in conflict with the nature and ultimate objective of a social security organization. A social security organization is supposed to be managed in the best interests of participants. All income of social security organizations, after the deduction of expenses, should be returned to the participants in the form of better services and benefits. This is inconsistent with the concept of profit and dividend.

Under a persero, the role and rights of participants are very limited. The nomination, selection, and appointment of the persero's board of directors and board of commissioners are fully in the hands of GMOS consisting of representatives of shareholders, with zero or minimal

involvement of the participant. On the other hand, the governance of a social security organization is supposed to be fully in the hands of the participants as they are the ultimate beneficiaries.

This problem has been identified. The working group, created by the coordinating Ministry of People's Welfare, is discussing the following three alternatives:

- To keep the legal structure of a persero for the social security organizations, but to introduce some adjustments (e.g., no dividend is given to the shareholders). In this regard, all the funds and income are used only for the benefit of participants.
- To change the legal structure of the social security organizations into PSA (Public Service Authority) or BLU (Badan Layanan Umum). This is a legal structure which is common in the Anglo-Saxon legal system. It is a more comprehensive legal concept than the old version of the state-owned nonprofit organization, perum. BLU recognizes the existence of badan pengawas (supervisory board) and pengurus (management board) with a more distinctive role and accountability. As such, BLU requires a higher degree of board accountability than perum.
- A trust fund is the most ideal legal format for a social security organization. The ultimate and supreme organ of a trust fund is the general meeting of participants (GMOP). However, Indonesia has no legal framework now to introduce the trust fund concept.

A. Perseros with some Adjustments

This type of institutional structure is based on Company Law No. 1 of 1985, with the intention to profit and distribute dividends to the shareholders. The adjustments require the passage of a government regulation and the subsequent approval of ministerial decrees:

- To be exempted from income tax, a ministerial decree from MOF is needed to recognize the income of these companies as nontaxable income.
- To be exempted from taxes on the company's profit, a ministerial decree from MOF is needed to recognize the profit of a company as nontaxable profit.
- To be exempted from dividend payment, the shareholders of a company, i.e., MSOE should issue a ministerial decree that will be subsequently reinforced through a GMOS. To be in line with such special conditions, the company should revise the company's by-laws (articles of association) to accommodate such special conditions, in particular the no-dividend clause.

In addition, there is still the unsolved issue that the persero does not recognize participants as its ultimate beneficiaries. The ultimate beneficiary remains the shareholder, i.e., MSOE. As such, GMOS remains the body that appoints the board of directors and the board of commissioners, instead of GMOP. This is fundamentally against the principle of trust fund governance.

There is no standard lead time for an issuance of the government regulation, the ministerial decrees, and the revision of the by-laws. However, we could expect the time frame to be less than a year if this program is considered a priority.

B. Badan Layanan Umum

This type of institutional structure is based on the law of BLU that was issued based on a nonprofit motivation. A BLU is a nonprofit organization managed at arms length by a government agency, with a mission to serve public interest (e.g., a public hospital under the MOH and a zoo under the provincial government). Although BLU is expected to be financially independent and managed professionally, the ultimate financing responsibility of BLU remains with the concerned government agency.

A government regulation is required to recognize the BPJS as BLU of a particular government agency. In this particular case, PT Jamsostek might become the BLU of MOM, PT Askes might become the BLU of MOH, and PT Taspen might become the BLU of MOF. However, some unresolved issues remain.

As a BLU, BPJS does not recognize participants as the ultimate beneficiaries. It remains the concern of a particular government body or ministry, and thus, it does not fit with the principle of trust fund governance. Significant adjustments are needed to tailor BLU to the functions of social security. An ordinary BLU generally recognizes the public interest on a simple transactional basis, e.g., paying a ticket to enter a zoo. The services offered under SJSN involve transactions that are far more complicated.

There is also no standard lead time for the issuance of the necessary government regulations and additional necessary adjustments. However, since there is already a law on BLU, it is possible that the time frame could be less than a year if this program is considered a priority and serious efforts are made by the Government.

C. Trust Fund

A trust fund is a legal entity that fits best with the ultimate objective of national social security programs. The best interest of participants is placed as the highest consideration and accommodated through the ultimate organ, GMOP. However, no legal framework can be used now as a legal basis for the trust fund concept. This means a new law is needed; one that has not yet been proposed by the Government and ratified by parliament. As there is no fixed lead time to issue a new law in Indonesia, that process may take a very long time while the deadline is very tight.

Table 1 provides a matrix of each alternative and its corresponding challenges and requirements:

IV. Stakeholder Assessment

A stakeholder assessment has been prepared based on interviews and discussions with 18 independent key opinion leaders relevant to SJSN. Its aim is to gain an insight into the performance of social security administrations in general and of PT Jamsostek, PT Taspen, PT Askes, and private pension funds in particular. The respondents were grouped into stakeholder groups or classification as follows:

1. Stakeholder group 1: representatives from the labor unions (3),
2. Stakeholder group 2: representatives from employers' association (2),
3. Stakeholder group 3: representatives from the Pension Fund Association (3),
4. Stakeholder group 4: independent experts of SJSN (3),

Table 1: Alternative Institutional Structures

Alternative legal format	Description	Prerequisites	Remark
Persero with special treatment	All characteristics of a regular persero are retained but: - without tax on income and on profit; - without dividend for shareholders, all the company's profits are retained for the benefit of participants; and - without corporate tax for the profit they earn.	Legal framework is available. It requires government regulations for all special treatments Note: Government regulations should be issued by the Office of the President, and used as basis by the concerned ministries to issue the relevant decision letters or ministerial decree, i.e., from MOF	A persero does not recognize participants as its ultimate beneficiaries. By law, shareholders remain the ultimate beneficiaries. This alternative should be complemented with a specific requirement to have representation from employers and employees in the board of commissioners
BLU or PSA	A nonprofit organization managed at arms length from the Government in serving the public's interest. The organization should be under certain government bodies (e.g., a hospital under MOH and a zoo under a provincial government). Although BLU is expected to be independent financially and managed professionally, the ultimate financing responsibility of for BLU remains with the relevant government bodies.	Legal framework is available. However, it requires government regulations to recognize BPJS as a BLU with a particular mission and role at arms length of certain government agencies. Note: Government regulations should be issued by the Office of the President, and used as the basis for the concerned ministries to issue the relevant decision letters or ministerial decree, i.e., from MOF, MOM, MSOE, and MOH.	As a BLU, it does not recognize participants as the ultimate beneficiaries. By law, it remains with the concerned government agency. BLU recognizes public interest through a simple transaction (e.g., paying a ticket to the zoo). As such, it requires some detailed adjustments for more complicated transactions under SJSN.
Trust Fund	A legal entity which best fits the ultimate objective of a national social security program. The best interests of participants are placed as the highest consideration and the ultimate organ is the GMOP.	There is no legal framework that can be used as a legal basis. It requires a new Law on Trust Funds.	Legislating on a new law could take a very long time while the deadline is very tight, not later than 18 October 2009.

BLU = Badan Layanan Umum, BPJS = Badan Penyelenggara Jaminan Sosial or Social Security Administrative Body, GMOP = general meeting of participants, MOF = Ministry of Finance, MOH = Ministry of Health, MOM = Ministry of Manpower, MSOE = Ministry of State-owned Enterprises, PSA = public service authorities, SJSN = Sistem Jaminan Sosial Nasional or National Social Security System.

5. Stakeholder group 5: representatives from line ministries (3), and
6. Stakeholder group 6: representatives from social security organizations (4).

A. Performance of the Social Security Organizations in General

Overall, the stakeholders are rather dissatisfied with the performance of the current social security administrations.

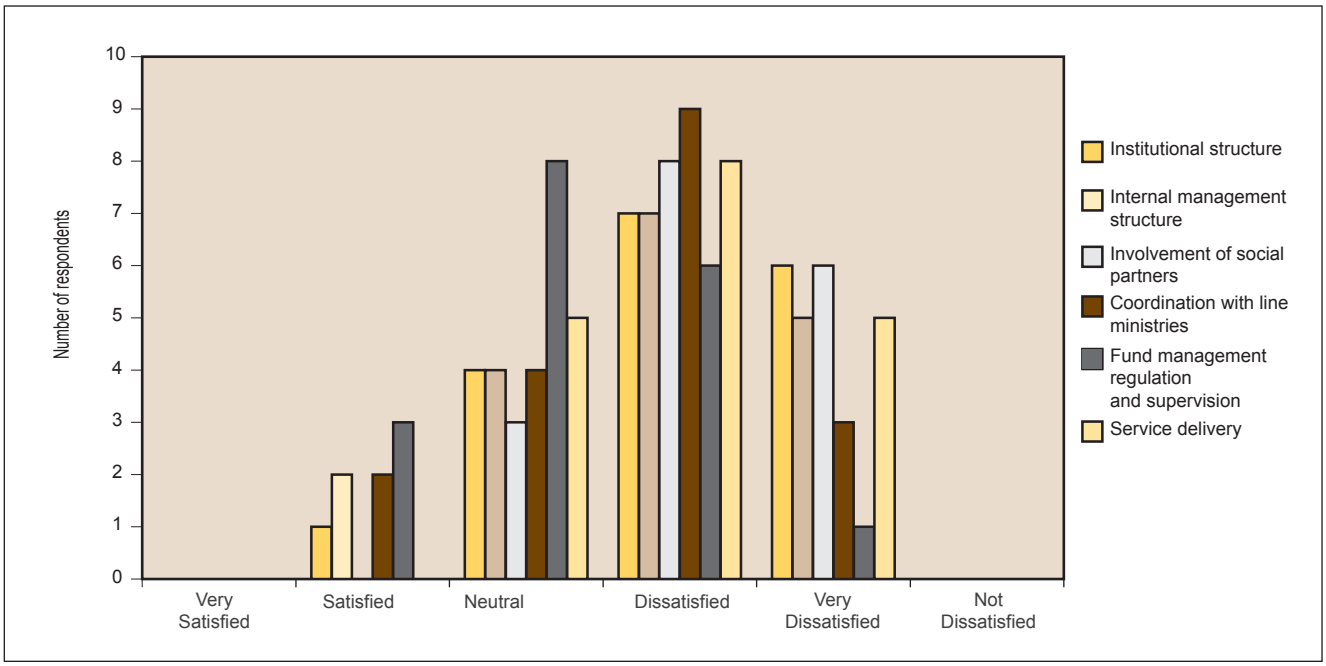
The current institutional structure (persero) is considered inappropriate for social security administration purposes as the legal structure of the existing social security organizations is profit-oriented in nature. Two main elements need to be addressed to make the structure more appropriate for social security—i.e., the corporate income tax that needs to be paid on the net income and the yearly targeted profit, which is expected to be distributed as dividend or to be retained as earnings rather than to be kept for the best interest of participants.

The stakeholders are also dissatisfied with the internal management structure for three main reasons:

- There is no transparency in the process of nomination, selection, and appointment of the board of directors and the board of commissioners. The process is entirely driven by the MSOE in coordination with concerned line ministries. Representatives of employers and employees are not included in the consultation process.
- There is no legal mandate for representatives of employers and employees to sit as board members in the board of commissioners. Although representatives from employers' associations and labor unions are sitting on the board of commissioners of PT Jamsostek, this is based on a decision of MSOE in anticipation of external or "political" pressure, rather than being legally mandated.
- There is no accountability mechanism for the board of directors and the board of commissioners to report to the employers and members. There is a lack of appropriate checks and balances for the governance and management of the social security organizations.

The stakeholders are generally dissatisfied with the coordination mechanism with the concerned line ministries. They do not see a clear coordination between the line ministries involved and the social security organizations, especially in the case of PT Jamsostek. There are three line ministries involved with PT Jamsostek—namely, MSOE, MOF, and MOM—but the coordination among them happens on an ad hoc basis rather than in a systematic

Figure 1: Performance of social security administrations (in general)



Source: stakeholder assessment

way. This occasionally creates confusion among the public when these respective line ministries express contradictory views on certain issues.

The stakeholders are also not satisfied with the fund management regulation and supervision by MOF. According to them, the regulation is insufficient to assure that the funds are managed in line with best practice. Examples can be found in PT Jamsostek and PT Taspen where the fund can be used to purchase equity in high-risk property investment. Now, the investment decisions can be made—based on the discretion of the board of directors—as long as they are in line with the longer-term plans and the annual plan of the company. No investment regulation limits the directors' discretion in line with a prudent investment portfolio reference or guideline as it is required for private pension funds. The absence of such regulations makes PT Jamsostek and PT Taspen vulnerable to political intervention. And this might result in investment decisions being taken not in the best interest of the members but of the other parties, leading to a higher-risk investment profile than advisable.

