Reforming Indonesia’s Pension System

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Summary findings

Indonesia's nascent capital markets stand to benefit significantly from a thriving pension industry. Now is the time to reform the pension system, while it has a vibrant economy, rapidly rising income, and a young and growing workforce. The three main reforms suggested by Leechor are to:

1. **Reconsider the role of mandatory defined contribution (Jamsostek) plan.** Long-standing public distrust of Jamsostek tends to undermine the government's credibility, and terminating the program would probably win popular support. Without Jamsostek, many firms might operate employer-sponsored plans. One argument for reforming it is that it could be a powerful instrument for resource mobilization. One option is to maintain mandatory participation but abolish the current monopoly on administrative and investment services and open them to competition from accredited banks, insurance companies, and pension-service companies. Another option is to allow firms already operating approved plans to drop Jamsostek contributions, but require other firms to make them, choosing their own administrative services.

2. **Make employer-sponsored pensions more attractive and affordable.** With compliance in the Jamsostek plan so low, the only realistic option for most workers (apart from private savings and relying on family support) is the employer-sponsored pension. Few companies now operate approved pensions, covering only 10 percent of the formal workforce. Certain measures might encourage private firms to adopt plans providing secured and portable pensions:
   - Simplifying and expediting registration and approval processes, raising the retirement age from 55 to 60, and not taxing pension plans directly.
   - Limiting political interference in investment decisions by adopting an exposure limit on pension funds' investments in firms with concentrated ownership (especially state banks and public enterprises).
   - Permitting pension funds to invest abroad (initially, with certain limits).
   - Using term annuities or phased withdrawals instead of life annuities.
   - Adopting an adequate government vesting policy as a model for the private sector.

3. **Contain the fiscal burden of the civil service pension plans.** Options Leechor discusses: improving investment results; setting limits on administrative expenses; providing the same vesting and portability of benefits required of private pensions (to facilitate labor mobility between private and public sectors); rationalizing benefits; raising the retirement age; and considering partial funding of benefit obligations.

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EXECUTIVE SUMMARY
INDONESIA: PENSION SYSTEM

As a matter of public policy, the pension system represents a particularly fertile field for cultivation. In many parts of the world today, meeting the needs of the old and the disabled has become a burdensome economic and social problem, as a result of adverse demographic shifts, slowing growth, and past policy mistakes. By contrast, Indonesia has a relatively clean slate. The economy is vibrant, with income rising rapidly. The work force is still very young and growing. If good choices are made now to set the course for the pension system, much of the future dilemma would be avoided.

Indeed, a sound and properly managed pension system can make significant contributions to the economy. First, it can assist in promoting saving and in facilitating efficient allocation of capital. Indonesia already carries a heavy load of external debt and therefore has much to gain from increased domestic resource mobilization. Second, the benefits of growth can be more widely distributed through the pension system, which preserves a share of the economic output for those who are no longer able to participate in the work force. Third, an adequate regulatory framework for pensions can alleviate some of the observed factor-market rigidities, including the friction on labor and capital mobility which arises from common business and tax practices.

The Indonesian pension system today is at a nascent stage. The rate of participation in the pension system is still very low, less than a fifth of the work force and less than one third of the formal sector. Of the current (1995) 12 million workers who have access to formal pension plans, about 8 million are members of the mandatory Jamsostek program, which has a defined contribution plan with modest rates of contributions. The other four million are covered by a civil service program. Employer-sponsored plans provide coverage for about three million workers, who are also members of Jamsostek. Total accumulation of pension assets in 1995 was less than 6 percent of GDP, compared with 12 percent in the Philippines, 40 percent in Malaysia, and 60 percent in Singapore.

To streamline the pension system and broaden participation, an adequate reform strategy would need to deal with three major challenges:

- Making employer-sponsored pensions more attractive and more affordable;
- Reconsidering the role of the Jamsostek program;
- Containing the fiscal burden of the civil service plans.
The choice of specific measures would need to be made by balancing the interests of the workers, the employers, the government, and the economy as a whole.

**Making Employer-Sponsored Pensions More Attractive**

Indonesia does not currently have a comprehensive, tax-financed pension scheme, as implemented in many countries. Nor is this option a likely prospect, given the country’s prudent fiscal management. The mandatory defined contribution Jamsostek program has not acquired sufficient public confidence to generate adequate compliance. Under the circumstances, employer-sponsored pensions represent the only realistic option for most workers in the country, apart from personal saving and reliance on traditional family support.

Most companies in the formal sector provide some retirement benefits of various types. But these benefits generally do not meet satisfactory standards of safety, portability, and funding. Only approved pension plans, which are not mandatory, are required to conform to adequate standards, and to provide comprehensive data to the authority on a regular basis. But at present, less than 1 percent of companies operate approved pensions, providing coverage for about 10 percent of the formal sector’s workforce. To provide more workers with access to secured and portable pensions, more companies should be encouraged to adopt approved pension plans. Among the measures that would make approved pensions more attractive and less costly to implement are:

**Scope of Regulations** It is desirable to extend the reach of pension regulations beyond their current narrow boundary. Commonly used plans that provide lump-sum benefits, as well as plans that are based on a broader set of eligibility, should also be covered. In addition, it would be useful to simplify and expedite the process of registration and approval. It would help, for example, to deem an application to have been approved thirty days after submission, unless the authority has responded with a written objection or inquiry.

**The Retirement Age** The funding of private pensions can be made more affordable, without sacrificing the security and benefits of the worker, by increasing the retirement age. This measure extends the period of asset accumulation and shortens the period of benefit payments. The current standard retirement age of 55 is low relative to international standards and relative to current and projected life expectancies of the relevant workforce. The retirement age could be raised to 60, or higher, over the next 10 years. The concern that raising the retirement age would limit the opportunity of younger job seekers may be misplaced. Under the current rule, the retired worker who wants to work simply switches to a new employer.

**Taxation of Pension Plans** The selective taxation of investment income and realized capital gains accruing to pension plans is contrary to standard international practices and is a major concern among employers. It raises the cost of doing business and has prevented firms from establishing adequate pension plans. Experience across countries has shown that the revenue foregone by not taxing pension plans directly is
more than offset by the gain in revenue collected from increases in taxable pension benefits and from new businesses financed by pension assets.

**Political Risk** Pension assets are often placed at considerable risk today by political interference on investment decisions. Particularly vulnerable to this risk are public-sector plans, which currently account for about three quarters of pension assets in the country. A useful measure for mitigating this risk is to adopt an *exposure limit*, which restricts the investment of pension plans in the securities issued by firms with concentrated ownership. The *limit should apply particularly to debts and equities issued by public enterprises and state-bank deposits*. In addition, pension funds operated by public enterprises should rely more on independent external investment advisors.

**Foreign Investment** The exclusion of foreign investments as a class of eligible assets for pension funds represents a hindrance on investment performance and increases the exposure of pension assets to Indonesia’s country-specific risk. Permitting pension funds to invest abroad, perhaps in designated countries only and possibly up to a stipulated limit of the portfolio initially, would reduce overall investment risks and enhance the stability of investment returns.

**Annuity** The rule requiring that 80 percent of pensions be paid in life annuity, even when the amount is relatively small, has been a cause of concern to firms, whether they are operating approved pension plans or considering the option. With a rudimentary capital market, with limited financial instruments and risk-transfer mechanisms, providing life annuities is a relatively expensive service. As a result of the high cost, the benefit payments to the retirees would be relatively small. To soften the impact of this rule, many countries, including the US and Singapore, have given companies and workers the option of using *term annuities or phased withdrawals over 10 to 20 years*, as a substitute for life annuities.

**Vesting and Portability** The vesting of pension benefits remains elusive to most workers. One reason is that most companies do not have approved pension plans and therefore do not have to comply with the vesting rule. Another reason is that the civil service pension plan, the largest plan in the country, provides no vesting before the age of 50. To promote labor mobility, particularly between the private and the public sectors, the government should set a good example by adopting an adequate vesting policy. As more companies establish formal pension plans and vest the benefits, more workers would have improved access to new jobs.

**Reconsidering the Role of Jamsostek**

*Public distrust of Jamsostek is long-standing and carries the risk of undermining the credibility of a government that otherwise has an excellent record in promoting growth and equity. A fundamental decision on the future role of Jamsostek in the pension system is needed.*
The mandatory social security program (Jamsostek), as it is structured and implemented today, has not served its members well. A defined-contribution plan based on individual capitalization accounts like Jamsostek is not viable unless record keeping is near perfect. And yet a large share of the assets under the program is currently not being posted to individual accounts. Particularly susceptible to losses are the unskilled and seasonal factory workers who return to their villages after a short period.

Administrative expenses at Pt. Astek, the company that administers the program, have nonetheless been exceptionally high, in spite of some recent reductions. Returns on investment are virtually nil after allowing for inflation and expenses. In addition, Pt. Astek does not -- indeed is not required to -- segregate the assets belonging to different program components, thereby exposing members’ provident funds to the risk of costly losses under the accident and medical insurance schemes.

Of particular concern are the opportunities for rent-seeking behavior. Such opportunities arise partly as a result of the monopolistic arrangement in which Pt. Astek is not subject to competitive market forces or adequate regulations. Furthermore, since the compulsory contributions produce poor value for the money, companies and workers have an incentive to do what is necessary to avoid making the payments.

As a result, the public has generally regarded the Jamsostek’s compulsory contributions as a tax. The rate of compliance is exceptionally low, less than 25 percent after 20 years of implementation, including the mandatory social security program before 1992. Furthermore, the contributions collected are considerably less than (about 60 percent below) what might be reasonably expected, based on the average wage rate and the number of contributors. Asset accumulation is limited, less than 1 percent of GDP today.

A major decision on the role of Jamsostek is now needed as a matter of priority. The options that have emerged involve either closing down the Jamsostek program altogether or reforming it in a significant way.

Abolishing Jamsostek? . . . Apart from the proprietor’s opposition, the idea of terminating the Jamsostek program would enjoy considerable popular support, both in the public and private sectors. Without Jamsostek, it is possible that many firms would choose to operate employer-sponsored plans. Those who would have no access to other pensions could do better by putting Jamsostek contributions into personal bank accounts.

Or Reforming It? . . . One argument against closing down Jamsostek is that, if properly implemented, a program like Jamsostek could be a powerful instrument for resource mobilization, as has been demonstrated by Malaysia’s Employees’ Provident Fund and Chile’s pension system. This argument would favor changing the way Jamsostek is implemented, rather than abolishing the only mandatory scheme available.

A desirable reform would be to maintain the mandatory participation, but also to abolish the monopoly on the attendant administrative and investment services. Under this
reform, any qualified banks, insurance companies or pension service companies would be accredited to provide the requisite services in competition with Pt. Astek. Employers with more than ten workers would be required to join the new system, but they would also have the choice of their own service provider. All service providers would follow appropriate pension and prudential regulations, including stipulated performance standards.

