This Country Note is an extract from the Economic Outlook for Southeast Asia, China and India 2014: Beyond the Middle-Income Trap, http://dx.doi.org/10.1787/saeo-2014-en.
Indonesia needs to further increase its efforts if it is to meet the goals it set in its 2010-14 National Medium-term Development Plan (RPJMN 2010-14) and its Master Plan for the Acceleration and Expansion of Indonesia's Economic Development 2011-25 (MP3EI). It can achieve equitable growth only if it makes education more widely accessible, strengthens natural disaster management especially with respect to floods, accelerates social protection reform, particularly the pension system. In the meantime it should maintain economic growth by improving the business climate.

It can widen access to education by improving government policies and making its current scholarship and CCT programmes more efficient. Indonesia is highly exposed to
natural disasters that claim lives and wreak and financial and economic damage, with the poor disproportionately affected. Its natural disaster management system, particularly with regard to flooding, needs to be strengthened. Reform of the country’s pension system, which is one of the pillars of its social protection system, must be accelerated. It is currently inadequate for providing secure income for the majority of the retired population. Indonesia must rise to these three overriding policy challenges against the backdrop of sustained economic growth. It must further improve the recent progress it has made to its investment climate by moving to simplify business procedures.

<table>
<thead>
<tr>
<th>Indonesia's medium-term policy challenges and responses</th>
</tr>
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<tbody>
<tr>
<td>• Widen access to education, in particular for low-income households</td>
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<tr>
<td>• Strengthen natural disaster management and protection infrastructure</td>
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<td>• Accelerate reform of the pension system to improve transparency and quality</td>
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**POLICY FOCUS**

**Widen access to education, in particular for low-income households**

Despite progress, access to education needs to be strengthened further.

Under the terms of the MP3EI, the government is committed to providing the poor with economic assistance in the form of subsidies and cash transfers to improve the access to education. After nine years of free, compulsory schooling, Indonesia has steadily improved access to basic education (OECD 2012b; 2013a). Nevertheless, for reasons of cost and opportunity, education is still beyond the reach of many children from disadvantaged families. The government should strengthen demand-side measures – such as targeted scholarship programmes and complementary CCT schemes – to help low-income households send their children to school.

Educational attainment in low-income households is substantially below that of the rest of the population. In 2008, the lowest quintile of the population aged age five years and upwards did not even have primary education. By contrast, in the highest quintile of the same subset of the population 40% had attained upper-secondary education or higher (Figure 2.3.1). The fact that expenditure on education rises with non-food household expenditure (Figure 2.3.2) suggests that low-income families do not have the financial means to continue to support their children beyond free basic education (OECD, 2010b).
Figure 2.3.1. *Educational attainment in Indonesia, by income level, 2008*

Highest qualification in percentage of population aged at least 5 years or over

StatLink  
http://dx.doi.org/10.1787/888932937852

Figure 2.3.2. *Household expenditure on education in Indonesia, by income level, 2008*

Percentage of household non-food expenditure

StatLink  
http://dx.doi.org/10.1787/888932937871
The performance and upward mobility of students from poor households need to be strengthened considerably. According to the results of tests in the 2009 round of the OECD’s Programme for International Student Assessment (PISA), the proportion of disadvantaged students who perform better in reading than would be thought from their socio-economic backgrounds is not only lower in Indonesia than the OECD average, but also lower than among its regional peers such as Thailand (Figure 2.3.3).

**Figure 2.3.3. Percentage of resilient students among disadvantaged students in Indonesia and other selected economies, 2009**

<table>
<thead>
<tr>
<th></th>
<th>Singapore</th>
<th>Shanghai, China</th>
<th>Indonesia</th>
<th>OECD average</th>
<th>Thailand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resilient (%)</td>
<td>40</td>
<td>52</td>
<td>20</td>
<td>35</td>
<td>30</td>
</tr>
</tbody>
</table>

Note: A student is classified as resilient if he or she is in the bottom quarter of the PISA index of economic, social and cultural status (ESCS) in the country of assessment and performs in the top quarter across students from all countries after accounting for socio-economic background.


Mixed results from education attainment measures on supply and demand side

The government’s strategy to enhance the educational attainment of students from poor families has combined supply-side and demand-side measures. Supply-side interventions include the School Operational Assistance Programme (BOS) (for further detail see OECD [2013a]). It provides direct financial assistance to schools with the aim of increasing enrolment rates and easing the financial burden of education on households. On the demand side, it has delivered assistance in the form of scholarships and CCT programmes.

