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In the past three years, the Government of Indonesia has pursued an aggressive minimum wage policy, sought to introduce wide-ranging new labor protection laws and, strengthened the union movement's voice in industrial relations. New safeguards regarding worker rights and more systematic regulation of minimum labor standards have created a much fairer environment for formal sector workers than in the past. However, many of the new regulations seeking to protect workers go well beyond the affirmation of minimum standards and basic rights. They now threaten modern sector employment growth, one of the main channels through which wages and productivity can grow and support widespread improvement in living standards for working people. While improved protection for labor standards and labor rights is important, the pendulum has swung too far towards government regulation in the modern sector. Many of the new laws are not necessarily pro-labor, when viewed from the interests of all working people. Not only does the legislation focus mainly on the interests of a minority of workers in the modern sector, even these workers stand to gain from such policies only in the short-term. This swing in policy undermines employment prospects at the expense of most Indonesian workers. Some new government policies ignore market realities, promote a more confrontational environment between formal sector workers and management, and implicitly ignore the interests of a much larger group of informal sector workers and those who seek to move out of very low productivity occupations in agriculture, services and trade.

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Technical Report

Labor Policy and Employment Creation: An Emerging Crisis?

By Chris Manning

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LABOR POLICY AND EMPLOYMENT CREATION: AN EMERGING CRISIS?

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PREFACE

This report has its origins in an emerging contradiction between the faltering capacity of the Indonesian economy to create new jobs, on the one hand, and rising pressures to intervene directly in the labor market to protect modern sector workers, on the other, in the post-crisis period. The dilemma has arisen principally from a combination of pro-labor government policies and a freer and more active union movement, which emerged in the new political setting following the economic crisis of 1997-98, and the downfall of the New Order regime. Economists at Bappenas supported by long-term consultants working for PEG-USAID in Jakarta saw this as an important issue for macro economic management and social policy in the first decade of the new millennium. The author of this report was subsequently commissioned to advise Bappenas on employment issues and labor policy over a sixteen-month period in 2001 and 2002.

The work was conducted at a time of considerable flux in labor policy in Indonesia. New drafts of the Manpower Protection and Industrial Relations Acts had been prepared in 2000, and were being debated in parliament and among stakeholders during the consultancy (the Manpower Protection Act was subsequently passed in early 2003 after the completion of this report). A new Trade Union Act had just been passed by parliament in 2000. Responsibility for minimum wage policy had been turned over to the regions in January 2001. The role of the Central Government, which had hitherto been dominant in wage policy formulation, was not yet clear.

Dr. Bambang Widianto, Director of the Manpower Bureau in Bappenas, directed the research effort with the aim of achieving greater consistency between labor policy, the prerogative of the Ministry of Manpower and Transmigration, on the one hand, and employment policy initiatives in the economics and line ministries, on the other. Two major areas of policy concern were addressed in this work at Bappenas:

- relationships between government labor regulations and employment, and potential improvements in the regulatory environment to support the creation of better jobs

- the interaction between new legislation in labor protection and industrial relations, and their affect on employment, productivity and earnings, given existing labor market conditions and structures

The main product of the research and policy discussions is to be a White Paper on Employment and Labor Policy issued by Bappenas in 2003. It is anticipated that the White Paper will be distributed widely and debated within government and among stakeholders. This technical paper provides an input into the drafting of the White paper.

Kelly Bird, supported by Bill Wallace (both PEG-USAID consultants at Bappenas in 2001-2002), played a central role in planning the research effort, in collaboration with Dr. Widianto and other Bappenas staff. Kelly Bird helped design and supervise an important study of the impact of minimum wages on employment, undertaken by the SMERU research institute in 2000-2001. He provided valuable moral and intellectual support for the work undertaken by this consultant and contributed directly to several of the tables presented in the chapter on minimum wage policy.

The author of the report drew on a variety of sources of information. In addition to the minimum wages study, the SMERU institute also undertook a survey of industrial relations laws and practice in private companies in major industrial areas in Java in 2001-2002. Researchers from the Economics Faculty of Universitas Parahyangan carried out a study on governance in the minimum wage setting process in West Java based on focus group discussions with stakeholders. A short-term consultant, Don Zimmerman, completed a valuable survey of industrial relations law in Indonesia, viewed in international perspective. Two renowned labor economists, John Pencavel and Alejandro Cox-Edwards, contributed ideas on international developments in labor regulation and industrial relations of relevance to Indonesia at a seminar held in March 2002. The Central Board of Statistics, CBS, provided valuable data and advice on interpretation of secondary statistics. Senior staff at the Coordinating Ministry of Economic Affairs and the Ministry of Manpower also provided important insights and, together with representatives of the Ministry of Trade and Industry, participated in a dialogue with senior officials from local government in major industrial centers on minimum wages in September 2002. Several discussions were also held with ILO representatives. Preliminary findings of the various research projects were discussed at a number of seminars held at in Jakarta and Bandung.

The author is grateful for the support of these institutions and individuals. Too many people contributed to the material presented in the report to be mentioned individually here. However special thanks are due to Pak Sukarno from Bappenas, Pak Stu Callison (who helped put the report together) and the PEG-USAID team (particularly Mrs. Siti Risrijadi for her administrative help and guidance), Sudarno Sumarto and Asep Suryahadi from SMERU, and Uzair Suhaimi from CBS. Working with the Bappenas team, led by Pak Bambang Widianto, and involving Kelly Bird and Bill Wallace, was a great learning experience, stimulating and enjoyable. It is hoped that the report will make a small contribution to helping think about policy and direct future research in a much-neglected field in Indonesia. Careful analysis and policy formulation in this field, where social and economic policy are often seemingly at odds with one another, is of great importance for the welfare of millions of Indonesian workers and families.

CHAPTER I

INTRODUCTION

LABOR FRIENDLY POLICIES: A CHALLENGE IN THE POST SOEHARTO-ERA

Indonesia is in the process of a major shift in labor policies, which began with the downfall of Soeharto and the subsequent granting of long awaited freedoms to trade union organizations. The momentum for reform speeded up in 2002. Following large increases in minimum wages earlier in the year, a fierce public debate raged about the new labor laws before the Parliament in June-September.[1] Business representatives and the newly formed crisis management council argued that on-going and proposed labor protection and industrial relations laws were promoting conflict and could cripple private enterprise in some sectors. The changes were beginning to squeeze profit margins and contribute to layoffs, higher unemployment and capital flight, in an already unfavorable economic environment.

In contrast, union leaders, human rights spokespersons and spokespersons for some government ministries and international agencies strongly supported past increases in minimum wages and the new draft laws. They argued that the employers were overstating the impact of new law, and that extensive protection for workers was necessary for both human rights and labor welfare, redressing the inequities from the past that had been too pro-business.[2]

What are the key issues in the debate and why have different approaches to labor policy emerged so starkly at this particular time in Indonesia's recovery program? Here, we start by summarizing some of the key matters of contention, and then seek to place them in a broader context of labor and employment policies in Indonesia during the Soeharto period, and in the context of what we term the 'East Asian' model of development.

Searching for a Balance in Labor Policy: A Summary of the Argument

This report examines these arguments in the context of labor market changes that have occurred in the recent past, and especially since the crisis. In the past three years, the government has pursued an aggressive minimum wage policy, sought to introduce wide-ranging new labor protection laws and strengthen the union movement's voice in industrial relations. New safeguards regarding worker rights and more systematic regulation of minimum labor standards created a much fairer environment for formal sector workers than in the past.

However, the overall thrust of many of the new regulations seeking to protect workers goes well beyond the affirmation of minimum standards and basic rights. It now threatens modern sector employment growth, one of the main channels through which wages and productivity can grow and support widespread improvement in living standards for working people. In a nutshell, we argue that while improved protection is important for improved labor standards and labor rights, the pendulum has swung too far towards government regulation in the modern sector. We suggest that many of the new laws are not necessarily pro-labor, when viewed from the interests of all working people. Not only does the legislation focus mainly on the interests of a minority of workers in the modern sector. Even these workers stand to gain from such policies only in the short-term.

This swing in policy undermines employment prospects at the expense of most Indonesian workers. Some new government policies support both improved productivity and labor standards at the same time. But others blithely ignore market realities and have promoted a more confrontational environment between workers and management.

The support for wide-ranging regulation is partly driven by the interests of some politicians, officials and labor leaders. To a considerable extent, however, it derives from a too narrow focus on the interests of formal sector workers currently with jobs, especially in relatively protected situations in the modern sector. In so doing it implicitly ignores the interests of a much larger group of informal sector workers and those who seek to move out of very low productivity occupations in agriculture, services and trade. An important goal of this report is to encourage government, unions and business to think about labor policy more broadly and to link it to immediate and longer-term strategies for improving living standards and eradicating poverty.

Foundations of the New Labor Policy: Responding the New Order Legacy

Indonesia has long had an extensive collection of labor laws and regulations aimed at protecting wage employees (Manning, 2002). But this legislation was not implemented widely even in the modern sector, and breaches of the labor laws were commonplace. In practice, labor policy was pro-business and conducive to output and investment growth, and to rapid expansion of modern sector employment for much of the New Order period. All this has changed with the recent liberalization of trade union representation (Basic Law 21, 2000), and a more active and stronger 'pro-labor' stance from the Ministry of Manpower and Transmigration (MOMT).[3]

Why the dramatic turnaround? Both the reality and perceptions of labor outcomes have contributed to the call for more active labor policies in Indonesia since the demise of the New Order government.

- First, it has been a reaction to the New Order policies, which undermined basic labor rights both through official controls over trade unions and *de facto* support for employers in resolution of industrial disputes.
- Second, partly in connection with the denial of labor rights, it is now widely believed that rapid economic growth and manufacturing export orientation under Soeharto failed to improve labor standards, or achieved too little in this area. It is now commonly observed that wages and working conditions improved little and often lagged behind those in neighboring countries.

Denial of Labor Rights. The first proposition cannot be doubted. Many Indonesian workers in the formal sector suffered greatly from lack of representation and extra-legal actions of security forces against union leaders and labor protestors. As in politics, the institutional framework of industrial relations did not guarantee basic rights. In practice, the resolution of labor disputes was weighted heavily in favor of employers, even though much of the legislation was pro-labor. In this, Indonesia followed the East Asian model of 'labor repression', and was much closer to its more extreme form as practiced in South Korea than to its more benign forms in Malaysia, Singapore or Thailand (Deyo, 1989; Ogle, 1990).

Employment Growth: Based on Wage Repression? The issue of wages and working conditions is more complicated. The core model of economic development in East Asia (which Indonesia followed from the early years of the Soeharto period, and especially since liberalization, *deregulasi*, in the mid 1980s) rested on promotion of rapid growth in output, employment and productivity, through two principal mechanisms.

- *First*, the promotion of labor-intensive manufacturing exports, and later more skill and technology-intensive products (often but by no means exclusively associated with large inflows of foreign direct investment).
- The *second* channel was through investments in human capital, both outside and within the work place. Improvement in living standards were achieved through providing 'surplus' labor from low productivity sectors with better jobs in terms of labor incomes and productivity, while at the same time broadening access to school and other sources of human capital improvement (Cortazar, Lustig and Sabot, 1998).

From the standpoint of improved living standards among most working class households, Indonesia was successful in pursuing this East Asian model, contrary to the perception of many observers both within and outside Indonesia. As in other HPAEs (High Performing Asian Economies), a substantial share of the work force was absorbed into more productive activities outside agriculture—especially in exported-oriented manufacturing from the mid 1980s, average incomes and wages rose, and poverty fell substantially.[4]

Why have so many have doubted, or discounted, the positive effect of rapid economic growth and export-orientation on the welfare of working people, to the extent that the government now feels it necessary to greatly extend labor protection and raise minimum wages? Several factors seem to be important and will be examined in detail in this report.

First, there is confusion regarding the causal relationships between **economic growth and government regulations**, on the one hand, and **labor rights, standards and welfare** on the other. In Chapter II, and Chapter III dealing with the Indonesian case, we demonstrate how rapid economic growth has a direct, positive impact on labor welfare in general. Growth also contributes to improvements in labor standards, such as a shorter working week, less manual and degrading work especially in the informal sector, although often with a greater time lag. But growth may have little direct impact on labor rights. Like in Korea or Taiwan, average incomes and wages rose rapidly in Indonesia in the first half of the 1990s, tight controls over trade unions notwithstanding (Galenson, 1992; Hadiz, 1997; Manning, 1998). Labor regulations, on the other hand, support labor welfare and labor standards; but in less industrialized countries where there are large informal sectors, they typically extend only to a small proportion of the work force. The coverage of regulations remain limited, moreover, under conditions of slow economic growth and slow (or even declining) employment expansion in the formal sector, a state of affairs that Indonesia has experienced since 1997.

Second, what about the relationship between **labor rights** on the one hand, and **labor standards and welfare** on the other? As we shall see in Chapter IV, the guarantee of labor rights is not a sufficient nor even a necessary condition for improvements in labor standards and welfare. Conversely, limitations on labor rights do not necessarily affect labor welfare or standards unfavorably, *in general*, even though individual workers and labor organizations are heavily penalized by these restrictions. Supporting both free trade unions and respect for labor rights are important goals of development, but so also is promoting increased labor income.

Third, there is a strong suspicion in Indonesia, especially among proponents of a stronger civil society, that market forces contribute to unjust outcomes for labor and a belief that government protective legislation can help overcome this problem. This suspicion is related to several factors:

- the relative strength of capital compared with labor in an economy where there is abundant 'surplus' labor, or workers willing to take employment at below a minimum standard of wages and under exploitative working conditions (long hours of work, unhealthy working environments, etc.).[5]
- glaring disparities in the labor market, as pointed out by labor leaders and some policy makers (for example, between the wages of unskilled workers, on the one hand, and highly skilled and professional workers on the other)
- low wage levels, either compared with international standards, or according to some pre-determined criteria of minimum needs

All of these criticisms have some truth. But from a standpoint of the wider social good, and especially improvements in living standards among the poor, none can justify the extent of regulation now proposed by the government and strongly supported by many unionists. Employers, of course, represent their interests, often under the false guise of promoting social advantage, as Adam Smith argued some two centuries ago. Their arguments in the name of the social good need to be examined carefully. However, we also contend in this report that the same rigor needs be applied to arguments advanced by labor representatives and politicians ostensibly in the interests of working class families. In particular, in Chapters IV and V, it is maintained that some regulations of labor standards penalize working class households and contribute to greater industrial conflict, especially under conditions of greater trade union freedom than existed in the New Order period. At the same time, we argue that it is no easy task to ‘get the balance right’ from a standpoint of protecting minimum labor standards, yet at the same time promoting output, exports and investment, in the interest of creating ‘better’ jobs.

Regarding disparities, unfortunately some increasing inequality in labor earnings is unavoidable in an open market economy. We argue, however, that these disparities are best tackled by fiscal policies rather than labor regulation, which often tends to dampen incentives for improving wages and productivity and penalizes those in the informal sector who are seeking ‘better’ jobs. Finally, for those at the bottom of the income rung in Indonesia, it is argued that low labor standards are mainly a sad reflection of the country’s early stage of economic development, rather than a product of labor repression that is unique to Indonesia’s social and political history or current power relationships.

Plan of the Report

These and several other issues related to labor policy will be examined in this report. The **second chapter** discusses how labor markets work, especially in countries at a similar stage of development as Indonesia. The chapter stresses the interconnections between different parts or segments of the work force, driven by large gaps in productivity and earnings across sectors. For example, policies that help certain groups of workers in the modern sector can have unfavorable effects in other parts of the labor market, especially in the informal sector. In this chapter, we also look briefly at cross-country experience on the labor market effects of globalization, bearing in mind that this is a key area of both national and international focus in Indonesia and elsewhere.

The subsequent three chapters deal with labor market trends and policies in Indonesia, with a focus on the crisis and recovery period over the past five years. The **third chapter** deals with labor market structure and trends and examines growth in wages and productivity. It also covers several other indicators of labor market performance related to changing economic fortunes and policies. It is demonstrated that the main contrast with the pre-crisis period is the slow growth of modern sector employment, which augurs badly for improvements in labor welfare and productivity in the medium to longer term.

In the **fourth and fifth chapters**, we focus on labor policies and the industrial relations framework. Special attention is given to the impact of minimum wage policy, which has broader implications for employment and productivity and affects other areas of labor policy such as severance pay and industrial relations. As noted above, some the innovations in the labor law are well overdue. However, our general conclusion is that the current thrust of labor policy has already affected formal sector employment unfavorably. If continued, it runs the risk of seriously damaging employment prospects and improvements in living standards of many Indonesian workers, and potential workers, in the coming years.

CHAPTER II

LABOR MARKET DYNAMICS AND POLICIES IN THEORY AND PRACTICE: LESSONS FOR INDONESIA

Making the right labor market policy choices requires basic understanding of how labor markets work, analogous in many ways to other markets in a mixed economy. It is useful to think of demand and supply for labor, equilibrium and dis-equilibrium at given prices (wage rates) and quantities (employment) of labor deployed. In the case of Indonesia and many other densely populated, less developed countries, we can envisage a simplified operation of a 'dualistic' labor market structure, distinguishing between modern and traditional sectors. Adoption of this structure as a basic analytical device helps to focus on the main effects of globalization. It also assists one to evaluate the impact of trade unions and government regulation on labor market indicators, especially wages, employment and conditions of work.

We start with a discussion of the main elements of labor market behavior. The chapter then turns to the operation of dual labor markets and the notion of the 'turning point' related to stages of economic development. Later sections examine the impact of globalization, trade unions and government policies on labor market outcomes.

The Operation of Labor Markets: Some General Principles

The following general principles underlie the operation of labor markets:[6]

- **Labor Demand and Supply**. Forces of labor demand and supply jointly determine the wage rate (the price of labor), and employment (the quantity of labor deployed). Adjustments to changes in demand or supply conditions mainly depend on information flows and labor mobility, and on the flexibility of employment and wages.
    - *The demand for labor* is a 'derived demand' related to product market conditions. Wage and employment adjustments occur mainly in response to demand and supply changes in product markets, which flow on to the demand for factors of production, including labor. However, labor market structure and conditions can also have an independent influence on wages and employment.

      In competitive markets, the wage rate and amount of labor demanded by firms are determined by the (marginal) productivity of labor, the price of goods sold and hence the level of profits made by firms. Where employers make excess profits, workers can capture some of these ‘rents’ either individually or collectively and hence receive wages above those that they would gain in a perfectly competitive product market.

- *The supply of labor* is mainly determined by the demand for income on the part of wage earners, and labor supply decisions are often made in the context of joint decisions made by other household members. Aggregate labor supply in a region or a country is partly determined by the size of population as well as labor force participation rates, which vary most among young and older people and prime age females.
- *Labor mobility* across firms, industries and regions (and even countries) is crucial to a smoothly operating labor market. It is determined by access to information on alternative job opportunities, the cost of moving, wage flexibility and access to alternative jobs. Labor mobility is typically low where most recruitment takes place within firms (or regions).
- *Wage and employment flexibility* depend on the ability of firms to hire and fire workers at relatively low cost, and on their ability to adjust wages. Mobility depends on the ability of workers to move to new jobs, and be willing to accept wage adjustments in response to changes in conditions of labor demand or supply.

- **Equilibrium Wages and Employment**. In a perfectly flexible labor market, wages adjust to forces of labor demand to produce full employment. In practice, wages tend to be sticky (inflexible) downwards, employment adjusts with a lag to changes in labor demand, and workers are less than perfectly mobile. Unemployment is thus a feature of the adjustment process in local and national labor markets. Wages tend to be especially inflexible in the short-run—employees are reluctant to work at wages below their expectations (their 'reservation' wage) and employers adjust to changes in product demand with a lag. Unemployment can also result from the preferences of employers who choose to discriminate in favor of workers of a particular race, sex or region of origin.

The Operation of Labor Markets: Dualistic Patterns

The operation of labor markets in many developing countries, such as Indonesia, can be best understood through reference to a dualistic economy and employment structure. Misunderstandings of the dynamics of labor market adjustment in a dualistic or quasi-dualistic context are at the heart of some of the debates about labor processes and policy.

A dualistic structure of output and employment can be envisaged as consisting of a ‘traditional’ and a ‘modern’ sector.[7] This dualistic structure does not fit the Indonesian – or indeed any – situation precisely. Nevertheless, many empirical studies draw attention to the gap between technology and productivity in small, modern segments and the much larger traditional segments of the economy (in agriculture, small-industry and the informal sectors in developing countries)[8].

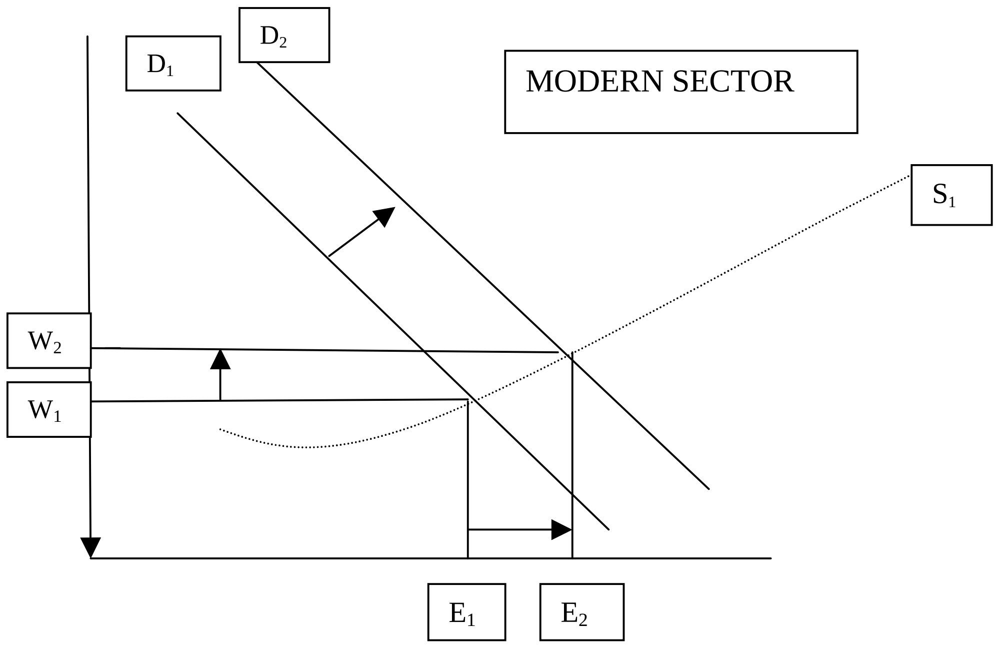
In a dualistic economy, the extent of 'labor surplus' is not manifested in unemployment. Rather it is marked by a crowding of workers into low productivity, traditional sector jobs.[9] In contrast to the situation in many developed countries, 'surplus' unskilled labor in these sectors tends to dwarf the number of unemployed.

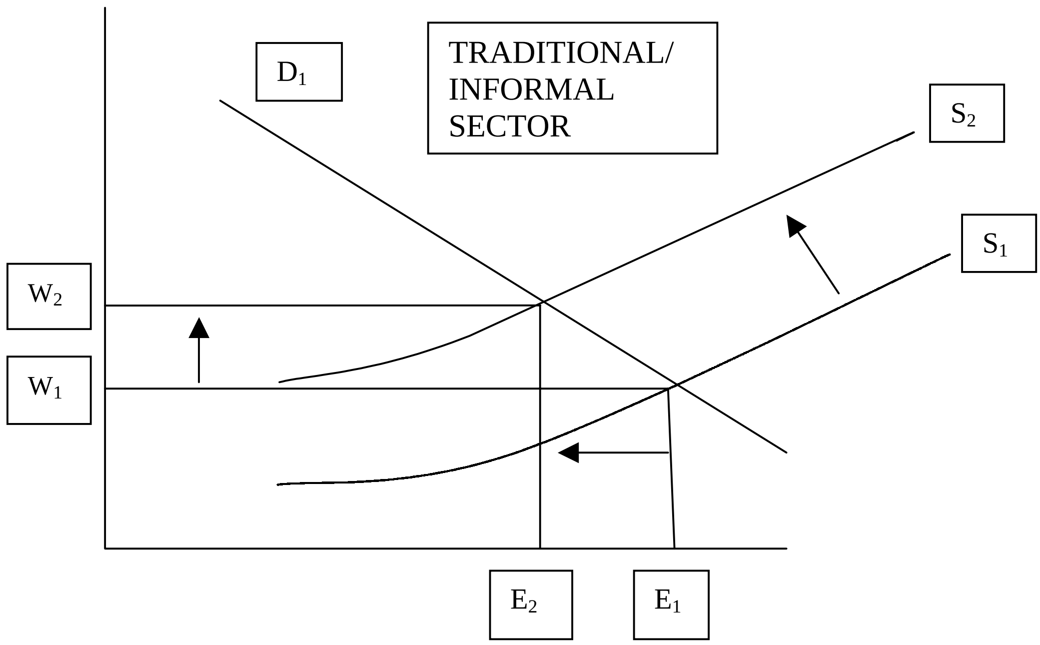
What are the dynamics of labor market adjustment in a dualistic economy? Three features are essential: 1) labor transfer out of low productivity traditional sectors, 2) the creation of better jobs in the modern sector, and 3) a transition from a dualistic to a more integrated labor market.

Labor transfer out of traditional sectors. Rapid absorption of 'surplus labor' into more productive modern sector jobs at constant wage rates, which are determined by earnings in the traditional sector, is the main feature of a 'virtuous' cycle of growth in of economic development in a dual economy. In a dual economy the transfer of low productivity workers out of the traditional sector and into the modern sector is central both to the process of capital accumulation and to improvements in living standards.[10] This occurs as a result of a wage rate premium in the modern sector, above wages in the traditional sectors, just sufficient to lure new workers into making the transition. The movement of workers out of overcrowded and low productivity, traditional-sector activities (often marked by high rates of under-employment) contributes to higher wages and output per worker in this sector. It plays a major part in narrowing the gap between traditional sector wages and productivity and those in the modern sector. However, slow growth of the modern sector will lock more traditional sector workers into low productivity jobs at low incomes and will deny them and their families a more secure existence.

The creation of 'better' jobs in the modern sector. The modern sector is the main (but not the only) source of what might be termed 'better' jobs—those that are both more productive and earn higher wages.[11] Even though **wage rates** may not be much higher than in traditional sectors, labor is utilized more intensively and employment and incomes tend to be more stable than in traditional sectors. Besides earning higher income and enjoying better working

FIGURE 2.1: WAGE AND EMPLOYMENT DYNAMICS AS THE MODERN SECTOR EXPANDS AND TRADITIONAL SECTOR CONTRACTS





conditions, modern sector workers have more opportunity to accumulate skills on the job and hence can also earn higher wages over their lifetime.

Labor Market Transition and the 'Turning Point'. Wages begin to rise in both the modern and traditional sectors only when the supply of workers in low productivity jobs in the traditional sector is exhausted. These processes are demonstrated in Figure 2.1. At this stage, modern sector employment growth acts as a stimulus for a 'tightening' labor market, pulling up wages in traditional sectors and contributing to accelerated improvements in general living standards.[12] This stage, termed the 'turning point' in the literature, signals the beginning of narrowing differentials in productivity and wages between modern and traditional sectors, and the creation of a more integrated labor market, similar to that described above.[13] The process of rapid movement of labor in to the modern sector leading to the turning point has been a feature of the somewhat unique development success story of the HPAEs (High Performing Asian Economies). The 'East Asian' model of rapid transfer of labor from traditional to modern sectors at constant (real) wage rates in the modern sector, is in essence a model of inter-generational transfer of income: the current generation makes sacrifices, the fruits of which are enjoyed increasingly by later generations, after labor markets begin to tighten (See Box 2.1).

BOX 2.1: LABOR MARKET TRANSITIONS IN EAST ASIA

The advent of the turning point when wages begin to rise across the board, in all sectors, came relatively early in the development process in small and integrated economies such as Singapore and Hong-Kong or Taiwan, and in very rapidly growing economies such as Korea and Taiwan. In the case of Korea, it is estimated that the turning point occurred some 15 years after comprehensive economic reforms were first introduced by Park Chung Hee in the early 1960s. The time period was probably less than a decade in Singapore, depending on how one defines the starting point.

It may take much longer, perhaps a generation or more, to achieve sustained growth in wages beyond the turning point in countries with relatively large populations and large traditional sectors, such as Bangladesh, Indonesia, India and China. This may make it harder to accept, politically, a development strategy that emphasizes modern sector employment growth as a basic strategy for improving living standards in the latter countries.

It is important to bear in mind that improvements in productivity in small-scale industry and agriculture are likely to play a very important, complementary, role in raising incomes in all labor surplus countries, including Indonesia. But expansion of SMEs, in particular, should not be viewed as an alternative to growth of the modern sector: the former played an essentially supporting role for growth in the modern sector in most of the HPAEs, especially in Northeast Asia, during the period of accelerated growth.

Sources: Bai (1987) and Manning (1995).

Thus, as the above discussion suggests, the appropriate benchmark from which to judge the adequacy of several (although not all) key labor indicators in the modern sector is the level of wages in traditional sectors. Contrary to the view of some observers, comparisons with international standards are not always relevant, especially if they are based on labor conditions in much more advanced economies (See Box 2.2). This applies especially to the level of wages, which is the single most important determinant of labor earnings and welfare. Driving a deep wedge between modern and traditional sectors by focusing on raising standards in the modern sector can lead to major social and economic disruption, and

BOX 2.2: MODERN SECTOR LABOR STANDARDS: WHAT IS THE APPROPRIATE BENCHMARK?

It is useful to describe wage (and productivity levels) in the modern sector in terms of their relationship to wages in traditional sectors. In the Indonesian debate, criticism of labor outcomes and calls for more intervention are often based on comparing wages and working conditions in the modern sector with some notional international or absolute standard. Foreign advocates of more intervention (some of whom unfortunately represent a 'hidden' protectionist agenda for their own countries) point to the parlous state of living conditions among industrial workers compared with industrial countries. Indonesian supporters of a more interventionist policy tend to focus on comparisons with neighboring countries, especially Thailand and Malaysia, which have much higher levels of per capita income.

While wages and working conditions in Indonesia are far from fitting (*layak*) from an international standpoint, these criticisms miss the main point for labor policy, which should have the goal of improving labor standards in general, rather than only for a small share of workers in the modern sector.

International comparisons can be useful, however, for policy formulation if they focus on the right variables. Comparisons of wage rates across countries make little sense unless they are related to other measures of economic advancement. Other indicators, such as unit labor cost that compares the ratio of wages to productivity, rather than their absolute values, are more useful. For example, one comparison of unit labor costs – the level of wages relative to productivity—found that because productivity levels are very low (especially in labor-intensive industries) in LDCs, the gap between DC and LDC unit labor costs was relatively small. In several East Asian cases (Malaysia and the Philippines), unit labor costs exceeded those in the USA in 1994 largely because of low productivity relative to wage costs.

There is an important policy message from these data. Governments need to seek ways to increase productivity first, in order to give business and labor room to bargain for higher wages. This is particularly relevant for labor policy in Indonesia in the *reformasi* period.

Source: Golub, (1999)

contribute to economic stagnation. Wage policies in Africa in the early post independence period and labor protection policies in many Latin American countries in recent times both illustrate this point vividly.[14]

Globalization and Labor Standards

The early models of the labor surplus economy were couched in terms of a closed economy, in which modern business mainly invested in goods of value either to other local producers, or to the large concentration of poorer consumers in the traditional economy. Later, the HPAEs showed that the main impetus to capital accumulation and employment growth in the modern sector, and associated improvements in living standards, can come from exports. Thus the HPAEs bypassed the problem of limited domestic purchasing power which worried earlier development practitioners (World Bank, 1993, 2000).

However, there has been increasing disquiet in recent years regarding engagement in the international economy through trade and investment, or in other words the impact of globalization on labor standards. Social researchers and NGOs, in particular, have pointed to a 'race to the bottom', drawing attention to how foreign investors exploit low wages in the poorest countries and divert investment and jobs away from higher income countries, thus dragging labor standards down.[15]

How accurate are these claims, and what is their relevance for Indonesia? Rama (2002) provides a comprehensive summary of the empirical research conducted on this subject, focusing on the relationship between the changing role of export orientation and role of FDI in national economies, on the one hand, and trends in wages and employment on the other. Although the conclusions are not always consistent from one study to another, the weight of evidence suggests that globalization tends to improve, rather than undermine, labor standards. The following conclusions emerge:

- *Wages*: Wages grew faster, and were significantly higher in the medium to longer-term, in more 'globalized' economies in the 1980s and 1990s. They also rose more quickly in countries where FDI was prominent.[16]
- *Employment*: The effects of globalization on employment were mixed. Aggregate employment rose in some countries after trade reform and fell in others. There were clear gainers and losers in terms of employment. However, the effects were generally positive for less advantaged groups. Younger females, often employed in export process zones, gained at the expense of older male workers in formerly protected industries and especially in public enterprises (where privatization was often linked to trade reform).

  There was also more 'churning' in employment, with many more workers changing jobs in some countries after trade reform (Rama, 2002: 14). Where job gains were substantial in non-farm sectors, as in China, there was a strong correlation between employment growth and poverty alleviation (Rama, p. 17).

- *Unemployment*: Unemployment effects were also mixed. Cross-country data suggest that was no obvious pattern of loss, or gain, according to official unemployment data. Unemployment remained high in several Latin American countries, long after reforms had been introduced. In contrast, it fell and remained relatively low in most of HPAEs during the period of rapid export-oriented growth.[17]
- *Inequalities*: Inequalities tended to increase *among employees* as a result of trade reforms and associated FDI flows, owing to a rise in the wage premium for educated workers. A good part of the explanation for this development appears to lie in more rapid technological change in liberalizing economies, which contributes to greater demand for skilled labor, rather than to the effects of trade reform *per se*.
- *Vulnerable workers*: Rama (p. 17-18) looks only briefly at vulnerable workers, focusing on child labor, and finds no clear evidence for an increase in child work with globalization.[18] In the East Asian case (including Indonesia) however, rapid economic growth and globalization were associated with a substantial decline in child labor, which had mostly consisted of unpaid family workers in the pre-liberalization period.

The Role of Trade Unions

So far we have concentrated on the labor market as an institution that mediates the determination of wages (and implicitly, working conditions) and employment between individual employees and individual employers, either at the firm, industry or national level. In practice, labor organizations, mainly trade unions, play an important role in representing labor in bargaining with employers over wages, in particular, and in the settlement of labor disputes.

Trade unions are a vital social and often political force many in developing countries. Historically, trade unions played a central role as agents for employees in most industrialized countries. During the early stage of accelerated economic development after World War II they were more tightly controlled by governments in many developing countries, including in much of East Asia. Nevertheless, in several countries such as South Korea and Taiwan, trade union organization emerged as an important social force for the advancement of labor standards and protection of labor rights at the factory, industry and national level in the late 1980s and 1990s.

At the same time, it is important to stress two realities regarding trade union membership and action in developing countries.

- Trade unions represent the interests of a relatively small share of the total work force in many of these countries (see Box 2.3), union members are generally not representative of the most disadvantaged members in society and their actions are often not in the economic interests of the poor and disadvantaged.

- Modern sector wageworkers who dominate trade unions tend to be a relatively privileged group, relative to agricultural and informal sector workers, despite their low earnings compared to wages earned in industrial countries.

Thus, policies advocated by unions purporting to represent the interests of working people in general need to be scrutinized closely, as in the case of any small and well-organized interest group. At the same time, the role of trade unions as a social and economic force has changed in more recent times. There is now a broader understanding among many employers and labor leaders that more can be gained for both parties from cooperation than conflict.

How important is the role of unions in modifying or reversing outcomes generated by demand and supply forces discussed above, and how do their actions tend to affect the welfare of non-union workers? Typically, union bargaining can earn a 'wage premium' for members above the market wage rate for non-members (around 20-30% in advanced economies), suggesting that union members benefit from membership. However, we know that wages are inversely related to employment (the demand curve for labor slopes downwards) in most firms and industries. Hence higher wages can be at the expense of employment of union members, either through lay-offs and fewer new hires in the short-term, or through adjustments in work organization and technology in the longer term. The effect on employment is partly determined by the competitive structure in industries in which unions operate. In situations of monopoly, or where firms and industries are protected from competition, union activity can capture some of the excess profits and thus not affect employment directly, at least in the short-run.

BOX 2.3: TRADE UNIONS REPRESENT A SMALL MINORITY OF WORKERS

Both the shift towards a services economy, and the tendency for smaller size economic units to replace larger firms, has meant that trade union membership has declined quite dramatically in the developed world over the past two decades. Similarly, trade unions mostly represent a small minority of workers in most developing countries. In relation to the breadth of union representation, Indonesia is no exception, despite extravagant claims to the contrary by labor leaders. Under conditions of imperfect information, union leaders tend to overstate their importance in order to bluff governments into accepting their proposals or face the threat of widespread industrial action.

In most developing countries, unions are largely limited to the modern sector and tend to be most effective in manufacturing. In East Asia, trade union density (the share of wage workers belonging to trade unions) was less than 20% in a range of countries surveyed and 20% in Singapore, which boasted the highest level of union density in East Asia outside Japan in the early to mid 1990s. Union membership probably does not exceed 5% of the **total** work force in any of the most densely populated, less developed countries in the region (including Indonesia, if regular dues-paying members are the basis for estimating union membership).

However, the potentially positive role of unions extends well beyond wage bargaining. Their actions can support the welfare of workers and contribute to higher productivity (Box 2.4). Unions act as an employee's agent against the arbitrary actions of employees, and represent the 'voice' of members in establishing, or safeguarding, rules of employment in the work place, especially in a cooperative, rather than antagonistic, bargaining environment (Pencavel, 2002: 18-20).

BOX 2.4: ENHANCING THE ROLE OF UNIONS

On the basis of experience in developed countries, Pencavel (2002) argues that three factors tend to enhance the effectiveness of unions as agents in support of their members (and society in general) and to minimize their 'rent-seeking' tendencies: (i) decentralized union bargaining, (ii) restriction of the government role to the guarantee of basic freedoms and (iii) the promotion of a more competitive economic environment. While all these factors are also relevant to the experience of developing countries, trade unions might need more government support, at least in the early stages of their development, owing to different labor market conditions and historical circumstances. More extensive regulation of collective bargaining and dispute resolution may promote labor's interests in certain situations. For example, workers may need greater guidance on how to bargain more effectively with employers during a period of transition from repressive controls over unions (of relevance in the Indonesian case).

At the same time, the experience of developed and middle-income countries suggests that the **political activities** of unions can have a major impact on political and social policy through industrial action in key industries, despite their small size relative to the total work force. Although in some cases these actions have supported more democratic political change, union actions frequently affect the broader social good and interests of the mass of disadvantaged workers adversely. Such actions include support for expansive macroeconomic policies (and hence higher inflation), opposition to privatization of non-essential industries, and support for trade restrictions and other non-competitive barriers. All three factors are likely to slow the rate of investment and modern sector employment growth, and hence delay the transition to the 'turning point' in developing countries.

Source: Pencavel (2002).

Regulating Labor Rights and Standards: The Role of Governments

Why is it necessary for government to regulate labor rights and standards? Four arguments provide a basis for government intervention: the vulnerability of wageworkers, market failure, the need to regulate industrial relations, and affirmation of basic labor rights.

- *The vulnerability of wageworkers*. Wageworkers tend to be vulnerable to exploitative behavior on the part of employers, especially in societies where there is an excess supply of labor for work in the modern sector. Certain groups of workers—especially children, women and minorities—are especially vulnerable; others are exposed to higher levels of risk, especially in mines or dangerous jobs, or in night work. While regulation of standards for these workers has a universal element, the form of regulation depends to some extent on national institutions, norms and practices. The result is a range of social and economic benefits, as well as costs. Bhagwati (1995: 754) sums up the objections to a single standards approach:

  "Indeed, the reality is that diversity of labour practices and standards is widespread in practice and reflects, not necessarily venality and wickedness, but rather diversity of cultural values, economic conditions and analytical beliefs and theories concerning the economic (and therefore moral) consequences of specific labour standards."
- *Market failure*. A second argument for intervention relates to market failure. Information is often imperfect, and recruiting agents or employers can manipulate workers who are unaware of prevailing standards or who are immobile (migrant workers are a typical example). In some more isolated environments, workers are subject to the monopsony power of employers. Regulations can provide workers and job seekers with knowledge of socially agreed upon minimum standards.
- *Regulation of industrial relations*. As also noted above, codes of conduct need to be established for collective bargaining and dispute resolution in order to minimize conflict that penalizes workers, employers and other members of society.
- *Basic labor rights*. Some standards, especially rights to join trade unions and bargain collectively, are widely regarded as universal in a democratic society and are typically protected through labor legislation.

However, potentially, there is an inherent conflict between regulation of labor standards by governments, on the one hand, and the determination of conditions of work either through market processes or bipartite (employer-employee) negotiation. In particular, improvement in labor conditions through rapid employment and productivity growth depends on allowing firms flexibility to respond to new opportunities and to cope with difficult circumstances in the modern sector of open, market-based economies. Extensive regulation of wages and working conditions, or of employment, can impede adjustment and slow the rate of output and job growth.

The most controversial issues for government intervention are typically the regulation of minimum wages, the employment of contract workers, and controls over dismissals, especially in the more highly valued jobs of the modern sector. All of these features of labor market adjustment are especially important in more open and globalized economies.

- While minimum wages can perform a valuable social role in setting a floor to levels of remuneration, they can also impede employment growth and adjustment if they seek to raise wages above those set in the market place for a given occupation.
- Longer-term contracts support productivity improvements, and higher and more stable wages over a worker's lifetime. At the same time, employment of part of the work force (or of all workers in some sectors, such as in the construction industry) on short-term contracts can make a substantial contribution to productivity and employment in industries where product demand is inherently seasonal or volatile.
- Employees have the right to protection from arbitrary dismissal and need access to some form of social insurance as a safety net in periods of unemployment. Firms, for their part, need to be able to avoid exorbitant costs in the retrenchment of workers so they can deal with changed economic circumstances or adopt new technology and better work practices.

