

# Legislating for Labour Protection: Betting on the Weak or the Strong?

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**December 2004**

Working Paper No. 2004/08

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## Abstract

This paper approaches the subject of labour standards from the standpoint of domestic labour market circumstances rather than international norms. The paper assesses government approaches to improving standards in the context of Indonesia's daunting 'employment challenge', and the capacity of institutions to implement reform since the fall of Soeharto. The discussion of recent reforms is divided into two parts: the affirmation of basic rights and freedoms, and legislation for the protection 'Survival' and 'Security' Rights. We find that while the protection of labour freedoms is long overdue, there is mounting evidence that regulation of setting labour standards in the modern sector benefits the few with 'better' jobs. It penalises many less fortunate Indonesians in the informal sector and agriculture, and also younger, new job seekers. Owing to a significant improvement in Basic and Civil Rights, the compliance regime in relation to labour standards has altered dramatically in recent years. This has closed the gap between rhetoric and reality: between formal ratification and the actual impact of labour regulations on labour costs, while giving no obvious boost to productivity. It is of concern especially in those internationally labour-intensive industries such as textiles footwear and clothing TCF, where Indonesia has had a comparative advantage in the past.

Key Words: Labour Standards, Labour Rights, Employment, Indonesia

JEL Classification: J23, J38, J80, J88

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# LEGISLATING FOR LABOUR PROTECTION: BETTING ON THE WEAK OR THE STRONG?<sup>1</sup>

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## I. INTRODUCTION

With the spread of with globalisation, there has been considerable attention on labour standards in poor countries. Inadequate standards have been highlighted in the context of charges of ‘unfair’ trade advantages gained by some Third World countries, in part through the ‘exploitation’ of hapless workers by multinationals.<sup>2</sup> Whether in pursuit of a protectionist or humanitarian cause, threats of trade and consumer boycotts are frequently linked to the failure of companies or countries to meet minimum absolute standards, the benchmark for which is often set in more developed countries.<sup>3</sup>

In this chapter we approach the subject of labour standards in a quite poor developing country, Indonesia, from a different perspective. Labour standards are assessed primarily from the standpoint of domestic labour market circumstances rather than international norms. We examine several aspects of labour standards from a broad perspective of basic, civil, survival and security rights. Minimum wages, the rate and principles regulating severance pay, and clauses legislation in dealing with contract labour were the main policy issues in the Indonesian context in 2003-2004. We assess government approaches to improving these standards in the context of Indonesia’s daunting ‘employment challenge’: providing more productive and better paying jobs for over half the work force in low paid, informal and marginal jobs, as well as for new job seekers.

Under Soeharto, Indonesia was in the international spotlight for abuse of rights and standards. At the same time, it was a country where the take-off in export-oriented manufacturing had a significant impact on employment and wages in the modern sector (Manning, 1998). Since the fall of Soeharto, enormous changes have occurred in the regulatory environment, with regard to both rights and standards. Three major acts were

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<sup>1</sup> The author is Head of the Indonesia Project, Division of Economics, Research School of Pacific Studies, the Australian National University. Ideas for this paper were first discussed at the Indonesian Study Group at the Australian National University in August 2003 and an earlier draft of the paper presented at the Asian Studies Association of Australia Annual Conference in Canberra in July 2004. The author wishes to thank participants at both seminars for comments and particularly Dr. Kelly Bird who has contributed to several of the ideas discussed. The usual disclaimers apply with regard to responsibility for material contained in the paper.

<sup>2</sup> For two alternative views on subject by well known economists, see for example Rodrik (1996), in favour of greater international efforts to regulate standards, and Bhagwati (2004) strongly against such actions, especially if they are linked to trade access. For general treatments see Moran (2002) and Elliot and Freeman (2003).

<sup>3</sup> By far the greatest attention in both professional literature and advocacy has been focused on the employment of child labour as both morally repugnant and a key element of the unfair advantage held by Third World countries, even though the issue is of minor significance in terms of employment or abuse of rights in many countries.

passed by parliament in 2000-2004, and Indonesia has ratified all core ILO conventions. At the same time, labour market circumstances have worsened. Economic growth has slowed and export industries struggled in a less favourable domestic and international environment for business (Van der Eng and Basri, 2004).

It is useful to think of these reforms as occurring in two stages in the post Soeharto period: reforms that deal mostly with labour freedoms and rights, and those that cover material standards and welfare. We look at the interaction of each of these developments with employment and wages. It is argued that protection of labour freedoms is long overdue. However, while legislation setting labour standards rigidly in the modern sector benefits the few with better jobs, it has the potential to penalise many less fortunate Indonesians.

Section 2 of the paper asks how we might usefully define of labour standards for analytical purposes. It examines issues of implementation capacity and institutions, and the nature of the relationship between economic structure and growth, on the one hand, and labour standards on the other. We then look briefly at the economic and labour market context in which labour reforms have been pursued in the post-Soeharto era. In sections IV and V, the main part of the paper, the discussion of recent reforms is divided into two parts: the affirmation of basic rights and freedoms, and legislation for the protection ‘Survival’ and ‘Security’ Rights in Indonesia since the fall of Soeharto.

## II. LABOUR STANDARDS AND EMPLOYMENT: GENERAL CONSIDERATIONS

The delineation of the boundaries between labour standards and basic rights, as well as the relationship of both to employment, earnings and labour welfare is both complicated and difficult to test empirically. The discussion first draws attention to several of these issues. In addition, we set the stage for a discussion of the Indonesian case by looking briefly at the range of instruments and institutions that are important for setting standards, and how they might relate to economic structure and growth.

### **Defining Labour Standards and Rights**

First, how might we usefully define labour standards and distinguish them from basic rights? Among the various classifications, we have adapted the typology developed by Singh (2003: 111).<sup>4</sup> Drawing on the work of several other authors, Singh suggests four broad groups all of which he terms as ‘rights’: Basic Rights, Civic Rights, Survival Rights and Security Rights (Table 1). The first group consists of basic standards or fundamental rights. Most observers agree that all should be incorporated in labour laws, even if precise definition and implementation is problematic: freedom from forced labour and coercion, abolition of child labour and non-discrimination in hiring, firing and remuneration. The second, civic rights, related to rights of collective bargaining and

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<sup>4</sup> An alternative grouping is “core” and “cash” standards (Elliot and Freeman, 2003: 11).

action, and expression of grievances, are also regarded by many as fundamental to modern labour codes.

These two groups together constitute, with minor differences, what ILO refers to as core labour rights, that should be enshrined in national laws and open to monitoring by national and international bodies (ILO, 2000). Importantly for our later discussion of Indonesia, affirmation of these two sets of rights has little **direct** relationship to labour costs.