**And a Hybrid Solution** But there is a third way, which combines the strengths of both options. This alternative involves:

1. dropping the mandatory Jamsostek contributions for those firms that are already operating approved pension plans; and,

2. keeping the mandatory contributions for those firms that are not currently operating approved pensions, but also abolishing the monopoly privilege of Pt. Astek in providing the program’s administrative services.

This hybrid solution thus would maintain broad access to pensions by workers in the country and at the same time resolve Jamsostek’s implementation problems.

**Containing the Fiscal Burden of the Civil Service Plan**

The civil service pension plan is partially funded. The funding comes entirely from workers’ contributions. The government currently makes no funding contributions and pays part of the benefits out of general revenue. Unless Taspen’s investment performance improves significantly, the pension assets under management are expected to reach a peak, then decline and become depleted within the next twenty years. Payments of pension benefits, about 20 percent of the government wage bill today, are expected to rise above 60 percent in the next 25 years. Existing unfunded benefit obligations for the civil service, not including post-retirement health care, are estimated to be 20 percent of GDP, a huge commitment that is seldom recognized. Unless corrective measures are taken now, the resulting budgetary burden would be difficult to manage. Among the options to be considered are:

First, Taspen needs to produce better investment results, which could be accomplished by resisting political pressures and using external investment advisors.

Second, limits on administrative expenses incurred by Taspen (relative to contributions and assets) need to be established, monitored and disclosed. These limits should be set on the basis of international experience.

Third, the civil service pension plan should provide the same vesting and portability of benefits as is required of approved private pensions. This consistency would facilitate labor mobility between the private and public sectors.

Fourth, pension benefits should be based on the average salary for the final three to five years of service, not on the salary of the final month.
Fifth, the cost-of-living adjustment should be done yearly to protect the purchasing power of the retirees. The adjustment should be based on the change in a stipulated price, and not wage, index.

Sixth, as with other plans, the retirement age should be raised to at least 60.

Seventh, partial funding of benefit obligations by the government, perhaps at a rate equal to workers' contribution or about 5 percent of salary, should be seriously considered. (An amendment of the budget law is needed for the government to make funding provisions.) The main drawbacks of funding are that Taspen may not be able to safeguard the assets adequately or to invest them well. If these risks can be overcome, then the government should start funding the program.

The measures listed above for the civil service plan have merits as a stand-alone package, but they could also be incorporated as part of broader civil service reforms.
I. Structure of the Pension System

In many parts of the world today, meeting the needs of the old and the disabled has become a burdensome economic and social problem. Many of the existing pension and social security programs were set up during a period of relative prosperity, with built-in generous benefits not always compatible with actuarial soundness. As economic growth slows down and the retiree population expands beyond expectations, many countries have found it difficult to maintain retirement benefits without raising taxes or cutting expenditures elsewhere.

By contrast, Indonesia has a relatively clean slate. The economy is vibrant, with income rising rapidly. The work force is still very young and growing. If good choices are made now to set the course for the pension system, much of the future dilemma would be avoided.

Indeed, a sound and properly managed pension system can make significant contributions to the economy. First, it can assist in promoting saving and in facilitating efficient allocation of capital (see box 1). Indonesia already carries a heavy load of external debt and therefore has much to gain through domestic resource mobilization. Second, the benefits of growth can be more widely distributed through the pension system, which preserves a share of the economic output for those who are no longer able to participate in the work force. Third, an adequate regulatory framework for pensions can alleviate the observed rigidities in the labor and capital markets which arise from common business and tax practices.

The Indonesian Pension System

Apart from the extensive network of family and community support, which remains the principal source of old-age income security for the vast majority of the people, the formal pension system consists of:

(1) **The voluntary employer-sponsored pension program.** Each company is free to choose whether or not to establish a pension plan for its employees. But to be qualified for tax benefits, the employer-sponsored plan has to comply with pension regulations, including being a separate legal entity distinct from the plan sponsor. These plans may be administered by the sponsoring company, under the direction of a board of trustees, or may be part of an approved financial-institution plan. This category of pensions has an estimated membership of about 3 million people and includes some of the largest employers in the country. Most of the existing plans are sponsored by public enterprises.

(2) **The civil service pension program.** Sponsored by the national government, the largest employer in the country, it is administered exclusively by a public enterprise, *Pt. Taspen*, independent of the pension law. As of 1995, there were about 4 million current members and about 1.5 million retirees. A closely related program is *Asabri*, which provides similar retirement benefits for about half a million military and police personnel and is administered by a separate public enterprise;
Box 1. Why Pensions?

Pensions provide people with a source of income in the old age. But not everybody needs or has access to pensions. Some may have the foresight, investment skills and discipline necessary to provide adequately for their own retirement. Others may have the access to strong family and community support that ensures security in their old age, while many may never earn enough money to provide for the future.

Pension saving has, nonetheless, proved to be a useful social innovation. Societies with well-functioning pension systems enjoy some advantages over those without. While pension schemes differ considerably in design, they all serve to provide more people with a secured source of income in the old age. Without pensions, more people might be left vulnerable. Without pension saving, it could be more difficult to finance long-term development projects, and, for high-growth countries, more reliance on external debt might be necessary. Without pension funds, it might be more difficult to issue and sell stocks and bonds. Without watchful monitoring of pension-fund managers, corporate management might be a bit more extravagant.

The increasing need for pensions, as an addition to individual saving and informal arrangements, is already evident in Indonesia. First, the share of people aged 60 or older is rising rapidly, from about 11 percent of the work force in 1995 to more than 20 percent by 2025. The expanding retiree population could contain a large number of those who are unable to support themselves. This group may become a cause of social tensions. Adequate access to pension coverage for today’s workers can serve to dissipate the threat. Second, amid this demographic shift, there is a rapid rate of urbanization, with people moving away from the farm to take up formal jobs in the cities. Urban lifestyle, as well as shortages of adequate housing, makes it difficult for younger family members to attend to the need of older ones. Family and community support no longer represents a secured prospect for an increasing number of people.

Even for those who have the foresight and the ability to save, pensions are nonetheless a useful arrangement. Pensions are normally organized by companies and involve regular deductions from the payroll, which enhances discipline and offers convenience for saving regularly. More important, pension funds, along with other contractual saving institutions, provide a cost-effective way for individuals to make use of professional investment management, which enhances the likelihood of getting satisfactory results.

Society also benefits from the pension system. Apart from meeting the needs of a potentially vulnerable group, pension funds have played an important role across countries in capital market development. Funded pensions generate long-term capital that is well suited for financing investment, but is generally in short supply among developing countries. They also build a class of institutional investors capable of monitoring companies’ management performance and influencing corporate governance.

(3) The mandatory social-security program. Also known as Jamsostek, it covered about 8 million people in 1995, out of an estimated 33 million employees in the formal sector. It is administered and managed exclusively by a public enterprise, Pt. Astek, independent of the pension law. Enforcement of the compulsory requirement is the responsibility of the Ministry of Manpower, which is also the regulator of Pt. Astek.
A distinctive characteristic of the Indonesian pension system is the absence of a mandatory public pension plan, which normally covers all workers in the formal sector and is financed by a payroll tax on a pay-as-you-go basis. These public pension plans are often considered desirable because if, properly designed and implemented, they offer a mechanism for redistributing income across groups and across generations, and thereby serve as a social safety net. In practice, however, these goals are often elusive. Public pension plans have generally been fraught with evasion, political manipulation and poor asset management, which often involve serious fiscal implications. Public sector plans based on individual capitalization accounts, which are funded and not redistributive, have proved to be more sustainable, as with the case of Malaysia and Singapore.

In addition to the programs above, most companies in the formal sector provide termination, including retirement, benefits, mostly in the form of lump-sum payments. Some companies also provide pensions (annuities) and health care benefits. These plans, however, are largely unfunded, do not always provide vesting and may not have worker representation in setting pension policy. And since these plans are not formally approved by the authority, they are also not subject to pension regulations or entitled to the tax benefits available to approved pensions.

The Size of Pension Assets

At the end of 1994, pension assets in Indonesia are estimated at Rph. 21.1 trillion (US$ 9.6 billion), with the following breakdown:

<table>
<thead>
<tr>
<th></th>
<th>Rph. Trillion /b</th>
<th>US$ Billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer-sponsored plans /a</td>
<td>9.6</td>
<td>4.4</td>
</tr>
<tr>
<td>Astek (Jamsostek)</td>
<td>2.5</td>
<td>1.1</td>
</tr>
<tr>
<td>Taspen (Civil Service)</td>
<td>8.3</td>
<td>3.8</td>
</tr>
<tr>
<td>Askes and Asabri</td>
<td>0.7</td>
<td>0.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>21.1</strong></td>
<td><strong>9.6</strong></td>
</tr>
</tbody>
</table>

Notes: a/ Includes public enterprises', private companies' and financial institutions' plans.
       b/ Based on "investment" data which include all assets, except self-occupied premises.

Sources: Ministry of Finance

These assets represented about 5.6 percent of concurrent GDP. By international standards, this is a relatively low level of pension asset accumulation, compared to other countries in the region and in the same income group (see the chart below). Clearly, pension assets tend to rise as a share of GDP as the country’s income rises, as shown in the chart. Indonesia’s may thus be expected to rise along with the rapid economic growth.
Given Indonesia's already high domestic saving rate, wider use of pensions may not make much of a difference in raising the volume of savings. Studies of pensions' impact on saving have not been conclusive, but they suggest that the overall effects are not large and depend on the type of pension schemes adopted (see box 3). Nonetheless, as more saving is channeled through pension mechanisms, the demand for long-term financial instruments may be expected to rise. The resulting financial services that emerge to fulfill this demand would contribute to capital market development. Domestic placements of stocks and bonds, whether private or public, would have better prospects. Domestic financial markets would offer more financing options to investors, and thereby lessening the reliance on external debt.
Box 2. Why Have So Few Companies Set Up Formal Pensions?

Early in 1996, only about 160 firms in Indonesia have established and operated approved pension plans. These firms represent less than one percent of the estimated number of firms in the formal sector. The coverage of these plans is available to only about 3 million workers, or less than 10 percent of the formal sector’s current work force. Why are there so few plans? Why don’t more companies set up pensions?

Under the best of circumstances, operating pensions involves extra costs to the employers. These costs vary depending on pension regulations, tax rules, the type of pension chosen and the size of the firm. These costs may or may not affect the firms’ profitability (or rate of return on investment), depending on the firms’ product market position and the tightness of the market for their relevant work force. Some firms are able to shift part of the costs to consumers and workers. But generally the unit cost of operating pensions goes down as the size of production and work force increases. Relatively large firms are in a better position to defray the pension costs.

As in most countries at the same stage of economic development, conditions in Indonesia today do not favor the establishment of formal company pensions. The following considerations suggest why most firms have not set up pensions:

- Company (or employer-sponsored) pensions are voluntary to be set up at the discretion of individual firms.
- The vast majority of firms in the formal sector are relatively small in terms of workers, which implies relatively high unit costs of operating pensions;
- There are already many legal requirements on employee benefits, including rapidly rising minimum wages, mandatory participation in the Jamsostek program, and mandatory termination benefits;
- The rules governing formal pensions, which are similar to those of much more advanced countries (like Canada), are relatively stringent, further increasing the costs of operating pensions (see below);

Among the rules that make pensions unattractive to the employers are:

- funding of pension obligations through a segregated entity;
- vesting of pension benefits in a relatively short period;
- relatively low retirement age of 55;
- that 80 percent of benefits be paid in annuity even when the amount is very small;
- unfavorable tax treatment of pension plans by international standards.