What safeguards can be provided for workers who are vulnerable to the whims of the market? Two points are relevant, related to social protection and the employment effects of regulation. First, while some protection can be extended through labor laws, the most important areas of social protection in most developing countries lie outside the scope of labor legislation. As for most traditional sector workers, comprehensive national unemployment insurance is not affordable or financially viable in most countries (especially if unemployment is less a reflection of social distress than a symptom of selective job preferences). Thus social protection typically takes the form of safety net programs for the poor and displaced workers and is directed towards helping households rather than individual workers. Subsidized basic food, education, and health and work fare programs are typical examples. Many such programs proliferated in Indonesia and other countries during the Asian crisis of 1997-1998.

Second, the *form* of intervention matters. Aside from the universal affirmation of basic labor rights, government regulation of labor markets will serve broader social interests if it is employment-friendly. Where possible, regulations should avoid displacing workers and be designed to support rapid increases in jobs. Examples of particular relevance to Indonesia include minimum wage policies that are responsive to changes in labor market conditions, or severance pay systems that support labor mobility and aim to minimize industrial strife. To be employment friendly, the regulation of hours and conditions of work needs to be anchored to (although not determined by) labor market conditions for most workers in a national or regional economy, rather than to standards that apply in other countries.

Despite rhetoric to the contrary, governments commonly represented by Ministries of Labor do not necessarily represent the longer term, social and economic interests of workers, in general, in matters of labor regulation. Governments typically derive influence (and individual officers may gain rents) from intervention. There is also political gain from being seen as the champion of labor, especially in countries where trade unions have strong political connections. Extensive regulation of labor standards in several Latin American countries, supported by powerful, populist unions, was one factor contributing to slow modern sector output and employment growth for several decades (See Box 2.5).[19] We shall see that a tendency towards over-regulation of wages and conditions of work could have similar consequences in Indonesia, acting in combination with several other factors that have tended to slow modern sector output and employment growth during the recovery.

In short, while some dimensions of labor market regulation are universal and others have specific cultural and social origins, there is a large grey area in which governments choose to regulate, or choose not to regulate. Further, when they choose to regulate, the outcome in terms of social benefits and costs will depend partly on the mode of regulation. While trade unions and populist politicians often tend to support greater regulation, intervention in some areas can harm employment growth and slow the improvement in living standards, of both modern and traditional sector workers. Finally, of particular relevance to the Indonesian case, the costs of regulation in these areas likely to be particularly high in countries with poor records in public administration.

Thus, Indonesia faces a critical choice at this stage of its economic and political development. Does it wish to go in the direction of more market oriented policies (the 'East Asian' route) or will it favor more interventionist policies (the 'Latin American' path) in terms of the structure of output, employment wages and income. The outcome will be mainly determined by trade and investment policies (levels of protection, policies towards FDI and access to capital). But policies towards labor can also be important, as the case of Latin America illustrates so well. Importantly, international experience suggests that it can take decades to reverse a political process that leads to the creation of a small, protected work force and inhibits modern sector job expansion. The expectations of organized workers and the interests of those in prime jobs (and associated institutions) become an integral part of the political-administrative superstructure as influential vested-interest groups.

Concluding Observations

This chapter has set out a basic framework to help us evaluate labor market trends and policies in Indonesia. It has been argued that policy formulation needs to be grounded in a basic comprehension of how labor markets work. Such an understanding needs to take account of specific dimensions of labor markets in less developed countries like Indonesia, where there is a clear divide between the modern and traditional sectors in skills, productivity and wages, and where most workers are still concentrated in traditional sector economic activities.

Two main propositions underpin the main guidelines for labor policy discussed above.

- **First**, the level of wages of unskilled workers for the entire work force – not just those in the modern sector – are largely endogenous to the growth process, in contrast to basic labor rights and some minimum standards. Given labor supply conditions, wages are largely determined by the rate of economic growth and associated employment creation, in the medium to longer term.
- **Second**, labor welfare and standards in traditional sectors are dependent to a considerable degree on expansion of the modern sector. Put briefly, rapid growth in the modern sector greatly contributes to improvements in wages and productivity in the traditional sector(s), whereas extensive regulation tends to slow this process of betterment. The modern sector tends to be the locus of internationally competitive technological change, of manufacturing exports, and of the supply of 'better' jobs and higher levels of productivity.

BOX 2.5: TWO MODELS OF LABOR MARKET CHANGE: EAST ASIA AND LATIN AMERICA

It is useful to think of labor market outcome being produced through two models of development and labor market structure. For convenience, we term these the 'East Asian' and the 'Latin American' models. The contrasting economic and labor polices of these two real-world models have resulted in very different structures of wages and employment, and also distinct patterns of income distribution.

- The *East Asian model* is characterized by relatively small differentials in wages, labor costs and productivity between modern and traditional sectors. Owing to promotion of labor-intensive, export-oriented production early in the development process, a large percentage of workers employed in traditional sectors were absorbed into new, more productive activities. Unemployment rates and the incidence of poverty fell quickly. Inequalities rose in the early stage of development but then fell quite dramatically during the labor-intensive phase, as real wages of unskilled labor began to rise rapidly. At the same time, heavy investments in education contributed to rising labor productivity and smaller wage differentials between skilled and unskilled labor. The supply of skilled manpower rose quickly. Neglect of labor rights in the modern sector meant many workers suffered unnecessarily. But this feature of the East Asian model was not essential for investment and labor absorption in the modern sector. It had more to do with political controls exercised by autocratic regimes than with the success of the growth model adopted in East Asia.

- The *Latin American model* is characterized by **above-market-clearing wages** in the modern sector and a large gap in wages and productivity between the modern and the traditional sectors. Wages are set artificially high in the modern sector partly because of labor legislation that limits employment growth and protects wages. In this model, countries under-invest in education, partly because slower economic growth does not release sufficient resources for social investment. In addition, restrictions on competition in the product market tend to favor capital-intensive, high-wage firms. Thus the modern sector was less able to compete in international markets. The sector did not use the country's most abundant resource, labor, as intensively as in East Asia. Relative to per capita income, a smaller share of labor is involved in the modern sector. Inequalities have thus remained much higher than in East Asia. In some cases, where democratic regimes emerged, trade unions acquired a greater voice in setting wages and the terms of employment in the modern sector. They shared the interests of protected employers in opposing economic reforms.

We have also suggested that globalization is on balance good for labor, although there are some major problems of adjustment to trade and investment reform that need to be addressed in a more comprehensive fashion than has often been the case in the past.

It has been argued that regulation of labor standards and industrial relations should aim to be employment friendly. Where possible the determination of wages and the negotiation of labor standards should be left up to the market and to the interested parties: the trade unions and employers. Government intervention plays an important social role in setting the rules of the game in collective bargaining and dispute resolution and in establishing core minimum standards and rights. Extensive regulation of labor markets, however, will slow employment growth in the modern sector and tend to depress earnings in traditional sectors.

In this discussion of the broader social benefits and costs of alternative labor policies, an important political point cannot be ignored. Private sector employers typically have considerable influence over policies affecting the modern sector. Sometimes their interests coincide with those of modern workers and conflict with other groups in society, such as in the case of trade protection. However, with respect to labor regulation, organized modern sector workers (mostly concentrated in urban areas) have a relatively strong political 'voice' on issues which tend to conflict with the interests of both employers and the large majority of working people. Typically, organized labor is supported by many advocates among the urban middle class, who identify with the interests of workers living in adjoining neighborhoods.

Small farmers and informal sector workers are usually over-represented among the poor and make up a larger share of the total population in the early stages of development; but they are typically under-represented in the process of labor regulation. Even though many laws do not directly affect these groups, their living standards can be significantly influenced, indirectly, by regulations in the modern sector.

It can be argued that it is the role of independent observers to be aware of and constantly remind governments and bureaucrats that they represent the interests of all labor groups in policy-making, rather than a small minority of more privileged employees. This is particularly important in periods of political transition, such as experienced in Indonesia today. Under such conditions, there may be a stronger temptation to pander to the interests of a more politically aware and vocal industrial working class at the expense of the interests of the majority of workers, who are not yet well represented in the political process, both at national and regional levels of governments.

Finally, we have given disproportionate attention to the determinants of wages and working conditions, and associated labor policies, in the modern sector. Needless to mention, improvements in technology, information and access to government support is equally, if not more, important for the mass of farmers, small-scale businesses and informal sector workers. Labor policy as conventionally defined in most countries does not directly affect the lives of these workers, many of whom are self-employed or family workers. Support for employment in this larger segment of the economy requires quite different approaches – for example, micro-credit, better quality assistance from government and improved access to information. These topics are not dealt with in detail in this paper. But they require at least as much attention if countries with an excess labor supply problem are to experience sustained improvements in living standards and declines in poverty.

CHAPTER III

THE LABOR MARKET UNDER STRESS: STRUCTURE AND CHANGE IN THE POST-CRISIS PERIOD

The dramatic turnabout in economic performance during the economic crisis and then the subsequent hesitant recovery have had a major impact on the labor market. There was a sharp cutback followed by slower growth in labor demand, especially in the modern private sector, across industries and regions throughout Indonesia. At the same time, the investment climate became less predictable. Political reform created the opportunity for greater popular participation but also more open political conflict and more frequent labor disputes.

All these developments have had direct implications for employment, productivity and wages. Their impact needs to be assessed in the context of longer-term demographic and economic changes set in train during the New Order period that continue to influence labor supply and demand.

This chapter examines structure and change in the Indonesian labor market of relevance to labor policy. It seeks to throw light on several questions necessary for the formulation of policy, both in the short-term and the medium to longer term.

- What are the salient structural features of the labor market – the labor force, employment, unemployment and wages – bearing in mind Indonesia's stage in economic development?
- In what ways has the labor market changed in recent years, especially as the country emerged from the Asian economic crisis, and what are the implications for the regulatory framework?
- Finally, how does the Indonesian labor experience – both structure and change – compare and contrast with that of other developing countries, especially in East Asia, and what can we learn from the experience of these other countries for policy in Indonesia?

In the previous chapter, we discussed general features of dualistic labor markets that typify countries like Indonesia in the early stages of development. Two basic themes were highlighted. First, wages tend to be low because of low average levels of productivity, especially related to the heavy a concentration of workers in 'traditional' sectors. Second, it was argued that improvement in average levels of productivity mainly occur through transfer of labor out of these low income jobs into higher productivity occupations, mostly in the modern sectors.[20] We noted that they also occur through improvements in productivity in traditional sectors, as has been the experience of several rapidly growing East Asian countries, and has also been stressed by Indonesian thinkers such as Bung Hatta. In short, improved living standards depend to a considerable extent on a synergism in the relationship between the modern and traditional sectors.

Some contend that modern sector growth is not of critical importance for the mass of workers. They stress the potential conflict between modern and traditional sector growth, and argue that cultivation of small-scale industry should be the main focus of development efforts.[21] Further it is asserted that such an approach will also help improve reduce income inequalities, which are believed to increase as a result of conventional, market-oriented growth processes.

The experience of Indonesia suggests otherwise. We show that both modern and traditional sector expansion have been complementary in the past. **It is the slow growth in the modern sector, and its implications for the traditional sectors, which poses the major threat to improvements in labor standards**. Even though relatively few people are directly employed in the modern sector, labor welfare has been greatly enhanced by its expansion in the past. Rapid modern sector expansion not only provided opportunities for better jobs among new job seekers and supported a range of mainly traditional sector activities, mainly in non-tradable goods industries. It also reduced pressure for jobs in the traditional sector, in ways depicted in Figure 2.1 in the previous Chapter. It is the absence of these direct and indirect benefits to workers related to slow modern sector growth that is now a major threat to improvements in living standards.

In this chapter, we first examine empirical data on the structure and changes in the labor market that are relevant to labor policy. In a final section, we look at how some features of the Indonesian labor market compare and contrast with those in several neighboring East Asian countries.

A. The Structure of the Indonesian Labor Market

In 2000-2002, the Indonesian labor market might be best described as pre-transitional. Low productivity work in agriculture, manufacturing, petty trade and services dominated employment, accounting for some two-thirds to seventy five per cent of all jobs. A high proportion of the work force had little formal education or skills, and was still quite young, even though both the educational and age composition of the work force had changed greatly in the previous two decades.

Besides improving labor rights, the greatest challenge in the short to medium term is to facilitate the movement of people out of low productivity jobs, on the one hand, and assist those still in traditional sectors through better use of resources and wider access to markets on the other. Unemployment and under-employment are also pressing problems. But we shall see that they are less important compared with the immense challenge of transforming the structure of employment in favor of more productive jobs.

Five Labor Market Characteristics

Table 3.1 provides some summary details of the labor force, employment and unemployment, and wages in 2001-2002.[22] Indonesia has a large labor force (just under 100 million in 2001) with quite high levels of labor force participation (just under 70%) by Third World standards. As in many developing countries, the educational status of the population and work force was still relatively low: more than 60% of both had only a primary school education or less, and only just over 20% had completed senior high school or university.[23] Also as in many developing countries, a large share (approximately 60%) of the population and work force resided in rural areas.

Five features of the labor market, in particular, contribute to low levels of productivity and wages, in general, and a sharp divide between various segments of the labor market.[24]

1. A Dualistic Employment Structure

The outstanding characteristic of the labor market in 2001-2002 was the continued dominance of traditional sector jobs and the small size of the modern sector in Indonesia, however defined.

TABLE 3.1: MAIN CHARACTERISTICS OF THE WORK FORCE INDONESIA 2001 AND 2002

	2001*					2002*
	Location		Sex		Total	Total
	Urban	Rural	Male	Female		
POP. & LABOR FORCE						
Population aged 15+ (m.)	64.34	79.69	71.32	72.71	144.03	Na
Labor Force (m.)	40.56	58.25	61.16	37.65	98.81	Na
Employment (m.) 1	36.1	54.71	57.13	33.68	90.81	Na
Participation Rate (%)	63.04	73.10	85.75	51.78	68.60	68.5
EMPLOYMENT (%)						
By Industry						
Agriculture	11.3	65.2	43.3	44.5	43.8	43.9
Manufacturing	20.0	8.9	12.2	15.2	13.3	13.0
Trade	30.5	11.8	15.7	25.2	19.2	19.4
Services	20.9	6.3	11.7	12.9	12.1	12.4
Other	17.3	7.8	17.1	2.2	11.6	11.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
By Status						
Employers	3.7	2.7	4.3	1.1	3.1	3.3
Regular Wage	49.7	15.8	31.9	24.8	29.3	28.8
Sub-total Formal	53.4	18.5	36.1	25.9	32.3	32.1
Casual Wage-Agric.	1.7	5.5	3.7	4.5	4.0	4.8
Casual Wage-Non Agric.	3.0	2.5	3.6	1.1	2.7	2.7
Self-employed	33.2	47.2	48.5	29.9	41.6	41.2
Family Workers	8.8	26.4	8.1	38.6	19.4	19.1
Total	100.0	100.0	100.0	100.0	100.0	A
By Occupation						
Professional & Managerial	6.2	2.2	3.3	4.7	3.8	3.9
Clerical	9.5	1.5	5.1	4.1	4.7	4.6
Sales	27.4	11.3	14.0	23.9	17.7	18.5
Services	8.9	2.2	4.1	6.2	4.9	4.9
Farmers	11.2	65.0	43.1	44.5	43.6	43.6
Production and Related	36.7	17.9	30.5	16.7	25.3	24.5
Total	100.0	100.0	100.0	100.0	100.0	100.0
Unemployment Rate (%)						
Standard definition	8.04	3.55	4.81	6.35	5.39	5.6
Adjusted 1	11.00	6.08	6.59	10.54	8.10	8.2
Under-employment						
% Working <25 Hours	9.39	20.80	10.50	26.12	16.23	Na
% Working <35 Hours	18.61	39.93	23.52	45.01	31.40	Na
WAGES (per month)						
Average Wage (Rp.000)	612	409	582	419	531	644
Percent <Rp.300000						
All sectors	24	43	23	49	32	Na
Agriculture	63	67	55	88	66	Na
Manufacturing	21	36	18	34	25	Na
Services	24	26	15	39	25	Na
Percent >Rp 1 million						
All sectors	16	6	13	9	12	Na
Agriculture	3	1	2	0	2	Na
Manufacturing	8	2	10	3	6	Na
Services	26	25	31	18	26	Na

*For 2001, based on annual National Labor Force Survey, SAKERNAS, conducted in August. For 2002, based on quarterly SAKERNAS conducted in May (quarterly surveys re-instituted for the first time in May since the early 1990s).

SOURCE: CBS, SAKERNAS 2001 and *Indikator Ketenagakerjaan, Mei 2002* (September 2002).

- Most workers (nearly two-thirds) were still located in rural areas, and agriculture accounted for the largest share of total employment, or around 45% of all jobs. Overall, informal sector work (including employment on family farms) accounted for two-thirds of all jobs, over 80% of all jobs in rural areas, and just under half of all urban jobs (**Figure 3.1 and Figure 3.2**).[25]

  Around two-thirds of people engaged in informal activities were self-employed. Casual wageworkers, much less affected by laws than regular employees (and generally outside the reach of trade union activity), contributed a small but significant share of the total (7%) or more than five million workers.

- Regular wageworkers who are most directly affected by labor regulation accounted for just under 30% of all employment and half of all urban employment. Around two-thirds of all regular wageworkers were employed in the private sector and a further one-third in the civil service or in state-owned enterprises. In manufacturing, some sixty per cent of employed people worked in small and cottage enterprises. Professional (and technical), managerial and clerical workers accounted for less than 10% of all employment, and some 15% in urban areas.

*2. **Low** Unemployment and Under-employment*

Under-utilization of labor in terms of intensity of work (hours worked a day and days worked a year), or the total number of jobs available, is not Indonesia's central labor market problem. Rather it is the supply of **better** jobs, and the creation of a more productive work force. Like in many other countries at early stages of development, unemployment rates, as conventionally defined, were relatively low (see Table 3.1). Even under-employment was not high compared with the concentration of fully 'utilized', low wage and low productivity workers in agriculture and the informal sector.[26]

- *Unemployment*. Under a revised definition adopted by CBS in 2001, some 8% of all workers were unemployed in the country as a whole in 2002.[27] The rate was 5% according to the conventional definition. Neither figure is particularly high by developing country standards (Turnham, 1993). 'Discouraged' workers, those people wanting to work but not inclined to undertake active job search, made up around one quarter of all unemployed under the new definition.

  As in many other countries, unemployment rates were higher among females in the work force and among workers in urban areas, where active job search among young and educated workers is more intensive. Over 40% of all unemployed in 2001 were secondary school leavers aged 15-24, the majority of whom lived in urban areas.

- *Under-employment*. Under-employment, crudely defined, involved a much higher share of the work force. Some 16% of employees worked less than 25 hours, and one-third less than 35 hours. Despite the widespread view that this latter figure, together with the unemployed, is an appropriate measure of unemployment in Indonesia (hence implying

FIGURE 3.1A: EMPLOYMENT BY INDUSTRY, INDONESIA 2001 (percentages)

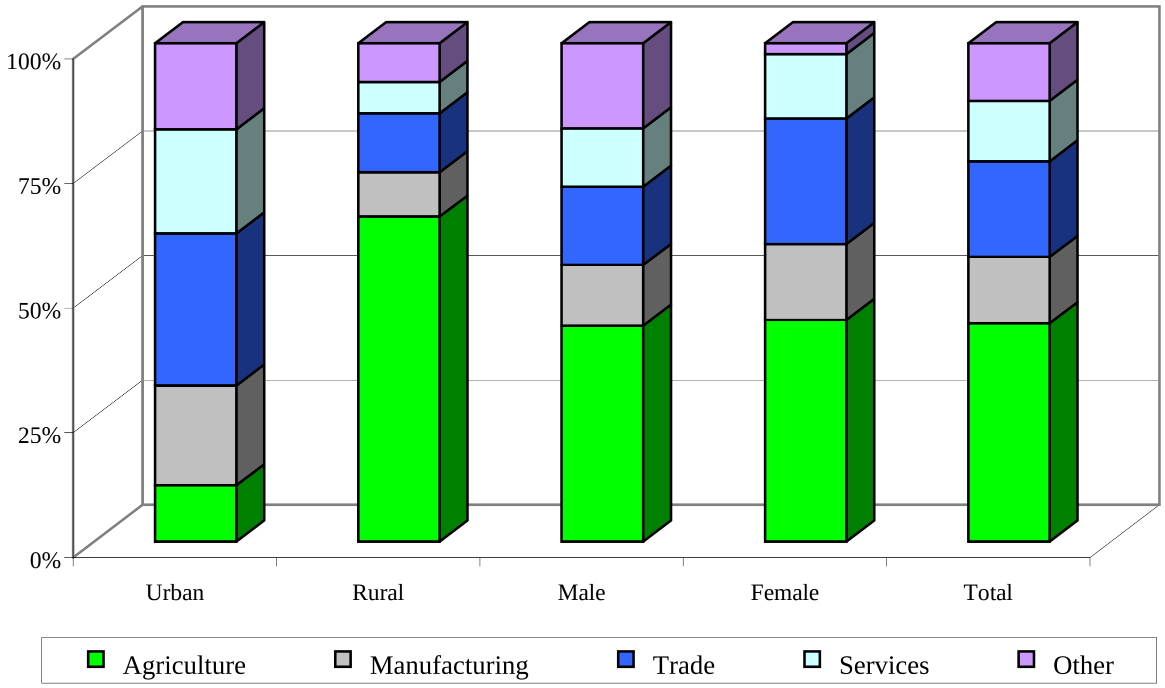


FIGURE 3.1B: EMPLOYMENT BY WORK STATUS, INDONESIA 2001 (percentages)

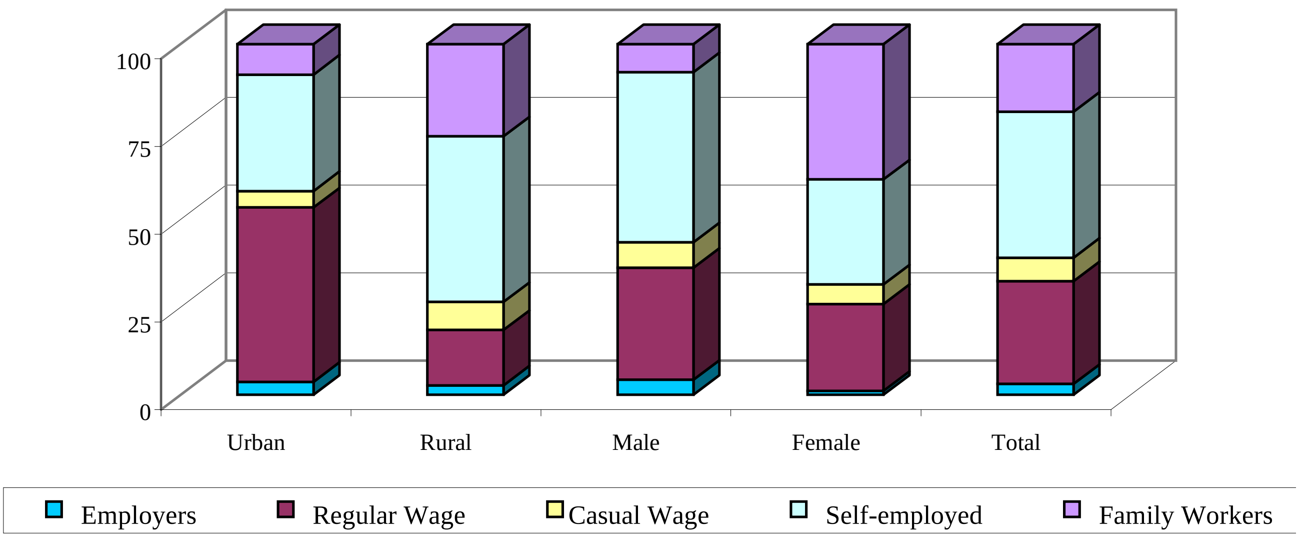
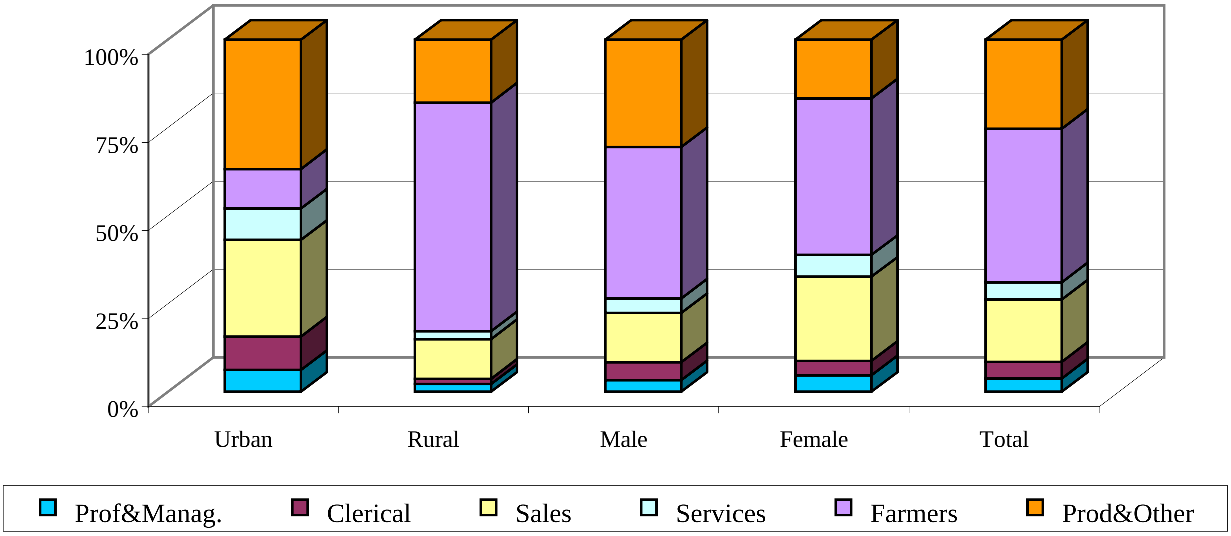


FIGURE 3.1C: EMPLOYMENT BY OCCUPATION, INDONESIA 2001
(percentages)



that total or 'global' unemployment in Indonesia is around 40%), the figure is not high for countries with large agricultural and rural sectors. Typically, children and married females combine schooling and household work with market and other income earning work as part-time family labor, self-employed workers and wage employees. Survey data suggest that around 75% of those working less than 35 hours a week are not willing to work longer hours, thus halving the rate of 'total' unemployment as defined above (CBS, 2000).[28]

3. *High Work Force Participation, Low Wages and High Unemployment among Females*

Female participation rates are high in Indonesia by international standards.[29] However, females tend to be overly represented in low productivity and low wage occupations, and among the unemployed and under-employed.

- Female participation rates were estimated at 50% in work outside the home in 2001 and have been increasing since the 1970s (Manning, 1998, Oey, 2002). Women are more highly represented in relatively low productivity sectors, especially retail trade, and they are especially manifest as family workers (just under 40% of all employed females) and earn relatively low wages compared with males in most sectors (see Table 3.1).[30]
- Female rates of unemployment were more than 60% higher than male rates, and under-employment rates were twice those of males, although part-time workers understandably accounted for a high share of females working less than 25 or 35 hours a week.

FIGURE 3.2A: EMPLOYMENT BY INDUSTRY, INDONESIA 2002 (%)

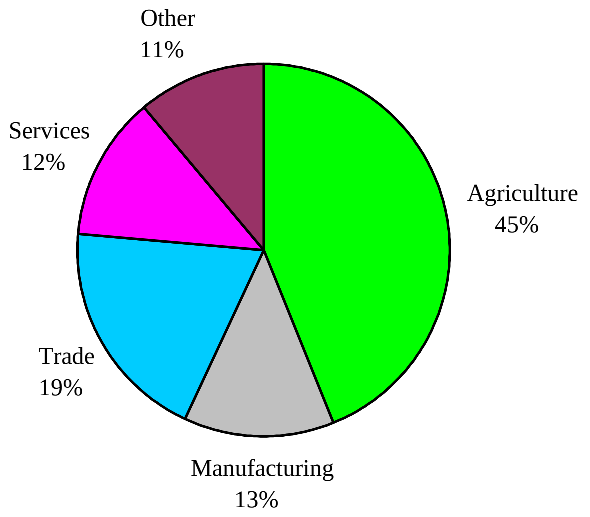


FIGURE 3.2B: EMPLOYMENT BY WORK STATUS, INDONESIA 2002

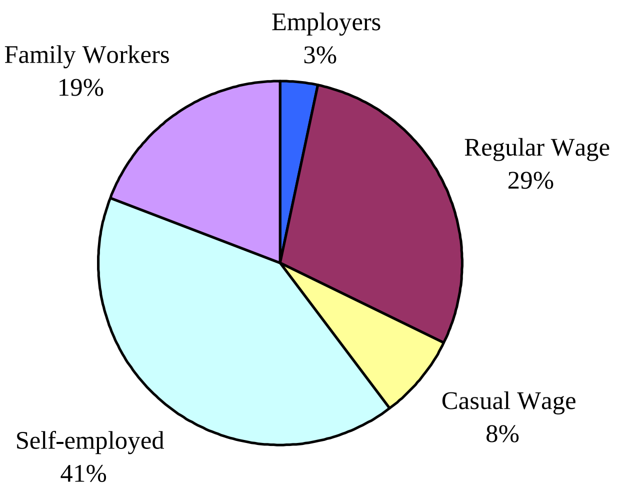
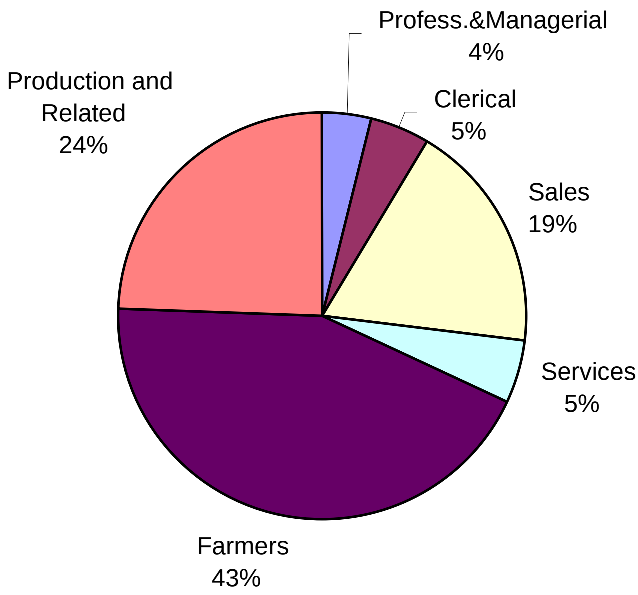


FIGURE 3.2C: EMPLOYMENT BY OCCUPATION, INDONESIA 2002



4. Low Average Wages and Significant Wage Inequality

Wages were very low by developed country or even middle income East Asian standards, and there were marked inequalities in wages across sectors, between urban and rural areas and, as we have seen, between males and females.

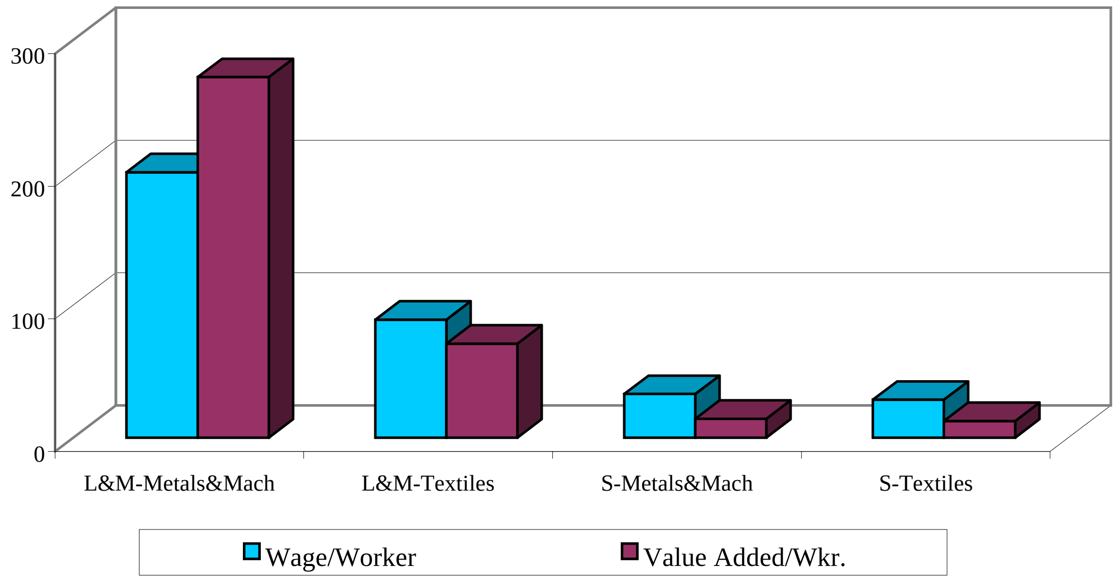
- The range in wages helps us see the large divisions in the labor market (see bottom section of Table 3.1). On average, wages were still low, averaging just over Rp. 500,000 or around $50 per month. However, one-third of all employees earned less than Rp. 300,000 in contrast to a small but significant number of people (some 12%) earning Rp. 1 million or more. Whereas those with low incomes were heavily concentrated in agriculture and rural areas, workers on higher wages were mainly employed in services – in professional jobs, in government administration, and in financial services.
- Wages were relatively low, on average, even in professional jobs in services and manufacturing, where relatively well-educated people only earned a small fraction of wages earned in neighboring countries. On average tertiary educated people earned only around Rp1-2 million per month from their main jobs, or $100-200 per month, in 2001.[31]

5. Dualism in Wages and Productivity

How big is the gap in earnings across the formal and informal, or modern and traditional sectors and to what extent is this gap related to differences in the productivity of workers in these sectors? We saw in Chapter 2 that under conditions of elastic labor supply of unskilled workers, wages by sector and industry are likely to be heavily influenced by wages (the supply price of labor) in the traditional sector.

- *Labor Productivity*. We do not have good data on earnings in the informal and traditional sectors. However, differences in productivity and wages by sector and scale of enterprise give a rough idea of contrasts between sectors. Average labor productivity was higher in capital intensive sectors, such as mining, and relatively low in trade, transport and services where most informal sector workers are concentrated (see **Annex Table 3.1**).

FIGURE 3.3: INDEX OF WAGES AND VALUE ADDED PER WORKER, BY SIZE OF FIRM, SELECTED INDUSTRIES (All Large, Medium and Small Industries=100)



Source: See Annex Table 3.2.

Contrasts between large and medium- and smaller-scale firms, and between more capital- and labor-intensive industries in manufacturing also give some indication of differences in productivity. Value-added per worker per year in large and medium manufacturing was some **ten** times that in small industry.[32] Even in relatively capital-intensive metals and machinery (ISIC 38) value-added was almost four times that in textiles, clothing and footwear (TCF industries – ISIC 32) (**Figure 3.3**).[33] These differences in value-added per worker to a considerable extent mirror the modern–traditional productivity gap discussed above.

Output per worker is higher in the 'modern' sectors for several reasons. These include large amounts of capital (and natural resources) relative to the number of workers, more advanced technology and different levels of human capital applied in the production process.

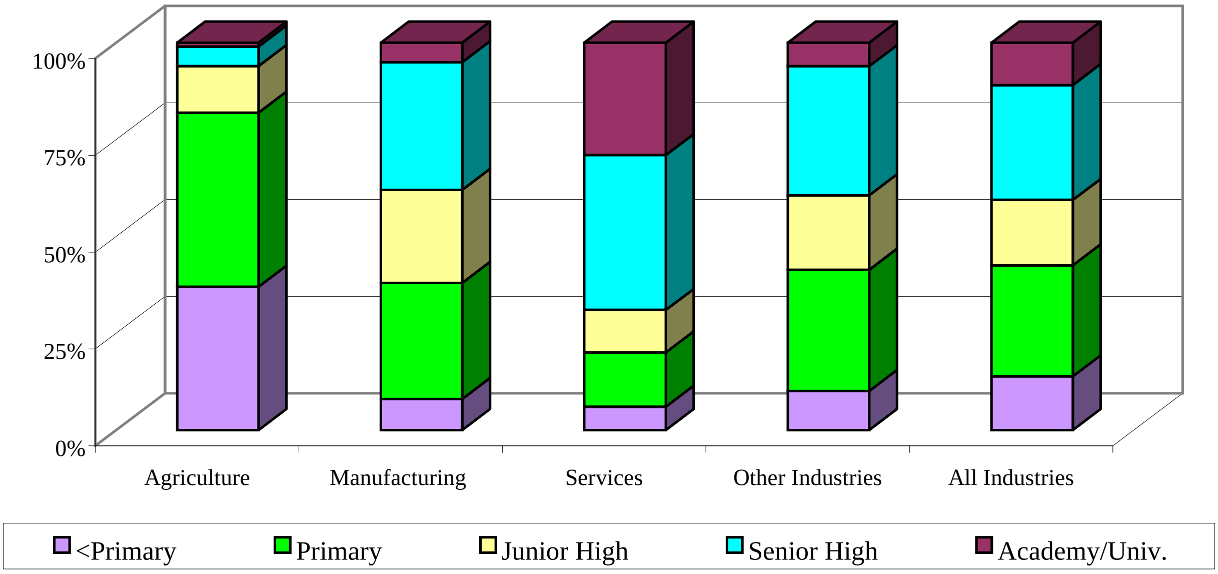
- *Productivity-wage relationships*. Wage differentials were closely associated with differences in productivity, although differences in productivity were much greater across sectors and types of firms in manufacturing. Average wages were highest in mining and utilities and lowest in agriculture. In larger firms they were around five times those in small-scale industry and average wages in metals and machinery were over twice as high as those in TCF industries (**Figure 3.4**).

  An excess supply of labor tends to limit wage premiums for unskilled labor in higher productivity jobs. However, part of the explanation for wage differentials by sector can be attributed to differences in human capital across industries and activities. For example, over 80 per cent of informal and agricultural sector workers, including casual wage employees, had only a primary school education or less compared with only 20-30% of all formal service sector workers in 2001 (see **Figures 3.4 and 3.5**). Conversely, only 10% of informal sector workers had an upper secondary level of schooling, while nearly half of all formal sector workers had completed upper secondary school. While the formal sector accounted for less than one third of all employed people, it provided jobs for over two-thirds of all workers who had completed senior high or tertiary schooling.

  In contrast to agriculture, the share of educated workers was much higher in the services, and average earnings were some 40% higher than in other major sectors of the economy. If the differences in levels of schooling are taken into account, there was much less difference in earnings across sectors, although wages in agriculture were still considerably lower, reflecting the lower productivity of workers there than in other sectors.[34] Wages are still relatively low in agriculture partly because productivity is low, due to less advanced levels of technology, as well as to the more intense supply-side pressures discussed in Chapter II.

