Labor Regulations and Industrial Relations in Indonesia

Alejandra Cox Edwards

Personnel management and incentive systems help firms establish a comparative advantage. Pay scales and hiring, firing and promotion decisions are central to competitive strategy. Ideally, labor regulations should facilitate voluntary agreements between employers and workers, helping reduce transaction costs.

Summary findings

Since the mid-1980s, deregulation has proceeded rapidly in Indonesia. Employment opportunities, the capacity to generate income, and the opportunity to negotiate better working conditions have all expanded. Still, many Indonesians have voiced concern that workers have not shared enough in the benefits of economic development. Many hold the view that increasing the minimum wage would bring the bottom wages up and reduce wage differentials. Additionally, international agencies such as the International Labour Organisation and representatives of the U.S. government have criticized Indonesia for violations of labor standards.

In response, the Indonesian government increased workers' statutory rights and removed obstacles to collective bargaining. Real minimum wages doubled between 1988 and 1995. Enforcement of regulations toughened. While in earlier periods statutory rights applied to a minority in the public sector, the expansion of manufacturing employment has broadened the coverage of these statutes, requiring the Ministry of Manpower to perform the nearly impossible task of enforcing them.

Now the government should close the gap between statutory rights and voluntarily agreed-on working conditions. This means correcting the legal standards and reducing government intervention in labor disputes. Current labor regulations in Indonesia inhibit

constructive discourse between workers and employers in three areas: dismissals, dispute resolution mechanisms, and contributions to social security. More appropriate legislative action, which also takes into account the role of other agencies is needed in two areas: job safety and child labor.

Personnel management and incentive structures help firms establish a comparative advantage. Pay scales and hiring, firing and promotion decisions are central to performance evaluation and competitive strategy. Individual and collective bargaining is at the heart of labor-management relations in modern enterprises, and industrial action (or the real threat of it) is generally part of negotiation strategy. Inviting public intervention rather than allowing such mechanisms as strikes and lockouts to operate isolates negotiations from market conditions.

Ideally, labor regulations should facilitate voluntary agreements between employers and workers, helping reduce transaction costs. They often do the opposite — and also discourage the creation of jobs. Keeping Indonesia's economy competitive requires a system of industrial relations that relies on voluntary negotiations of wages and working conditions. The tasks workers perform and the employers for whom they perform them must be subject to change. This process is a normal feature of healthy labor markets.

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1. Introduction

Since the mid 1980s, the Indonesian economy has embarked on a major deregulation process, and has advanced at a very fast pace. Employment opportunities, the capacity to generate income, and the opportunity to negotiate better working conditions have all expanded. In spite of the progress, Indonesian observers and policymakers have expressed uneasiness with labor conditions and labor policy for a number of reasons. Many Indonesians, including government officials, have voiced concern that workers have not shared sufficiently in the benefits of growth. On the other hand, with rising wages and visible labor unrest, the task of balancing equity objectives and preserving employment growth seems to be getting out of reach of policymakers. To complicate things further, international agencies such as the ILO and representatives of the United States government have criticized Indonesia for violations of labor standards.

This paper offers a way of thinking about labor policy that can reconcile the good record in employment creation over the last decade and these concerns, with the aim of contributing to a more informed discussion about the role that labor policy can play in economic growth. Contrary to conventional wisdom, this paper argues that good performance of modern enterprises depends less on technical factors and more on the rules and habits by which enterprises live.

Labor regulations should ideally exist to facilitate voluntary agreements between employers and workers, helping to reduce transaction costs. But, most often, labor regulations do exactly the opposite, discouraging the creation of jobs and more importantly, distorting direct communications between workers and employers. Preserving the competitive position of the Indonesian economy, while wages are increasing and workers are sharing the benefits of growth, requires a functional industrial relations system that relies on voluntary negotiations of wages and working conditions. To combine a dynamic economic environment with the goal of full employment, the tasks that workers perform and the employers for whom they perform them will have to be subject to change. Accepting this process as a normal feature of the labor market requires an appreciation of the internal dynamics of the labor market.

Background Market liberalization in Indonesia since the mid 1980s, has brought new opportunities and challenges for individuals to perform in a riskier environment. So far, entrepreneurs and workers have been willing to take risks and have experienced the pay-off of open markets. Indonesia has made a leap out of an agriculture-based economy to a more diversified economy not only oriented to agriculture, but also to labor-intensive manufacturing, and self-employment in urban services. Yet, the overall share of wage employment is still low, at around 30 percent, and one third of wage employment is in industry. The bulk of employment is now based on low-skill, daily or fixed-term assignments, as entrepreneurs organize resources to accomplish specific tasks or to fill merchandise orders from international buyers. This mode of business operation does not

require entrepreneurs to engage in long-term obligations with workers and absorb the associated risks.

Although there is no reason to believe that Indonesia will abandon these activities in the near future, especially since there is still a significant fraction of youth who leave school before completing the primary cycle, sustained economic and social progress will rest on further expansion of industrial activities and further modernization of the service sector, which will increase the overall share of wage employment. Only such sustained upgrading can reconcile employment growth with rising workers' incomes. But, given current labor regulations, can we expect the Indonesian modernization process to continue? The answer is No.

Modern enterprises rely heavily on specialization and division of labor, personnel management, and on-the-job-training. Since labor policy has direct influence over personnel management, the question examined in this paper is central. In Indonesia, the law restricts employers from dismissing workers on long-term contracts, sets a minimum wage, overtime pay, menstruation leave, a 13th salary, paid holidays, and contributions to social security.