Indonesia introduced its first pro-poor education programme, the Social Safety Net scholarship scheme (Jaring Pengaman Sosial, [JPS]), in the wake of the 1997-98 Asian crisis with the aim of improving the access of students from poor families to education (OECD, 2010b). Apart from problems with geographical targeting and leakages to non-poor students, especially in rural areas at primary school level, the programme is considered to have been successful in raising enrolment rates. The cash transfer contained the increase in drop-out rates by easing households’ need to draw on the labour of their children. Nevertheless, more accurate targeting would have improved the efficiency of the programme (Sparrow, 2004).
The Special Assistance for Students scheme, or Bantuan Khusus Murid (BKM), was introduced in 2001 with the objective of complementing and phasing out the JPS scholarship programme. As fuel subsidies were reduced at the time, the purpose of the BKM scholarship programme was to reduce the negative impacts of fuel price increases on the welfare of poor households by easing the burden of education expenses. However, as a result of inadequate co-ordination and the lack of long-term financial planning and monitoring, the programme proved inefficient (SMERU, 2003). In 2005, as it introduced the BOS programme providing block grants to schools, the government substantially reduced coverage of the BKM scholarship and gradually phased out the scheme.

In 2008, Indonesia initiated Bantuan Siswa Miskin (BSM), the Help Poor Students scholarship programme. Its aim was to raise the efficiency and widen the coverage of targeted scholarship programmes. BSM, a package of cash transfer programmes, provides currently enrolled students from poor households with an annual cash transfer to pay for school fees and other non-fee school costs, such as transport and uniforms, in one lump-sum instalment. However, the BSM scheme has a number of weak points: its targeting and coverage are poor; it lacks co-ordination and is poorly thought out; the scholarship is inadequately endowed; and poor design hampers the transition from elementary to junior high school (Agustina et al., 2009 and World Bank, 2012b).

Indonesia needs to enhance the effectiveness of its scholarship programmes by targeting, designing, and co-ordinating them better. It should fine-tune their design to ease the transition between school levels – particularly from primary to junior secondary education – by increasing support for students in their final year. The benefit package also needs to be revised upwards to reflect rising education costs. The different scholarship schemes could be consolidated into a single programme to avoid fragmentation at school and district levels and between secular and faith-based establishments. Moreover, independent monitoring arrangement should be introduced for greater efficiency and transparency.

Scholarship programmes do encourage parents to send their children to school by reducing overall education cost for households. However, they are not so successful in addressing other non-financial issues – such as the low perceived value of education – and essentially target only students who are already in school (Agustina et al., 2009). By contrast, CCT programmes make school attendance a condition for receiving assistance. In this way, they send strong signals to parents about the value of education and increase the opportunity cost of dropping out of school. They are important, efficient complementary demand-side interventions (Agustina et al., 2009).

In 2007, the government launched two pilot CCT schemes. One was the Family Hope Programme, or Programme Keluarga Harapan (PKH), which targeted households. The other was an incentivised community block grant scheme, the National Community Empowerment Programme – Healthy and Smart Generation (Programme Nasional Pemberdayaan Masyarakat – Generasi Sehat dan Cerdas, [PNPM Generasi]). It targeted the very poor and was conditional on school attendance and the use of maternal and child health-care services. An interesting and welcome feature of these CCT pilot programmes was their impact evaluation architecture: together with control groups, the government incorporated random assignment into the selection of beneficiaries (i.e. built-in randomised control trial design) to allow for rigorous assessment.
More effectively designed and targeted CCTs are needed to increase school enrolment

The impact of PKH on school enrolment rates among the very poor has been limited so far. Although the children who have benefited from the PKH stay in school longer, the already high enrolment rates and low drop-out rates in basic or junior secondary education have not changed. Nor have there been significant reductions in child wage labour (World Bank, 2012c).

One of the main reasons for PKH’s limited impact may be that the cash transfer does not cover the full cost of attending school. For instance, a PKH cash transfer for junior secondary schooling covers only 43% of total education costs when transport costs are included (World Bank, 2012c). Moreover, according to Febriany et al. (2011), PKH’s effectiveness in increasing the use of basic school services is also hindered by the lack of general infrastructure – transport, energy, and water and sanitation – in remote areas, inefficient compliance monitoring, the lack of support from schools, and the jealousy-induced conflict with non-recipients.