The third and fourth group, Security and Survival Rights, “relate to conditions of work that affect workers well being, but do not necessarily directly affect freedom of choice” (Singh, 2003: 110).<sup>5</sup> Survival Rights are most problematic in that they are not always covered in labour codes and may vary significantly according to levels of development. The fourth group termed Security Rights are typically covered in national legislation, dealing with rights against arbitrary dismissal, retirement and separation payments (severance pay) and survivors’ compensation.<sup>6</sup> The most obvious example is the level of wages or compensation, which increases with economic progress (World Bank, 1995).<sup>7</sup>

### **Implementation and Institutions**

A second issue relates to the mechanisms for setting standards either in place of or in addition to government legislation, and what institutions tend to facilitate or, alternatively, to hinder the setting of socially acceptable standards? Aside from regulation of basic standards, some countries such as the USA set many labour standards through collective bargaining at the establishment level, rather than through legislation. This results in much greater variation in labour standards across firms and industries, in accordance with the economic and labour market conditions. In contrast, many European countries (and especially in Scandinavia) have legislated many of the basic standards mentioned above, or allow them to be set through centralised collective bargaining processes.<sup>8</sup> The latter centralised bargaining and arbitration system has historically been a key feature of setting labour standards in Australia and New Zealand.

Legislation by national governments has been by far the dominant mode for regulation of labour standards in Third World countries, including East Asia (Nayyar, 1995; Lee,

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<sup>5</sup> In some discussions the distinction is often made between process and outcomes, where process relates to basic freedoms or rights and outcomes to standards which correspond to a given level or pattern of development.

<sup>6</sup> We have added severance pay to the list of standards compiled by Singh, as comprising Survival Rights.

<sup>7</sup> Although to this author’s knowledge there has not been systematic research on the subject, there also appears to be a clear (positive) relationship between the level and form of several other labour standards (hours of work, amounts of accident compensation and health and safety conditions, and a country’s stage of economic development).

<sup>8</sup> See especially Engerman (2003) and Moene and Wallerstein (2003) on the origins of present labour standards legislation in the USA and Scandinavia, respectively. Historically, those standards regulated by government have tended to be the responsibility of the central authorities. The USA is again an exception, where the setting of basic labour standards has been under the jurisdiction of state governments. More recently, regional governments in some developing countries such as the Philippines, have begun to assume responsibility for minimum wage regulation.

1996). Other channels for regulation of labour standards have emerged in recent years, although their application is still limited to small groups of consumers and multinational corporations. These include certification of sub-contracting arrangements by large multinationals such as Nike and compliance labelling by first world consumer groups who seek to restrict the imports of goods produced in low wage and 'exploitative' settings (Golub, 1997; Moran, 2002). The ILO has played a more active role in disseminating information and advising on policy in recent times.<sup>9</sup> But international efforts to enforce of labour standards have had limited success, and country proposals that have sought to utilise the World Trade Organisation to impose better labour standards have fared little better.<sup>10</sup>

Political and legal institutions play an important role in supporting the implementation of standards. Countries with democratic traditions or newly established democratic systems of government have tended to give greater reign to trade unions. In the Asia-Pacific region, the Philippines, South Korea and Taiwan are outstanding examples, all of which have experienced greater labour freedoms after democratic reforms in the 1980s. Legal institutions also play an important role in dispute settlement (even if excessive litigation in countries like the Philippines can hamper resolution of labour disputes).

At the same time, implementation of the national labour code is a problem in several Asian countries (Hutchison and Brown, 2001). Autocratic governments and security organisations that override the rule of law, either through direct intervention or indirect mechanisms, have been able to neutralise labour protests and trade union action. In addition, an underpaid bureaucracy is likely to support extensive regulation often to the detriment of both employers and workers: local officials accept bribes in return for turning a blind eye to labour law transgressions, thus raising the cost to business and penalising employment.

### **The Importance of Economic Structure and Growth**

Before turning to the Indonesian case, we look briefly at some general dimensions of the interaction between economic structure and growth, and labour standards. This is of some relevance to Indonesia, bearing in mind that the country experienced rapid economic growth and structural change in three decades before the Asian economic crisis, but has suffered a major turnabout in fortunes since.

Three points are relevant. First, with regard to economic structure, less open trade and investment regimes (often associated with both more dualistic economic structure), have tended to be associated with greater protection of modern sector workers through labour legislation. It is no accident that the most protective labour codes have been in countries where the modern sector has been insulated from international competition, such as in

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<sup>9</sup> See Elliot and Freeman (2003: Chapter 5).

<sup>10</sup> Moran (2002: 103) notes that the ILO has only been successful in recommending a cut in international links with one country, Myanmar (over the issue of forced labour). Elliot and Freeman (2003: 116-119) discuss the role of the ILO in helping implement the US-Cambodian Textile and Apparel Agreement, although they do not assess the potential effects of a new minimum wage regime on employment.

much of Latin America, and also in India in Asia.<sup>11</sup> At the same time, the pressures to protect workers in modern sectors outside enclave industries are likely to be particularly intense in protected economies, and also resource rich yet labour abundant countries like Indonesia. In such economies, the gap in wages between the capital-intensive, enclave modern sectors, and the rest of the economy tends to be large. This leads to upward pressure on wages through regulation, or collective bargaining, in other less protected modern sectors, and especially in large export-oriented and labour-intensive, manufacturing plants (Berg, 1969; Manning, 1998). Under such circumstances, jobs are likely to be lost and employment growth slow.

Second, the rate of economic growth and employment expansion is also important for labour standards. Worker demands for protection are likely to be greater in relatively stagnant than in rapidly growing industries, regions and countries. Witness the calls for protection of standards in declining industries such as textiles, footwear and garments in developing countries, or the persistently high level of protection afforded to workers in the slow growing modern sector in India over many decades. Similarly, calls for labour protection from developed countries through international trade sanctions have been most strident in support of sunset industries such as garments, that are most threatened by imports from developing countries.

As Srinivasan (2003: 183) has rightly noted, “Many types of labour standards such as caste discrimination [in the case of India] in employment and wages tend to disappear in a tight labour market and with urbanization, both of which are associated with rapidly growing economies.” Similarly, he notes (page 184) that issues of child labour have received most attention in countries like India and Pakistan where slow employment growth in the modern sector has denied parents access to better and more stable jobs, and low levels of education have offered children little alternative to work. We shall see that slow growth, in particular, would seem to feature strongly in the call for greater protection of workers in Indonesia in the post-Soeharto period, notwithstanding the greater pressure for worker rights associated with more democratic processes.

Third, with regard to trade reform, liberalisation has been opposed, especially by protected workers fearful of losing their jobs. And complaints among both domestic and foreign NGOs and labour groups about labour exploitation have been strongest with regard to wages, working conditions and labour rights in newly emerging the export industries, where employment growth has tended to be most rapid. Some of these complaints are well justified where foreign direct investors have lobbied to undermine labour laws, especially in the case of rights to form trade unions and strike in export processing zones.<sup>12</sup> But the weight of evidence suggests that even in the labour-intensive garment and footwear industries, wages have tended to be at least as high (and to rise

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<sup>11</sup> See especially Cox-Edwards (1997).