Are these legally established benefits the ones that workers would press for, and employers would grant in an environment of voluntary negotiations? Workers want their work to be recognized and rewarded. Employers want to meet their targets, fulfill sale orders, and keep their operations cost effective. It is in the employer interest to keep workers motivated and loyal, and the use of incentive systems that encourage worker cooperation is a rational choice. Governments, for their part, want to preserve an environment of peace and security, and they are typically inclined to rely on command and control measures. While each group may have different immediate interests, it is easy to see that cordial labor-management relations and rising total factor productivity is a common goal.

Since 1994, after a change in legislation, independent workers' organizations have developed. Nevertheless, the extent of intervention of government policy on matters of compensation is currently substantial.

The policy challenge. Can a market economy, where actions are driven by market-based incentives, produce an industrial relations system where workers and managers cooperate, and where total factor productivity rises? The answer is Yes, although appropriate government policy to ensure open access to employment opportunities is a precondition for success. There are a number of reasons for this. First, workers will constantly search for the most attractive jobs and the best employers. Second, competition for workers in an environment of abundant employment opportunities will improve workers' negotiating power. Third, market-based incentives lead workers and employers to negotiate rationally and consider the costs and benefits of their actions. Fourth, with wages determined by demand and supply forces in a market economy, equity is achieved by open access to schooling and jobs. Fifth, competition in

the products market leads to quality improvements and/or price reductions, a simple way to define an increase in total factor productivity. Entrepreneurs will adapt the organizations of production so that their operations keep generating profits. This allows countries with vast differences in wages to compete in the same product market internationally.

However, an open system of representation in labor negotiations, which precludes government control as well as monopolistic action, is a basic condition for this process of adaptation to continue. This notion goes counter to conventional wisdom about the role of powerful and centralized unions because monopolistic unions are capable of negotiating relatively high wages and conditions that appear very favorable to workers in small bargaining units. However, experience clearly shows that monopolistic unions are a very powerful mechanism to stifle competition in the labor market, which reduces employment creation among small and medium private enterprises and stalls the adjustment process.

The rest of the paper is organized as follows. Section 2 defines labor policy and presents an overview of its evolution in Indonesia since independence in 1945. Section 3 highlights the role of the labor market in the transformation of the Indonesian economy. Section 4 describes the current regulatory framework in the Indonesian labor market. Section 5 discusses three priorities for labor policy reform and two additional areas of labor policy that need attention and complementary action. The three priority areas for labor reform include: lifting restrictions on dismissals; seeking the use of acceptable procedures for electing workers' representatives in labor negotiations, encouraging bipartite negotiations and lessening direct intervention of the Ministry of Manpower in dispute resolution; and introducing financial discipline to the various programs under the social security umbrella. There are two areas where the Ministry of Labor needs to cooperate with several agencies to advance social goals: safety in the work place and child labor. Section 6 draws some lessons from the experience of other countries with labor policy, and the final conclusions are in Section 7.

2. Labor Policy

Labor regulations define a framework for individual and collective bargaining and establish statutory worker's rights. The latter are legal requirements regarding the characteristics of individual labor contracts that cannot be modified by voluntary agreements between workers and employers. Examples of these requirements include the minimum wage, the prohibition of child labor, mandated contributions towards social security, and job security protection. If statutory rights are centrally defined without proper participation by those who will be affected by them, there will be conflicts between the system of statutory rights and the results of voluntary negotiations.

2.1 The Role of Statutory Rights

Labor laws establish basic worker's rights and the application of the law has a significant influence on workers' bargaining power. For example, an established minimum wage, gives workers the right to demand that level of compensation as a minimum. Yet, workers do not have control over the availability of jobs. In fact, the Latin American experience indicates that guaranteed entitlements by law can go against the grain of progressive social policy. Setting minimum standards on working conditions may simply change the boundaries between the formal and the informal and may create conflict as workers demand that the standard be applied and find resistance among employers.

It is widely accepted that labor standards have to be tailored to the level of development of each country. What has not been sufficiently explored are the proper mechanisms and criteria to set such standards. Of the two direct channels of government influence on labor, workers organizations and legal mandates, the majority of developing countries, have chosen a mix of generous statutory rights and controls over the system of worker's representation. Progress towards a modern and effective system of industrial relations, requires closing the gap between statutory rights and the minimum working conditions that would result from voluntary negotiations between freely elected representatives and employers.

2.2 Factors that affect individual bargaining power

Some individual workers clearly have substantial market power. Workers with rare and valuable skills, or those who have crucial knowledge of the particular enterprise's operations, or those in whom the employer has a significant stake, may have substantial bargaining power relative to their employer. Yet, when one worker is hired to accomplish a relatively standard task and in an environment where it makes little difference which worker gets hired, fired, or leaves, his/her bargaining power is limited compared to that of the employer.

Hirschman (1970) proposed a distinction between "exit" and "voice" to analyze economic relationships. In the labor market, a worker can signal his preferences by choosing to leave (exit) the relationship with one employer and move to another job that offers a better package of workers' benefits. Alternatively, the worker can signal his preferences by staying with the original employer and using persuasion, politics, or other means (voice) to change conditions in the current workplace. These two mechanisms are used to a smaller or larger degree by all economic actors, including employers and workers.

Governments have an indirect impact on worker's bargaining power to the extent that their overall policies promote or hinder economic growth.