Overall, PKH needs further support, fine-tuning and extension to the whole country. Above all, the programme should co-ordinate and collaborate more closely with education service providers and other local government services, as well as with the community-based PNPM Generasi scheme. It is also important to better integrate conditional income-support programmes with micro-credit schemes to ease the transition towards self-empowerment (OECD, 2010b). Also, the skills and capacity of facilitators, the front-line contacts with households, need to be enhanced. Benefit levels, too, which have been the same since the start of the programme, should be reviewed and indexed to the cost of living. A final point is that CCT programmes which impose performance-related conditions, such as not failing grades, can increase efficiency (Saavedra and Garcia, 2012).

By contrast, the PNPM Generasi programme is generally considered successful. Community funds are allotted to villages, with the amount depending on the number of beneficiaries in a village, and then spent on improving the provision and use of maternal and child health care and basic education services (OECD, 2013a). The benefits include the expansion and improvement of physical facilities and easier access to basic education services. According to Febriany et al. (2011), PNPM Generasi reduced drop-out rates and absenteeism, while boosting students’ motivation. Olken, Onishi and Wong (2011), find that PNPM Generasi’s most notable impact was the increased participation rate among the children of primary school age group, particularly in areas with low baseline education indicators. PNPM Generasi needs to be further expanded by prioritising regions with low health and education indicators.

The efficiency of current scholarship and CCT programmes can be improved substantially through more accurately targeted financial support to students from disadvantaged backgrounds. Poor targeting leads to leakages as non-poor students are nearly as likely to receive benefits as poor ones. A national targeting system (NTS) could be the cornerstone of better designed and implemented targeting methods and more closely co-ordinated programmes. An NTS would serve as a unified registry, providing sufficient quality data for all kinds social assistance programmes. Progress has already been made in this direction since a large-scale survey in 2011 – Data Collection for Targeting Social Protection Programs (Pendataan Programme Perlindungan Sosial [PPLS11]). Conducted to identify poor households, PPLS11 covered around 45% of the population; it found
that an NTS would need to be managed in an accountable, transparent way. As for the different targeting methodologies, besides proxy means-testing, community-based and self-targeting methods could increase accuracy and further satisfy community needs (World Bank, 2012d; Alatas et al., 2012).

Box 2.3.1. Conditional cash transfer (CCT) programmes: Examples from OECD countries

Conditional cash transfer (CCT) programmes implemented in OECD countries are generally considered to be effective in increasing school attendance.

The best known CCT within the OECD, the Oportunidades scheme, was launched in Mexico in 1997. The programme covers around 20% of families. Eligibility is determined by first identifying geographical communities with high proportions of poor families and then by selecting low-income households with the help of proxy means-testing. An interesting feature is that the actual cash transfers are paid to mothers directly, as evidence shows that they are more likely to spend the money on children. Beyond the positive impact of Oportunidades on school attendance, it is also considered to have reduced the head-count poverty rate by 10% and to have had an even more significant positive impact on measures of extreme poverty such as depth and severity.

The Turkish Social Solidarity Fund, introduced in 2001, targets the poorest 6% of children and has around 2.6 million beneficiaries. Low-income families are identified through proxy means-testing. The programme also seeks to address gender bias in education by paying more to girls both at primary and secondary school levels. Evaluations show a favourable impact on poverty reduction and a measurable positive effect on school enrolment and attendance.

Further CCTs with educational objectives implemented in OECD countries include the Opportunity NYC programme from New York, United States which requires no early childhood or health measure conditions. The only requirement is participation in compulsory education. There are also CCT programmes – in Austria, Australia and Germany, for example – that continue to pay child benefits that are conditional on the child going on to higher education once he or she is over the age of 18.


POLICY FOCUS

Strengthen natural disaster management and protection infrastructure

Indonesia needs better mechanisms to cope with natural disasters, particularly flood protection infrastructure

Indonesia's geographic location and inadequate disaster risk management infrastructure expose it to natural disasters. The country suffers from droughts, wildfires, floods, landslides, earthquakes, volcanic eruptions and tsunamis. Between 1980 and 2010, more than 21 million people all over the archipelago were affected by 321 sizeable natural disasters, which claimed over 190 000 lives. Although earthquakes - and attendant tsunamis - kill more than other natural disasters (the tsunami that struck the province of Aceh in 2004 caused more than 100 000 fatalities), floods are the most frequent natural hazard (Figures 2.3.4 and 2.3.5.). The number recorded by the Ministry of Public Works almost tripled between 2006 and 2011.
Climate change and the resulting increase in rainfall are one element behind the rise in the incidence and severity of floods in recent years. Furthermore, the damage caused by floods is aggravated by the fact that they often happen in major cities that are built in basins and rendered especially vulnerable by their dense populations, unplanned urban sprawl and the lack of flood management infrastructure. In other words, the climate-change-induced rise in the amount and intensity of rainfalls combined with the rapid pace of urbanisation puts further strain on flood protection infrastructure.
Jakarta’s flood protection infrastructure needs to be improved as Indonesia continues to urbanise

