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Reforming The Civil Service Pension and Tabungan Hari Tua (THT) Programs

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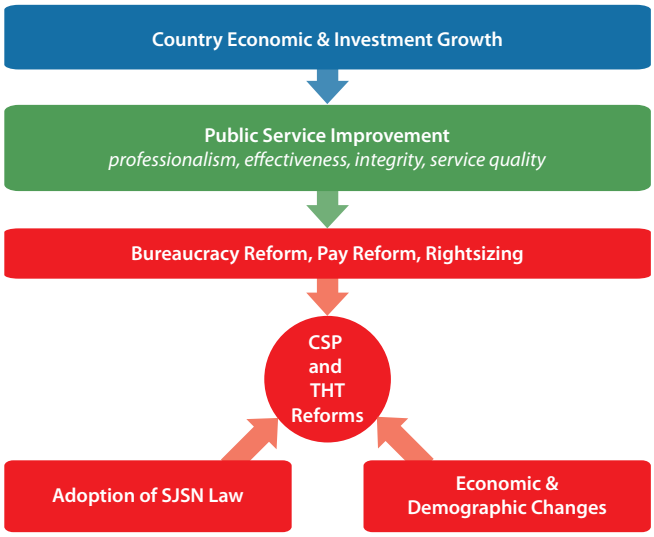
Background

Indonesia's civil service pension program (CSP) and endowment savings program (*Tabungan Hari Tua*, THT) are stand-alone retirement programs, distinct from retirement income programs covering other segments of the labor force. The CSP program provides civil servants with a lifetime annuity following retirement and is fully funded by the government through the annual budget. The THT program provides lump-sum benefits at retirement as well as pre- and post-retirement death benefits and is supposed to be fully funded by employee contributions.

However, the current programs, which date back to 1969, reflect obsolete objectives and are inconsistent with current Indonesian administrative reforms. Both the CSP and THT programs do provide some financial security to civil servants and their dependents throughout their retirement. Over time, internal changes in the civil service such as reformed career patterns and remuneration policies, as well as external causes like increases in Indonesian longevity mean the programs no longer meet important, basic objectives for any retirement scheme, such as fairness, adequacy, affordability, sustainability, and efficiency.



Proper actuarial valuations must be carried out diligently and transparently to estimate and disclose the cost of the CSP and THT programs for civil servants. Reliable data and commonly recognized and accepted methodology and assumptions must be used for the actuarial valuation of CSP and THT programs.

The political and economic environments of Indonesia have changed dramatically since 1969. The Indonesian economy has grown and continues to grow rapidly each year. Indonesia is now a lower-middle income country with an expanding middle class. As a result, the types of services citizens expect from the government have changed. This requires a better educated and more professional civil service work force.

The CSP and THT programs would benefit from a major overhaul to adapt to current and future economic and demographic conditions, the new environment created by the adoption of National Social Security System (SJSN) Law in October 2004, ongoing bureaucracy and pay reforms in the civil service and the increasing importance of sub-national government. This combination of demographic changes, civil service reforms and the central government's decentralization initiatives pose significant challenges to the sustainability and effectiveness of the current pension schemes. Many governments are reviewing their benefit programs to control and mitigate risks through reforms of the pension design and delivery systems. Indonesia needs to do the same.

In fact, the Government of Indonesia is currently reviewing and analyzing the design and financing of its CSP and THT programs. But to make informed decisions, the GOI needs better knowledge of the factors

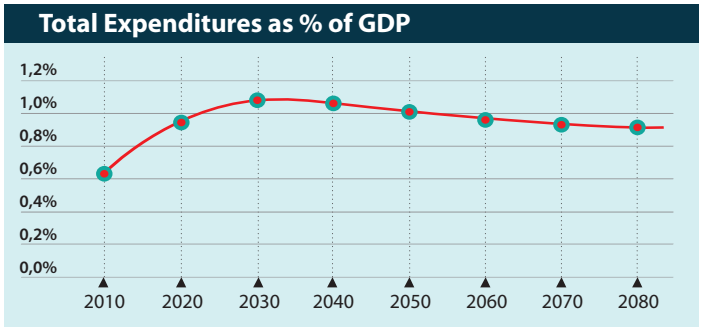
driving pension costs and the financial impact of changes in system design. In addition, upcoming changes in accounting rules will require the GOI to more accurately measure and disclose the accounting expense and liabilities of its pension programs.

