

Policy Note on SJSN

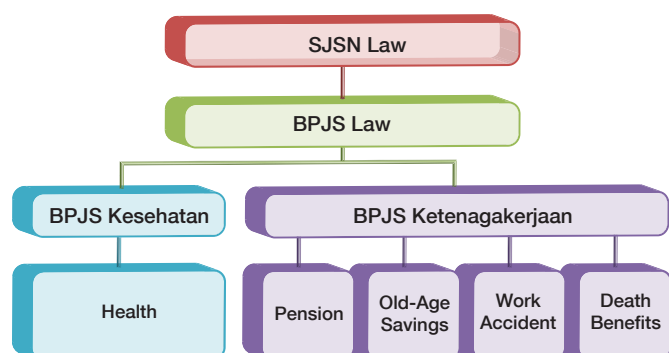
PROGRAM AND POLICY IMPLICATIONS

Issue 2, July 2012

Design and Financing of SJSN Employment Benefits

The Government of Indonesia (“government” or “GOI”) will implement a new National Social Security System (*Sistem Jaminan Sosial Nasional* or SJSN) over the course of the next four years that will radically change the social protection paradigm. The legal bases for these changes are the SJSN Law No. 40/2004 and the Law No. 24/2011 on Social Security Administrative Bodies (referred as *Badan Penyelenggara Jaminan Sosial* or BPJS law).

The new social protection program will cover all Indonesians, including formal and informal sector workers, for five benefits – health, pension, old-age savings, death benefits and worker accident and provide the same benefits for all. The BPJS Law mandates the establishment of BPJS Kesehatan and BPJS Ketenagakerjaan, by transforming current administrators, PT Askes and PT Jamsostek, from state owned enterprises to public legal entities.



This policy note will focus on the key issues that should be considered in the design and financing of the SJSN employment programs (pension, old-age savings, work-accident and death benefits), with particular emphasis on the two retirement programs – the pension and old-age savings programs.

Legal framework. The SJSN law identifies the types of social security programs, but offers only minimal guidance regarding the level of benefits. Similarly, the law states the basis for calculating contributions for salaried and non-salaried workers and the poor, but it does not state the required contribution rate. These fundamental issues are left to regulations.

Articles 30, 36, 40 and 44 of the SJSN Law define who is a participant in the four SJSN employment programs. There are slight differences in the definition of participants among the programs that should be noted.

Similarly, Articles 34, 38, 42 and 46 of this law state how contributions are determined for each of the four programs. Again, the wording varies by program and employment group. Different rules apply to contributions for salaried workers, workers who do not receive a salary and the poor. However, a common theme applies to all four programs. Salaried workers make contributions as a percent of payroll while non-salaried workers pay a flat amount in rupiah.

The table below summarizes both the participation and contribution rules for the four SJSN employment programs.

Program	Participant	Salaried	No salary	PBI*
Work-Accident	Person who has paid contributions	Percent of salary, fully paid by employer	Pay nominal amount	Not mentioned
Old-Age Savings	Those who have paid contributions	Percent of salary. Employer and employee share cost	Pay nominal amount	Not mentioned
Pension	Employee who has paid contributions	Percent of salary. Employer and employee share cost	Not mentioned	Not mentioned
Death Benefit	Person who has paid contributions	Percent of salary, fully paid by employer	Pay nominal amount	Not mentioned

*PBI: Penerima Bantuan Iuran (recipient of contribution assistance)

From this table, it is clear that the basic structure of contributions is similar for all four programs, but the cost sharing arrangements vary by program. Employers and salaried workers share contributions for the old age savings and pension programs. However, the employer pays the full cost of the death benefit and worker accident programs.



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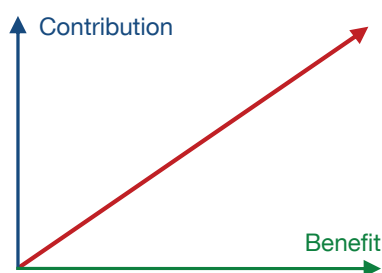


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Perhaps surprisingly, it also appears that non-salaried workers do not participate in the pension plan, and the government does not appear to be required to pay contributions for the poor for the SJSN employment programs. It would be interesting to understand why these differences exist. Non-salaried workers are in need of lifetime income after leaving the labor force just as much as salaried workers. Although measuring actual income might be difficult for non-salaried workers, proxies for income could be used to simplify administration and provide non-salaried workers with this important benefit. It also appears that the government is not obligated to pay for the poor for any of the employment programs. This means the poor will not benefit from any of these important social protection programs.

Design determines cost. A fundamental principle of social security program design is that **the design determines the cost of the program**. In this context, cost means the expected amount of benefits to be paid by the program each year. A program with higher benefits will cost more. While this may seem fundamental and obvious, cost is often confused with contributions. Often policymakers believe that two programs with the same required contributions cost the same or that the contribution rate is the cost of the program.