The strength of the "exit" or "voice" options as ways to pressure employers for better working conditions are always affected by individual characteristics and by market

conditions. In fact, when the relevant labor market is tight, attempts to gain an increase in wage will be likely to succeed even if they are voiced by workers with no job-specific skills. Governments have an indirect impact on labor market conditions to the extent that their overall policies promote or hinder economic growth. To that extent, it is easy to argue that there is an indirect way to increase workers bargaining capacity and ultimately promote their well-being. That is, to expand their job opportunities through an environment that facilitates economic growth.

2.3 Key influences on collective bargaining power

The right to unionize is considered a basic statutory right. If unionization is indeed a free choice, workers will unionize if the gains from doing so offset the costs. Workers stand to gain from collective bargaining because employers have a higher stake in a group than in an individual worker. However, workers also have to consider the costs of unionizing. These include giving up the right to negotiate their own working conditions, and paying union dues.

The bargaining power of a union is determined in part by the organization of the industry, by market forces, and by legal and political factors. The key economic factor that influences bargaining is the availability of alternatives for the negotiating parties. From the legal point of view, there are four groups of instruments that can influence unions' bargaining power: union recognition procedures (the right to represent workers in collective bargaining and the obligation of employers to negotiate with unions); statutory extension practices (that make collective agreements extend to third parties); union security (that makes affiliation or payment of dues compulsory); and regulations concerning industrial disputes (for example, the right to strike and lock-out, and the right to replace striking workers.) These legal instruments affect the competitive or monopolistic character of unions, which, in combination with the organization of the industry, ultimately determines the impact of unions on wages and employment creation.

Governments have a direct impact on unions' bargaining power through labor statutes.

a. *Competitive unions.* If workers can choose to unionize or not unionize and can choose their leaders in a democratic way, union leaders will work to maintain and expand support from members. This leads them to concentrate in preserving the jobs that their members have, and on improving the conditions of employment for these jobs. In a competitive environment, these objectives can only be met by compromising with management in an effort to increase the efficiency of the enterprise. On the other hand, in a non-competitive environment in the products market, unions tend to organize in a way that allows them to negotiate effectively for a share of rents. For example, if the industry is characterized as an oligopoly, unions are more likely to organize at the industry level and negotiate common working conditions.

b. *Monopolistic Unions* If unions membership is mandatory or the right to represent workers is granted to a majority union, union activities will reflect attempts to maintain

support from the authorities and collective bargaining will represent the interests of large enterprises. Medium and small enterprises will lack effective representation and will be forced to abide by agreements that are acceptable in large enterprises. This will put medium and small enterprises at a competitive disadvantage, and will stall their creation and expansion. This has been, for example, the experience of Argentina (see Cox Edwards, 1996).

c. *Competition in product market.* Competition in the product market restricts the employer response to workers' demands because there cannot be cost shifting to higher prices. Balancing competitive pressure on the product market and worker's incentives often results in a two-tier system of contracts. Workers with "firm-specific" human capital benefit from negotiable long-term contracts. Other workers, whom employers consider "easy to replace" are given fixed-term contracts, and earn salaries that reflect alternative opportunities.

d. *Concentration in the product market.* If there are entry restriction to the product market in question, employers do have the option of raising costs in response to workers' demands, and passing these costs on to consumers, as long as their competitors do the same. In this case, sector-level collective bargaining with sector-wide sharing of rents is an acceptable solution to employers. This is what happened in most OECD countries in the 1960s and 1970s and in many Latin American countries before the trade liberalization reforms of the 1980s.

3. The Indonesia Experience

Figure 1 attempts to capture the evolution of the industrial relations system in Indonesia since independence. Time is on the horizontal axis, and the development of a representative industrial relations system is on the vertical axis. The solid line represents an "average" labor supply price, relative to which we measure statutory rights (with the thick broken line) and voice and representation (with the fine broken line). Following Hirschman (1970), voice and representation may be the result of a functional industrial relations system and may also be the result of dynamic employment creation, which allows workers to vote with their feet. The position of the three lines indicates the premature introduction of statutory rights, above what would have been voluntarily negotiated, and the subsequent introduction of controls on the labor movement.

Generous statutory rights were established in the early 1950s. They included a 40-hour working week and the right to menstruation leave and maternity leave for women. By the mid 1950s, laws had also been passed regulating the procedures and compensation for industrial accidents, labor inspections, child and female work, the right to form unions and bargain collectively, and restrictions on the right of employers to dismiss workers without prior government approval. (Manning, 1993).

Figure 1: Towards a Modern Industrial Relations System

In 1957, the government introduced anti-strike measures in vital industries and for all public sector employees, including most newly nationalized states. The New Order government banned the leftist union and set the stage for the government-backed Indonesia Labor Federation (currently named SPSI) which has been the only recognized union since 1973. Since then, labor policy in Indonesia has been centered around the key objective of preserving stability and creating jobs while avoiding labor unrest. Local officials of the Ministry of Manpower have the initial responsibility for mediating labor disputes. According to regulations dating from 1957, and still in place, any differences that cannot be resolved by local manpower officials have to be mediated at higher levels. This mediation process is handled by tripartite committees at the regional level -- P4D, and at the national level --P4P.

In essence, generous statutory rights coexisted with controlled representation and government intervention in dispute resolution. This two-sided labor policy is directly relevant to the formal sector (which is comprised of public enterprises and modern industry and services), a relatively small portion of the labor market, but with much scope for expansion. Labor policy has been less relevant to the majority of workers in the informal sector.¹

Meanwhile, the economy grew, amid macroeconomic stability and sensible investment of oil revenues. The pace of growth accelerated as a result of the deregulation process that began around 1985. The rapid expansion of manufacturing exports led to strong growth in wage employment, greater scrutiny of violations of ILO standards, and greater pressure on government to respond to criticism of labor standards (see Box 1). These three factors have contributed to increase the strength of the “voice and representation” factor.