B. Performance of PT Jamsostek

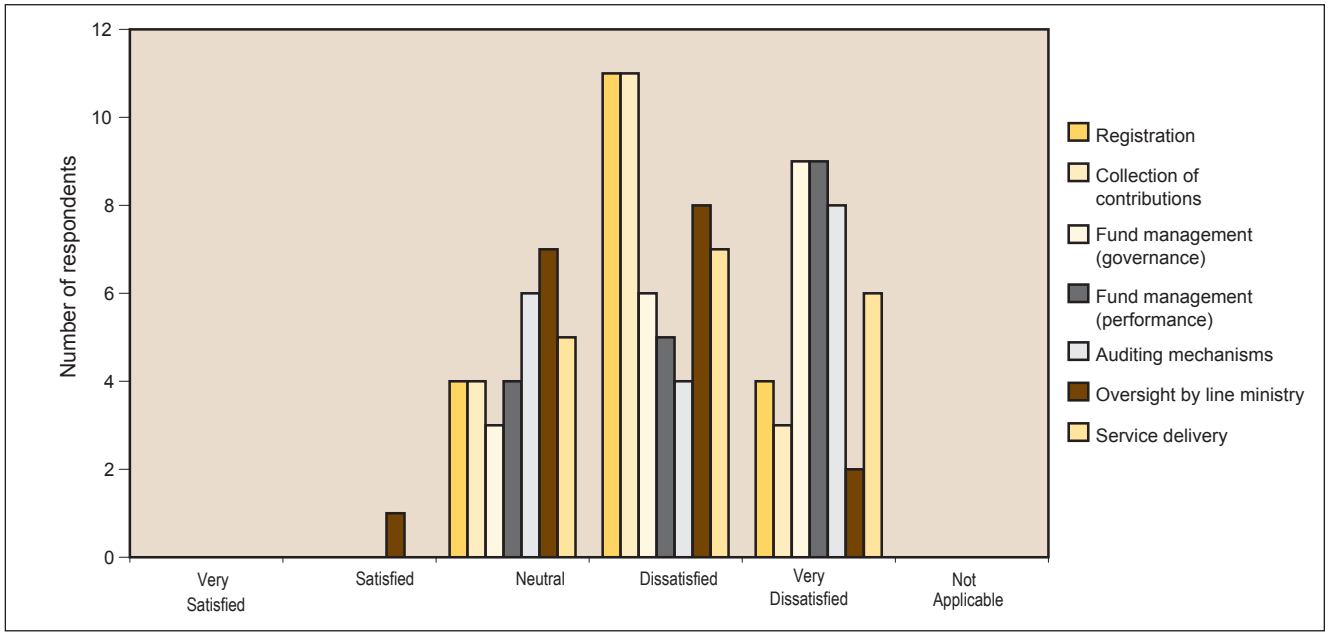
The stakeholders rated the performance of PT Jamsostek as the least satisfactory among the social security administrations. PT Jamsostek has the lowest score for each program area.

The stakeholders believe that the registration of members is far from satisfactory. The current ratio of members versus the total population of formal workers is very low while, at the same time, serious efforts to improve the registration has been lacking. It is a fact, for example, that employees of the state-owned national electric company (PT PLN) are not yet registered with PT Jamsostek. So far, no legal action has been taken to force PT PLN to comply with the law, leaving a big question mark of "legal enforcement" on PT Jamsostek, which is in the hands of MOM.

The collection of contributions is also below expectation. Often, employers are late in paying their contributions to PT Jamsostek, especially SOEs. As mentioned before, there is no legal enforcement penalizing late contribution payments. It is a current practice for PT Jamsostek's management to rely on lobbying and persuasion to convince SOEs to pay the contributions.

The stakeholders are very dissatisfied with the fund management, both in terms of the performance and governance. The performance of fund management is very low compared with the market return while, at the same time, there is no transparency and accountability to the participants on the way the fund is being managed. This leads to the public perception that PT Jamsostek's fund management has a lot of leakage, especially in determining the placement of funds, types of investment, and selected institutions. In addition, the audit reports are not publicly accessible; thus, limiting the oversight by the stakeholders and members to assure that the fund is being managed in

Figure 2: Performance of Jamsostek



Source: stakeholder assessment

their best interests. Stakeholders and members must rely on the oversight function by the line ministries, especially MSOE and MOF, which have access to the audited accounts of PT Jamsostek's fund management.

The stakeholders are doubtful whether the current oversight mechanism is functioning effectively. MSOE uses a simple target for the company's fund performance that is always set below the market expectation. The focus of MSOE is on the company's profit as targeted, with an expected dividend payment, leaving no checks and balances on the management of the fund itself. Similarly, MOF—that is supposed to have an oversight function on PT Jamsostek's fund management—is checking more on the formality of the execution rather than carrying out effective checks and balances to assure that the fund is well governed and managed in the best interest of the participants.

All of these are compounded by the vulnerability of PT Jamsostek to political interventions. Thus, the stakeholders have no confidence that the fund management of PT Jamsostek could be improved without a drastic change in its institutional structure (that is, from a corporation format to a "trust fund"), where involvement and oversight by participants form the core "checks and balances."

C. Performance of PT Taspen

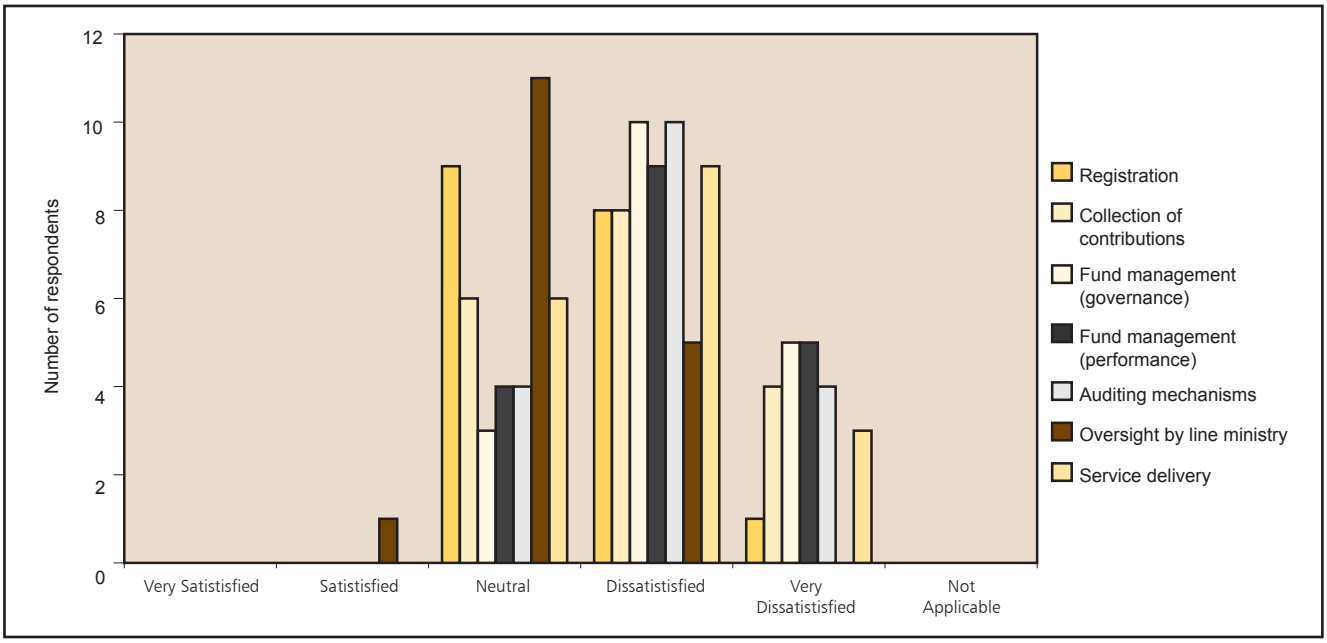
Although the scores are slightly better for PT Taspen compared to PT Jamsostek, the stakeholders are generally dissatisfied with the performance of PT Taspen.

Under PT Taspen, the members are registered from the moment they are appointed as civil servants. The accuracy and effectiveness of registration is fully dependent on the accuracy and effectiveness of the main records provided by the Ministry of State Apparatus (MSA). These records contain details on civil servants relevant for the JHT and THT programs, such as their rank, seniority, and salary. The stakeholders are not satisfied with the registration of members at PT Taspen since the source of the records is inaccurate and not updated. In addition, the accuracy and effectiveness of the internal information management system in PT Taspen is questioned.

The stakeholders are dissatisfied with the current performance in the collection of contributions. The contributions to PT Taspen are paid from the state budget and need to be paid regularly to ensure its liquidity in paying out the benefits. However, there have been significant backlogs of contribution payments from the Government to PT Taspen that have caused liquidity problems and delayed benefit payments to the participants.

Although PT Taspen is a pay-as-you-go benefit program, the contributions by the members are accumulated in a fund to cover part of the pension cost. The stakeholders are not satisfied with the current performance and governance of the fund management. Similar to PT Jamsostek, the performance of fund management is very low compared with the market return while, at the same time, the fund is being managed without transparency and accountability. In addition, the audit reports are not publicly

Figure 3: Performance of Taspen



Source: stakeholder assessment

accessible, thus limiting the oversight by the stakeholders and members to ensure that the fund is managed in their best interests. Stakeholders and members must rely on the oversight function of the line ministries, especially MSOE and MOF, which have access to the audited accounts of PT Taspen's fund management.

The stakeholders are more dissatisfied with the effectiveness of the oversight by the line ministries than they are with PT Jamsostek. The independence of MOF, the most influential line ministry, is questioned because of the huge backlog of contribution payments from the Government—to be paid through MOF—to PT Taspen. The stakeholders also questioned the oversight role to ensure that the fund is managed in the best interest of the members. The stakeholders are dissatisfied also with the monitoring approach of MSOE, whose focus is more on monitoring whether the company's profit is on target and checking the formality of the execution rather than effective checks and balances.

Regarding the service delivery to members, the stakeholders are not satisfied with the level of services provided by PT Taspen. The processes are considered too bureaucratic and time consuming.

D. Performance of PT Askes

Compared to PT Jamsostek and PT Taspen, the stakeholders were more satisfied with the performance of PT Askes.

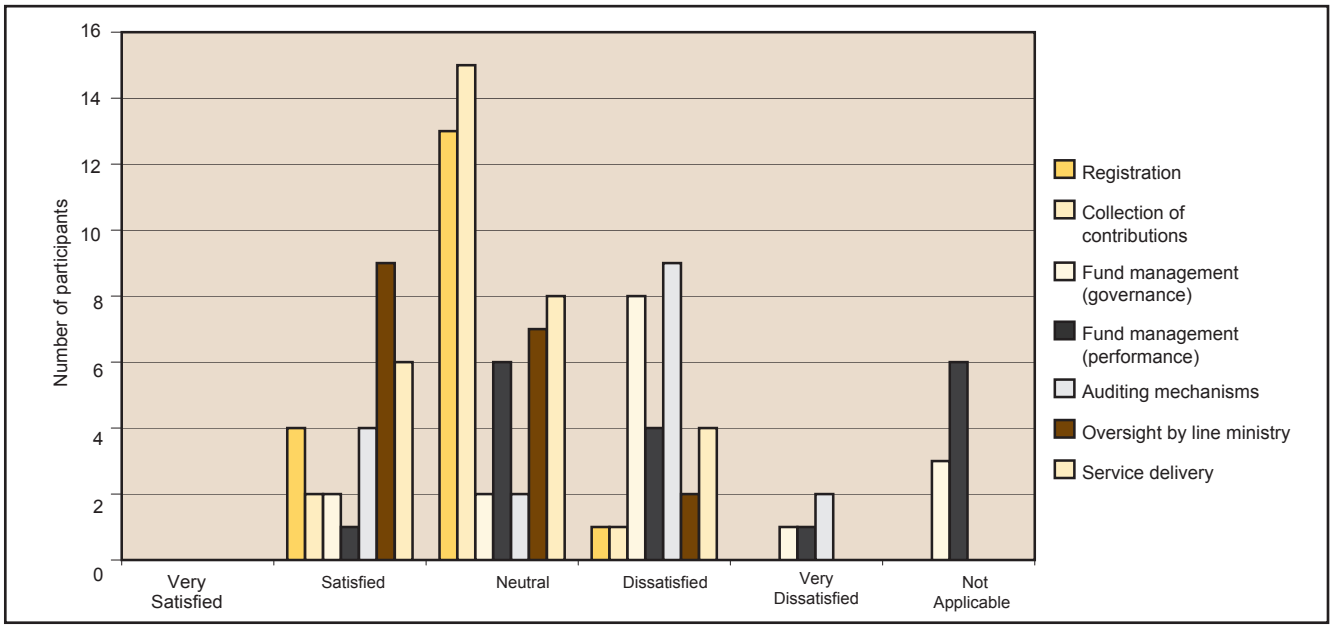
The stakeholders expressed different opinions on the performance of the three schemes managed by PT Askes: (i) mandatory health insurance scheme for civil servants, (ii) voluntary health insurance scheme, and (iii) Askeskin or the health-care scheme for the poor.

The stakeholders are dissatisfied with the registration process of the civil servants with PT Askes for the same reasons as with PT Taspen. They are neutral regarding the registration of the voluntary members and the poor under the Askeskin scheme. For Askeskin, the stakeholders believe that the program is relatively new and consider it too early to judge its performance. The same opinions were voiced regarding the collection of contributions. The employers expressed concerns regarding late contribution payments, especially by SOEs.

PT Askes has no fund under its custody. Hence, the stakeholders are less concerned about the performance and governance of PT Askes' fund management, including the access of the members to the audits and accounts. However, they expressed their concern about the lack of transparency and public accountability of PT Askes to the members.

The opinions of the stakeholders on the involvement and oversight by the line ministry are divided. The current level of involvement and oversight by MOH satisfied some, whereas others were dissatisfied. The basis for this difference in opinion is the perceived service delivery to the members. On one hand, some stakeholders are satisfied with the current delivery of services that meets their expectations

Figure 4: Performance of Askes



Source: stakeholder assessment

given the low level of contributions paid by the members. On the other hand, some stakeholders are dissatisfied because they believe that MOH needs to increase its level of health services for the members.

E. Performance of Private Insurance Companies

Overall, the satisfaction level with the performance of the private insurance companies is neutral among the stakeholders, except for their transparency and public accountability. They were dissatisfied with those aspects of governance and expressed serious concerns about possible implications.

Currently, unless publicly listed, private insurance companies do not provide audited financial reports to the public. Consequently, members of the insurance company are in a vulnerable position because they do not have any information on whether or not the company is in a financially sound shape to fulfill their services as promised. Once they find out, it is probably too late and the paid contributions or premiums would be hard to recover.