<sup>12</sup> Moran (2002: 59-60) documents specific cases of such lobbying in the Philippines and the Dominican Republic

more quickly) in foreign firms and their sub-contracting agents than in many other industries, and especially compared with smaller scale firms.<sup>13</sup>

To sum up, a wide range of labour standards are regulated in national labour legislation in most developing countries. This has been the main mechanism for setting standards in environments where labour unions are weak, and where excess demand exists for jobs in the modern sector. The impact of labour standards on employment depends in part on the economic structure and the rate and pattern of economic growth. The need for, and advocacy of, extensive protection for workers is likely to be less pressing in rapidly than in slow growing economies. But we have suggested that trade and economic growth are not always “complementary” with labour standards.<sup>14</sup>

As noted in the introduction, there have two waves of labour legislation in Indonesia since the Soeharto era. First was affirmation of basic labour rights and freedoms culminating in a Trade Union Act (*Undang-Undang*) in 2000 and, second, efforts to improve labour standards culminating in the passing of the Manpower Protection Act of 2003.<sup>15</sup> We trace the main elements of reform in both labour rights and standards, and their relationship to employment and wages in sections IV and V of the paper, drawing attention to parallels and contrasts with labour standards and rights and their implementation before the downfall of President Soeharto in 1998. First, however, it is necessary to look at the labour market context which changed dramatically during the economic crisis year of 1998, and has remained much less favourable than in the Soeharto period.

### III. THE ECONOMIC AND LABOUR MARKET CONTEXT

Three features of the Indonesian labour market are important in helping interpret the implications of recent changes in labour legislation and their implementation in Indonesia. With a GDP per capita of around \$600-700 in 2002-2003, it is still a low income country (World Bank classification). The economy and the structure of employment display the features of an under-developed country. GDP per capita is well below that of middle income countries such as Thailand and Malaysia in Southeast Asia. Low productivity agriculture and services still played a major role in the economy, and are of even greater importance for employment (Table 2). A small proportion of both agricultural and non-agricultural workers are employed as wage employees, and hence

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<sup>13</sup> See especially Rama (2001: 14-18) on the effects of globalisation on employment, wages and equity. Moran (2002) has marshalled impressive evidence on wages and working conditions among FDI firms and their sub-contractors, drawing attention to the substantially improved working conditions and skill levels in EPZs that have begun to shift into higher-tech industries.

<sup>14</sup> This is notwithstanding Elliot and Freeman’s (2003: 139) more optimistic description of the relationship at the end of their informative book: “Globalization and labor standards are not mortal enemies but complementary ways – Siamese twins, in our analogy – to make modern economic growth work better for all.”

<sup>15</sup> The Basic Laws were No. 21, 200 and No. 13, 2003 respectively. A further Act governing dispute resolution was passed by the parliament in early 2004.



potentially affected by labour regulations, although many are not covered in practice.<sup>16</sup> While not a particularly useful indicator of short or longer term labour market imbalance, unemployment rates (around 10%) were quite high by Third World and regional standards.<sup>17</sup>

Second, as in other countries, wages and labour productivity are very much higher in the formal sector: in manufacturing, for example, average wages were several times higher in large and medium than in small enterprises, even before minimum standards legislation began to be implemented more intensively in recent years. Differences in value added per worker were of a similar magnitude (Table 3).<sup>18</sup> Moreover, of relevance to our later discussion of minimum wages policy, wages per worker rose faster in the modern sector, despite slow employment growth, after the economic crisis in 1998.

This large absolute difference in earnings is of direct significance to discussion of the impact of labour market regulation on the welfare of workers. More rapid expansion of the formal sector offers major opportunities for better jobs among informal sector workers, especially if the greater stability of jobs among the former is taken into account. From this standpoint, legislation that discourages inter-sectoral movements of labour penalises job seekers from small-scale and informal sectors.

Third, job creation in the modern sector emerged as a major problem in the post economic crisis era. GDP growth slowed significantly, and most observers highlight the slow-down in investment, both domestic and international, as Indonesia's key development problem (Hill, 2004). As a consequence, whereas the share of output and employment in non-agricultural sectors, and wage employment rose quite rapidly before the economic 'crisis' of 1998, both slowed once Indonesia had regained economic stability after 1999 (see Table 2). Even though unemployment did not rise much, wage employment outside agriculture declined by around 10% from 1996 through to 2003, after growing by some 50% and creating just under 60% of all new jobs created in the previous decade.<sup>19</sup>

A similar pattern was apparent in labour manufacturing. Before the crisis, wages and employment in the labour-intensive and export-oriented textile, clothing and footwear (TCF) industries (in which foreign investment played an important role), increased quite substantially and rose more quickly than in all industries (Table 4). In short, although average wages were lower in labour-intensive compared with more capital-intensive activities, widespread repression of labour rights (see below) was not synonymous with

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<sup>16</sup> Although labour laws apply to all wage workers, in practice workers in most small and cottage establishments (some 60% of the total in the case of manufacturing and a higher share in other sectors) are outside the ambit of regulations. See SMERU (2001) for a discussion of the coverage, in practice, of minimum wage legislation.

<sup>17</sup> Relatively high rates may be partly explained by a broader definition of unemployment in Indonesia. According to the official definition, a significant share of all unemployed workers (around 40% in 2002) consisted of 'discouraged' workers, who were not involved in job search activities.

<sup>18</sup> The table shows data for large and medium and small firms only, which accounted for around 60% of total manufacturing employment.

<sup>19</sup> Estimates based on data from the National Labour Force surveys, 1986-2003.

wage repression. However, after the crisis, employment in the TCF industries barely increased, and real wages fell and remained below pre-crisis levels in 2001. Thus the introduction of new labour legislation and institutions should be viewed in the context of a labour market under stress, and particularly a modern sector which has performed well below its potential in terms of creating new and better jobs for Indonesia's large and growing population.<sup>20</sup>

#### IV: LABOUR REFORMS STAGE I: AFFIRMATION OF BASIC LABOUR RIGHTS

The fall of President Soeharto in 1998 ushered in a new period for labour rights and standards in Indonesia. Under Soeharto's New Order, labour freedoms were tightly controlled, the above-mentioned increases in wages and employment notwithstanding (Hadiz, 1997; Manning, 1998).<sup>21</sup> The rights of organised labour were kept under control through one official trade union (SPSI) that was closely aligned to the ruling party. Collective bargaining was encouraged in legislation, and strikes permitted by law (outside 'essential industries), and the latter increased in periods of greater political openness and economic stress. However the right to air grievances and participate in dispute resolution were limited. In practice, labour complaints were dealt with harshly by local police and military, which were commonly on the payroll of the larger companies (Hadiz, 1997). Labour disputes that were taken to local and central government Disputes Councils either dragged on for long periods, or were frequently settled in favour of employers through bribes to council members. It was an open secret that labour inspectors and local officials were also on the payroll of private companies.

With the downfall of President Soeharto in 1998, and the emergence of a more open democratic system, the government could no longer continue to publicly suppress labour rights. As Indonesia experienced its worst economic crisis in three decades, political change permitted a freer trade union movement and several important labour reforms.

First, the government ratified several key ILO Conventions, including rights to compete without discrimination and freedom of association. Four conventions were signed in 1998-2000, dealing with Basic Rights (minimum age of employment, worst forms of child labour, abolition of forced labour and freedom from discrimination).<sup>22</sup> Ratification of the key ILO convention on the Freedom of Association (Convention No. 87), which provides for the right of workers to establish unions of their choosing, effectively ended the long period from 1973, some 25 years, in which workers could only join one, government sanctioned, trade union.