Indonesia is steadily urbanising. By 2025, according to the 2011 Revision of the UN’s World Urbanisation Prospects, the urban population will account for some 60% of the population – over 160 million. The population of Jakarta alone will rise by around 30% to nearly 13 million habitants (Figure 2.3.6). Although the Jakarta metropolitan region and other urban areas in Java will continue to lead urbanisation, medium-sized cities across the rest of the country will grow at a steady pace as well.

Figure 2.3.6. Expansion of the urban population in Indonesia, 2000-25

Million people

StatLink © http://dx.doi.org/10.1787/888932937947

The floods that perennially affect Jakarta have been growing worse in recent decades. Estimated financial and economic flood-related losses in 2002 were over USD 1 billion (World Bank, 2012e). The most recent flood – in January 2013 – affected around 8% of the city’s area, claimed 41 lives and, according to official government estimates, caused economic losses through damage to property, production downtime, and other factors, that could be as high as USD 3.3 billion (Al Azhari, 2013).

Severe flooding also curbs investment in affected areas and has a disproportionate impact on the poor, who tend to live in hazard-prone areas that are low-lying or situated along waterways.

Jakarta sits in a low-lying coastal basin, with 40% of the city lying at, or below, sea level. Its exposure to flooding is compounded by the high annual average rainfalls and rising sea levels caused by climate change. Moreover, rampant urbanisation has overrun water catchment areas, green areas and wetlands, turning them into extensions of city sprawl and drastically weakening the absorption and retention capacity of the flood control system. The incidence and severity of the floods that overwhelm Jakarta are further aggravated by land subsidence. It increases the risk of tidal floods and weakens the gravitational pull that channels storm water out to sea.
The two pillars of Jakarta's structural flood control system – the West and the East Flood Canals, completed in 1992 and 2009, respectively – can only partially ease Jakarta's vulnerability. Even though the East Flood Canal still has some unfinished parts, the fact that the two major canals are not connected will always substantially impair overall flood control efficiency. Moreover, the Ministry of Public Works and Jakarta City Council (DKI) lack the capacity to maintain the flood control infrastructure. The result is considerable sediment build-up in primary floodways and drains (Jha, Bloch and Lamond, 2012).

Some progress in disaster risk reduction, but budget allocation as well as co-ordination and early warning systems need to be improved

As it happens, Indonesia has improved its disaster risk reduction system in recent years. In 2004 a tsunami devastated the province of Aceh. The government responded in 2006 by formulating the first National Action Plan for Disaster Risk Reduction (NAP DRR). The following year it enacted the first comprehensive law on disaster management (ASEAN Inter-Parliamentary Assembly, 2012). Indonesia has also established the National Agency for Disaster Management (Badan Nasional Penanggulangan Bencana [BNPB]) as the first independent disaster management body in the country with real powers at ministerial level. By the time the 2010-14 Disaster Management Plan was formulated in 2009, all provinces had developed their own disaster management plans. However, despite the progress Indonesia has made in nationwide disaster management, the budget allocated to it remains limited and, even though it is increasing, it is smaller than in developed countries.

When it comes to flood control planning and management, there are co-ordination difficulties across the relevant authorities. For instance, the inadequate spending on floodway maintenance by the Ministry of Public Works, which is responsible for the floodways that cross provincial boundaries, also has a negative effect on the drains and retention basins within the boundaries administered by the DKI. As for land planning, there is also a lack of co-ordination between regencies in Greater Jakarta (Jha, Bloch and Lamond, 2012).

However, with respect to contingency planning there are promising signs, such as the hazard impact modelling tool, Indonesia Scenario Assessment for Emergencies (InaSAFE). InaSAFE was launched in October 2012, after being tested during the 2011-12 Jakarta flood season. It proved effective in providing an understanding of hazard impacts through maps and estimates of potential damage and communicating them to support disaster risk management decisions.

To protect Jakarta's remaining natural flood absorption capacity, there should be no new property developments on any undeveloped land such as water catchment areas, green spaces and wetlands. In the same spirit, those green spaces that have already been converted into urban areas should be repurposed back into non-urban areas as far as possible (Rukmana, 2013).