Apart from the mounting pressure on the international front to raise labor standards, two additional factors have added a sense of urgency to labor policy concerns. First, the civil rights movement sees increasing worker’s rights as a way to advance human rights. Second, Indonesian policymakers perceive that the benefits from economic development have not been sufficiently shared by workers. The view that an increase in the minimum wage would result in rising wages at the bottom of the wage scale and a reduction in wage differentials is commonly held.

¹ With more than half of the labor force employed in agriculture, the majority of jobs would be considered informal. Workers are the primary managers of their own time, which is typically distributed across various activities diversifying the risks associated to specific markets. (see Sjahrir, 1993)

The government has reacted by increasing workers' statutory rights and by removing obstacles to the setting of enterprise unions, further increasing the strength of the "voice and representation" factor. Minimum wages doubled in real terms between 1988 and 1995. In January 1994 Minister of Manpower Latief revoked a 1986 Ministerial decree which permitted private sector employers to directly call upon Army units to intervene in strike situations. The same year, decree #1 of the Ministry of Manpower legalized a new form of representation at the level of the firm. Meanwhile, the same Ministry has started to be stricter in enforcing labor regulations (i.e. minimum wage). The Ministry of Manpower does not have the capacity to perform its new role effectively, since traditionally it has played a mediation role.

Unlike in earlier periods when statutory rights applied to a minority of workers in modern public sector enterprises, the expansion of manufacturing employment has meant that a much larger proportion of workers are covered, thus expanding the job of the Ministry of Manpower. Figure 1 captures the notion that voice and representation have grown considerably since the early 1990s by having the lower line turn upwards. There has also been an increase in workers' statutory rights, with the increase in the minimum wage. This is captured by a blip in the top line. By letting the bottom line meet the solid line, it is being assumed that Indonesia is moving toward a modern system of industrial relations. The government should aim to close the gap between statutory rights and voluntarily agreed conditions. This requires some correction to the legal standards and gaining experience with the new forms of enterprise unions. We turn to the specifics in section 6.

The central challenge for Indonesian policy makers is to reconcile an effective and representative industrial relations system with the requirements of economic stability and growth.

Box 1: International Labor Agreements and National Sovereignty

Labor conditions, like poverty reduction and overall development, are legitimate areas for international concern. This concern prompted the formation of the International Labor Organization in 1919. Since then, the ILO has developed a set of International Labor Standards, which were drafted in consultation with member States, of which there are 150.

Ratifying an international labor convention commits a country to report regularly on the application of this convention in law and practice. Employers' and workers' organizations have the right to provide information as well. In essence, the ILO conventions act as international pressure for countries to abide by their own labor laws.

Yet each country is sovereign and can choose its own laws. Generally, there is a correlation between the text of a country's labor law and the ILO conventions that the country has ratified and implemented. As the box figure shows, the average number of conventions in force varies significantly by region, the largest being in the OECD, followed by LAC. It is interesting to note that there is a significant variation within the OECD. The United States has only nine ILO conventions in force while Spain has 101. The fact that a country has signed a large number of conventions is not necessarily an indication that its social policy is better than that of other country, but a sign that the country's labor legislation addresses a large number of issues that have been the subject of ILO agreements.

Thus, in response to the international pressure for effective approaches for dealing with social problems, developing countries must devise a strategy that emphasizes economic development and that sets standards that are appropriate for and can realistically be implemented at their level of development.

In 1994 following the NAFTA agreement, the governments of Canada, the U.S.A., and Mexico, signed the North American Agreement on Labor Cooperation. This document established procedures to deal with any dispute that may arise about the application of the labor legislation of each of the three countries. Differences in the interpretation of the laws will be taken to a committee of experts, and ultimately to a Panel of Specialists, who will establish a plan of action. Links between domestic labor standards and international trade agreements can be counterproductive if they become an instrument of protectionism.

With rising pressure for linkage between trade agreements and labor practices, it becomes increasingly important for individual countries to have clear and enforceable labor laws.

3.1 Economic development and the expansion of the labor market

Economic growth has resulted in important changes in the structure of employment and in enormous increases in average productivity (see Agrawal, 1996). The improvement of transportation and communication channels has enabled local producers to have access to a wider market, changing the pattern of work within sectors such as agriculture. Job opportunities have expanded rapidly in services and industry, inducing households to specialize and encouraging workers to move to urban areas for longer and more extended periods of time. A number of self-employment and micro-enterprise activities have expanded to service the basic needs for shelter, food, transportation, and clothing of an increasing number of workers in the urban areas.

It is normal for an expanding economy to experience a change in the sectoral allocation of employment. Economic development is about changing the ways in which societies solve their economic problems. This process involves, among other things, an increased degree of specialization and division of labor and an expansion of the role of markets. One measure of this change is the increasing importance of the services sector compared to agriculture or industry.

The changing composition of employment in developing economies has been recognized in the literature for many years (Kuznets, 1965, Chenery and Syrquin, 1975). One way to capture this change is to examine the correlation between per capita GDP and

employment allocation by sector in all countries at one point in time. Figure 2 is a stylized representation of this relationship, and we can see that in higher income countries, the share of the services sector is greater by far, than that of industry and agriculture.