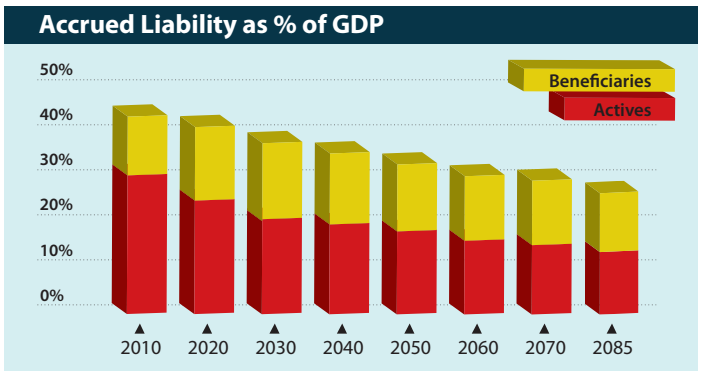
Facts about the Current CSP Program

The current civil service pension program provides lifetime annuities equal to 2.5% of final base pay for each year of service to a maximum of 75%. Despite expected increases in expenditures over the next 15 years, the civil service pension program appears to be fiscally sustainable and the cost is low by international standards. Expenditures as a percent of GDP will increase over the next 15 years due to a temporary surge in retirements but then they will decline and stabilize. The accrued liability is about 44% of GDP today and declines steadily over time due to rapid GDP growth relative to wage increases. The size of the accrued liability should not be of concern since it declines over time and the annual costs of the program are affordable.

Despite the favorable financial outlook, there are a few major design and equity issues surrounding the current pension program:

- **No credit is given for service over 30 years** although many civil servants will have more than 30 years of service at retirement, particularly if retirement ages are increased in the future.





Myth about civil service pension (CSP) program…
CSP program is too expensive and its cost needs to be reduced

Fact is…
CSP program is affordable and fiscally sustainable but it provides highly inadequate benefits to mid-level and senior civil servants when they retire

- **Pension benefits are indexed to the Presidential matrix (wages), rather than to inflation, making the program more expensive while constraining policy options.** Normally, pension benefit increases are tied to inflation in order to maintain the purchasing power of pensions. Pensioners normally to not share in the productivity gains of the active workforce.

- **The pension payable is calculated using final base pay, which is only a small percent of the total take-home pay received by civil servants, especially for mid-level to senior officials.** Consequently, the pension benefits received by mid to high level officials can be highly inadequate compared to the total compensation they were receiving prior to retirement.

- **Final base pay is used to calculate benefits under the current programs rather than average pay for all years of a worker's career.** Final pay is an inappropriate basis for calculating benefits because it is not representative of pay over the worker's entire career. Today, many civil servants get promoted near retirement and pension benefits become based on an artificially increased salary.

The CSP program needs to be reformed to create a more equitable system. It is possible to restructure the current program to give higher and more equitable benefits at the same cost as the current program. Fiscal space can be created by gradually increasing retirement ages to reflect Indonesians' increased life expectancy and the fact that civil servants as a group are healthier than the population as a whole, and by indexing pensions to inflation rather than to the increase in civil service wages. These changes alone reduce plan liabilities and expenditures by half. These savings can then be used to move to a plan based on total indexed career average pay that gives credit for up to 40 years of service.