In order to alleviate flood impacts, the flow and retention capacities of existing infrastructure should be enhanced through river dredging and the construction of retention basins. The flood control systems affected by subsidence ought to be realigned as well, while the East Flood Canal should be connected to the West flood Canal for further flood protection. Upstream management and coastal protection, which require long-term planning, need to be prepared and implemented on a consensual basis by all stakeholders (World Bank, 2012e).
However, Jakarta will continue to be exposed to the risk of flooding despite all the flood mitigation efforts. It is therefore essential to continue to develop and improve early-warning systems (Box 2.3.2) and contingency planning and to invest in community preparedness.

Box 2.3.2. Flood early-warning systems and risk assessment: Examples from OECD countries

The Japanese flood warning system is characterised by a very high level of efficiency in the collection of data on flood incidence. There is also close co-operation between government agencies – such as the Japan Meteorological Agency (JMA) and the Ministry of Land, Infrastructure and Transport (MLIT) – and relevant research institutes, such as the Public Works Research Institute (PWRI) and the International Centre for Water Hazards and Risk Management (ICRARM). Flood forecasts draw on a highly sophisticated, accurate watch system. Rainfall and river levels are monitored through radar, rain gauges and telemeters, while high-capacity IT networks communicate flood forecasts to cities, towns, and even villages. Disaster prevention information is supplied in real time on a designated website (www.river.go.jp).

In the United Kingdom, a large-scale regional monitoring programme covering the southern part of the country was implemented to ensure a systematic approach to the collection, management and analysis of data for use in strategic and operational management of coastal erosion and flood risk. The monitoring programme includes analytical databases and geographic information systems that provide high quality, long-term, time-series data sets, at appropriate spatial and temporal resolution. The programme’s design also ensures that the different agencies responsible for the management of short sections of the coastline work in effective partnership.

The tool for flood risk management developed in France by IRSTEA (Institute of Research into Science and Technologies for the Environment and Agriculture) draws on local socio-economic criteria and comprehensive river basin data. It produces final risk maps that build on hazard and vulnerability maps. While vulnerability maps take into account both the economic value of damages and the social cost of floods, the design of hazard maps uses detailed assessments of catchment areas and river behaviour as well as past flood experience and theoretical models.


POLICY FOCUS
Accelerate reform of the pension system to improve transparency and quality

Demographic changes make pension reform urgent

Indonesia is reforming its social protection system through the Masterplan for Acceleration and Expansion of Indonesia Poverty Reduction (MP3KI). The MP3KI seeks to transform social protection programmes from current poverty alleviation schemes – like the Help Poor Students scholarship programme and other conditional cash transfer measures discussed in Policy Focus on education – into a comprehensive set of actions that will ensure a sustainable livelihood for the poor and vulnerable.
The Indonesian pension system, a pillar of the social protection system, is inadequate for providing a secure income for most retired people. The need for reform is driven by various factors, such as the ageing population, the weakening of family support and the growing middle class. Recognising this, the government is committed to implementing a social safeguard system in the form of universal social insurance in accordance with the Master Plan for the Acceleration and Expansion of Indonesia’s Economic Development 2011-25 (MP3EI). However, there is room for improvement in extending coverage, ensuring financial sustainability, providing adequate retirement income, consolidating and rationalising existing pension schemes, and improving overall governance and transparency of the pension system.

As Figure 2.3.7 shows, the demographic transition arising from the combination of falling fertility rates and rising life expectancy is leading to a rapidly ageing population in Indonesia, as in most Southeast Asian countries and China (OECD, 2012b). The percentage of the population aged 65 and over is projected to almost triple from 5.6% in 2010 to 14.9% by 2040. The old-age dependency ratio will follow the same trend, rising almost three-fold from 8.2% to 22.2% over the same period (Figure 2.3.8).

Figure 2.3.7. Fertility rate and life expectancy in Indonesia, 1980-2040

Source: UN Population Division of the Department of Economic and Social Affairs, World Population Prospects: The 2010 Revision. StatLink: http://dx.doi.org/10.1787/888932937966
The current pension system in Indonesia is composed of different retirement-income schemes for different labour market groups. The schemes differ from each other in retirement age, type of benefit scheme and benefit payment mode, legal status and contributions (Table 2.3.1).