A major objective of this report is to suggest options for selectively relaxing some of these stringent requirements to make them more attractive to a larger set of firms and thus increase the likelihood that more workers will have access to adequate pensions (see chapter 2 and the executive summary).
Pension Investment

At year-end 1994, aggregate pension investments were allocated among asset classes as shown in the chart below. Differences in asset allocation are small across pension categories. The aggregate picture thus captures the main characteristics.

A distinctive feature is the predominant share of short-term instruments or cash-equivalent assets, including short-term government papers (issued primarily by Bank Indonesia) and bank deposits. The share of capital market assets, such as stocks and bonds, which is about 19 percent of total investments, is very small. Among other countries, the portfolio share of capital market instruments is much higher, as shown in the table below.

<table>
<thead>
<tr>
<th>Pension Funds Asset Allocation Across Countries</th>
<th>Indonesia</th>
<th>Philippines</th>
<th>Malaysia</th>
<th>U.S.</th>
<th>U.K.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks</td>
<td>8</td>
<td>11</td>
<td>10</td>
<td>43</td>
<td>82</td>
</tr>
<tr>
<td>Bonds</td>
<td>11</td>
<td>46</td>
<td>78</td>
<td>36</td>
<td>12</td>
</tr>
<tr>
<td>Other Assets</td>
<td>81</td>
<td>43</td>
<td>12</td>
<td>21</td>
<td>6</td>
</tr>
</tbody>
</table>

Sources:  
Indonesia - Ministry of Finance.  
United States - “Flows of Funds”, Board of Governor, Federal Reserve System.  
United Kingdom - Seki (1995)
Box 3. Do Pensions Raise Domestic Saving?

Considerable research efforts have been devoted to the relationship between pension programs and the rate of domestic saving, but few conclusive results have been found. For one thing, pensions produce offsetting behavioral responses in the saving decision, thus generating relatively small net effects. Another reason is that pension programs differ in major ways across countries, and in any one country the circumstances change over time, partly in response to pension policy.

Among the variables that affect the relationship between pensions and saving are: the fiscal stance of the country, taxation of capital income, the saving rate in the absence of pensions, as well as design features of the pension system. Because of the uncertainty involved, many competing hypotheses have been advanced. The nature of the arguments is illustrated in the following examples:

One controversial hypothesis holds that mandatory, unfunded, and government-managed pension programs reduce national saving, at least initially. According to this argument, the first group to benefit from the program - those who are close to retirement when it is introduced - receives a windfall gain. These individuals tend to increase their consumption. The younger generation pays the payroll taxes that finance the pension payments and thus has fewer resources left to be saved. The increased consumption by the first-generation pensioners, according to this hypothesis, is not offset by the reduced consumption of the younger generation. Thus, national saving declines, unless the reduction in private saving is offset by an unlikely increase in public saving. Some would argue that the payroll tax revenue also increases public consumption.

Empirical studies have neither confirmed nor rejected this hypothesis. One reason for the uncertainty is the behavioral response of the people under these mandatory and unfunded pensions. In particular, younger people may recognize the time inconsistency of the program and thus increase personal saving in order to provide for their own retirement.

Another hypothesis postulates that, mandatory, funded pensions, whether managed by the government as in Malaysia and Singapore, or by private firms as in Australia and Chile, have been found to raise the saving rate. The increase in saving, however, is generally smaller than pension contributions. For each dollar of contributions collected, about 50 to 60 cents are attributed to increased saving (Bateman and Piggott). Even voluntary pensions that are funded have been found to raise private saving. In the case of the US, about 40 cents out of every dollar of voluntary pension contributions represent a net increase in saving (Munnell and Yohn). Furthermore, factors other than pension policy, including economic growth and financial liberalization, may over time exert a stronger influence on the rate of saving.

Irrespective of the impact on the saving rate, funded pension programs have a positive effect on the composition of savings. Generally, a large proportion of pension assets is invested in longer-term financial instruments and thus contributes to capital market development and innovations (see box 1).
The Demographic Pattern

Key demographic features for pension considerations are:

- A relatively young work force which will experience significant aging;

- Increasing life expectancy of the general population, which will increase the duration of retirement from 15 to 20 years by 2025, based on the current retirement age of 55;

- Declining fertility, with the largest age cohorts about to enter the work force and subsequent cohorts becoming smaller.

Together, these trends imply that the size of retiree population relative to the work force, or the dependency ratio, will increase significantly in the next thirty years. The dependency ratio is projected to rise from about 17 percent today to about 30 percent by 2025 at the current retirement age.

The population of Indonesia is currently (1995) estimated to be 195 million and projected to be 261 million in 2025. One third of the population is under the age of 15, while 10 percent is over the age of 55. Today’s largest cohort, which is of the age 10 - 14, will continue to be the most populous group with the projected decline in fertility. The age distribution of the population, and the expected movement in this distribution for the next 30 years, are shown in the chart below.

The size of the labor force is currently 86 million (44 percent of the population.) It is expected to grow, both in absolute number and also as a share of the population. By 2025, the work force is expected to be 153 million or 59 percent of the population. Formal sector employees, the initial
target groups of most pension programs, now number about 33 million or two-fifths of the total work force.

### Box 4. To Fund or Not to Fund - That is the Question

A pension plan is funded if advance provisions are made to cover its benefit obligations. An unfunded - pay-as-you-go (PAYG) - plan has essentially no assets and uses current contributions to pay benefits. Partially funded plans make some advance provisions, but not sufficient to cover future obligations.

All approved defined benefit (DB) plans in Indonesia are subject to funding requirements. Defined contribution (DC) plans are generally fully funded, although unfunded DC plans may also be offered as in Sweden. The Jamsostek program is in principle a fully funded plan, but the inadequate posting of contributions and the commingling of assets under different schemes raise the possibility that part of the future obligations may not be met. Many approved employer-sponsored plans are currently under-funded and require additional funding for past service obligations. The civil service plan is, by design, partially funded by workers’ contributions.

Mandatory PAYG schemes are often purported to:
(a) cost less in terms of members’ contributions;
(b) allow redistribution of income across generations;
(c) ensure support for those whose life span is longer than anticipated.

But these arguments seldom hold up under scrutiny. PAYG plans would cost less than funded plans only under a very stringent condition - that the growth rate of workers’ earnings plus the growth rate of the labor force exceed the rate of return on pension investment. Not many countries meet this requirement; nor can the condition be generally expected to hold. As for the intergenerational transfer, each generation could be better off if the same restrictive condition above is met. When the condition doesn’t hold, all but the first few cohorts of retirees would carry an extra tax burden under the PAYG program. As to the support for those who live longer than expected, it is immaterial whether or not a plan is funded. What is needed is a separate public assistance program for the indigent. The merit of such a program could be debated for appropriations without the presumption of being an irrevocable entitlement.

PAYG plans in the public sector may also have an adverse impact on fiscal discipline. Early surpluses of PAYG plans can be used to obscure current budget deficits by overlooking future benefit obligations. As the PAYG plans mature, benefit obligations become large commitments that severely limit budgetary flexibility.

Funded and mandatory public-sector plans generally cost less in contributions and improve fiscal discipline, but a major risk is mismanagement of assets. Funds could be misused or poorly invested.

Age profiles of the workers in Indonesia, for different types of employers in the formal sector, are given in the chart below. Note that, while workers in private companies and public enterprises are relatively young, civil servants tend to be older than the rest.
Life expectancy at birth, for the general population, is currently 61 years for males and 64 for females. These figures are expected to increase to 69 years (males) and 72 years by 2025. For members of pension plans, post retirement life tends to be even longer, with expected duration of life after retirement (at age 55) now at 15 years and rising to 20 years by 2025. The old age dependency ratio, which gives the size of those in retirement relative to those at the working age, for the general population is given in the table below. At the current retirement age of 55, the age old dependency ratio will nearly double in the next 30 years, from 17 percent in 1995 to 30 percent in 2025. If, however, the retirement age were to be raised to 60 in the near future, then the dependency ratio in 2025 would be kept at about 20 percent, not much higher than it is today.

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>2005</th>
<th>2015</th>
<th>2025</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population Age 55 + Pop. Age 15 - 55</td>
<td>17.3</td>
<td>20.0</td>
<td>23.3</td>
<td>30.4</td>
</tr>
<tr>
<td>Population Age 60 + Pop. Age 15 - 60</td>
<td>11.0</td>
<td>13.6</td>
<td>14.7</td>
<td>20.0</td>
</tr>
</tbody>
</table>
Box 5. Regulating Pensions

Experience shows that pensions need to be regulated. Generally there is information asymmetry between the plan sponsor, on the one hand, and the plan participant, on the other. Without adequate regulations, it would be costly for participants to monitor the plan. Their interest could be placed at risk through fraud, moral hazard or manipulative practices.

Regulatory provisions are designed to enhance the security of workers’ benefits, through a role in policy making, information disclosure, financing and transfer of claims. Among the requirements commonly found are:

- Pension plans must be a legal entity distinct from that of the plan sponsor;
- The plans are to be administered by trustees, with worker representation;
- Plan assets must be adequate to cover accrued liabilities;
- Annual disclosures are to be made to members; and
- Benefits must be fully vested within a short period of service.

The Indonesian pension laws, which apply only to approved employer-sponsored pensions, contain these provisions.

A large part of regulations governs pension investments. Many countries put a ceiling on certain asset classes, particularly equity investments. Some put restrictions on foreign investments. The intent is to regulate plan sponsors’ desire to take more risks in order to improve returns and save on the necessary contributions. But differences in risk are just as large within any given asset class, as they are across asset classes. Such rules tend to restrict investment opportunities without necessarily reducing risks. As an interim prudential measure, however, this regulation may serve to contain investment losses that may arise because of the lack of experience on the part of fund managers, the lack of depth in the capital markets and the inevitable, though occasional, speculative excesses.

Indonesia has recently removed the ceiling on pension plans’ equity investments. It is a step in the right direction, particularly when the government has already taken the precaution of not providing a public guarantee on pension benefits. There remain, however, restrictions on foreign investments and constraints arising from selective taxation of many classes of assets held by pension plans. In addition, there are limits placed on the exposure to individual issuer of securities, as well as limits on the percentage of any individual security held by a pension plan.

Where securities are issued by partially divested public enterprises, there is a political risk. Public enterprises in which the government retains effective control may not act in the best interest of minority shareholders, including pension funds. The regulatory framework should address this issue. In Chile, for instance, a ceiling is placed on pension plans’ investments in securities issued by firms with concentrated ownership, whether private or public. This ceiling is lower than the exposure limit applied to issuers with dispersed ownership.