As per capita income grows, there are a number of things that induce the change in employment allocation. On the one hand, consumption patterns change in the sense that households can afford more than just basic needs items. The opportunity cost of time spent in the household rises (as individuals recognize that there are employment opportunities in the labor market). This encourages a reorganization of the household economy and an increase in labor force participation, especially among young women. There is also an increasing reliance on the market economy and a surge in the activity of, for example, the transportation sector, food vendors, and repair shops. All of these jobs, along with those in commerce, banking, government, health, education, and entertainment, make up the service economy that absorbs an increasing share of the labor force.

Figure 2: Development shifts workers from agriculture to industry and services

Source: World Bank staff estimates; ILO.

As the sectoral distribution of employment changes, the type of employment also changes. From a situation where most workers were self-employed in the agriculture sector, countries experience a steady increase in wage employment as a percentage of total employment. In relative terms, the labor market becomes more important to the household economy in the allocation of time, and trade-offs in that time allocation intensify. Employers must compensate workers in relationship to their opportunity costs if they want to secure a stable and reliable labor force. The changes in organization of production, along with the use of labor-saving equipment, makes possible an increase in labor productivity everywhere.

3.2 Current practices in labor relations in Indonesia

Indonesia is a country in the midst of a rapid transformation. Traditional forms of production coexist with modern ones in a very heterogeneous economy with important regional differences, but with a well- integrated labor market (Manning , 1994). Wages within specific sectors experienced a cycle associated with the real devaluation of the mid 1980s, but have shown no trend. Yet average wages have risen. This suggests that the wages (or the income) of a representative worker have increased as workers move from lower-paid to higher-paid jobs, within and across sectors.

Different regions of the country are characterized by pockets where the labor market is tight but are surrounded by areas where the labor market is slack. For example, in the area around Medan, which is dominated by plantation agriculture, it has been increasingly difficult to find workers for the peak seasons since the mid-1980s. Labor-intensive weeding in plantations has been replaced by the use of chemicals, and every year there are fewer men and young women available for work on plantations. While labor supply can be very elastic to some areas, the possibility of local labor shortages is supported by evidence of rapidly rising wages (above the minimum wage) in some areas and by improved working conditions in other areas. In Medan, an increasing proportion of construction workers were reportedly on weekly (implicit) contracts in 1995. Similar patterns are observed in Java. Godfrey (1993) reports wages rising rapidly in Bandung, and in Jakarta, construction sector wages have been rising since 1987 (Manning, 1994).

Employers typically put in place systems of incentives that link compensation with productivity. They also make widespread use of fringe benefits in an attempt to make jobs attractive and to secure workers loyalty. These benefits include meals, transportation, and often some form of medical coverage. Attempts to change the organization of production as labor costs rise were observed in one cigarette producer in Surabaya. Facing a fast growth in cigarettes sales, and given that the degree of labor intensity in cigarettes rolling is difficult to change, much of the planned addition of labor to the production of cigarettes will be on fixed- term contracts in the villages. This suggests an attempt to relocate production to labor-abundant localities, although it may also reflect a move to increased risk-sharing or to reduce the monitoring costs associated with wage contracts.

Workers move easily between jobs in search of the best working conditions. In garments, for example, workers' mobility is very high, reflecting both instability in the placement of sales orders and the continuous entry and exit of workers to and from the market. This mobility can be interpreted as a form of negotiation, where workers who find conditions unfavorable simply leave the job rather than voice a complaint (see Indraswari (1995) for an account of mobility in manufacturing). There is also plenty of evidence on the mobility of temporary as well as permanent workers across regions, with internal migration becoming a powerful channel for the dissemination of labor markets information. Most workers return to their villages at least once a year to celebrate Ramadan.

On the other hand, labor turnover is extremely low in public enterprises. In these enterprises, employment conditions are characterized by relatively flat basic wage scales, steep age-earnings profiles, and no turnover. These conditions were imposed by collective agreements when the corresponding product (or service) markets were monopolized, and have been maintained in spite of the rapid change that has permeated the rest of the economy. Yet the degree to which this situation can be sustained is lessening due to the deregulation process. In fact public enterprises are already using subcontractors to lower costs, and it is expected that with more competitive pressure on the product side, they will increase the extent to which they subcontract in an effort to reduce the degree of fixity of their production costs.

With practically no rotation of personnel in the public sector apart from voluntary exits, job security statutes have become a problem for the modernization of public sector enterprises. The capacity of these enterprises to adapt to the competitive conditions brought about by deregulation is hampered. Although a change in labor-management practices within public enterprises will create fears among workers that have been in those companies for many years, in the absence of a reform of labor-management to mimic practices among their private sector competitors, the survival of the enterprises themselves is a stake. It is interest to mention here that the experience in other countries shows that a change in the management rules can be sufficient to change the behavior of workers and to change the competitive position of enterprises, with minor, but critical changes in personnel. (For a reference to the case of schools transferred to private managers and their impact on personnel in Chile, see Cox Edwards, 1996a)

4. Current labor regulations

4.1 Statutory rights

An extensive labor protection system is part of Indonesian law. These protections include a minimum wage and the right to form unions. In addition, the law also establishes overtime payments for work above 40 hours a week, the right to maternity and menstruation leaves, a 13th month salary, and job security protection.

Safety, Act#1 1970 (PER04/MEN/1987) gives the Ministry of Manpower the authority to set up Safety and Health Committees to develop safety- related practices at the enterprise level. About 10,000 of these committees are currently functioning. The law also requires employers to report accidents to the Ministry of Manpower. Medical attention is typically offered at the expense of the employer with reimbursement from Astek, the agency that handles contributions towards workers' accident insurance.