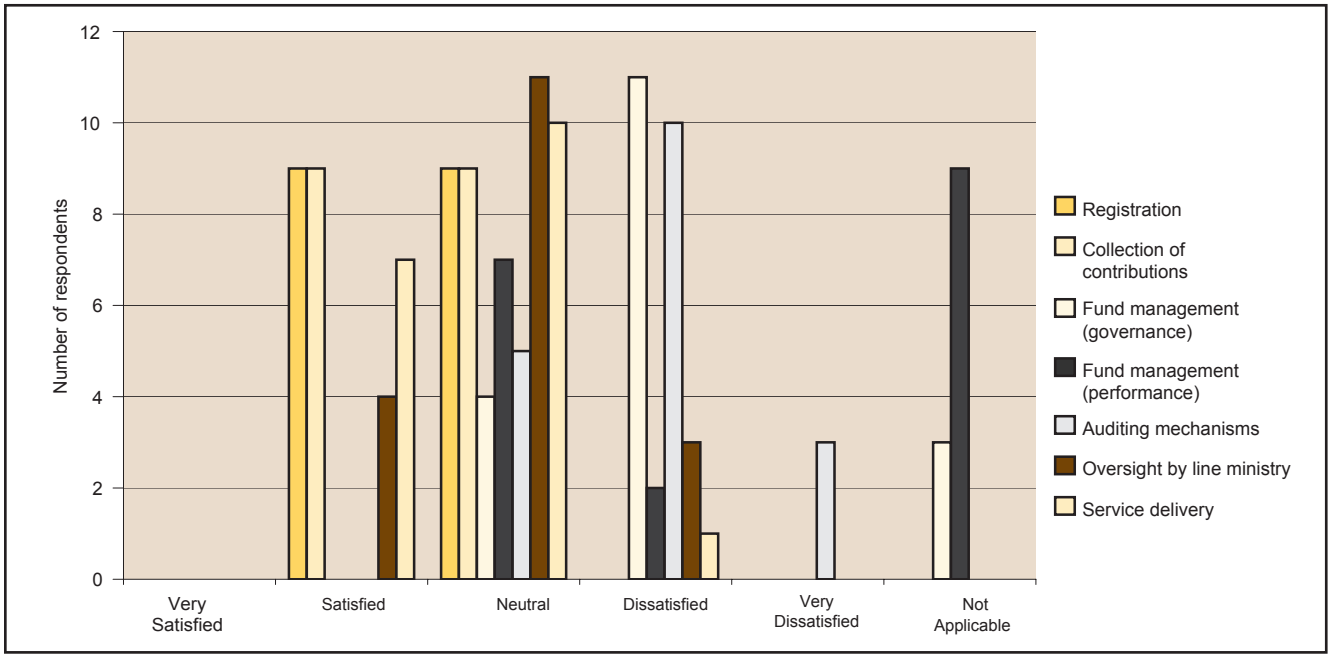
F. Stakeholders' Suggestions to Improve Institutional Structure

All stakeholders agree that the ideal institutional structure for a social security administration is a trust fund. It fits the accountability requirements of a social security organization, where the funds are governed and managed according to the best interest of participants. As a trust fund, a social security organization is exempt from any tax and dividend payments. Unfortunately, there is no law on trust funds in Indonesia. It will take years to formulate and ratify a new law while SJSN must be implemented before 18 October 2009.

As an alternative, the stakeholders suggest a transitional structure, which only requires a government regulation, where the existing organization remains a persero with a number of modifications:

- All profits are retained in the company in the best interest of the participants. Consequently, no dividend is paid to the Government.
- The majority of the board of commissioners are representatives of the key stakeholders, especially employers and employees. If necessary, the same mandatory requirements can be applied to the board of directors.
- In addition, the role of MOF in monitoring the financial management of social security programs needs to be strengthened, especially for PT Jamsostek.

Figure 5: Performance of Private Insurance Companies



Source: stakeholder assessment

G. Stakeholders' Suggestions to Improve Transparency and Accountability

The quality of transparency and accountability is closely related to the institutional structure of the social security organizations. The limits in transparency and accountability under the persero structure will be resolved once it changes to a trust fund. Meanwhile, some initiatives could be undertaken to improve transparency and accountability by issuing a government regulation that requires social security organizations to release audited financial and operational reports publicly, including the fund management performance. By having such a regulation, stakeholders can exercise their monitoring role over the company's governance and management practices better.

H. Stakeholders' Suggestions to Improve Financial Management

The stakeholders shared the opinion that financial management needs to be improved in general, particularly for PT Jamsostek and PT Taspen. More involvement of MOF is expected, especially in the case of PT Jamsostek, in providing investment policy and guidelines and in setting the target return of fund management and by monitoring its compliance. For PT Taspen, the dominant opinion was that there should be a change from the pay-as-you-go system to a funded program where the contribution should be paid by the participants and not from the government budget. For all private insurance plans, the defined benefit plans should be converted into defined contribution plans, as this will reduce the pressure for the fund management to seek high-risk investment. These proposed changes need to be complemented with a strengthened stakeholders' involvement to provide more checks and balances over the fund management.

I. Stakeholders' Suggestions to Improve Coordination Mechanism among the Social Security Organizations (BPJS)

Coordination among social security organizations is critical to the success of the implementation of Law No. 40 of 2004. The following are some opinions from the stakeholders:

- Since Askeskin is considered the basis for the national social insurance program, all health insurance-related programs should be placed under Askes' coordination.
- PT Jamsostek and PT Taspen should agree on a common pension system. Ideally, the pension system should be the same for both civil servants and private sector workers.
- The other SJSN programs should be under PT Jamsostek's coordination, as most of the programs mentioned under SJSN are already present in PT Jamsostek.

V. Good Governance for Pension Plans

Almost every country is concerned about "guarantees" for their defined contribution pension systems. By this, they usually mean a guaranteed minimum investment ROR. They want assurances that returns will never be negative and, in many cases, that they will exceed inflation each year. Often, they suggest contributions can only be invested in short-term government bonds and time deposits at state banks and that the private pension funds should guarantee the minimum ROR with their own capital. For example, this is how the Slovenian pension system works. These requests illustrate a lack of understanding of the basic principles of portfolio investment and risk management. Such guarantees inevitably reduce RORs and pension benefits upon retirement.

Most countries also fail to appreciate and overlook the importance of other forms of system protection that are far more crucial than any ROR guarantee. Collectively, these come under the heading of good governance. In this section, we will examine basic principles of good governance for pension plans, with particular focus on governance of public-defined contribution programs (provident funds). We will also briefly comment on proper governance procedures for private pension plans and defined benefit plans.

One of the key determinants of the success of any pension system is the quality of the governance procedures. Good governance refers to those elements of pension fund operations that increase system transparency and assure accountability for everyone providing services to the pension fund. The governance structure can be divided into three broad categories:

- *Governing Body*. Sets the overall goals and objectives for the pension plan and ultimately is responsible for all aspects of fund performance. The governing body can establish sub-committees for different functions

and hire outside advisors as necessary. However, it remains the ultimate plan fiduciary and reports directly to stakeholders or their representative.

- *Management.* Responsible for the day-to-day affairs of the pension fund and ensures that the goals, objectives, and policies of the governing body are implemented. Senior management hires the staff and outside consultants and purchases needed resources. Ultimate responsibility lies with the executive director who reports directly to the governing body.

- *Oversight*. Reviews the performance of the governing body and ensures it is accountable for its actions. It represents the interests of the stakeholders, primarily the plan members. Typically, this is the country's pension regulator or legislature, or a special supervisory board composed of stakeholder representatives.

This illustrates the fundamental principle of checks and balances that should be contained in any good governance structure. No one body should have total freedom to do as it wishes. Everyone's actions should be subject to review by another. Although the governing body has broad authority to set the strategic goals for the pension plan, its actions are subject to review by an oversight group.

Although management has broad authority over the pension fund daily, its senior executives are often appointed and removed by the governing body. The governing body should set and measure management performance against agreed-upon goals, objectives, and benchmarks.

The members of the oversight committee also do not have complete freedom. The representatives of any supervisory board are elected by stakeholders and can be replaced for failure to perform. If a legislature is responsible for oversight, they are ultimately responsible to the electorate. Thus, no one has complete freedom of action. Everyone is subject to scrutiny.

The procedures used by the pension fund must ensure that:

- everyone's responsibilities are clearly defined;
- appropriate benchmarks are established;
- performance is reviewed against established benchmarks; and
- nonperformers, those who do not follow established policy or violate the law are removed.
- All stakeholders are well educated and are kept informed about all important developments.

Stakeholders should be aware of and understand the plan's goals, objectives, and risks; know who is responsible for the different aspects of their plan's operations; and know the plan's financial and operational results. Full and complete disclosure to stakeholders is a critical part of good governance, particularly for public plans where oversight may be weak or nonexistent.

The minimum acceptable disclosure requirements to the regulator or legislature, plan members and the public for a defined contribution pension fund should include the following:

- Full description of the terms of the program;
  - Workers who are eligible to participate and whether participation is mandatory or voluntary;
  - Required contribution rates from workers and employers;
  - Investment options and any investment guarantees;
  - A full description of the eligibility conditions for receiving benefits;
  - The benefit payout options;
  - Rights and responsibilities of all parties; and
  - Employee's methods of filing grievances and seeking redress.
- Full description of the pension fund's investment policy;
- Regular reporting of investment performance in a standardized format in absolute terms and against agreed-upon benchmarks; and
- Regular written communication to individuals of amounts contributed and account balances.

The governance, reporting and disclosure requirements, and the rules and regulations for plan operation must be included in the relevant legislation and regulations. The regulatory agency or oversight body must also be given the full statutory authority it needs to protect the pension fund and the interests of its members.

Table 2 summarizes the governance responsibilities for different types of pension programs.

For Indonesia's four perseros, the governing body is the board of commissioners, management is the board of directors, and oversight is the responsibility of MSOE.

The board of directors is the body with ultimate responsibility for management of the persero and is responsible for setting strategy, operations, and performance. It is composed of the senior management team – the President Director and the Directors of the major divisions. In a typical corporation, the board of directors would be a separate body from senior management and would be the

Table 2: Governance Responsibilities for Pension Programs

Type of Plan	Governing Body	Management	Oversight
Public provident fund	Board of the provident fund	Pension organization, executive director, and senior staff	Legislature, financial regulator, or government ministry
Defined benefit social security system with benefits based on wages and service	Board of the social security organization	Pension organization executive director and senior staff	Legislature or government ministry
Mandatory accumulation system based on individual choice	The individual	The pension company selected by the individual	Pension regulator
Mandatory accumulation system based on employer-employee choice	Joint employer-employee committee	The pension company selected by the committee	Pension regulator
Voluntary occupational pension plan	Board of Directors of the plan sponsor	Plan sponsor staff and outside consultants	Government pension regulator; special committee of the Board of Directors

Source: Wiener

governing body. However, in this instance, it seems proper to classify the board of directors as management. It is not really a "Board" in the true sense of the term.

The board of commissioners is responsible for oversight of the board of directors and its performance. This makes the board of commissioners the governing body in this structure. MSOE appoints both boards and is responsible for oversight. This is also an unusual arrangement, since normally the governing body is responsible for appointing senior management and reviewing its performance. In a typical structure, MSOE–in its role as shareholder–would elect the board of commissioners and the board of commissioners would appoint the board of directors (senior management).

Various other government institutions (such as the MOF, MOH, and MOM) also have oversight responsibilities. Unfortunately, the roles and precise division of oversight responsibilities is not as clear as it should be. Also, the legislation is flawed because it requires all parties to act in the best interests of the shareholders (the government) rather than in the best interests of the members.

VI. Governance of the Asset Management Process

One of the paradoxes of investing is that those who try to minimize the risk of losses by investing only in relatively safe instruments such as short-term government bonds or state-owned bank time deposits will usually earn the lowest ROR in the end. Meanwhile, those who occasionally suffer manageable losses end up far wealthier.

Achieving higher RORs requires careful and professional management of investments. There are international standards for proper pension portfolio management to maximize RORs while minimizing risk. Proper laws and regulations, together with effective regulatory oversight and enforcement, is the primary method of "guaranteeing" the good RORs and not requirements for minimum rates of return, very strict limits on permissible investments, or requirements for social or infrastructure investing. These requirements actually reduce the ROR and benefits.

The application of good governance principles is very important in the asset management process. It should come as no surprise that the pension plans with the best governance are also those that earn the highest ROR on investments. The most important governance principles for pension fund asset management are:

- *The primary goal must be to maximize ROR to members within established risk parameters*. All other goals must be secondary. Pension fund assets should not be used to achieve political goals.

- *Written investment policy*. Overall goals and objectives, permitted asset classes, percentage range for each asset class, risk parameters, methods for selecting investment managers and investments, benchmarks, methods of performance review and standards for replacing managers, etc. should all be clearly stated in a written investment policy statement.

- *Clear performance benchmarks*. All asset managers should understand and agree to the rules that will be used to measure their performance. Regular performance reviews must be made against these established benchmarks and nonperformers terminated.

- *Adherence to principles of safety, liquidity, diversification, and profitability.* Investments should be in highly rated securities, traded on recognized exchanges with sufficient daily trading volume, and in highly diversified portfolios so that losses in one portion of the portfolio will be offset by gains in other parts and vice versa.

- *Prudent expert standard*. Investment decisions must be made in the same manner as a pension fund investment expert, given a fund of similar size and circumstances with similar investment objectives. In other words, the fund manager should not deviate from accepted international standards without very good reason. If the manager deviates from accepted practice, the burden of proving that the actions were prudent rests with the manager and the manager must be personally liable for losses arising from violation of international standards. This principle should be applied even if the law contains specific quantitative investment limits by asset class.

- *Strict limits or prohibitions against self-investment*. The fund manager should not invest in the best interests of the plan's sponsor, the government, its political allies, or itself. Social investments, investments in special nonmarketable government bonds, and investments in government-favored businesses, for example, should all be prohibited. All investments should be based solely on maximizing returns and benefits to members.