**Table 2.3.1. Pension system in Indonesia**

<table>
<thead>
<tr>
<th>Type of workers</th>
<th>Civil service pension</th>
<th>Jamsostek Old Age Savings</th>
<th>Private pensions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of benefit scheme</td>
<td>Civil servants, military and police</td>
<td>Private sector workers</td>
<td>Informal sector workers</td>
</tr>
<tr>
<td>Legal status</td>
<td>Defined benefit (DB)</td>
<td>Defined contribution (DC)</td>
<td>Both DB and DC</td>
</tr>
<tr>
<td>Retirement age</td>
<td>56 or 50 with 20 years of service</td>
<td>55 or after 5 years of contribution</td>
<td>Normally 55, but maximum 60</td>
</tr>
<tr>
<td>Accrual rate</td>
<td>2.5% for each year of service</td>
<td>5.70%</td>
<td>DB: max. 2.5%/year; DC: max. 20%/year</td>
</tr>
<tr>
<td>Maximum benefit</td>
<td>75% of basic salary</td>
<td>-</td>
<td>DB: 80%; DC: 20%/year</td>
</tr>
<tr>
<td>Benefit payment method</td>
<td>Lifetime annuity</td>
<td>Lump sum payment</td>
<td>20% lump sum, 80% lifetime annuity</td>
</tr>
<tr>
<td>Employee contribution</td>
<td>4.75% of wages</td>
<td>2% of wages</td>
<td>2% of income (at minimum wage level of IDR 1 million/month)</td>
</tr>
<tr>
<td>Employer contribution</td>
<td>Varies on actual expenditure</td>
<td>3.7% of wages</td>
<td>None</td>
</tr>
<tr>
<td>Coverage (participants contributing)</td>
<td>4.5 million (2.8% of population aged between 15 and 64)</td>
<td>9.3 million (5.7% of population aged between 15 and 64)</td>
<td>0.4 million (0.2% of population aged between 15 and 64)</td>
</tr>
</tbody>
</table>

Pension coverage and benefits need to be enhanced significantly

The majority of the population is still not covered by any old age pension scheme. Except for civil servants, the military and police personnel, coverage is very low. The total number of active contributors to any retirement saving scheme as a percentage of the population aged between 15 and 64 is only around 10.5%. Although the coverage of the mandatory Jamsostek private-sector savings scheme has widened in recent years, only some 25% of eligible workers actively contribute, which indicates high levels of evasion (Muliati, 2013). Nevertheless, expanding the coverage of the pension system in its current form would not be feasible. Extending it to the formal sector alone would cost 2.13% of GDP and covering the entire labour force would swallow 5.83% of GDP (Guerard et al., 2012). Increasing coverage would be feasible only if costs were also rationalised. A possible first step towards expanding the span of the pension system might therefore be to increase the retirement age for those who stand to benefit the most from the current setting – civil servants – then use the proceeds to widen coverage.

The fragmentation of the present retirement income system causes disparities. Apart from those that arise from the sheer size of the population without any pension coverage, there is the gap between civil servants, the military and the police, who receive relatively generous benefits, and everyone else.

More importantly, the current system of pension programmes must be enhanced particularly for old-age income security. First, as the benefit payment of the Jamsostek programme is a lump sum rather than an annuity, it is up to employees to decide whether they will save it as a lifetime old-age income. In fact, around 90% of the benefit payment is made before retirement indicating that it is used for purposes other than retirement (Muliati, 2013).

Second, benefit levels can be improved. Measured by the net replacement ratio, the pension levels of the mandatory Jamsostek saving scheme for private-sector workers are very low (Figure 2.3.9). Even under the otherwise generous civil service system, benefits for higher paid civil servants can be less than 20% of total salary at retirement, as they are calculated from the final base pay without bonuses and allowances. Benefits at all income levels also need to be adjusted to ensure old age income security by guaranteeing the fiscal sustainability of the system.

Another important measure would be to reform the pension benefit scheme in line with pay policies in the civil service. Under the civil service pension programme – a defined benefit scheme – the indexation of benefits should take the form of pension payments that are automatically adjusted to reflect changes in the cost of living. Such an arrangement would protect the value of pensions and contain costs.
Figure 2.3.9. Net replacement rate of pension entitlements for average earners in Indonesia and other selected countries

Note: The net replacement rate is defined as the individual net pension entitlement divided by net preretirement earnings, taking account of personal income taxes and social security contributions paid by workers and pensioners.


StatLink © http://dx.doi.org/10.1787/888932938004

Figure 2.3.10. Longevity of retirement with constant retirement age at current levels in Indonesia and OECD countries, 2005-40

Notes: In the case of Indonesia, longevity of retirement is calculated with constant retirement at the age of 55. In the case of OECD average, longevity of retirement is calculated with constant retirement at the age of 65.