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<sup>20</sup> One favourable development, however, has been a slowdown in growth of the working age population, owing the age structure effects of past declines in fertility, which had begin to significantly affect the number of new entrants into the labour force by the year 2000.

<sup>21</sup> Although formal controls were relaxed somewhat in the last years of the regime when the government passed legislation permitting the formation of independent unions at enterprise level.

<sup>22</sup> The four conventions and their date of ratification by Indonesia were No. 138 (1999), No. 182 (2000), No. 105 (1999) and No 111 (1999) respectively. Previously the government had ratified two conventions (No. 28 on forced labour (ratified in 1950) and No. 98 (1958) on the right organise and bargain collectively.

Second, more importantly, the right to organise was enshrined in law through the Trade Union Act in 2000, setting the minimum size of trade unions (10 members), conditions governing multiple unionism in single establishments, and rules for the formation of union federations and confederations. The Trade Union Act has contributed to a proliferation of unions across the country. From just one trade union, 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). A study by a social research institute, SMERU, of industrial relations in major industrial areas in 2002 found that over half of all enterprise unions had been set up after 1997. The study also found that the process of signing collective agreements had accelerated at enterprise level.

For employers, this was a major change in the industrial relations framework. Many were shocked by the ‘big bang’ nature of the reforms, doubting that firms would be able to deal with multiple unionism. But in reality the opening up of the industrial relations system appears to have had little negative effect on employment and did not result in a significant increase in employer complaints. Jobs and wages in large and medium scale firms which fell during the crisis, subsequently grew, albeit slowly, in the new industrial relations environment in the period 1998-2001

However implementation of new legislation related to both **Survival** and **Security Rights** was another matter. We argue that it was these reforms, much more than the reforms to basic rights, that have threatened to slow the expansion of employment in the modern sector. We now turn to these reforms, giving special attention to minimum wages, new rates of severance and the employment of contract workers.

## V. LABOUR REFORM STAGE II: EXTENDING SURVIVAL AND SECURITY RIGHTS<sup>23</sup>

Before the crisis in 1998, governments had legislated for quite comprehensive set of labour standards covering both survival and Security Rights, most of which had been introduced through Basic Laws (Acts) in the 1950s and 1960s before Soeharto came to power.<sup>24</sup> However, there were problems in ensuring that these were guaranteed even in the small modern sector, owing to shortcomings in the political, bureaucratic and institutional framework for implementation and supervision. In part, this can be attributed to the above-mentioned tight formal and informal controls over the trade union movement which limited the capacity and right of appeal by workers in cases of disputes over standards. By East Asian standards, the Labour Acts (some based on legislation in

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<sup>23</sup> Some of the material presented in this section overlaps with material discussed in Manning (2004: 238-245).

<sup>24</sup> Most of the early labour protection legislation was passed shortly after independence in the 1950s and 1960s, although limitation of several key rights (including the right to strike) were imposed even in this period as the ‘left’ leaning labour unions began to pose a political and economic challenge to the government during a period of economic decline.

force in Holland after World War II), were quite favourable to labour, providing for a 40 hour week (compared with 48 hours in many other countries in the region until quite recently), generous overtime provisions, 12 days annual leave and two days menstruation leave.<sup>25</sup> All dismissals and retrenchments had to be approved by Labour Disputes Councils.

Following the passing of the Trade Union Bill in the year 2000, labour protection shifted to top priority on the labour reform agenda in the populist Wahid government (1999-2001), and the subsequent government under Megawati Sukarnoputri (2001-2004). Ex-union leaders appointed as Ministers of Manpower championed reform on the grounds that Indonesian workers had suffered in terms of both Survival and Security Rights in the past. In particular, raising minimum wages and providing better protection for laid-off workers was viewed as essential, given that workers were seen to have suffered on both counts under Soeharto and during the Asian economic crisis.

Although preceded by stand-alone regulations, the passing of the Manpower Protection Act in early 2003 embodied the new, more interventionist approach to labour standards. It covers almost every conceivable aspect of labour protection – manpower planning, employment of child, female and foreign workers, wages and condition of work, contract employment, dismissals, collective bargaining and settlement of grievances – in large and small enterprises in some 18 chapters and nearly 200 articles. The Act provided greater certainty for both business and labour.<sup>26</sup> But at the same time, the basic law had the potential to undermine efforts at collective bargaining and the role of the newly empowered union movement, which was now in a much stronger position to bargain with employers than had been the case for several decades. It also had the potential to break any nexus between productivity and labour standards, which might have been enhanced through collective bargaining in different firms, industries and regions.

We now look at several examples of articles in relation to both survival and Security Rights in the Manpower Protection Act, and their potential impact on wages and employment.

### **Survival Rights: Minimum Wages**

Minimum wages (MW) are regulated in the Act that provides for annual revisions to wages through Provincial Government Decrees, based on the recommendation of District Governments.<sup>27</sup> The criteria for setting MW are to be based on a ‘decent’ or ‘suitable’

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<sup>25</sup> The main laws were Act No. 14, 1969, Law No. 12, 1964. See Manning (1998: Chapter 8) for details on labour law and rights under Soeharto, and Nayyar (1995) for some comparative data for East Asia.

<sup>26</sup> Although there remains considerable uncertainty, given that many issues were not sufficiently resolved in the legislation and depend on implementing legislation and machinery, which will take several years to put in place.

<sup>27</sup> The MW is to be set at either District or Provincial level for all industries and also according to specific sectors (see Articles 87-98 of the Manpower Protection Act of 2003). ‘Bipartite’ negotiations between employers and worker representatives or trade unions provide are required to make recommendations to the district governments.

standard of living (*kehidupan layak*), to defined in detail by subsequent regulations issued by the Ministry of Manpower.<sup>28</sup>

MW regulation had already been a key element in labour policy under Soeharto. An index of minimum living needs (KHM – *Kehidupan Hidup Minimum*) had become the main basis for assessing minimum wages relative to the needs of workers, at the provincial level, before the crisis in 1996.<sup>29</sup> However, even under Soeharto, the MW was never viewed as a social safety net for lower paid workers, as is commonly the case in many other countries. Rather it was regarded as a standard for unskilled wages throughout the modern sector. The absolute value of the KHM was high by most criteria of disadvantage in Indonesia (for example, it was more than twice the level of per capita poverty line in 2001), and included several items that were not regularly consumed by low income families.<sup>30</sup> While minimum wages had remained well below average wages for much of the New Order period, SMERU (2001) found that were much closer to the prevailing wages of for majority of workers by 2000 and were "bunched" around the minimum wage. Compliance with the minimum wage had steadily increased over time and the MW was 'binding' for the most workers in the formal, urban sector. In comparison to wages outside the modern sector, the MW could not be described as a 'survival' wage (Bambang Widiyanto, 2003).

