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Creating Better and More Jobs in Indonesia: A Blueprint for Policy Action

Guntur Sugiyarto

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ERD POLICY BRIEF NO. 43

Creating Better and More Jobs in Indonesia: A Blueprint for Policy Action

Guntur Sugiyarto

December 2005

Guntur Sugiyarto is an economist in the Development Indicators and Policy Research Division of the Economics and Research Department (ERD), Asian Development Bank. This brief is the outcome of a labor market study conducted by ERD, and has benefited substantially from comments and suggestions from Ifzal Ali, Rana Hasan, and Yun Hwan Kim. Peter McCawley, Chris Manning, Hal Hill, and Sudarno Sumarto also provided insightful and helpful suggestions. The discussions in the Workshop on Improving the Labor Market in Indonesia held 15 November 2005 in Jakarta also shaped the brief. The views expressed herein are those of the author and do not necessarily reflect the views and policies of the Asian Development Bank, its Board of Directors, or the governments its members represent. All errors and deficiencies remain the author's.

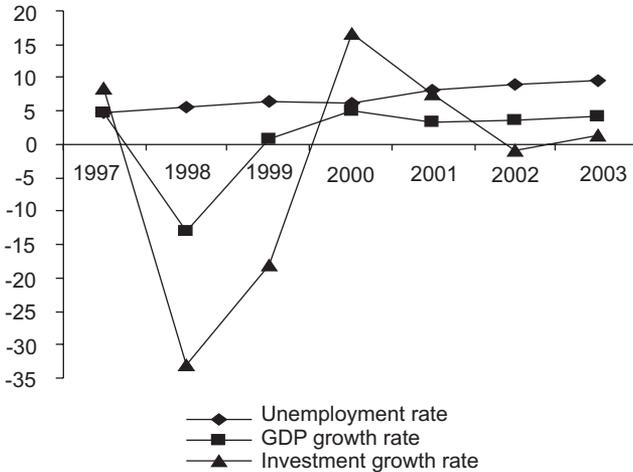
Key Challenges

There has been a dramatic deterioration in the Indonesian labor market performance since the Asian financial crisis mainly due to the decline in investment and a much more regulated labor market. This has resulted in real wages outstripping productivity growth, increasing “informalization”, increasing wage inequality, and disappointing export performance for labor-intensive manufactures. In this context, the Government of Indonesia has been under pressure to reduce open unemployment from 10 to 5% over 2004–2009. In a country of more than 220 million people, the high and increasing unemployment is aggravated by widespread underemployment accounting for more than 35% of the total labor force or 35 million workers. Currently, about 37 million Indonesians live in poverty, which is likely to increase as more workers are laid off due to business closures. This problem is a reflection of underdevelopment and policy decisions taken in recent years. Taking into account new entrants, unemployed, and underemployed, the main challenge is to create 50 million productive and decent jobs in the next 5 years, 15 million of which will be for new entrants alone; or 10 million good jobs per year, one third of which is for new entrants.

Apart from creating more productive jobs, the economy needs to simultaneously attain higher and more sustained growth. Current growth is mostly consumption-driven and is not enough to significantly increase per capita income and reduce poverty. The government has set a target of raising GDP growth from 5 to 8% and cutting poverty incidence from 17 to 8%.

The employment challenge is daunting given that current growth has not sufficiently expanded employment opportunities. While investment has been low, it has also become more capital-intensive, i.e., more investment is needed to create jobs, especially after the crisis (Figure 1). In addition, nonlabor-market aspects have further contributed to worsening labor market and other outcomes. International comparisons indicate that key governance indicators are weak, and starting up and closing a business take longer and are costlier in Indonesia—which also has one of the poorest rankings in

Figure 1
Growth in Investment, GDP, and Unemployment Rates (%)



Source: ADB (2005a).

terms of red tape. Indonesia is lagging in terms of access to infrastructure such as electricity and telephones, and financing costs and access have become more problematic. Improving the investment climate and increasing investment are therefore critical to improving labor market outcomes.

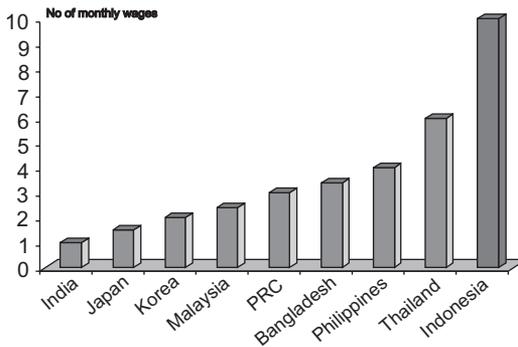
Main Findings

The Economics and Research Department of the Asian Development Bank (ADB) has been conducting research on labor markets in Asia, including Indonesia, to better understand the challenge of strengthening the inclusiveness of the growth process (ADB 2005b). The labor market plays a crucial role in an economy. A well-functioning labor market will achieve two primary objectives: efficiency and fairness in allocating resources, incomes, and risks. Labor markets are also one of the main channels through which globalization affects developing countries (Rama 2003).