- *Clear asset valuation rules*. Asset valuation should follow international standards. The rules for asset valuation should be stated in writing; conform with legislation, regulations, and international best practice; and be followed on a consistent basis at all times.

If the governance structure is properly established, it is highly likely that long-term investment performance will be good. However, if the governing body is primarily composed of government representatives and political appointees instead of investment experts, the results will certainly be poor. The Canada Pension Plan's procedures for eliminating government interference in the investment process are probably the best in the world. We will describe these procedures in detail later in this report.

VII. Special Governance Issues for Public Plans

The principles outlined in the previous two sections are particularly hard to implement for public plans—plans established for government workers or plans administered by the Government for private sector workers like Indonesia's provident funds—because the Government has a natural conflict of interest. The state is the plan sponsor, employer (for plans covering government workers), service provider, regulator, fiduciary, and the issuer of some of the pension fund's investments. These conflicts of interest and the legal framework itself often lead to decisions that are not in the best interests of fund members. Preventing abuses requires extraordinary government diligence and a strong and proper legal framework.

Among the problems that regularly occur throughout the world for public sector pension programs in both developing and developed countries are:

- Investment mismanagement risk. Funds are invested in the best interests of the government rather than the best interest of fund members.
- Funds are used to make personal loans to members of the governing body, their friends, or political allies.
- Regulator and oversight authority is either nonexistent or is distributed widely and poorly. The result is limited oversight of governing board actions.
- Decisions of the governing board are often made in secret.
- There is little or no disclosure of information to stakeholders.
- Lack of true fiduciary responsibility by the governing body.

As a result, public sector pension funds with strong governance often incorporate special features to prevent or minimize the potential for conflict of interest, including some or all of the following features:

- The pension fund is set up as a private autonomous institution.
- The pension fund is subject to the same regulatory framework as private sector pension plans.

- The pension fund's board meetings and decisions are public and there is member participation in the governance structure, either through the governing body or through an oversight committee.
- There is a strict ethical code of conduct and conflict of interest regulations.
- There is a written investment policy statement designed with the participation of outside experts. This should be a public document.
- There is an open process for formulating and executing pension fund investments.
- Assets are invested solely to maximize the expected ROR to participants and are based on the principles of safety, liquidity, diversification, and profitability.
- The asset management function is outsourced to the private sector and performance is strictly reviewed against agreed-upon benchmarks.
- There are statutory prohibitions against political interference in the pension fund's decision-making process.
- Annual reports and independent audits are required and the results are made public.
- Financial reports are based on international accounting standards and audited by an outside accounting firm and actuaries.
- Assets are valued at fair value using international standards.

While these strict standards are used in some parts of the world, for the most part, a traditional tripartite governing board continues to control most public pension plans and under the SJSN Law, a similar type of board will control the National Social Security Council. These types of boards inevitably make investment decisions based on politics and not in the best interest of the members and beneficiaries.

VIII. The Governance Structure

In this section, more details about the specific role of the governing body, management, and oversight in the overall governance process are given.

A. The Governing Body

The governing body is responsible for setting goals and objectives and setting key policy parameters for the system. It is also responsible for hiring the senior executives of the management team and overseeing their performance. Among the key responsibilities of the governing body are:

- Establish the goals and objectives, strategies, standards of performance, and benchmarks for the pension program.
- Ensure proper performance of all pension fund administrative tasks.
- Select, monitor, and compensate external advisors. These advisors are needed when the governing body does not have members with the required expertise in a particular area or when highly specialized professional skills are needed.
- Appoint the executive director of the pension fund and ensure senior pension fund staff and external advisors have relevant qualifications. Appropriate educational qualifications, experience, and moral character for each position must be met.
- Ensure compliance with all applicable laws and regulations.
- Hire an independent auditor, actuary, custodian, and others to oversee plan operations and identify irregularities. They should be independent experts who will advise the governing body and protect the interests of plan members.
- Report to the body responsible for oversight.

The next major objective for good governance is good communication and disclosure requirements and written procedures for pension fund operations and review. Every pension plan should have written documents that clearly outline the fund's goals and objectives and the strategies selected to achieve them. These documents should be drafted and periodically reviewed by the governing body or one of its committees, and assisted by outside experts.

For the governing body to perform its duties effectively, it must receive regular periodic reports that allow it to easily review management's performance and receive early warning of potential danger. Among the reports and analysis needed by the pension plan's governing body are the following:

- Regular performance assessments of all pension fund professional staff and outside experts against agreed-upon benchmarks or other performance measures.
- Regular review of compensation arrangements to ensure they reward desired behavior and discourage improper behavior.
- Review of information technology systems and

software for accounting, financial reporting, statistical analysis, risk management, data mining, and other required information needed for effective fund management.
- Methods for identifying and monitoring potential conflicts of interest. All potential conflicts of interest should be fully disclosed in advance.
- Adequate system for risk-management measurement and review.
- Regular assessment of systems for regulatory compliance.
- Code of conduct to ensure that everyone is aware of the high level of ethical behavior expected from professional staff and outside experts and the penalties for violations.
- Methods for protecting the privacy of individual data.

In addition, the governing body must ensure full and complete disclosure of plan terms, members' rights, financial results, changes in plan provisions, and other relevant information that the members need to understand their pension plan fully. It also must ensure that all required regulatory reports and information are timely and accurately filed.

B. Management

Management is responsible for the day-to-day operations of the pension fund. The director, and perhaps other senior staff, are normally appointed by and removed from office by the governing body. Management implements the governing body's strategy and directives. If the governance structure is good, the director and senior staff will not be members of the governing body. Governance and management should be separate activities.

Key management responsibilities include:
- day-to-day operations of the plan;
- hiring all required staff. Staff should meet appropriate education, experience, and moral character requirements;
- hire and review the performance of outside advisors, as needed;
- purchase all required computer hardware, software, and other equipment needed to run the business effectively and efficiently;
- develop strategies and tactics to meet agreed-upon investment targets, must either retain staff for asset management and/or hire outside asset managers; and
- prepare financial statements and other regular reports need by the governing body.

Pension plan administrative tasks vary with the type of institution. The data needs of a voluntary occupational pension plan will be much less than that of a national social security system. Table 3 identifies the typical functions of different types of pension systems and how they are carried out.

Management is always responsible for these functions. However, depending on the structure, management may directly perform all required activities or may outsource them to third parties. The governing body must ensure that all administrative activities are properly performed, generally by requiring detailed reports and by using outside auditors and other professionals to check on performance.

C. Oversight

This is perhaps the most neglected aspect of pension fund governance. The governing body has overall responsibility for all aspects of pension fund performance. It sets the goals and objectives and hires senior management to implement them. The governing body reviews the performance of management. But who reviews the performance of the governing body to ensure that they are operating the plan in accordance with their fiduciary responsibilities?

The members of the governing body are required to act in the best interests of the members and beneficiaries always. The purpose of oversight is to ensure that the governing body is accountable for its actions. To accomplish this, the governing body must report to another entity that has the power to compel it to change its policies and/or penalize it for violations, and force it to compensate the pension fund for any losses caused by its actions. The entity responsible for oversight should be a representative of the stakeholders.

In the private sector, the legal basis for accountability is personal liability. The members of the governing body are personally liable for any damages caused by their improper actions. This does not mean, however, that they are responsible for poor investment results per se. But they are responsible for investment losses caused by violations of the law or the plan's investment policy. They are also responsible for losses caused by their failure to replace poorly performing asset managers who have not met the goals set in their contract.

For private sector plans, the primary oversight body is the pension system regulator(s). In the United States, this is the Department of Labor and the Internal Revenue

Table 3: Pension Systems Administrative Tasks by Type of Pension System

	Central provident fund	Mandatory accumulation system	Social security system	Voluntary Occupational pension
Marketing	No marketing required	Competing private funds market to potential fund members	No marketing required	No marketing required
Enrollment/ Registration	Law defines those who must join. Provident fund must register all eligible employers and workers	Law defines who must join. Private pension funds enroll workers who join their fund. In some systems, enrollment is through a government body	Social security system must register all eligible employers and workers	Employer normally enrolls its workers
Contribution and data collection	Provident fund is generally responsible for collecting data and contributions each month. In some systems, the tax authority may perform this function	Collection is either done by a government body such as the social security system, the tax authorities, or by the individual pension funds	In many systems, the tax authority collects contributions and data and gives them to the social security system. Alternatively, the social security system may collect both itself	The employer uses its human resources system to prepare data and withhold contributions from worker pay
Asset management	The provident fund often manages assets internally. Alternatively, asset management may be outsourced in whole or in part. Outsourcing can be to private asset managers or a special government entity	The pension fund management company normally manages the assets. Alternatively, some or all of the asset management may be outsourced to private asset managers.	The social security system often manages any reserves internally. Alternatively, asset management may be outsourced in whole or in part. Outsourcing can be to private asset managers or to a special government entity	The employer normally selects private asset managers. In rare instances, the employer may manage the investments itself
Recordkeeping	The provident fund normally maintains records of individual contributions and account balances. In some systems, this function is outsourced to the private sector	The pension fund management company is normally responsible for record keeping. In some countries, a central government organization performs this function	The social security system normally maintains all individual records of contributions and years of service. Records for all years in members' working careers must be maintained	The employer usually hires a private company to maintain records of individual contributions and account balances. In some instances, the employer may maintain all required records
Payouts	The provident fund is normally directly responsible for approving and making payments. In some countries, the provident fund directly pays annuities and in others in transfers funds to an insurance company to purchase annuities	The pension fund management company normally pays periodic withdrawals and lump-sums itself and transfers money to insurance companies for those who elect annuities	The social security system normally directly approves and makes all payments. It self-insures all annuities	The employer's staff normally approves payouts. For defined benefit plans, monthly annuity payments are made directly from the fund. For defined contribution plans, the pension fund pays periodic withdrawals and lump-sums itself and transfers money to insurance companies for those who elect annuities
Compliance, reporting and disclosure	The provident fund is responsible for compliance with all laws and Board directives, and for reporting and disclosure	The pension fund management companies are responsible for compliance, reporting and disclosure	The social security system staff is responsible for compliance with all laws and Board directives, and for reporting and disclosure	The employer's staff is responsible for compliance, reporting, and disclosure. Often the employer hires outside legal counsel or consultants to assist

Source: Wiener

Service. In Canada, it is the financial sector regulator or OSFI, and in many other countries, it is a special pension system regulator. The regulator normally has the authority to impose penalties and fines, order changes in behavior, order changes in the composition of the governing body, or shut down or take over the pension plan to protect it. It can also file criminal or civil lawsuits against the plan fiduciaries on its own or on behalf of plan participants.

The other primary source of "oversight" is the plan members. They are normally entitled to file criminal or civil lawsuits against the plan fiduciaries to recover losses suffered due to the fiduciaries' improper actions. In this context, plan fiduciaries includes not only the governing body, but also all other organizations that exercise significant control over the management of plan assets or administration. The lawsuits for fiduciary damage could be directed against the asset manager, plan record keeper, or other organizations or individuals.

In the public sector, oversight is generally lacking for several reasons. It is more difficult to hold the members of the governing body responsible because, in many cases, the pension laws create rules that impede the governing body from performing. For example, the pension law may stipulate very specific investment guidelines. Even if the governing body believes these guidelines are not prudent, they are powerless to change them unilaterally. The same is true about decisions on contribution rates and funding policy. Consequently, it is difficult or impossible to enforce the concept of personal liability. In the United States, the Government concluded that the principle of personal liability that applied to private sector plans was not viable for the governing body of the Thrift Savings Plan for government workers.

Requiring the governing body of a public institution to report to the pension system regulator is rare. The law in many countries requires a particular ministry to oversee the activities of the provident fund or social security organization, but it is rare for the ministry to perform oversight actually. Instead, it usually provides its "subsidiary" with political protection and support. These problems are normally addressed in one of several ways (when it is addressed at all).

- Sometimes a special committee composed of stakeholders is formed to review the performance of the governing body and recommends improvements.
- The governing body may report to the entire legislature or to a particular committee of the legislature.
- If the governing body is largely independent on the government, a ministry may be responsible for conducting audits and recommend improvements.
- An external audit, in addition to the audit normally conducted by the State's Audit Commission, may be required.
- The provident fund or social security commission is often required to prepare a very detailed annual report that is presented to Parliament and made public.

Unfortunately, a vast majority of cases simply has no real oversight. In many cases, the governing body is not even required to hold open meetings, disclose the composition of the investment portfolio or performance, prepare a comprehensive annual report, or disclose the kind of information that would allow an independent review of its activities and results. The governing body, in effect, polices itself. We will see examples of this in a later section of this report, which discusses international experience and gives examples of good and poor governance arrangements.

Indonesia's provident funds, as currently structured, cannot possibly have good governance procedures. Since they are established as for-profit state-owned companies, their legal obligation is to their shareholders (the Government). Consequently, all decisions must be made in the best interests of the Government by law. Without a change in legal structure and/or regulations, it is virtually impossible to manage the system in the best interests of its members.

D. Governance under the SJSN Law

It is important to articulate clearly the governance structure of the national social security system as a whole and the governance structure of the Social Security Administrative Body. The SJSN Law is very general. Detailed regulations and decrees are needed to clarify these issues. Our views and concerns regarding the overall governance structure are presented hereafter.

It is important for the law and regulations to clarify who is the governing body, who is responsible for management and oversight of the national social security system, and the specific responsibilities and interrelationships among these entities.

- *Governing Body*. Based on the language of the SJSN Law, it appears that the Social Security Council is the governing body for the entire system. It is a policy-making body and many of the responsibilities listed in Article 7 are typical of a governing body:

- formulate general policies for the social security system;
- synchronize system administration;
- set overall investment policy;
- prepare system budget; and
- monitor and evaluate the system.