Related to the high level of the KHM, and through the efforts of an ostensibly pro-labour Ministry strongly in support of raising standards, the MW was increased steeply after the crisis.<sup>31</sup> Even though employment conditions were difficult, the Central Government encouraged rapid minimum wage growth from 1999, resulting in a complete recovery in real rupiah terms by 2001 and significant growth in the major industrial areas in 2002, compared with the pre-crisis period (Figure 1). In dollar terms, the minimum wage had recovered to pre-crisis levels, the large rupiah depreciation notwithstanding (Manning, 2004).<sup>32</sup>

What was the impact of rising minimum wages on employment? Several researchers found a strong negative relationship between minimum wages and employment in the modern sector, especially affecting unskilled, less educated and female workers (SMERU, 2001). The relationship was much stronger in the post crisis period (Bird and

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<sup>28</sup> The Act also stipulates that firms must set wage and salary scales according to level (*golongan*), job, years of service, education and competency, to be regulated further by the ministerial decree (Article 92).

<sup>29</sup> Five other overlapping criteria including the interests of business, were recommended by the Ministry of Manpower as relevant to recommending minimum wage increases at the provincial level. However, clear guidelines were never established as to how information on these other criteria might be collected and applied.

<sup>30</sup> The KHM was calculated according to on regular estimates of the prices of a basket of 43 items. According to the Manpower Act, the basket of goods was to be expanded to provide a decent standard of living, which according to Ministry of Manpower calculations would raise the standard of basic needs by around 20% above prevailing absolute value of the KHM.

<sup>31</sup> It was used to restore wage levels after a substantial decline in real terms owing to high inflation (a close to 100% increase in the CPI) during the economic crisis in 1998.

<sup>32</sup> The new MW probably helped the recovery in the index of textile, clothing and footwear wages by 2001, after they plummeted in 1998 (see Table 4 above).

Manning, 2002).<sup>33</sup> As we have seen, the impact was partly hidden. Labour was absorbed into the informal sector rather than resulting in higher unemployment rates in a country where there were no unemployment benefits. Unemployment rates were not significantly affected, although they did rise in 2002.<sup>34</sup>

Two other potential effects are also worth noting. First, wage differentials by skill and years of experience were likely to be compressed, as firms reacted to steeply rising minimum wages and labour costs by narrowing the margins for skill and experience. Individuals were now likely to have less incentive to invest in human capital. Second, a range of other labour costs tied to minimum wages were also likely to rise. This was the case with severance pay to which we now turn.

### **Security Rights I: Severance Pay**

As we have seen, the economic crisis created a major challenge for modern sector employment in Indonesia. Manufacturing employment alone declined by over 10% and over a million wage jobs were also lost in other sectors outside agriculture in 1998. Although there was some subsequent recovery in employment, large numbers of both educated and less educated people lost their jobs in the modern sector, in an environment where there are no publicly funded unemployment benefits and few people had private unemployment insurance. There was strong pressure on firms to give generous payouts to their workers and more severance than required by legislation, even though rates had already been increased substantially by government regulation several years earlier.

Minimum rates of severance pay and long service pay have subsequently been regulated in detail in the Manpower Protection Act of 2003. As in other countries, a distinction is made in the rights to severance depending on the cause of separation, and in rates of severance and long service payments: different coverage is mandated for quits and dismissals, and in the latter category for dismissals for economic reasons (including downsizing and bankruptcy), minor violations of company regulations or, lastly, major violations or offences (Table 5). Unlike in many other countries where rates of severance are lower for dismissals due to economic cause, the maximum rates apply according to the new Act in Indonesia.

Reflecting rates already raised several years earlier, in a controversial earlier Ministerial Decision, the new Manpower Act increased the rate of severance and long service pay by 30-40%.<sup>35</sup> Business had cause for concern. It had initially protested strongly regarding

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<sup>33</sup> Several other studies have found little relationship between minimum wages and employment in the pre-crisis period when output and investment were growing rapidly, and minimum wages were not binding on the wages for most workers. See Islam and Nazara (2000), and Alatas and Cameron (2001).

<sup>34</sup> National unemployment rates rose only very slightly during the crisis and remained stable at around 5% to 2001 (or around 8% according to the new definition employed in the national labour force surveys). By 2003, they risen to 10% according to the new definition.

<sup>35</sup> Although there were some important changes, mainly in response to lobbying from business, the rates of severance remain the same in the Manpower Act as in the Ministerial Decision of 2000 (Decision No. 150), and most articles in Ministerial Decision were incorporated in the Act.

increases in severance and long service pay in the year 2000.<sup>36</sup> Comparative data reveal, moreover, that severance pay was now several times higher in Indonesia compared with most neighbouring countries. The number of months of pay which firms had to give in severance for employees who were dismissed for economic cause was three to five times more than in China, India, Korea and Malaysia in 2003-4.<sup>37</sup> The difference was smaller with Philippines and Thailand (1.5-2.5 times higher in Indonesia). But absolute costs were probably as high or higher for firms in Indonesia than in both these countries, despite much higher wage rates in both the Philippines and Thailand.

Aside from increasing the overall rate of severance by some 200% over the past 20 years (see Figure 2), and more than 50% for workers with longer years of service since 2000, these changes have had a twofold effect on the incentive structure with regard to severance.

- First, it has raised the cost of dismissing workers with longer years of service (10 years or more) relative to workers with fewer years of service. The steeper lines for total severance (including payments for years of service, also regulated in the Act) according to the regulations in 2003 and 2000 compared with earlier years (1986 and 1996) shown in Figure 2 indicate this advantage accruing to more experienced workers.
- Second, it has raised the total relative cost of dismissing workers for economic cause, precisely at a time when many firms were under pressure to lay off workers. Figure 2 demonstrates that severance pay for workers dismissed for economic cause had more than doubled for most years of service from 1986 to 2003, and nearly tripled for workers who had been employed with the same firm for 10 years or more.

Even though increases in severance and long service pay were much larger several years earlier, they were likely to have quite a significant effect on labour costs and hence employment in the post-crisis period. Greater pressure for higher levels of compliance and slow growth in demand were particular problems. This was especially true in larger labour-intensive establishments in competitive industries, such as garments and footwear, where profit margins are slender and job-hopping is common. Further, the large recent minimum wage increases discussed above were one additional factor contributing to higher costs of severance.<sup>38</sup> Thus for example, the costs of dismissal for economic cause of a worker, earning the minimum wage and with ten years experience, in Jakarta was approximately Rp. 3.4 million in 2000 (around US\$400) prior to issue of the Ministerial Decree in 2000. The cost rose to just over Rp. 5 million after the decree was issued in the same year. But it had ballooned to Rp. 13 million (\$1450) by the time that the Manpower Protection Act was passed in 2003 for the same category of worker, with the increase being wholly due to the rise in minimum wages.

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<sup>36</sup> Larger changes introduced in 1996 (Ministerial Decree No. 3, 1996) caused less of a stir when the economy was still booming, dismissals for economic cause were rarer, and compliance was low.

<sup>37</sup> See Hill (2004), citing data compiled by Dr. Kelly Bird (USAID) in Jakarta.