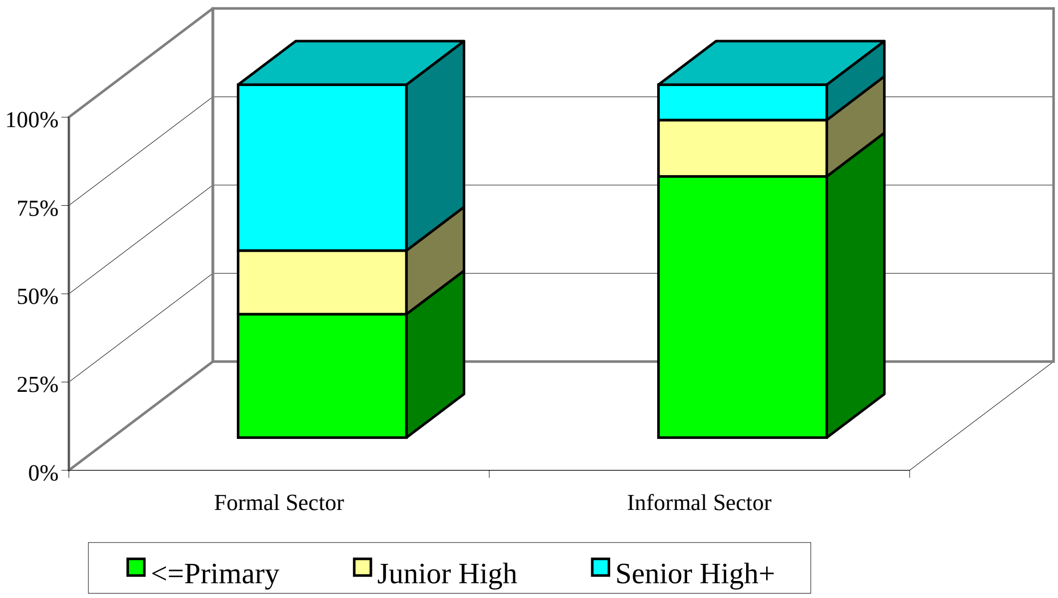
  In addition, a higher concentration of younger workers aged 15-29 was found in the formal sector. Older, less active workers were more likely to be employed in informal sector work, thus contributing to the productivity differences between the sectors (**Figure 3.6**).[35]

FIGURE 3.4: THE PERCENTAGE DISTRIBUTION OF WAGE WORKERS BY LEVEL OF SCHOOLING IN DIFFERENT INDUSTRIES



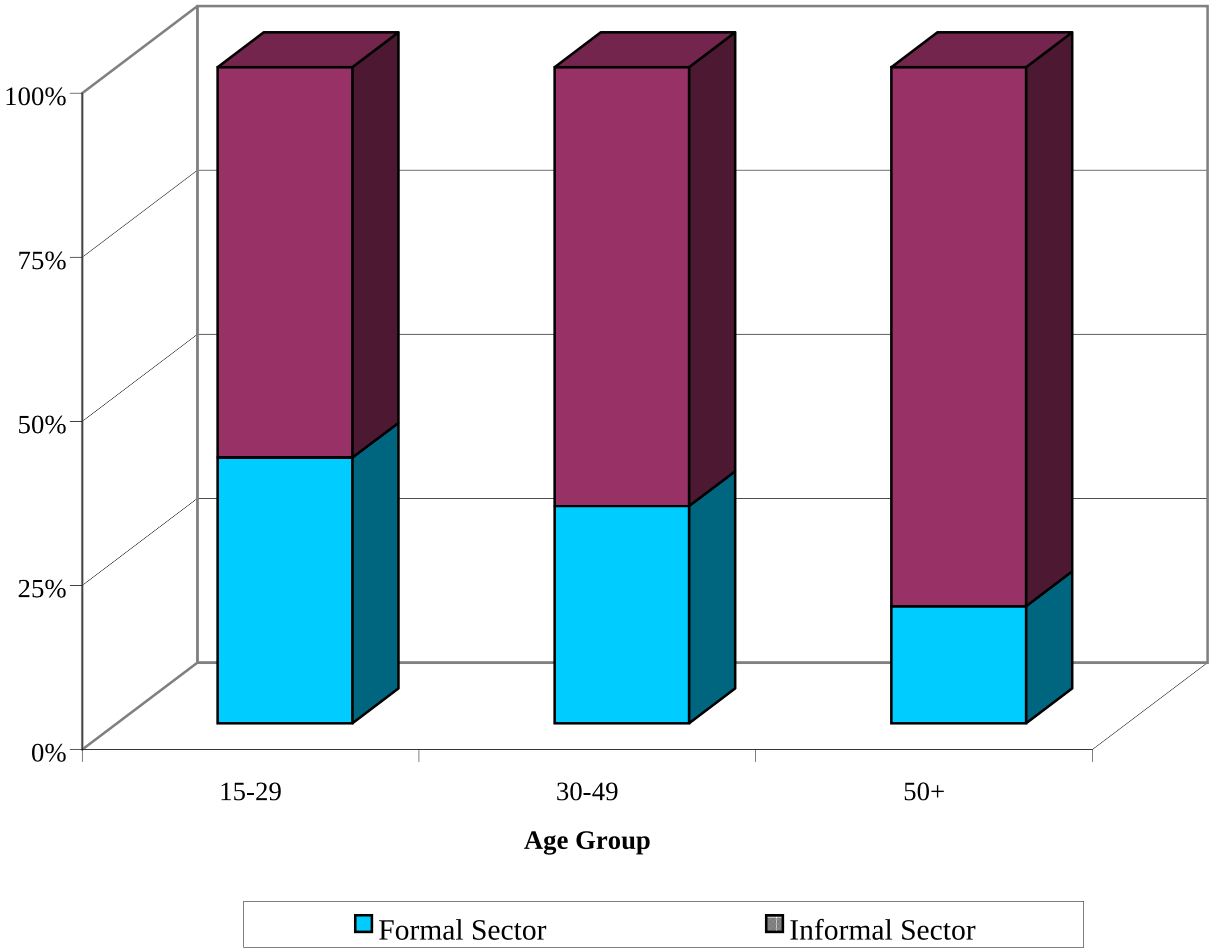
Source: See Annex Table 3.3

FIGURE 3.5: SHARE OF WORKERS WITH A COMPLETED SCHOOLING OF PRIMARY OR LESS AND SENIOR HIGH OR MORE, IN THE FORMAL AND INFORMAL SECTORS, INDONESIA 2001



Source: See Annex Table 3.7.

FIGURE 3.6: PERCENTAGE OF FORMAL AND INFORMAL WORKERS BY AGE GROUP, INDONESIA 2001



Source: CBS, SAKERNAS 2001

B. Labor Market Change

Indonesia's economic crisis in 1997-1998 was the worst in Asia, both in terms of macroeconomic instability and the extent of recession. The recovery in growth rates in 1999-2001 has been slower than in neighboring countries, with the partial exception of Thailand. The impact of much slower recent and projected economic growth rates on labor demand, and their affect on wages and employment, are the most important labor market issues in Indonesia today.

Two questions are particularly pertinent for labor market policy

- First, how can an economy that is growing at half the rate of the pre-crisis period continue to absorb enough people into 'better' jobs in the modern sector?
- Second, to what extent can labor markets that were quite flexible in the boom years remain so in a period of both slower economic growth and more democratic and decentralized public decision-making?

The latter question is especially relevant given the much stronger union movement, a more powerful legislature (the Parliament, or DPR) more prone to political and interest-group influence, and a weaker executive than in the Soeharto period.

These issues need to be viewed in the context of important longer-run changes in the balance of labor demand and supply, which are beginning to have a major impact on labor outcomes. We look first at some of these longer-term issues, mainly on the labor supply side, before turning to the economic slow-down and its impact on labor demand, employment and wages.

Labor Supply

Several labor supply developments are a reflection of longer-term demographic changes, some of which were beginning to impact strongly on the labor market around the year 2000. As discussed in Chapter II, wages and employment both depend on the rate of growth in the working age population and labor force, even though labor demand changes tend to receive more attention (because they are less predictable and more amenable to government policy in the short run).

Thus, the extent to which workers are able to get 'better' jobs in the medium to longer term depends very much on how fast the labor force is growing relative to employment opportunities. This balance also affects the rate of transfer of workers out of traditional sectors, and thus contributes to determining wages and productivity for the entire work force.

Three quite favorable developments from the point of view of labor absorption underpin labor supply trends in Indonesia over the past 20 years.

- Population growth has slowed in the past decade and can be expected to do so in the future, especially with respect to younger, new entrants to the work force. As a consequence, the age distribution is shifting significantly in favor of prime age and older workers relative to younger, recent entrants to the labor force.
- Slowing population growth rates have been counterbalanced by sharply rising participation in the work force, especially among females. As a result, the labor force has continued to grow rapidly. Nevertheless, this growth can be expected to taper off in the future, as participation rates begin to plateau at quite high levels by international standards.
- The crisis notwithstanding, there have been dramatic improvements in the educational composition of the work force, and of the employed population. Supply-side factors continue to provide support for improvements in productivity and living standards, even though the quality of new graduates is a major issue.

We deal with each of these developments in turn.

Population and labor force growth.

Table 3.2 shows that growth rates of the total population and of the labor force aged 15 and above have slowed in recent years compared with the 1980s and early 1990s.[36] The declining rates of growth were especially marked for ages 15-24.[37] The working age population (aged 15 and above) growth rate fell from over 2.5% per annum in 1980-90 to just above 2.2% in 1995-2000. Growth rates slowed most in the younger age groups in the 1990s. As a result, the percentage of people aged 15-24, fell from over 25% in 1980 to just over 20% in 2000.[38] Fewer younger people are now entering the work force than was case even a decade ago. This has occurred partly because of the rapid expansion in schooling. But, more importantly, it is also a consequence of lower fertility, which is now contributing to significantly slower growth of the younger age population.[39]

The impact of declining population growth rates on the labor force will become much stronger in near future. The number of young people aged 10-14 years old fell for the first time in the 1990s, and this is expected to flow through to the 15-19 year old population by around 2005. Fortunately in this period of slower economic growth, Indonesia is now over the ‘hump’ in labor force growth that resulted from high fertility in the past. The task of absorbing new entrants into the labor force is less demanding than a decade ago.

TABLE 3.2: GROWTH OF EMPLOYMENT, UNEMPLOYMENT, LABOR FORCE AND WORKING AGE POPULATION BY AGE GROUP, INDONESIA 1980- 2000*

	Employment	Unemployment	Labor Force	Population Aged 15=
1980-1990				
15-24	2.29	11.95	2.84	2.15
25-49	3.66	6.72	3.69	2.91
50+	3.91	1.93	3.90	3.06
Total 15+	3.37	9.76	3.52	2.69
1990-2000				
15-24	0.68	8.20	1.54	1.42
25-49	3.27	10.01	3.39	2.58
50+	3.88	5.61	3.89	1.88
Total 15+	2.86	8.61	3.07	2.09

* Population data for 2000 adjusted for non-response and under-coverage on a pro-rata basis; Excludes East Timor in 1980 and 1990

Source: CBS, Population Census 1980, 1990 and 2000.

Participation rates.

Participation rates continued to rise in the 1990s and thus offset the effect of slowing population growth on labor force growth rates.[40] The slower decline in the growth of the labor force was a consequence of rising participation rates, especially among females at all ages, and among older people of both sexes.[41] These increases in female participation rates were substantial in both urban and rural areas and especially among less educated females (See **Box 3.1** and **Figures 3.7 and 3.8**).[42] Most likely, the latter is related to strategies of coping with difficult economic circumstances after the crisis.[43] More older people are being absorbed into the work force probably for similar reasons.

Levels of Schooling.

The share of the less educated people in the labor force has fallen quite sharply since 1980 and continued to decline after the crisis (**Figure 3.9**). Those who had not completed primary schooling fell from two-thirds of the work force in 1980 to 44% in 1990 and a little over 20% in 2000. The number of people in the population and work force without a primary degree declined absolutely from 1990 onwards. On the other hand, the shares of primary, secondary and tertiary educated people in the work force all doubled in the same period. The share of secondary educated people, mainly with a senior high degree, rose from just over 10% to one-third of the working age population in the 20-year period.

BOX 3.1. HIGH AND RISING FEMALE PARTICIPATION RATES

The increases in female participation rates have been dramatic in Indonesia. At prime ages (age 25-49), around two-thirds of all females are now engaged in the work force, compared with only 35-45% two decades ago and around 45-50% in 1990. Recorded female participation in the work force is now high by international standards and higher than in most East Asian countries in the late 1990s (Manning, 1999). Only Thailand recorded participation rates comparable with the Indonesian rates in the 2000 population census.

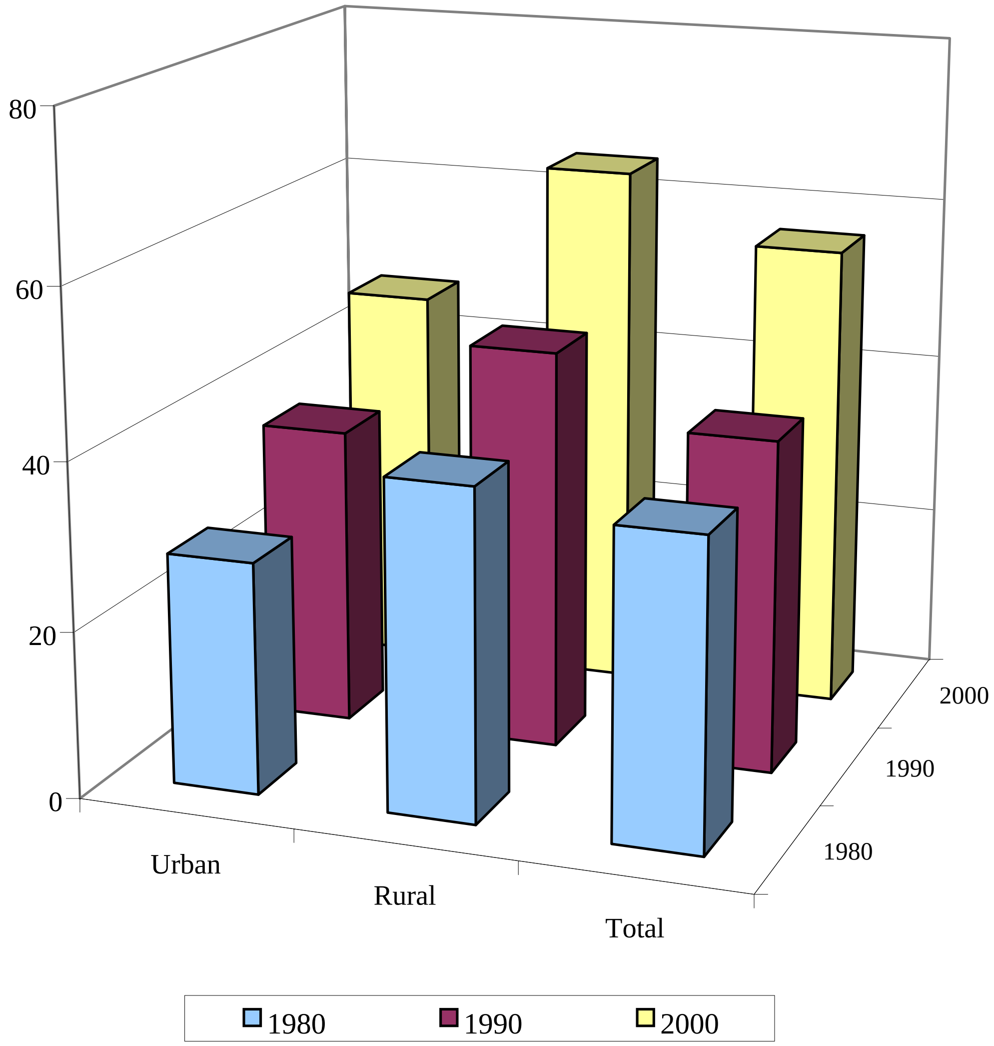
As noted above, the increases have been especially marked among **less educated** females. Hence the hitherto quite large gap between more educated and less educated females in the labor force has narrowed considerably over the years and accelerated in the 1990s (**see Figure 3.8**). At the same time, the changing composition of the work force towards more educated women, who normally have higher rates of participation, has also contributed to the rise in overall female involvement in the labor force.

One can speculate that two factors have been important in this rise in female participation in the work force, especially among less educated females, in addition to the likelihood of greater enumeration of female workers in the recent census.

- Many females were attracted to jobs in industry and related services in during the economic boom of the first half of the 1990s, associated with rising exports in labor intensive industries.
- More females are likely to have entered the work force during the crisis, both as secondary and primary workers, to help cushion the effects of falling household incomes.

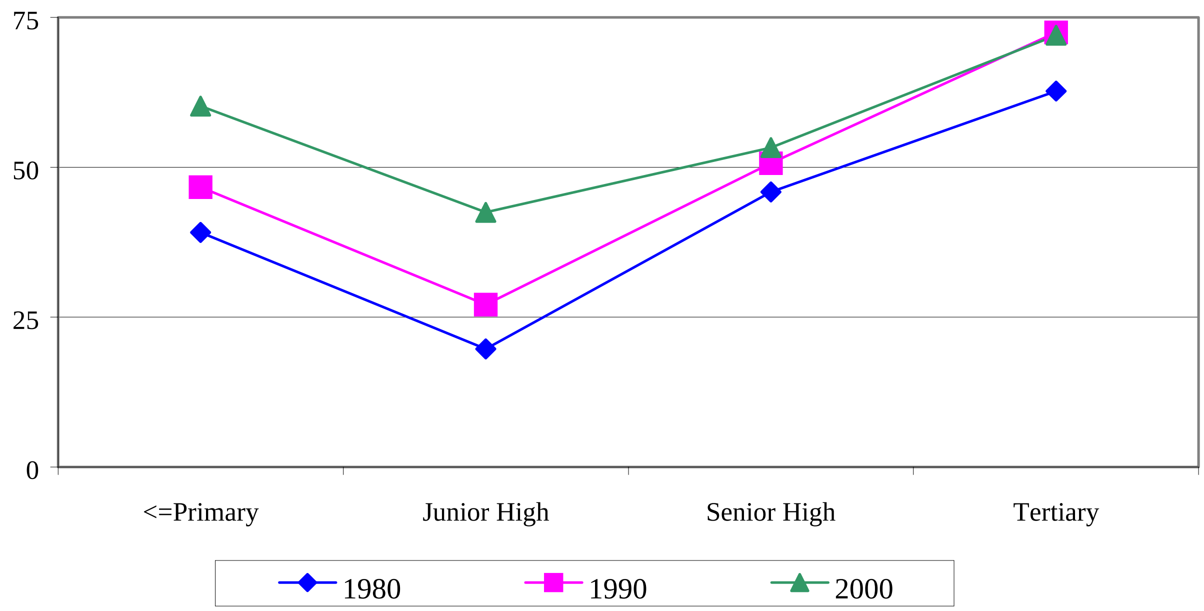
Source: See especially Mayling Oey (2002).

FIGURE 3.7: FEMALE LABOR FORCE PARTICIPATION RATES, URBAN AND RURAL AREAS, INDONESIA 1980-2000 (%)



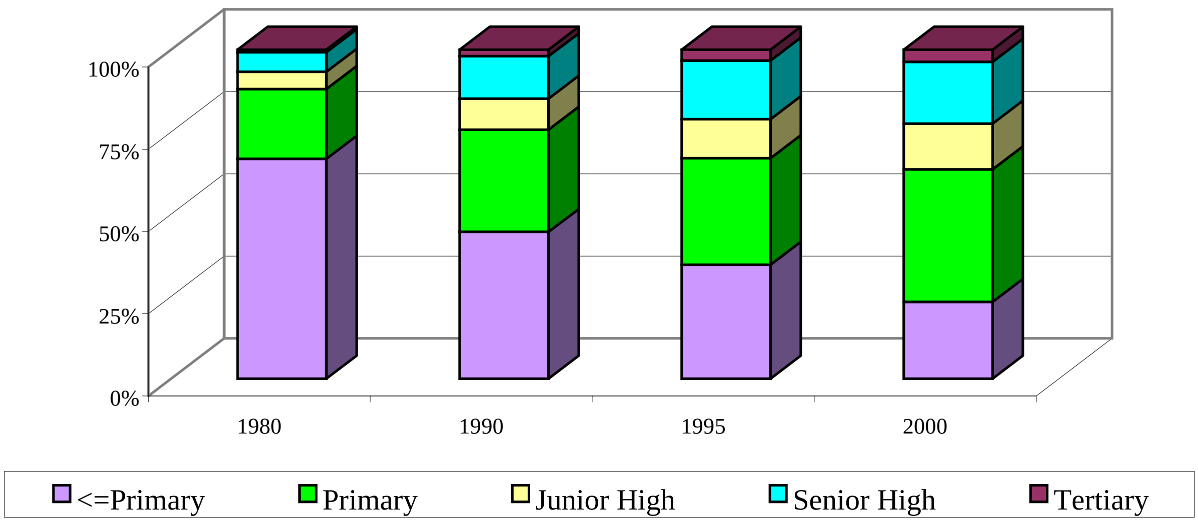
Source: Annex Table 3.5.

FIGURE 3.8: FEMALE LABOR FORCE PARTICIPATION RATES BY LEVEL OF COMPLETED SCHOOLING, 1980-2000 (%)



Source: CBS, Population Censuses 1980, 1990 and 2000.

FIGURE 3.9: COMPLETED SCHOOLING OF THE LABOR FORCE, INDONESIA 1980-2000



Source: See Annex Table 3.6.

While many studies have pointed to the falling quality of schooling, these large shifts are obviously a positive factor for improved levels of productivity in the work place. The large majority of more educated people have been absorbed into gainful employment, mostly in the formal sector, even though improvements in the education of working age people has also been accompanied by a big increase in the number and share of educated unemployed.[44]

In sum, while many policy makers are quite rightly absorbed in the effects of the crisis and recovery, there are very fundamental shifts in the structure of the work force under way in Indonesia. As a result of slower population growth, and increases in female participation rates, and increases in completed schooling, the work force in Indonesia is fundamentally different today from two decades ago. On the one hand, possibilities for increasing productivity are greater, provided the government can create a more conducive economic environment for private business, small-scale industry and agriculture. But on the other, the more educated work force is demanding fairer treatment and a greater say in labor management matters than their parents did in the past. As we shall see in Chapter IV, the challenge is to channel these demands in directions that improve both labor standards and productive employment, rather than pursue the former at the expense of the latter.

Labor Demand: Employment Growth and Structural Change

Indonesia has experienced a major reversal in economic performance since the Asian economic crisis and the beginnings of political reform (*reformasi*) in 1997-1998. Slower economic growth rates, especially in the modern sector, pose a major problem for the creation of 'better' jobs and improvements in wages and associated welfare indicators.

Economic Developments

Even disregarding 1998, when the economy slumped by some13%, economic growth rates since the crisis have been only around half of those (6-8%) recorded for most of the preceding 30 years, and there were no signs of a significant improvement in 2002. In short, Indonesia is now experiencing what Deepak Lal has referred to as the 'Hindu' rate of growth of around 3%, which is barely enough to absorb new job entrants, let alone expand the share of 'better' jobs significantly. Thus, the major economic challenge is the recovery of investment and support for sustained economic growth. Set in context of longer-term growth in Indonesia and East Asia, Indonesia had experienced a long period of economic boom, stretching back 30 years. Even though it still had a relatively low per capita income (just over US$1000), on the eve of the crisis in 1997, the country shared much in common with its East Asian neighbors: rapid growth in manufacturing production and exports, high rates of saving and investment, supported by large capital inflows, relative macroeconomic stability and significant improvements in social indicators of development (education, health and the poverty status of the population).

Not only have economic growth rates been much slower but investment and exports have remained sluggish, after the massive capital outflow in 1997-98 (**Tables 3.3 and 3.4**). The capital account registered continuing net outflows through to 2002. Exports performed well initially but then tapered off. Thus GDP growth, at much slower rates than in the past, has largely been held up by consumption growth in the past 2-3 years. International assistance, under the umbrella of a recovery and reform program negotiated with the IMF, has assumed greater importance for the budget and macroeconomic stability.

TABLE 3.3 CHANGE IN GDP BY MAJOR SECTOR, INDONESIA 1987–2001[A]
(% PER ANNUM)

	Pre-Crisis		Crisis and Recovery		
	1987-1993 *Early Deregulation*	1993-96 *Later Deregulation*	1996-1999	2000	2001*
Agriculture	3.1	2.2		1.7	0.6
Mining	2.5	5.8		5.1	-0.6
Manufacturing	10.0	11.0		6.1	4.3
Electricity, gas & water	12.4	12.9		8.8	8.4
Construction	9.9	12.7		5.5	4.0
Trade, hotels & restaurants	7.6	7.6		5.6	5.1
Transport and communications	8.2	8.2		9.4	7.5
Finance, rent	7.9	9.2		4.3	3.0
Other services	5.0	4.3		2.2	2.0
Total	6.4	7.7		4.9	3.3

* Preliminary figures
[1] Measured in 1993 constant prices.

SOURCE: CBS, The National Income of Indonesia, various years.

TABLE 3.4: KEY MACROECONOMIC INDICATORS, 1990-2001

	1990-95[1]	1996	1997	1998	1999	2000	2001
OUPUT & INVESTMENT							
GDP Growth	7.6	7.8	4.7	-13.2	0.2	4.9	3.3
GDI/GDP	28	31	32	25	20	21	21
TRADE/FDI							
Export Growth (% p.a.)[2]	12	6	8	11	-31	26	2
Import Growth (% p.a.)	12	8.1	15	-5	-41	21	8
Current Account (Deficit)	-2.2[3]	-3.4	-2.3	4.3	4.1	5.2	4.7
Debt Service (% of Exports)	20[4]	21	13.7	12.9	16.7	11.2	13.8
FDI ($billion)	2.1	6.2	4.5	-0.4	-2.8	-4.6	-3.3
MONEY AND PRICES							
Gth in Money Supply(M2, % p.a)[5]	22.5	29.6	25.3	62.8	12.2	16.6	12.8
InflationRate[6]	8.8	7.9	6.7	57.6	20.5	3.7	11.5
Interest Rate[7]	11.8	14	27.8	62.8	23.6	10.3	15
Exchange rate							
Nominal: Rp/US$	2053	2342	2909	10014	7855	8422	10261
% Change[8]	4	4	24	244	-22	7	22
PUBLIC BUDGET[9]							
Expenditure/GDP(%)	14.9	15.6	15.7	18.8	17.4	17.3	22.9
Budget Deficit (% GDP)	0.7	1.2	-0.7	-2.9	-1.1	n.a.	-1.2

1. Unless otherwise specified 1990-95 period average. 2. Merchandise export values
3. 93-95 period average 4. 1992-1995. 5. M2, average annual growth; 1992-1995
6. Consumer prices. 7. Daily inter-bank rate; first column for 1991-95 (period average)
8. Annual shifts, positive figure denotes depreciation. 9. For 1995 only.

Given limited options for increasing public expenditure, policy reform is critical to the recovery effort. Slow progress in asset sales, debt restructuring and privatization, partly as a result of DPR interventions, and indications of increasing protectionism in agriculture, were worrying signs for the reform momentum so important for economic recovery and accelerated growth in employment and wages (Alisjahbana and Manning 2002a).

At the same time, there have also been some positive signs for the labor market. Macroeconomic stability was much improved by mid 2002: inflation had fallen to close to single digit levels, the exchange rate had improved, and interest rates on SBIs had fallen by several percentage points. By mid 2002, the budget was in better shape than any time since the crisis, as the government reduced fuel and other subsidies, and a modest 2-3% deficit was predicted for 2002.[45] The Bali bombings in October 2002 were a set-back to investor confidence. But they did not have a major direct impact on macroeconomic stability and the longer-term impact on growth from these events **alone** is likely to be quite small. To a considerable extent, this attests to the achievements of the government in restoring macroeconomic stability so necessary for renewed growth.

Employment

How has the employment structure changed in recent years, in the context of the difficult economic circumstances since the crisis and the labor supply trends discussed above? Three themes are pertinent for labor policy:

- First, **employment growth has slowed**, partly in response to slower labor force growth and partly as a result of lower rates of investment since the crisis.
- Second, **the informal sector has increased in importance**, reversing the trends towards expansion of the wage economy in the period preceding the crisis.
- Third, **there has been a 'switching' of employment in favor of tradable goods** industries that have expanded more rapidly than non-tradables, partly in response to the large depreciation of the rupiah. However, the real exchange rate advantage that Indonesia had in the years immediately after the crisis has been significantly eroded.

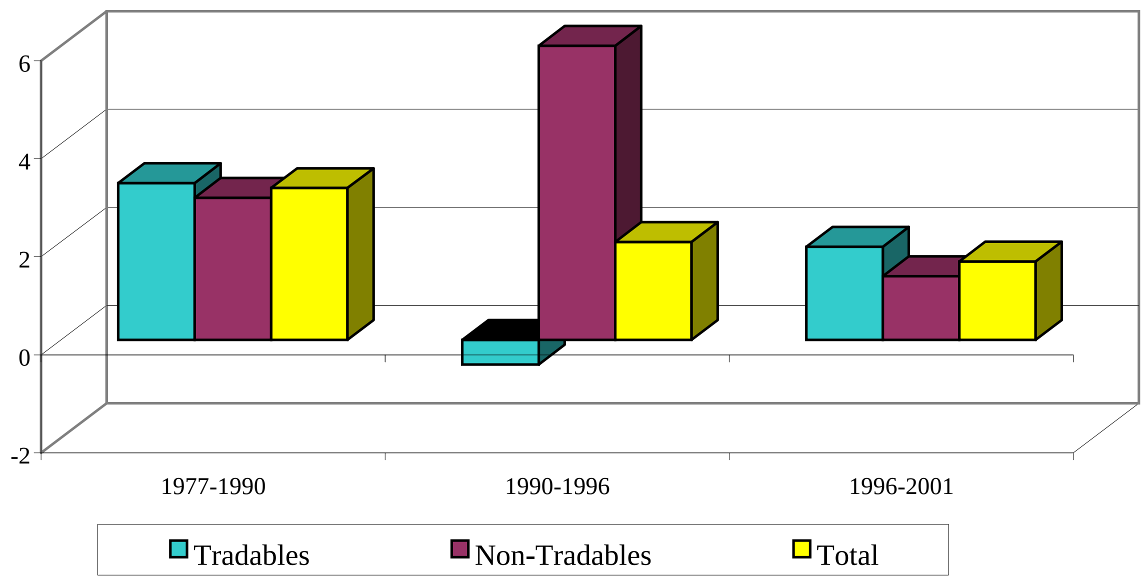
Table 3.5 indicates the change in employment by major sector, in the pre-crisis and post-crisis periods. It indicates the substantial fall in the share of agriculture in the pre-crisis period was reversed after the crisis. In addition to incentives for agricultural production, data on labor productivity imply that more people also crowded into agriculture in the post-crisis period. At the same time, rural employment grew very slowly, whereas jobs in urban areas continued to expand rapidly. Although agricultural employment expanded, this sector was

TABLE 3.5: EMPLOYMENT GROWTH BY MAJOR SECTOR, 1977-2001

	1977-1990	1990-1996	1996-2001
Tradables	3.2	-0.5	1.9
Agriculture	2.9	-1.9	1.8
Manufacturing	4.7	5.6	2.7
Non-Tradables	*2.9*	*6.1*	*1.3*
Construction	6.9	10.2	0.4
Trade	3.8	6.2	2.0
Services & Other	1.8	5.2	0.6
Urban	7.3	6.9	5.5
Rural	2.1	0.1	-0.6
Total	3.1	2.0	1.6

CBS, SAKERNAS 1977, 1990, 1996, 2001.

FIGURE 3.10: EMPLOYMENT GROWTH IN TRADABLE AND NON-TRADABLE INDUSTRIES, INDONESIA 1977-2001



Source: See Table 3.4.

not providing sufficient stimulus for other rural jobs. Many more people were seeking employment in the urban informal sector.

Employment in tradable goods industries that had expanded so rapidly during the early years of deregulation, and then slowed in the late New Order period, picked up relative to non-tradables in the recovery period (**Figure 3.10**). However, growth in tradable goods employment has been a fraction of growth rates achieved prior to the crisis, partly due to a slow-down in export-oriented growth in labor-intensive industries (see below).

Manufacturing Employment and Value-Added. Manufacturing employment recovered somewhat after the sharp fall in employment (10 %) during the crisis in 1998, partly in response to the rapid growth in export-oriented activities in 1999-2000. Numerous reports suggest that this recovery stalled in 2001 and 2002, when export growth slowed and there were increasing reports of job layoffs in labor-intensive industries in particular. Overall, despite the recovery in manufacturing after the crisis, annual growth in employment was only half that in the pre-crisis period.

Employment in modern manufacturing had been a major (in many respects **the** major) source of income growth in Indonesia following deregulation and the spurt in labor-intensive exports in the last decade of the New Order. Even though exports, output and employment slowed from around 1993/94 in the labor-intensive industries, employment and wages continued to grow until the crisis, and recovered after the sharp dip in production in 1998 (**Figures 3.11a and 3.11b and Table 3.6).** Some two million new jobs were created during this period, doubling employment in large and medium manufacturing at average wages several times that offered in small-scale enterprises. The present challenge is to regain the momentum in manufacturing employment growth while at the same time providing greater safeguards for worker rights and protection basic labor standards.

In the past few years, the country does not appear to have got the balance right. This is perhaps understandable, given neglect of labor rights in the past. Nevertheless, there seems to be little awareness of the economic and social cost of neglecting employment growth as a central goal of government policy. Most reports suggest that several of the critical labor-intensive sectors – food and beverages, textiles, clothing and footwear, furniture and timber,

FIGURE 3.11a: EMPLOYMENT IN MORE LABOR-INTENSIVE AND OTHER INDUSTRIES, LARGE AND MEDIUM MANUFACTURING 1986-2001

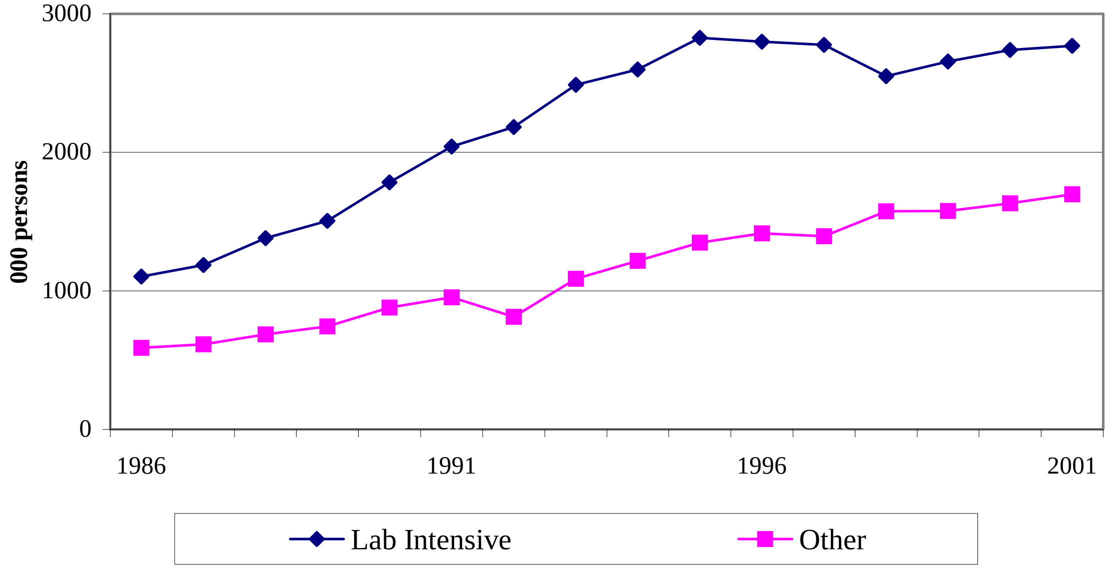
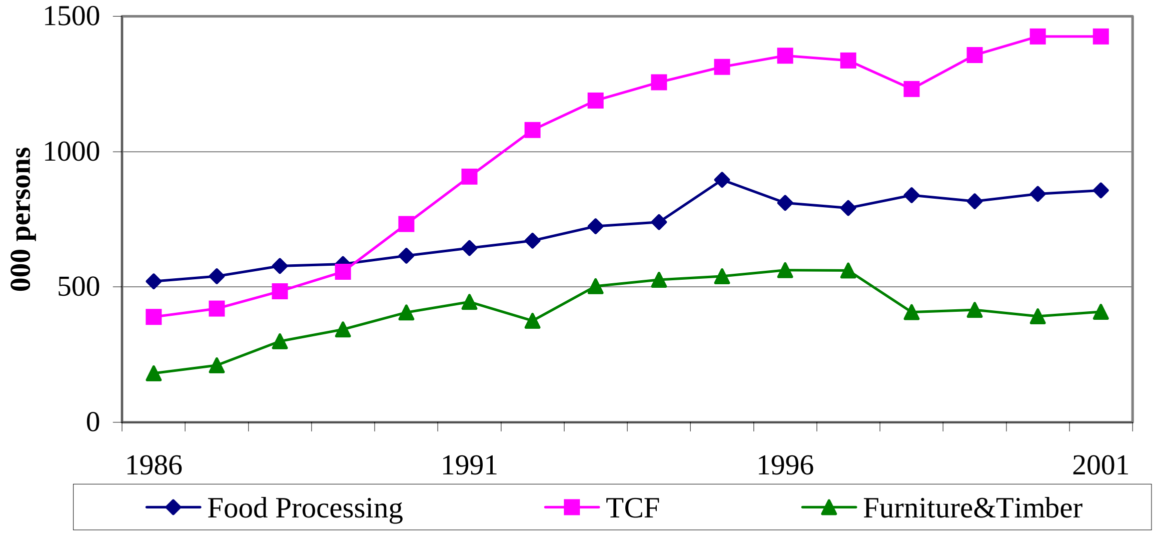


FIGURE 3.11b: EMPLOYMENT IN LABOR-INTENSIVE INDUSTRIES, LARGE AND MEDIUM MANUFACTURING, INDONESIA 1986-2001



Source: CBS, Surveys of Large and Medium Manufacturing, 1986-2001.

TABLE 3.6: EMPLOYMENT, REAL WAGES AND VALUE ADDED, INDONESIAN MANUFACTURING, 1986-2000 (% PER ANNUM)

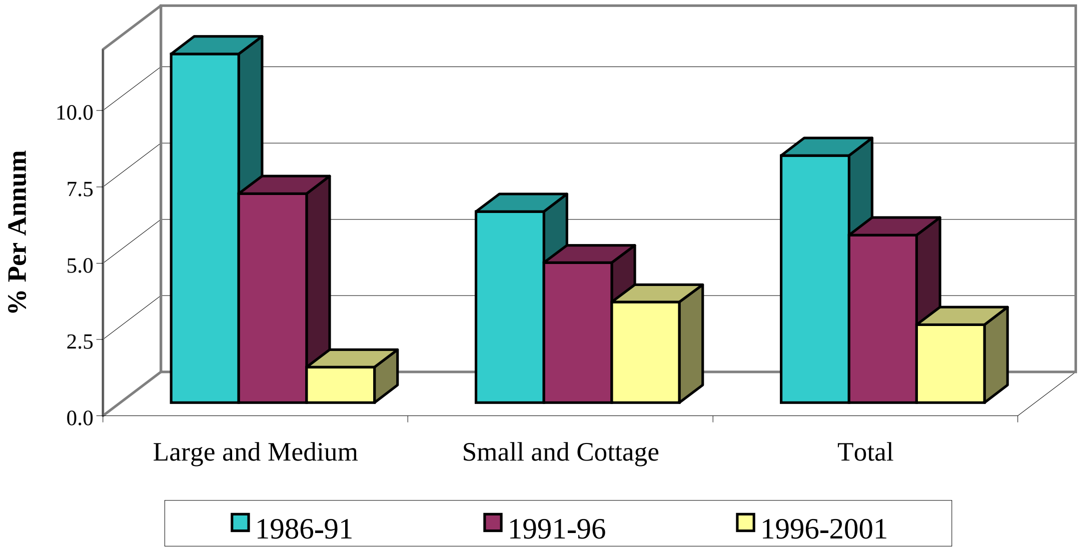
	Large and Medium	Small & Cottage	All Firms	Contribution of the L&M Sector To Growth (%)
	Annual Rate of Growth (%)			
Employment				
86-96	9.1	5.4	6.8	50.2
96-00	0.9	2.1	1.6	23.2
Wages				
86-96	4.06	4.51	5.89	87.0
96-20	0.85	-6.50	-0.59	-
Value Added				
86-96	5.86	1.12	7.13	92.6
96-00	0.72	-0.96	0.35	93.0

Source: CBS, Statistical Yearbook of Indonesia, 2001.

toys and various 'miscellaneous' industries – may have begun to shed labor in 2002. Anecdotal evidence suggests that the footwear and textile industries have been particularly hard hit by the slow-down. The flight of capital from labor-intensive industries has been highlighted by foreign investors, especially Koreans, and by foreign and domestic firms in the garments and footwear industries.[46] Although still a small proportion of some 500,000 workers reported to be employed in Korean companies, the closure of several high profile Nike and Reebok contractors resulted in labor protests in 2002.[47] Footwear manufacturer and association head, Anton Supit reported that some 200,000 workers have lost jobs in this industry from mid 2000-mid 2002 (*Asian Wall Street Journal*, August 13, 2002). In garments, Great River, one of the country's largest exporters, reportedly shed some 5,000 of its 15,000 workers in the same period as a result of labor problems.

Overall small-scale and cottage industry employment expansion was twice the rate of growth in jobs in large and medium manufacturing from 1996 through to 2001 (**Figure 3.12**). Production in these smaller firms was disrupted most by the crisis but recovered strongly after 1998, absorbing close to 80% of all jobs in the post crisis period, compared with only around half before the crisis (see Table 3.6**)**. Conversely, employment in large and medium manufacturing, which had grown very strongly in the decade before the crisis, only recovered slowly through to 2001.[48]

FIGURE 3.12: GROWTH IN MANUFACTURING EMPLOYMENT BY FIRM SIZE, INDONESIA 1986-2001 (% per annum)



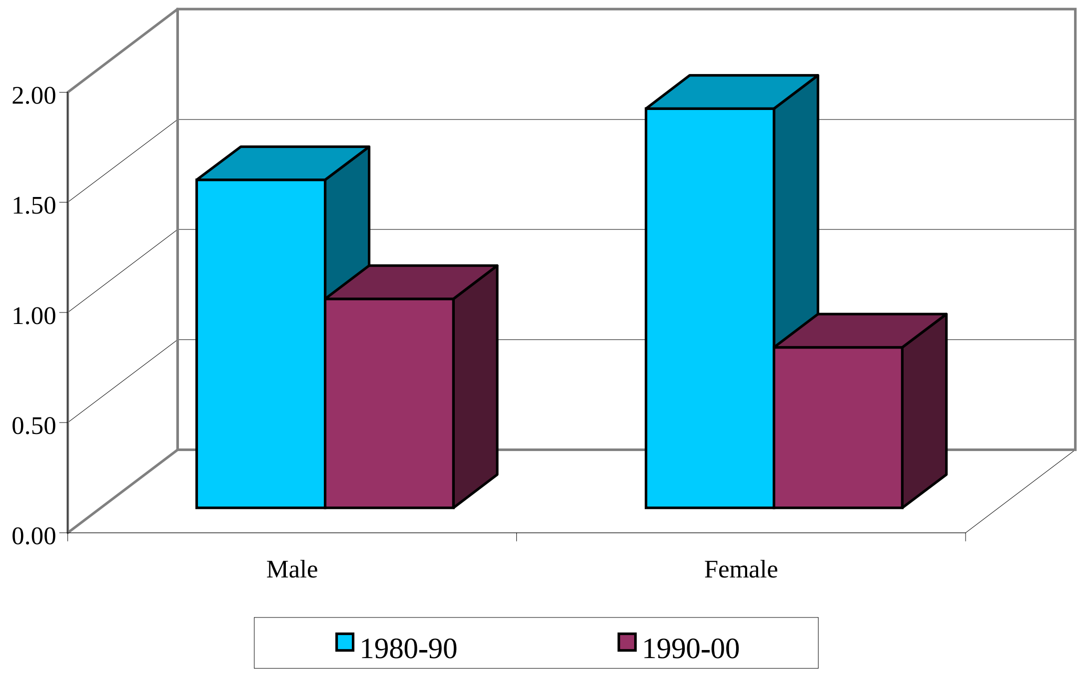
Source: CBS, Surveys of Large and Medium Manufacturing, 1986, 1991, 1996 and 2001.