Source: UN Population Division of the Department of Economic and Social Affairs, World Population Prospects: The 2010 Revision.

StatLink © http://dx.doi.org/10.1787/888932938023
Sustainability and transparency of the pension system should be further enhanced

A fast ageing population will place strains on the fiscal sustainability of the pension system in the medium and long term. As the retirement age has not been adjusted to longer life expectancy, the longevity of retirement is projected to increase substantially. The result will be shorter contribution and longer benefit periods. Given a life expectancy of 70 years old and retirement at the age of 55, the length of time that an Indonesian can currently expect to spend in retirement is 15 years. If the retirement age remains at current levels, then the time spent in retirement will increase to over 20 years by 2040 (Figure 2.3.10). The retirement age needs to be increased to reflect improving life expectancy and support the pension system's fiscal sustainability, while possibly widening its coverage and providing adequate benefits.

The transparency and the quality of the different pension schemes’ accounting standards are inadequate. The civil service benefit fund supplies no accurate, transparent information as to its financial status and the pay-as-you-go accounting practice it applies is not in line with international accounting principles. Although the Jamsostek fund has improved its management practices by starting to publish annual financial statements, there is a real need for further disclosure of information relating to participants’ benefits. Moreover, Indonesia’s pension fund asset growth is hampered by the lack of management oversight and the poor transparency of the mandatory pension plans (Muliati, 2013). The regulation and supervision of mandatory pension funds should be developed along the lines of the Ministry of Finance’s strict regulation of private pension funds to improve transparency and governance. It is also important to ensure consistency in funding and prudential requirements and enhance accounting practices (OECD, 2012b).

In response to the 1997-98 Asian financial crisis and its dire social consequences, Indonesia amended its constitution to require the establishment of a national system of social protection. The National Social Security (SJSN) Law, which was enacted in 2004, furnished the blueprint for a comprehensive system of social protection that would cover all Indonesians. The SJSN Law envisaged five national social security programmes, including pensions, that would be funded through workers’ contributions and would provide the same benefits for all under the management of social security administrative bodies (BPJSSs) (OECD, 2013a).

New law paves way for separately administered transparent, sustainable pension system

Mindful of the situation, the government has taken a major step towards actual implementation of the comprehensive system of social protection, with a law enacted at the end of 2011 providing for the creation of social security administrative bodies. One such body was to be BPJS Employment (BPJS Ketenagakerjaan) that would administer pension as well as occupational health and safety benefits, old-age pensions, and death-related programmes. The law also mandated that BPJS Employment would be a public legal entity managed as a trust fund on a non-profit, compulsory-participation basis. It is scheduled to start providing SJSN employment programmes in 2015.

Reform of the new pension system under the terms of the BPJS law will generally improve governance, management and supervision. The BPJSSs themselves will be governed by Boards of Commissioners, comprising government, employee and employer representatives, and Boards of Directors, also made up of professional members (Muliati, 2013).
The BPJS Law establishes important safeguards by separating BPJS assets from social security fund assets. BPJSs are to be monitored both internally by the Board of Commissioners and an internal audit department and externally by the National Social Security Council (DJSN), the new Financial Services Authority (OJK), and the State Financial Audit Board (BPK). The BPJSs will be responsible not only for registering participants and collecting contributions, but also for keeping beneficiaries informed about the status of their savings and applying sanctions in the event of non-compliance.

Although the BPJS' regulatory structure and design are still to be decided in detail and yet to be implemented, some issues will need to be addressed, e.g. the collection of contributions from micro-enterprises, the organisational capacity needed to transform the Jamsostek fund into BPJS Employment, and the issuance of identification numbers needed for registration. Furthermore, the contribution rates and benefits of the new national pension programme administered by BPJS Employment will need to be designed with care so that it addresses effectively such considerations as old age security, financial sustainability, impacts on the labour market, and the future viability of private pension programmes.

Box 2.3.3. Linking pensions to life expectancy: Examples from OECD countries

Notional defined contribution (NDC) pension systems link pensions to life expectancy by assigning contributors' payments to an individual notional account. Although the system is still financed by pay-as-you-go contributions, the future pension payment flow on retirement adjusts to current life expectancy. The objective of NDC schemes is to ensure financial sustainability through pension payments from a given notional capital account which decrease if life expectancy lengthens.

Some OECD countries – Italy, Norway, Poland and Sweden – have already introduced NDC pension systems, albeit with different characteristics.