Facts about Current THT Program

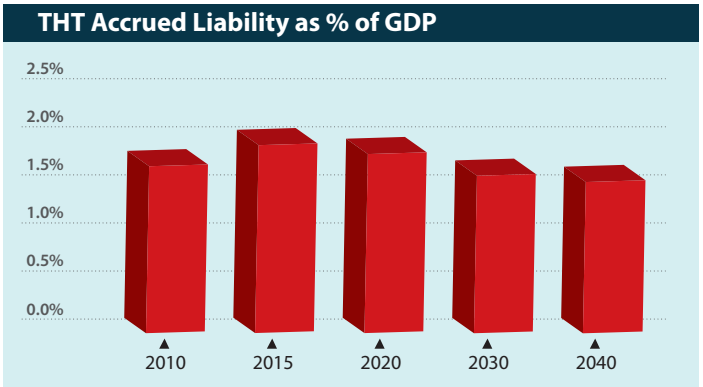
The THT program is separate and distinct from the current pension program; however, it involves the same participants and competes with it for fiscal space. The program provides a lump-sum benefit at retirement and both pre and post-retirement death benefits. As fiscal resources are limited, the allocation of post-retirement benefits between lump sums and income protection during retirement is a strategic decision in terms of benefit adequacy, liquidity needs and affordability.

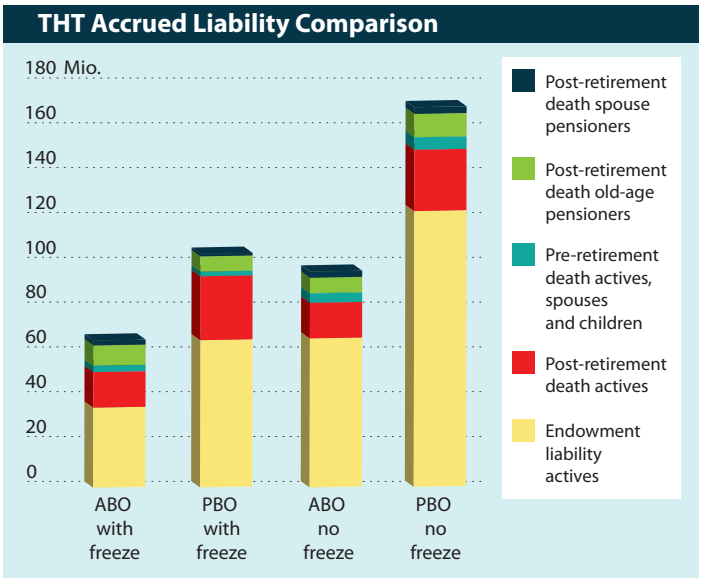
The THT program appears to be a defined contribution program because it is funded by a 3.25% employee contribution rate. However, it is in reality a defined benefit scheme because benefits at retirement are based on a formula and not on the accumulated employee contributions. Furthermore, the THT contribution rate is not based on actuarial calculations of the required funding rate. The required contribution rate to fully fund the program is more than double the current 3.25% rate. The THT program has been underfunded for many years and the current structure assures that the unfunded liability will continue to increase each year. The size of the unfunded liability is expected to continue increasing as a % of GDP for the next 5-10 years.

The THT program shares similar shortcomings to the pension program since the benefits are calculated based on final base pay. The 5% to 20% per year basic pay increases over the past five years have significantly increased the THT liability, since both endowment and post-retirement death benefits are based on basic pay at retirement.

The improper funding has already necessitated a benefit freeze in 2001 and in recent years the government has been regularly making special contributions from the annual budget to the program even though it is supposed to be fully funded by employee contributions only.

THT program is not financially stable. Its unfunded liabilities are higher than has been previously reported and will create an ever increasing burden for the State budget. Therefore, THT program needs to be restructured to maintain the sustainability of the program and minimize a potential financial impact on the government budget.