Services and the Informal Sector

In contrast to manufacturing and even agriculture, employment in non-tradable sectors have barely recovered from the crisis. The construction industry was only just back to 1996 levels of employment by 2001, and services, including government, community and private services, as well as transportation also grew quite slowly. The slow growth in domestic demand combined with the switching of some activities to making tradable goods meant these industries were unable to play the significant role in total employment expansion. At least in part, this might also be attributed to the slow growth in modern sector manufacturing, which had employed increasing numbers of young village people, especially females, and provided a stimulus for service sector expansion in the rural economy before the crisis.

As mentioned above, the most important shift that occurred during and after the crisis was the movement of both males and females into informal sector work in urban areas. After growing very rapidly in manufacturing, construction and retail trade during the 1980s, urban wage employment growth had begun to plateau in the mid 1990s and then slowed considerably. Conversely, non-wage employment rose, mostly in the informal sector and especially as a share of female jobs in towns and cities across Indonesia (**Figure 3.13**).[49] Many more urban dwellers renewed links with the agricultural sector and more women

FIGURE 3.13: RATIO OF GROWTH IN WAGE EMPLOYMENT TO GROWTH IN NON-WAGE EMPLOYMENT, WORK OUTSIDE AGRICULTURE, INDONESIA 1980-90 AND 1990-2000



Source: CBS, Population Censuses 1980, 1990 and 2000.

shifted into urban jobs in trade. Males, on the other hand, found jobs in urban services and there was a sharp drop in wage jobs in the construction industry (reflected in the sharp decline in the 'trade and other' category in all wage employment shown in Annex Table 3.7).

Unemployment and Under-Employment

Unemployment had already begun to rise in the period preceding the crisis as increasing numbers of young, educated people began to queue for their first jobs in the modern sector (Manning and Junankar, 1998). Durations of unemployment were typically long, nearly half all young first job seekers and a third of those previously employed were unemployed for 12 months or more in the early 1990s. But in the absence of unemployment insurance, most young job seekers gained work by the age of 25-29 and few remained unemployed beyond the age of 30.

However, difficult economic circumstances during the crisis were not reflected in dramatically increased unemployment rates, or in under-employment. Unemployment rates rose during the crisis, but only by relatively small amounts and actually declined slightly to 5.4-5.5% in 2001-02 from a peak of 6.4% in 1999. This contrasts with a tripling of unemployment in South Korea and Hong-Kong, and a doubling in Thailand in 1997-1998, albeit from a low base level.[50]

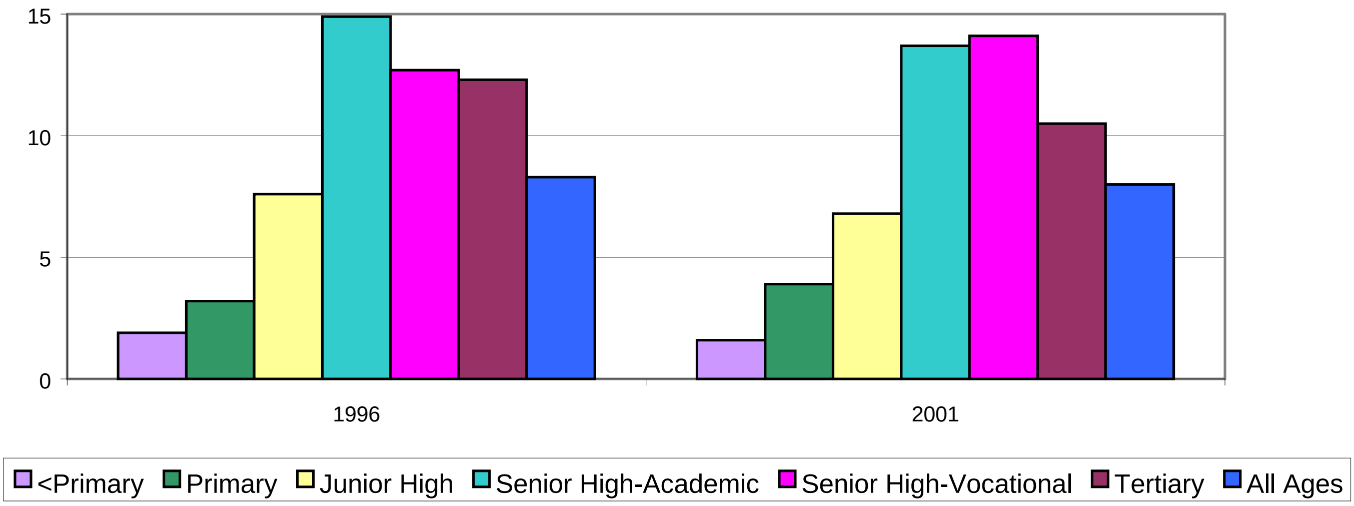
The composition of the unemployed changed during the crisis but only temporarily. The share of workers aged 30 and above, most of whom had been previously employed, rose sharply from less than 20% of all unemployed before the crisis to 40% in 1998, reflecting widespread job layoffs in the formal sector. But by 2001, most of those older workers had either retired or found other jobs, many of them using severance pay and savings to invest in enterprises in the informal sector.[51] In 2001, rates of unemployment by age and education were remarkably similar to those recorded before the crisis (**Figure 3.14**).[52]

Like unemployment, under-employment rates showed no clear trend during the crisis or during the recovery (**Table 3.7**). While more people worked less than 35 hours a week in most sectors in August 1998 than on the eve of the crisis in August 1997, fewer under-employed persons of both sexes were available for additional work in 1998.

Further, there appear to be no clear trends in labor under-utilization by hours of work during the recovery. Approximately one third of all employed persons worked less than 35 hours in the reference period from 1997-2001, although only around 12% of those who worked less than 35 hours were available for more work (more than twice the rates of unemployment). And although a much higher percentage of employed females than males worked less than 35 hours, especially in agriculture, most of these women were part-time workers who were not available for more work.

These data suggest that neither unemployment nor under-employment as currently measured are particularly useful measures of labor market imbalance in Indonesia (**Box 3.2**). In short, however appealing statements about the size and shift of 'total' or 'global' unemployment in Indonesia are to politicians and some consulting groups,[53] the significant labor market changes during the crisis, and in the post-crisis period, barely show up in measures of unemployment and under-employment. Rather they are illustrated in the worsening balance between better and worse jobs, crudely reflected in the formal-informal sector divide, and in trends in wages and productivity across different parts of the labor market. We turn to this latter subject in this final section of the Chapter.

FIGURE 3.14: UNEMPLOYMENT RATES BY EDUCATIONAL LEVEL, INDONESIA 1996 AND 2001 (%)



Source: See Annex Table 3.7.

TABLE 3.7: WORKERS EMPLOYED LESS THAN 35 HOURS A WEEK AND AVAILABLE TO WORK MORE HOURS, BY SEX AND INDUSTRY, INDONESIA 1997-2000

	1997	**1998**	**1999**	**2000**
MALE				
Agriculture	17.6	11.4	18.9	17.4
Manufacturing	5.9	4.7	6.4	3.9
Trade	7.6	5.3	7.5	5.8
Services	7.7	5.0	8.5	6.5
Other	5.7	4.6	5.8	5.1
Total Male	11.1	7.8	12.1	10.7
FEMALE				
Agriculture	21.1	18.5	21.8	20.2
Manufacturing	12.7	11.0	12.2	9.5
Trade	8.6	7.4	8.9	6.4
Services	12.3	8.4	13.6	10.5
Other	9.6	4.7	11.2	7.1
Total Female	15.0	13.1	15.7	13.8
Total: Both Sexes	12.5	9.8	13.5	11.8

Source: CBS, SAKERNAS 1997-2001

BOX 3.2: UNEMPLOYMENT AND UNDER-EMPLOYMENT: POOR INDICATORS OF LABOR SURPLUS?

Some have speculated that under-employment must have risen steeply in Indonesia in the absence of significant increases in unemployment, during the worst months of the crisis in 1998. The total number working less than 35 hours and available for more work was large, fluctuating around 10 million from 1997, compared with some three million unemployed. Together this puts overall rates of under-utilization at around 15-18% of the total labor force, based on these measures alone. At the same time, the data challenge the notion, now popular in Indonesia, that around half the workforce are under-utilized, and that the main labor market challenge is to provide these 'surplus' workers and job seekers with employment.

Why didn't unemployment and under-employment rates rise more in Indonesia during the crisis and why have unemployment rates fallen again, despite difficult economic circumstances in the recovery period? Several factors have been important.

- Part of the problem is conceptual. Unemployment does not capture labor market dynamics well in a country like Indonesia, even in urban areas. Unemployment as conventionally defined is a poor measure of labor market dis-equilibrium, or adjustment to shocks, especially in the informal sector and rural areas. In the latter, much of the work is in family businesses and on farms. In these activities, job search is quite different from efforts needed to gain modern sector employment, or job search practices more generally in industrialized countries.
- Low unemployment rates attest to the flexibility of Indonesian labor markets and the capacity of many people to find new jobs after being retrenched from wage employment. The informal and agricultural sectors offer alternatives for many rural-urban migrants who lost their jobs, especially if their families were already involved in family businesses. Moreover, unlike more developed countries, the Indonesian government has no system of unemployment insurance that might encourage people to leave poorly paid work and spend time searching for a new job.

Source: See SMERU (2001), Dhanani (2001)

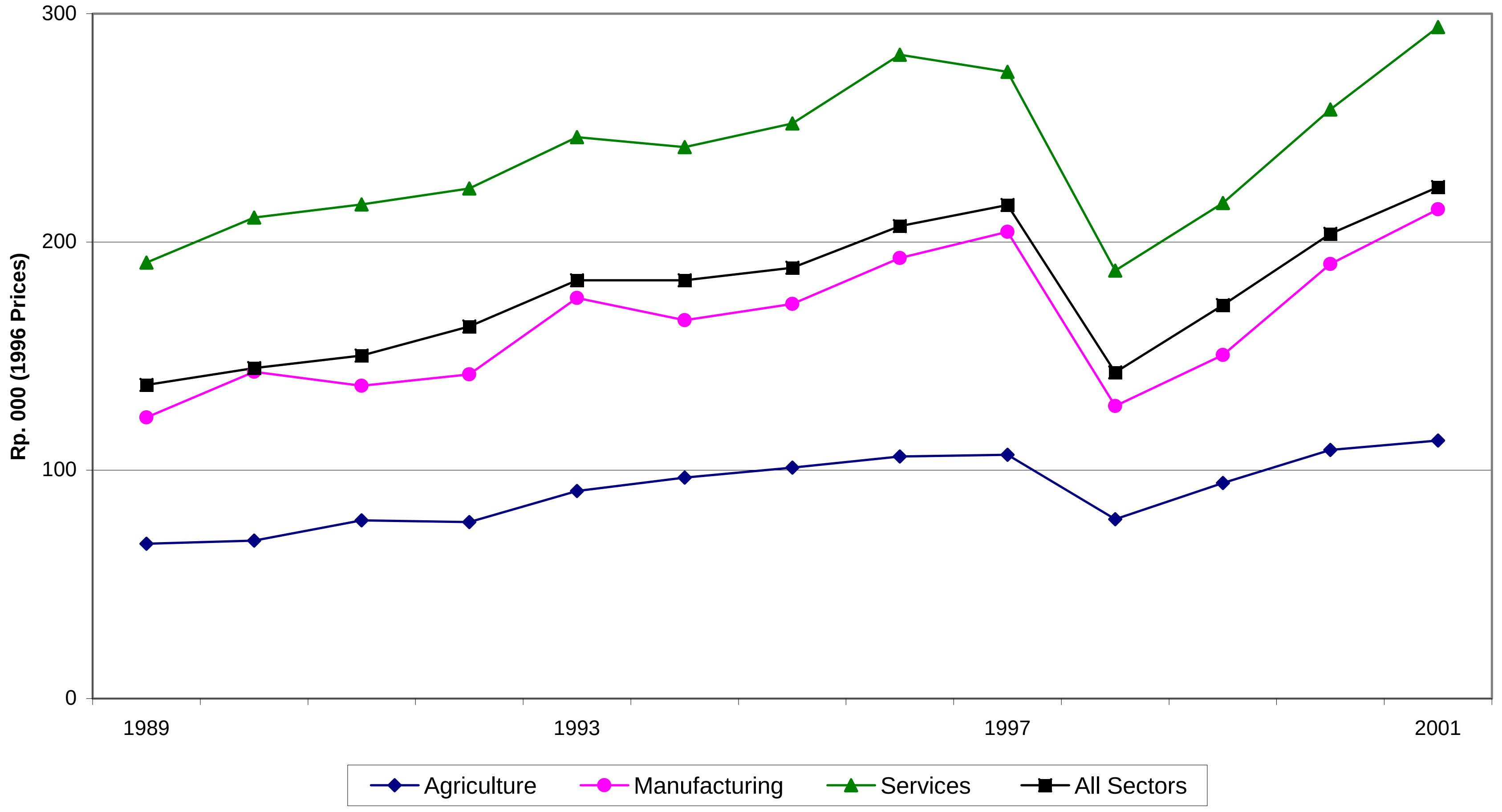
Trends in Wages and Productivity

Both the welfare of working people and the competitiveness of Indonesian tradable industries depends critically on trends in wages and productivity. Developments have not been favorable in the post-crisis period. Wages have increased in real terms (after taking account of inflation) in modern industry and services to above pre-crisis levels but they have stagnated for most workers in agriculture, especially on Java. We shall see in Chapter V that the increase in modern manufacturing wages appears to be closely related to labor market regulation, in particular minimum wage increases in the past few years, rather than increased competitiveness. Further, the slow-down in modern manufacturing growth has meant average levels of both wages and productivity have declined in real terms for the sector as a whole.

Figure 3.15 shows the growth in wages in major industries from the late 1980s through to 2001. The steady increase in real wages was halted by the crisis, when rapid inflation eroded the real value of wages in most sectors. Since then both services and manufacturing have recovered to above pre-crisis wage levels, and continued to rise in 2001. The wages of agricultural workers, which accounted for approximately 20% of all wage employment (only slightly less than in manufacturing), also experienced a recovery in 1999 and 2000. However, the increases were slower and tapered off in 2001. Wages in the single largest sub-sector for employees, rice agriculture, had not recovered to their pre-crisis levels by early 2002 on Java, although they grew more strongly in some Outer Island provinces (Papanek, et. al., 2002).

Within manufacturing, there was a major turnabout in performance compared with before the crisis, mainly due to the slow growth in the more productive large and medium sub-sector. The real value of wages declined and value-added per worker rose very little compared with levels reached in the pre-crisis period **(**see Table 3.6**)**. Real wages fell quite steeply in the small and cottage industry sector, suggesting a quite flexible labor market. Even though wages rose slightly in large and medium firms, it was the slow-down in wage performance in this sector compared with the pre-crisis period which helps explain much slower wage growth in total manufacturing wages and value-added during the recovery. Whereas higher productivity and wages in the large and medium scale sector contributed to increases in both average productivity and wages in the pre-crisis period, the reverse occurred

FIGURE 3.15: REAL WAGES IN MAJOR SECTORS, INDONESIA 1989-2001 (1996 prices)



Source: CBS, SAKERNAS 1989-2001, Intercensal Survey (SUPAS) 1995.

during the recovery. Average productivity and wages stagnated, as most of the new employment was in cottage and small-scale manufacturing.

The contrast between the two periods is dramatic. Total employment, average value added and wages all increased by six to seven per annum in all manufacturing in the pre-crisis period, whereas employment and value added barely increased, and real wages fell slightly overall from 1996-2000. In short, the rapid expansion of 'better jobs' has stalled in manufacturing in the post crisis period.

Not only are the prospects for better jobs for labor hurt by stagnation in productivity, total employment also suffered as a result of the reduced competitiveness of Indonesian industry, in contrast to developments in the New Order period. This can be proxied by trends in unit labor costs, which measure productivity growth (value-added per worker) relative to changes in labor costs, taking into account shifts in the exchange rate, in large and medium manufacturing. Despite substantial improvements in output per worker, unit labor costs had risen in the first half of the 1990s, as wage growth outstripped that of productivity (Manning, 2002).[54] Nevertheless, as already noted, employment continued to rise in this period, hence producing a 'win-win' situation.

Subsequently, unit labor costs fell sharply in Indonesia in the period 1996-1999, mainly because of the depreciation of the rupiah during the crisis. However, they began to creep up again in 2000, and appear to have risen quite steeply in 2001 because of rapid growth in both nominal wages and consumer (non-tradable goods) prices, and slower growth in output per worker.[55]

In sum, whereas rising wage costs before the crisis were also accompanied by sharply rising productivity, this has not been the case since the crisis when labor productivity has stagnated. Both increasing unit labor costs and slow expansion of the modern sector mean that Indonesia is increasingly facing difficulties in generating further growth in better jobs.

C. Some International Comparisons

Given the dualistic features of the labor market, it is worth looking at how Indonesia compares and contrasts with neighboring countries, both in labor market structure and change. For example, were employment conditions in Indonesia so different from those in neighboring countries as to suggest the government should adopt different labor policies? And how did labor market change in Indonesia compare with other East Asian economies, especially in relation to employment, wages and productivity growth in manufacturing, which played a central role in past labor market transitions in the HPAEs of East Asia (Manning, 1995).

The Structure of Labor Markets

Around the year 2000, Indonesia shared many labor market features with neighboring countries at similar stages of development, suggesting that the country can indeed learn from the experience of neighbors. Employment structure was quite similar to countries with slightly higher or comparable levels of per capita income (**Table.3.8**). Thailand, the Philippines and Vietnam, for example, all had a large share of the work force still employed in agriculture (Thailand unusually high at over 50% for a country at its stage of development; in Vietnam the share was over 70%, which is also very high by East Asian standards). The percentage of wage employment (a crude proxy for the formal sector) in total non-agricultural work was also relatively small in all these countries, although a little larger than in Indonesia. The participation of females in the work force was also similar.

However, the structure of employment in Indonesia did differ substantially from the more developed countries in the region like South Korea or Malaysia, where a small proportion of the work force was engaged in agriculture and the informal sector, and where labor costs and wages were much higher. In these economies, labor protection policies could be expected to have a major impact on the income of a high proportion of the work force (two-thirds or more), which was typically concentrated in the formal sector. Moreover, more advanced countries in the region, such as Japan, Korea and Singapore, could better afford to adopt policies which provide more protection for workers in the modern sector, since they could draw on a broader revenue base from the much larger middle class.

Do wages in Indonesia appear to be repressed compared with the other countries at similar stages of development? In general, the answer is no. While wages and value added per worker in manufacturing were quite low in Indonesia (although the latter not as low as in Vietnam), wages as a share of total value-added was quite similar in all countries (see bottom section of Table 3.8 and **Figure 3.16**). The level of wages was also generally consistent with each country's ranking in per capita income.[56]

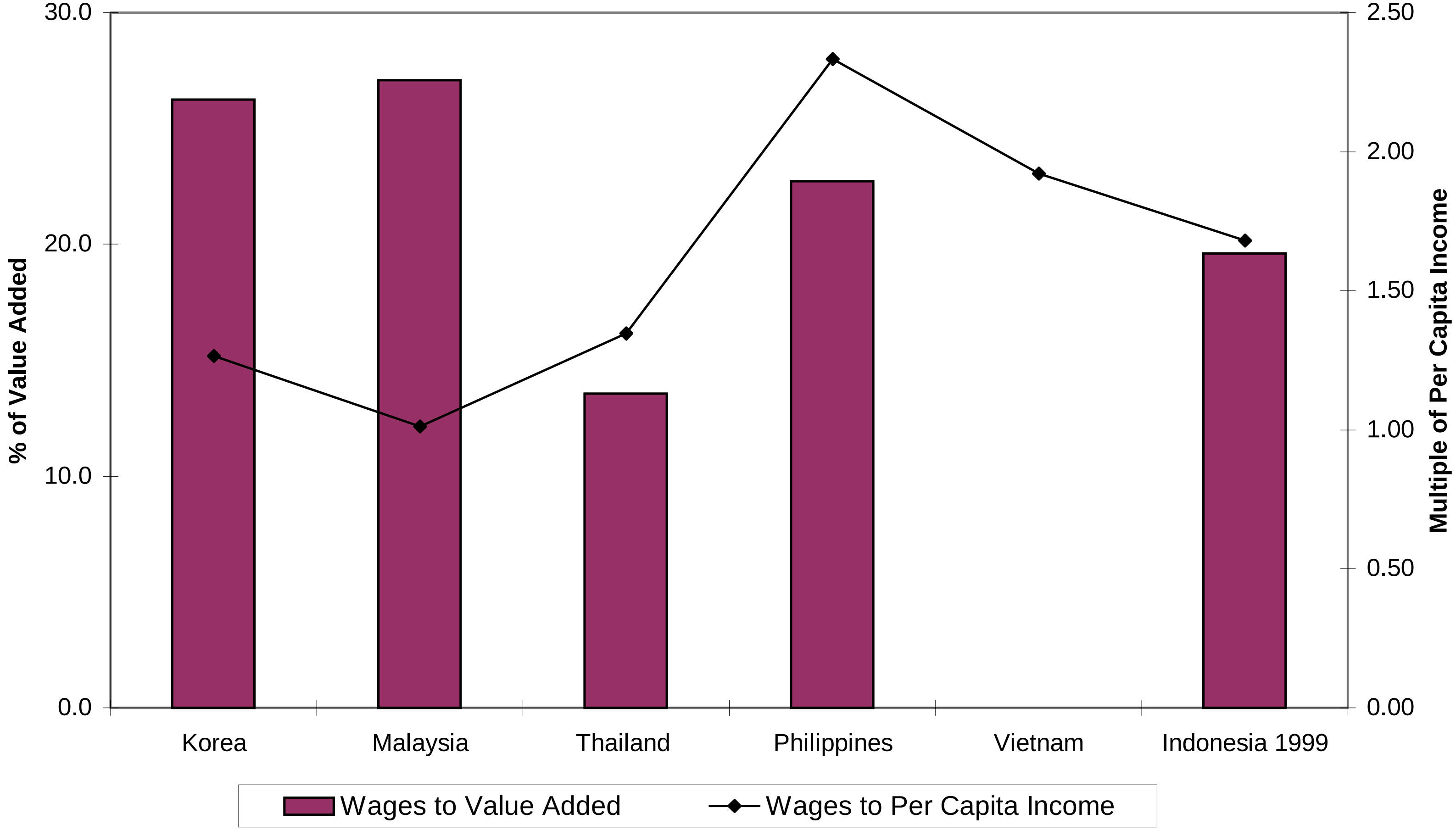
TABLE 3.8: LABOR FORCE AND EMPLOYMENT INDICATORS IN SELECTED EAST ASIAN COUNTRIES, CIRCA 1999

	Korea	**Malaysia**	**Thailand**	**Philippines**	**Vietnam** [2]	**Indonesia**
Per Capita Income						
Labor Force (m)	24	9	24	31	40	99
Unemployment rate (%)[1]	6.8	3.2	3.4	9.6	na	6.4
Employment Shares						
Agriculture	12	19	51	39	73	41
Industry	28	32	18	16	13	19
Services	60	50	31	45	14	40
	100	100	100	100	100	100
Female Work Force:						
Participation rate (%)	41	38	46	38	49	41
Share of Unemployed	34	65	46	38	na	51
Share of Employed - Agriculture	48	29	45	26	49	41
Industry	29	32	42	29	42	34
Services	47	42	50	51	52	42
%Children 10-14 in the work force	0	3	13	6	6	8
Average Hours Worked per Week	48	na	na	43	47	45 [3]
Lab. Cost per Worker in Manuf.	10743	3429	2705	2450	711	1008
Value added per Worker in Manuf.	40916	12661	19946	10781	na	5139
Ratio of labor costs to value added, per worker [4]	0.26	0.27	0.14	0.23	na	0.20

1 Unemployment data for 1996-1998
2 No data on unemployment for Vietnam; calculation of employment assumes the rate is the same for both sexes.
3 For wage employees only
4 Labor cost per unit of value added per worker

Source: World Bank, World Development Indicators 2001, Tables 2.1-2.5

FIGURE 3.16: AVERAGE WAGES AS A MULTIPLE OF PER CAPITA INCOME AND AS A PERCENTAGE OF VALUE ADDED IN MANUFACTURING, SELECTED EAST ASIAN COUNTRIES CIRCA 1999



Data presented for this small sample are thus consistent with the findings of larger international studies which find that wage rates across countries tend to be closely correlated with differences in national productivity, education levels and per capita incomes (Freeman, Oostenstorp and Rama, (2001).[57] Finally, these differences were consistent when calculated at purchasing power parity (PPP) prices, which take into account differences in purchasing power in each of the countries. Average wages were ranked in the same order as per capita incomes across countries.

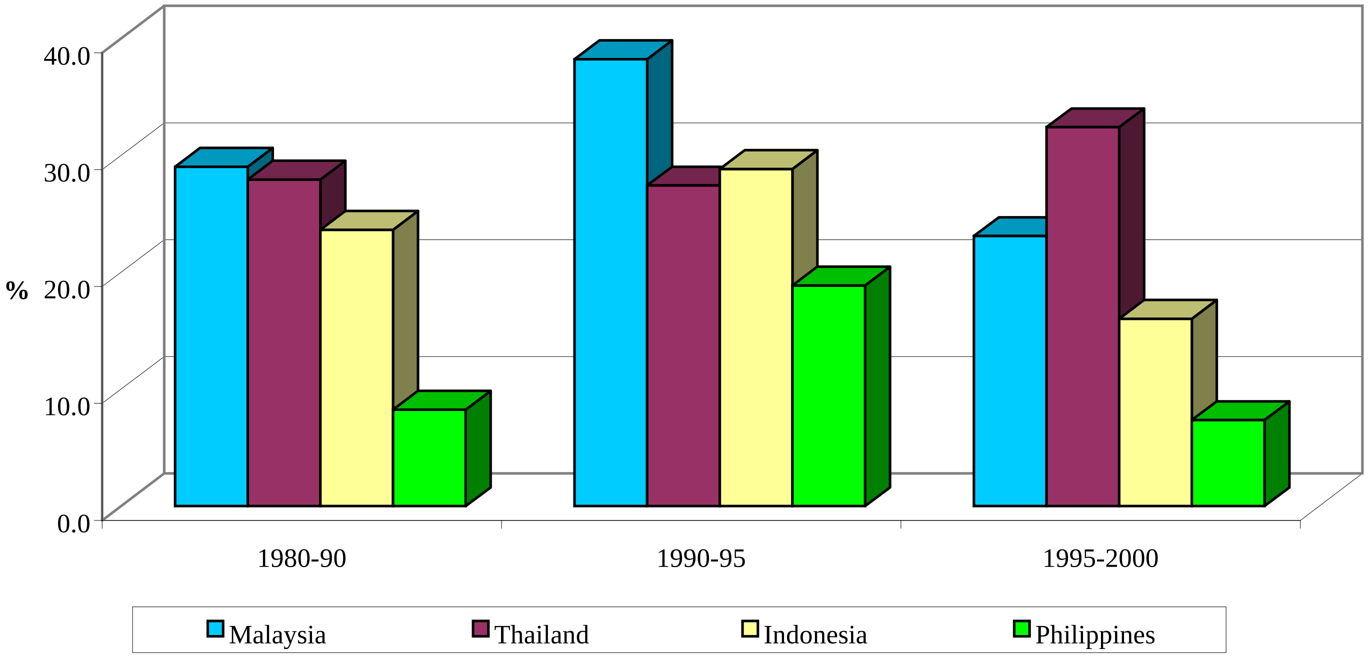
In sum, wages have been distressingly low in Indonesia. But they are not markedly different from what one might expect given its stage of development, measured by per capital income and levels of labor productivity.

Labor Market Dynamics

What about labor market **changes**? Has Indonesia lagged behind the other countries in employment growth, wages and productivity? The answer, again, is no. Among three other ASEAN countries with a similar economic structure – Malaysia, Thailand and the Philippines – manufacturing employment growth was only slightly slower in Indonesia compared with Malaysia and Thailand in the 1980s and 1990s. It was much more rapid than in the Philippines, before and even after the crisis. In relation to the share of non-agricultural jobs created in manufacturing, the Indonesian experience is closer to that of Malaysia and Thailand than to the Philippines (**Figure 3.17**).

Thus despite its high share of relatively capital- and resource-intensive industries, Indonesia was able to absorb well over 20% of all non-agricultural workers into manufacturing, a share that rose close to 30% during the period of rapid export-oriented growth in the early 1990s. In contrast, in the Philippines the share of all non-agricultural jobs created in manufacturing rarely rose above 15% (and was below 10% in the 1980s and again in the late 1990s). Slow manufacturing employment growth was not only associated with a more protectionist industrial policy in the Philippines than in Indonesia and the other three countries; in addition, labor policy there was more interventionist, especially with regard to minimum wages, as we shall see in Chapter V.

FIGURE 3.17: PERCENTAGE OF NEW NON-AGRICULTURAL JOBS GOING INTO MANUFACTURING, SELECTED SOUTHEAST ASIAN COUNTRIES 1980-2000



Source: ILO, Yearbook of Labor Statistics, Various Years.

Wages also grew as rapidly in Indonesia in the pre-crisis period as in several other rapidly growing Asian economies. A comparison with two of the East Asian 'tigers', Korea and Thailand, illustrates the point.[58] Real wages (nominal wages deflated by the CPI) rose steeply in all countries, on average by around 6-7% per annum (**Table 3.9**). Wage growth occurred across all sectors, both tradable and non-tradable.[59]

TABLE 3.9: GROWTH RATE IN AVERAGE EARNINGS, KOREA, THAILAND, AND INDONESIA, 1991-1996 (1995 PRICES)[1]

Sector	**Korea**	**Thailand**	**Indonesia**
1991-1996			
Tradables			
Agriculture	nd.	7.2	6.1
Manufacturing	6.9	7.8	6.9
Non tradables[2]	5.4	6.7	5.3
All Sectors	6.7	7.0	6.4
1996-1999			
Manufacturing	1.2[3]	1.2	-8.3
All Sectors	4.1[3]	1.4	-6.1

nd.= No data
Notes:
1. Data for Korea and Indonesia refer to annual averages, and average of February and August quarters in Thailand. All nominal average wages deflated by the CPI in each country.
2. Trade in Korea, Services in Thailand and Indonesia
3. Data for regular employees, to third quarter 1999.

Sources: Indonesia. Central Bureau of Statistics (various years a); Korea. National Statistical Office (various years) and the Korean Labor Institute, *Quarterly Labor Review*, 12(4), page 8.; Thailand, National Statistical Office (various years).

Whereas Korea had long faced shortages of unskilled labor, the relative labor surplus of earlier periods appeared to be finally over in Thailand and Indonesia by the early 1990s. Previously, the main adjustment in the labor market in both countries had been through absorption of new labor force entrants and agricultural workers into the modern sector at constant real wage rates – following the classic labor surplus model discussed in Chapter II. However, by the 1990s, real wages had begun to grow quite rapidly in the modern sector as labor moved out of agriculture and into manufacturing and services. The combination of an expanding demand for labor and slower labor supply growth was beginning to impact the incomes of less skilled workers and contributed to a steep fall in the incidence of poverty in all three countries (Asian Development Bank, 2000: 179-82).

These data beg the following questions, to be addressed in Chapters IV and V:

- Is it in the interests of most workers for Indonesia to emulate the more nationalistic and interventionist industrial and labor policies of the Philippines and several Latin American countries?
- Or, alternatively, will workers be better served by drawing on the experience of other countries in the region with more extensive controls over organized labor but a much better record of job creation and improvements in living standards, including poverty alleviation?[60]

It has been argued that employment growth which delivers better jobs for a higher proportion of job seekers, and especially for employees in low productivity jobs, is the most important priority for improving living standards of most working families. However, in Chapters IV and V we also suggest that there is a middle ground between extreme market-oriented and interventionist policies. The choice is not simply between a pure market-oriented approach that neglects basic labor rights and standards (as in some East Asian countries in the past), on the one hand, and interventionist polices that intrude on private sector decision-making and discourage employment in the modern sector, on the other.

D. Conclusions

Three themes in have been emphasized in this chapter, all of which provide the empirical basis for our discussion of labor policy in Chapters IV and V.

First, over the past three decades, economic growth has created a small but significant share of more productive 'better' jobs at relatively high wages in modern manufacturing, services and the very small extractive sectors (oil and minerals). The rate of job creation in the modern sector faltered, however, after the Asian economic crisis of 1997-98. Before the crisis, the creation of better jobs in the modern sector occurred mainly through market processes. The government's direct role in the labor market was limited to interventions on the labor supply side (especially through population and education policies) and controls over labor organizations on the other. However, as we shall see in next two chapters, government regulation of minimum standards and the activities of a free trade union movement have played more important roles in improving labor standards of modern sector workers in recent years.

At the same time, the Indonesian labor market is still dominated by informal sector and agricultural employment at low wages. In the medium to longer term, a major challenge is to increase the supplies of better jobs and of more qualified job seekers.

Second, the negative impact of the crisis and slow economic recovery has been mitigated in its effects on the labor market through a flexible response in employment and wages, and favorable longer-term developments in labor supply. These provided a cushion for many households, although levels of poverty rose significantly in the aftermath of the crisis. Maintaining this flexibility together with greater labor protection for the vulnerable is important for further employment growth and improving labor standards in general.

Third, associated with slower economic growth, Indonesia is now at a crossroads in terms of regaining momentum in modern sector employment growth, which was critical for improvements in living standards before the crisis. While average wages in modern manufacturing recovered quite quickly after the crisis, employment has grown quite slowly. Coupled with this, the government can no longer afford to provide a significant share of 'better' jobs for more educated people, a role that it once played during the oil boom years. One central element of an employment-friendly strategy is the creation of a much higher share of 'better' jobs than in the past.

These developments suggest that employment-friendly policies are urgently needed if the country is to regain the momentum in creating more productive and rewarding jobs in both modern and traditional sectors. Labor policies that encourage employment growth in higher productivity jobs would seem to be a necessary condition for improved living standards in coming years. At the same time, unlike during the New Order, the government will have to define and meet minimum (and affordable) standards of social welfare, as well as guarantee basic labor rights in a more democratic polity.

In the next two Chapters we examine the extent to which labor policy and emerging institutions have supported favorable labor market outcomes, and how policies can best be molded to help meet Indonesia's pressing challenges in providing new and better jobs and raising labor standards.

CHAPTER IV

EMPLOYMENT FRIENDLY LABOR POLICIES: INDONESIA'S CHALLENGE

As noted in the introductory chapter, Indonesia is at the crossroads in developing labor policy in the *reformasi* and post-Soeharto period. Important breakthroughs have been achieved or are in the making in the regulation of worker rights and standards. They include the affirmation of basic trade union rights, improvements in social security through some aspects of severance pay regulation, and the setting of minimum standards for child labor and less advantaged workers. However, some of these changes will be costly in social and economic terms. The government has initiated, and is in the process of introducing, regulations and laws that have already harmed employment growth in the modern sector. They have the potential to affect productivity adversely and to slow the creation of 'better' jobs and improvements in living standards in Indonesia.

The emphasis in this Chapter is on the role of labor policy in modern sector employment growth and improved living standards in the traditional sector in the post-crisis period. As mentioned, government regulation has helped recovery in labor conditions since the crisis. But it is now beginning to tread a dangerous path from the standpoint of modern sector employment growth and related improved welfare in the informal sector.

We start by placing these developments in some historical perspective. For the directions of future policy, it is important to recognize that from an international standpoint, labor laws and regulations have long sought to protect modern sector workers. It is the implementation of labor protection policy that is deficient.

The chapter deals changes in the regulatory environment in the post crisis period, drawing particular attention to polices on labor standards, changes in severance pay policy and the new labor laws now before Parliament. Finally, we examine industrial relations processes that are also undergoing major revision.

A. Historical Antecedents[61]

Contrasts are often drawn in economic performance and structure between Indonesia's main eras, the Soekarno period, the government of Soeharto (the 'New' Order), and the current period of political reform, the *reformasi* period. While there were some important differences, there were also similarities that are relevant to the discussion of labor institutions and policies. Labor law, derived from prevailing practice in Holland after the Second World War, has been quite pro-labor in many respects, especially related to retrenchment of workers and hours of work (40), overtime and special provisions in the labor law such as leave granted to women experiencing menstruation and maternity leave.[62]

Second, the main articles of the labor law tended to be implemented in state enterprises and these created a standard, outside the civil service, for practice in the modern private sector. State enterprises have been an important feature not only of services but also of manufacturing and plantations where a significant proportion of the modern sector work force was employed, especially in the Soekarno period (Hill, 1990). It was only with deregulation in the mid 1980s that privately owned establishments began to dominate the modern sector. Like in other countries, public enterprises were heavily protected and were hence often comfortable in offering generous wages and conditions of work to industrial workers, compared to what they could earn elsewhere in the economy (Manning, 1979).[63]

The fundamental difference between earlier periods and the late Soeharto and *reformasi* eras was that the potential conflict between protective labor laws and employment was never a major policy issue in earlier periods. There are several reasons for this. First, the modern sector was tiny for much of the Soekarno era, and even for many years into the Soeharto period. This share rose slowly but even by the time of the fall of Soeharto it was far below the 25-30% of the work force that was absorbed into this sector in Korea, Taiwan and Malaysia at similar stages of development (Athukorala and Manning, 1999).

Second, the manufacturing sector was highly protected until the mid 1980s. Thus the tension between the need to maintain a competitive cost structure and keep labor costs down, on the one hand, and the political pressures to improve labor standards, on the other, was not felt so sharply. *Third*, in both periods, but especially in the Soeharto era, tight controls were exerted over the organization and actions of trade unions (Hadiz, 1997).

With the market-oriented reforms of the second half of the 1980s industrial disputes became a major economic issue for the first time in decades. Export-oriented enterprises were much concerned about labor costs and paid wages much closer to the market rate than many protected firms. Labor disputes became a concern for the first time since the 1950s (Manning, 1998). Labor unrest increased in response to both domestic and international pressures. The government refused to release its tight control over trade union organization at the national level, although it did permit the formation of unions not affiliated with SPSI at enterprise level from 1994 onwards. Instead, its strategy was to offer industrial workers significantly higher minimum wages set by the Central Government for each region, and to step up enforcement of minimum wage laws. This legacy of government wage regulation now poses a challenge for policy makers, as compliance has risen with the new free labor movement.

B. Labor Policy in the *Reformasi* Period: General Considerations

Conceptually, it is useful to think of labor policy in the *reformasi* period since 1998 as focusing on four sets of overlapping areas of regulation:

- *Labor Cost Issues*. Policies which **directly affect the cost of most workers in the modern sector**, most importantly minimum wages but also the regulation of overtime, severance pay regulations and social security regulations which require contributions by employers.
- *Labor Market Flexibility*. Policies that **directly affect the flexibility of wages and employment**, most importantly severance pay regulations, including laws governing dismissals and retrenchments, several clauses in the proposed labor protection act. Minimum wage regulations should also be included here, since they can hinder any downward adjustment of (nominal or real) wages in response to adverse developments in product markets.
- *Labor Protection*. Policies which **directly provide social security, protection and social safety nets for less advantaged workers**, especially limiting the use of child labor, outlawing forced labor, and protection of female workers. Minimum wages in many countries seek also to protect vulnerable workers, although we shall see that in Indonesia the objective of recent policies has been to regulate entry levels wages for all unskilled and semi-skilled workers.
- *Industrial Relations and Labor Disputes*. Policies which **directly regulate the industrial relations climate, trade union freedoms, collective bargaining and processes of dispute resolution**. Many of these subjects are regulated in the proposed labor protection act (and hence create some confusion for workers and employers) and in the proposed disputes resolution act, both still before the Parliament in September 2002.

As implied by the above description, single sets of policy can have multiple objectives and consequences, such as the minimum wage policy or severance pay regulations as currently applied in Indonesia. But in general terms, we will argue that labor policy should concentrate most on the third and fourth objective (providing social safety nets for the disadvantaged and regulating industrial relations processes). In order to maximize employment creation and productivity improvements, it should attempt where possible to minimize the impact of official policies and regulations on the general level of wages and the capacity of employment and wages to adjust to changing economic circumstances.

Before turning to each subject in turn, it is necessary to reiterate the general principles that underpin sustained improvements in living standards for most workers, discussed in Chapter II, based on the accumulated experience of both developed and developing countries in the past 20 years or more.[64] The principal goal of all development policy and labor policy in particular is to protect citizens' basic rights, increase public participation in decision-making and raise the standards of living of the population. Aside from affecting technology improvements and shifting investment and jobs into more productive and rewarding work environments, modern sector productivity depends critically on bargains voluntarily arrived at between employees and employers in the workplace. The principal goal of employment-friendly government labor regulations should be to enhance this process.

Support for trade union freedoms and explicit rules on how contracts are made, and conflicts resolved, are an essential part of providing a more just and productive work environment. Protection of vulnerable working groups is also critical. At the same time, there is no example in modern history of sustained improvements in productivity and living standards achieved through regulations and institutional structures that override the bargaining process at enterprise (or industry) level. Unfortunately, some current and proposed policies in Indonesia are seeking to do just that, with strong political and civil society support.

C. Labor Standards And Protection[*]

There is an inevitable tension between asserting a minimum standard of labor rights and protection, on the one hand, and confronting labor market realities in a dualistic and relatively low-income economy like Indonesia. Thus countries have tended to set varying minimum standards according to national needs and social and political conditions. As noted in Chapter II, even seemingly indisputable core standards, such as child labor, are interpreted differently across countries according to social and cultural norms.[65] Maximum hours of work at normal pay, overtime rates, and a host of other standards vary across countries. Rights to organize and bargain collectively, as set out in ILO conventions 87 and 98 are standard across countries, yet regulations on issues such as multiple unionism in the work place differ from one country to another.