For example, in Thailand, the initial contribution rate for the formal sector pension program was set at 6% despite the fact that the true long-term cost of the plan was estimated at 11.6%. Looking at the program in the short-term only, it appears that even the 6% rate is excessive. Under Thailand's program, like Indonesia's SJSN pension, participants must contribute for 15 years to be entitled to a pension. Since the program started in 1999, no one is yet eligible for a pension and contributions are much higher than necessary. In the meantime, in 2006, Thailand increased their benefit formula but left the contribution rate unchanged at 6%. But now the true cost of the plan is about 18% and the plan will run into financial difficulties starting in the mid-2020's.

This same misconception occurs in many countries. An argument will be made that a larger benefit doesn't cost more because the initial required contribution rate is the same. This ignores the fact that **the contribution rate will ultimately have to be increased if the benefit is higher, or else the benefits will ultimately have to be reduced in order to keep the cost the same**. This distinction between cost and financing is a fundamental factor to keep in mind during design discussions if Indonesia is to avoid repeating the mistakes of others.

Design and contribution rates should not be separately determined. The primary reason many social security systems become underfunded or insolvent is that **benefits and contributions are determined separately. Design and cost are related and contribution rates must be directly related to both design and cost**. For any social security program, the contributions that are collected must be sufficient to pay for all future promised benefits and cover the plan's administrative expenses.

For any given program design, there will be one expected cost calculation showing the expected benefit payments and administrative expenses in each future year for the program. However, for a given set of costs, there are numerous possible contribution paradigms.

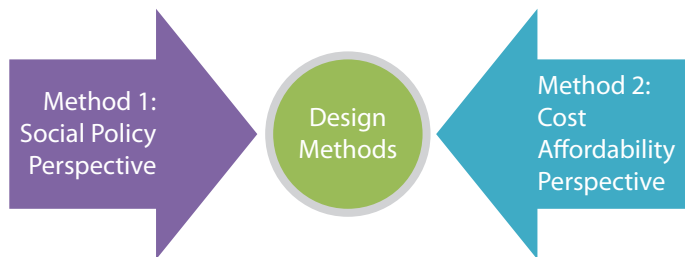
At one extreme, the contribution rate could be set so it is exactly sufficient to cover benefits and administrative costs each year. On this basis, contribution rates usually increase each year. This is often referred to as pay-as-you-go funding. On the other end of the spectrum, contribution rates could be determined so they are expected to remain level for extended periods of time. This is often referred to as target funding or full funding. And there are many options in between. What is important is **complete transparency about the current level of contributions and the expected future level of contributions** to fully finance expected costs.

Whenever the government of Indonesia considers a design option for any of the SJSN employment programs, it is important for the government to calculate the cost of the program at the same time and to make sure the contribution rates that are established are sufficient to ensure the solvency of the fund over an extended period of time. The level required contribution rate over a 75-year period is a common international standard for comparing the cost of different pension program designs.

Design options should be supported by cost analysis of the options. A 75-year cost projection is a common international standard for comparing the cost of different program designs.

The program design process. There are two fundamental ways to think about designing the SJSN employment programs. The first method – the social policy perspective – is to determine the desired level of benefits and then calculate the costs and required contribution rates. This appears to be the primary thought process of policymakers at the moment. The goal is to assure that no one receives smaller benefits under SJSN than they are receiving today and that Indonesia complies with all established international norms for benefit levels. This is an admirable goal, but the risk is that the required contribution rate will be too high

for employers, labor and the government to afford. The temptation is then to leave the benefits unchanged and set the contribution rate at a lower level and hope for favorable experience. This is a common pathway to insolvency.



For example, if the SJSN employment programs are based on the civil service health and pension program benefits and the Jamsostek old age savings program, death benefit program and work accident program, the total required contribution rate on a fully funded basis could exceed 25% of payroll, and the cost of severance pay would be in addition to this amount. This contribution rate is highly unlikely to be acceptable to workers, employers and the government.

The second method is to start by determining the amount that employers, labor and the government are willing to contribute and then work backward to determine the affordable level of benefits. This is also an admirable approach, but it may result in proposed benefits that are too low to be meaningful and to meet the fundamental goals of the SJSN law and the country's social policy.

In practice, it is best to use a combination of both methods to produce optimal results. **The goal is to find a combination of benefits and contributions that are both meaningful and affordable even in the face of adverse experience.** Governments have a tendency to make overly optimistic assumptions about the country's future demographic and macroeconomic circumstances when determining affordable benefits. When actual experience fails to meet these lofty expectations, the programs become underfunded. Proper practice is to use conservative assumptions to be sure the programs are financially sustainable even in the event of adverse circumstances. This is often referred to as the "robustness" of the pension program.