Regulations alone won’t adequately safeguard against investment risks. Also essential are competition among investment managers and workers’ representation in setting investment policy.
II. Employer-Sponsored Plans

Recent years have seen considerable and positive efforts by the authorities to modernize the pension system. There have been regular consultations with professional pension specialists and with those affected by policy and regulatory changes. The authorities have also shown a willingness to take remedial actions on issues of concern to the public.

This Chapter reviews the policy and regulatory environment that affects the integrity and growth of employer-sponsored pensions. Recognizing the limited coverage of the pension system, the Chapter focuses on the constraints faced by employers in establishing and operating voluntary, but regulated pension plans. It also addresses some of the social costs that may arise from the current regulatory framework, including restrictions on labor and capital mobility.

Policy Environment

The Central Role of Employer-Sponsored Pensions Perhaps for good reasons, Indonesia does not currently have a mandatory, tax-financed public pension scheme, which is often regarded, not always accurately, as a safety net for the old age. The mandatory Jamsostek program is in fact not a social security program, but a defined contribution plan based on individuals’ accounts. (See Chapter 4.) Furthermore, the Jamsostek contribution rates are relatively low, and therefore provide limited post-retirement income security.

Under the circumstances, employer-sponsored plans take on particular significance. Apart from personal saving and informal family and community support, most workers in the private sector will need to rely to some extent on company-based pensions (see box 1). Furthermore, private pensions can be an important vehicle for raising long-term capital that helps finance investment and fosters capital market development. Unlike the funds mobilized by public pension schemes, which could be subject to political control, private pensions are generally managed by competing independent investment professionals.

Private pensions in Indonesia are at an early stage of development. As in most countries, employer-sponsored pensions are voluntary, to be set up at the company’s discretion. Most companies offer some retirement benefits, but the schemes do not necessarily meet satisfactory standards with respect to safety, portability and funding adequacy, as required by the regulatory authority. To induce more employers to upgrade their pension schemes, the authority offers special tax incentives for those plans that conform to the required standards and have been officially approved.

So far limited progress has been made. Of the estimated 165,000 employers operating in the formal sector, only about 160 firms (a small fraction of one percent) have operated approved pension plans. These plans cover only a minority, less than 10 percent, of workers in the modern sector. Nonetheless, even with the limited number of plans and narrow coverage, employer-sponsored pensions in 1995 have already mobilized about US$ 5 billion of assets or about one half of total pension assets in the country.
To further broaden the coverage of approved pensions and improve workers’ access to adequate plans, certain changes will be needed to balance the cost and benefit that companies face in establishing and operating approved pensions. Indonesia’s current regulatory framework is modeled after those of advanced countries and involved many stringent requirements, as reviewed in some details in this Chapter, that may not be appropriate at this stage. Softening some of the regulatory requirements, perhaps for a few years, may lower the cost of implementing approved pensions and thus encourage more companies to participate. Moreover, the benefits of operating approved plans, primarily the tax incentives provided, are more restricted in Indonesia (as discussed below), compared to the countries that apply similar regulatory frameworks.

**Taxation** Tax rules applicable to approved company pensions are as follows:

- Employer and employee contributions are deductible, subject to limits;

- Retirees’ pension benefits are taxable as regular income;

- The pension plan, *as a legal entity separate from the sponsor*, is subject to tax.

The treatment of contributions and benefits (but not of investment income, as discussed below) is consistent with international practices. The deductibility of contributions is restricted, both for the employee and for the plan sponsor, to curb tax avoidance and evasion. The ceiling on employee’s tax deductible contributions is based on current salaries. The limit on the sponsor’s contributions depends on the level of net assets under the pension plan. Once plan assets have exceeded accrued pension obligations by more than 20 percent, further contributions by the sponsor are no longer tax deductible.

As with standard practices elsewhere, pension benefits are treated as regular income. Retirees are required to include pensions with other sources of income and the overall income is subject to a graduated structure of tax rates.

*The tax treatment of approved pension plans, however, is considerably at variance with international practices.* Approved pension plans, which are legal entities separate and distinct from the sponsoring companies, are subject to tax in Indonesia. Realized capital gains and investment incomes earned by pension plans are generally taxable, except when they are *associated with locally listed securities and bank deposits.* (There is, however, a tax of one tenth of one percent on the sales of equity shares, which pension plans, or anybody else, have to pay.) But the tax incentive related to locally listed securities does not apply if pension plans hold these securities through open-ended mutual funds. (A new Ministry of Finance decree of April 1996 has attempted to limit double taxation of mutual funds investments by dropping the tax on distributions and redemptions of mutual funds, but retaining the tax on investment income and realized gains accruing to mutual funds. This new rule relieves double taxation for individual investors. For pension funds, however, the stipulated tax incentives are lost.)

Two general *tax regimes* are applied to pension systems across countries. Most countries exempt contributions, exempt investment income and then tax pensions - *the EET regime.* A few countries tax contributions, exempt investment income and also exempt pensions - *the TEE*
The two regimes have different cash flow patterns, but have the same marginal effective tax rate and the same incentive effect on saving. A key characteristic which is common in the two regimes is that the investment income of pension assets is exempted from taxes. This tax provision has been a key reason that voluntary pension plans have been widely used and that pension funds have become major institutional investors across countries. By contrast, Indonesia taxes pension funds’ investment income.

The table below shows the tax rules applicable to different types of investment income earned by pension funds in selected countries with well-developed pension systems.

<table>
<thead>
<tr>
<th>Taxation of Pension Plans’ Income and Capital Gains</th>
<th>Bank Deposits</th>
<th>Listed Local Securities</th>
<th>Open-Ended Mutual Funds and Unlisted Securities</th>
<th>Properties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Interest</td>
<td>Int &amp; Div</td>
<td>Int &amp; Div</td>
<td>Rental</td>
</tr>
<tr>
<td>Canada</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
</tr>
<tr>
<td>U.S.</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
</tr>
<tr>
<td>U.K.</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
</tr>
<tr>
<td>Chile</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
</tr>
<tr>
<td>Singapore</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
</tr>
<tr>
<td>Malaysia</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
<td>No Tax</td>
</tr>
<tr>
<td>Indonesia</td>
<td>No Tax</td>
<td>No Tax</td>
<td>Fully Taxed</td>
<td>Fully Taxed</td>
</tr>
</tbody>
</table>

Notes: Only approved (qualified) plans are considered. For Indonesia, plans with pre-1992 approval also get tax exemption for property income.
Sources: Davis (1993), and information supplied by Malaysia’s Employee Provident Fund and Singapore’s Central Provident Fund.

The failure to grant tax-free status for pension plans is obviously motivated by the intention to protect tax revenue. The implications of this practice, however, may not be well understood. One consequence of the selective taxation as practiced in Indonesia is to reduce the safety of pension assets, as investment managers cut the allocation of assets with taxable earnings and thereby limit the benefits of diversification. In most other countries, the cost-benefit analysis of this question has pointed conclusively in one direction - not to tax pension plans. This choice is an acknowledgment of the need to limit the adverse effect of income-based taxation on saving, particularly long-term saving. Furthermore, the tax revenue foregone by not directly taxing pension plans is more than offset by revenue gains elsewhere, including increased taxable pension benefits and increased business activities which are financed by pension assets.

Retirement Age For the purpose of making public policy, setting an appropriate retirement age is one of the most crucial decisions. The choice made has major implications for the attractiveness of pensions, both for the sponsor and the worker, as well as the old age security of the retirees. Currently, the standard retirement age in Indonesia is 55. In other ASEAN
countries, it is 60. Among industrialized countries, the retirement age is now generally 65 or higher. The effects of these differences in the retirement age are illustrated in box 7.

An early retirement age is sometimes thought to open up job opportunities for younger people. This view, however, would be correct only if the retirees actually give up holding salaried jobs. There is ample evidence that people above the retirement age simply switch jobs by moving to another company. In many of the erstwhile socialist countries, early retirement was regarded as an entitlement and was thus extensively used. The subsequent increase in life expectancy and the expansion of retiree population made many of those pensions insolvent.

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**Box 6. Pension Contributions and Taxes**

There is a common perception, in Indonesia and elsewhere, that pension contributions are actually taxes, either on the use of labor or on the worker. Is there any merit in this perspective? Under what conditions are such perceptions justified? The answer depends on the type of pensions involved. In general pension contributions and taxes are very different, although under certain conditions some types of contributions are similar to taxes in their economic effects.

A compulsory defined-benefit pension is indeed equivalent to a tax, one that is made more onerous if it is also managed by the public sector under inflationary conditions. The ultimate cost of this tax is not known in advance and depends on inflation and the rate of return on past contributions. The tax is paid in the form of employer contributions, but the burden of the tax is probably borne by workers, as the employer can adjust the wage rate or the level of employment as necessary.

A compulsory defined-contribution plan is a less damaging tax. The tax cost is known to the employer in advance (equal to the contributions), independent of the investment return or inflation. The worker, however, bears the risk of uncertain benefits.

The case of Indonesia's Jamsostek is an example of a tax. Jamsostek contributions paid by both the worker and the employer are compulsory. It is managed by the public sector with virtually no real return on investment. Workers seldom expect any benefits in return and regard Jamsostek unequivocally as a tax.

But when the establishment of pensions is voluntary, as with most employer-sponsored plans in Indonesia and elsewhere, the case for equating contributions to taxes is weak. Unlike taxes, contribution payments are entirely made at the employer's discretion. If she does not wish to pay, she can simply avoid setting up a plan or even to terminate an existing one. To set up a pension plan, an employer is usually motivated by the need to attract and retain a necessary work-force caliber. The expenses associated with voluntary pensions are essentially market-determined costs of doing business.

The dramatic effects of raising the retirement age is illustrated in the table below. For simplicity, the illustration is based on a defined contribution plan; the implications for defined benefit plans are similar. A relatively small change of raising the retirement age from 55 to 60 is used to show the effect on:

- the rate of salary replacement at a fixed rate of contribution;
- the necessary contribution for a fixed replacement rate.
### Implications of Raising the Retirement Age
(from 55 to 60; all figures in percent of salary)

<table>
<thead>
<tr>
<th>Real Return on Investment</th>
<th>Real Wage Growth (%)</th>
<th>Replacement Rate with 5.7% Contribution/ a</th>
<th>Contribution Needed for a 50% Replacement/ a</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
<td>(B)</td>
<td>(C)</td>
</tr>
<tr>
<td>%</td>
<td>Retire at 55</td>
<td>Retire at 60</td>
<td>Retire at 55</td>
</tr>
<tr>
<td>0</td>
<td>9</td>
<td>13</td>
<td>31</td>
</tr>
<tr>
<td>2</td>
<td>7</td>
<td>9</td>
<td>37</td>
</tr>
<tr>
<td>4</td>
<td>5</td>
<td>7</td>
<td>57</td>
</tr>
<tr>
<td>2</td>
<td>17</td>
<td>23</td>
<td>17</td>
</tr>
<tr>
<td>2</td>
<td>12</td>
<td>16</td>
<td>25</td>
</tr>
<tr>
<td>4</td>
<td>8</td>
<td>11</td>
<td>34</td>
</tr>
<tr>
<td>0</td>
<td>30</td>
<td>44</td>
<td>10</td>
</tr>
<tr>
<td>2</td>
<td>20</td>
<td>28</td>
<td>14</td>
</tr>
<tr>
<td>4</td>
<td>14</td>
<td>19</td>
<td>20</td>
</tr>
</tbody>
</table>

Notes: a. Contributions start at age 20.