In the past, compliance was low and there were always means of circumventing legislation in Indonesia. Although these practices still go on, compliance in the modern sector is now much higher, as trade unions demand their rights in accordance with the law and collective labor agreements. It now matters for employment and for wage costs, primarily in the modern sector, if standards are set at levels that bear little relationship to labor market realities.

It is assumed, implicitly, by policy makers that many articles of the labor code (often based on the economic environment of the industrial countries) will apply mainly to larger scale firms, as is the case in Indonesia today (SMERU, 2002). Nevertheless, standards that are set with reference to developed country norms will tend to increase tensions in the work place and contribute to evasion of the law. The government's difficult challenge is to find a level of protection that is enforceable in the modern sector and yet does not threaten the creation of new and better jobs for the many 'unprotected' workers in informal and traditional sectors.

Some employers argue that many clauses of the proposed labor laws are too extreme because they do not accord with practice in some neighboring countries, such as China and

[*] This and subsequent sections were written prior to the new Manpower Protection Act (No. 13 2003) passed by parliament in early 2003. While the large majority of articles from the draft act were included in Act 13, there are several minor differences of detail, especially with regard to rates of severance pay, and in relation to the treatment of workers dismissed for criminal acts and the offer of pay to striking workers.

Vietnam. Implicitly they threaten to take their investments off-shore. This is not a valid argument for diluting labor laws in Indonesia. The country must make up its own set of regulations based on domestic conditions, not those in China, or indeed developed countries. Moreover, it can be argued that Indonesia has a real opportunity to bring in a labor code which is not only fairer to workers than in some countries such as China, but is likely to give it a competitive edge as companies begin to create a more stable and committed work force. In addition, Indonesia has a real opportunity to adapt the labor law to more recent international best-practice in some fields. In this it is able to take into account the longer term challenges of globalization and to avoid some of the pitfalls against the best interests of the total labor force, such as occurred in some Latin American countries in earlier decades.

In the area of labor law (and industrial relations), Indonesia is engaged in a major transition after many years of neglect. As noted above, the shortcomings of the present system are not so much in the laws related to labor protection, as in the levels of compliance and absence of respected institutions entrusted with implementation, an outcome of neglect during the Soeharto years. For this reason, there are strong arguments for establishing priorities (rather than going for the 'big bang' approach so often favored by politicians and policy markers), which introduce standards that are enforceable and can be extended, as capacity for labor administration and collective bargaining improve and institutions develop. Prioritization might relate to the time frame for implementation, the regional coverage of laws and the size or nature of enterprises (larger rather than smaller firms). The experience of Korea (for example, in the case of multiple unionism at plant level) and some other countries suggests that implementation of some clauses of the law may be delayed until implementing institutions are better prepared. For example, we shall argue that the ambitious target of introducing labor courts across the country might be better achieved by focusing on key industrial centers first, and then extending the new institutions to regions where labor regulation is a less pressing issue for improvement in the welfare of workers.

What are the key areas of labor protection? Five can be singled out for special attention in the context of furthering the twin goals of improved standards and continued job growth:

- Protection offered to all employees on basic conditions of work.
- Protection to disadvantaged and vulnerable groups.

- The regulation of dismissals and retrenchments
- The regulation of contract workers
- The regulation of severance pay – in reality unemployment benefits for many.

We deal with the main issues, both in past and proposed legislation on each of these subjects.[66]

General Labor Protection

As noted above, aside from minimum wages, severance pay and regulation of dismissals, Indonesia has long already established a comprehensive set of labor regulations with regard to labor standards. These cover hours of work (a 40-hour working week), annual leave (12 days), overtime payments, and annual bonuses or the Idul Fitri bonus (1 month's pay). All of these subjects are regulated in the new labor protection law. The issues here, therefore, relate more to implementation of the law, than to the introduction of new regulations. Improvements on these basic standards should be considered matters for collective bargaining at the enterprise and industry level.

Unfortunately, there has been a tendency to extend some of these provisions in the new labor law, such as mandating companies to offer long service leave (3 months) after six years of service with a company (on the basis of capacity to pay). While not a major issue, such clauses are best left to negotiation between employers and unions rather than mandated on a vague capacity to pay basis.

Protection of Disadvantaged and Vulnerable Workers

Like general standards of work, Indonesia has a quite comprehensive set of regulations now included in the new labor protection act covering female and child workers. Several of these are covered in the ratification of ILO Conventions No. 100 (ratified in 1958), 111 (ratified in 1999) on discrimination in employment and occupations by sex and race, and 138 and 182 on minimum age of employment of children and worst forms of child labor, the spirit of which is now included in the labor protection act. Together with the ratification of the ILO Conventions on forced labor and trade union freedoms, this means that Indonesia has now signed up on all the eight 'core' ILO conventions.

There are still some controversial clauses, however. One is a total prohibition on night work for pregnant females including, for example, night work among nurses, a key occupation for female employees. Another is the long-standing obligatory two days leave during menstruation, which is rare in modern labor codes. Both are examples of paternalism, which could be better dealt with in bipartite negotiations at industry and enterprise level.

Protection Against Dismissal and Retrenchment

Not only are wages in the modern sector relatively less flexible than in the past as a result of minimum wage regulation and increased compliance. There are also major constraints to downsizing the permanent work force in individual enterprises. Part of the inflexibility in employment decisions relates to higher costs of severance. But contrary to popular reports in the press, the high cost of dismissals has not merely been related to the level of severance pay set out in the controversial Ministerial Decree on severance pay (*Kepmen 150*) or provisions that replace it in the proposed Labor Protection Act.[67] But the regulatory framework has long made it difficult for private enterprise to lay-off or dismiss workers.[68] More importantly, retrenchments have been costly in the past partly because they are required to be referred to the government disputes councils, in the regions or in Jakarta, for permission in *every case* of separation.

Both employers and employees have been penalized by the slow and uncertain process of decision-making through the regional (provincial) and central government disputes' councils.[69] The decision-making process in relation to dismissals has been neither transparent nor consistent, and hence creates uncertainty and the chance for opportunistic behavior on the part of unions, employers and government officials (SMERU, 2002). In the past, the judgments of the councils often (but not always) worked in favor employers. But since *reformasi*, under a more sympathetic Manpower Ministry, many more decisions appear to have gone in favor of the workers, resulting in either reinstatement or substantial severance payments (often set by Manpower officers at well above the required rate) to dismissed and retrenched workers.[70]

It is not altogether clear how this will work in the future, with the planned disbanding of the disputes councils and their replacement with industrial courts under the new proposed acts. In some respects, the costs of dismissal may be lower now than they were in the past.[71] Nevertheless, greater pressure for compliance with the regulations has probably contributed to less control over staffing policies in recent years. This has occurred precisely at a time when there are good arguments for giving business greater freedom to adjust the size of their work force, as firms seek to adjust to a more competitive and uncertain global environment, which impacts on the demand for their products.

A modern labor code should give discretion for hiring and firing decisions to management, subject to enforcement of contracts, bipartite negotiation of circumstances which constitute unfair dismissal, and a legal framework which allows workers and unions to have appeals heard in industrial tribunals or courts. In the absence of unemployment benefits, regulated severance payments are also justified in the Indonesian case.

In his evaluation of the new industrial relations framework, Zimmerman (p. 39) notes that “Even where, as in the Manpower Bill, employment termination decisions must be based upon valid reasons, advance approval is not required by international labor standards and is contrary to most modern labor codes.” He suggests that advance approval might only be required by law for certain categories of vulnerable workers, such as union officials. In short, the entire set of regulations related to dismissals, introduced in the protected economic climate for business of more than 30 years ago is no longer appropriate for today’s conditions and is in need of a total overhaul.

Contract Workers.

While employment of workers on fixed, short-term contracts is permitted under the proposed law,[72] there are strong pressures to restrict these arrangements to certain industries and for limited durations. The issue has been important in debates on labor regulations in Latin America, where it has been argued that tight controls over temporary employment of contracts have severely limited the flexibility of production and the capacity of firms to respond to fluctuations in product demand (Cox-Edwards, 1997: 137). It would be harmful to Indonesia’s capacity to compete in international markets, and hence provide more jobs in the modern sector, if tighter restrictions on temporary contracts were introduced precisely at a time when international practice is moving towards shorter rather than longer employment contracts in many industries. Further, in addition to the need for flexibility to meet fluctuating export orders, wide variations in the seasonal demand for agricultural-based commodities is an important structural feature of the Indonesian economy.

There are good arguments for ensuring that employers do not exploit contract work regulations by re-appointing contract workers to avoid incurring the costs of a more permanent employment relationship. Thus the duration of contracts and conditions for their extension are usually regulated by governments.

However, employment would be reduced by introducing tight restrictions on employment of workers for contract work (either from time to time or on a seasonal basis) in the modern sector. In the context of a dualistic labor market discussed above, it is important to bear in mind that there will always be a continuum of employment relationships in an economy with a large informal sector. In one sense, temporary contracts in the modern sector link the formal and informal labor markets. Workers tend to earn higher pay and have more stability of earnings under temporary contracts in the formal sector, than is the case with much of the work and pay in the informal sector.

Viewed from this perspective, temporary contracts can be steppingstones for entry into more permanent employment relationships in the modern sector, while at the same time giving firms greater opportunities for flexibility in production and exports. It is unrealistic, and harmful to employment, to try to divide the labor market into two discrete segments, a modern formal sector characterized by permanent employment relationships and a traditional sector where temporary employment is the norm.

The 'formalization' of jobs in more permanent contracts can, of course, be encouraged through public sector investment in human capital, as well as through the emergence of large economic units as economic growth proceeds. However, it is not clear that mandating permanent contracts in the modern sector will in some way contribute to higher productivity (as some labor activists suggest) in industries where there is a strong rationale for employment of a significant number of workers on temporary contracts. It will almost certainly be harmful to job creation, both in the short-run and probably also in the longer term.

Severance Pay and the Debate over *Kepmen 150*

The most controversial change in labor regulation in recent times relates to the Ministry of Manpower Ministerial Decision no. 150 passed in 2000 (hereafter referred to as *Kepmen 150*) regarding dismissals and regulation of severance and long service pay (*uang* *penghargaan/jasa*).[73] Most articles in this Decision have been incorporated in extraordinary detail in the proposed Labor Protection Act (articles 145-167 on dismissals, in the Draft Act before parliament in September 2002).

The new legislation increases the return to voluntary quits, in particular, and raises the costs of turnover more generally.[74] Compared with regulations already passed in 1996, its significance was more symbolic than real.[75] Nevertheless, the two pieces of legislation have major implications for labor costs and human capital formation. In short, the severance pay system is urgently in need of reform. The system now operates in the context of a more active labor movement and hence implicitly in a higher compliance regime. Costs will thus be higher and there are likely to be more disputes over severance, at least in the short-term, even without increased rates of severance pay. More importantly, since it is calculated as a multiple of monthly salary at the time of dismissal/quits, the cost of severance has risen steeply over time due to large recent minimum wage increases. **The combination of increasing minimum wages and high rates of severance pay raises labor costs and has potentially significant, and worrying, implications for employment, labor flexibility and productivity**.

Severance pay regulations in Indonesia do not differ *significantly* from a host of similar regulations in other Third World countries (Cox-Edwards, 1997; 2002). It is true that *Kepmen 150* (and the proposed Labor Protection Act) is more far-reaching than laws in other countries, but only to a limited extent. It provides severance for voluntary quits and for employees who are dismissed for major (criminal) transgressions, such as stealing or violent behavior in the work place.[76] But *Kepmen 150* brought to the surface the already high cost of severance, the latter dating from a new regulation introduced in 1996 prior to the crisis (Ministerial Regulation No. 3).

There are two central changes involved in *Kepmen 150,* much of which has been incorporated in the proposed Labor Protection Act.[77]

- The new regulation regulates that several **new groups of workers be paid severance pay. (Table 4.1).** Formerly**,** these groups were not eligible to receive severance pay or/and long service leave. This applies specifically to those dismissed for 'just cause' *kesalahan berat* and those leaving voluntarily (henceforth referred to as voluntary quits).

From year 2000, all categories of workers received some payment, either severance pay or long service pay under the new law.[78]

- The law increases the **rate** of severance pay and long service leave (**Table 4.2**). The rate of severance pay rose by 30-40% in 2000, coming on top of increases of some 100-150% four years earlier in 1996.[79]

To what extent does this contribute to higher turnover and higher costs for Indonesian firms? Probably not much, in general, given difficult labor market conditions (that tend to tie most modern sector employees to their current jobs). For example, even if turnover doubled from say 5-10%, the total impact would be a doubling of labor costs from around 6 to 12%, and an increase in total costs in labor-intensive industries from around one to two per cent.

Thus the new regulations (and proposed references to the subject in the Labor Protection Act) on severance pay are not as harmful for labor costs as many businesses suggest, compared to the previous system and levels of severance pay that had been increased substantially in 1996. It created a stir mainly because of the inclusion of some clauses that are unusual in most labor codes, and the recognition that greater compliance **would** contribute to higher labor costs. Thus, for example, despite employer objections to the contrary, payment of long service leave to workers for voluntary quits is not unusual internationally. But payments to workers deemed to have committed major transgressions with criminal implications is not common in other codes.[80]

Nevertheless, the increases are significant for highly competitive industries, and in large labor-intensive establishments, such as garments and footwear, where job-hopping is common. Moreover, since minimum wages have pushed up wage rates in recent years, the cost of severance has risen substantially in absolute terms and contributed to higher wage costs relative to total costs. These increases will tend to reduce labor market flexibility. It acts as a tax on dismissals and on new hires, and will encourage groups of workers who gain most from the regulations to seek to change jobs more often, although rates of turnover can be expected to vary according to labor market conditions.[81]

Table 4.1: Severance Pay According to the New and Old Laws

	Old Regulations				*New Regulations**			
	Original *No. 2/*1986		Revised No 3/1996		No. 150/2000**		No. 77/2000	
	Severance Pay	Long Service Leave	Severance Pay	Long Service Leave	Severance Pay	Long Service Leave	Severance Pay	Long Service Leave
Dismissals								
Economic Cause	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Dismissal	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
-Unjust Cause								
-Just Cause: Minor offense	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
-Just Cause: Major offense	No	No	No	***Yes***	No	***Yes***	No	***No***
Other Cause								
Voluntary Quits	No	No	No	No	No	***Yes***	No	No

* Ministry of Manpower Regulation 150 2000 was briefly overturned by Regulation 77, 2001.
****** Also incorporated in the new labor law before parliament July-September 2002.

Source:
Old Regulations: Ministerial Laws No. 2, 1986 and No. 3 1996 (Ministry of Manpower) Basic Law No. 12, 1964
New Regulation: Ministerial Decree No. 150, Year 2000 and Ministerial Decision No. 77, 2001; Proposed Labor Protection Act (June 2002).

Table 4.2: TOTAL MONTHS OF SEVERANCE PAY AND LONG SERVICE LEAVE PAYABLE FOR DISMISSALS/QUITS IN INDONESIA FROM JULY 2000, AND PERCENTAGE INCREASE SINCE 1986

	Years of Service		
	3 Years	10 Years	20 Years
	No. of Months Salary		
No. of Months Salary (Year 2000+)			
Dismissal for:			
--Economic cause	10	18	21
--Minor offense	6	8	11
--Major offense	2	4	7
Voluntary Quits	2	4	7
	% Increase in Severance		
1986-1996			
Dismissal for:			
--Economic cause	100	100	114
--Minor offense	0	75	150
1996-2000			
Dismissal for:			
--Economic cause	25	50	40
--Minor offense	50	29	20

Source: See Table 1. More complete data presented in Annex Table 1.

In sum, the present and proposed system of severance pay in Indonesia raises a number of questions about labor costs and productivity, and hence employment, in the context of the general regulatory environment in Indonesia. The three major concerns are:

- The system acts as a tax on employment and discourages firms from dismissing older workers, partly because the firms cannot pass on the costs in the form of lower wages, due to the minimum wage system.
- The costs of severance are rising steeply over time due to sharp increases in minimum wages; the rates are already high, and increasing them through large minimum wage increases raises the incentives for employees to get themselves dismissed at any given point at time.
- The system encourages industrial disputes because firms are not required to 'invest' in severance pay up front, and hence are often not in a position to pay severance, and it encourages employees to seek dismissals rather than quit voluntarily.

What might be done to improve the situation?

- *First*, the government could remove the controversial clause related to compensation for those committing criminal acts from legislation.
- *Second*, in the medium term, it should review the rates of severance pay to ensure that they do not to put Indonesia at a disadvantage with other countries in the region.
- *Third*, related to this review, it should not specify the rates of severance in the basic Labor Protection Act, since these regulations are likely to be subject to change from time to time. This is another case of over-regulation in basic laws.
- And *finally*, it should move towards a system, again in the medium term, where employers make anticipated severance payments up front, paid into a fund like JAMSOSTEK contributions, hence guaranteeing payments in the longer term.

At the same time, we should bear in mind that increases in the minimum wage have been the most important influence on the level of severance pay in the recent past, and will probably continue to be so in coming years. We return to this subject in Chapter V.

D. Industrial Relations

Sustained improvements in labor standards and labor productivity that support modern sector employment growth depend on fair and predictable system of industrial relations. In the past, the law and practice of collective bargaining and dispute resolution was heavily weighted in favor employers. The Trade Union Act (No. 21/2000) together with the two Acts before parliament in September 2002 are an important step forward in helping providing greater balance. They provide for collective bargaining by free trade unions and some improvements in the dispute resolution processes.

However, there are ambiguities in a number of areas, partly as a result of poor drafting.[82] In other areas, the new legislation is overly ambitious, given the lack of experience among the actors and the weak institutional base. It does not always support mutuality in decision-making between employers and employees, which is basic to a modern industrial relations system. In addition, the legislation seeks to introduce an entirely new system of enforcement through labor courts.

International experience suggests that industrial relations systems evolve over time. In many East Asian countries, the legal framework tended to provide strict guidelines for union representation, collective bargaining and dispute resolution in the early stages of their development.[83] As noted, Indonesia has taken the 'big bang' approach, in particular by granting the rights to form small (10 employees or more) trade unions and to have multiple union representation and bargaining units in the work place. This is perhaps understandable given the long period of heavy restrictions on union freedoms. Nevertheless, the task of providing greater certainty and predictability in industrial relations processes (at a time of concurrent, greater political uncertainty) will harder during the transition to a fairer system, owing to lack of precedence and experience and the weak institutional basis.

In this section, we look at several aspects of the present and planned industrial relations framework, taking into account aspects of international experience in this field. It is a complex area of labor policy in which specific legal aspects play a central role. The section seeks to outline the broad areas of policy direction and controversy rather than attempt to deal with the details of the existing and proposed labor acts.[84] The discussion covers trade union organization, collective bargaining, dispute resolution and strikes, and administration and enforcement.

Union Freedoms and Representation

The Trade Union Act No. 21 was bold step forward in establishing union freedoms in Indonesia after several decades of only one (*de facto*) recognized, government-backed trade union. Aside from providing rules for the formation union federations and confederations, the Act provides for multiple union representation at the plant level for any organization with membership of 10 workers or more. The Act has been criticized by employer groups both for small minimum size of union bodies permitted and the difficulties that would arise in bipartite negotiations and collective bargaining from the presence of more than one union.

The move towards legalization of more than one union in the work place is understandable, given social and political goals of encouraging competitive unionism, and the emphasis on restoration of rights in *reformasi* period.[85] But it has made collective bargaining more difficult for inexperienced enterprise unions and management.

The Trade Union Act has contributed to a proliferation of unions across the country. From the passing of the Act in 2000 to early 2002, a total of 61 federations were reported to be in place across the country and (according to official estimates) as many as 10 million or more members from a total number of non-casual wage workers of some 26 million in April 2001, 24 million outside agriculture, including 8 million in manufacturing (SMERU, 2002).[86] A SMERU study of industrial relations in major industrial areas in 2002 found that over half of all enterprise unions had been set up after 1997. However, this survey found that multiple unionism at the establishment level was not common, nor did it provide insurmountable problems for management in the firms surveyed.[87] Employers were more concerned with the potential threat of conflict posed by more than one union in their work place than with a reality of heightened industrial conflict.

Collective Bargaining

Indonesia has long had regulations governing collective bargaining and the scope of collective labor agreements.[88] However, in the Soeharto period, wages and working conditions were set mainly by company 'regulations', according to a ministerial decree, specifying basic wages, hours and conditions of work (but not always basic employee rights). Since 1997, and especially since 2000, many more firms have concluded collective labor agreements with their workers, a process which SMERU found has worked relatively smoothly at the establishment level.

The new Labor Protection Act encourages but does not mandate the negotiation of collective bargaining agreements (*Perjanjian Kerja Bersama, PKB*) between employers and trade unions (see article 113-132 of draft law of June 2002). Union involvement in the negotiation of PKB was specified as follows:

- Only one PKB is permitted in an individual firm.
- Unions with a majority membership of workers are entitled to negotiate PKB on behalf of all workers in a firm (article 116).
- If no union has a majority membership, then.[89]
    - Any union that is voted by a majority of workers to represent labor is entitled to negotiate a PKB on behalf of all workers.
    - Two or more trade unions can form coalitions that represent the majority of workers and negotiate on their behalf.
    - Two or more trade unions can form a bargaining unit in proportion to their membership and bargain on the behalf of all workers.

Some union groups have criticized these articles of the Act as favoring larger unions. While this might be true, it is worth pointing out that limiting the bargaining unit to one trade union is not unusual in developing country circumstances.[90] It is probably the best compromise from the point of view of industrial peace and productivity improvements in a period of transition. As with other aspects of the labor code, a phased introduction of various conditions of a more liberal code permits both workers and employers a breathing space to learn how to operate more effectively in a new industrial relations climate.

In their criticism of the Trade Union Act, employers have focused on multiple unionism at the enterprise level, which they claim complicates arrangements for representation in collective bargaining (or the formation of bargaining units), as a major deficiency in the proposed regulatory framework.[91] These latter criticisms seem to be unwarranted. As with several other articles of the labor law, the immediate shift from a tightly controlled union environment to one of virtually open unionism at the enterprise level is a major change. However field research suggests that many firms and workers have nevertheless been able to adjust quickly to the new multiple union environment.

Strikes and Dispute Resolution

Employer groups, especially APINDO, and trade unions have been least happy with the proposals for resolving industrial disputes and especially strikes. Strikes are permitted but only after notice is given seven days in advance to the local manpower office and employers are informed of worker’s intent (Article 136). The local manpower officials are required to make every effort to resolve the conflict and prevent the strike. Nevertheless, one party in the dispute can take the matter to mediation, and the other party is obliged to cooperate in this process.

According to Zimmerman (p. 34-35), the effect of the legislation is to prevent strikes if one party takes the issue to mediation, thus undermining the unions’ basic right to strike. More generally, he and other experts argue that any move towards mediation should be based on mutual consent of both parties, including greater freedom to choose a mediator in cases of dispute. Mutual agreement is required if the dispute is taken one step further to arbitration.[92] To minimize the recourse to legal processes, Zimmerman (p. 35) recommends that the Act should “encourage privately reached agreement to take disputes to arbitration as an alternative to the Industrial Disputes Courts”.

Both Zimmerman and Pencavel (2002) suggest “final offer” selection as one method of arbitration that could discipline unions and employers to make more realistic offers. Under the final offer arrangement, each party makes one submission to the arbiter and she selects one of the offers only, without formulating a new settlement or compromise agreement. This may be difficult to enforce in Indonesia where the emphasis tends to be on arriving at consensus solutions. However, final offer selection should have the effect of limiting ambit claims that tend to characterize submissions at this early stage in developing approaches to collective bargaining, mediation and arbitration in many work places.

Two other areas of the proposed dispute resolution process have been the focus of employer complaints.

- *First*, employers object strongly to being required to pay wages to striking workers, which is currently mandated under the new Labor Protection Act. As Zimmerman (p.31) points out, the principle of ‘no work, no pay’ is a near universal rule in industrial relations. The requirement that wages continue to be paid to striking workers unless the case has been taken to mediation and arbitration will tend to undermine “good faith” bargaining and resolution of disputes. The effect of the ‘no work, no pay’ rule is to encourage unions to internalize the costs of industrial action and thus to limit opportunistic behavior, especially in the case of politically oriented actions.
- *Second*, the law prohibits the replacement of striking workers. While some labor laws (in the USA and New Zealand) permit such action in certain circumstances, the Indonesian law is in line with general international standards on this matter. A compromise solution would be to retain this article in the Act but to ensure that the ‘no work, no pay’ principle is upheld.

Labor unions for their part have opposed the ban on strikes in vital industries in the Labor Protection Act (Article 135), especially in the oil and gas sector. Such a clause is common in many countries (although Zimmerman questions whether the oil and gas sector should be considered ‘vital’), especially in developing countries. While this is an infringement on labor rights, reinstatement of a blanket right to strike in “vital industries” could have significant economic and social costs. The difficult question for Indonesian decision-makers is whether the country can afford potentially damaging disputes which are costly to unprotected individuals and communities, during what is shaping up to be protracted period of economic recovery.

Industrial Disputes Courts. As noted, the proposed formation of new Industrial Disputes Courts (IDC) at district and national level is one of the most radical aspects of the new legislation, and it is the main subject of the proposed Disputes Resolution Act. The main objections are twofold:

- The industrial courts are entirely new in the Indonesian context. They are likely to take a long time to introduce and staff, with many teething problems along the way. One alternative is to try to improve the working of the existing Disputes Councils. For example, the bi-partite parties and parties chosen by them could be given greater representation on the Disputes Councils to help eliminate the heavy hand of government.
- Given the bad reputation of the existing civil court system, **both unions and employer representatives are suspicious of any arbitration processes that are to be carried out through existing legal system**. One problem is that courts will need to be formed across the country in some 370 districts. Further, unionists, in particular, believe that arbitration of disputes through the courts will benefit employers who have better recourse to expensive legal advisors.

An alternative approach is to establish specialized industrial tribunals, independently of the court system. While this would require an equally new institutional framework, tribunals offer greater flexibility and less rigid application of rules and procedures, which can be tailored to the interests of trade unions and employers, than the proposed courts. Zimmerman (p. 38) sums up the case:

> "Specialized labor tribunals in other countries best function in the interest of the parties and the public with more flexible dispute resolution methods, and with more flexible and informal rules and procedures, than typically attend court proceedings."

Thus Heads of the Tribunals would be appointed independently by provincial and/or district parliaments, they would be able to employ staff with expertise in the field and have the power to investigate specific issues where necessary. None of these characteristics would be likely to typify the Industrial Disputes Courts.

As with some other aspects of the labor law, it would make sense to adopt a conservative program of **phasing in the new Courts slowly**, if indeed the government goes ahead with this proposal. Around 90% of industrial labor in the modern sector, who are involved in most disputes, are concentrated in less than 20 districts across the country.[93] These districts could become the focus of the reform for the foreseeable future, existing side-by-side with the Disputes Councils during the transition period.[94]

Administration and Enforcement

The Indonesian government is proposing a system of industrial relations with heavy government involvement in administration and enforcement at a time when international practice in industrial relations has moved increasingly towards voluntary resolution of disputes and enterprise-level collective bargaining to support labor standards and productivity growth. The proposed framework is much closer to that of Argentina than more decentralized systems in the United States, New Zealand, Korea, Taiwan or Chile.[95]

It is ironic that precisely at a time when unions have been granted much greater freedom to bargain and resolve conflicts with employers, the government has introduced a labor bill which severely limits the subjects over which labor can negotiate – minimum wages, severance pay, dismissals, training and a host of other subjects are all regulated in considerable detail in the new Acts. The Ministry of Manpower has positioned itself not only in a central position in the setting and supervision of standards (through drafting the Acts and later a host of implementing regulations) but also in the mediation and arbitration processes, with the one exception of the proposed Industrial Disputes Courts.

Extremely heavy fines and criminal penalties (jail sentences) for non-compliance were one aspect of the draft legislation proposed in June 2002, although many of these were removed in subsequent negotiations. In the revised draft Act, fines for non-compliance range from Rp 10 million to a 100 million ($1000-10,000) for relatively minor matters (failing to appoint workers after the three month probation period, neglect of regulations regarding female employment) to Rp.100-400 million for worse offenses, such as employment of under-age child labor. Zimmerman (pp. 36-37) suggests a more common procedure is to establish penalties on an incremental basis accompanied by warnings for initial violations. The fines would no doubt act as a deterrent, to some extent. However, they would probably also lead to protracted legal proceedings. They would be a heavy blow to small-scale firms (more prone to break the regulations) that get caught up in industrial disputes.

E. Conclusion

In this chapter it has been argued that the new regulatory environment in Indonesia has the potential to slow modern sector employment growth, discourage new investment and hence is likely to slow the movement of people out of low wage jobs. Much slower modern sector employment growth will, in turn, undermine potential improvements in living standards for the large majority of workers who seek better jobs and can benefit from more productive work environments.

These developments in labor policy have the potential to undermine the fundamental processes that saw dramatic and sustainable improvements in wages in many other East Asian countries in the past. From the standpoint of welfare of all Indonesian workers, both formal and informal, and would-be entrants into the work force, they could be swinging the country dangerously towards the 'Latin American' model (see Box 2.5. in Chapter II). Over-regulation in some countries in Latin America contributed to a crippling of modern sector employment growth and reduced improvements in welfare and conditions of employment for a majority of the labor force for several decades.

It is recognized that the government's task in labor policy is not an easy one. At the heart of the matter is the difficult agenda of regulating labor standards and labor rights, yet at the same time maintaining a flexible labor market that supports employment creation in a more uncertain, globalized context. It must do so at a time when trade unions have a much stronger 'voice' than in the past for protection of their members, who are already mostly in better formal sector jobs.

Thus, the government must balance the poorly articulated interests of the excluded majority, in the rapid creation of better jobs, with those of better organized workers (and their civil society supporters), already in enjoying superior wages and better jobs in the formal sector. It is under pressure to raise wages and giving more labor protection in the modern sector, partly as a reaction to the repressive labor controls during the Soeharto era. Yet, if it continues to bow to political and social pressures for further intervention, it may inadvertently, but surely, damage prospects for the more rapid creation of better jobs that is at the center of the development process.

Drawing extensively on the work of Zimmerman, we have stressed the need for an approach with much greater voluntarism and mutual consent in the setting of standards and resolution of conflicts. The relatively privileged parties (both management and union members) to disputes in the modern sector should themselves bear the costs and reap the benefits of their decision-making, not the large majority of less fortunate workers and employers outside the modern sector.

Ultimately, recovery in the industrial sector will depend not only on new investment but also on higher productivity. Unfortunately, neither is encouraged by many of the articles of the new labor law, despite a much more democratic industrial relations framework than in the past. Excessive regulation will inevitably lead to efforts to circumvent the law through corruption and other semi-legal charges. Such a response is likely to be counter-productive for labor. The outcome could be exactly the opposite of the intention of the law and the hopes of unionists, reformers and civil society leaders. More people are likely to find themselves employed on short-term contracts, or in sub-contracting arrangements and putting-out of production, all of which are likely to offer lower lifetime rewards and reduce the potential for skill improvement than permanent employment in the modern sector.

CHAPTER V
MINIMUM WAGE POLICY: IS INDONESIA GOING THE LATIN AMERICAN ROUTE?

Rapid increases in the minimum wages (MW) in Indonesia in recent years roused an intense debate in late 2001 and early 2002 on wage policy in Indonesia. Minimum wages emerged as the most contentious labor policy issue from the standpoint of creating of 'better' jobs in the formal sector in Indonesia.[96] On one hand were the proponents of substantial increases in the MW – principally the Ministry of Manpower, the unions, some NGOs and much of the media. They supported MW policy in the context of what was regarded as an embarrassingly low standard of wages in Indonesia compared with many neighboring countries.[97] On the other, employers and some researchers have argued that Indonesia could not afford major increases in the MW, which have for several years been rising at rates significantly above the rate of growth in market wages. They argued that such increases had the potential to disrupt industrial production and exports and adversely affect employment.[98]

This chapter examines the arguments for and against MW increases, in the context of empirical data and recent research findings on this subject in Indonesia. We focus on policy alternatives associated with the dilemma of dealing with strong popular pleas for minimum wage increases at a time of weak demand for labor. The analysis is undertaken in the context of past policies that raised the value of MW close to the level of average wages by the late 1990s (SMERU, 2001).

In a nutshell, it is proposed that Indonesia return to setting MW as 'social safety net', at least in the medium term. This is in contrast to a policy that views minimum wages as the principal instrument of incomes policy for working class households, as was the case in several Latin American countries in the 1980s. The more vocal social and political groups who support the policy of continued rapid increases in the MW have argued from the standpoint of wage levels in more developed countries in the region (or industrialized countries). As was pointed out in Chapter II, this ignores the fact that wages are largely endogenous to the development process. In other words, low wages are, for the most part, a reflection of low per capita incomes in Indonesia, and hence they are not directly amenable to significant improvement by government regulation.[99]

The chapter is divided into five major sections. The next deals with the MW setting process and the institutional context in Indonesia. In the second and third, we examine the impact of MW on employment in the formal and informal sectors respectively. The impact on future labor demand and policy recommendations are dealt with in the final two sections.

A. Setting Minimum Wages in Indonesia: Regulation Out of Control in the Era of Decentralization

Historically, in most countries, the principal goal of MW as a policy instrument has been to help overcome 'exploitation' of certain marginal or less organized groups in the labor market, or to attempt to place a 'floor' to the level of wages (Starr, 1981). MW policy has very rarely been viewed as an instrument to raise the *average level* of wages or *average standard of living* of workers. Almost universally, in both developed and developing countries, governments have tended to leave the determination of *average wages* to the market. They have sought to meet 'basic needs' of the poor through expenditures on social welfare, sometimes specially targeted to assist wage workers. Indonesia's policy dilemma lies in the fact that MW policy has for some time been considered an instrument for raising the *average* standard of living of workers and hence raising average wage costs. As a result, MW policy has major macroeconomic, and not merely social, implications.

Real minimum wages rose significantly in Indonesia during the pre-crisis period, then fell when inflation got out of control during the crisis before rising again quite steeply after 1999 (**Table 5.1**). These national increases hide large variations in MW across regions. The MW has been raised most quickly in industrial cities such as Jakarta and Surabaya (and environs) where average wages are already relatively high. In general, after narrowing during the early 1990s, the gap in minimum wages between high and low wage provinces and the variability across provinces tended to increase after decentralization began formally in January 2001 (**Table 5.2**).

There have also been major differences in MW at district level. For example, in West Java, the highest minimum wage was more than twice the lowest across districts and sectors: ranging from Rp. 576,000 per month in the highly industrialized districts of Bekasi and Bogor to Rp. 281,000 in less industrialized districts (such as Sukabumi and Kuningan).[100] These differences would appear to be much greater than differences in average wages, even

TABLE 5.1: THE NOMINAL VALUE AND ESTIMATES OF THE REAL VALUE OF MINIMUM WAGES, INDONESIA 1996-2002

Nominal Minimum Wage		Value of KHM	Minimum Wage as % of the KHM	Index (1998=100) *		Real Minimum Wage (1998 Prices)	
Year/ Month	Value (Rp.000)	(Rp.000/mo.) *		KHM*	CPI**	KHM	CPI
Apr-96	122	132	0.92	0.52	0.48	234	257
Jan-99	180	253	0.71	1.00	1.00	180	180
Jan-00	225	266	0.85	1.05	1.02	214	220
Jan-01	307	343	0.90	1.36	1.12	226	275
Jan-02	363	422	0.86	1.67	1.26	218	289

* The minimum wage each year takes into account estimates of the KHM in Oct.-Dec. in the preceding year
and estimated changes in the KHM in the preceding 12 months (the official estimate of KHM is unweighted by province)
** Index of the CPI for December in the preceding year. Changes in the index reflect December on December adjustments

Source: Ministry of Manpower, Unpublished data and Central Bureau of Statistics, Indicator Hidup Pekerja, various years.

TABLE 5.2: INDICATORS OF SPREAD IN MW ACROSS 21 PROVINCES, IN SELECTED YEARS, 1991-2002*

	1991	**1996**	**2000**	**2002**
Mean (Rp. 000)	42.5	118.4	216.8	382.8
Standard Deviation	9.8	17.4	39.9	87.9
Coeff. of Variation	0.23	0.15	0.18	0.23
Minimum (Rp. 000)	22.5	96.0	173.0	285.0
Maximum (Rp. 000)	62.5	156.0	315.0	591.0
Q1	40.0	108.0	192.0	315.0
Q3	48.3	127.5	233.0	438.0
Min/Max(%)	36.0	61.5	54.9	48.2
q1/q3	**82.8**	**84.7**	**82.4**	**71.9**

Source: CBS, *Indicator Hidup Pekerja*, various years;
Ministry of Manpower, unpublished data.

without taking into account variations in individual worker and firm characteristics across districts.

It is quite possible, therefore, that increased minimum wages have contributed to a widening rural-urban gap in average wages since the crisis, as evidenced by the slower growth of agricultural compared with manufacturing and service wages in 2000 and 2001 (see Figure 3.15 above).

Decentralization of Wage Regulation

How were minimum wages set? In the pre-crisis period, minimum wages were set by the Minister of Manpower on the recommendation of the governor of each province (See **Box 5.1**). However, an important change in responsibility for the policy took place with decentralization in 2001. The MW policy was taken out of central government jurisdiction and turned over to the provincial and district (*kabupaten* and *kotamadya*) governments and, implicitly, their parliaments.[101]

> Minimum wages are now set at many levels in Indonesia, thus enormously complicating the decision-making process, in contrast to many other countries where there is only one national minimum wage or at most provincial/state MW.[102] According to government regulation, MW are set by provincial governments for districts within each province, based on the recommendations of the district government. They are also set on an

BOX 5.1: THE ORIGINS OF THE CURRENT MINIMUM WAGE POLICY

What are the foundations of Indonesia's minimum wage policy (MWP) and what are the important recent developments? The origins and fundamental principles underlying current policy go back to the early New Order period. The policy foundations were set in the early 1970s when the modern sector was small and mostly protected and the dualistic structure of wages and employment conditions was more marked even than it is today.

Initially the central government set minimum wages mainly for construction workers on government projects in Jakarta and later in the 1970s and 1980s in other regions on the recommendation of governors to the Minister of Manpower. Local wage research councils (Dewan Penelitian Pengupahan Daerah) comprised of representatives from government, unions, business and academia were set up to research various factors that were pertinent to minimum wage levels. This council recommended changes in the minimum to the Governor in each province who, in turn, made recommendations to the Minister of Manpower in Jakarta. The Minister approved minimum wages through ministerial decrees for each province (sometimes these were also set at an industry and provincial level, such as for textiles in West Java or forestry in South Sumatra). In making his decision, the Minister was advised by a Central Government Wages Council (*Dewan Pengupahan Nasional*), with a representation of interests similar to the provincial councils.

Although all provinces had introduced region-wide minimum wages by the mid 1980s, MWP received little serious attention before the 1990s. Adjustments were made on an ad hoc basis, sometimes every year and sometimes every two or three years in a particular province. In general, adjustments were cautious at a time when the government placed major emphasis on employment creation.

All of this changed following trade and investment deregulation in the mid 1980s. The government came under increasing criticism, both at home and abroad, for its "cheap labor" policy: for leaving wage determination to the market, and for tight controls over trade unions and abuse of labor rights. Especially under Manpower Minister Latief (1993-98), a revamped MWP sought to raise the minimum across the country according to provincial minimum physical and later minimum living 'needs'(KFM and KHM respectively).

The policy was judged to be successful in achieving KFM in most provinces by 1996. The new needs indicator, the KHM, which was 20% higher in rupiah terms than the KFM, replaced the latter as a standard for setting MW wages in 1996. Volumes or units of 47 items make up the KHM for an individual worker, including food, fuel, housing needs, clothing and other needs, designed on advice of the nutrition researchers. It also includes an increased rice allocation (based on an estimated minimum requirement of 3000 calories a day) and several higher quality items compared with those in the KFM, including medium rather than low quality rice. Provincial offices of the Ministry of Manpower were given the task of estimating the prices of individual items and the total value of the KHM each month, in collaboration with the Provincial Statistics Office. The stated objective was to gradually raise the standard of living of most unskilled and semi-skilled wage workers, especially in the rapidly growing labor-intensive and export-oriented industries. An unstated objective was to counter growing labor unrest and protests over abuse of labor rights and labor freedoms.

(See, for example, Manning (1979) on average wage differentials between the small and larger firms in the 1970s and Manning (1998) for a discussion of the origins of present policies.)

industry basis, although this process is rather ad hoc. In addition, regulations specify that the provincial government should set a provincial minimum wage, and this sets the floor to minimum wages in each province. The minimum in districts and in selected industries (and sometimes for industries within districts) may be set above this provincial minimum, depending economic conditions, proximity to other higher wage regions, or sometimes at the whim of the local government or parliament.

In making his decision on annual increases in the MW, the governor and the district head are advised by a Wages Research Council (in some provinces, Provincial and District level, Labor and Employment Councils). These councils are comprised of local manpower office, employer (APINDO) and labor union representatives and expert advisors.[103]

Some provincial governments responded to local pressures by raising minimum wages substantially, and sometimes on several occasions, in the first year of the new policy in 2001.[104] However, by 2002, most provinces and districts adjusted minimum wages only once, early in the new year, following a period of intense negotiations between unions and employer representatives on the Wages Council in the period October-December.