Minimum Age As recommended by the National Child Labor Conference, the Ministry of Manpower is currently revising its legislation on child labor. Currently, legislation dating from 1925 allows the employment of children above the age of 12. The government favors a pragmatic approach that will eliminate child labor gradually. Current

draft legislation allows, but restricts, the employment of children between the ages of 13 and 15. Such restrictions include limiting working hours to four, banning employment in hazardous and dangerous environments, and requiring parental consent for children to work.

Job security. Formal contracts, unless established for fixed-term (which is not restricted), are presumed to be permanent. The law establishes a three-months *probationary period* during which dismissals do not require special procedures, nor do they oblige employers to pay severance compensation.

Also exempted from special procedures and severance compensation are the following cases :

- (1) Employment was for a fixed period of time which has expired.
- (2) The worker has resigned in writing.
- (3) The worker has retired or reached retirement age as set in a Work Agreement, Company Regulation, or Collective Agreement.
- (4) An absence of more than six days without a written explanation is considered to be a voluntary withdrawal. This particular article (# 6 PER04/MEN/1986) is the legal tool that is often used to dismiss workers who go on unauthorized strikes.

Other dismissals These are regulated by PER04/MEN/1986. The decree requires that employers negotiate any termination of employment. Employers must request mediation services from the Department of Manpower if negotiations fail to produce an agreement. Mediation results in a decision concerning severance payment. After the local official of the Ministry of Manpower has mediated the dispute (and produced a report), the employer's application for a permit to terminate can go forward to the regional P4D for processing. Decisions reached at the regional level can be appealed at the national level --the P4C committee. These decisions, in turn, can be appealed to the Minister of Manpower. The overwhelming majority of the cases that come before the P4D and P4C committees involve worker terminations.

Dismissals with justified cause. The usual serious offenses (such as drunkenness or absenteeism) are considered just cause for dismissals and eliminate the obligation of the employer to pay severance.

Severance payment. The dismissal bonus is determined as follows:

Service period of less than a year.....	1 month wage
Service period of between 1 and 2 years.....	2 months wages
Service period of between 2 and 3 years	3 months wages
Service period of 3 years or more.....	4 months wages

Those who have served more than five years are also entitled to a service fee:

Service period of between 5 and 10 years.....	1 month wage
Service period of between 10 and 15 years	2 months wages

This goes up to 5 months wages for those with more than 25 years of service. The regulation contemplates the inclusion of a fee to cover the cost of moving to a new job and also any other matters determined by the P4D or P4C committees.

Minimum Wage. While minimum wage legislation is straightforward, in that it sets a minimum hourly wage within each region, the way it has been applied has led to confusion. Part of the confusion is due to the fact that workers often do not receive an itemized statement of their earnings. The legislation is clarified in Circulars SE-6/M/BW/1989 and SE-07/MEN/1990. Any employer unable to comply with the minimum wage provisions as meant in Article 3 (PER-05/MEN/1989) may ask the Head of Regional Office of the Department of Manpower for a postponement (which can be granted for up to 12 months).

Whenever workers receive wages in several components, the basic wage plus any permanent allowances cannot be below the minimum wage. No more than 25 percent of basic wage plus permanent compensation can be paid in kind (where is this rule stated?). The basis for calculating overtime pay is either the minimum wage or 75 percent of total compensation (whichever is larger). The basis for calculating wages for severance is the basic wage plus any permanent component.

There are four additional statutory workers' obligations and rights. The worker and employer contribution to Astek-Jamsostek and the benefits of Lebaran Bonus, Annual Leave, and Special Leaves MM #8 1981.

Jamsostek provides the following social security benefits to workers: (a) life insurance; (b) retirement (provident fund) benefits; (c) free health care for workers, their spouses, and up to three children; and (d) workers' compensation insurance for work related accidents and illness. The law was enacted in 1992 and since then every worker is entitled to Jamsostek coverage, although there is a provision for participation to be phased in over time. The current implementation regulations restrict initial participation to firms with more than 10 employees or a payroll of more than 1 million rupiah. Employers can opt out of the health maintenance program if they have a superior program in place.

Most of the cost of the new social program is to be funded by contributions nominally placed on employers (3.7 percent for health, plus 0.3 percent for death benefits, and a contribution toward workers' compensation insurance that ranges from 0.24 to 1.74 percent), with a small contribution (2 percent for the old age provident fund program) nominally placed on workers. These are fully funded programs without any provision for government subsidy. The regulation requires the entire program to be administered by Astek, a state-owned enterprise, which had the mandate of administering workers compensation programs in the past. (Nayar, 1994)

The Indonesian old-age program is a fully funded, contribution-defined program. Benefits are received at age 55 and are equal to contributions plus accrued interest. In

1991, Astek reported a gross rate of return (without subtracting administration costs) of 14.4 percent on its investment fund, while the average return from the State Bank's time deposits ranged from 20-22 percent depending on maturity (McLeod, 1993).

The health insurance program provides comprehensive medical benefits for the worker, spouse, and three children. Services are provided by a list of approved doctors, clinics, hospitals, pharmacies, and opticians throughout Indonesia. Each of these providers enters into a contractual arrangement with Astek that specifies the scope of services offered, the billing and payment procedures, and the fee or price for each kind of service. Disability pensions are a proportion of earnings that varies with the degree of disability.