Sources: World Bank staff calculations.

As is evident from the table above, the effects of a relatively small increase in the retirement age, from 55 to 60, are indeed very large. From the workers' point of view, the resulting increase in the replacement rates (from column A to column B) is about 40 percent, without any increase in contributions. The cost of financing the plan would also be lower. As shown in columns C and D, the higher retirement age would reduce the cost of funding significantly. The rate of contribution necessary to achieve a 50 percent replacement rate would fall by about one third on average.

### Regulations of Employer-Sponsored Plans

**Benefit Policy** Retirement benefits vary from one firm to another. Of particular importance are those set by the government and public enterprises, which, by virtue of being the largest employers, tend to influence benefit policies in the private sector. Today the retirement benefits promised by public enterprises are very generous in relation to pay. A major element of the benefits is the post-retirement health care granted throughout the public sector.

Liberal retirement benefits among public enterprises can be illustrated by the case of Pt. Telkom, whose information was made available in an initial public offering (IPO) in November, 1995. Telkom’s retirement obligations as of 1994 were estimated to be Rph. 1.4 trillion (US$ 630 million). Only about 13 percent of the obligations were funded. If the benefit obligations at the time were to be fully funded (and thus segregated from the company’s assets), Telkom’s net worth would decline by more than 25 percent.
Box 7. The Retirement Age and the Funding Cost of Pensions

A proposition maintained in this report states that: *Raising the retirement age, for any stipulated level of benefits and demographic conditions, will unambiguously lower the necessary rate of pension contributions.* How does one know that it is correct?

The reasoning is straightforward. The retirement age determines two key variables:

1. The number of working years, over which saving accumulates;
2. The number of post-retirement years, over which pensions are paid.

for any given life expectancy and the age of entry into the work force. For example, the current retirement age of 55 sets the number of working years at 40 and the post-retirement years at 15, for the current worker’s life expectancy of 70 and entry age of 15.

These two variables have opposing effects on the funding cost. When the working period is long, there is more time to save, for any stipulated benefits, and hence the necessary rate of contributions is low. By contrast, if the post-retirement period is long, then the saving available upon retirement has to be large in order to pay many years of benefits. Thus, the rate of contribution has to be high enough to accumulate the requisite saving.

Now consider the effects of raising the retirement age from 55 to 60. The working period will rise from 40 years to 45, allowing more years for asset accumulation, which tends to reduce the necessary rate of contribution. Similarly, the post-retirement period will be cut from 15 years to 10, which would reduce the size of saving needed at retirement and therefore also reduce the rate of contribution needed during the working years.

It is also possible to see this relationship more heuristically. The impact of changing the retirement age can be inferred directly, without the analytical breakdown discussed above. Suppose that the proposition is false and therefore lowering the retirement would cut the rate of contributions. Thus, if we set the retirement age at 15, with little or no time to work, then by this hypothesis the worker would pay very little contribution to finance a long period (about 55 years) of retirement. This is obviously not possible. In fact, it would not be possible even with 100 percent rate of contribution.

Alternatively, suppose again that the proposition is false and hence raising the retirement age would increase the rate of contribution. If we set the retirement age at the time of death, or at least at the age of 70, with virtually no benefits to be paid, then, according to this hypothesis, the contribution rate must be very high to pay zero benefits. Again, there is obvious contradiction. Since all opposing hypotheses are false, the proposition itself must be correct.

A more rigorous and elegant proof of the above proposition is given in Vittas (1993b).
Pension Assets and Liabilities of a Public Enterprise

<table>
<thead>
<tr>
<th></th>
<th>Rph. Millions</th>
<th>US$ Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension Assets</td>
<td>187,600</td>
<td>85</td>
</tr>
<tr>
<td>Retirement</td>
<td>1,387,600</td>
<td>631</td>
</tr>
<tr>
<td>Obligations/a Unfunded</td>
<td>1,200,000</td>
<td>545</td>
</tr>
<tr>
<td>Obligations Earnings (1994)</td>
<td>798,000</td>
<td>362</td>
</tr>
<tr>
<td>Wage Bill (1994)</td>
<td>1,128,600</td>
<td>513</td>
</tr>
</tbody>
</table>

Note: a. Pension plan and post-retirement health-care benefits

Telkom’s benefit policy is typical among public enterprises. But its prospects, and financial position, are not typical. In fact, it was selected for privatization on the basis of its exceptional growth prospect and strong balance sheets. Nonetheless, the existence of large and mostly unfunded pension liabilities played a role in depressing investors’ demand and the valuation of Telkom’s shares. For other public enterprises, whose prospects are generally not as bright as Telkom’s but whose pension obligations are comparable, the privatization process may prove even more difficult. If unfunded liabilities were to be fully accounted for, many of the public enterprises, particularly state banks, would probably have negative net worth.

**Contributions** Rates of contributions for employer-sponsored plans are set by individual companies subject to funding rules. The division of contributions between the employer and employees is also left to the plan sponsor. There is a ceiling set, however, on the level of salary for which a pension may be set up and funded. This ceiling also sets a limit on tax-deductible contributions, irrespective of whether the sponsor or the worker makes the payments.

Such a restriction on pensionable salary is not unusual. Many countries impose similar restrictions. The salary ceiling of Rph. 5 million per month (or just over US$2,000) currently set in Indonesia, however, appears too low. It limits the potential for the pension system to mobilize resources. It may also penalize older workers under new pension plans who have relatively high income and little time to build up saving. It might be useful to adjust this ceiling upward, say by 100 percent, and thereafter index the ceiling to the rate of inflation.

**Vesting and Portability** Approved pensions are required to vest benefits fully within 5 years. The vast majority of firms (more than 99 percent) in the formal sector, however, offers no vesting of benefits. In addition, the government, the largest employer in the country, does not vest benefits until the worker is 50 years old. (See Chapter 3.) A reality of the labor market today is that most workers are facing many impediments in seeking new employment.

**Disclosure** Sponsors of approved pensions are required to provide reports to members at least annually. Independently audited financial statements must be submitted to regulators once a year. In addition, actuarial assessments must be made and submitted once every three years.
Even when disclosure rules are followed, the quality and comparability of information remains a concern. The accounting procedures adopted, particularly for the valuation of assets, are not the uniform across pension funds. Investment performance is not reported on a comparable basis.

It is desirable to adopt standardized performance measures to be reported by all pension plans. While individuals cannot switch pension plans without changing jobs, they are nonetheless represented, as required by law, on the board of directors that control pension policies. If the investment results are known to be inferior, they are capable of making changes. This is particularly important for defined contribution plans where most of the investment risks are borne by the worker. But, even for defined benefit plans, poor investment results indicate risks. The sponsor has the option to terminate the plan.

**Funding** To qualify for official approval, employer-sponsored defined-benefits plans are to be funded in an actuarially sound manner. For past service obligations, the funding target may be met over a stipulated period. Most of the large companies are currently making funding provisions to cover past services. The funding rule does not apply to the civil service plan, however, as discussed in Chapter 3. Informal plans, which are not approved by the regulators, but are nonetheless widely used, generally make no funding provisions, except in the form of book reserves based on the sponsor’s assets.

Today asset accumulation due to company pensions is about Rph 10 trillion or less than 3 percent of GDP. As existing pension funds build up assets to meet funding requirements, the accumulation will increase somewhat but not substantially. The significant potential lies in the establishment of new, voluntary and funded pensions. If, for instance, the share of companies with approved pensions rises, from below 1 percent today to 10 percent, the size of assets held by company pensions may well exceed 10 percent of GDP.

**Prudential Regulations** Employer-sponsored pensions, other than the civil service plan, are subject to fiduciary rules. First, the plans must be distinct legal entities, administered by a board of trustees with representation of workers and management. Second, pension assets must be segregated from company assets, and there is a ceiling on self-investment by the sponsor. Third, limits are placed on many asset classes, including prohibition of foreign investments by pension funds, a 15 percent ceiling on property, a 20 percent ceiling on direct investment. (The limits on the share of listed equity and fixed-income securities have been lifted.) Fourth, within each asset class, there is an exposure limit on investments made to individual borrowers or individual issuers of securities.

Of particular importance is the restriction on foreign investments, which constrains the capacity of domestic pensions to diversify investment risks. Without foreign securities in the portfolio, a pension plan is vulnerable to financial turbulence like that of Mexico in December 1994. Such events would severely depress asset values and undermine the actuarial soundness of all pension plans in the country. There is therefore scope for liberalizing investment regulations to permit foreign investments.

In spite of the restrictions on pension investments, there is a major safety risk that deserves closer attention. Most employer-sponsored plans today are exposed to considerable
political risks through their investments in the securities of public-enterprises in which the government has effective control, as well as through deposits in state banks. In many countries, including Chile, exposure limits are used to restrict investments by pension funds in securities issued by companies with concentrated ownership. These limits are lower, and thus more stringent, than those applied to issuers with widely dispersed ownership.

Implementation of Company Pensions

Approval Process The Pension Directorate within the Ministry of Finance is responsible for reviewing and approving pension plans. Under the Pension Law Number 11 (promulgated April 20, 1992), two types of pension plans are recognized:

1. employer pension plans, which are administered by a board of trustees, with assets segregated from those of the founding company; and

2. financial-institution pension plans, which are established and administered by banks and insurance companies. Self-employed persons and companies may participate in financial-institution plans.

Since the pension law was passed in 1992, fewer than 500 firms have submitted pension plans for approval. Of the applications, however, only 162 plans have been approved, leaving more than 300 requests awaiting official approval. Many applicants have experienced long delays in getting official response while other plan sponsors have been subject to unexpected inquiries.

Investment Management Pension assets are primarily managed in-house by plan administrators. Of the estimated pension assets of Rph. 21 trillion, less than one trillion, or 5 percent of total assets, has been allocated to professional investment management companies. There are indications, however, that pension funds are beginning to seek the services of external investment advisors. Over one half of approved pension funds are reported to have retained external investment managers. But the share of assets actually parceled out is still very small.

The limited use of professional investment managers is not a reflection of shortages on the supply side. There are more than 50 fund management companies that have been licensed by BAPEPAM - the equivalent the Securities and Exchange Commission (SEC) in the United States. Many international investment management companies, including Citibank, Jardine Fleming, and MeesPierson and Schroeders, offer their services in Indonesia.