<sup>38</sup> Severance is calculated as a multiple of monthly salary at the time of dismissal, depending on years of service

In short, the reforms act as a tax on employment and discourage firms from dismissing older workers. Further, they are likely to encourage industrial disputes. Neither employers nor employees are required to 'invest' in severance pay up front, and hence firms are often not in a position to pay severance at times of unexpected difficulty. Higher rates of severance pay are likely to compound the effects of higher minimum wages by encouraging firms to employ fewer permanent workers. It would be hardly surprising if many prefer out-sourcing jobs or other forms of temporary contract. However, this too has been another area where the Manpower Protection Act would seem to be heavily penalising new job seekers.

## **Security Rights 2: The Employment of Contract Workers**

One strategy for conserving labour costs in light of higher severance pay rates (especially for workers with longer periods of service) is the substitution of regular employees on permanent contracts for workers on fixed term contracts. Another possibility is greater outsourcing of activities, especially where production tends to fluctuate owing to seasonal work or unpredictable variations in demand, such as variations in orders from domestic and overseas buyers.

However, the Indonesian government has also sought to regulate contract work and outsourcing, at the same time as it has increased the rates of severance pay. With regard to fixed term contracts, the Manpower Protection Act permits contract work for one-off production activities, production runs which extend for no longer than three years, seasonal work and work associated with the introduction of new products which are still of a temporary or experimental nature (see Clause 59).<sup>39</sup> Such activities are only permissible for up to three years (two years initially, plus one year extension) initially, and for a further two years under a new contract. The Act limits labour outsourcing to 'non-core' activities (that are outside the production process), which support the company "as a whole" and do not inhibit production processes. Typical examples are service activities such as cleaning, catering or security (Article 64).

The provisions in the Manpower Protection Act are not overly restrictive compared with regulations in many other developing and developed countries. Limitations on fixed-term contract work are consistent with modern labour codes, although they are likely to exacerbate problems for modern sector firms under difficult labour market conditions, such as those experienced by Indonesia in the post-crisis period.

The attempted regulation of outsourcing is probably more serious for employment. In practice, the limitations on outsourcing seek to remove *putting-out* activities to households or companies, which may be called on by a company to produce extra output at times of peak demand, such as regularly occurs in industries like garments. Sub-contracting to households typically occurs for low-quality products produced for local markets or for export, especially if there are marked seasonal changes or shocks in

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<sup>39</sup> See also Ministry of Manpower, Ministerial Decision No. 100 2004.



demand and supply conditions. Outsourcing of parts of the production chain which are part of core activities is now an established aspect of production in global markets, especially in industries like electronics.

Further, it is questionable whether introduction of bans on outsourcing improves the welfare of poorer households. In particular, such regulations discriminate against those who are less able to perform jobs on a fixed working schedule or in shift-work, especially older workers and married females. Community policing and solutions rather than straight out bans may be a more equitable outcome.<sup>40</sup>

More generally, the limitations on contract work and the outsourcing of core activities, usually to smaller firms on a seasonal basis, can also affect employment adversely precisely in industries like textiles, where flexibility in output and employment is critical for international competitiveness. The capacity of many large companies to meet the demands of foreign and sometimes domestic buyers at times of peak demand depends crucially on such arrangements in labour-intensive industries like textiles, clothing and footwear.<sup>41</sup> It can be argued that strict limitations on such activities (if they could be enforced) would be a setback for Indonesia, bearing in mind that breaking up, the production process within (and across) countries through intra-industry trade has been a major factor in export growth and employment in East Asia from the latter part of the 20<sup>th</sup> century (Athukorala, 2004).

## VI. CONCLUSIONS

In the short space of some six years since the economic crisis in Indonesia in 1998, there has been a major rewriting of Indonesia's labour code in the fields of industrial relations and labour protection, after little serious reform for almost 30 years. Labour policy has been transformed, both with respect to Basic and Civic ('Core') labour rights, as well as Survival and Security Rights. The former were tightly controlled during the New Order period under Soeharto. The latter were regulated quite extensively, but sanctions for non-compliance were low and breaches of the laws were commonplace.

At the same time as labour policy has stressed rights and standards, government statements (and those of all political parties and presidential candidates in 2004) repeatedly emphasized employment creation as one of Indonesia's most important challenges.<sup>42</sup> However, few government leaders and political spokespersons have acknowledged the potential for conflict between achieving employment goals – creating better jobs – and tightly regulating Survival and Security Rights in the *reformasi* era in

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<sup>40</sup> Of course, some of the most important solutions often lie well beyond the scope of labour standards, such as incentives and support for the education of poor children unable to attend school.

<sup>41</sup> Much hinges on the definition of 'core' activities which is likely to be subjective, especially in components industries like electronics.

<sup>42</sup> For example, the new President cited unemployment as foremost amongst the social challenges faced by the country and employment creation as a major goal of the new government, in his Inauguration Speech of October 20, 2004 ("Our economic growth this year, which is still below 7 percent, is definitely inadequate in stimulating employment", *Jakarta Post*, October 21, 2004).

Indonesia. Nor has there been serious discussion of an alternative strategy of setting minimum standards, and allowing firms and workers to bargain over most standards, according to industry and firm circumstances.<sup>43</sup> In short, in contrast to the pluralism in post-New Order government policy with regard to many other dimensions of public life, Survival and Security Rights have been regulated by government decree in extraordinary detail, ostensibly in favour of workers whose formal protection was seen as neglected during the Soeharto era. We have argued that the regulations are only likely to protect the interests of employed workers in the ‘protected’ modern sector, in practice, to the exclusion of rights of those in the informal sector and agriculture. The latter are only marginally, if at all, protected by some clauses in the legislation. To the extent that the legislation penalizes employment growth, as some research and a priori reasoning suggests, it penalizes many of these poorer workers, and also younger, new job seekers who seek ‘better’ modern sector jobs.

Thus, a consistent policy framework is vital to reconcile incentives for job creation by private enterprise with the need to provide basic social protection for workers. In particular, there has been little public discussion on the implications for employment of a raft of clauses which regulate rights in the Manpower Protection Act No. 13, 2003, the most important national policy document for labour standards.

This Chapter has examined some of these relationships with special reference to Survival Rights embodied in minimum wage policy, and Security Rights regulated in the clauses in the Act on dismissals and severance pay, contract workers and out-sourcing. We have discussed the effects of regulation in both areas in the context of much more difficult labour market conditions in Indonesia since 1998, compared with the Soeharto period. The Chapter also notes the importance of the compliance regime in assessing the impact of regulations on Survival and Security Rights. Before the economic crisis, ‘compliance costs’ were low because employers could ‘arrange’ settlements in their favour, faced with a weak and tightly controlled labour movement. Employment was determined largely by labour demand associated with the rate of economic growth, and the volume and quality of labour supply. With a significant improvement in Basic and Civil Rights, the compliance regime in relation to labour standards has altered dramatically, with the recognition of freedoms of association, together with liberal policies on the formation of trade unions. The comprehensive revision of the labour protection regime and its implications for job creation, need to be viewed in this context.