The members of the council are appointed by the President. The council includes representatives of key ministries, employers, workers, and independent experts.

- *Management*. It is clear under the SJSN Law that the Social Security Administrative Body (the four current perseros) is responsible for management of the five social security funds. However, it is not clear which entity or entities are responsible for which social insurance programs.

- It is also unclear who will be responsible for appointing the board of directors and board of commissioners of the administrative body, particularly after its legal structure has been changed. Under the SJSN Law, the administrative body will no longer be a persero. It will be a nonprofit institution required to act in the best interests of its members. Consequently, it does not make sense for MSOE to be responsible for the appointment and removal of board members. In theory, this should become the responsibility of the governing body of the national social security system (the council).

However, it is also important that appointments to the two boards be based on objective technical criteria and not politics. Board members should be appointed based on relevant background, experience, and moral character. The process of making appointments and changes to it should be open and transparent, and board members should be protected against removal for political reasons. The administrative body must have a fiduciary responsibility to its members and the boards should be responsible for operating the administrative body only in the best interests of members.

The regulations and decrees changing the legal structure of the perseros should establish the process for appointing and removing members of the boards so that it meets these goals and objectives. The council should not be able to appoint board members in a way that would effectively give it management control over the operations of the administrative body.

- *Oversight*. One item lacking clarity in the SJSN Law is the institution responsible for oversight and protection of members' rights. As previously mentioned, the descriptions of the duties of the council in the SJSN Law are those traditionally associated with the governing body. The structure of its board is also better fit for a policy-making governing body than for an oversight body representing the interests to the stakeholders.

- There must be an organization or organizations separate and independent from the council that is responsible for oversight of the council's actions on behalf of the system 's members, supervising and regulating the day-to-day activities of the Social Security Administrative Body and protecting its members' rights. It is important to ensure that the council acts in the best interests of the members of the social insurance funds.

The council members are appointed and removed by the President. By nature, this makes it a political and relatively nontransparent process. Transparency could be increased by setting up a nominating process for council members. For example, employers and workers could be permitted to nominate their representatives to the council. They could either nominate a specific candidate or send a list of two or three possible candidates from whom the President could select. Similarly, there needs to be a nominating process for the six outside experts. Different stakeholders should be permitted to nominate candidates for the expert positions. Once again, the President would make the formal appointments from a list of potential candidates. Another option would be to set up a separate nominating committee with appropriate representation to send a list of candidates to the President for appointment. Either of the options would increase transparency and give stakeholders a greater role in the appointment of council members.

There is also a need for strong technical oversight of the operations of the administrative body. The council would not have the expertise or staff for this role and the SJSN Law does not give the council appropriate enforcement authority. It makes sense for an independent Bapepam LK or the new OJK to have a strong role in supervising and regulating the operations of the administrative body with respect to the technical aspects of the pension and insurance funds. Similarly, MOH should supervise and regulate the administrative body with respect to the technical operations of the health insurance fund.

Another way of increasing transparency and accountability is to create a special oversight board composed primarily of employer, worker, and informal sector representatives. This oversight board could review the performance of the council and the effectiveness of the national social security system and make recommendations to the President. Its report should be a public document available to members and the public.

IX. Fiscal Management of Defined Contribution Pension Programs

Successful fiscal management of provident funds or mandatory accumulation systems is based on very different factors than those for defined benefit systems such as those found in typical unfunded or partially funded national social security schemes. In this section, we discuss the key risks that must be properly managed to have a successful mandatory defined contribution program of any type. We also discuss some of the most controversial issues in defined contribution plan design and administration.

- *Investments*. Participants' benefits and their standard of living following retirement depend on the ROR earned on contributions to individual accounts. While pension assets certainly should not be invested speculatively, it is equally important not to invest too conservatively. While investing only in government bonds and bank deposits will limit the chances for negative rates of return, it virtually ensures that benefits will be inadequate. Investments in a diversified portfolio of safe, liquid assets selected in accordance with modern portfolio theory and designed to maximize the ROR to participants are critical. Most pension laws have limits on the maximum amount of pension fund assets that can be invested in various asset classes and in the securities of any one issuer. In addition, most laws require the pension fund to have a written investment policy statement. The pension regulator normally checks portfolio composition for compliance with laws, regulations, and the investment policy very frequently. Many countries do this daily.

- *Expense control*. The expenses of managing a central provident fund or mandatory accumulation system will be higher than those for a standard social security system will be. There will be administrative expenses for marketing and enrollment and management of fund assets, trading costs associated with the purchase and sale of securities and for individual account recordkeeping. There will also be expenses for audits, custodian services, and regulation. A variety of models has been used to try to limit and control the expenses of individual account systems. The section on international experience discuss these in more detail. Both expense control and an adequate ROR on investments are critical to the overall success of any defined contribution program.

- *Benefit adequacy for vulnerable groups and women*. Pension systems based entirely on individual accounts have a high risk of providing inadequate benefits to the differently abled, unemployed, underemployed and women. To receive an adequate benefit upon retirement, participants should make regular contributions and should have a salary that increases each year. Those who are often out of the workforce or whose pay is irregular will probably not have sufficient account balances to finance an adequate pension upon retirement. Women also may not receive adequate pensions because they may be out of the labor force for child birth and to raise young children, are more likely to have jobs in the informal sector and often retire earlier than men. Since women live longer than men, women may also receive a smaller pension than a man the same age may if they both pay an equal amount to purchase an annuity from an insurance company.

- *Payout options and longevity risk management*. Management of the payout phase in a defined contribution plan is more complex and carries more risks for workers than in a traditional social security system. In a social security scheme, the pension system is responsible for making payments to workers from retirement until death. If workers live longer than expected, the pension system and the government make up for any shortfalls. This is not the case in a defined contribution system. Here workers take the risk rates of return on contributions will be inadequate, and the risk of living too long. Participants typically have a choice of leaving their money in the individual account upon retirement and making withdrawals from the account until it is exhausted or purchasing an annuity from an insurance company. In the first case, participants may exhaust their account before

death and live in poverty thereafter. Alternatively, they may take very small payments to avoid exhausting the account and find these payments are neither adequate to prevent poverty nor sufficient to maintain their prior living standard. If there is a well-developed annuity market, participants may have the option of transferring the longevity risk to an insurance company. The insurer will then guarantee payments of a monthly annuity for life. However, the families of those who die shortly after purchasing an annuity may be dissatisfied with this arrangement. Annuities are also not flexible. Once the contract is purchased, the terms and conditions cannot be changed if life circumstances and needs change.

- *Evasion.* In many countries with defined contribution schemes, evasion is a serious problem. In Indonesia, it appears about 75% of all workers evade required contributions to Jamsostek. Evasion typically occurs when workers do not trust the government or private institutions responsible for running the scheme, or when rates of return, net of expense charges have been poor. Workers may also evade because they prefer to keep the contributions for current consumption rather than saving for retirement. All of these are possible reasons for the high evasion rate in Indonesia. If enforcement is weak, many workers will choose not to participate. It could be argued that evasion is not a problem for the government. Those who do not contribute will simply have little or no account balance upon retirement. The evasion does not directly create liabilities for the government as it often does in social security schemes. However, if those who evade eventually receive social assistance benefits, then evasion does have a cost to the government.

- *Recordkeeping (individual accounts).* In defined contribution systems, an individual account must be maintained for each worker and its value must be updated periodically. In many pension systems, assets are valued each business day. The recordkeeping process is complex. The daily valuation process involves updating portfolio compositions, determining the market value of each asset in the portfolio, calculating the net asset value and unit value of the fund, and updating all participants' account balances. This must be done accurately and fairly.

Four other issues are often debated when designing a defined contribution system. These relate to administrative efficiency and cost control, and maximizing returns on fund assets. Each of these issues is discussed in more detail in the remainder of this section of the report.

- Permitted and prohibited investments.
- Government versus private asset management.
- Centralized versus decentralized contribution and data collection.
- Lump-sum payout options.

A. Permitted and Prohibited Investments

There are two general approaches to investment regulation – the prudent expert approach and the quantitative limits approach. Most countries in the world choose the second approach. Under the prudent expert approach, there are no specific quantitative limits by asset class. Instead, there is a general and flexible requirement that the fund manager invest in a similar manner to the way an expert would invest a fund of similar size with similar objectives. The asset manager is given a great deal of discretion. Countries that follow English common law tend to use this approach.

The quantitative limits approach is usually found in civil code countries and less developed countries. Under this approach, the law contains specific maximum limits as a percentage of the portfolio by asset class. Typically, there are no minimum requirements for any asset class and the limits themselves allow for a wide range of different possible portfolios with different risk and reward characteristics.

Regardless of which approach is selected, pension fund investments are typically limited to high-quality securities traded on a regulated exchange. The primary principles governing investments are safety (high quality), liquidity (easy to buy and sell quickly), diversification (invest in a wide range of different types of securities) and profitability (expected investment income). Diversification refers to diversification by asset classes, geographic regions, currencies, industry, etc. The goal is to protect the pension fund by buying assets that do not move in tandem up or down in response to macroeconomic changes or shocks. Typical pension fund investments include:

- *Fixed income*: Highly rated government bills, notes and bonds, corporate bonds, municipal bonds, mortgage bonds, mortgage-backed securities, commercial paper, other money market instruments, etc.

- *Equities*: Usually, the equity portfolio is broadly diversified by country, industry, size, currency, and other factors. Normally, only equities of highly rated

companies meeting certain minimum capitalization requirements and traded on major exchanges are permitted.

- *Open-end investment funds*: The investment funds already hold a broad portfolio of different securities so they automatically provide some diversification. Additional diversification is possible by buying open-end funds with widely different objectives.

- *Real estate*: Some pension funds permit direct investment in real estate. However, this type of investment is difficult to value and not very liquid—i.e., it can be difficult to sell quickly at a fair price. However, real estate investment is also possible through securities such as real estate investment trusts (REITs), mortgage-backed securities, mortgage bonds, and equities of companies in the real estate business.

Investments in hard assets such as art, coins, collectibles, and physical gold and silver are normally prohibited. They are difficult to value and hard to liquidate quickly. More controversial are investments in derivatives (options and futures contracts), swaps, private equity funds, and hedge funds. These vehicles offer higher potential gains and losses, and often, highly leveraged and involve short selling. If used improperly, they can cause very large losses. Many countries prohibit the use of these vehicles while others allow them to be used for reducing portfolio risk only. If permitted, both the industry and the regulator must have expert knowledge of these products.

B. Government versus Private Asset Management

For any defined contribution system to be successful, contributions must earn the maximum possible ROR that is reasonable given the purpose of the fund. In other words, since workers' pensions will depend on the ultimate account balance:

- investments should not be so conservative that the ROR will be too low;
- investments should not be overly aggressive or speculative and risk large losses;
- investments should be in securities that are frequently traded and can be quickly bought or sold as market conditions change;
- investment should be well diversified to avoid the risk of large losses;
- investment management fees must be controlled. Small reductions in ROR, when compounded over many years, can significantly reduce the ending account balance and pension;
- administrative fees for fund service providers must be controlled; and
- proper governance procedures must be in place to assure transparency, accountability, and disclosure for the pension system as a whole and for the investment management process.

In many countries, there is disagreement over who should manage the assets in a government-mandated defined contribution system. In some countries, the state manages the assets while in other countries the private sector manages the assets.

The typical arguments advanced for the state to manage the assets of a mandatory defined contribution pension system are as follows:

- Private funds have high advertising and marketing costs. By having a single state-run fund, these costs can be avoided.
- Private fund managers are in business to make money and their fees include a margin for profits. These profit margins can be avoided by having the state manage the assets (it should be noted that this argument would not be valid in Indonesia since the perseros are for-profit and pay corporate taxes and dividends).
- The portfolios of mandatory private pension funds are very nearly identical in many countries, so there is no real competition and choice anyhow. It is much simpler to have just a single state-run fund.
- With only a single state-run fund, a separate regulatory agency is not needed and oversight of the process is much simpler than when there are many competing funds.
- There is no need for an elaborate process to license fund managers, suspend licenses, impose penalties, etc.

On the other hand, many arguments are raised against state asset management and in favor of private management of pension fund assets. Many of these arguments are very applicable to Indonesia.

- A single government-run fund is a monopoly. There are no incentives to run the fund efficiently or maximize returns.

- The Government is likely to invest the money in its own best interests, loaning money to itself at below market rates, investing in favored political projects and in businesses that have strong political ties to the current ruling party.
- The investment portfolio usually contains very conservative investments that are unlikely to have sufficiently high rates of return.
- Investments are selected based on political criteria rather than internationally accepted portfolio management principles.
- Governance procedures are usually inadequate and there is no effective regulation or oversight of the State-managed fund.
- It is impossible to fire the state if its performance is poor and participants have no one to complain to if administrative services or investment results are poor.
- A government bureaucracy is unlikely to focus on high-quality customer service.
- State funds often credit a declared ROR rather than the actual return on plan assets.