Traditionally, external fund managers have been relied upon primarily for the purpose of equity investments. In recent years (1994-95), however, the local stock markets have not provided attractive returns. Plan sponsors may have reduced the equity share in their pension portfolios and thereby limiting the need for external managers. Among the public sector plans, however, the investment guidelines may have precluded the use of external fund managers. Taspen, for instance, reports that the MOF has denied its request to hire external investment managers.
Box 8. Should Life Annuities Be Required?

Company pensions are voluntary in Indonesia. But once a pension plan is set up and approved, most of the benefits (80 percent) must be paid in the form of life annuities with survivor benefits. The prevailing sentiment is that, if given lump-sum benefits, most people would fail to make allowances for the long term and spend the money quickly on pilgrimages or children's marriage ceremonies.

The annuity requirement is common across countries. What is not generally appreciated by the regulators is the costs involved in the provision and purchases of annuities. In most developing countries, providing annuities is extraordinarily expensive because of inadequate information on mortality, which makes it difficult to price the necessary long-term contracts, and the lack of long-term financial instruments, with which the annuity provider may hedge the risks. In the absence of crucial information and inadequate risk-transfer mechanisms, there are few suppliers of the annuity products. Prices tend to be high. High prices for annuities mean that, for a given level of saving, the retiree will get relatively small annual or monthly payments.

Inadequate markets for annuities have sometimes led to the idea that the government should operate pensions or sell annuities to the public. But this idea is not a solution to the problem. It simply shifts the burden from retirees to taxpayers, unless the government charges a price that fully recovers the costs of annuities. And if the government also incurs higher administrative costs than annuity companies, which is likely, then everybody is worse off.

In Indonesia, the intrinsically high cost of providing annuities is further exacerbated by the low threshold for the annuity requirement. Even small benefits, say of Rph. 100,000 or less than US$ 50, which is about the level of monthly minimum wages, are required to be converted into annuities. Many companies have identified the annuity requirement as a major obstacle, along with taxes, for setting up approved pensions.

The US, Singapore and Chile have found a useful solution. In those countries, a program of phased withdrawals (or term annuities) over twenty years is an acceptable alternative to the annuities. Phased withdrawals ensure that retirement benefits are not used up immediately. Plan sponsors do not incur the risk of unexpected longevity, or the costs of purchasing annuities in imperfect markets.

By adopting similar provisions, Indonesia could make pensions less costly to establish. Phased withdrawals (or term annuities) would be a useful option, whereby the pension plan would allow retirees to withdraw one tenth, or perhaps 7 percent, of the retirement saving each year, while the balance would earn the average time deposit rate offered by commercial banks. Although phased withdrawals fail to cover the risk of unusual longevity, they nonetheless represent an option that may induce many additional firms to set up formal pension plans. For those workers who are not now covered by secured pensions, a coverage of 10 to 15 post-retirement years is of considerable value, and is certainly better than nothing at all.

Returns on Investment Data on investment performance for individual pension funds are not currently available to the public. Moreover, relative performance across pension funds is also difficult to assess due to the use of different accounting procedures. Limited data are available, however, for a few asset classes, from which estimates may be made for the investment returns of pension funds as a group.
Investment Returns by Asset Class
(average annual returns for 1988-95 in percent)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Nominal</th>
<th>Real</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time Deposits</td>
<td>17.6</td>
<td>9.4</td>
</tr>
<tr>
<td>Bonds and Govt Papers/a</td>
<td>17.6</td>
<td>9.4</td>
</tr>
<tr>
<td>Equities</td>
<td>46.3</td>
<td>38.9</td>
</tr>
<tr>
<td>Properties/b</td>
<td>46.3</td>
<td>38.9</td>
</tr>
</tbody>
</table>

Notes:  
a. Assumed to be the same as time deposits  
b. Assumed to be the same as equities

Sources: MeesPierson Finas and staff calculations

Based on the estimates above and the composition of pension assets as shown in the previous Chapter, the overall returns on investments for pension funds as a group are estimated to be 21 percent in nominal terms and 13 percent after allowing for inflation over the eight-year period from 1988-95. Individual pension plans of course would have different rates of return depending on actual asset allocation and actual securities held. Moreover, the gains credited to participants or plan assets are net of management expenses.

Although the estimates above may contain a wide margin of errors, they nonetheless suggest very attractive real investment returns in the recent past. Even if the estimates above were to be 100 percent too high, which is unlikely according to fund managers, the real return on pension investments would still be very attractive at 6 percent per annum in the past 8 years.

Options for Reform

Among the measures that would make approved pensions more attractive and less costly to implement are:

First, it is desirable to extend the reach of pension regulations beyond their current narrow boundary. Commonly used plans that provide lump-sum benefits, as well as plans that are based on a broader set of eligibility, should also be covered. In addition, it would be useful to simplify and expedite the process of registration and approval. It would help, for example, to deem an application to have been approved thirty days after submission, unless the authority has responded with a written objection or inquiry.

Second, the funding of private pensions can be made more affordable, without sacrificing the security and benefits of the worker, by increasing the retirement age. This measure extends the period of asset accumulation and shortens the period of benefit payments. The current standard retirement age of 55 is low relative to international standards and relative to current and projected life expectancies of the relevant work force. The retirement age could be raised to 60, or higher, over the next 10 years. The concern that raising the retirement age would limit the opportunity of younger job seekers may be misplaced. Under the current rule, the retired worker who wants to work simply switches to a new employer.
Third, the selective taxation of investment income earned by pension plans is contrary to standard international practices and is a major concern among employers. It raises the cost of doing business and has prevented firms from establishing adequate pension plans. Experience across countries has shown that the revenue foregone by not taxing pension plans directly is more than offset by the gain in revenue collected from increases in taxable pension benefits and from new businesses financed by pension assets.

Fourth, pension assets are often placed at considerable risk today by political interference on investment decisions. Particularly vulnerable to this risk are public-sector plans, which currently account for about three quarters of pension assets in the country. A useful measure for mitigating this risk is to adopt an exposure limit, which restricts the investment of pension plans in the securities issued by firms with concentrated ownership. The limit should apply particularly to debts and equities issued by public enterprises and state-bank deposits. In addition, pension funds operated by public enterprises should rely more on independent external investment advisors.

Fifth, the exclusion of foreign investments as a class of eligible assets for pension funds represents a hindrance on investment performance and increases the exposure of pension assets to Indonesia's country-specific risk. Permitting pension funds to invest abroad, perhaps in designated countries only and possibly up to a stipulated limit of the portfolio initially, would reduce overall investment risks and enhance the stability of investment returns.

Sixth, the rule that 80 percent of pensions be paid in annuity, even when the amount is relatively small, has been a cause of concern to firms, whether they are operating approved pension plans or considering the option. With a rudimentary capital market, with limited financial instruments and risk-transfer mechanisms, providing annuities is relatively expensive. The size of benefit payments would be relatively small under defined contribution plans and the cost funding annuities would be high under defined-benefit plans. To soften the impact of this rule, many countries, including Singapore and the United States, have given companies and workers the option of using phased withdrawals over 10 to 20 years, as a substitute for annuities.

Seventh, the vesting of pension benefits remains elusive to most workers. One reason is that most companies do not have approved pension plans and therefore do not have to comply with the vesting rule. Another reason is that the civil service pension plan, with the largest number of workers in the country, provides no vesting before the age of 50. To promote mobility in the labor market, the government should set a good example by adopting adequate vesting policies for its employees. As more companies establish formal pension plans and vest their pension benefits, more workers would have improved access to new jobs.

Eighth, the ceiling for tax deductible contributions by workers should be raised significantly, perhaps by 100 percent, and thereafter index it to inflation.
III. The Civil Service Retirement Program

The civil service retirement program has three major schemes:

(a) the pension plan, which pays a stream of post-retirement annuities;

(b) the lump-sum benefit (THT) which is paid upon retirement; and

(c) the post-retirement health care benefits.

Both the pension and lump-sum benefit (THT) are defined-benefit arrangements based on final pay. Together, they provide a retirement benefit equivalent in value to about 100 percent of the worker's salary after 35 years of service, and thus represent a relatively generous plan. But inadequate vesting under the pension plan restricts the worker's mobility and makes it less attractive, as discussed below.

The funding practice for the program is unusual. All funding comes from workers' contributions, and none from the employer (government). Civil servants make monthly contributions of 8 percent of salary. Almost half of the contributions (3.25 percent of salary) is used to finance a portion of the lump-sum benefits (THT), a defined-benefit scheme for which the government has a financial obligation. The rest (4.75 percent of salary) goes into the pension fund which pays for a portion (currently 22.5 percent) of pension benefits.

The government is not currently permitted by law to make advance funding provisions for retirement obligations. It can only pay retirees' benefits. The civil service plan is thus largely unfunded, a major issue reviewed later in this chapter (see also box 4).

In 1995, the civil service retirement program had about Rph. 10.2 trillion in assets and Rph. 9.3 trillion investments, making it the largest pension fund and one of the most important institutional investor in the country. Two-thirds of the assets belong to the pension plan and the rest to the THT scheme. Asset allocation for the program in 1995 was as follows:
Implementation of the Civil Service Retirement Program

Unlike other employers, the national government is exempted from pension regulations. As a result, a few major issues arise, including:

**Vesting and Portability** Currently no vesting takes place under the pension plan until the worker reaches the age of 50, irrespective of the time of service. A civil servant who leaves the government before the age of 50 would lose most of her accrued benefits, including her own contributions. The THT (lump-sum) benefits, however, are available upon termination of employment.

By making job changes more costly to the worker, such practice inhibits labor mobility. This policy may also constrain the government’s ability to recruit more competent staff, since superior candidates tend to have more options and are more likely to avoid the one-way street offered by the civil service. Since labor mobility is of vital interest to the country, the government, as the largest employer in the country, should consider adopting the vesting rules followed by employer-sponsored plans.

**Pension Base** A common practice in the public sector is to use the final month’s salary for the purpose of computing pensions. This seemingly innocuous practice has significant financial implications for the plan sponsor, especially the government. For example, an increase of Rph. 30,000 in the final month would cost the employer an additional Rph. 5,000,000 in the present value of extra pensions for an average worker.

The potential for such costly increases could be avoided by adopting the final three- to five-year average salary as pension base. With this provision, the impact of sudden salary
increases in the final month would be relatively small. The incentive for giving "midnight" promotions would be diminished. This average salary, however, should be indexed against inflation.

**Cost-of-Living Adjustment** Under relatively high inflation, averaging 10 percent per annum in recent years, pensions need to be revised upward regularly to protect the retirees’ purchasing power. The adjustment is normally part of benefit policy left to the discretion of the plan sponsor.

The government currently has no explicit policy on cost-of-living adjustments. The civil service plan provides pension adjustments from time to time, depending on the budgetary position and at the discretion of the policy makers. When the adjustment is made, however, it is made on the basis of wage changes for the active civil service, rather than according to the change in purchasing power.

This practice carries many risks. First, the interval between adjustments may be too long, causing a loss of purchasing power and undue hardship on the retirees. Second, the adjustment made may or may not be sufficient to compensate for the loss of purchasing power. Third, there is a fiscal or financial risk to government. Over the long run, wage increases reflect both price changes and increases in productivity. If pensions increase along with wages, the assets backing pension obligations may not be adequate. If the plan is unfunded or under-funded, as is the case with the civil service plan, the sponsor may not be able to honor future obligations.