In the latter half of 2001 (for 2002), the process of minimum wage determination varied considerably across regions. For example, only one minimum wage was set for the province of Jakarta, whereas in West Java minimum wages were proposed by individual districts and ratified by the provincial government for every district in 2002. The provincial government set a floor MW level based on the lowest proposed MW from districts (Rp. 281,000 per month in 2002).[105] In East Java the process was different. The Provincial Government did not set a province-wide minimum but played a much more active role in coordinating policy across various groups of districts, or *rayon*, partly in reaction to worker unrest which occurred in the previous year.[106] Outside Java, some provinces only set one minimum wage province-wide in consultation with neighboring provinces. Other provinces allowed for district variations.[107]

An aggressive policy of raising MW has been justified by the Ministry of Manpower and Transmigration on two principal grounds: MW are considered too low, in relation to needs of working families (the KHM) and too low compared with wages elsewhere in Asia.[108] We shall turn to these two issues next, and then we'll examine studies of the impact of minimum wages, first on employment in the formal sector and secondly on wages and earnings in the informal sector.

Meeting Basic Needs of Working Families through the KHM

Raising minimum wages to equal the minimum living needs (KHM – *Kehidupan Hidup Minimum*) became the main basis for evaluating the adequacy of minimum wages relative to the needs of workers, at the provincial level, after 1996.[109] Five other criteria have been recommended by the Ministry of Manpower as relevant to recommending minimum wage increases at the provincial level. These include both needs and labor market conditions: cost of living increases, expansion of employment, the existing level of wages, employer and industry circumstances and the rate of economic growth at provincial level.[110]

However, clear guidelines have never been set out on how information on these other criteria might be collected and used for recommendations for policy makers, either at the central or provincial government level. Thus, as in many other countries, most of the debate on the adequacy of the MW has been about its relationship to a somewhat arbitrary assessment of worker 'needs', rather seeking to estimate its economic or employment effects.

How is the KHM determined? Prior to 2001, the standard was based on regular estimates of the cost of living made by regional government Manpower officer based on a basket of 43 items. This was high by most criteria of disadvantage in Indonesia. For example, in 2001, it was more than twice the level of per capita poverty line, and included a range of items in a total list of 43, many of which are not regularly consumed by low income families (See Box 5.1).[111] The provincial and district wage councils are required to play a key role in undertaking research and making recommendations for MW revisions to the regional government, based on estimated changes in the KHM.

Under decentralization, the district wage council proposals to regional governments for MW increases for 2002 were based on assessments made (sometimes independently) by union and employer representatives of changes in the level of KHM in local markets. In practice, these estimates often varied widely depending on the type of market visited, the quality of goods surveyed and the expertise of the survey team. In West Java and East Java (the two largest provinces for industrial employment) unions typically found increases in the KHM well above the increase in the CPI in the same province, and above those estimated by the employer groups. Estimated annual increases in the KHM made by some union groups in late 2001 were in the range of 30-50%, far above the 10-15% increase in the CPI in most provinces in the same 12-month period.[112] In Jakarta, faced with competing assessments of the level of the KHM from unions and employers, the Wage and Manpower Council decided on an estimate of per capita income in 2001 as the standard to justify a 38% increase in minimum wages for 2002 (See Aslam Sumhudi, 2002; and **Box 5.2**).

Thus, often quite arbitrary estimates of changes in the minimum cost of living, the KHM, had become the main basis for setting minimum wages at the provincial and district levels by the end of 2001. Fundamental problems in this process are demonstrated from average figures across the nation for real MW increases, using alternatively the KHM and CPI as deflators, to adjust for cost of living increases in 1996-2002 (see **Table 5.1**). The real value of minimum wages fell during the crisis, irrespective of which index is used as a deflator. However, in the post crisis period, the results were quite different depending on whether the KHM or CPI was used as a deflator. If the KHM is adopted, the real MW was estimated to be still below pre-crisis levels in early 2002. If we use the CPI, the data suggest that the real MW had recovered by 2001 and was well above pre-crisis level in 2002.[113]

These discrepancies were mainly the result of a ‘negotiated’ KHM in many regions, since it is inconceivable that prices of basic commodities consumed by workers increased by more than twice the price of goods consumed by the general urban population. Faced with potential industrial unrest, the wage councils and provincial governments tended to side with the unions and to err, substantially in many cases, on the high side in estimating the KHM.

Bringing the Indonesian Minimum Wage into Line with International Standards?

In the debates over the 2002 minimum wage (MW) increase, it was frequently suggested that Indonesian wages are 'too low' compared with other countries in the Asian region.[114] In making comparisons with international data, two sets of issues need to be addressed:

- First, are Indonesian minimum wages higher or lower than is warranted by the general standard of living, compared with neighboring countries?
- Second, are they lagging behind wage trends elsewhere in the region, or in relation to the CPI and the price of labor in Indonesia, after taking into account exchange rate movements?

BOX 5.2: THE CONTROVERSY OVER MINIMUM WAGES IN JAKARTA IN 2002

One of the largest increases in provincial level minimum wages in 2002 was in the capital city, the Special Region (DKI) Jakarta. The MW was increased 38%, coming on top of a 49% increase in nominal wages in the previous year. Since the early years, the MW in Jakarta has been a barometer for minimum wages in other provinces, partly because nominal wages have always been relatively high in the capital and partly because of the political importance of the capital in national policy decision-making.

Like in other regions of Indonesia, the real value of minimum wages had fallen in Jakarta during the crisis. By 2001, it had been restored to above the pre-crisis peak the MW reached in January 1997. In early 2002, the MW of Rp. 591,000 was just under 40% above the peak in 1997 in **real** Rupiah terms (taking into account inflation) and almost exactly the same as in 1997 in Dollar terms (assuming an inflation rate of 10% for year 2002 and an exchange rate of Rp. 10,000/$US).

What were the considerations behind such a large increase and how was the MW determined? The decision can best be described as political expediency on the part of the controversial Governor of Jakarta, who was a candidate for re-election later in 2002. In the case of Jakarta, parity of the minimum living needs level (KHM) for Jakarta was not the dominant consideration. The MW was increased to 14% above the estimated KHM of Rp. 519,000 in the capital in late 2001. Rather, the Jakarta government decided to base the increase on estimated per capita income in the province. This strategy overcame a deadlock between unions and employer representatives on the Provincial Wage and Social Security Commission (the former had demanded a MW increase of slightly less than 60% whereas the latter argued for a rise of 10%, or slightly below the year on year level of inflation for the country as a whole).

In addition, the Jakarta government's decision on the MW increase occurred almost exactly at the same time as the Governor of West Java issued a decree raising minimum wages to Rp. 590, 000 in the adjacent Tangerang (now part of the new Banten Province) district, and to levels slightly below this in the Bogor and Bekasi districts. As in previous year, the increases were coordinated between Jakarta and these neighboring districts, although the formal ratification came first in West Java and the Head of the Commission mentions that the KHM, employment and economic considerations were taken into account.

The Jakarta branch of the employer's association involved in labor negotiations (APINDO) took the unprecedented step of challenging the Jakarta government's decision, on the MW increase for 2002 in the local administrative court in December 2001. It argued that its representations were not taken sufficiently into account in the decision and that such a ruling would cause considerable hardship to APINDO members who were struggling to recover from the crisis. The court's decision was initially in favor of APINDO, although it was subsequently overturned a month afterwards. It did indicate, however, the depth of concern in the business community over both the process and the outcome of MW negotiations for 2002.

A final caveat is worth noting. Precisely at the time the Jakarta government was raising minimum wages it had also announced its intention to limit 'illegal' migration into the city of temporary migrants looking for work without work permits. The decision was strongly criticized by civil society groups, particularly the Urban Poor Consortium. Left out of the debate on both sides, however, was the reality that the Jakarta minimum wage was now more than twice the level in many of the poorer districts in West and Central Java, which have traditionally been the principal source of supply of temporary migrants to the Capital City, and that gap had widened in recent years. The wage-gap between regions, and between urban and rural areas, has been a major factor in determining the rate of urban-rural migration in many Third World countries, especially in Africa, where it contributed to high rates of urban unemployment and increasing crime during the early decades after independence.

Source: Aslam Sumhudi, *Upah Minimum Propinsi dan Permasalahannya: Kasus UMP 2002 DKI Jakarta*, Jakarta, January 24, 2002.

One common source of data cited by the Ministry of Manpower and Transmigration in late 2001 and 2002 to support its MW policy is a report from the Asian Financial News (2000). Based on this source, the Ministry reported that the Indonesian minimum wages were $28 per month and were below those in all other Asian countries, including Vietnam, Cambodia and Myanmar, except Pakistan and India.[115] However, these data were rebutted in a table prepared by the Korean Chamber of Commerce, which argued that Indonesian minimum wages in **dollar terms** were higher than several neighboring countries, including Vietnam and Bangladesh (*Jakarta Post*, August 23, 2002).

Which source is correct? There were some major problems in applying the Asian Financial News data for MW policy in 2002:

- First, the data cited from the Asian Financial News are problematic. For example, the Indonesian monthly minimum wage of $28 refers to an (unweighted) average value of wages across Indonesia prevailing in early 2001, when the exchange rate was extremely low. It is well below the national figure in 2002 (just under $40 per month in April-May, falling slightly to around $35 with a small decline in the value of the rupiah later in the year). More importantly, the Ministry of Manpower estimate is much below the MW in the major industrial centers ($50-60) where wage costs are important for exports (Jabotabek, Bandung and Surabaya).
- Second, the comparison between Indonesian average and MW levels in several other countries is of doubtful usefulness because the coverage of the MW is radically different.[116] In short, we are comparing apples with oranges, not apples with apples.

Few countries have only one minimum wage, so we have to decide what is the appropriate standard for comparison. We want to compare apples with apples not apples with oranges. There should be two main considerations.

- *Location*: First, since MW often vary across regions within countries, we should try to compare regions with similar economic characteristics (for example, capital cities, major manufacturing regions, agricultural regions, etc.).
- *Industry/Sector*: Second, we should attempt to compare the MW applying to groups of workers in similar work situations: in modern manufacturing, in major export industries, in FDI firms, etc..

Comparisons Across Countries. **Table 5.3** seeks to compare 'apples with apples' in MW in the Asian region. It presents data for 2002 to reflect the impact of recent policy changes in Indonesia.[117] The comparison includes three different groups of MW by location and industrial type across countries: MW in major capital cities in the region (Manila, Greater Bangkok and DKI Jakarta); other major manufacturing centers in Indonesia (Bogor and

TABLE 5.3: COMPARISON OF NOMINAL MINIMUM WAGES IN MAJOR URBAN INDUSTRIAL CENTERS IN ASIA APRIL 2002
(ANNUAL WAGES, US$)*

Country/Major industrial center	**Minimum Wages**			**Rank per capita income*** **
	Per Year*	**Per Month***	**Legal Coverage of MW**	
1. Capital Cities, Comparable Coverage				
Manila, Philippines a]	1,793	149	All formal sector	2
Bangkok, Thailand b]	1,128	94	All formal sector	1
Jakarta, Indonesia**** c]	755	63	All formal sector	4
2. Indonesia: Other Major Manufacturing Centres				4
Bogor and Bekasi	735	61	All formal sector	
Bandung	627	52	All formal sector	
Surabaya	601	50	All formal sector	
3. Other Countries: Manuf. Workers/Export Industries				
Vietnam d]				6
--*Ho Chi Minh City/Hanoi*	692	58	Only FDI firms	
--*Ho Chi Minh City/Hanoi*	146	12	Domestic firms	
Cambodia f]	540	45	Garments	8
Sri Lanka e]	372	30	Garment	3
Pakistan	360	31	Large firms*****	5
Bangladesh g]	284	24	Unskilled, textile workers	7

* Exchange rates are taken from Bloomberg, April 2002. For Indonesia, the rate is Rp. 9393/US$. Minimum wages are from official government sources and the US Department of State, Bureau of Democracy, *Country Reports on Human Rights Practices* (2001 and 2002)

** Daily or monthly minimum wages were converted to annual rates for comparison with data on per capita income.

*** Country rank in per capita income for 2001 except Pakistan and Sri Lanka (data for 2000). Maximum Thailand $1827 (Rank 1), and minimum Cambodia $250 (Rank 8); In Indonesia, per capita income was $692 (Rank 4). World Bank (2002).

**** The same minimum wage was set in the large industrial center of Tangerang, adjoining Jakarta.

***** Firms with 50 or more workers

Sources:
Indonesia: Ministry of Manpower and Transmigration, official data (various sources, unpublished)
Thailand: Department of Labor (Bank of Thailand website)
The Philippines: Department of Labor and Employment, National Wages and Productivity Commission (official website)
Cambodia: Department of Commerce, Phnom Penh, official data (unpublished)
Other countries: US Department of State, Bureau of Democracy, *Country Reports on Human Rights Practices* (2001 and 2002) (www.usis.usemb.se/human/2001)

EXPLANATION/DEFINITIONS

a\ Philippines has provincial minimum wages. The rate is a daily rate. The annual rate is based on a 365-day year (legal requirement).
b\ Thailand has provincial minimum wages. The rate is a daily rate. We calculate the monthly rate based on a 25-day working month.
c\ Indonesia sets monthly minimum wages across provinces, and since 2001 across all districts.
d\ Vietnam sets different monthly minimum wages for FDI and non-FDI firms.
e\ Sri Lanka sets monthly minimum wages across sectors. The major manufacturing sector is the garment industry
f\ Cambodia sets a national monthly minimum wage, but in practice the minimum rate is enforced only in the garment sector, which is the only major modern sector industry in the country (besides tourism) and accounts for 85-90% of Cambodia's total exports. There are about 180,000 garment workers out of a work force of 6 million. Thus, coverage of the minimum wage is very limited.
g\ Bangladesh set monthly minimum wages across sectors and skills – lower minimum wages for unskilled workers compared to skilled workers. Separate minimum wages are set for the export processing zones. The textile sector is a major modern sector industry and accounts for 65-70% of the country's total exports. The industry is a major employer of unskilled workers.

Bekasi, Bandung and Surabaya); and third, manufacturing sector MW in other Asian countries, especially in relation to FDI and exporting industries.

What do the data show? Three patterns are apparent.

- *First*, by 2002 Indonesian wages in dollar terms were quite high relative to comparable official MW levels in the Asian region. In dollar terms, in April 2002, they were above Vietnam, Cambodia, Sri Lanka and Bangladesh. It is not true that minimum wages are generally lower in Indonesia than in countries at similar stages of development.[118]

- *Second*, Indonesia's rank in minimum wages relative to per capita income, in major manufacturing areas outside Jakarta compared favorably with a selection of Asian countries.[119] Thus it is also not correct that the official minimum wages in Indonesia in 2002 were low compared to the country's level of per capita income.

- *Third*, Indonesia's minimum wage tends to be **higher in labor-intensive industries** than MW in many other part of Asia, including those that tend to compete with Indonesian exports. Thus, the minimum wage in West Java was about the same as the MW set for foreign firms in Vietnam. But it is around **four times** higher than the MW for domestic firms in Vietnam, many of which are also engaged in exporting. In labor-intensive industries such as textiles and garments, the provincial MW was considerably higher in major manufacturing areas Indonesia than in neighboring countries.[120]

Comparisons Over Time. What about the contention that MW increases have been lagging in Indonesia? It is instructive to compare trends in MW in two countries - Indonesia and Thailand – during and since the crisis. MW did fall more abruptly in Indonesia during the crisis due to high inflation. But they then rose sharply in dollar terms relative to Thailand from 2000 onwards (**Figure 5.1**).[121] Thailand, on the other hand, where MW have been similarly quite low relative to GDP per capita, experienced a less sharp drop in the dollar value of minimum wages but also a much slower rate of recovery in the post crisis situation. Minimum wages were similar in relation to per capita income in both countries in 1996. But whereas this ratio remained relatively constant in Thailand during the crisis and recovery, it rose significantly in Indonesia in 2002.

In short, the Thai government, mindful of competitiveness of export industries and the employment effects of high minimum wages, followed a cautious MW policy during difficult economic times in the recovery period. In contrast, the Indonesian government has adopted a much more expansive MW policy, despite even grimmer economic circumstances.

Do these data suggest that Indonesian MW are too low compared with those in Thailand, taking into account differences in the stage of development? The answer is no. In

FIGURE 5.1: RATIO OF MINIMUM WAGES TO PER CAPITA INCOME, THAILAND AND INDONESIA, 1996-2002 ($US PER ANNUM)

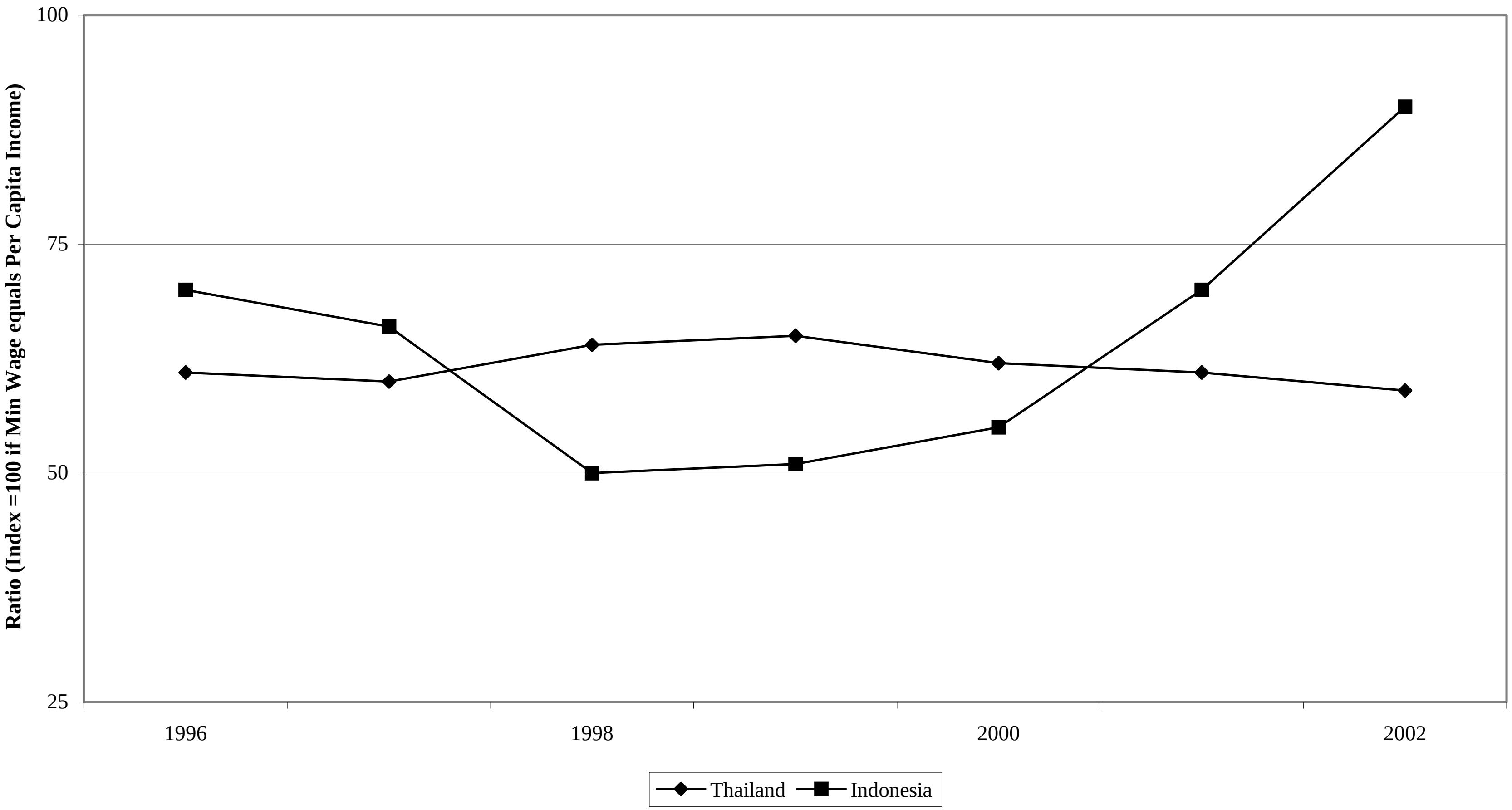
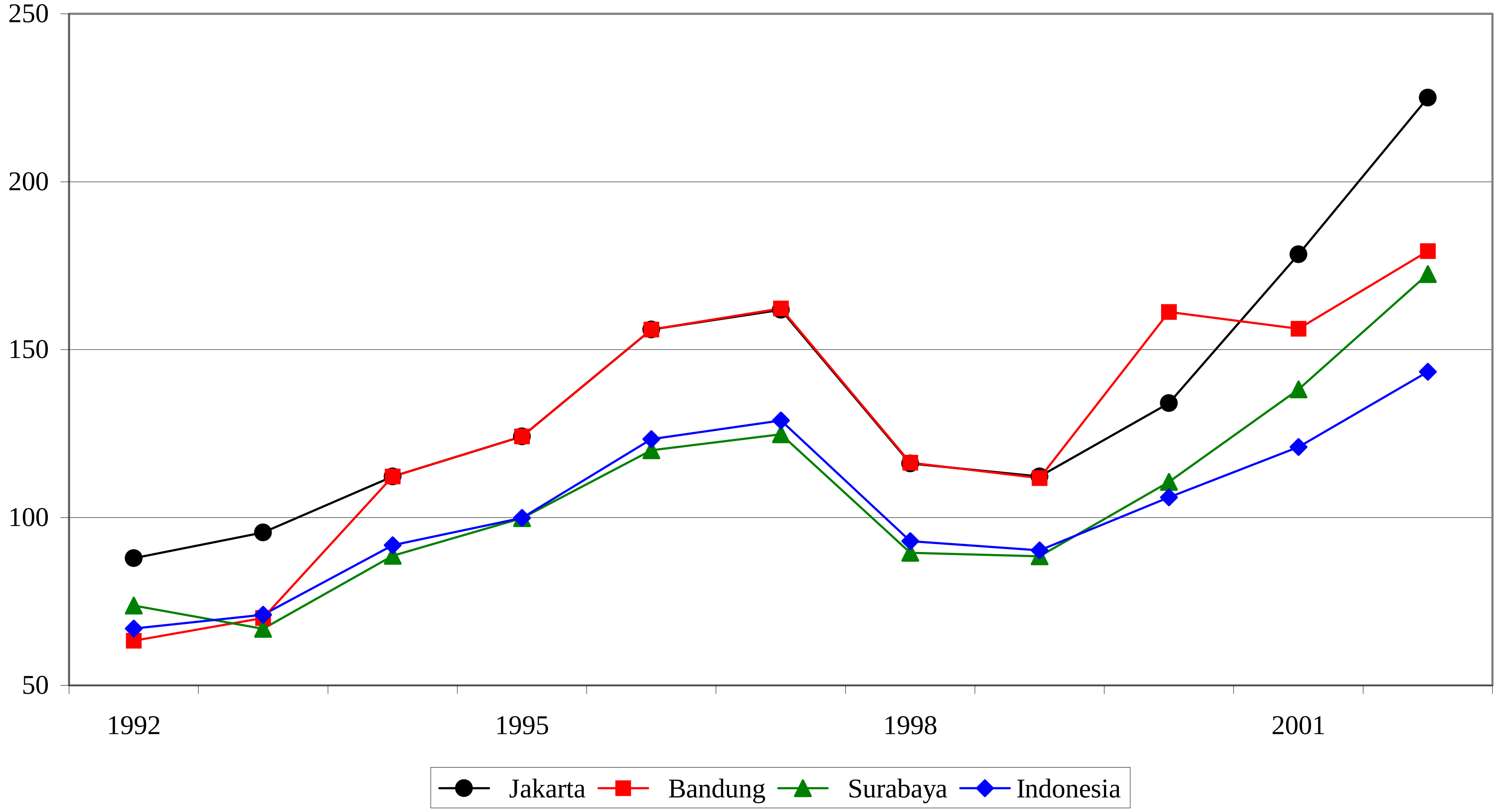


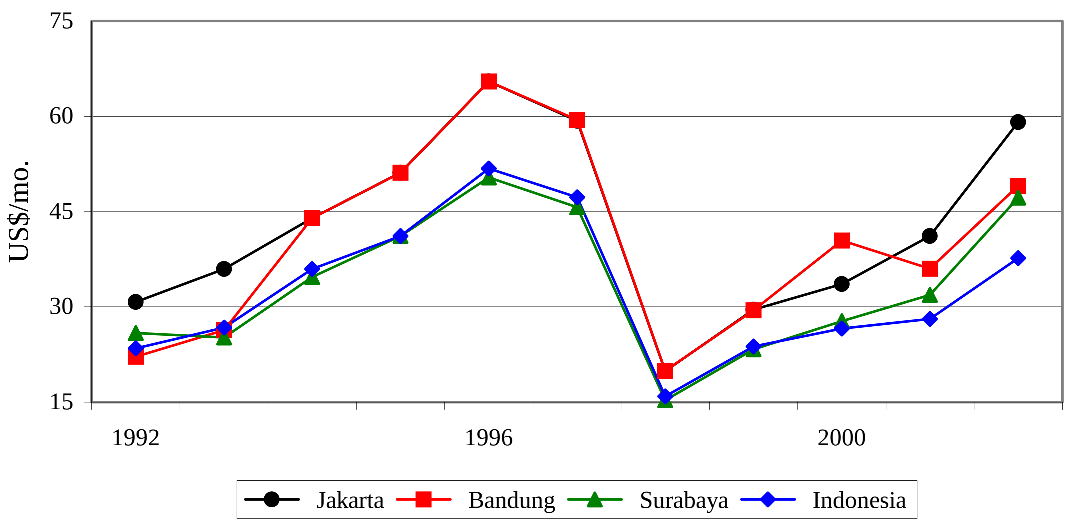
FIGURE 5.2: REAL MINIMUM WAGES IN MAJOR INDUSTRIAL CENTERS AND ALL INDONESIA, 1992-2002 (RP. 000 PER MONTH, 1996 PRICES)



both countries, minimum wages fluctuated between 50-70% of per capita income for most of the period (in Thailand between 59-65%), although they rose (to 90%) significantly above this bracket in Indonesia in 2002.

International Competitiveness. Finally, what about the combined impact of changes in the CPI and exchange rate movements in major exporting regions on Indonesian wage costs. In **Figures 5.2 and 5.3**, we present data on movements in the real value of MW (after taking account of changes in the CPI) in rupiah and dollar terms in Indonesia's three major exporting regions, Jakarta (and environs), Bandung and Surabaya from 1996.[122] As already noted from the national data, the value of minimum wages rose pre-crisis and then fell dramatically, especially in dollar terms, during the crisis in all three centers. The recovery since then has been quite astonishing, however. By 2001, they were above their pre-crisis levels in real rupiah terms and by 2002 they had recovered to almost exactly their pre-crisis levels in dollar terms, at the improved exchange rate of Rp. 9000/$ from around May 2002.

Figure 5.3: Minimum Wages in US$ Converted at Nominal Average Annual Exchange Rates, Major Industrial Centers and All Indonesia, 1992-2002.



As noted earlier, however, there were significant variations in policy across regions. MW have increased most in recent years in rupiah and real terms in DKI Jakarta (and the surrounding districts of Bogor, Tangerang and Bekasi, known collectively with Jakarta as JABOTABEK) and Surabaya, whereas the Bandung government (both city and district) has followed a more conservative approach.[123]

Summary: To sum up, the data presented above suggest three major conclusions:

- **Indonesian MW are not low by regional standards**, among developing countries in the Asia. Of course, they are low relative to wages in developed countries, such as Japan and USA. But so too are wages in all the other poorer countries of Asia.
- **Indonesian MW are not low relative to Indonesia's level of per capita** income compared with other countries in the region
- **Indonesian MW have risen rapidly since the crisis**, despite the country's larger nominal devaluation (which should have reduced the dollar value of wages relative to other countries). Comparisons with one country, Thailand, suggest that they may have risen much faster (in both foreign and domestic currency terms) than in other countries in the region.[124] In terms of dollar costs, the value of real wages had returned to pre-crisis levels, and were well above them in rupiah terms, in major manufacturing export regions in 2002.

In short, while MW did fall further during the crisis, subsequently Indonesia has been pushing up labor costs much faster than in other countries. If this trend continues, it is likely to put Indonesia at a cost disadvantage compared with its main competitors in the region. Later we show how this has adversely affected employment and has probably contributed to more, not less, poverty in the country.

B. Minimum Wage Increases and Employment in the Formal Sector

The arguments advanced to question the effects of the MW on employment in Indonesia (and in some other countries) rest on two basic propositions:

- MW do not affect employment much in the modern sector because they are a small proportion of total costs. In other words, labor demand is relatively inelastic with regard to changes in wages.
- The spending undertaken by those earning the MW has second round affects on employment, and creates jobs in the informal sector.

Evaluation of the first argument might seem relatively straightforward. Basic economic theory tells us that raising minimum wages in the formal sector will tend to reduce employment in that sector in most circumstances. However, the empirical issue is whether these effects are statistically significant, and even if they are, whether the effects are large to enough to deny the gains from protection which the MW offers to marginal groups of workers in the modern sector. While there once was broad agreement among economists that the MW affected employment negatively, there is no longer a consensus on this issue, based on recent empirical research in developed countries in particular.[125]

The second argument regarding the stimulus to the informal sector is more complicated. However, while it is clear that some informal sector workers might receive a stimulus to their businesses from the MW, others clearly lose. More people who were formerly were employed in the modern sector are now forced to work in lower income jobs in the informal sector.[126]

In the case of developing countries like Indonesia, we need to go back to the framework discussed in Chapter II to better understand the relationship between minimum wage increases and employment. In that discussion, we noted that one of the fundamental processes through which incomes rise in a dualistic economy is through the transfer of labor out of the traditional (informal) into the modern (formal) sector. Under most circumstances (a less than perfectly inelastic demand curve for labor), an increase in minimum wages will tend to reduce employment and contribute to higher unemployment and/or push people into the informal sector. In a dynamic context, increases in investment might be sufficient to absorb some of the displaced labor and help ameliorate unemployment and growth in the informal sector. We saw in Chapter III that this occurred in the pre-crisis period. But if the economy is growing slowly and there is little (or even negative) expansion in new jobs, such as during the crisis, then the backwash effect of the minimum wage on employment in the modern sector and earnings in the informal sector will be exacerbated.

The SMERU Study of Minimum Wage Effects in the Formal Sector. Bappenas commissioned SMERU to investigate the impact of minimum wages on employment in the formal, urban sector. The study comprised two components. The first is a statistical analysis of the impact of minimum wages on market wages and employment across provinces in the modern sector, and for different groups of workers—male and female, educated and less educated, adults and youths, white collar and blue collar workers. The second component comprises a qualitative survey of more than 200 workers and 50 firms in JABOTABEK and Bandung to ascertain factors that influence compliance with minimum wages. The key findings of the study were as follows:

1. **Minimum wages are now binding for the bulk of workers in the formal sector.** The SMERU report (2001) shows the impact of minimum wages on the distribution of workers' wages during the period 1988 to 2000. Each graph depicts the distribution of workers' wages in the formal, urban sector. The vertical line represents the minimum wage. In 1988, the minimum wage was set well to the left of the

distribution meaning that it was not binding for most workers. By 2000, most wages in the formal sector were "bunched" around the minimum wage. This tells us two things. First, compliance with the minimum wage has steadily increased over time. Second, the fact that wages were by 2000 "bunched" around the minimum rate suggests that the minimum wage was binding for the bulk of workers in the formal, urban sector. In other words, further increases in minimum wages will tend to put pressure on the **average wage** in the modern sector.

2. **A high minimum wage relative to the market wage rates reduces formal sector employment.** A minimum rate well below the market wage rate is not considered a problem. It may even be a useful social policy tool for helping the very poor at the bottom end of the wage distribution. However, the minimum wage becomes a problem when it is 'binding' for most workers. This is because any further increases in the minimum wage which outstrip the growth in productivity raises the minimum wage above the market-clearing wage rate, and is likely to result in a fall in employment of these workers. These workers either become unemployed or take refuge in the informal sector where they are forced to accept lower wages than before.

   The results of the study showed that this has been the case in Indonesia in recent years. As an example, **Table 5.4** shows the potential negative effect of the increase in the minimum wage in 2001 on employment, based on the coefficients found in the SMERU study. On average, real minimum wages increased by 24 percent compared with 2000. Given economic growth of 3.5 percent this year, we estimate that as many as 467,000 jobs may have been lost in the formal sector in 2001.

TABLE 5.4
PROJECTED LOST JOBS IN THE MODERN SECTOR IN 2001
(NUMBER OF JOBS)

	Number of jobs created (+) or lost (-)
Economic growth of 3.5%	+375,000
Increase in real minimum wages of 24%	-841,000
Net effect on jobs in the modern sector	-467,000

Note
The assumptions are as follows: inflation was 13% in 2001; Working-age population growth was 2%; the GDP-employment elasticity was 0.34 (i.e., a 10% increase in GDP leads to a 3.4% increase in formal sector employment). The real minimum wage-employment elasticity based on the SMERU study was -0.11 (i.e., a 10% increase in real minimum wages reduces modern sector employment by 1.1%).

Source: Manpower Bureau, Bappenas, 2002 (unpublished report).

3. **An increase in the minimum wage under circumstances described in 2. above has a disproportionate, negative effect on more marginal workers**. Further, while minimum wages increases affect all workers in aggregate, the analysis of sub-samples of workers show that such increases have a greater impact on employment of certain groups of workers—women, youth and the less educated. On average, a 30% increase in minimum wages such as occurred in many regions in 2002 can be predicted to reduce all employment in the formal sector by 3.3%; female and youth employment by 9%, and employment of less educated workers by 6%.[127].

What was the process through which these employment losses occurred? **Annex 5.2** and **Annex 5.2 Figure 1** describe and illustrate how the increase in the minimum wage was likely to reduce employment in the formal sector as well as contribute to an expansion of the informal sector (discussed below). The Figure compares, heuristically, the situation of rising minimum wages in the pre-crisis period 1992-1997 with that during the crisis and recovery period, 1997-2001. In the former period, employment continued to expand despite MW increases because labor demand was growing rapidly, especially in relatively labor-intensive and export-oriented industries. In the latter period, labor demand contracted, resulting in a loss of jobs in the modern sector. However, the rise in real minimum wages tended to exacerbate the effect, further reducing employment in the modern sector.

Thus the increase in the MW in the past few years is likely to have slowed or even reversed the growth in modern sector employment, especially for less well established groups in the labor force, thus contributing to much slower average wage and productivity growth, as discussed in Chapter III.

Wage Costs and Biaya Siluman ('hidden' costs). Several commentators have argued that raising minimum wages is not a threat to jobs in the modern sector. The argument goes that wages are so low in Indonesia, or capital is so expensive, that raising minimum wages does not affect competitiveness.[128] Such an argument ignores the crucial role which labor costs play in supporting employment growth in labor-intensive industries, especially those oriented towards exports.

Wages are a small share of total costs and value-added and hence increases in MW are unlikely to affect profitability, production and employment in some capital-intensive sectors, especially basic minerals, chemicals and machinery industries (typical examples are fertilizer, cement, steel and oil refining). However, wages are a significant share of total value-added (which determines basic decision-making about investment and employment) in more labor-intensive industries. Good examples are food processing and textiles, especially garments, weaving and footwear industries. Many of the more labor-intensive industries tend to be export-oriented, where profit margins are small. Thus, it is not surprising that employers have reacted to an increase in MW by reducing employment growth.[129]

Data assembled in **Table 5.5** demonstrate this point. They show the ratio of wages to total value-added (much more relevant than total costs for decision-making) in several industries and among small and medium firms.[130] An increase in the wage bill of 10% in the year 2000 would not have had a major effect on total costs in the short-term, even in labor-intensive firms in textiles, clothing and footwear (TCF). However, increases in minimum wages by a similar amount over three years (or a 30%-50% increase in wages) will have a significant impact on a firm's costs and competitiveness. For example, a 30% rise in labor costs in TCF industries would increase total costs by six per cent, and a 50% rise would lead to a 10% increase. The effects would be much greater in small firms who are obliged to follow the MW policy. Bearing in mind that real increases in minimum wages have greatly exceeded these percentages in the major centers of manufacturing in Indonesia, it is no wonder that MW have begun to have an impact on total employment in the formal sector.

TABLE 5.5: THE IMPACT OF INCREASES IN WAGES ON COSTS IN MANUFACTURING

	Wage Share in Value Added (%)	**Impact of Wage Increase on Total Costs (% Increase)**		
		10% Wage Increase	30% Wage Increase	50% Wage Increase
Large and Medium Firms				
All firms	16	1.6	4.9	8.1
Textiles, footwear and clothing	21	2.1	6.2	10.4
Small Firms	37	3.7	11.2	18.7

Source: Based on data on wages and total costs included in the annual survey of Large and Medium Manufacturing Establishments 2000 (BPS, 2001).

In relation to the contribution of wages to total costs, it is often argued that the government should pay attention to 'hidden costs' (*biaya siluman*) or costs associated with bribery, which may raise total costs by some 30-40% in some industries and firms, rather than penalize poorly paid workers. The argument is attractive from a standpoint of equity. But it is misplaced as an argument for retaining or increasing minimum wages.

While reduction in these *biaya siluman* is long overdue in Indonesia, little progress seems to have been made in this area in the post-Soeharto era. It would appear that significantly reducing hidden costs must be part of long-term reform agenda, and can only occur simultaneously with many other reforms to the legal and political systems. In the meantime, it seems hardly fair to penalize existing and potential workers in the modern sector, simply because other costs are also high, and inequitable. Attempts to reduce hidden costs by raising minimum wages are likely to occur, moreover, in precisely those industries in which the impact of higher MW on employment is likely to be highest but where the "hidden costs" themselves are less due to their competitive nature.[131]

C. Impact of MW on the Informal Sector

The impact of minimum wages on employment in the modern sector is only part of the story. Their impact is equally important (if not more so) on the welfare of workers in the lower paying informal sector, which accounts for the bulk of workers in Indonesia (see Chapter III). A worker who loses her job in the formal sector has no access to unemployment insurance and instead takes refuge in the informal sector, where earnings are likely to adjust downwards in response to additional labor supply pressures (see panel C in **Annex 5.2 Figure 1**). Thus we can hypothesize that a rise in the minimum wage forces more workers into lower wage jobs in the informal sector and also depresses earnings in this sector.

Preliminary research suggests that this has indeed been the case (Bird and Manning, 2002). Increases in MW were positively associated with an expansion in informal sector employment and lower wages in informal sector jobs in the post-crisis period. A 10 percent increase in real MW raised the share of informal sector employment by 3.1 percent relative to formal employment and reduced informal sector real wages by 2.1 per cent.

What about the spending effects from increased MW discussed above, in food stalls (*warung*) and markets, in transport (*bajay and ojeg*) and in other services? We have not been able to measure the extent of these effects on employment and earnings in the informal sector. Insofar as they have been important (and are likely to be visible close to the main centers of manufacturing in such as Tangerang, Bekasi and Bandung), the data imply that the positive effects of such developments have been counterbalanced by pressure from displaced workers. The latter are forced to search for informal sector jobs and hence put downward pressure on earnings.

D. Impact on the Demand for Labor in 2003

Before the shock to the economy from the Bali bombings, several regional governments were considering large increases in minimum wages to be introduced in January 2003. The mooted increases were likely to be similar to those in the previous two years: in the range the 20%-40%. Following the bombings, unions were persuaded that exceptional circumstances demand a special approach for 2003, and several provinces, including Jakarta, have accepted a much lower increase in minimum wages than originally planned.[132]

Nevertheless, as discussed above there is a widespread belief that large minimum wage increases will not jeopardize employment in the modern sector. In this chapter, it has been argued that the employment effects are likely to be large and should be taken into account by provincial governments in planning minimum wage increases. **Table 5.6** shows the potential loss in jobs in 2003 as a result of alternative increases in nominal minimum wages of 10 percent, 20 percent and 30 percent under low and high economic growth scenarios. In these scenarios, it assumed that inflation will be 9 percent and the working age population grows by 2 percent. The table shows that there are likely to be significant losses in jobs as a result of the proposed increases in minimum wages.

Under the government's economic growth projection of 4 percent for 2003 (revised downwards after the Bali bombings), 428,000 jobs would be created. However, an increase in nominal minimum wages of 20 percent would cut jobs by as much as 381,000, slightly less than the number of jobs created through economic growth. The net effect would be a miniscule gain in employment of 47,000 jobs in the modern sector.[133] But with the labor force growing by 2 percent, this would be insufficient to reduce unemployment or to prevent growing underemployment in the informal sector. The number of workers looking for jobs in the informal sector or unemployed would increase by some 386,000.

A much larger 30 percent increase in the nominal minimum wage would have greater effects on employment. In our estimates, a 30 percent increase in the minimum wage would reduce jobs by over 700,000. This job loss is almost double the number of modern sector jobs likely to be created by an economic growth rate of 4 percent. The net effect is a reduction in total modern sector employment by over 300,000. The number of workers looking for jobs or pushed into the informal sector or unemployed would increase by more than twice that amount or close to 740,000.

In contrast, a 10 percent increase in nominal minimum wages would cut jobs by 35,000. Overall, with 4 percent economic growth, modern sector employment would increase by nearly 400,000. In general, the data in the table suggest that minimum wages should not increase by more than around 10% – close to actual rate of inflation in 2002 – in the current (and projected medium term) low economic growth environment of around four per cent per annum.

TABLE 5.6
PROJECTED JOBS CREATED OR LOST IN THE FORMAL SECTOR IN 2003
(NUMBER OF JOBS)

	Economic Growth			
MW increase	0	2%	4%	6%
0%	0	214,000	428,000	643,000
10%	-35,000	179,000	393,000	608,000
20%	-381,000	-167,000	47,000	262,000
30%	-728,000	-514,000	-300,000	-85,000

Note
MW refers to nominal minimum wage.
The assumptions are as follows: inflation will be 9% in 2003; working-age population growth to be 2%; the GDP-employment elasticity remains at 0.34 (i.e., a 10% increase in GDP leads to a 3.4% increase in formal sector employment). The real minimum wage-employment elasticity based on the SMERU (2001) study was -0.11 (i.e., a 10% increase in real minimum wages reduces modern sector employment by 1.1%).

Source: Manpower Bureau, Bappenas, 2002 (unpublished data).