The method of selecting and licensing asset managers varies greatly among countries. Options range from full government to full private asset management with several possible public-private options in between. Some examples from different countries are listed below:

- In India's new pension system for government workers (NPS), the Government will conduct an international tender to award asset management licenses to a limited number of companies. Each company that receives a license will be required to establish three standardized funds with different investment objectives and level of risk. All portfolios will be created by purchasing index funds. The Government will use public facilities such as post offices and banks for enrollment and will hire a central recordkeeping organization through a tender process. The record keeper will be responsible for maintaining records of pension fund membership, processing transfers, and individual account recordkeeping. The selected asset management companies will be responsible only for investments.
- In Thailand's Government Pension Fund (GPF), the Government is fully responsible for all aspects of plan operations. It registers workers, collects contributions, manages assets, and keeps individual accounts. The Government has the option, but is not required to outsource some of the asset management to private firms.
- In Malaysia and Singapore, a government provident fund is responsible for all aspects of plan operations. It registers employers and workers, collects contributions, manages assets, and keeps individual accounts. In both countries, a small portion of the assets can be allocated to funds run by private asset managers.
- In the United States, the Thrift Savings Program (TSP) for government workers is managed by a separate Thrift Savings Plan Board, which outsources all functions to private institutions through international tenders. Separate contracts are awarded for record-keeping, asset management, custodian services, and annuity purchases. The selected asset manager establishes six different index funds with different investment objectives. Participants can allocate their contributions among these index funds.
- In Croatia, licensed private pension companies manage assets. The pension companies establish the fund's investment policy and create portfolios within the guidelines contained in the pension law. Workers select the pension fund they wish to join. However, a central government organization is responsible for enrolling workers in a pension fund, collecting contributions, processing transfers and maintaining individual accounts.
- In Sweden, workers create their own investment portfolio by allocating contributions among licensed open-end investment funds (mutual funds). There are hundreds of licensed funds available. Sweden's government also fully centralizes the contribution collection, enrollment and individual recordkeeping functions.
- In Kosovo, there is a single mandatory accumulation fund administered by the Kosovo Pension Trust (KPT). KPT sets the investment policy for the fund, collects contributions, and maintains individual accounts. However, private asset managers are hired through a tender process to manage different portions of the pension fund portfolio. Since there is only one fund, workers do not have a choice among funds. Both Ukraine and Armenia are considering similar structures to Kosovo—single fund with government administration and private asset management.
- In Bolivia and Macedonia, the Government conducted an international tender to award a pension

asset management license to two pension companies. The Government is responsible for contribution collection and the pension companies are responsible for marketing and enrollment, asset management and individual account recordkeeping.

- In Poland and Bulgaria (and many other countries), the government awards licenses to manage mandatory pension fund assets to all firms meeting specific criteria. The government collects contributions, while the private pension funds are responsible for marketing and enrollment, asset management and individual account recordkeeping.
- In Chile (and most other countries in Latin America), the government awards licenses to manage mandatory pension fund assets to all firms meeting specified criteria. In some countries, contribution collection is centralized while, in others, private pension funds collect their own contributions. Once again, the pension companies are responsible for marketing and enrollment, asset management and individual account recordkeeping.

All these examples show that actual practice ranges from fully privatized schemes to fully State-run schemes. In between are public-private partnerships with functions allocated between the state and private sectors.

Today, Indonesia has different provident funds for different employee groups. Each provident fund performs all required functions and has a single investment policy. The assets are managed by the provident funds and are SOEs that pay taxes on their profits and pay dividends to the government.

This structure inevitably leads to weak oversight and conflicts of interest between the interests of the government/shareholders and the interests of members. The governance could be improved if the provident funds delegated the asset management function to the private sector. Then the provident fund's management would be responsible for setting investment policy and overseeing the performance of the private funds rather than managing the assets itself. This would provide a cleaner separation of management and oversight responsibilities that is lacking under the current structure. However, major improvements in governance would require changes in the legal form of the provident funds.

C. Contribution and Data Collection

Another key issue is how contributions to pension and social insurance funds are collected. In Indonesia today, each persero collects its own data and contributions for its participants. This means each must have staff, information technology systems, and procedures for collection and enforcement. The same issue arises in countries with multiple private pension fund managers. Should each fund collect for itself or should a central organization collect for everyone?

Indonesia must ask itself whether it continues to make sense to have four administrators performing the same functions. It might be more effective to have one organization to collect contributions and data on behalf of all social insurance funds so that the process would be efficient and follow a uniform procedure for all funds.

Contribution Collection Process

In many countries, the contribution collection for social insurance programs is treated as a passive process in which the responsible organization simply processes the money it receives with scant regard for accuracy and timeliness. This method might be acceptable for a voluntary savings program. However, for mandatory government-sponsored social insurance programs, the administrative organization or organizations have a far greater responsibility.

The goal of the contribution collection process is to collect on time and efficiently the correct amount of payroll contributions from each employer and worker who is required to participate, and then store and ensure the accuracy and safety of the individual data. This requires a change in mentality and approach to the contribution collection process:

- The administrators must think of themselves as debt collectors rather than bank tellers. They must proactively collect the correct amount of contributions rather than just accept whatever comes in through the door.
- Contribution and data collection must be linked. Each month, the contributions paid should match the submitted data. Data submitted should be consistent from month-to-month and should match the data submitted to the government for other purposes, such as payment of taxes.
- Data should be submitted electronically using standardized software developed and distributed free of charge by the administrators. The software should be designed to validate data and prevent the input of incorrect or inconsistent data.
- Administrators must have proper accounting control procedures. Contribution revenues should

be deposited to special bank accounts for each fund and should not be mixed with other revenues.

- Responsibilities for enforcement must be defined clearly in the law and in written agreements between various government institutions.

There are four distinct steps in any effective contribution collection process for social insurance programs. The same steps apply—though perhaps in slightly different ways—regardless of whether the country has a defined benefit social security system, mandatory accumulation system, or a central provident fund.

- *Contribution collection*: This is the process by which the collecting organization receives and records contributions from those who are required to pay. Normally, contributions are collected either by the social insurance organization, the tax administration, a specialized government institution, or private pension funds (for mandatory or voluntary accumulation systems).

- *Data collection*: The data gives information about each individual employee for whom contributions were made. It should identify the employee in some unique way and show information regarding wages and contributions to each social insurance fund for each employee. The organization collecting data need not be the same as the one collecting contributions, but the process will be simpler if the same organization is responsible for both. For example, the tax administration may collect contributions while the social insurance organization(s) collects data.

- *Reconciliation of contributions and data*: This is often referred to as the control function. An organization must determine whether data are accurate and complete, and if the contribution amounts paid match the submitted data. If not, the control organization must contact the employer to resolve any discrepancies.

- *Enforcement*: If the government believes that an employer is evading completely, or is not paying the correct amount for each worker and no amicable agreement can be reached, then the government must collect what is due. Actions could include anything from fines for late payment to legal action to seize and liquidate employer assets to settle obligations.

Under Indonesia's current system, the provident funds are responsible for contribution and data collection and reconciliation. However, it seems that the provident funds do not have the proper authority to enforce and no other government organization is performing this function effectively. As a result, about 75% of all formal sector employers are evading their responsibility to register and pay contributions to Jamsostek with little or no apparent consequences.

Centralized versus Decentralized Approaches

There are two general types of contribution collection procedures, usually referred to as centralized and decentralized methods. Under the centralized method, one government or private organization is responsible for the payroll contribution and data collection functions. Decentralized contribution collection is the opposite of centralized. More than one government or private institution is responsible for these functions. Indonesia has multiple social insurance institutions and each collects contributions for its own programs. In this sense, the system is decentralized even though all institutions are SOEs.

Table 4 shows the relative advantages of the centralized and decentralized approaches in the Indonesian context.

The logical conclusion that can be drawn from the table is that the centralized approach makes the most sense providing the government institutions involved have the administrative and IT systems and procedures necessary to support it and the institutions have the political will to work together. The decentralized approach can be viewed as the method of choice for those countries that do not (yet) have the capacity to fully support a centralized approach or have government institutions that cannot easily coordinate with each other. The political process is also more difficult if existing institutions will be required to give up functions, staff, and budget because of the change.

D. Lump-Sum Payout Options

Most pension systems do not permit payouts prior to retirement age, except in the event of permanent disability or death. Such payouts are usually in the form of a life annuity. This is particularly true in social security systems and is often true for mandatory accumulation systems as well. The reason is that the purpose of a pension program is to prevent poverty in old age. However, there are defined contribution systems such as provident funds, government pension funds, and some mandatory accumulation systems

Table 4: Centralized versus Decentralized Approach to Contribution Collection

Centralized	Decentralized
Avoid duplicating administrative structures. Greatest savings are achieved if all social contributions and data are collected by one institution.	Faster transfer of money to each social insurance fund. Money is sent directly to each fund rather than passing through another institution first.
Employer can submit all contributions and data for all social insurance funds to one institution in a single submission for all workers.	Avoids improper use of funds by the state collection agency. For example, the agency might delay transferring money to other funds to earn interest.
Easier to assure consistent data is reported to all social insurance funds.	Helps protect citizen privacy. For example, workers may not want to participate in the social insurance system if they know the tax administration will be able to locate them.
Easier to enforce contribution payments, monitor the entire system and develop statistical reports and analysis.	Centralized works best when the government has substantial capabilities including: • unique employer and employee ID numbers, • good cooperation among different government institutions, and • electronic databases and automated contribution and data transfer procedures. Otherwise, decentralized may be the only true option.

Source: Wiener

that also permit or even require lump sums. Pensioners in many countries prefer to receive all their money at once or want to receive a portion of the money in a lump sum to allow for major purchases upon retirement and greater flexibility to adapt to changing life circumstances.

For this reason, many defined contribution schemes offer multiple payout options upon retirement:

- *Lump sum*: The entire account balance is paid out once.

- *Periodic withdrawals*: The account balance is paid in installments. Payments stop once the entire account balance has been withdrawn. The payout period normally approximates the participant's expected remaining lifetime following retirement, but could be shorter.

- *Life annuity*: The account balance is used to purchase an annuity from an insurance company. The insurer promises to regularly remit payments to the participant for the rest of the participant's life. The advantage of life annuity is that the participant is guaranteed to have an income for as long as the person lives. Several different forms of annuity are usually made available to workers, including annuities that continue benefits to the spouse after the worker dies and annuities that guarantee payments for a minimum period so that workers in poor health can still receive significant benefits.

It is also possible to create payout options that are a combination of the three options listed above. Some examples found in pension systems around the world include:

- a percentage of the account balance can be taken as a lump sum and the balance must be used to purchase an annuity;
- the account balance must be used to buy an annuity, but if the annuity would provide a benefit in excess of a specified replacement ratio—for example, 50%—the excess amount can be taken as a lump sum;
- a participant can receive periodic withdrawals for a period of years—for example, up to 5 years—and then purchase an annuity at a later date;
- a participant can receive a lump-sum payment equal to the present value of expected payments that would have been received in the first 5 years, for example, and then receive an annuity starting 5 years later.

The issue of lump-sum payments is controversial and different countries have different decisions regarding the availability of lump sums. They typically depend on the structure of the retirement system, tax considerations, culture, and the government's philosophy regarding its obligations to citizens.

- The primary reason for prohibiting lump sums is that the purpose of the pension system is to prevent poverty among the elderly and ensure pensioners have income for as long as they live following retirement. If pensioners are given a lump sum, they may squander it, find themselves living in poverty, and thus, become a burden to the state welfare system.
- If the state pension system provides a universal pension equal to the poverty level or if a sufficient benefit is provided through a social security system, then it might be reasonable to allow the benefit in excess of the poverty level to be taken as a lump sum.
- It is common for individuals to move to another location or make changes in their lifestyle when they retire. These pensioners may need a lump sum to pay for certain expenses that occur immediately following retirement and an annuity that provides them with a regular monthly income. A partial lump sum may help meet those needs.
- Lump sums may be permitted, but adverse tax consequences may limit their use. If a country has progressive personal income tax rates (rates that increase with income), then a lump sum may be taxed at very high rates while the tax rate may be much lower if taken in installments. This may not be an issue in countries with a flat-rate tax structure, countries with special tax provisions for lump sums, or countries where most citizens do not pay personal income tax.

Each country will have to decide whether to allow lump-sum pension payments from the state-mandated pension system. The decision will depend on the specifics of each country's pension system design and the degree to which the country is paternalistic and feels it is obligated to protect its citizens against poor decisions or living in poverty post-retirement.

X. Fiscal Management of Defined Benefit Pension Programs

Social security systems that base benefits on wages and years of contributions have very different fiscal management issues than defined contribution systems such as Indonesia's provident funds. Although Indonesia does not have a social security system, the SJSN Law would create one. In this section, we discuss the key risks that must be properly managed to have a successful social security system.

- *Demographic risk*: Unfunded or partially funded social security systems are subject to big demographic risks. The contribution rate is a direct function of the system dependency rate—the ratio of pensioners to contributors. If the population is aging due to decreased fertility and an increasing life expectancy, then the dependency ratio can skyrocket quickly. If the dependency ratio doubles, then so will the required contribution rate. This risk is not nearly as critical in systems based on provident funds because each worker's contributions are saved for that person's retirement, rather than paying for the benefits of current pensioners.

- *Long-term fiscal stability*. Managing the financial stability of traditional social security systems is challenging. The government is promising to pay a benefit upon retirement based on a specified formula. If there are insufficient funds to pay benefits when due, then the state budget must make up for any shortfall. As previously mentioned, changes in demographics can drastically impact on the cost of the system and may require the buildup and management of large reserves. Actuaries and sophisticated computer models are needed to prepare long-term projections (50 years or more) of the current pension system's finances and to measure the impact of proposed system changes.

- *Political risk*. Social security systems can be easily changed by the government. Retirement ages, benefit levels, contribution rates, and pension indexing can all be changed. These changes may have a small fiscal impact in the short-run, but a devastating impact on system finances in the medium to long term. Special benefits are often granted to politically favored groups, big pension increases are often promised just prior to elections, and system reserves are often misused. The opportunities for interference are less in many fully funded defined contribution schemes, particularly those with private asset management. However, systems with government asset management are also exposed to significant political risks.

- *Evasion (complete or partial)*. In a traditional social security system, it is imperative to collect the correct amount of contributions from each employer and worker who is legally obligated to participate.

Otherwise, the pension system may have deficits that must be financed by the state budget, benefits may have to be decreased, or contributions may have to be increased. In many cases, workers still receive service credit even though contributions were not made, especially if the employer is at fault. This is the worst of both worlds for the government where it does not receive contributions, but must still pay all benefits.