The retirement program appears to be well-defined on paper but lacks the discipline of competition on the fund-management side. The health and workers' compensation programs have an inherent problem, which is the fact that they do not seem to rely on co-payments from beneficiaries. So far, contributions are being paid into a fund, and Astek reimburses expenses to those enterprises that make use of the program. However, who is deciding on the type of services that are covered?; How is that decision reached?; and How is the question of "normal fees" resolved? In essence, this system has to be build up to make sure it does not become a source of financial deficits for the government through Astek's budget deficits.

4.2 Regulations on Collective Organizations and Labor Contracts

The right of Indonesian workers to organize and to engage in collective bargaining is established in the 1945 Constitution (Article 28). However, union recognition statutes are very strict. In order for a workers' organization to gain recognition as a union, it must first register with the Department of Home Affairs as a social organization that accepts and support the principles of "Panca sila" -- a set of five principles to guide labor-management relations. "Panca sila" fundamental idea is the rejection of conflict between the interests of workers and management, and an emphasis on common goals, cooperation and conciliation based on "family" principles. (Manning, 1993).

To gain union recognition, a workers' organization must also be able to demonstrate that it was organized by and for workers and has:

- (1) Union offices in at least five of the country's 27 provinces.
- (2) Branch offices in 25 districts
- (3) One hundred plant-level units
- (4) 10,000 members if, because of the nature of the industry, it is so geographically confined that it would be unable to meet standards 1-3 (for example, in mining) (PER03/MEN/1993)

Only one labor organization has been able to meet the requirements for recognition -- the All Indonesian Workers Union SPSI. Two other large labor organizations have

made unsuccessful attempts to gain recognition. The Solidarity labor organization is reported to have been unable to meet numerical standards. The SBSI claimed membership of 30,000 in April of 1993 but was denied recognition on other grounds. With the exception of teachers, public employees do not have the right to join unions or to engage in collective bargaining. The teachers' association (PGRI) was granted union status in 1990, but has not engaged in collective bargaining (Gallagher, 1995).

Recent developments. In 1994, the government introduced a new form of representation at the level of the firm. PER01/MEN/1994 established Company Unions (SPTP). These can be formed in companies that do not have union representation and have a minimum of 25 employees. There can only be one SPTP per company. Members of the SPTP must have Indonesian citizenship, and must be employees of the company but not in management positions. A majority representation (50 percent or more of the eligible workers) is required for the recognition of a SPTP. Employers have to be informed, and the organization has to register at the local office of the Ministry of Manpower. Collective agreements have to be registered at the local Manpower Office and are binding for both of the signing parties.

This new regulation offers a way to formalize organizations that had already developed within enterprises, and it makes it possible for new workers' organizations to be formed. The fact that these organizations have to restrict themselves to representing workers in collective bargaining and that the potential leaders must gain the confidence of employers since they do not have legal protection as union representatives is a very clear attempt to limit the rights of these new organizations and to prevent them from gaining political representation.

A number of firms (publicly owned and well established ones) are reported to function well with workers' representation linked to the official union (SPSI). Other firms (privately owned) are operating with SPTPs (independent of the union movement). Currently, it is estimated that around 1,000 companies operate with SPTPs and about 11,000 have established unions affiliated to SPSI. It is unclear to what extent these new organizations can remain independent in the long run. Article 12 of the law states that "after 12 months of being established, it is suggested that the SPTP unite with the Labor Union of the corresponding business sector."

In spite of this new avenue for representation, in companies with a high degree of employment rotation, the capacity of workers to organize themselves in councils or unions is naturally limited, and it is often this incapacity that triggers public protests by minority groups. Of the 47,000 companies that employ 25 workers or more, only 40 percent of them have signed collective labor agreements with their workers (see Jakarta Post, Friday Nov 24, 1995). The rest of the workers have implicitly agreed to accept company policy regarding their work arrangements, although in most cases, there is no clarity about what that policy is. We turn to the representation question later in section 6.

Dispute resolution systems Disputes and conflict emanating from dismissals or any other breach of contract are to be resolved in accordance with Act # 22 (1957) and #12 (1964). In the case of labor disputes, if either of the two parties (workers or employers) intends to take action against the other (lock-out or strike), their intention has to be notified in writing to the other party and to the chairman of the regional committee. (art. 6 Act # 22, 1957). This starts a process of conciliation during which the two parties are still bound by their continuing contracts. Just as in the case of disputes associated with dismissals, decisions at the regional level can be appealed to higher levels. Meanwhile, if employers were to suspend activities, they would presumably be liable for unpaid wages, and if workers strike, they can be dismissed. The law states that an unjustified absence of more than six days is “just cause” for dismissal.

5. Three Priority Areas for Reform and New Challenges

The regulatory system exists to facilitate voluntary agreements between employers and workers, and it must recognize that any attempts to force alternative outcomes would have an enforcement cost and would require a major implementation effort. There are three areas where current labor regulations inhibit constructive discourse between employers and workers: dismissals; dispute resolution mechanisms; and social security contributions. In addition, there are two important areas of social concern where current legislation is insufficient, and where additional action channels need to be considered: safety on the job and child labor.

As the Ministry of Manpower has concentrated on the implementation of the regulatory system in place, inspectors have experienced serious problems. The reason for this is that some of the regulations are close to impossible to monitor or implement. A revision in the statutes is required. Further progress in the area of labor policy depends also on the way in which government officials communicate their intent and their choice of policy instruments to the public.