In Italy, the conversion rate of notional capital to pension benefits depends on the age of retirement, with values determined according to a formula based on actuarial equivalence. Poland and Sweden both apply an annuity divisor. In Poland it is linked to average life expectancy on retirement and individual retirement, while Sweden takes contemporaneous life expectancy based on unisex mortality rates in the previous five years.

Regarding the valorisation of notional accounts, contributions are uprated in line with the five-year moving average of nominal GDP growth in Italy, with the real growth of the wage bill in Poland, and with earnings growth in Sweden.

Annex. Strengthen the investment climate by simplifying business procedures

Important as they are, the reform policies discussed in this country note will come into their own only if they are carried out against the backdrop of a vigorous, attractive business environment.

In recent years, one of Indonesia’s overriding priorities has been to improve the country’s investment climate in order to attract more foreign and domestic investors. It is beyond doubt that Indonesia has been mostly successful in its goal of the country appealing to investors. According to the Investment Co-ordinating Board of the Republic of Indonesia (Badan Koordinasi Penanaman Modal [BKPM]), foreign direct investment (FDI) almost doubled between 2007 and 2011 when it reached USD 20 billion. In parallel, the credit rating agencies, Fitch Ratings and Moody’s, uprated Indonesia to investment grade status.

The main measures the Indonesian government has taken to improve the investment climate and distribute investment more evenly across the country’s different regions are as follows:

- simplify business procedures,
- improve investment-related laws and regulations,
- develop a national logistics system,
- enhance the information system for export and import processes,
- develop Special Economic Zones.

The Indonesian government has also already put together a package of incentives in the form of tax allowances and holidays for the business sectors it considers strategically important to economic growth and competitiveness.

However, the single greatest hindrance to improving the investment climate is cumbersome business procedures. They must be improved. The World Bank (2013a) ranks Indonesia 128th out of 185 countries for ease of doing business. Even more worrying is the fact that the country is further still down the rankings – 166th – for ease of starting a business. It takes 9 procedures and 47 days (Figure 2.3.A1).

To ease business procedures, the government has opened one-stop-shops throughout the country to provide a single port of call for investment licence formalities at both district and provincial levels. By June 2013 there were 468. However, an outstanding challenge is to put in place a standardised procedure and services for one-stop-shops themselves and to make the licensing process and fees transparent. The licensing process has been improved by an online tracking system for investment licensing introduced in 2012 by the Investment Co-ordinating Board. There are plans to implement the system in ten provincial and ten district one-stop-shops by the end of 2013.
Figure 2.3.A1. Number of days and procedures needed to start a business in Indonesia and other Southeast Asian countries


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Notes

1. The programme did not only improve coverage with some 2.1 million children benefitting from the scholarship by February 1999. Sparrow (2004) also found that it increased the probability of children attending school in the previous week by 1.5 percentage points and reduced the incidence of child labour from 14% to 10%.

2. The overall coverage of the BSM programme is 3% of enrolled students. Only around half of all BSM scholarships are distributed to the poorest 40% per cent of households. The rest benefit middle-class and better-off households in the top 60% (World Bank, 2012b).

3. The BSM programme consists of ten largely independent scholarship programmes with responsibilities and budgets delineated by type and level of education (World Bank, 2012b).

4. As the values of BSM scholarships are fixed in nominal terms from year to year, they do not keep pace with yearly price inflation. Between 2003 and 2009, nominal education costs rose at yearly rates of over 27% in primary education, 18% in junior secondary schools, and 13% at senior secondary level, with real education expenditure mounting much faster for poor than for non-poor households (World Bank, 2012b).

5. Education expenditure rises most steeply when pupils move from one education level to the next one. Expenses are always highest at the beginning of the registration period. As a result drop-out rates are highest during transitions between different levels of education. Nevertheless, owing to design issues and administrative difficulties, the BSM programme does not distribute scholarships to students in the final grades of any schooling level (the sixth year for elementary and the last semester of the third year for junior and senior secondary) (World Bank, 2012b).

6. The early withdrawal rule allows participants to withdraw their accumulated pension benefit after five or more years of service (Muliati, 2013).

7. The net replacement rate is defined as the individual net pension entitlement divided by net preretirement earnings, taking account of personal income taxes and social security contributions paid by workers and pensioners.

8. The administrators of the social insurance programmes for civil servants and military and police personnel (PT Taspen and PT Asabri) will be only transformed later, but prior to 2029, as the integration of these programmes into the national social security system require more time (Muliati, 2013).
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