**Operational Efficiency** Taspen currently has a staff of 2500, with 4 regional offices and 40 branch offices, in addition to the headquarters in Jakarta. Contrary to general perceptions, Taspen does not maintain employee records nor process pension claims. There is no day-to-day collection of contributions. In addition, 80 percent of the monthly pensions are already being dispensed through the Post Office and the banking system. Taspen essentially calculates pensions, pays out 20 percent of the benefits and invests the pension assets. These tasks do not justify the size of staff, the branch network and the expenses incurred.

In 1995, Taspen’s administrative expenses, covering both the pension and THT programs, were about Rph. 58 billion (US$ 25 million.) This amount represented 7 percent of contributions and 0.6 percent of invested assets, both of which are high by international standards, though not as high as those incurred by Pt. Astek (see table on page 36, chapter 4). Returns on investment were 11.3 percent, marginally above the rate of inflation.

The responsibility of Taspen could thus be easily outsourced at a small fraction of the current costs. Employee records and claims processing are already being handled by the Central Government Service (CGS). Pension calculations could easily be absorbed within the same organization. Thus the CGS would be responsible for civil service pension administration, as is the case in the United States and many other countries. Investing pension assets, which today is mainly a task of looking after bank deposits and government papers, could be more productively done by professional fund managers at an annual cost of less than one percent of the assets.
In addition to Pt. Taspen, there are two other public enterprises responsible for government retirement benefits. Pt. Asabri is Taspen’s counterpart for the armed forces. And Pt. Askes administers health care benefits. Policy change to simplify pension plans and consolidate pension organizations would go a long way in lowering costs and cutting public expenditures without sacrificing quality.

Fiscal Implications of the Civil Service Plan

By contractual agreements between the government and Pt.Taspen, the responsibility for meeting retirement obligations is divided. The civil service pension assets, derived from workers’ contributions and managed by Taspen, are designated to pay all of the lump-sum benefits (THT) and 22.5 percent of the pension benefits. The government, through budgetary allocations, is responsible for paying 77.5 percent of the pensions and all of the health-care benefits.

This contractual division of responsibility, however, is valid only as long as Taspen can draw on the pension assets and investment income to make the necessary payments. Should these assets be depleted, which is not a far-fetched prospect as shown below, the government has the final responsibility in honoring all of civil-service retirement obligations, regardless of the division of responsibility under the contract.

The Government's Contractual Responsibility At year-end 1994, benefit obligations under the pension plan (excluding the THT and health care) are estimated to be Rph. 95 trillion or 25 percent of concurrent GDP. (These are the present value of projected benefit obligations. The comparison with concurrent GDP is given only to show the relative size, or order of magnitude, of the amount in question.) The government is directly responsible for 77.5 percent of the benefit payments, or Rph. 73.6 trillion (19.5 percent of GDP.) In addition, the government is obligated to pay post-retirement health care benefits of the civil servants. This liability is estimated to be Rph. 40 trillion or 10.6 percent of GDP, assuming the health-care benefits are about the same as those provided by public enterprises (see the chart below).
Unfunded Government Benefit Obligations
under the Civil Service Retirement Plan
(% of concurrent GDP)

Note: Government pension liabilities are 77.5 percent of total estimated obligations.
Sources: Data provided by Taspen and staff calculations.

Obligations to be Paid out of the Pension Assets In principle, workers’ contributions,
and the attendant investment income, are used to pay for all of the THT benefits and 22.5 percent
of the pension. The pension assets are managed by Pt. Taspen. In practice, however, these assets
fall considerably short of the corresponding actuarial liabilities. The shortfall may be attributable
to:

(a) incompatibility of contributions and benefits;

(b) low returns on investment; and high administrative costs.

Under the THT program, the assets available were about Rph. 2.7 trillion as of year-end
1994, while the accrued liabilities are estimated to be Rph. 6.2 trillion, implying an unfunded
amount of Rph. 3.5 trillion.

Under the pension plan, the assets amounted to Rph. 6.3 trillion, while the accrued
liabilities were Rph. 21.4 trillion (equal to 22.5 percent of total pension obligations), leaving
unfunded liabilities of Rph. 15.1 trillion, as shown in the chart below.
Benefit Obligations to Be Paid from the Pension Fund
under the Civil Service Retirement Plan
(% of concurrent GDP)

- Unfunded
- Funded

THT 0.93
Pension 4.01

Note: These liabilities are 22.5 percent of total estimated civil service benefit obligations.
Sources: Staff calculations based on Taspen’s data.

**Budgetary Implications** The under-funding of the civil service plan is expected to have a major impact on the budget and the domestic financial markets. The budgetary expenses arising from the government’s contractual responsibility is projected to rise significantly. Furthermore, substantial new outlays would be needed to cover THT and pension obligations that are now being paid by Taspen. The severity of this impact is due in part to the demographic shifts, which would increase the number of retirees relative to the work force. Since the civil service represents a relatively mature work force (see Chapter 1), the rise in the dependency ratio occurs sooner than the rest of the population.

Based on current practices under the plan, and the standard macroeconomic assumptions as given in the accompanying charts, the benefit payments under Taspen’s THT program are projected to rise significantly and to exceed cash inflows (consisting of contributions and investment income) by the year 2006. Thereafter the THT assets would be drawn down to meet the required payments. By the year 2015, the THT assets would be completely depleted. To pay for the THT benefits thereafter, the government would need to make additional cash outlays, which are not required today. (See the charts below.) The size of this extra annual outlay would rise to about the same as the employees’ contributions to the THT program or 3.25 percent of wages.
Far more significant, however, would be the budgetary impact of the pension program. At present, total pension payments represent about 30 percent of the civil service wage bill. These payments are expected to rise progressively under current funding policy, reaching a peak at 70 percent of the wage bill in 25 years (see chart below). But, long before that, payments of pension benefits would exceed cash inflows from contributions and investment income. Thereafter, Taspen’s pension assets would be drawn down to meet payments obligations. By the year 2010, Taspen’s pension assets would be completely depleted. After that point, pension payments would require additional budgetary outlays. Overall, to fulfill the civil-service obligations, the government’s pension payments would increase from about 22 percent of the government wage bill today to about 66 percent in 25 years.
Notes: Among the key assumptions are;
Regular Government Payment 77.5% of benefits
Worker Contribution 4.75% of wages
Long-term real rate of - Return on Assets 4.0%
- Wage Increases 3.0%
- GDP Growth 6.0%
Long-term rate of inflation 5.0%
Pension increases = nominal wage increases
Civil service employment is held constant at the current level throughout.

Implications for Domestic Financial Markets Apart from the major budgetary and fiscal implications, local financial markets would also face serious adverse developments. Taspen, currently the single largest institutional investor in the local financial markets with more than one-third of the country’s pension assets, would play a diminishing role. Its assets would first decline rapidly as a share of GDP, then begin to fall in absolute terms by about 2005 and become entirely depleted before 2015 (see below). Domestic banks, which hold a considerable amount of Taspen’s deposits now, would see rapid withdrawals within the next ten years. At the same time, local stock and bond markets would face considerable selling pressures as Taspen liquidates its holdings to pay pension benefits.
Options for Reform

Unless corrective measures are taken now, the resulting budgetary burden would be difficult to manage. Among the options to be considered are:

First, Taspen needs to produce better investment results, which could be accomplished by resisting political pressures and using external investment advisors.

Second, limits on administrative expenses incurred by Taspen (relative to contributions and assets) need to be established, monitored and disclosed. These limits should be set on the basis of international experience.

Third, the civil service pension plan should provide the same vesting and portability of benefits as is required of approved private pensions. This consistency would facilitate labor mobility between the private and public sectors.

Fourth, pension benefits should be based on the average salary for the final three to five years of service, not on the salary of the final month.

Fifth, the cost-of-living adjustment should be done yearly to protect the purchasing power of the retirees. The adjustment should be restricted to the change in a price index, and not to wages. The current practice of indexing pensions to wages is not fiscally sustainable.

Sixth, as with other plans, the retirement age should be raised to at least 60.
Seventh, partial funding of benefit obligations by the government, perhaps at a rate equal to workers' contribution or about 5 percent of salary, should be seriously considered. (An amendment of the budget law is needed for the government to make funding provisions.)

The main drawbacks of funding are that Taspen may not be able to safeguard the assets adequately or to invest them well. If these risks can be overcome, then the government should start funding the program.

The measures listed above for the civil service plan have merits as a stand-alone package, but they could also be incorporated as part of broader civil service reforms.

Further protection for the government's fiscal integrity would be afforded by consolidating the fragmented pension-service organizations, including Taspen, Asabri and Askes, and by requiring all public enterprises to meet the funding requirements for their benefit obligations, including the post-retirement health care benefits.
IV. The Jamsostek Program

Design and Regulations

Jamsostek is a mandatory retirement program that aims to cover the entire formal sector, except for the smallest firms and the self-employed. The principal part of the program is a provident fund (thus a defined contribution plan) based on individual capitalization accounts. By design, Jamsostek has no redistributive effects and no guaranteed minimum pensions. The program is administered by a public enterprise, Pt. Astek, which has exclusive jurisdiction on asset custody and investment management. At its discretion, Pt. Astek may use external investment managers and is beginning to do so.

The Jamsostek program has four distinct components:

- the pension scheme, also known as provident fund, with a contribution of 5.7 percent of wages, out of which 3.7 percent is paid by the employer;

- life insurance (death insurance), with a contribution of 0.3 percent of wages;

- workmen compensation insurance, also known as employment accident insurance, requiring a contribution of less than 2 percent of wages;

- health insurance, also known as medical insurance, with 3 percent - 6 percent contribution.

Health insurance may be waived if adequate coverage is independently provided by the employer. The rest is compulsory.

The program had about 9.1 million participants at year-end 1995, employed in 60,000 companies. Total assets, also in 1995, amounted to Rph. 3.4 trillion, well below 1 percent of concurrent GDP. For investment purposes, assets were allocated as follows:
The Jamsostek program is superficially similar to many successful national provident funds, such as those of Malaysia, Singapore and Chile. But the appearance is misleading. There are significant differences. First, while the other programs are subject to strict prudential regulations to ensure the safety of members’ assets, Jamsostek is virtually unregulated.

Second, unlike social security programs elsewhere, the investment income earned by the Jamsostek plan is fully subject to tax.

Third, Jamsostek by design and implementation is not a stand-alone program. While the other programs are capable of providing at least 40 percent salary replacement after a full career, Jamsostek will provide less than 10 percent, based on current contributions and past investment performance (see the table below). Members will need additional saving for post-retirement income.
Percentage of Final Pay Replaced at Retirement under the Jamsostek Program

Assumptions

<table>
<thead>
<tr>
<th>Real Return on Investment (%)</th>
<th>Real Wage Growth (%)</th>
<th>Contributions Starting at Age</th>
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<tr>
<td>0</td>
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<tr>
<td>4</td>
<td>14.2</td>
<td>10.1</td>
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</tbody>
</table>

Sources: Staff calculations.