Another reason social security programs tend to become underfunded is that they create a natural conflict of interest for politicians and policymakers. The programs will be in place for many years and **decisions about benefits that are made today may have minimal impact on costs in the near-term but a significant effect in the long-term.** Consequently, it is tempting for politicians and government policy makers to increase benefits today, knowing that the impact on costs over the time they are likely to be in office will be minimal, and then leave the long-term financial problems they create to a future generation of leaders.

Indonesian policymakers will have a difficult time resisting the urge to provide rich benefits while setting an initial contribution rate that is too low. Workers and employers will support such an arrangement because they get high benefits while paying for low benefits. The government will be happy because the budget expense is kept down. However, in just a few years, the programs will become badly underfunded.

Payroll contributions and the labor market. It is important to understand that social insurance programs –programs that are financed by payroll taxes on employers and workers—raise serious labor market, labor relations and macroeconomic issues. Employers and workers will both be required to pay contributions to each of the four SJSN employment programs (and the SJSN health program). These contributions will be a percent of covered payroll. If benefit programs are too rich, then the contribution rates could be high enough to create some serious problems.

- High payroll contribution rates discourage hiring of new workers and encourage employers to substitute capital for labor
- High payroll contribution rates directly reduce workers' take-home pay. Workers may then pressure employers to increase their pay by enough to compensate
- High payroll contribution rates reduce employer profits and put pressure on employers to raise the price of their products
- If Indonesian payroll contribution rates are higher than in other countries in the region, then it could negatively impact the regional and global competitiveness of Indonesian goods and services
- Labor costs are a significant determinant of foreign direct investment. High payroll contribution rates may discourage foreign investment in Indonesia
- Rich benefit programs may crowd out private pension programs, occupational pension funds and private insurance products.

While workers may appreciate receiving high benefits from the SJSN employment programs, they will not like the higher payroll contribution rates needed to finance them. Consequently, the government should be cautious about the level of benefits and contributions due to their implications for the labor market and macro economy.

Indonesian policymakers need to be realistic about the true cost of its social security programs and the affordable level of benefits. If programs are properly priced, employers and workers will be forced to make a choice between paying higher contributions or receiving smaller benefits.

Integration of the Pension and Old Age Savings Programs.

The SJSN Law will create a traditional World Bank multi-pillar pension program for Indonesia. Pillar 1 will be the SJSN pension program, a mandatory, contributory defined benefit plan, while Pillar 2 of the pension program will be the old age savings program, a mandatory, contributory defined contribution pension program. This has become a very common design for national pension schemes throughout the world, and particularly in Eastern Europe and some parts of Latin America.

The government should think about these as two components or pillars of a single retirement income system rather than as two separate programs. The pension program provides guaranteed lifetime monthly income (longevity insurance) while the old age savings fund provides liquidity at retirement by paying benefits as a lump sum.

The two programs complement each other well because they have very different risk characteristics and treat vulnerable groups very differently. Under the pension program, longevity and investment risk are primarily born by the pension fund while these risks are with workers under the old age savings program. The pension program also provides better protection for women and vulnerable groups than the old age savings program.

Women live longer than men and the pension program guarantees payments for life. Therefore, women tend to get greater benefits relative to contributions than men. The pension program also contains survivor benefits for spouses and children in the event of death of the wage earner before or after retirement. Pension programs can also be designed to allow benefits to accumulate for women who are temporarily out of the work force to raise children, for those who are disabled and for those who are temporarily unemployed or underemployed.

By contrast, the old age savings program simply pays a lump sum at retirement based on contributions actually made and investment income earned. This is problematic for women since contributions are rarely made for women who are temporarily out of the labor force. Women also live longer than men, so they will have to spread their retirement savings over a longer period of time. There are also no post-retirement death benefits under the old age savings program and disability and survivor benefits prior to retirement are equal to the accumulated account balance. This benefit can be highly inadequate, especially for those who die or become disabled at a young age.

The government will need to decide the relative balance of these two programs. At one extreme, the government could provide a flat defined benefit pension that is just sufficient to prevent poverty and have a large contribution to the old age savings program. At the other end of the spectrum, the government could focus on assuring the pension program provides guaranteed lifetime pay-related benefits that allow workers to maintain their standard of

living following retirement while keeping the old age savings plan contribution small. The proper balance depends on the government's goals and objectives for the combined programs and the affordable level of payroll contributions.

How the World Bank can support the Government.

The World Bank will work together with various government offices/agencies and other development partners to meet the government's technical and financial needs for the implementation of BPJS Ketenagakerjaan.

The Bank has strengths in many areas relevant to the implementation of BPJS Ketenagakerjaan. We have global, regional and local expertise in pension and old age savings plan design, computer modeling, actuarial analysis, and pension program administration.

Our prior work with the government on SJSN actuarial modeling and training, and on passage of the BPJS law will also allow us to add value to the implementation process. Moreover, our PROST (Pension Reform Simulation Toolkit) model is recognized internationally as a valuable tool for fiscal analysis of pension programs such as the SJSN pension and old age savings programs.

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