In short, assuming a downward sloping demand curve for labour and (relatively) competitive product markets in tradable goods industries, we have argued that several dimensions of government policy will contribute to slower modern sector employment growth, and less labour market flexibility. The latter is of concern especially in those internationally labour-intensive industries such as TCF, where Indonesia has had a comparative advantage in the past, and in light of the more competitive international environment, in the post-crisis and recovery period in Indonesia.

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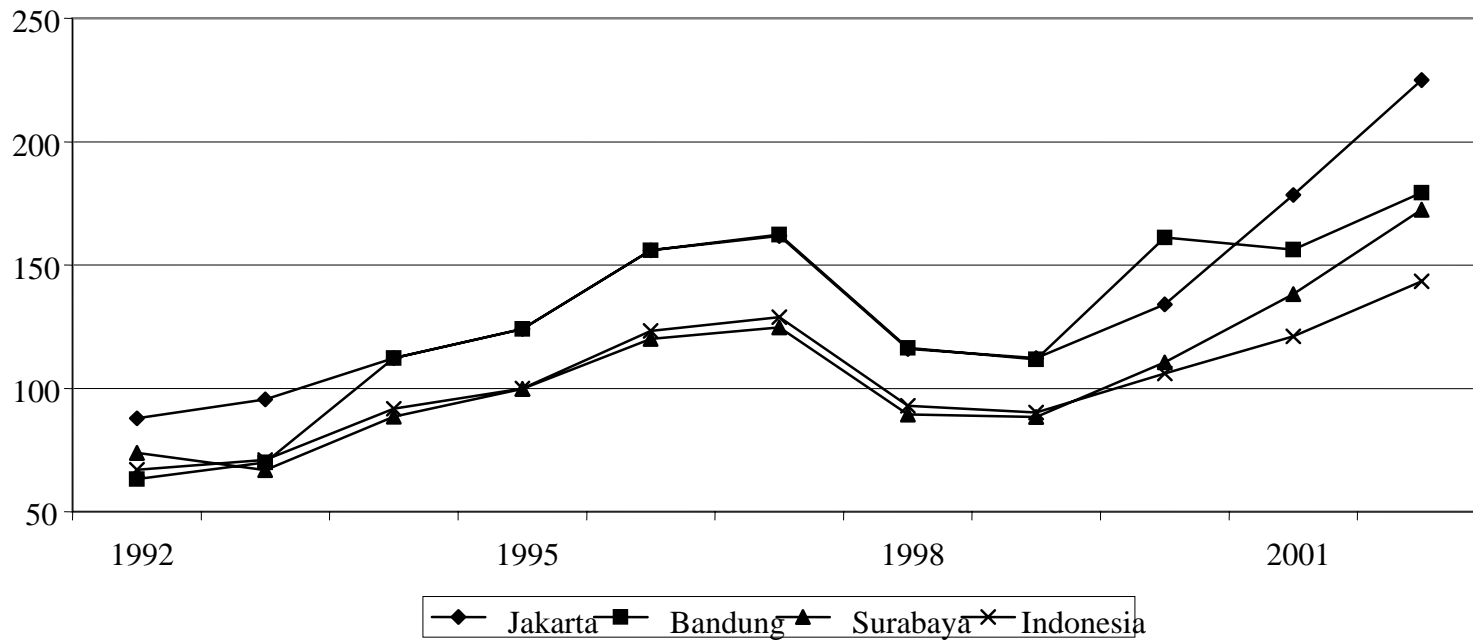
<sup>43</sup> One important exception is the National Planning Bureau (Bappenas) White Paper on Employment published in 2003.

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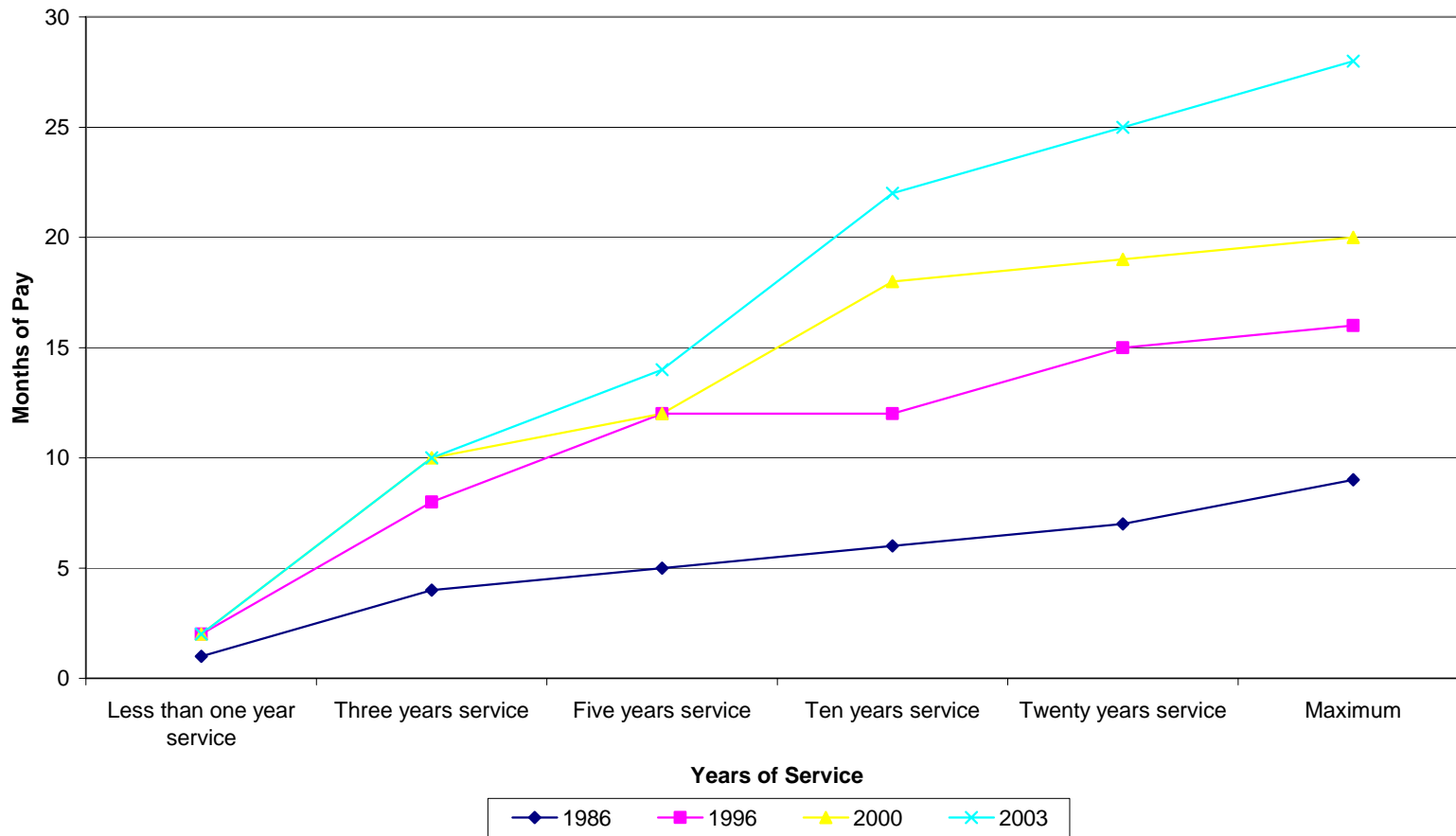
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**Figure 1: Real Minimum Wages in Major Industrial Centres and All Indonesia, 1992-2002 (Rp. 000 per month, 1996 prices)**



Source: Indonesia, Ministry of Manpower, unpublished data, various years.