- *Record keeping (wage and service history)*. It is critical to have accurate records of wages and years of service to calculate benefits correctly upon retirement. In many parts of the world, service records are kept in labor books and the worker is responsible for keeping wage histories and providing them to the government upon retirement. This method is subject to a high risk of fraud. Instead, it is imperative to maintain an electronic database of wages and service history and update the database at least once a year and preferably more frequently. A national pensioner database must also be maintained and regularly checked against the country's death records to be sure payments stop when they should.

- *Reserve management*. To protect against future deterioration in demographics, many social security systems accumulate significant reserves. Workers and employers pay more than is necessary to meet benefit obligations now to create the reserve. These reserves are then used to supplement contributions in years in which contributions alone are insufficient to meet benefit obligations. These reserves must be properly invested and must be protected against "raids" by those who want to use the reserves for other than their intended purpose.

- *Benefit adequacy*. The social security system must provide adequate benefits and prevent poverty for all participants from the lowest-paid to the highest-paid. There are also practical limits on the size of payroll contributions that can be charged. If the required contribution rate is too high, it will encourage evasion, increase unemployment, increase business costs and/or decrease business profits. It can also hurt a country's competitiveness in the regional or global economy. Finding the right balance often requires increasing retirement ages to compensate for increasing life expectancy and providing minimum benefits for the lowest-paid workers.

- *Retirement age*. It is virtually impossible to provide adequate benefits at a reasonable cost if retirement ages are too low. As life expectancy upon retirement increases, the retirement age must be increased to keep the system in balance.

- *Pension indexing*. Benefits may be adequate upon retirement but they will quickly become inadequate if benefits are not adjusted for inflation. Without pension indexing, pensions will drop below the poverty line after a period of years even if inflation is very low. However, pension indexing also significantly increases the cost of the social security system.

Over the past 15 years, many countries in the world have gone through the painful process of making politically unpopular changes to their pension systems to restore long-term fiscal balance. Changes have included increases in retirement ages, elimination of privileged pensions, reduction in benefit accruals and introduction of multi-pillar pension systems.

While social security systems have many advantages, it will prove difficult for Indonesia to introduce one now. Indonesia currently has a young population, but it will start to age rapidly in the years ahead. If Indonesia starts a social security system now, the immediate costs will be very low, but they will increase by a factor of 10 over the next 30–40 years. This will require constant increases in contribution rates and/or decreases in benefits. Consequently, this is not really a viable option.

XI. International Examples

In this section, we review the governance structure of several different types of public and mandatory private pension systems around the world. We will discuss in detail the following five systems, as they illustrate the wide range of good and poor current global practices:

- *Canada Pension Plan (CPP)*: Partially funded defined benefit national social security system with government oversight of private sector asset managers;

- *US Thrift Savings Plan (TSP)*: Mandatory defined contribution plan for certain employees of the US federal government and armed forces with government oversight of private sector asset management;

- *Hong Kong mandatory fully funded system*: Mandatory defined contribution plan for formal sector workers and the self-employed with private asset management;

- *Singapore Central Provident Fund*: Central provident fund for formal sector workers with primarily government asset management; and

- *Thailand Government Pension Fund*: Pension fund for most government officials with primarily government asset management.

A. Canada Pension Plan (CPP)

This is a partially funded defined benefit national social security system. A board of directors governs it. The CPP Investment Board, an independent Crown corporation with full discretion regarding investment policy, invests system reserves.

- *Governing body*: The CPP Board consists of the federal and provincial ministers of finance. They make recommendations for changes in benefits and contributions every 3 years.

- *Management*: Social Development Canada, which is part of the Ministry of Social Development, administers the plan. CPP has separate accounts to record all inflows and outflows. These are not part of the federal government's revenues and expenditures. The tax authority is responsible for collection of contributions as well as control and enforcement.

- *Oversight*: There are several layers of oversight designed to protect the system's fiscal integrity and members' rights.

  - The Chief Actuary is required to prepare a report every 3 years on the financial status of the system and make recommendations for changes in benefits or contributions to preserve the system's long-term financial stability. An independent panel of actuaries periodically reviews these reports, which are submitted to the MOF and the House of Commons.
  - The Chief Actuary is required to prepare a fiscal impact report on all bills introduced in Parliament that would change system parameters.
  - Appeals of CPP benefit decisions go to the Minister of Human Resource Development for review, then to an independent review tribunal and finally to a pensions appeal board (if they agree to hear the case).
  - The Auditor General of Canada conducts an independent audit of CPP financial statements.
  - The Ministry of Social Development and the MOF prepare a comprehensive annual financial report that is submitted to each House of Parliament and the provinces.

- Changes in benefits, retirement age, contributions, or the investment framework for reserves can be changed only by Parliament and require the consent of two thirds of the provinces covering at least two thirds of the population.

The governance structure for the CPP investment function may be the best of any public plan in the world. The CPP Investment Board (CPPIB) is responsible for the investment of all system reserves and has its own governing body, management, and oversight structure. Its hallmark is "independence, accountability, and performance." Its mandate is to "invest in the best interests of Canada Pension Plan contributors and beneficiaries and maximize investment return without undue risk of loss."

The directors of the CPPIB are the governing body. The director and senior staff of the CPPIB are management, and the federal and provincial MOFs are responsible for oversight.

- The CPPIB's only responsibility is the investment of CPP reserves. It has no responsibility for policy or administration. Its only mandate is to manage system reserves.
- The federal finance minister, in consultation with the provincial finance ministers, appoints directors of the CPPIB. Directors are chosen from a list complied by a nominating committee. The federal finance minister appoints the chair of the nominating committee, and each participating provincial government appoints one representative. The nominating committee recommends candidates for appointment and reappointment.
- Only those with expertise in investment, business, and finance are appointed to the board.
- The principal duty of the board of directors is to oversee the management of CPPIB. A governance

manual has been developed that defines the roles and responsibilities of the board of directors, committees and the president and chief executive officer. Specific duties of the board of directors include:

- establishing investment policies, standards, and procedures;
- appointing an independent auditor;
- approving procedures to identify and resolve conflicts of interest;
- developing a code of conduct for directors, officers, and employees;
- appointing the president and chief executive officer of the CPPIB;
- monitoring and assessing management's performance;
- assessing the performance of the board itself through a self-assessment process using outside consultants; and
- approving financial statements.

- Management is expected to comply with the Canada Pension Plan Investment Board Act and regulations as well as all policies approved by the board. Management's responsibilities include:

  - development of the strategic direction of the organization, in consultation with the board;
  - risk-management policies and controls;
  - monitoring and reporting mechanisms;
  - developing benchmarks that objectively measure the performance of markets and asset classes in which CPP assets are invested and assisting the board in evaluating management's investment performance; and
  - full and timely disclosure to the board and the public of all material activities, as well as quarterly and annual financial results.

These policies and procedures show the extraordinary efforts made by the Government of Canada to insulate the administration and investment activities of CPP from political interference. The investment function has been put in the hands of experts and while the Government has oversight responsibilities, it is effectively precluded from interfering in the day-to-day operations of the system.

B. US Thrift Savings Plan (TSP)

This is another example of a system where the Government has gone to great lengths to establish a structure that precludes political interference in pension plan operations. TSP is a mandatory defined contribution plan covering most employees of the US federal government and the armed forces. The program makes five different index funds available to plan members for investments. It also has a life cycle fund that invests in the other five funds with the mix varying according to the member's age.

- *Governing body*: The Federal Thrift Savings Investment Board (TSP Board) administers the plan. It is responsible for investment policy and overall management of TSP and oversight of the record keeping firm and accounting firm,

  - The president appoints the five members of the TSP Board for a 4-year term each. The members are from the private sector and have particular expertise in pensions, investments, and insurance. The Board appoints an executive director. The Board also contracts with a private sector record keeper, asset manager, and annuity provider (insurance company).
  - The TSP Board has a legal fiduciary responsibility to manage the system in the best interests of members and beneficiaries. There are many prohibited activities to prevent conflict of interest.

- *Management*: The executive director and his staff are responsible for day-to-day management of the program, including coordination and oversight of the record keeper, asset manager, and annuity provider selected by the Board.

- *Oversight*: The TSP has an Employee Thrift Advisory Council that makes recommendations for changes to the system. The Department of Labor is responsible for conducting annual audits of the TSP Board, the management and outside service providers. It makes recommendations for changes and improvements, but the recommendations are not binding on the Board.

It should be noted that the structure of the NPS for government workers in India is very similar to the structure of the TSP.

C. Hong Kong Mandatory Provident Funds

Hong Kong introduced a mandatory provident fund in 2000. Under this system, all employees and the self-employed are required to participate. Only civil servants, teachers, and judges are exempted because they have their own system.

All employers must join a master trust, establish an employer-sponsored plan, or join an industry plan. A master trust is an open pension fund that can be used as a funding vehicle by many different employers and by individuals. Industry plans are for the construction and catering industries only. All services such as administration, asset management, and record keeping are provided by the private sector.

The mandatory provident fund authority (MPFA) regulates the system. It is the principle body responsible for oversight. MPFA has the following key responsibilities:

- ensure compliance with the law,
- register provident fund schemes,
- license and regulate trustees, and
- issue regulations governing contribution payment and administration.

Trustees are fully responsible for plan administration. They are responsible for contribution and data collection and individual record keeping. The trustees can perform all functions themselves or can hire outside service companies to perform some or all of the required services. The trustees appoint the administrator, the asset managers, and the custodian. Before beginning operations, the trustees require a license from the MPFA and must meet minimum capital requirements. The trustees must market their services through sales agents who must pass a licensure examination.

A master trust can offer more than one pension scheme with different investment objectives. If an employer is a member of a master trust, all pension schemes are available to its employees. Each individual scheme also must be approved by MPFA.

Investment managers require a license from the Securities and Futures Commission and must be qualified to manage unit trusts and pooled retirement schemes. There are minimum capital requirements for investment managers as well.

The governing body under this structure is the employer since it hires the trustee and reviews its performance and those of subcontractors it may hire. The trustee is the manager and the MPFA is responsible for oversight.

From this description, it should be clear that the conflicts of interest that exist when the government is the primary administrator or asset manager are far fewer when the system is based on private administration and asset management. Now, the government is not making investment decisions and doing administrative tasks itself. Under this structure, the government ensures compliance and protects members' rights. It has a clear oversight responsibility and it is not the governing body or the fund manager. This makes the governance structure much cleaner and there is a better chance of decisions being made in the best interests of the members.

However, there is still a governance problem in the Hong Kong system and it has to do with the independence of the MPFA. For the MPFA to function effectively, its decisions and actions must be free from political interference. It must decide, based on objective criteria contained in the law, who should get licenses or have them suspended, who is violating the investment rules, etc. Even in a private system, a determined government can still significantly weaken the governance structure.

Under the Hong Kong law, a group of directors, all of whom are appointed by the Chief Executive of Hong Kong, runs MPFA. The appointments are made mostly on the tripartite structure, based primarily on politics rather than knowledge of pensions. The Chief Executive also has the right to remove directors and has the power to direct the MPFA to take any action that does not conflict with the mandatory provident fund law. This means the Chief Executive can easily influence licensing and disciplinary decisions and can replace board members who do not comply with his or her wishes.

This should not be the case, of course. A well-designed system will appoint the board of directors based on knowledge of pensions, investments, and other relevant disciplines. There should be stringent conditions for fit and proper members of the board. The board members should be protected also against removal for political reasons. Their terms of office should not coincide with the political cycle, it should only be possible to remove a member for cause and the government should not be able to reverse the regulator's decisions, unless it violates the law or regulations.

Even these provisions will not necessarily protect the system. For example, all of the provisions suggested in the previous paragraph are contained in the law in Macedonia. Despite that, following the August 2006 elections, the director and deputy director of the pension regulatory agency were dismissed. The dismissal was clearly illegal but was not challenged by either person because they knew the

court case would be prolonged for years and they probably would not be appointed to a position in the government again if they did not go quietly. So without the rule of law and an honest judiciary system, the best will in the in the world cannot guarantee that the most appropriately designed governance structure will succeed.

D. Singapore Central Provident Fund (CPF)

Singapore is an example of a country that violates most procedures for good governance. Singapore has a central provident fund providing multiple types of benefits to its members, including funds for retirement, health, home purchases, and education. Almost 70% of assets are withdrawn prior to retirement age. It covers most of the workforce, except top civil servants.

The provident fund law makes it clear that the primary purpose of CPF is not to maximize returns to members. The stated goal of the fund is to "make the assets and services available to help meet Singapore's social and economic objectives, thereby improving the quality of life of all Singaporeans and CPF members." Given these objectives, it is hardly surprising that its procedures are not designed to maximize benefits to members.

- *Governing body*: The CPF Board has 12 members and is composed of government, employer, employee, and professional representatives. There are no requirements regarding education, experience, or moral character. The Board has no policy autonomy, only administrative autonomy. The Government of Singapore Investment Company manages investments outside the board. They outsource most assets to government investment holding companies whose operations are secret by law.

- *Management*: The CPF is the administrator. The board appoints the director.

- *Oversight*: There is no oversight of investments and very limited oversight of administration. There is virtually no transparency, accountability, or fiduciary responsibility. There is no requirement to disclose the holdings or the performance of the investments or the composition of the investment portfolio. On the balance sheet, all investments are shown as nonmarketable government securities.

- Credited rates of return to members are not based on the actual return on investments. Instead, there is a minimum credited ROR set by regulation. It is really a notional account plan. The government keeps any excess investment earnings.

- Most funds are used for housing, medical expenses and education. Very little is actually used for retirement. Most housing money is used to purchase government-constructed housing.