This brief examines the key impediments and main challenges of the Indonesian labor market since 1990, which has been characterized by a wave of policy changes ranging from a repressive to populist approach against the backdrop of an economy experiencing boom, crisis, democratization, and decentralization (for the full study

on which this brief is based, see Sugiyarto et al. 2005). Unfortunately, the dramatic changes after the Asian crisis have made the labor market more restrictive or rigid. Regulations on unions, minimum wages, and severance pay are of particular concern. The number of unions has mushroomed from 1 to 87; minimum wage increase has been higher than both inflation and workers' productivity; and severance pay has become one of the most expensive in the Asian and Pacific region (Figure 2).

Figure 2
Severance Pay in Monthly Wages for an Employee
with 4 Years Service Dismissed for Economic Reasons



Source: Alisjahbana and Manning (2005).

Three important labor problems are highlighted (see Box 1). First, there is persistent unemployment with unfavorable characteristics. Unemployment is most prevalent among women, youth, and educated. Second, there is widespread underemployment and informalization, which further indicate the need for good jobs in the modern sector in urban areas, and in the agriculture sector in rural areas. The increasing trend of workers going back to agriculture and the informal sector after the crisis is in contrast with the situation in the precrisis era. Third, low productivity can be traced to the overall low quality of the labor force combined with overall poor working conditions. Women, youth, poorly educated, rural, and agriculture and construction workers are among the worst-off from the current developments in the labor market in Indonesia.

Business associations and think tanks have highlighted the need to improve labor skills and productivity as well as to rationalize government policies on minimum wage, severance pay, hiring, firing,

**Box 1. Three Main Labor Problems
in Indonesia**

Unemployment
Underemployment and informalization
Low productivity

and outsourcing. Labor unions have argued that low worker productivity should also be attributed to outdated and low technology, which has not been upgraded due to lack of investments after the crisis. The unions also pointed out that high severance pay is needed due to lack of appropriate social safety nets for workers. Perspectives from international scholars further confirmed the rigidity of the Indonesian labor market, and that the economy is experiencing, not a recovery, but a transition to a new economy that is different from that of the precrisis era. Many aspects of economic institutions and other business environments have undergone dramatic changes, hence it is important to have clear policies with detailed implementation schedules.

Policy Implications

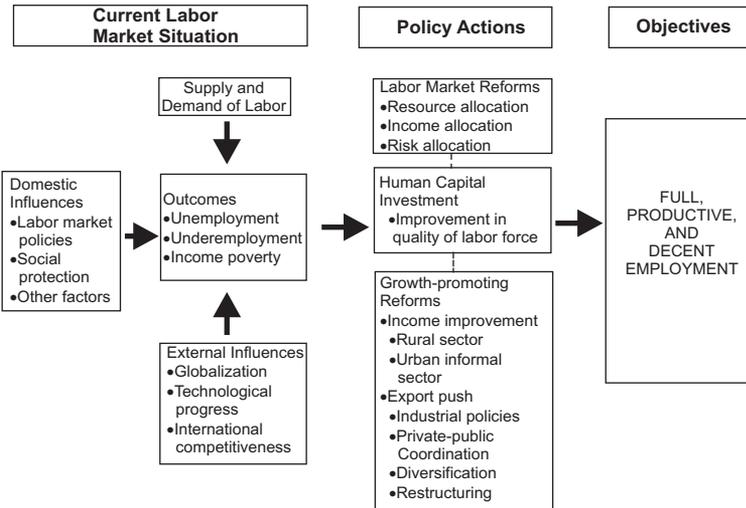
Given the complexities of the problems and regulations, the strategy of relying on economic growth and trickle-down effects is inappropriate. This was made even clearer by growth posted in 2000–2004, which has not led to employment expansion but instead has led to increasing unemployment and a burgeoning informal sector. It is very important to carefully examine each issue to distill policy lessons. Promoting labor-intensive industries to increase job creation is important, including improving the agriculture and services sectors, which absorb more than 80% of the work force. More active labor policies are needed, including finding the right balance between productive and protective employment policies, as well as developing more flexible labor market conditions. In this context, the government's proposal to amend the law on unions is welcome.

The government has identified major causes of labor market rigidity and acknowledged that the current situation is far from meeting the government's goals of (i) a decentralized system of labor markets with strengthened union movement and collective bargaining, and (ii) replacement of government regulations with legislated safeguards.

Conclusion

The government must give maximum priority to promoting full, productive, and decent employment. The suggested blueprint consists of three blocks (Box 2). The first block focuses on implementing appropriate labor market policies to improve the functioning of labor markets and to remove antilabor bias. The second block highlights growth-promoting policies to improve income and productivity of both the formal and informal sectors. Efficient growth is needed for creating more productive employment opportunities. The third block addresses human capital development policies to improve labor quality and skills to match the demands of the industrial sector and to enable the bypassed and the marginalized to benefit from newly created employment opportunities. To provide decent employment, the government should also ensure that workers' basic rights are met, and appropriate social protection provided to them. Social protection is also necessary to create the constituency for reforms needed for structural adjustment. A virtuous cycle triggered by labor market reforms, human capital development, and growth promotion will need to be exploited to move toward full, productive, and decent employment in Indonesia.

Box 2
Blueprint for Full, Productive, and Decent Employment



Source: *Key Indicators 2005* (ADB 2005b).

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