**Figure 2: Legally Payable Severance, Number of Months Pay by Years of Service, Indonesia 1986-2003**



Source: Indonesia, Ministry of Manpower, Ministerial Regulation No. 4 1986, Ministerial Decrees No. 3, 1996 and 150, 2000, and the Manpower Protection Act, (Act No. 13, 2003).

Table 1: A Classification of Labour Standards as Rights

TYPE OF STANDARD/RIGHT	DESCRIPTION
<b>Basic Rights</b>	Right against involuntary servitude/forced labour Right against physical coercion Right against discrimination Right against (exploitative use of) child labour
<b>Civic Rights</b>	Right to free association Right to collective representation Right to free expression of grievances
<b>‘Survival’ Rights</b>	Right to a living wage Right to full information about work place hazards Right to accident compensation Right to limited hours of work
<b>Security Rights</b>	Right against arbitrary dismissal Right to severance and long service pay Right to retirement compensation Right to survivor’s compensation

Source: Adapted from Singh (2003), page 111

Table 2: The Structure of Indonesian GDP and Employment and Output per Workers, 1986-2002

	1986	1996	1998	2000	2002
<b>Share of GDP</b>					
Agriculture	24.6	16.5	18.0	17.7	16.9
Industry	35.5	43.0	42.7	43.6	43.6
<i>Manufacturing</i>	17.9	25.0	25.6	26.7	27.0
Services	40.0	40.6	39.3	38.7	39.4
	100.0	100.0	100.0	100.0	100.0
<b>Share of Employment</b>					
Agriculture	55.1	44.0	45.1	44.3	44.3
Manufacturing	8.2	12.6	13.0	13.2	13.2
Services	36.7	43.4	41.9	42.4	42.4
	100.0	100.0	100.0	100.0	100.0
Wage employees	45.8	50.0	48.9	49.2	47.9
Non-wage employees	54.2	50.0	51.1	50.8	52.1
<b>Output per worker (Rp. Million)*</b>					
Agriculture	1.5	2.1	2.0	2.1	2.1
Manufacturing	7.5	11.3	11.5	10.8	11.2
Other**	5.4	7.7	6.6	7.0	7.3
<i>Total**</i>	3.4	5.7	5.1	5.2	5.5

\* At constant 1995 prices. Includes services and other industry

\*\* Includes all services, mining, utilities and construction

Source: National Accounts and National Labour Force Surveys (various years)



Table 3: Employment, Wages and Value Added in Large & Medium and Small Firms in Indonesian Manufacturing, 1995-2002

	No. of Firms	Employment	Wage Costs	Value Added	Average Wage	Value Added per Worker	Ratio of Wages to Value Added	Ratio of Small to L&M firm wages per worker
		000	(Rp. b.)	(Rp. b.)	(Rp.m./wkr)	(Rp.m.)		
<i>Large&amp;Medium</i>								
1995	21551	4174	13627	73909	3.26	17.71	0.18	0.29
1996	22997	4215	15752	93332	3.74	22.14	0.17	0.24
1997	22386	4170	18642	100900	4.47	24.20	0.18	0.19
1998	21423	4124	28642	154651	6.95	37.50	0.19	0.23
1999	22070	4234	30438	191393	7.19	45.20	0.16	0.25
2000	22851	4371	36085	222112	8.26	50.81	0.16	0.19
<i>Small</i>								
1995	190767	1598	1498	3888	0.94	2.43	0.39	
1996	228978	1915	1715	4612	0.90	2.41	0.37	
1997	241169	2077	1774	4802	0.85	2.31	0.37	
1998	194564	1507	2420	6923	1.61	4.59	0.35	
1999	225564	1779	3240	8182	1.82	4.60	0.40	
2000	256823	2005	3127	8380	1.56	4.18	0.37	

Source: BPS-Indonesian Statistics, *Indonesian Statistical Yearbook*, various year (data from the Annual Survey of Large and Medium Manufacturing, and periodic surveys of small scale industry)

Table 4: Growth of Employment, Value Added and Wages in TCF, and All Industries 1986-2001 (% per annum)

	Textiles, Clothing & Footwear	All Industries
<i>Employment</i>		
1986-1991	16.9	11.4
1991-1996	8.0	6.8
1996-2001	1.0	0.7
<i>Value Added</i>		
1986-1991	24.1	29.8
1991-1996	25.3	16.2
1996-2001	22.1	21.7
<i>Real wages</i>		
<b>Growth</b>		
1986-1991	5.3	4.6
1991-1996	5.3	3.5
1996-2001	-2.1	-1.3
<b>Index (1996=100)</b>		
1986	59	67
1996	100	100
1998	70	70
2001	90	94

Source: Source: CBS, Statistical Yearbook, 2001 (data from Survey of Large and Medium Manufacturing, various years). Real Wages are calculated by deflating average nominal wages by the national CPI Index.

Table 5: Months of Severance and Long Service Pay, According the Cause of Separation, Indonesia 2003

	Basic Rates	<i>Cause of Separation</i>							
		Economic Cause	Bankruptcy	Retirement/Death/ Illness*	Change of Firm Status		Dismissal		Voluntary Quit
					Dismissed	Quits	Minor Offense	Major Offense	
<b>Months of Pay</b>									
<b>Severance Pay</b>									
Less than one year service	1mth.	2	2	2	2	1	1	0	0
Three years service	4mth.	8	8	8	8	4	4	0	0
Five years service	6mth.	12	12	12	12	6	6	0	0
Ten years service	9mth.	18	18	18	18	9	9	0	0
Twenty years service	9mth.	18	18	18	18	9	9	0	0
Maximum	9mth.	18	18	18	18	9	9	0	0
<b>Long Service Leave</b>									
Less than one year service	0	0	0	0	0	0	0	0	0
Three years service	2mth.	2	2	2	2	2	2	0	0
Five years service	2mth.	2	2	2	2	2	2	0	0
Ten years service	4mth.	4	4	4	4	4	4	0	0
Twenty years service	7mth.	7	7	7	7	7	7	0	0
Maximum	10mth	10	10	10	10	10	10	0	0
<b>Total Severance</b>									
Less than one year service		2	2	2	2	1	1	0	0
Three years service		10	10	10	10	6	6	0	0
Five years service		14	14	14	14	8	8	0	0
Ten years service		22	22	22	22	13	13	0	0
Twenty years service		25	25	25	25	16	16	0	0
Maximum		28	28	28	28	19	19	0	0

\* In lieu of a company financed pension scheme. Prolonged illness for 12 months or more.

Source: The Manpower Protection Act No. 13 2003, Clauses 156-167