Jamsostek Operations

Compliance An issue of concern today is the degree of compliance under the mandatory Jamsostek program. Started in the 1970s and substantially revised in 1992, the social security program has a coverage of 24 percent of the target group. The general public shows little confidence in the program design and administration. Even those who are making contributions to the program express skepticism about the benefits promised and regard their contributions as a tax. With the current design and administration, the prospect for improving public confidence and broadening participation is limited.

The concern is not without foundations. The returns credited to members’ accounts have been below what they can get from bank deposits. Members complain that disclosure and services have been unsatisfactory. Furthermore, information system has been inadequate, with about 40 percent of the assets currently not being posted to individual accounts. Moreover, Astek’s financial management imposes undue financial risks on members, as no segregation is made of the assets and earnings under different program components. Losses under the workmen compensation (accident) and health insurance (medical) schemes could siphon off the assets of the retirement plan. (Management of Pt. Astek believes, however, that for the time being adequate reserve is maintained for each program component.)

Collection Lapses The low rate of Jamsostek participation is well known. But another dimension of the compliance problem is more difficult to detect. Among those participating in the program, the contributions made are much lower than what is expected. Based on total contributions and the number of participants in 1994 as reported by Pt. Astek, the average monthly salary is some Rph. 125,000, which is almost 60 percent below the average salary of Rph. 300,000 for workers in the formal sector. The contributions collected are therefore lower than what is to be expected.
Box 9. Designing Mandatory Pension Schemes


In many countries, participation in a public pension system involving some kind of redistribution is compulsory. But there are growing fears that the value of these pensions will not be sustained. As many public pensions fail, the case for compulsory private pension schemes become stronger. The state has an obligation to ensure that the system works well, is simple and will deliver the targeted benefits.

*Defined Contribution or Benefit?* Increasingly, compulsory schemes are of the defined contribution variety with individual capitalization accounts. These schemes tend to be fully funded, fully vested, and fully portable, although the performance risk of pension investments is transferred to workers.

*Size of Contribution?* Experience suggests that a contribution of 5 percent is inadequate for long-term capital accumulation and for an appropriate pension level. An additional 2 to 3 percent is required to cover operating costs and premiums for term life insurance and disability insurance. Basic contribution rates, including insurance, are 13 percent in Chile, 11 percent in Argentina, and 23 percent in Malaysia.

*Who Should Manage the Funds?* Experience in both developed and developing countries shows that decentralized, competitive private management has achieved higher real returns, net of expenses and fees, than public centralized management.

*What Types of Regulation?* The main focus of regulation should be prudential norms and fiduciary standards. Rules for separating pension assets from those of the sponsoring company and against self investment are essential. Detailed investment rules setting upper limits on different assets by type and by issuer may also be necessary to ensure diversification in less developed capital markets. But reliance on the “prudent man” rule should provide adequate protection.

*What State Guarantee?* State guarantee can take many forms. If not properly formulated, these provisions can create moral hazard and increase the cost of entry. A minimum pension guarantee is often used. Cháve, for instance, offers a guarantee of 25 percent of the average wage of the workers who have contributed for at least 25 years.

*Individual Choice and Competition* Individual choice is essential even in a compulsory pension scheme. In Malaysia and Singapore, workers can decide how to invest part of their own balances, provided that they choose from a menu of approved assets. In many Latin American countries, workers can choose their fund management companies and can switch from one company to another.

*How to Offer Tax Incentives?* Tax incentives should be used to ensure compliance. Two regimes are commonly used. One exempts contributions and investment income from taxes, but taxes pensions - the EET regime. The other taxes contributions, but exempts investment income and pensions - the TEE regime.

This shortfall may be attributable to a variety of factors, including under-reporting by employers, failure to make contributions for the full year, or inadequacies in the posting and accounting of member contributions. In addition, Jamsostek does not require contributions based on overtime pay, which for some companies represents a large proportion of workers’ compensation. Such collection lapses are not unique to Indonesia, but appear to be a universal
problem, caused by evasion, temporary unemployment or withdrawal from the work force. They are also observed in Latin American and OECD countries.

Members of Jamsostek have little to gain from their participation. Based on past results of the program, a member can expect to receive an annuity of about 7 percent of their final salary after making 35 years of contributions. This low replacement rate is primarily a reflection of the low rate of return on investment that Astek has been able to produce. The returns credited to members are further reduced by high administrative expenses, leaving no gains after inflation in recent years. (Each member could do better by simply putting the 5.7 percent contributions in a bank account and paying taxes on the interest, which after 35 years could be expected to provide a replacement rate of about 12 percent of the final salary.)

**Operating Expenses** In 1995, Pt. Astek has about 2,600 employees and 90 offices, divided into 8 regions around the country. The headquarters in Jakarta has a staff of about 426. There are 60,000 employers making monthly contributions on behalf of about 9.1 million members and about 1 million retirees.

As with most centralized public sector pension organizations throughout the world, Pt. Astek incurs considerable administrative expenses in its operations. In spite of recent management changes, which have resulted in some gains in efficiency, there is still a significant scope for further improvements, as shown in a cross-country comparison of administrative expenses and investment performance in the table below. Note that Taspen, which operates under a similar economic environment as Astek and is relatively costly by international standards, has nonetheless kept its expenses well below those of Astek.

### Relative Cost and Performance of Pension Administration

<table>
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<th>Singapore</th>
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<td>Pt. Astek</td>
<td>Pt. Taspen</td>
<td>EPF</td>
<td>CPF</td>
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<tr>
<td>Admin. Expenses as % of:</td>
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<tr>
<td>Contributions</td>
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<td>0.6</td>
<td>0.2</td>
<td>0.1</td>
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<td>Real Investment Returns (% per annum)</td>
<td>0.0</td>
<td>1.3</td>
<td>4.8</td>
<td>2.9</td>
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Sources: World Bank - *Averting Old Age Crisis*; Factbook on Jamsostek 1994; and data provided by Pt. Taspen.

**Resource Mobilization** With low compliance, high lapse rates and poor investment results, resource mobilization under the program has been limited. While similar programs in Chile, Singapore and Malaysia have accumulated assets of at least one-third of GDP, Jamsostek is not expected to mobilize more resources than 2.5 percent of GDP in the next 50 years even if its coverage rises to 80 percent (see figure below).
**Disclosure** Sponsors of approved company pensions are required to provide reports to members at least annually. In addition, independently audited financial statements as well as actuarial assessments must be submitted to regulators once a year. These rules do not apply to Jamsostek program, however. The disclosure under the program has been inadequate. Apart from the assets which have not been accounted for, individual members do not receive regular reports on the current status of their accounts. Some companies have been able to receive the reports upon requests, but only after long delays. Pt. Astek's management says that efforts are being made to upgrade the information system, with the hope of giving individual members electronic access to their accounts by way of "Jamsostek Cards."

**Credibility** Many features of the Jamsostek program have opened up significant opportunities for rent seeking. The mandatory-participation rule gives enforcement officials a chance to engage in petty extortion, particularly from small firms that have not enrolled. These firms may find it advantageous to pay a bribe, rather than making full contributions. Furthermore, since Pt. Astek is the sole administrator of the program with no competing service providers, its employees are in a position to extract personal benefits in return for any services rendered. More significantly, Pt. Astek is in charge of a large sum of assets. Those with the authority for making investment decisions may be guided more by self interests than by an abstract sense of fiduciary responsibility, as the experience of many state banks has shown.

**Options for Reform**

The considerations above make Jamsostek a dubious choice of public policy. Of greater concern perhaps is the risk that the widespread public distrust of Jamsostek would undermine the credibility of a government that otherwise has an excellent record on promoting growth and social equity.

**Should Jamsostek be abolished?** An emerging view among responsible public officials is to close down the Jamsostek program. Under the current circumstance, little would be lost by such measure. There would be considerable public support, from both companies and workers alike. Nearly half the Jamsostek subscribers are already covered by approved company plans.
The rest of the members - those who are not currently covered by separate company plans - would do better by putting the Jamsostek contributions into bank accounts.

But abolishing Jamsostek outright has one important implication. It would leave the majority of workers in the private sector without any coverage. What remains is a voluntary system of employer sponsored pensions (ESPs). At present, with so many small-scale enterprises and stringent pension regulations, it may be premature to make ESPs mandatory (see chapter 2 and box 2). Furthermore, once Jamsostek is closed, it would be difficult to introduce any mandatory pension schemes soon, since public resistance would be strong.

Closing down Jamsostek may also be an overkill. The program could be a powerful instrument for creating institutional investors and developing capital markets. The program design, with some changes, could be made to work, as has been shown elsewhere, including Chile, Malaysia and Singapore. The main problem with the Jamsostek program is one of implementation, and that should not be an insurmountable obstacle.

**How to reform Jamsostek?** Poor performance of Jamsostek, and the resulting public resentment, is rooted in the monopolistic position granted to Pt. Astek. Like monopolies elsewhere, whether public or private, there has been a lack of attention to client’s interest and a disregard for the quality of services. With the monopoly power, the mandatory requirement for Jamsostek participation has spawned opportunities for corruption. Reform measures that are meant to build confidence and to be sustained will need to address this issue.

A necessary ingredient is to remove Pt. Astek’s monopoly in providing administrative and investment services. Any qualified banks, insurance companies or pension service companies could be accredited and licensed to provide the necessary services. Companies participating in the reformed program would have a choice, other than Pt. Astek, for the purpose of record keeping and asset management. The service providers would be subject to appropriate prudential and investment regulations.

Competition among service providers would create a culture of client orientation. Quality of service and investment performance would become necessary for attracting business. Opportunities for corruption would disappear. If Pt. Astek is to survive and operate in this competitive environment, it would have to upgrade its standards significantly.

**A hybrid solution.** The options of abolishing Jamsostek or reforming it are not mutually exclusive. There is also the possibility of a hybrid solution, which involves:

(1) eliminating the Jamsostek mandatory requirement for those companies that have already operated approved pension plans. For these companies, the contributions that they are now making to Pt. Astek would no longer be needed, for as long as the approved pension plans remain in effect.

(2) continued mandatory requirement of Jamsostek contributions for the companies that do not operate approved pension plans. These firms, however, would have the right to choose any accredited pension service companies to administer the program. They
may choose to stay with Pt. Astek, if they wish, but that would not be an obligation as it is today.

This hybrid solution represents an incremental reform of the Jamsostek program, that retains the promise and the potential that was envisaged when the Jamsostek was introduced. It also provides a mid-course corrective action to resolve the implementation issues raised by Pt. Astek. But perhaps most importantly it allows the pension system to provide a broad-based coverage to the workers who would otherwise have no pensions.

To the extent that part of Jamsostek remains after the reform, further design changes would be desirable. The investment income of the Jamsostek provident fund should be exempt from taxation. The retirement age should be raised to 60, or higher. Assets of different program components should be clearly segregated.
References


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