E. A Minimum Wage Policy Agenda for 2003 and Beyond

The research above suggests that there has emerged a stark (and unprecedented) trade-off between minimum wages and employment in Indonesia in 2002, a dilemma which is likely to continue in coming years. The employment implications of various minimum wage levels are daunting – some half a million people could loose jobs or fail to get jobs next year or in coming years, if the government allows the present policy direction to continue.

In this chapter, it has been demonstrated that minimum wage policy has begun to break new, and potentially hazardous, ground. The relatively high level of MW has put pressure on average wages, and hence influenced wage costs and employment significantly. The policy is reaching far beyond the goal of simply providing a social safety net for vulnerable workers. Most importantly, it is beginning to damage Indonesia's comparative advantage in labor-intensive industries that have been at the heart of improved living standards in the past. The following points have been highlighted:

- The process of wage determination has a number of serious shortcomings, especially in heavy reliance on the KHM, and the way this index has been calculated, in practice, since decentralization.
- Although it was left behind during the crisis, Indonesia no longer lags relative to neighbors in terms of the level of MW relative to the national standard of living.
- Increased minimum wages tend to adversely affect not only employment prospects in the modern sector but also earnings of the poor through greater crowding into the informal sector, in addition to potentially higher rates of unemployment.

What steps might be taken to improve the situation? We divide recommendations into three groups: the institutional framework for decision-making, and steps that might be taken in the short and the medium term.

1. **The Institutional Framework for Decision-Making**

*First, supporting consensus building **within** the government.* In the immediate future, there is an urgent need to reach a consensus between the various wings of the central government on policy changes needed to achieve a better balance between employment creation and minimum wage increases for 2003 and in the coming years. Emphasis should be on the already successful recovery of real wages since the crisis and the need to consolidate these gains through more 'employment-friendly' policies. The most important players are the Ministry of Industry and Trade and the Ministry of Manpower and Transmigration, under the guidance of the Coordinating Minister of Economic Affairs and Bappenas and advised by CBS on technical matters.[134] Comparable government agencies in the provinces should play a similar role.

*Second, developing a more cooperative approach **among stakeholders**.* Once a consensus has been achieved, the government should aim to develop a more cooperative rather than confrontational approach to minimum wage setting on the part of major stakeholders. It is noteworthy that consultation between the key stakeholders in wage councils at the provincial and district level has been part of the MW setting process under decentralization. This is a major achievement compared with more confrontational situations in other countries. Nevertheless, there is a notable absence of policy direction from the Central Government. A high-level Employment and Wages Council could be established under the Coordinating Ministry of Economic Affairs with representation of major stakeholders (union and employer representatives) to discuss wage policy options each year. These meetings would be convened at the latest in August-September, so that the government could then announce guidelines to the regions for policy in the coming year.

Third, research and dissemination of information. All parties, employer groups, trade unions and government officials in the Central Government (and in the regions) need to be much better informed on labor market trends and price movements if bargaining and decision-making is undertaken in the public interest. A more informed and intensive dialogue is urgently needed between economic and social policy makers and stakeholders, given that the politics of minimum wage policy is adversarial by nature. Ambit claims by trade unions are often based on cost of living arguments that have no basis in reality. Yet neither government officials nor employer representatives are well enough prepared to counter such claims. This is true despite comprehensive and timely data on cost of living and labor market developments available from the Central Statistics Board. The economic ministries need to be better informed on these matters and to be advised by at least one technical expert on labor affairs.

It is imperative that agencies responsible for economic policy-making in the Central Government take the initiative in undertaking policy-oriented research and in making information available on the employment and welfare implications for most workers of various MW policy options. It is critical to achieve an improvement in public understanding—in the media, among academics and among civil society groups—regarding the relationships between public wage-setting, employment and worker welfare. There especially needs to be a better understanding of how high MW can adversely affect employment growth in the modern sector. Their adverse effects on employment and the negative welfare implications for the vast majority of workers, who are in SMEs and the informal sector, are also important.

2. **Policy in 2003-4**.

Four specific proposals could be considered immediately as part of a new policy approach:

- *First, announcement of guidelines for MW increases*. Given difficult economic circumstances and the announcement that there would be no increases in civil service salaries in 2002, the government should announce that it hopes that minimum wage increases will not exceed the expected rate of inflation in any province in Indonesia, and **especially in major manufacturing centers**. A ball-park figure would be 10% in 2003-2004 . The government should recommend against any further increases in the MW in any province or region following the January 1 round of wage increases.[135]
- *Second, a professional approach to estimating cost of living changes*. It is timely that the national statistics body, CBS, play a more active role in alerting stakeholders of cost of living increases over the coming year, as the appropriate professional (and independent) agency responsible for calculating cost of living increases through the CPI, and if necessary the KHM. Provincial CBS offices should also be made responsible for reporting on CPI and KHM increases to the Central Government and the Provincial Government wages councils in each region in the 12 months prior to determination of minimum wage increases. This would help reduce 'horse-trading' over the KHM, which has been a prominent feature of union management negotiations in the past two years.
- *Third, negotiation of increases in the MW biennially instead of annually.* Officials and stakeholders suggested to the a government-led survey team on employment and wage policy that it would be desirable to limit MW increases to every two years beginning in 2004. The administrative costs of, and the uncertainty arising from, adjusting MW across the country every year are substantial. There are good reasons to make these adjustments no more than once every two years. Such an approach would also facilitate a more professional approach on the part of stakeholders and the government, who would have more time to prepare their cases for tripartite negotiations.
- *Fourth, removing the right for firms to appeal for a waiver in MW*. One aspect of policy is particularly disingenuous. In the heated debates over the 2002 minimum wage increases (and indeed in earlier years), the authorities pointed out that firms can always apply for an exception to the MW policy, provided they are prepared to submit themselves to a public audit. Setting aside the issue of the cost of such audits, both formal and informal (which are likely to be substantial), it should be pointed out that one standard rule of effective public policies is that they be implemented by all organizations and individuals who are covered by a regulation. Tariff and tax policies are not formulated with a footnote that firms who are adversely affected by regulation can apply for exemptions. There is no good reason why such a policy should be allowed in the case of wage policy. Either the regulation extends to all firms at risk, and the government accepts responsibility for social disruption caused by firms in difficulty, or the regulation is modified to avoid such negative consequences.[136]

In addition, several new approaches to wage policy and the welfare of wageworkers in general might be introduced in 2003:

- *A commitment to supporting working conditions of wageworkers*. The government should stress its commitment to improving the welfare and safeguarding the rights of wageworkers. This can be achieved through guaranteeing freedoms to organize and negotiate wages and working conditions with employers, and through a government commitment to welfare spending in education and health. Although unlikely to reach the poorest group of wageworkers, the government could seek to undertake several relatively costless initiatives that benefit wage employees in the modern sector, while not posing a threat to employment. For example, it could find a way to allocate relatively small amounts of expenditure to a number of carefully targeted programs for improving health and safety in the workplace, and improving the capacity of labor unions to undertake collective bargaining with employers. Some subsidized support for housing of low wage workers in major industrial centers (Jabotabek and Gerbangkertosusilo) could also be considered, although the cost and difficulties of such a program would need to be weighed up against other alternatives.[137]

The government might also be more pro-active in anticipating and responding to events that affect employment and the real value of wages. These include policies that threaten jobs in the short-term (*ie.,* structural adjustment policies) or tend to raise the cost of living of workers, and hence erode the real value of workers' wages, yet at the same time threaten to flow on into higher wage costs. The fuel price increase in 2002 is a case in point (See Box 5.3). The effect on the cost of living was grossly exaggerated in Parliament and in the press, yet there was relatively little effective counterpoint from the government to this misinformation. It did announce policies to compensate those worst affected, which was a positive step forward. Some policies will inevitably have short-term effects on employment and real wages as the economy recovers and restructures. The government needs to be ready with timely policy responses to such developments, in a way that was not necessary during the period of both tighter political controls, and more rapid growth, under Soeharto.

- *Integrating wage policy with macroeconomic policy*. The central government should 'integrate' MW policy with its decision-making on macroeconomic policy, rather than leaving minimum wages in a separate box as a 'social' rather than economic issue. Higher minimum wages not only penalize employment in the modern private sector but also affect international competitiveness and the cost of all public programs involving unskilled and semi-skilled workers, including the wages of government employees. Thus, it is an area in which the Ministry of Finance will need to become involved in the future, in addition to several of the line agencies with more direct interests in this policy.

3. Policies in the Medium Term

In the medium term, two fundamental changes are of primary importance for a revamped minimum wage policy to be effective in both increasing productive employment and safe-guarding the wages of the lowest paid workers.

First, encouragement of collective bargaining over wages. As we have argued in Chapter IV, there needs to be much greater effort made to move away from government regulation of wages in favor of collective bargaining at the enterprise level, involving trade unions as equal partners with employers in the negotiating process. This should be recognized as central to wage determination in a context where workers now have the right to

BOX 5.3: THE IMPACT OF FUEL PRICE INCREASES ON THE COST OF LIVING AND REAL WAGES OF WORKERS IN 2002

The government announced that it would increase fuel prices by an average of 30 percent in 2002, as part of its efforts to maintain fiscal sustainability and free up funds for social development expenditure. Workers were concerned that the resulting increase in consumer prices would erode their incomes. The government faced a delicate balance between saving jobs and raising wages to compensate workers for the fuel price increase. Employers were concerned that given this increase in fuel prices, any substantial increase in wages would lead to greater increases in production costs. Given the weak economy, this would lead to reduced employment.

A number of commentators (including some business and labor groups) in the media criticized the government's decision to increase the fuel price by 30% in June 2001, claiming that this would increase prices of various commodities by at least 20%. As it turns out, these claims were greatly exaggerated. In order for a fuel price rise of 30% to increase the price of a commodity by 20%, fuel would have to account for about 70% of its total cost of production. This of course is true for only a very few goods produced in the country. Rather, fuel costs make up well below 10% of total costs for most products. Based on past experience with fuel price increases, the Bappenas inflation model estimates that a 30 percent increase in the price of fuel would lead to a one-time additional increase in the consumer price index of 3-4 percentage points and would erode real wages by a maximum of five per cent, depending on transport costs. Overall inflation is expected to be in around 9 percent in 2002.

form trade unions, are now free to bargain collectively and to take industrial action. In addition to concerns related to trends in the welfare of workers, the link between increases in labor productivity and wages would be central to such negotiations, as in most other countries.

Unfortunately, many employers are unwilling to treat workers as equal partners, and trade unions are inexperienced and often weak at the enterprise level, both a legacy of tight controls over labor under the New Order. As we have seen in the previous chapter, efforts to improve the industrial relations climate are therefore a matter of great urgency.[138] This should be central to a medium term strategy for raising productivity, and improved standards of living, and the creation of better jobs for wageworkers. Such reform is integral to achievement of macroeconomic as well as social policy goals in the medium term.

Second, a concerted effort could be made to simplify the current morass of regional-sectoral minimum wages. Simple economic theory teaches us the law of one-price. This applies to labor and wages as much as to other goods and services (and capital) under the conditions of relatively high factor (labor) mobility existing in Indonesia. It is not necessary to set minimum wages in most sectors in the regions, given that workers are willing and able to move relatively easily from one unskilled job to another, across sectors. Similarly, setting minimum wages at the district (kabupaten) level only complicates the wage setting mechanism, except in special cases.[139] It increases the opportunity for KKN and makes enforcement more difficult. Separate provincial minimum wages are justified in a country as large as Indonesia, since they tend reflect differences in the cost of living and in income levels across regions. However, the single most important minimum wage should be at the national level, indicative of supply and demand interactions in an integrated, national labor market.

What is an appropriate strategy in the medium term? The central government should be mandated to issue annual guidelines, **and not regulations**, on minimum wages, the national tripartite negotiation process, and criteria for wage increases, should be broadened to include economic considerations (related to employment and productivity) and, finally, the KHM or similar measures of worker needs should no longer be used as the main standard for evaluating the adequacy of the level of wages. To achieve these objectives, the Government might consider appointment of two technical advisors, one foreign and one domestic, to work with the five key ministries/national bodies to develop a new strategy over a two-year period.[140]

- *Guidelines not Regulation.* The central government and national union and employer groups need to take the lead in providing **guidelines** for national minimum wage increases to be negotiated at the establishment level each year. Singapore (the NWC) and South Korea could be taken as successful examples of policies which seek to influence private sector wage adjustments indirectly rather than through direct regulation. However, national trade union bodies will be required to play a much more important role in the Indonesian case.

- *National Tripartite Negotiations and Economics Ministry Participation.* The National Wages Research Council could play a pivotal role in these deliberations. However, given the importance of wage trends for macroeconomic stability, employment growth and productivity, it is suggested that key economics ministries (Bappenas and the Ministry of Finance) be represented in the National Wages Council, as well as the Ministry of Manpower, and that it be chaired by the Coordinating Minister for Economics and Finance. The Central Statistics Body, BPS, should also be included as a member of the Council to offer expert, independent advice on employment, productivity and cost of living trends.

- *Broaden the Criteria for MW Adjustment Approach.* The criteria for recommended wage increases should be modified to reflect a broader mix of policy objectives: employment growth (creation of better jobs), productivity increases and income protection among lower-paid wage earners. As we have noted, several of these objectives are already specified in guidelines provided by the Ministry of Manpower; but there are no explicit instructions on how such criteria can be applied, and hence they tend to be ignored in practice.

In particular, three criteria should be taken into account in negotiations at the national and provincial levels, especially in major urban and industrial areas:

- ♦ Past and projected national economic trends (bearing in mind that this is the single most important determinant of labor demand in most locations in Indonesia; most regions are part of a lively, functioning national labor market). Indicators of national economic performance would be supplemented *with quarterly reports* prepared by Bappenas in collaboration with BPS on the national labor situation (now made possible by the reintroduction of the quarterly labor force survey in 1992).
- ♦ Regional economic developments, perhaps best proxied by regional investment, agricultural production and export trends (given that RGDP data are available only with a considerable time lag).
- ♦ The rate of inflation both nationally and at provincial levels.

The outcome of these negotiations should be announced several months before the end of each year, in order that companies would have sufficient time to negotiate wage increases with their workers. Provincial governments could also play a role in advising workers and companies on the recommended increase for specific regions, provided these still fell within the range of recommended guidelines announced by the National Wages Council.

- *Establishing MW as a Wage Floor*. An implicit goal of this medium-term strategy should be to seek to move away from 'binding' provincial minimum wages and to replace them with provincial floors to wages, designed to protect the lowest paid workers in the modern sector. Thus the KHM (or similar measures) would no longer be used as benchmark for the level of regional minimum wages, although it would no doubt be used by unions and management in enterprise level in negotiations on wages which take into account increases in provincial cost of living indices relevant for working people.

ENDNOTES

[1] See especially *The Van Zorge Report*, 14-21 August and September 2002, and reports in *The Asian Wall Street Journal*, August 13 2002, *The Jakarta Post* 9, 22 and 27 July, 24 and 25 September 2002, and *Kompas*.21 September 2002. In an unprecedented statement, the Korean Chamber of Commerce in Indonesia referred to the backwash effects of the "irrational" minimum wage policy and new labor laws, and associated industrial unrest. The Chamber noted that these developments had contributed to substantial job loss in Korean firms which had shut down their Indonesian operations in labor intensive industries that had been the backbone of modern sector employment growth in the 1990s (*Jakarta Post* and *Kompas*, August 22, 2002).[1]

[2] For example, the Head of the ILO Office in Jakarta stated that he doubted that labor policies had contributed to loss of Korean investment in labor-intensive industries, citing other factors to do with the business climate as the root cause (Jakarta Post, August 24 2002).

[3] A reflection of the shift in emphasis WAS the appointment of the leader of the largest union in the country, SPSI, as the Minister of MOMT in the Megawati cabinet installed in August 2001.

[4] See especially Manning (1998) for a detailed exposition.

[5] Complaints from employers about the effects of minimum wages or excessive protective measures are often viewed as simply special pleading in the interests of capitalists and cronies, rather than a mounting a genuine case for the broader social good.

[6] The following presents the main elements of basic framework of standard labor economics based on the core principles neo-classical theory. We need add several elements to that basic core theory, some of which come from classical economists concerned with issues of longer-term economic transformation, and have been modified by development economists in the second half of the 20th Century. See especially Ehrenberg and Smith (2000) for a policy-oriented approach to the subject.

[7] The term 'traditional' is used to denote activities that are highly labor intensive and to a large extent utilize technology which has its origins in relative prices in the domestic market.

[8] The initial formulation of this idea comes from Arthur Lewis in classic articles published in 1954 and 1958 on wage determination and capital accumulation in a surplus labor economy. It should be noted that the essence of the model is **not** based on a dualistic division between agriculture and industry (and was never intended to be so by Lewis), as suggested by many critics of the Lewis model. Rather it was between modern or formal on the one hand, and (quasi) traditional or informal sectors, respectively, on the other.

[9] It should be stressed that we are abstracting from the continuum of work situations, productivity and wages which tend to link the modern and traditional sectors, in reality.

[10] Note that the excess supply of labor to the modern sector applies only to unskilled or semi-skilled labor. The opposite is often the case for skilled workers, which tend to be in short supply in the modern sector, and hence wage differentials are typically much larger than in developed countries.

[11] Of course, more intensive utilization of capital and improvements in technology and work practices in traditional sectors can also make a significant contribution to higher productivity and labor earnings as well.

[12] See especially Athukorala and Manning (1999) for a discussion of these processes in the East Asian context.

[13] Ryoshin Minami (1973) popularized this term in his study of Japanese economic development.

[14] See especially Berg (1971) and Edwards and Lustig (1997). We take up this subject of the level of Indonesian wages relative to those in other countries in the discussion of minimum wages below. Suffice to mention that wages are fundamentally *endogenous* to an economic system—they are determined by levels of productivity associated with economic progress. The fact that Indonesian wages are only around 20%-30% (in PPP terms) of those in Malaysia, or less than 10% of those in Korea, is of major concern. But the appropriate policy conclusion should be to establish the conditions for sustained wage growth through economic progress, as occurred in these countries, rather than try to raise wages through non-market regulation. The latter process has nowhere been a successful model for raising living standards on a sustained basis. Indeed it has tended to undermine improvements in living standards through slowing the rate of economic growth.

[15] For surveys of the literature see Lee (1997) and Golub (1997) and Manning (2003).

[16] See Figures 1-3 in Rama (2002). The reporting of these trends is based on regression analysis conducted by Freeman, Oostenstorp and Rama (2002). Nevertheless, wages fell initially after the trade reforms but then rose over time, and were significantly higher after five years.

[17] As mentioned above, open unemployment is not a particularly good measure of welfare gain or loss, and Rama (p. 18-19) implies that this result is less significant than the findings on wages and employment.

[18] Rama (p. 18) points out, however, that the adverse effects of globalization are probably most felt in child trafficking and sex trade areas.

[19] See especially Marquez (1999), Edwards and Lustig (1997) and Edwards (2002)

[20] For convenience, we refer to the modern and traditional sector as singular entities in this chapter. In reality, there are many modern and traditional sectors, which in practice overlap and merge into one another, according to the various criteria used in their definition (size, technology and organization). Note, following the practice

of Chapter II, we prefer to emphasize the contrast between 'modern' and 'traditional' rather than 'formal' and 'informal' sectors, since the former imply more advanced technology, as well as differences in size and organization of production. However, in practice, it is easier to distinguish between 'formal' and 'informal' categories in the analysis of empirical data on labor force and employment structure and change.

[21] In Indonesian, this view is especially associated with the philosophy of the proponents of 'peoples economy' (*ekonomi rakyat*) who argue that growth of large-scale firms, many of which are foreign-owned or owned by domestic conglomerates, tends to be at the expense of production in smaller-scale firms, it tends to displace labor and contributes to widening disparities in the work force.

[22] Data for 2001 are based on the annual National Labor Force Survey (SAKERNAS). From the second quarter of 2002, SAKERNAS was conducted on a quarterly basis and we present some of the findings of the first quarterly survey in Table 3.1 (these data are likely to be susceptible to seasonal variations)

[23] As a share of the population aged 15 and above.

[24] These characteristics overlap with Key Labor Market Indicators recommended by the ILO and adapted for Indonesia by Irawan, Ahmed and Islam (2000).

[25] The informal sector as defined here refers to all self-employed and family workers. Some self-employed professionals and family businesses would not normally be included as part of the informal sector, if some maximum income or productivity criteria are applied. However, the number of relatively high income participants is quite small, accounting for much less than 5% of all IFS participants as defined above.

[26] In Indonesia, the term 'open unemployment' is used instead of unemployment as conventionally defined in most labor force surveys. This terminology leads to the use of the somewhat misleading terms 'total' or 'global' unemployment, which refers to the sum of unemployment and under-employment, or a measure of labor under-utilization.

[27] The new definition takes into account those who wish to work but are currently not working.

[28] Thus the CBS study suggests that only 8% of the labor force were working less than 35 hours and willing to undertake more work in 1999.

[29] See, for example, Manning (1998: Chapter 9).

[30] The wage differentials were partly the result of fewer hours worked on average by females than males. However, even after accounting for this difference, male hourly wages were some 30-60% higher than those of females for the same level of schooling in specific sectors. The differential was less for more educated workers than for the less educated.

[31] It is important to note that this refers to work on 'main' jobs. Especially in the public sector, main jobs are rarely the only job undertaken by individuals, especially at upper echelons of the civil service, where earnings in supplementary jobs may be several times those earned by an employee in her main job.

[32] Some of the difference in productivity per annum was related to fewer hours worked per year by workers in small-scale industry. But output per worker was still five times higher in large and medium firms, assuming employees in these firms worked twice as many hours a year as workers in small-scake firms.

[33] See **Annex Table 3.2** for details.

[34] See **Annex Tables 3.3 and 3.4**.

[35] Nearly 40% of all formal sector workers were aged less than 25, whereas a smaller share of informal sector worker were in younger age groups. On the other hand, relatively few formal sector workers (11%) were aged 50 and above, compared with just under 25% of all informal sector workers.

[36] Data exclude information on the former province of East Timor. The 2000 Census results are problematic owing to undercounting and non-response. Nevertheless, they are the most reliable source on longer-term changes in population growth.

[37] The number of 15-19 year olds in the work force actually fell in 2000, compared with 1990 and especially 1995.

[38] The fall in the growth of the labor force in the 1990s was much greater among people aged 15-19 and among young males. Among females, steeply rising participation rates rose counterbalanced the age structure effects on growth rates for young people aged 20-24.

[39] The effect on labor force growth was muted in the 1990s. An increasing share of the total population concentrated at prime ages, where labor force participation rates are higher, counterbalanced the effect of the fall in labor force growth at younger ages.

[40] Higher participation rates were also partly the result of a shift in the structure of the population away from younger people who typically have low participation rates. A more inclusive definition of work used by enumerators in censuses has probably played some role in these increases in participation rates, especially among females, over time, even though the formal definition of work used in the census has not changed over time.

[41] Estimated participation rates fell only at ages 15-19 in the 1990s, as more young people went into school.

[42] For details see **Annex Table 3.5**.

[43] The increase in participation rates among older people was especially dramatic for people aged 65 and above (recorded as rising from less than 40% in 1990 and 1995 to 60% in 2000). The 2000 census may have had an upward bias in the enumeration of older working people in particular compared with the previous censuses.
[44] See **Annex Table 3.6**, and below for details.
[45] All of this applies to the situation prior to the Bali bombings, which threatened to slow growth in the last quarter of 2002 and posed a potential threat of greater political instability that would feed back into economic performance.
[46] These issues came to a head in the second half of 2002 as the implications of large increases in minimum wages coupled with an uncertain economic environment became apparent to many investors. The Korean Chamber of Commerce reported that 36 companies had closed down in garments, footwear and toy making in 2001-2002 (*Jakarta Post*, August 23, 2002).
[47] Once the largest exporter of Nike footwear in the world (with 38% of the market in 1996), Indonesia had slipped way behind China. Many of the new investors were reported to be choosing Vietnam over Indonesia whose share of exports of Nike products has risen from 2% in 1996 to 16% in 2001-2002 (Dhume, S. and M. Tkacik, Far Eastern Economic Review, September 12, 2002, pp. 47-49).
[48] This has been attributed to both reform fatigue in Indonesia, and the growth in new investment in labor-intensive manufacturing (textiles in particular) in China (James, Ray and Minor, 2002).
[49] See also **Annex Table 3.7**
[50] By the last quarter of 1998, unemployment in South Korea had more than tripled from 2.2% in 1997 to close to 8%; in Hong Kong, Malaysia and Thailand it more than doubled from 2–2.5% in 1997 to 5–6% in 1998 (Manning 1999).
[51] In a survey conducted by the Social Monitoring Early Response Unit conducted in several cities in Indonesia in February-March 2000, it was found that a high proportion of university graduates who lost their professional and administrative jobs in finance, construction and other sectors in 1997 and 1998 shifted to self-employment and small-scale business with relative ease. The large majority had found new jobs within 3-6 months of retrenchment and a significant number were not planning to return to wage employment (SMERU, 2000).
[52] See **Annex Table 3.8** for details.
[53] In drawing attention to parlous labor market conditions, and arguing for greater government action, well-known consulting groups have persistently argued that unemployment covers some 40% of Indonesia's work force.
[54] Slower productivity growth in this period can probably be attributed partly to compositional effects within manufacturing, namely the shift of investment and output towards more labor-intensive industries.
[55] Real value added per worker (productivity) barely increased in L&M manufacturing, whereas real wages per worker rose by some 10% in 2001.
[56] Wages were high in the Philippines in relation to per capita income and value added, compared with Indonesia. Minimum wages have been part of the policy agenda in the Philippines for some decades. This probably helps account for high wages in manufacturing. However, in addition to more restrictive trade policies, high minimum wages may also help to account for slow employment growth in manufacturing in the Philippines, in comparison to Indonesia and several other countries in the region (see below).
[57] Figure.3.16 shows that only in the Philippines and Vietnam were average wages in manufacturing a higher multiple of per capital income than in Indonesia. The reverse was true for Korea, Malaysia and Thailand.
[58] See Manning (2002a) for a more detailed discussion of both employment and wage trends before and after the economic crisis in Korea, Thailand and Indonesia.
[59] The one exception appears to be the construction industry in Thailand where real wages grew at almost half the rate of those in other sectors (data not shown in the table). This might be explained by the influx of migrant workers from Myanmar (Burma), Laos and Cambodia into sectors that employed a high proportion of unskilled workers.
[60] According to national poverty lines, the incidence of poverty in the Philippines was 40% in 1997 compared with less than 20% in Indonesia. These figures are not directly comparable, owing to different national standards to measure the poverty line. However, Indonesia also performed much better than the Philippines in reduction of poverty in the previous two decades (-10% per annum in Indonesia compared with –2% per annum in the Philippines). See the World Bank, *Attacking World Poverty*, World Development Report 2000/2001, p. 48 and Appendix Table 4 (p. 280-81).
[61] This section draws heavily on from Manning (2002b).
[62] To cite one example, several countries in East Asia recognized a 48 not a 40-hour working week during much of their period of rapid industrialization (Nayyar, 1995).
[63] In many respects, wages structures and payment systems were modeled on those in the civil service, with clearly specified increments based on a years of service, payments in kind and family allowances.
[64] See, for example, *PROPENAS* (The National Development Program) 2000-2004, Bappenas, Jakarta, 2001.

65 The ILO convention on child labor distinguishes, for example, recognizes the economic reality of higher minimum ages of entry into the work force for children in developed compared developing economies.
66 The legislation covered here refers to the draft of June 2002. The bill has been evolving slowly through negotiations with employers and employees and some clauses were in the process of modification at the time of writing (September-October 2002).
67 Potentially, *Kepmen 150* has raised labor costs, partly because of recent changes to the rates and coverage of severance (see below)
68 The basic framework for action on dismissal cases go back to Basic Law 12, passed several decades ago in 1964, when the state was the major employer of labor in the modern sector, and large private enterprise firms were a very small proportion of total employment, and especially manufacturing sector employment.
69 Cases of 'individual' retrenchment of less than 10 workers are decided in the Provincial Disputes Councils (P4D) and of 'mass' dismissal are referred to the Central Government Disputes Council (P4P). Appeals on decisions of the P4D are made to the Central Government Disputes Council.
70 One major complaint from employers has been the informal fees which they have had to pay to Manpower officials (SMERU, 2002).
71 There is one important change in the new proposed Labor Protection Act, namely dismissals of less than 10 persons no longer requires permission of any committee, provided that the parties (the worker(s) and management), agree to severance payment terms (Article 145). The proposed new law is not altogether clear on this matter since firms are required to take all possible actions to avoid retrenchment, the specification of such actions is to be determined in a special government regulation. If they are deemed not be fulfilled by the 'authorities, then the case must go before the industrial court (See articles 145(3) and 146).
72 Workers are permitted to be employed for up to a two-year short-term contract, extendable to three years.
73 The legislation was initially overturned by a Ministerial Decision (No. 78) in 2001 leading to major demonstrations in several cities and especially in Bandung and an almost immediate reinstatement of the original decision by the Minister of Manpower and several Governors (despite questions regarding the legality of these decisions).
74 Potentially higher rates of severance pay also raises labor costs, given that minimum wage legislation prevents firms from adjusting wages downwards in response to the higher level of severance pay.
75 It was brought in at a time of increasing uncertainty for business under the Abdurrahman government, and at the same time as several major labor disputes were on-going in the main industrial areas.
76 We refer to Kepmenaker 150/2000 here rather than the articles in the proposed Labor Protection Act.
77 The rates and coverage are identical in both *Kepmen 150* and the proposed Labor Act.
78 Workers dismissed for major offences and voluntary quits receive long service leave, after three years of employment, but do not any receive severance pay under the new law.
79 Data shown in Annex Table 4.1 shows details of severance pay and long service leave by various causes of separation/turnover.
80 No distinction is made in KEPMEN 150 between minor and major criminal acts. Payment of long-service leave to those committing minor criminal acts (such as petty stealing in the factory) might have been acceptable, if distinguished from major crimes (even though such a clause is understandably distasteful to employers and hardly an incentive for discipline in the work place).
81 See **Annex 4.1** for a fuller discussion of these issues.
82 This section draws particularly on Zimmerman (2002) who reviewed articles on industrial relations in the Labor Protection Act and the Disputes Resolution Act before parliament in June 2002.
83 See for example Deery and Mitchell (1993), Verma et. al. (1995) and Bamber et al. (2000).
84 The reader is referred to the above-mentioned study by Zimmerman (2002), and the Trade Union Act of 2000 and proposed Labor Protection and Labor Disputes Acts for details.
85 The new political parties, PKB and PDI-P, which dominated the executive wing of government from late 1999, saw competitive unionism at the establishment level as a pre-condition for challenging the dominant position of the former government-backed union, The All Indonesian Workers Union (SPSI).
86 The estimated number of union members made by the Ministry of Manpower is almost certainly a gross overestimate. Somewhere between 2-5 million due-paying members is probably closer to the mark (since union dues no longer have to handed over to the central government, official data are likely to be very wide of the mark).
87 The SMERU study (2002) of industrial relations found that more than one union had been set up in relatively few firms. Where more one union was established it was more difficult, but not a major problem, for management to negotiate with workers.
88 The initial law was passed in 1954.
89 See Article 118.

[90] For example, in its new labor law of 1997, South Korea allowed for multiple unionism in the work place but postponed the implementation of this aspect of the labor code for five years. This occurred a decade after unions won new freedoms from the previously highly controlled industrial relations system.
[91] The Trade Union Act law provides for a blanket right to join trade unions of choice at all levels (Act 21, 2000, Article 5), and permits the formation of more than one union at the enterprise level. This is new in Indonesia, and has been raised as a major problem by APINDO, AMCHAM (The American Chamber of Commerce) and other organizations.
[92] Although, in the case of failure to agree on the appointment of an arbitrator, the draft Disputes Resolution Act allows one party to refer the dispute to the proposed Industrial Disputes Court.
[93] Most of these districts are located in and around Jakarta, Bandung and Surabaya.
[94] Conservation of scarce skilled manpower is an additional argument for phasing in the tribunals in major industrial areas first.
[95] See Zimmerman (2002: 7-16, and 46-72) for details of the industrial relations framework in these countries.
[96] As we saw in Chapter IV, minimum wages also affect the level of severance pay and social security benefits, and hence the costs of dismissals and retrenchments. See, for example, *Kompas* newspaper reports 18 December 2001 and 13 January 2002.
[97] For example, see articles by Ballinger and Keady (*Jakarta Post*, 18/01/02, p. 5).
[98] For an assessment of the adequacy of minimum wages in the context of relative wages **within** Indonesia see Gardiner (*Jakarta Post*, 4/01/02, p. 5), Ikhsan (*Kompas*, 8/01/02, p. 4-5).
[99] As we saw in Chapter III, wages in the formal or modern sector in Indonesia are comparable to those in Asian countries at similar levels of per capita income, and they are high compared with earnings in the informal sector in Indonesia.
[100] See Annex 5.1.
[101] See the Minister of Manpower and Resettlement Decree No. 226/2000 (discussed SMERU, 2001: 18). MW are also covered in planned, new labor legislation. The proposed labor protection law, proposed by the Ministry of Manpower and hotly debated in the parliamentary committee (*Komisi V)* in June-September, also set out detailed procedures for implementation of minimum wages.
[102] Even in countries as large as the United States and Australia, for example, there is only one national minimum wage which sets the floor to wages across the country. Both Thailand and the Philippines started with a national minimum wage and then brought in a regional minimum wage at the Province level.
[103] The Central Government is also advised by a wages council, which played an important part in minimum wage determination in the past but has played only a minor role since decentralization.
[104] The SMERU survey of establishments found that one *kabupaten* government announced **four** increases in official minimum wages in 2001.
[105] See Annex 5.1.
[106] As in West Java, this unrest occurred mainly due to higher or lower MW announced in some districts compared with neighboring districts. However, the recommendations of the Provincial Government were not always followed by the districts (for example, the District Government of Gresik near Surabaya refused to revise its first recommendation of large minimum wage increases for 2002, despite recommendations from the Provincial Government).
[107] For example, in southern Sumatra, the provinces of South Sumatra, Jambi and Bengkulu coordinated MW increases for 2002.
[108] The Minister of Manpower has mentioned all three factors in various public statements in regarding minimum wage policy (see for example *Kompas* 11 October 2002).
[109] Box 5.1 describes how MW policy evolved as a policy to support the wages of working families during the New Order period, partly to compensate for the tight controls which the government maintained over trade union organizations.
[110] See Ministry of Manpower, *Pedoman Penyusunan dan Pelaksanaan Upah Minimum* (Jakarta, 1999).
[111] In the late 1990s, the Ministry has introduced a higher minimum standard of living, *kehidupan layak* (KL), or an 'appropriate' standard of living, for assessing the adequacy of minimum wages, which was to apply once all provinces had set wages equal to the KHM. Owing to the crisis, this standard had not been officially recommended by the Ministry as a national yardstick for by 2002, although the Wages Council in several provinces such as Jakarta had foreshadowed its imminent introduction. If introduced, this would raise the standard of basic needs by around 20%, which would mean wage levels that are above per capita income in most provinces by standards prevailing in 2001. The Labor Protection Law of 2003 includes *kehidupan layak*, as the new benchmark for setting minimum wages.
[112] An inter-ministerial team set up by the Coordinating Ministry of Economic Affairs conducted interviews with unions, employers and government officials groups in Jakarta, Bandung and Surabaya in September 2002

on the process of MW fixing in the province in the previous year and underway at the time for setting a new MW in January 2003. See Annex 5.1, which reports on the findings of the field visits to West Java and Jakarta.

[113] Official data reported by the Ministry of Manpower, averaged across all provinces, find that increases in the KHM were around 25% in 2000 and 2001. In contrast, December on December CPI increases were 9% in 1999-2000, and 13% in same two years.

[114] Ballinger and Keady (*Jakarta Post*, 18/01/02, p. 5).

[115] This source suggests that Indonesian official minimum wages were even below those in Vietnam ($40), Sri Lanka ($43) and Myanmar ($163), countries with a lower per capita income than Indonesia. It was widely cited in discussions of the minimum wage increases in Indonesia for 2002. See, for example, Mardjono, Penetapan Upah Minimum (Setting Minimum Wages), Jakarta, January 2002 (notes presented to a briefing of the Commission V of the Parliament [DPR]).

[116] The average MW in Indonesia in 1999 is compared with MW paid in foreign firms in Vietnam and the garments industry in Cambodia. Whereas the MW in Indonesia apply to all firms with 10 workers or more, the MW in Vietnam and Cambodia are legislated to apply to a tiny segment of wage employees typically located only in the major cities. Vietnam, in fact, has a much lower MW for workers in domestic establishments, which really should be point of comparison with wages in most Indonesian regions (see below).

[117] This is in contrast to the much out-of-date Asian Financial News data cited above (which mostly apply for 1999/2000)

[118] The only country for which minimum wages are quite high relative to GDP per capita, compared with Indonesia, is the Philippines. This country has a long history of minimum wages. But manufacturing employment has also expanded much slower than in most non-communist states in the East Asian region.

[119] Per capita incomes relative to MW are a useful point of comparison for evaluating whether the level of minimum wages is 'too high' or 'too low', since per capita GDP are the most widely used measure of general welfare of the population, despite many shortcomings. The US$ comparisons shown in Tables 1 and 2 are based on prevailing nominal exchange rates which are a very crude measure of real prices in an economy compared with international prices (depending on the flexibility of exchange rates and trade regime). Incomes expressed in purchasing power parity terms are a much better measure of relative welfare differences across countries; in turn, the number of people below the poverty line is a better measure of welfare of incomes of the disadvantaged, which the MW seeks to address.

[120] The difference was smallest with Cambodia. But data in the latter country apply only to foreign firms which have invested in the garments industry in recent years, under a special quota agreement with the USA (including articles governing labor standards). In practice, these wage standards to not apply to domestic firms producing for the local market (see, for example, *The Cambodia Daily*, September 1-2, 2001, p.4-5.

[121] See **Annex Table 5.1**

[122] See **Annex Table 5.2** for details.

[123] The Jakarta and Surabaya governments increased MW by over 40% and 39% in rupiah terms on average annually in 2001 and 2002. Because of their proximity to Jakarta, Bogor Bekasi and Tangerang district governments were all obliged to match increases offered by Jakarta provincial government (since the mid 1990s wages in these districts have all been on a par with Jakarta). In 2002, wages were slightly but not significantly lower than in the capital city (ranging from Rp. 576,000-590,000 compared with 591,000 in Jakarta.).

[124] The data suggest that MW in Indonesia rose much faster than the Philippines over the same time period. In fact, the dollar value of minimum wages actually fell in Manila from just under $1,300 per year in 1996 and 1997 to just under $1800 per year in 2001 and 2002.

[125] There has been considerable controversy over this issue in developed countries in recent years, especially in the USA. Some researchers have found that increases in the MW had negligible effects on employment (see especially Card and Krueger, 1994). Others have challenged these results and suggested the more conventional finding that MW have significant negative impacts on employment (Kim and Taylor, 1995; Neumark and Wascher, 1996; Burkhauser, Couch and Wittenburg 2000)

[126] We examine these effects in the next section.

[127] The study also shows that for every 10% increase in the real minimum wage, employment of white-collar workers rise by 10%. This arises because firms are probably substituting capital for labor with the outcome of employing more white-collar workers (as complements with capital production processes) and less blue-collar workers. White-collar workers, however, make up a small proportion of the labor force.

[128] See, for example, the statement by labor ‘expert’ Fauzi Abdullah from the NGO Sedane Labor Information, that Indonesia’s labor costs remained competitive compared with other countries (*Jakarta Post*, 26 August 2002). Adbullah cited comparisons with industrial countries as a basis for his conclusion.

[129] According to law, minimum wages apply to all firms, including small-scale firms where wages are typically a much higher share of total costs and value-added. Although, in practice, compliance is weak in smaller firms,

the effects may also be increasingly felt in these establishments as the trade unions become more organized and effective.

[130] Firms are primarily interested in maximizing the returns in relation to value-added, that is the returns to labor, capital and management, assuming that the costs of material inputs are given. Especially in exports, it is the efficiency of the production process that adds value (often to imported raw materials) at international prices which gives firms a comparative advantage.

[131] These *biaya siluman* are likely to be less high in precisely those industries of concern from the point of view of employment: the export-competing industries which operate in a relatively deregulated environment, especially if they produce in bonded warehouses or export-free zones. On the other hand, they are likely to be high in those protected capital-intensive industries, such as fertilizer or steel, where workers can share in the rents earned, and where an increase in the MW is likely to have less effect on employment.

[132] The increase recommended by the Jakarta Government Wages Council was 7% in November 2001.

[133] To put this figure in perspective, some 200,000 new jobs were created each year in large and medium manufacturing alone in the period 1986-1996. In total, the modern private sector (including mining, hotels, banks and other services) would have created 0.5-1.0 million new jobs each year at this time, equivalent to around 25-50% of all new job seekers (some 2 million people). See Chapter 3 for more details.

[134] These agencies were engaged in the 'fact-finding' study on employment and wage policy under the leadership of the Coordinating Ministry of Economic Affairs conducted in September 2002

[135] In fact, according to SMERU (2001: 32), more than one revision of the official MW each year contravenes the Ministry of Manpower regulation No. 226/2000.

[136] Nor is it particularly useful to point out, as several senior officials have, that relatively few firms applied for exemptions, as a way of avoiding paying the 2002 MW increases (see also Sumhudi, 2002). It is hardly a secret that most business-people must haggle and pay for the granting of exceptions from regulatory bodies, and there is no reason to expect any different outcome in the case of wage regulations (See SMERU, 2002 for a discussion of 'informal' payments to labor inspectors and labor mediators in the case of labor disputes).