- Some investments in outside funds are permitted, but are quite limited and the transaction costs are very high.

Some of these characteristics are true for Indonesia's provident funds as well. Most funds are withdrawn prior to retirement age, the actual ROR is not the rate credited to members, and the primary goal of the system is not to maximize benefits for members. Indonesia's system has somewhat greater transparency, but is still not sufficient to meet international standards. However, Indonesia's provident funds do manage their own assets.

E. Thailand Government Pension Fund (GPF)

GPF covers the majority of government officials. It is a mandatory accumulation system funded by a 6% contribution (3% each from workers and employers). The benefit from GPF is in addition to a defined benefit lifetime pension payable from the state budget.

- *Governing body*: GPF has a committee composed of 15 members. Nine positions are ex officio and the balance is representatives of members and outside experts. The other members of the board elect the expert members. The permanent secretary of the MOF is the chairperson. The committee is also responsible for the investments of the fund. The director-general of the fiscal policy office of MOF chairs the investment sub-committee. This sub-committee also includes a representative of the Bank of Thailand and four outside experts appointed by the committee. The committee has the authority to manage assets itself or outsource asset management in full or in part to the private sector.

- *Management*: The committee appoints a secretary-general to be the senior executive officer of the GPF. There is no required expertise in pensions or investments to be appointed to this position. An employment contract determines the conditions for removal

from office. The secretary-general is a member of the committee and the investment sub-committee.

- *Oversight*: The GPF is required to let all members know their account balance at least once a year. It also submits a monthly report to the minister of MOF and must prepare and submit annual financial statements to the office of the auditor-general each year as well as submit a report to the general meeting of members. The members may submit opinions and recommendations to the committee, but these are not binding. However, these recommendations along with the audited financial statements are submitted to the cabinet and are published in the Government Gazette.

This system is a significant improvement over the governance procedures in Singapore and in Indonesia, but still leaves much to be desired. GPF is not an SOE but is a legal entity with obligations to its members. The actual rate of investment return is credited to individual accounts and there are regular published financial statements and statements of individual account balances. There is also some oversight and review of management's activities.

However, committee members and investment sub-committee members are not required to have particular expertise in pensions or investments and there is regular political interference in the investment decisions of the committee. The secretary-general of the GPF is a member of both the committee and investment sub-committee. This is a violation of proper practice. Management and the governing body should be completely independent of each other. There is also insufficient oversight of the policies and decisions of the committee.

XII. Strengthening Pension Regulation

The nonbank financial regulator, Bapepam LK, and its pension fund directorate do not have a direct role today in the regulation of the current social insurance programs administered by the four perseros. The SJSN Law does not address many aspects of the supervisory and regulatory structure of the new national social security system.

We suggest Indonesia strengthen the supervisory and regulatory role of Bapepam LK and its pension fund directorate in the technical supervision and regulation of the pension and old-age savings funds created under the SJSN Law. A strong and independent regulatory agency is one of the main elements of good pension system governance, and is one of the key institutions needed to protect the assets in Indonesia's various existing and future pension and old-age savings systems.

The primary reasons for stronger involvement by the pension directorate of Bapepam LK are set below.

- *Highly technical area*. Pensions are a highly technical area and few Indonesian citizens have the expertise to understand fully all aspects of pension system operations. However, citizens rely on the pension system to prevent them from living in poverty following retirement and to maintain their pre-retirement living standard. To protect the state budget and convince citizens that the pension system is safe, it is important for the government to have a specialized institution staffed with pension experts.

- *Government-mandated programs*: GOI sponsors a number of mandatory government pension and provident funds. Since the government compels participation, it is legally and morally responsible for protecting the safety and integrity of the system. A pension regulator would provide far greater system protection than general ministry supervision.

- *Coordination of pension programs during SJSN transition*. Once the SJSN Law is fully implemented, there will be five social insurance funds covering all Indonesians. However, it will take many years to make the complete transition from the current system to the national social insurance system. During this period, there will be multiple pension and old-age savings programs covering different groups of workers. MSOE and other government ministries currently regulate the existing social insurance institutes. However, the pension directorate of Bapepam LK is not directly involved. It makes sense for the pension directorate of Bapepam LK to be responsible ultimately for technical supervision and regulation of the SJSN pension and old-age savings programs. While the Social Security Council is charged with formulating general policy, it does not have true regulatory responsibility nor the staff and expertise to assume this role. The pension directorate of Bapepam LK could also take over the role of regulating the existing social insurance institutes once they are no longer perseros.

- *Need for consistent rules*. Today, the various pension systems operate under different rules regarding

retirement age, permitted and prohibited fund investments, asset allocation guidelines, accounting rules, asset valuation methods, benefit payments, and other key aspects of pension system design and administration. Although the SJSN Law will eventually create a system covering the entire population with equal benefits for everyone, the transition period could take between 10 and 20 years. During this transition period, multiple programs will continue to exist and these should operate under similar rules and regulations as far as possible.

- *Promote labor and pension mobility*. Indonesia's pension programs should promote labor and pension mobility and full employment rather than restrict it. Workers should be able to move from one sector of the economy to another or from one company to another without loss of benefits or adverse tax consequences. Again, careful coordination of the different pension schemes will be needed during the transition period.

Bapepam LK (or the future OJK) will function more effectively if it is independent of any one ministry so it will not be subject to political interference in its operations. Key elements that assure independence include the following.

- Reports to the President or Parliament and not any single ministry.
- Financing by fees assessed against the industry rather than by the state budget.
- The ability to pay competitive salaries so it can attract and retain qualified professionals. If the agency is to function effectively and is to be respected, it needs to have professional staff with the same or better qualifications than those in the private sector.
- The agency's director and deputy director should be appointed for extended periods so their terms do not coincide with the terms of the government and it should be impossible to remove them from office for political reasons. They must be able to make decisions without fear of political reprisal.
- The pension laws must give the regulatory agency the statutory authority it needs to act and the right or requirement to issue regulations in key areas.
- The agency's board should include experts with particular expertise in investments, insurance, actuarial science, administration, business, and law. Board members should be appointed using a process that minimizes political interference in agency decisions.

XIII. Summary

The system of governance is the most important guarantee of pension system safety. It is far more important than any ROR guarantees, guarantee funds, or other forms of protection. A strong governance system improves RORs and system safety. Other types of guarantees normally reduce rates of return and benefits, and offer mostly illusory protection. The key elements of a strong system of governance are:

- *Clear fiduciary responsibilities*. There must be a designated "governing body" ultimately responsible for the proper operation of the pension system. Members should have proper education, experience, and training in relevant subject areas. Responsibility and accountability for all functions must be clear and stated in writing. Ideally, the governing board should be personally liable for losses caused by violations of fiduciary duty

- *Benchmarks, review, and replacement for failure to perform*. There must be mechanisms for performance review to ensure those responsible are performing their jobs well and to replace them if they are not. This applies to the members of the governing body as well as to those responsible for management and oversight.

- *Suitability requirements*. There should be clear educational and experience requirements for members of the governing body, people in key management positions in the industry and in the regulatory agency, and there should be requirements for good moral character. Those responsible for managing or protecting other people's money must meet higher moral standards. The same is true of professionals providing services to pension funds such as accountants, auditors, and actuaries. The public relies on these professionals to protect them and give them information they need to make informed decisions. These are positions of public trust.

- *Separation of governance, operations, and oversight*. There must be one group responsible for policy and management oversight, another for performing key functions, and a third for overseeing the activities of the governing body. A system of checks and balances is necessary to ensure that no one has absolute power

or is working in isolation without any review of their work and decisions. In many cases, the oversight function involves the use of outside experts, such as actuaries and auditors. The pension regulatory agency is the key institution for oversight in private plans. In public plans, the government, legislature, or special oversight committees may be necessary. Standards for disclosure, transparency, and prevention of conflict of interest need to be even more stringent in the public sector.

- *Transparency and full disclosure*. The entire pension system must be transparent. There must be full disclosure of the results of pension system operations (strategic goals and objectives, members of the governing body and management and their backgrounds and responsibilities, investment policy, portfolios, RORs, plan features, member rights, individual account balances, etc.). Meetings of governing boards and oversight committees should be open to the public. Minutes of all meetings should be kept and be available to the public. Decisions should be in writing with a full explanation of the rationale and methods of appeal. Nothing should be done in secret and all calculations, procedures, and methodology should be fully explained.

Needless to say, Indonesia's provident funds for the formal sector, government workers, and the military fall well short of these goals and much work is needed to strengthen overall governance. If the government makes a concerted effort to improve the governance structure, it will be rewarded with greater public support for the programs, reduced evasion, better-qualified personnel managing and administering the program, improved service to members and improved rates of return on investments. Under SJSN, the four administrators will serve as the backbone for the proposed new national pension system. If the foundation is weak, the new system will not be successful no matter how well it is structured.

The first step in any pension reform is to fix the existing system and Indonesia is no exception. The primary focus of early reform efforts should be on an improved governance structure, codified in law and regulations, and properly implemented. Emphasis is also needed on key SJSN implementing regulations. Listed below are the actions required in the short, medium and long-term for implementation of the SJSN Law and improvements to the existing system.

Short-term actions (next 3 months)

- Review of the Presidential Decrees on the creation of the council and the procedure for appointment of the council members, clarifying the governance structure of the SJSN system, particularly with respect to responsibilities for oversight, assuring system transparency, protecting the system from political interference and assuring accountability of all parties. Clarify the role of Bapepam LK (or OJK) and its insurance and pension directorates in the regulatory structure.
- Appointment of the members of the Social Security Council. This is the body for responsible for all coordination and policy. It is difficult to move forward without a properly appointed council in place.
- Decision taken regarding the interim legal structure of the four perseros, and necessary legal documents prepared for implementation. Whatever structure is selected should make the organizations nonprofit, eliminate the requirement for dividends, and make the primary goal that of maximizing benefits for members. Appropriate changes should also be made in each social insurance institute's by-laws.
- Clarification of the role of each institute that is a member of the Social Security Administrative Body under the SJSN Law. Will each existing institute be assigned responsibility for one or more of the national social insurance funds? Will all institutes be permitted to establish five funds and compete for members? In particular, it would be helpful to clarify the future role of PT Askes and PT Jamsostek with respect to the health insurance program so expansion of Askeskin can proceed on a firm legal basis.
- Decision taken on centralized or decentralized approach for contribution and data collection and identification of responsible institute(s) that is (are) a member of the Social Security Administrative Body under the SJSN Law.
- Decision on a method for creating or purchasing computer models for health and pension modeling. Decide what organization or entity will be responsible for maintaining and updating the models and preparing analysis.
- Guidelines prepared for clear separation of management and oversight responsibilities in the asset management process. Consider outsourcing asset management to the private sector with oversight by the relevant social security institute.

- Guidelines prepared for clear standards for accounting, asset valuation, reporting, and disclosure to the government and to participants.
- Action plan for implementation of unique ID number for all Indonesians.

Medium-term actions (next 3–12 months)

- Improvements to the financial management and governance of PT Jamsostek:
  - Create a proper written investment policy. This should include rationale for the investment policy, investment horizon, cash flow and liquidity needs, measurement of liability duration, risk tolerance, investment limits, asset class minimums, and maximums, proper calculation of ROR, comparison with appropriate indices, etc.
  - Improve the overall investment process to ensure all investments are made in the best interest of members with the goal of maximizing returns within acceptable risk parameters. Consideration should be given to outsourcing asset management to the private sector with oversight by the PT Jamsostek board of directors.
  - Improvement of the governance structure within Jamsostek. Strengthen the oversight role of the board of commissioners to ensure the rights of the members are upheld. The majority of the board should be composed of independent commissioners that represent the interests of members.
  - Compliance improvements. PT Jamsostek must register all employers and workers who are required to contribute and collect contributions and data on time. Existing records must be reviewed to eliminate duplicate records for any individual and to store historical information electronically.
- Implement changes in the interim legal structure of the administrators so that they are not for-profit institutions that are legally responsible to their members.
- Develop the strategy and business processes for a fully automated system of contribution and data collection.
- Conduct a public tender to purchase an appropriate pension and health insurance computer-forecasting model or hire a consultant to assist the government in the creation of their model. Fully implement the modeling analysis institution.

Long-term actions (1–3 years)

- Implement a fully automated system for collection of contributions and data. Employers should submit electronic data using standardized software developed and provided by the government. An electronic database must be maintained for each individual with a full history of wages and contributions.
- Finalize the contributions and benefits under each of the SJSN social insurance funds, including a complete analysis of the short and long-term fiscal consequences.
- Create a trust fund law and change the legal structure of the Social Security Administrative Body to a trust fund structure.
- Carry out systematic and structured public education about SJSN. Public education should target the Government, Parliament, journalists, universities, and the general public. It is important to build public understanding and support for the goals and rationale of the social insurance system.
- Clarify the specific responsibilities of various government entities supervising and regulating the social insurance system. Formal memoranda of understanding or other legal documents among all institutions should spell out the specific responsibilities of each organization in the overall governance structure of the national social insurance system.
- Prepare and publish regular annual actuarial valuations of the pension and health insurance programs under SJSN. Prepare annual audit reports using international auditing standards for all SJSN funds

We look forward to meeting with all stakeholders to discuss any concerns and questions.

About the Preparatory Studies on National Social Security System in Indonesia

In 2004, Indonesia enacted the National Social Security System Law. The intention of the law is to open a new era of social security programs providing coverage to the entire population, based on an improved management. The law does not specify details, major strategic policy options, amounts of benefits, and contribution rates still need to be determined by implementing regulations. The existing social security institutions have a 5-year transition period to adjust themselves to the new legislation.

The Preparatory Studies on the National Social Security System in Indonesia provide background studies on the fiscal and governance aspects, including a draft implementation roadmap, to guide the government in further discussions on the gradual introduction of the law.

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