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Indonesia

By Mitchell Wiener

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Since early 2007, I have been working with the Ministry of Finance of the government of Indonesia to implement a new social protection system for the country. The Asian Development Bank has financed my work. This project is an excellent illustration of the changes in Asian society brought about by macroeconomic development and demographic changes.

Until now, the primary form of social security in Indonesia is extended family and community. Only civil servants and workers in large private enterprises had any type of formal social security. In the past, Indonesia was largely a rural agricultural economy and was characterized by very large families (about six children per mother). Extended family tended to live together. Family members cared for their elders and took care of each other and communities helped out families that were experiencing difficulties.

However, over the past 20 years, Indonesian demographics have changed dramatically. Family size has sharply decreased (the fertility rate is now about 2.2 children per mother), life expectancy has increased at all ages and the country has become increasingly urbanized. Children often leave the villages where they were born and move to major cities in search of better wages. As a result, the family support system is breaking down and there is now a need for greater government participation in establishing, facilitating and financing social protection.

As a result of the 1997 financial crisis and these societal changes, the Indonesian Constitution was amended to require the government to establish a comprehensive system of social protection. The government subsequently passed Law No. 40 of 2004, commonly referred to as the SJSN law, to meet its new constitutional obligations.

This law outlines the broad features of the new social protection system but provides few details on how the system should operate. It requires the establishment of five social insurance funds covering all Indonesian workers and their dependants. Contributions to the social insurance funds will be a percent of pay and shared between workers and employers for the formal sector. The informal sector will pay contributions either as a percent of income or as a flat amount in local currency. The government is required to pay the social insurance contributions for those who are deemed poor.

The SJSN programs include:

- National health insurance,
- Defined benefit pension system paying monthly annuities,
- Old-age savings program—a defined contribution program providing a lump-sum benefit at retirement,
- Worker accident insurance, and
- Death benefit program.

The new system requires universal coverage and equal benefits for all Indonesians. This is particularly challenging because almost 70 percent of Indonesian workers are in the informal sector. In the United States, we think of the informal sector as tax-evaders and criminals, but this is not the meaning of the term in Indonesia. Instead, it is a term generally

applied to all workers who are not employed by a registered employer and receiving a fixed wage. Generally speaking, the informal sector is composed of self-employed workers, micro-enterprises, unpaid workers in family businesses and casual laborers.

In order to understand the SJSN law, it is first necessary to understand the current system of social protection and the institutions responsible for managing those programs. There are a variety of social insurance programs in existence in Indonesia today, but each covers limited groups of workers.

Social insurance institutes, referred to in Indonesia as "perseros," run each program. These perseros are for-profit state-owned enterprises and are required to pay taxes on their profits and pay dividends to the government. In recent years, the dividend and tax requirements have been wholly or partially waived by regulation, but this doesn't change their fiduciary obligation to the government.

There are four social insurance institutes providing benefits to civil servants, military and police, and employees of large formal sector employers. These same institutions are designated as the future administrators of the new universal SJSN programs. However, the law states that their legal form must be changed to not-for-profit institutions managing social security trust funds. These new administrative institutions are referred to in the law as BPJS.

The SJSN law also established the National Social Security Council (referred to as DJSN). It is responsible for oversight of the administrators and for managing the implementation of the new system. The council is a tripartite body composed of 15 members who are appointed by the president and contains representatives of key government ministries, employers, labor and outside experts. The DJSN members were appointed in November 2009.

The SJSN law is a "framework law"; it does not provide many of the details of the new system. Instead, most key system parameters must be specified in various types of additional laws and government regulations. Among the key aspects of the new system that are not specified in the law are benefit levels and contributions, manner of determining the number of poor, and the full legal and governance system.

As an advisor to the Ministry of Finance, I have been asked to assist the government in several key areas:

- Strategy for the governance structure, design, financing and administration of the new system;
- Design of the pension, old-age savings and death benefit programs;
- Management of the investment process for the old-age savings program;
- Harmonizing the new SJSN programs with existing social insurance and social assistance benefit programs;
- Development of a risk management and modeling capability within the Ministry of Finance; and
- Identification of the prerequisites and a roadmap for the start of the SJSN system.

The implementation of the new system of social protection will permanently change the social support structure of the country and the

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role of government.

This assignment presented me with many unique challenges:

- No other country with such a large informal sector has attempted to implement a universal social insurance system.
- Indonesia is the fourth largest country in the world, with a population in excess of 230 million scattered over a wide geographic area.
- The country's decentralization law passes a great deal of responsibility for social protection to the regions.
- The country is undergoing rapid demographic change and economic growth. It faces a whole new set of macroeconomic challenges as it becomes a middle-income country.