[137] Such a proposal has been made by economist Chatib Basri as a trade-off for slower increases in minimum wages. The author had in mind the Singapore example of public housing funded out of worker social-security funds. While this is an attractive proposal, Indonesia clearly faces a complex set of issues in public housing for the poor. These include the large size of the population which might be included, the migrant status of many industrial workers whose families live in rural areas, and capacity to pay at much lower present and projected wage incomes than in Singapore. For all these reasons, such a program might be politically opportune but not particularly significant for improving living standards of most wageworkers.

[138] These issues are being investigated in a Bappenas supported study conducted by SMERU, October 2001-January2002.

[139] Special cases relate to districts such as Tangerang, Bekasi and Bogor or Sidoardjo and Gresik, which are clearly more closely integrated with the neighboring province of DKI Jakarta and the district of Surabaya, than with all of West and East Java, , respectively.

[140] Such an advisor might work under the direction of Bappenas or the Coordinating Ministry of Economic Affairs.

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ANNEX TABLE 3.1: VALUE OF OUTPUT, EMPLOYMENT, WAGES AND LABOR PRODUCTIVITY BY MAJOR SECTOR, INDONESIA, 2000

Sectors of Production	Value of Output	Employ-ment	Output per Worker	Index of Output per Worker	Average Wages	Index of Wages	Productivity/ Wages
	Rp. Trill.	*Million*	*Rp.M./Yr.*	*(Indon.=1.0)*	*(000 per per month)*	*(Indonesia =1.0)*	*Ratio*
Agriculture	218.4	40.55	5.4	0.37	230	0.53	1.95
Mining	166.6	0.45	370.2	25.76	648	1.51	47.61
Manufacturing	336.1	11.66	28.8	2.01	402	0.93	5.98
Electricity, Gas etc.	15.1	0.07	215.7	15.01	NA	NA	NA
Construction	92.2	3.54	26.0	1.81	423	0.98	5.13
Trade, rest. And hotels	196.1	18.50	10.6	0.74	401	0.93	2.20
Transport	64.5	4.55	14.2	0.99	547	1.27	2.16
Finance	80	0.89	89.9	6.25	723	1.68	10.36
Services	121.8	9.60	12.7	0.88	545	1.27	1.94
ALL SECTORS	1290.8	89.81	14.4	1.00	430	1.00	2.79

Note: NA: Utilities are combined with Mining

Source: CBS, Indonesia Yearbook 2001; SAKERNAS, 2000.

ANNEX TABLE 3.2: ANNUAL VALUE ADDED, OUTPUT PER WORKER AND WAGE COSTS PER WORKER IN MANUFACTURING, INDONESIA, 2000 (LARGE AND MEDIUM, AND SMALL FIRMS)

	BASIC DATA			VALUE ADDED AND AVERAGE WAGES				
Firm Type & Year	No. of Firms	Employ-ment	Average No. wkrs per firm	Wage cost per Worker/mth	Value added Per wkr/mth	Output per Worker/ Month	*Ratio of Wages to:* Value Added	Output
		000		(Rp/000)	(Rp.m.)	(Rp.m.)		
L&M								
32: TFC	4960	1368	276	486	2344	6853	0.21	0.07
38:Met &Mach.	2503	531	212	1093	8992	20018	0.12	0.05
All Firms	22851	4371	191	688	4235	11112	0.16	0.06
Small								
32: TFC	41438	370	9	156	416	1390	0.38	0.11
38:Metals &Mach.	10638	78	7	180	470	1224	0.38	0.15

Note:
Minimum wage is the unweighted average of minimum wages in the six largest provinces.

Source: Statistical Handbook of Indonesia 2000, Table 6.1.2

ANNEX TABLE 3.3: THE DISTRIBUTION OF WORKERS AND WAGE LEVELS BY SECTOR AND LEVEL OF SCHOOLING INDONESIA 2001

	Level of Schooling						
	<Primary	Primary	Junior High	Senior High	Academy/ University	All Employees	
Share of workers							
Agriculture	37	45	12	5	0	100	
Manufacturing	8	30	24	33	5	100	
Services	6	14	11	40	29	100	
Other	10	31	19	33	6	100	
Total	14	29	17	30	11	100	
Ratio of Wages to Wages in All Sectors							*Average Wages per Month (Rp.000)*
Agriculture	0.8	0.7	0.8	0.7	0.8	0.5	268
Manufacturing	1.1	1.1	1.0	0.9	1.3	1.0	508
Services	0.9	0.9	1.0	1.2	1.0	1.4	723
Other	1.5	1.2	1.0	0.9	1.1	1.0	534
Total	1.0	1.0	1.0	1.0	1.0	1.0	
Average Wages per Month (Rp.000)	261	342	452	666	1092		531

Source: CBS, SAKERNAS 2001.

ANNEX TABLE 3.4: WAGE DISTRIBUTION BY SECTOR BEFORE AND AFTER STANDARDIZING FOR DIFFERENCES IN SCHOOLING, INDONESIA 2001

	Actual Wages		Wages Standardized by Level of Schooling [1]	
	Rp.000	Index (Total=1.0)	Rp.000	Index (Total=1.0)
Agriculture	268	0.50	405	0.76
Manufacturing	508	0.96	559	1.05
Services	723	1.36	552	1.04
Other	534	1.01	563	1.06
Total	531	1.00	531	1.00

1 Wages recalculated assuming that the level of education was the same in each sectors as in all sectors.

Source: CBS, SAKERNAS 2001.

ANNEX TABLE 3.5: TOTAL LABOR FORCE PARTICIPATION RATES BY SEX IN URBAN AND RURAL AREAS, INDONESIA 1980-2000

	Male	**Female**	**Total**
Urban			
1980	70.0	27.8	48.7
1990	74.6	36.0	55.0
2000	78.5	46.5	62.5
Rural			
1980	83.2	39.5	60.7
1990	86.8	48.1	67.0
2000	86.1	64.3	75.1
Total			
1980	80.1	36.8	57.9
1990	82.8	40.1	61.1
2000	82.8	56.5	69.6

Source: CBS, Population Census 1980, 1990 and 2000.

ANNEX TABLE 3.6: CHANGING EDUCATIONAL COMPOSITION OF THE LABOR FORCE AND POPULATION, 1980-2000(%)

	Labor Force Status			**Population**	**Population**
	Working	Unemployed	Labor Force	**[000]**	
1980					
<=Primary	67.1	52.6	66.8	64.8	56239
Pri	21.1	22.0	21.1	22.1	19137
Lsec	5.2	9.4	5.3	7.2	6212
Usec	5.8	15.0	5.9	5.2	4537
Tert	0.8	1.0	0.8	0.7	609
Total	100.0	100.0	100.0	100.0	6734
1990					
<=Pri	45.4	18.2	44.6	43.5	49227
Pri	31.3	24.6	31.1	30.4	34466
Lsec	9.2	15.2	9.4	12.7	14375
Usec	12.1	37.5	12.9	11.9	13441
Tert	1.9	4.5	2.0	1.5	1688
Total	100.0	100.0	100.0	100.0	113198
1995					
<=Pri	36.3	13.4	34.7	34.8	44875
Pri	32.9	26.6	32.4	32.1	41328
Lsec	11.5	16.5	11.9	15.0	19290
Usec	16.2	37.7	17.8	15.6	20154
Tert	3.1	5.8	3.3	2.5	3158
Total	100.0	100.0	100.0	100.0	128805
2000					
<=Pri	24.2	8.0	23.4	22.2	32150
Pri	40.9	29.3	40.3	38.7	55911
Lsec	13.5	21.0	13.9	17.2	24906
Usec	17.9	36.4	18.8	18.8	27179
Tert	3.6	5.3	3.7	3.1	4448
Total	100.0	100.0	100.0	100.0	144593

Source: CBS, Population Census 1980, 1990 and 2000 and Intercensal Survey 1995

ANNEX TABLE 3.7: EMPLOYMENT SHARES BY SECTOR AND STATUS, 1980-2000

	Male				Female			
	1980	1990	1995	2000	1980	1990	1995	2000
Wage employment								
Agriculture	3.5	3.6	3.1	4.2	2.9	2.5	2.3	3.4
Manufacturing	9.8	14.3	14.2	12.0	11.2	17.3	15.4	12.2
Services	24.0	20.1	20.5	28.3	26.7	27.6	26.1	24.1
Trade and Other	19.6	23.5	21.4	14.4	5.4	9.2	9.7	9.4
Total	56.9	61.5	59.2	58.9	46.3	56.7	53.5	49.2
Non Agriculture	53.4	57.9	56.1	54.6	43.3	54.1	51.2	45.7
Non-Wage Employment								
Agriculture	6.5	7.1	6.7	10.7	4.3	4.3	4.9	10.2
Manufacturing	3.3	2.3	3.4	1.9	4.8	2.9	4.9	2.1
Services	8.7	5.1	5.5	6.2	11.8	5.8	5.3	4.8
Trade and Other	24.5	23.9	25.1	22.3	32.9	30.3	31.5	33.7
Total	43.1	38.5	40.8	41.1	53.7	43.3	46.5	50.8
Non Agriculture	36.5	31.4	34.1	30.4	49.4	39.0	41.7	40.6
Total employment	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total Wage	56.9	61.5	59.2	58.9	46.3	56.7	53.5	49.2
Total Non-Wage	43.1	38.5	40.8	41.1	53.7	43.3	46.5	50.8

Source: CBS, Population Census 1980, 1990 and 2000 and Intercensal Survey 1995

ANNEX TABLE 3.8: UNEMPLOYMENT BY AGE AND EDUCATION, URBAN INDONESIA1976-2001

	Unemployment Rates (%)				**% Distribution**			
					1996		2001	
	1976	1986	1996	2001	Unemployed	Labor force	Unemployed	Labor force
15-19	20.4	14.3	27.1	24.6	25	7.7	22.9	7.5
20-24	17.1	19.4	22.1	21.8	41	15.6	39.8	14.7
25-29	5.7	7.7	11.0	10.8	21	16.0	20.3	15.2
30+	1	0.9	1.7	2.2	13	60.7	17.0	62.6
					100	100.0	100.0	100.0
<Primary	3.7	1.2	1.9	1.6	3	14.1	2.6	12.9
Primary	6.8	2.4	3.2	3.9	13	27.4	12.5	25.7
Lower Secondary	8.7	5.3	7.6	6.8	15	16.7	16.3	19.3
Upper Secondary								
Academic stream	11.2	14.2	14.9	13.7	37	20.7	34.1	19.9
Vocational stream	11.1	9.2	12.7	14.1	21	13.5	22.0	12.6
Tertiary	4.0	9.7	12.3	10.5	11	7.6	12.5	9.6
					100	100.0	100.0	100.0
All Ages	6.3	5.8	8.3	8.0	2511	30163	3261	40556

Source: CBS, SAKERNAS 1976, 1986, 1996 and 2001.

ANNEX TABLE 5.1: NOMINAL MINIMUM WAGES AND GDP PER CAPITA IN THAILAND AND INDONESIA (ANNUAL NATIONAL US$ VALUE)

	Minimum Wages		**GDP Per Capita a**		**Ratio of minimum wage to GDP per capita**	
	Thailand (Bangkok)	**Indonesia (Jakarta)**	**Thailand**	**Indonesia**	**Thailand**	**Indonesia**
1996	1,883	786	2,995	1,129	61	70
1997	1,505	711	2,499	1,078	60	66
1998	1,174	238	1,826	474	64	50
1999	1,286	355	1,983	697	65	51
2000	1,212	403	1,960	730	62	55
2001	1,117	494	1,827	692	61	70
2002	1,128	755	1,917	856	59	90
Poverty rate 2000 b\\	13%	23%				

The 2002 figures are estimates based on estimates of growth in GDP for 2002 from various sources.
a\ National GDP per capita
b\ Percentage of the population below the $1.00 poverty line (Asian Development Bank, *The World Economy*, *Developing Asia*, *and the Pacific*, 2000).

ANNEX TABLE 5.2: MINIMUM WAGES IN JAKARTA, SURABAYA AND BANDUNG, 1992-2002

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 Exchange Rate $US		
											10,000	9000	8000
Nominal Value (Rp.'000)													
Jakarta	62.5	75.0	95.0	115.0	156.0	172.5	198.5	231.0	286.0	426.0	591.0		
Bandung	45.0	55.0	95.0	115.0	156.0	173.0	199.0	230.0	344.0	373.0	471.0		
Surabaya	52.5	52.5	75.0	92.5	120.0	133.0	153.0	182.0	236.0	330.0	453.0		
Real Minimum Wages													
Rupiah Values (000, 1996 Prices)													
Jakarta	88	95	112	124	156	162	116	112	134	178	225		
Bandung	63	70	112	124	156	162	116	112	161	156	179		
Surabaya	74	67	89	100	120	125	89	88	111	138	172		
Dollar values ($/month)													
Jakarta	30.8	35.9	44.0	51.1	65.5	59.3	19.9	29.6	33.6	41.1	59.1	65.7	73.9
Bandung	22.2	26.4	44.0	51.1	65.5	59.5	19.9	29.5	40.4	36.0	47.1	52.3	58.9
Surabaya	25.9	25.2	34.7	41.1	50.4	45.7	15.3	23.3	27.7	31.9	45.3	50.3	56.6

ANNEXES

<u>**Annex 4.1**</u>

SEVERANCE PAY AND DISMISSALS[1]

Severance pay can be thought of as mainly a form of unemployment insurance.[2] Unemployment benefits are customarily paid by the state or by individual workers in developed countries. In contrast, in many developing countries, severance pay is made by employers rather than the state, which typically cannot afford such unemployment insurance.

What are the effects of severance pay on employment and wages? These depend on a number of factors: the flexibility of wages and employment (partly influenced by labor regulations and the strength and strategies of labor unions), labor market conditions and the rate of discount with respect to future incomes on the part of different groups of workers.

- *A Tax on Employment*? Since regulations require payments to be made by employers to the benefit of workers, severance is often viewed as a tax on employment. Theoretically this should not be the case, but in practice it is likely to be so.
    - ♦ With the introduction of severance payments, there should be compensating (downwards) adjustments to wage rates, as firms adjust the **composition** of the wage bill to equate marginal product of labor costs, over a given time period (in a **perfectly operating labor market)**.[3] Workers, for their part, should simply view severance as a deferred method of wage payment, and hence are prepared to accept lower current wages (depending on the rate of discount for future versus present wages).
    - ♦ But if nominal **wages are sticky downwards**,[4] an increase in severance pay (or extension of its coverage) will raise labor costs for a given level of employment, and hence act as a tax on employment. At the same time, workers who typically earn low wages can be expected to place a high rate of time discount on future versus present income. Hence they will resist employer attempts to bring about a compensating reduction in current wages. Thus, mandated severance pay tends to reduce labor market flexibility. It acts as a tax on dismissals and on new hires, and will encourage groups of workers who gain most from the regulations to seek to change jobs more often, although rates of turnover can be expected to vary according to labor market conditions.[5]

    Generally there will be a negative impact on employment compared with competitive market conditions. As with any increase in wage costs, firms with a less than perfectly inelastic demand curve for labor will reduce employment. They might conserve on labor through a variety of strategies: lay-off workers, or hire fewer workers who are eligible to receive severance pay (through adjustments to the organization of work or technology, or by reducing output). The latter might involve sub-contracting arrangements to small

[1] Drafted 19 June 2002
[2] Hereafter, we assume that severance as includes both severance pay and long service payments. Both depend on the number of months worked.
[3] Of course, in a perfectly flexible labor market, total labor costs would remain the same if employers were able to pass on all the costs of an increase in severance pay rates to workers in the form of lower wages.
[4] This appears to be the case in many developing countries and large segments of the Indonesian labor market.
[5] Following an increase in severance payments, workers are less likely to risk dismissal in the hope of getting severance pay and then finding a new job, in a slack compared with a tight labor market.

firms, or direct hiring of short-term contract workers, who are not eligible to receive severance pay.

- *Funding*. A separate, perhaps more important issue relates to how severance is funded, and the institutional arrangements for access to benefits owed to workers. There are several options:

  - ♦ if employers bear the cost of severance, payments can be made up front, as in the case of many relatively new schemes in Latin America, such as in Brazil and Peru.[6] The potential for conflict over severance payments is reduced, if employers bear the total cost and pay up-front. This is especially the case if no distinction is made between voluntary quits and dismissals, in allowing workers access to these funds. In cases where no such distinction is made, workers are usually required to spend a minimum period (5-7 years) before they can directly access severance pay.

  - ♦ individual accounts can be set up which workers can draw on if they are dismissed or quit voluntarily. The main issue here, especially relevant to Indonesia, is the protection of these accounts from financial mismanagement

  - ♦ employees can be allowed/encouraged to contribute to individual severance/ retirement funds voluntarily, thus providing them with a more secure platform to change and search for jobs

  As we shall see, none of these options have been tried in Indonesia, but all deserve some attention in a comprehensive reform of labor protection regulation.

- *Quits versus Dismissals*. One final issue, given great attention in the discussion over severance pay, relates to whether workers who take voluntary quits are eligible to receive severance pay. Some laws exclude voluntary quits from severance coverage, and this tends to encourage labor disputes, as workers seek to provoke dismissal in order to be eligible for severance pay. It is arguable that it is more efficient and equitable if the law allows workers who are dismissed for whatever reason (excluding criminal offences), and those who quit, to have the same access to severance pay (Edwards, 2002). As noted, there may however be a minimum time period before employees are eligible for severance.

The Coverage of Severance (and Long Service) Pay in Indonesia

Severance is regulated for several categories of workers:

- Workers dismissed for economic cause: bankruptcy, cutbacks in output or economic restructuring
- Workers dismissed for unjust cause or minor offences (just cause).
- Workers dismissed for major offences
- Workers who take voluntary quits

[6] In Brazil, for example, employers are mandated to pay 8% of the workers salary into a fund which can be accessed by the workers in cases of dismissal or voluntary separation (Marquez, 1995; Cox-Edwards and Manning, 2000: 363)

In Table 4.1 we saw the **coverage** of these payments according to Kepmen 150 and the earlier regulations (passed in 1986 and revised in 1996), which it replaced.[7] What payments have remained the same and what have been the main changes?

- *No change*: since 1986, dismissal for economic cause and unjust cause
- *Change in 1996*: Long service pay given to employees dismissed for minor and major cause.
- *Change in 2000*: Long service pay given to all employees who quit voluntarily. It is not true, as many employers claim, that people who quit voluntarily receive severance pay and this is only paid after three years service.

Thus from year 2000, all categories of workers received some receive some payment, either severance pay or long service pay under the new law. However, workers dismissed for major offences and voluntary quits did not any receive severance pay.

The issue of quits versus dismissals has been highlighted in the literature on Indonesia. Before 2000, those who quit were not eligible to receive severance pay, and hence the law provided an incentive for employees to seek dismissal in some way, and hence gain severance pay. This discrepancy has always been the case in Indonesia but was sharpened after the large increases in severance rates in 1996.[8]

Rates of Severance Pay in Indonesia.

From 1986, rates of severance pay and long service leave, all based on a standard formula involving monthly wages by months of service,[9] were increased by government (Minister of Manpower) decree in 1996 and then again in the year 2000. Overall, the largest increases were in 1996, whereas those in 2000 were smaller. For workers employed five years or more, basic rates of severance pay increased from 25%-50% in 1996 and then again by another 25-40% in 2000 for those with 10 years experience or more (**Annex Table 4.1**).[10] Long service pay was also increased although by smaller amounts. In addition, the 1996 reform **doubled** the rate of severance and long service pay for all cases of dismissal for economic cause. This latter change was by far the single most important increase in severance pay over the past two decades.

Total Costs of Severance in Indonesia

Annex Table 4.2 provides a rough estimate of the cost of severance, and the change in this cost over time. As noted, those who **quit** receive long service pay as part of their severance package after three years of service, which might range from around 1-3% of total wage costs at an annual rate of turnover of 5%. If **layoffs** (dismissals) occur at the same rate, perhaps because the firm is in difficulty, the percentage of total wage costs would be around 4-7.5%.

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[7] See Ministerial Regulations (Kepmenaker) No. 2, 1986 and No. 3 1996, and Basic Law No. 12, 1964.

[8] A worker who had been with the firm for 10 years, and was dismissed for a minor offence would receive 18 months pay, whereas one who left voluntarily would receive nothing. The difference has been narrowed since *Kepmen 150*: a worker quitting after 10 years now receive 4 months pay, but the difference is still quite large.

[9] Total payments for workers (ΣP_a^i) who are dismissed or quit, at any point in time, for the *ith* worker with *a* years of experience, are calculated as follows: $\Sigma P_a^I = \Sigma((W^i*MS_a^i) + (W^i*ML_a^i))$ where W is the monthly wage, MS eligible months of severance pay, and ML eligible months of long service pay owed to the *ith* worker, according to the severance pay regulation.

[10] Annex Table 1 provides details of implications of changes in regulations since 1986.

However, if conditions deteriorated and turnover increased to 10%, the annual cost of severance could rise to 8-15% depending on years of service, and even more at higher rates of turnover, which are sometimes experienced in smaller firms.

ANNEX TABLE 4.1: CHANGES IN SEVERANCE AND LONG SERVICE PAY FOR VARIOUS CATEGORIES OF DISMISSAL/SEPARATION IN INDONESIA, 1986-2000

	Rates (months of salary)			**Voluntary Quits**		**Dismissals**								
						Economic Cause			Minor Offense			Major Offense		
	Old Law		New Law	Old Laws	New Law	Old Law		New Law	Old Law		New Law	Old Law		New Law
	1986	1996				1986	1996		1986	1996		1986	1996	
Severance Pay														
Less than one year service	1mth.	1mth.	1mth.	0	0	1	2	2	1	1	1	0	0	0
Three years service	4mth.	4mth.	4mth.	0	0	4	8	8	4	4	4	0	0	0
Five years service	4mth.	5mth.	5mth.	0	0	4	10	10	4	5	4	0	0	0
Ten years service	4mth.	5mth.	7mth.	0	0	4	10	14	4	5	4	0	0	0
Twenty years service	4mth.	5mth.	7mth.	0	0	4	10	14	4	5	4	0	0	0
Maximum	4mth.	5mth.	7mth.	0	0	4	10	14	4	5	4	0	0	0
Long Service Leave														
Less than one year service	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Three years service	0	0	2mth.	0	2	0	0	2	0	0	2	0	0	2
Five years service	1mth.	2mth.	2mth.	0	2	1	2	2	0	2	2	0	2	2
Ten years service	2mth.	2mth.	4mth.	0	4	2	2	4	0	2	4	0	2	4
Twenty years service	3mth.	5mth.	7mth.	0	7	3	5	7	0	5	7	0	5	7
Maximum	5mth.	6mth.	10mth	0	10	5	6	10	0	6	10	0	6	10
Total Severance														
Less than one year service				0	0	1	2	2	1	1	1	0	0	0
Three years service				0	2	4	8	10	4	4	6	0	0	2
Five years service				0	2	5	12	12	4	7	6	0	2	2
Ten years service				0	4	6	12	18	4	7	8	0	2	4
Twenty years service				0	7	7	15	21	4	10	11	0	5	7
Maximum				0	10	9	16	24	4	11	14	0	6	10

* Selected years of service only shown. Compensation changes for each year of service up to 5-6 years (severance) and up to 24 years for long service.
* ** For mass dismissals (10 workers or more) because of bankruptcy, employees who are laid off are only paid one times the severance pay rate.
Source: Based on material taken from Ministry of Manpower, Indonesian Labor Laws and Regulations, 1950-2001.

ANNEX TABLE 4.2: SIMULATION OF SEVERANCE PAYMENTS AS A PERCENTAGE OF WAGE COSTS, FOR DIFFERENT TURNOVER RATES AND YEARS OF SERVICE, INDONESIA 1986,1996 AND 2000

	Turnover rate (% per annum)		
	5%	*10%*	*20%*
Voluntary quits: 2000			
Av. Years of service of 3 yrs.	0.8	1.7	3.3
Av. Years of service of 5 yrs.	0.8	1.7	3.3
Av. Years of service of 10 yrs.	1.7	3.3	6.7
Dismissals			
Av. Years of service of 3 yrs.			
2000	4.2	8.3	16.7
1996	3.3	6.7	13.3
1986	1.7	3.3	6.7
Av. Years of service of 5 yrs.			
2000	5.0	10.0	20.0
1996	5.0	10.0	20.0
1986	2.1	4.2	8.3
Av. years of service of 10 yrs.			
2000	7.5	15.0	30.0
1996	5.0	10.0	20.0
1986	2.5	5.0	10.0

Annex 5.1

MINIMUM WAGE SETTING IN WEST JAVA AND JAKARTA[11]

A. WEST JAVA

1. Setting Minimum Wages in 2002

In 2002, the minimum wage for the province of West Java was set for the province after all proposals had been submitted from each Kabupaten. However, the minimum wage for each district was set by the Bupati rather than by the Governor, as is required by national legislation. The Provincial minimum (Rp. 281,000) as the floor to MW in the province. All kabupaten MW were subsequently set at or above this level by each Kabupaten and Kotamadya by their Wage Councils or Tripartite Bodies, although some had not made a decision until well into December 2001, to take effect on January 1 2002. The range was between Rp. 281,000 and Rp. 591,000 across districts in the province, with a median minimum wage of Rp.480,000

The negotiations on increases for 2002 were genuinely bipartite with the employer's association, APINDO, involved in intense negotiations with union representatives, principally the SPSI and the Textiles, Clothing and Footwear Union, on cost of living issues and wage increases.

<u>The Minimum Physical Needs (KHM)</u>: The increases in the MW were based on estimated price levels of the 43 items which make up the KHM index in five markets in each district/city, surveyed together by tripartite members in areas where wage workers tended to be concentrated.

However, in practice, the level of the MW finally agreed upon seems to have been only loosely related to the level or estimated increase in the KHM (**see Table A1**). Thus, to give two extreme examples, the KHM increases in 2001 over 2000 were estimated to be largest in Subang and Indramayu Kabupaten, where provincial KHM were estimated close to or above Rp. 600,000, an increase of close to 50% on the previous year. Yet the minimum wage in both regions were both set at below Rp. 400,000, below the provincial average of near Rp. 450,000, and increased by 30 and 20% respectively compared with the previous year.

Large variations in the estimated KHM level and increases appear to have relatively little to do with actual price levels and movements. The estimated increases in the KHM ranged from an improbable 6 to 52% across various *kabupaten* in the province in September/October 2001 compared with the previous year. It was reported that the main factor contributing to high or

[11] Based on a field trip by an inter-departmental team led by staff of the Coordinating Minister for Economic Affairs, to Bandung 10-12/09/02 and to Jakarta 14/09/02. The team met with government officials at the Provincial level, union and private sector representatives, including members of the Wage Councils, and officials of the Bandung Kabupaten and Municipal governments.

low increases in the estimated KHM was the treatment of housing (rental) costs, transport costs, costs of schooling and recreational costs.[12]

Other Factors: There was no systematic attempt to incorporate the five other criteria for minimum wage increases recommended by the Ministry of Manpower: the cost of living index, regional product per capita, wage levels, employment conditions and specific industrial circumstances. Some districts consulted neighboring districts and some did not. Thus the final outcome was generally based on judgments made by the Head of the District taking into account past levels of minimum wages and MW relative to other districts. Political considerations played an important part in the outcome in several cases.[13]

2. The Outcome in 2002

The previous tradition of the provincial government setting the MW for groups of districts with common characteristics and borders, on the recommendation of districts, was discontinued with decentralization in 2001. Nevertheless, in practice, there were several clearly distinguishable groups of districts in West Java province:

- The Greater Jakarta region (Bogor, Bekasi cities and districts, and Depok district) with a range Rp. 575-579,000, similar to the National Capital, Jakarta, and Tangerang in the Banten Province with a minimum of 591,000
- The *Priangan* and neighboring regions: Purwakarta, Sumedang, Bandung City and District: Rp. 471-487,000
- The North Coast districts of Cirebon City and Kabupaten, Subang and Indramayu: Rp. 315-350,000
- The Upland districts Ciamis, Tasikmalaya, Cianjur and Sukabumi: Rp. 281,000-310,000

In general, The MW was set higher in the more industrial regions and relatively low in more agricultural-based regions where estate workers and small-scale industry were more common (see below). [14] However, the gap between the high wage and low wage groups widened in 2002. Districts and cities in the Greater Jakarta region matched the Jakarta increase in nominal wages of 38%. In the Greater Bandung region the increase was just over 20% and in many (although not all) of the agricultural regions it ranged between 10-20%.

In practice, the National Capital acted as a wage leader for West Java districts, mainly for those close to the capital. In Bandung district and city, the minimum wage (Rp. 471,000) were 'de-linked' from the Jakarta level, which both regions had followed in earlier years. West Java representatives were in the process of negotiating with the Jakarta officials on minimum wage increases for 2003, and were particularly concerned that large increases in

[12] There are only vague guidelines in the Ministry of Manpower instructions on how transport and schooling costs in particular should be calculated. According to the Ministry of Manpower Guidelines (1998/99), transport costs are estimated based on the rental of urban public transport for an (average) return fare for 365 days a year, whereas schooling expenses are based on the needs of 'training, courses, newspapers or other reading materials' during a year. In the latter case, an annual subscription to a magazine is recommended as one criterion for setting the minimum wage. The guidelines suggest that recreation should be based on the average cost of a movie ticket purchased once a month.

[13] For example, the parliament of Bandung City/Municipality made recommendations for increases over and above that agreed initially with Bandung City, based on lobbying by some groups of labor activists. This upset parity with Bandung District, and the outcome was finally a compromise Rp. 471,000 in both areas.

[14] Some Districts set different wages for certain sectors (manufacturing/non-manufacturing; or by detailed industry groups). The range across sectors was between 10-30%.

Jakarta would place pressure on the West Java districts that had lagged behind Jakarta to give large increases in the MW in 2003. West Java officials are also discussing the next round of MW increases with Central Java districts, especially for districts close to the Central Java border.

3. **Implementation and Consequences**

The government and labor groups reported that wage increases did not have a significant impact on employment. In contrast, APINDO representative pointed out that higher minimum wages were one factor contributing to substantial job losses especially in the textile industry during 2002. They also noted that some unions had lost large numbers of members as a result of layoffs. To counter employer claims of job losses related to wage increases, a common argument from the Manpower Office was that wages were only one factor (indeed a minor factor) contributing to business difficulties. High business costs due to corruption and fuel price increases, and smuggling of second-hand clothes in the case of textiles, were other factors mentioned.

Productivity. One argument for higher wages has been the positive effect they would have on productivity, since workers would be more content and healthy. Employers in West Java reported that there was no clear productivity effect, partly because the increase in wages was introduced by the government rather than through collective bargaining. Productivity improvements do not feature at all in the justification for minimum wage increases or as a pre-condition for workers receiving higher MW. Indeed, some employers argued that the effect on productivity might well have been negative because workers at the plant level felt increases were guaranteed regardless of productivity (partly because higher MW meant higher severance pay, and there were reports of workers shifting places of employment because of the combination of higher MW and the new severance pay rules under KEPMEN 150).

It was also generally reported that compliance with the MW was widespread in large-scale enterprises, but less so in the small and medium sector. Few firms applied for exemptions that permitted by the regulation on minimum wages, although some large garments enterprises such as Great River in the Bekasi region were granted exemptions. In at least two industries, in the traditional textile center of Majalaya south of Bandung and the tile making in Majalengka, employers refused to implement the minimum wage, however, and were permitted to come to special arrangements with their workers.

4. Minimum Wages for 2003

All parties believed that a similar process would be followed for 2003 as in 2002 and there was no sense in any of the meetings that the government was urging wage restraint. Employers felt that employment considerations were to be introduced into discussions for upcoming MW increases but the government had offered no guidelines as to how this might be done. There was a greater sense that employment growth was a greater challenge in the industrial sector, nevertheless, in West Java than in Jakarta.

Nevertheless, government representatives had initiated discussions with the Jakarta government on minimum wage increases for 2003, requesting the Jakarta government to exercise some constraint in order not to put undue pressure on wages in the Bandung region.

Union representatives in Bandung City pointed out that they were unhappy with the gap that had emerged between wages in the city and those in the capital in Jakarta. They felt that their members would not accept a continuation of this situation without industrial action, and rejected the argument that more labor-intensive industries might suffer have more in Bandung than many of the more capital-intensive enterprises in the Jakarta region.

B. JAKARTA[15]

1. Setting the Minimum Wage in 2002

Unlike in West Java, employer representatives and unions conducted separate rather than joint surveys of the KHM in local markets and came to very different conclusions: the unions estimate was Rp. 664,000 versus the employer estimate of Rp. 490,000. Given this gap, the Jakarta government decided that regional per capita income (Rp. 591,000) should be a standard for minimum wages in 2002. Surprisingly, even the Head of Bappeda, the economic planning office, was unperturbed by the high wage increase in 2002 in Jakarta. He suggested that increasing minimum wages was one way to reduce government spending on welfare, that workers in modern industry deserved fair wages and that a different standard needed to be applied to the capital city. Unions were strongly in support of the high increases.

Unions argued that the KHM no longer reflected the needs of workers in the capital city. There was a sense in the meeting that the union movement was better organized and had more political influence in Jakarta than in West Java, and the government was more responsive to its demands. At the same time, large inequalities between the middle class and working class families in Jakarta was a strong argument made in favor of a much higher minimum wage. The Jakarta government and unions also argued that wages were still a very small share of total labor costs and hence increases in the MW were unlikely to hurt firms significantly. The arguments were not vigorously rebutted by the employers groups who complained of high wages but did not provide solid evidence of backwash effects, although some made reference to greater use of sub-contracting work to smaller firms, where compliance was low, to avoid payment of minimum wages.

2. Implementation and Compliance in 2002

Compliance was reported as an issue in small and medium firms and also in some service activities (often acting as a sub-contractor to government) such as the cleaning service, but not in most large firms. Only a small number of firms (27) applied for exemptions in 2002, which the government saw as evidence that the wages were not too high (it did not acknowledge that firms felt applications for exemptions were time-consuming and costly, especially since they often involved large 'informal' charges made by officers of the Manpower Ministry).

[15] See also Box 5.2.

3. Minimum Wages for 2003

The Jakarta government passed a regulation in 2002 increasing the number of items in the KHM list from 43 to 55, suggesting that the standard needed to be raised to ensure a fitting minimum standard of living in the city.[16] Thus, it was unilaterally revising the guidelines set by the Ministry of Manpower on the calculation of the KHM, although the new measure was in line with the Ministry's higher recommended standard, the *Kehidupan Layak*, or 'Appropriate Standard of Living'.

More generally, the Jakarta government and unions were not sympathetic to the argument that the capital city should take note of the effect of high wages and large wage increases in the capital on workers in other regions. Indeed, the head of the Regional Planning Agency, Bappeda, argued that movement of some labor-intensive industries out of Jakarta was a desirable outcome, as the capital city was really more appropriate as a center of services and high-tech industry.[17]

[16] New items included purchase of water, detergent, purchase of a watch, sanitary pads, a color television, a fan, deodorant and telephone charges.
[17] In the wake of the Bali bombings and its potential negative effect on investment, the Jakarta Wage Council subsequently agreed, unexpectedly, upon an increase of only seven per cent in 2003 in November 2002.

TABLE A1: MINIMUM WAGES AND KHM BY DISTRICT IN WEST JAVA, 2001 AND 2002

	City/ District	KHM 2001	KHM 2002	Minimum Wage 2001	Minimum Wage 2002	% Increase KHM	% Increase MW	MW/KHM (%) 2001	MW/KHM (%) 2002
		Rp. 000							
Region									
Bekasi	City	507	605	417	576	19	38	82	95
Bekasi	District	562	653	417	576	16	38	74	88
Bogor	City	487	623	417	576	28	38	86	92
Bogor	District	469	631	417	576	35	38	89	91
Depok	District	589	662	417	576	12	38	71	87
Average		*523*	*635*	*417*	*576*	*21*	*38*	*80*	*91*
Bandung	City	495	530	390	471	7	21	79	89
Bandung	District	438	490	389	471	12	21	89	96
Purawakarta	District	461	514	380	485	11	28	82	94
Sumedang	District	410	535	372	470	30	26	91	88
Average		*451*	*517*	*383*	*474*	*15*	*24*	*85*	*92*
Ciamis	District	308	406	245	284	32	16	80	70
Tasikmalaya	District	342	401	245	290	17	18	72	72
Sukabumi	City	452	533	276	311	18	13	61	58
Sukabumi	District	358	386	276	281	8	2	77	73
Cianjur	District	358	496	280	300	39	7	78	60
Average		*364*	*444*	*264*	*293*	*22*	*11*	*73*	*66*
Subang	District	381	579	270	350	52	30	71	60
Indramayu	Distict	436	641	276	331	47	20	63	52
Cirebon	City	350	477	Na	Na	36			
Cirebon	District	352	473	Na	Na	34			
Majalengka	District	354	389	250	285	10	14	71	73
Kuningan	District	299	363	259	281	21	8	87	77
Average		*368*	*493*	*264*	*312*	*34*	*18*	*72*	*63*
Provincial Average (unweighted)		**411**	**512**	**333**	**416**	**22**	**25**	**78**	**79**

Notes: Bogor Kabupaten: MW apply only for manufacturing; the non-manufacturing minimum wage was Rp. 470,000. In Sukabumi district, higher wages apply for manufacturing industries (Rp.300-315,000)

Source: Unpublished data, Provincial Manpower Office, West Java.

<ins>**Annex 5.2**</ins>

IMPACT OF MINIMUM WAGES ON EMPLOYMENT: THEORETICAL RELATIONSHIPS

Figures 4 (A) to (B) illustrate the meaning of a binding minimum rate and its impact on employment in the formal sector. Figure A (over the page) depicts a stylized version of labor market outcomes in 1992 and 1997, i.e., in the pre-crisis situation. The labor demand curve (Ld) in the modern sector is downward-sloping, while the aggregate supply curve (Ls) is upward-sloping. In 1992 the market-clearing wage rate (W'92) is where demand (Ld'92) and supply curves (Ls) intersect and employment in the modern sector is at E'92. To simplify, the discussion assumes that all workers are paid at the market-clearing wage (average wage).

Economic growth over the period 1992 to 1997 shifts labor demand from Ld'92 to Ld'97. Consequently, market-clearing real wages increase from W'92 to W'97 and employment in the modern sector increases from E'92 to E'97. The way figure A is drawn, minimum wages do not have a negative impact on employment. For example, even though real minimum wages increased from MW'92 to MW'97, they did not affect the market wage and hence they did not have an impact on employment of wageworkers. This is because real minimum wages are set well below the point in which the market clears (i.e., minimum wages are not binding).

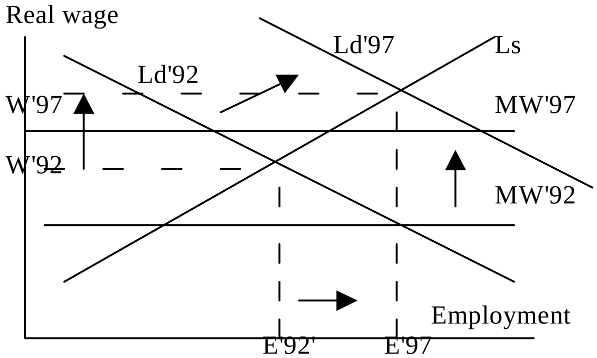
During the crisis, demand for labor falls and the demand curve shifts to the left - i.e., from Ld'97 to Ld'01. Consequently, both real wages and employment in the modern sector fall. If there were no minimum wages, real wages would have fallen from W'97 to W' and employment from E'97 to E'. However, the government increased real minimum wages to MW'01. The minimum wage is now set above the market-clearing rate of W' - i.e., it is binding. This has two effects. First, where compliance is strong, the minimum wage artificially (i.e., irrespective of productivity growth) increases the market wage from W' to MW'01. Second, the higher real wages reduces employment from E' to E'01. Overall, as a result of the recession and the increase in minimum wages, employment falls from E'97 to E'01. The fall from E'97 to E" is due to the economic recession, while the fall from E" to E'01 is due to the increase in minimum wages.

The percentage reduction in employment due to an increase in minimum wage is known as the employment elasticity with respect to minimum wages. As noted, the SMERU study estimated this employment elasticity for groups of workers and found that for every 10% increase in real minimum wages, aggregate employment falls 1.1%, employment of female workers falls by 3%, youth workers by 3% and less educated workers by 2%.

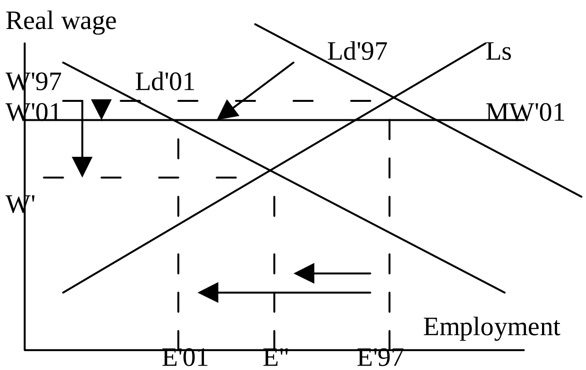
But the effect of the minimum wage on employment in the modern sector is only part of the story. Figure 4(C) depicts what happens in the informal sector when minimum wages become too high in the formal sector. Those workers who lose their jobs in the modern sector as a result of the minimum wage (E'-E'01) are forced into the informal sector. Consequently, the supply of labor to the informal sector (which is typically more elastic than in the formal sector) increases from Ls'97 to Ls'01. Assuming demand remains constant, real earnings of workers in the informal sector decline from W'97 to W'01.

ANNEX 5.2 FIGURE 1: A STYLISED PORTRAYAL OF THE IMPACT OF MINIMUM WAGES ON WAGES AND EMPLOYMENT, FORMAL AND INFORMAL SECTORS, PRE- AND POST-CRISIS

(A) Pre-crisis real wages and formal sector employment



(B) Post-crisis real wages and formal sector employment



(C) Post-crisis real earnings in the informal sector