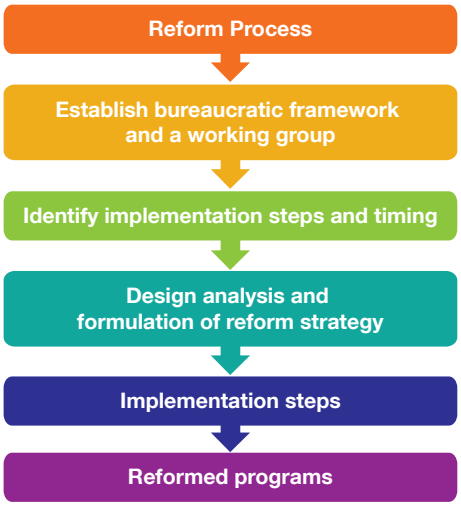
There is also an issue with undervalued liabilities. The interest rate and salary increase assumptions currently used to calculate plan liabilities are inconsistent with recent experience and the current macroeconomic environment. In addition, the post-retirement death benefit liability for current and future retirees is significant and much higher than has been previously reported. About half of total THT liabilities are for endowment benefits and the other half are for death benefits.

If the GOI decides to use total indexed career average pay when calculating CSP benefits, it would be logical and consistent to use the same pay for the THT benefit as well. However, this would significantly increase THT endowment and death benefit liabilities.

The current THT program will never be financially stable as currently designed and is not financially sustainable without significant annual government special contributions. Either the benefit should be fixed and contributions actuarially determined or the contribution rate should be fixed and the benefit should be the accumulated value of the contributions.

REFORM GOALS

- Support HR policy by linking benefits to total career average pay
- Provide equitable benefits to all civil servants at all pay levels
- Provide balance between monthly income and liquidity
- Increase retirement ages and link to life expectancy increases
- Index benefits to inflation rather than wages
- Costs within fiscal envelope for civil servant total compensation
- Fiscally sustainable in short and long-term
- Fairly allocate risks between civil servants and government
- Equitable among generations of civil servants and taxpayers
- Funding policy tied to macroeconomic goals
- Implement international accounting standards
- Allocate accounting expense to sub-national level
- Efficient and accurate program administration



Why Reform is Necessary

CSP and THT reform is necessary to support the strategic orientation of Indonesia's bureaucracy and pay reforms, assure consistency with overall HR strategy for civil servants, and eventually, assure integration with the National Social Security System (SJSN) programs, although this will not happen until 2029. The CSP and THT programs should be harmonized with the SJSN programs in a way that allows the objectives set for CSP and THT programs to be achieved in the aggregate by the combination of these programs and the SJSN programs. When defining reform options, the Government must take into account political economy, technical, administrative, legacy and transition issues and reform goals.

Who Needs to be Involved

It is necessary to have policy dialogue among relevant government offices and with a working group comprising government officials representing key stakeholders, including, but not limited to, the Vice President's Office, Ministry of Finance (MOF), State Minister for State Apparatus and Bureaucracy Reform (Kemenpan), Civil Service Agency (BKN), and the State Administrative Institution (LAN).

Support Provided by the World Bank so far.....

The World Bank has run capacity building workshops, conducted financial analysis of the potential future costs and sustainability of the existing CSP and THT programs, analyzed a range of reform options and presented the results to various government officials. The results of our analysis have been documented in an actuarial report and in an executive summary. These documents can serve as a basis for discussion of reform options. However, senior government officials must take a more active role to move the process forward.

This Policy Brief was produced as part of the World Bank inputs to the Government of Indonesia on the Civil Service Pension Reform and is the first in a series of Policy Briefs on civil service pension program reform issue. This brief was prepared by the Poverty–Social Protection unit of the World Bank Office Jakarta and written by Mitchell Wiener (Senior Social Protection Specialist, EASHS) and Iene Muliati (Social Protection Specialist, EASHS). This brief is based on the Executive Summary "Civil Service Retirement Programs for a New Era", the 2011 Actuarial Consultant Report by Yves Guérard for the World Bank and on various consultations with key representatives from the Government of Indonesia. The authors would like to thank Theo Thomas, Staffan Synnerstorm, Erwin Ariadharma (WB-Jakarta-based Public Sector Management team) and Yves Guérard (Actuarial Consultant) for comment and discussion.

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