Some of the most interesting political and technical challenges I have faced in this project include:

- *Balancing affordability and benefit adequacy*. This is an issue in all pension design assignments, whether in the United States or overseas. However, the issue is particularly contentious in a country like Indonesia. Both employers and workers are opposed to high payroll taxes, but of course, labor wants high benefits anyway. In addition, the Ministry of Finance is worried about the impact of these programs on economic growth and unemployment. Private pension funds and insurance companies also do not want to see high taxes or benefits, as they are afraid it will crowd out the benefits they provide.

- *Severance pay program restructuring*. One of the biggest obstacles to labor market growth and mobility in Indonesia is the severance pay provisions of the labor law. A multiple of monthly salary must be paid to all terminating workers and the amount varies with years of service and cause of termination. This discourages employers from both hiring and terminating workers. The severance pay program is an unfunded defined benefit program that creates an accounting expense of about 15 percent of payroll. Employers are reluctant to support the SJSN programs unless it is accompanied by severance pay reform, while labor is reluctant to agree to reductions in benefits.

- *Acceptable financing arrangement for the pension program*. The pension program does not grant past service benefits and requires attainment of retirement age and 15 years of contributions in order to be eligible for a benefit. Consequently, benefit levels start out at virtually zero and then increase rapidly over time and benefits don't fully mature until about 40 years after system inception. At the same time, the Indonesian population is rapidly aging and will move from about 13 percent of the population over age 60 today to close to 40 percent by 2050.

- *Private vs. public asset management models*. Only formal sector workers currently have a quasi-defined contribution savings program. The social security institute manages the investment of assets and rates of return have generally been below expectations There is significant disagreement about who should manage the assets in the new program.

- *Dealing with existing social insurance institutes and their vested interests*. The difficulty with reforming most social security systems is the need to reduce benefit levels and increase retirement ages. Indonesia does not have this problem, as there is currently no national system.

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The legacy issue in Indonesia is the role of the existing social security institutes. Understandably, none of them want to give up programs they currently manage and all of them want to manage the new programs.

The other major obstacle is the lack of capacity to manage the new programs. Key areas that must be strengthened include:

- Redesign of the existing system of collecting and enforcing contribution payments. Current compliance rates are too low.
- Proper method for supervision and control of the technical operations and financial solvency of the new administrators and the social security trust funds;
- Creation of an Office of the Actuary and risk management capability within the Ministry of Finance;
- Creation of a new organizational structure, job descriptions, business processes and IT systems for the transformed administrators;
- Creation of a strong DJSN capable of strategic and political leadership in the SJSN implementation and management process.

At this time, there is no true "champion" managing the implementation process. As a result, various parts of the SJSN implementation have been moving forward, but the progress has been uneven and uncoordinated. DJSN is the logical body to take the lead. However, it is in its infancy and has not yet developed into a strong institution.

Another recent blow to the SJSN process is the resignation of the minister of finance, Sri Mulyani Indrawati. She resigned as minister in early May 2010 and started a new job as a managing director of the World Bank on June 1, 2010. She was one of the leading reformers in the country and is well respected internationally. Her successor will have to be educated quickly about the SJSN programs and their potential impact on the country's social structure and the state budget.

At the current time, the SJSN programs have little impact on the state budget, employers or labor since they have not yet begun. However, once the programs begin, the cost of the programs will have an immediate impact on the budget and the macroeconomy. My estimates indicate the initial cost of all the SJSN programs will be about 3.1 percent of GDP, increasing to 6.1 percent by 2050. The government is obligated to pay contributions for the poor from the state budget. Depending on the number of poor, the cost will range from 0.2 to 1.4 percent of GDP in the early years of the program to 0.7 to 3.8 percent of GDP by 2050.

It has been my pleasure to work with senior policymakers on these challenges over the past three years. Although it will undoubtedly take longer than planned to implement, the new social protection system will ultimately create a more just society, reduce poverty, and provide greater stability in dealing with future macroeconomic and financial shocks.

For those who are interested in a more comprehensive description of the Indonesian challenge, a summary of my work over the past three years can be found in a white paper that has been publically released as a joint work product of the Ministry of Finance and the Asian Development Bank. A copy of this report is available from my website at *http://web.me.com/mcwiener/Mitchell_Wiener/Links.html.*

This article was written prior to the author joining the World Bank. The article represents the views of the author and not necessarily the views of the World Bank. □