5.1 Dismissals: Why is the current legislation inappropriate?

Indonesia’s labor regulations discourage the dismissal of workers and make hiring decisions in the formal sector practically irreversible. The impact of this regulation has so far been contained to because it does not apply to a large proportion of workers that are on fixed term contracts. In fact, an important segment of Indonesian manufacturing operates on fixed-term contracts, job security legislation has virtually no impact there. By contrast, in many other countries, in Latin American, South Asian, and the Middle East, fixed-term contracts are also limited by law, extending the impact of job security regulations to the entire formal sector. It may be argued that this contributes to enhance the competitive position of labor-intensive manufacturing relative to some developing countries. However, to the extent that this regulation slows down the transformation of the services sector, it hurts the competitive position of all export-oriented manufacturing.

The transformation of any economy requires significant labor reallocations. Experience clearly shows that growth in labor productivity, within and between sectors, typically requires the elimination of some jobs and the creation of new ones. The Korean plywood industry is a case in point. Employment in Korea's manufacturing sector grew from 771,000 jobs in 1965 to almost 5 million in 1990. During this period, the manufacturing sector's share of total employment increased from 10 percent to 30 percent. However, this economic success was unevenly distributed across industries and often resulted in the destruction of jobs. Real wages grew rapidly during this period, inducing a productivity-enhancing transformation in plywood industry. Employment in the plywood industry expanded from 23,000 jobs to 32,000 jobs between 1970 and 1979 but then fell after 1980 (see Figure 3).

Figure 3: The rise and fall of the Korean plywood industry

Source: UNIDO data; Republic of Korea Survey of Mining and Manufacturing, various years.

The Korean example is dramatic, yet it exemplifies the impact of competitive pressures on specific industries in all countries. Productivity-enhancing transformation is in part based on the capacity of entrepreneurs and resource owners --including workers-- to leave low-productivity activities and move to higher-productivity ones. Yet, in a number of countries, including Indonesia, government policy protects workers from losing their jobs, or makes it difficult for employers to dismiss workers. These labor laws slow down job destruction, but at the same time they discourage risk taking, and therefore slow down the job creation process in the formal sector.

Recent empirical work in developed and developing countries demonstrates the importance of flows in and out of jobs in the labor market. Hamermesh (1993) examines

evidence for a large number of cases and/or countries and calculates that on average, “For each additional job in the total stock of employment there are nine changes”, including dismissals, attrition, new entrants, and reallocation (see also Davis and Haltiwanger, 1990, 1992; Roberts and Tiebout, 1995).

The essence of job creation is a decision by an employer to seek a new worker for the purpose of engaging in production and of generating profits. Continuity in a worker-employer relationship is a reflection of success in the joint effort, and is typically accompanied by job-specific investments such as training. Job destruction is reflected in a separate decision to terminate an existing employment relationship because the expected profitability of the productive activity no longer justifies its continuation.

Individual workers, unions, and policymakers have traditionally emphasized job security as a means to improve workers’ well being. Nevertheless, the best way workers can respond to the opportunities and risks associated with a more competitive and globalized economy is by increasing their capacity to adapt and to move to better-paid jobs. To facilitate these changes, workers have to rely on well-functioning markets for schooling and training, housing, and other services (such as health insurance) that are sometimes offered as a fringe benefit associated to employment. Furthermore, in a world characterized by abundant opportunities and competitive markets, job security is increasingly offered by the labor market and not by a particular employer. Not only is job security more difficult to guarantee at the enterprise level, but also legal mandates that penalize dismissals tend to discourage risk taking and job creation on the part of entrepreneurs. Furthermore, the illusion that legal mandates would somehow guarantee job security tends to reduce individuals’ incentives to invest in their human capital.

Job security rules are not only a deterrent to taking risks in the hiring process, but they also induce “statistical discrimination” and encourage “poaching.” The high costs of dismissals induce employers to rely more heavily on third party information about workers, including evidence on their performance in other companies, so that the likelihood of having to dismiss them is reduced. For the same reasons, opportunities for workers that come from distant places or from new schools would be limited, since they carry less information for employers.

The Indonesian system can be improved by allowing the termination of contracts by the unilateral decision of the worker or the employer and possibly by establishing a minimum compensation for dismissal. This change would encourage voluntary agreements between workers and employers that allow for the sharing of risks, specially if accompanied by improvements in the system of representation and collective bargaining. It is easy to see that such a change would provide widespread opportunities to entry into jobs that offer longer term employment opportunities, with the terms and duration of those contracts to be negotiable.

As can be seen in Figure 4, the handling of dismissals has become an increasingly important task for the Ministry of Manpower. After a detailed analysis of Indonesia’s

system of labor relations administrative appeals, Gallagher (1995) concludes that it is “a system at war with itself.” He finds that in the three years between 1991 and 1994, 56 percent of the dismissal decisions reached at the regional level (P4Ds) were modified at the national level (P4P), and 15 percent of those appealed to the Ministry of Manpower were reversed at that higher level.

There are two types of dismissal cases that go before the Ministry of Manpower; mass dismissals (often in the context of plant closings) and individual dismissals (where the issue at stake is severance payment. In any given year individual termination cases can represent two times the volume of mass termination cases (although the number of workers affected in the second case can be 20 to 30 times larger). During the two fiscal years of 1992/93 and 1993/94, the number of individual termination cases for cause amounted to 98 percent of that caseload, indicating that an enormous amount of the P4Ps time is spent in adjudicating matters of individual discipline.

Figure 4

Source: Ministry of Manpower

The main reason for the large number of cases that go through mediation is that none of the parties loses by going that route. For each of them, the payoff of going forward with the case is the possibility of turning the case in their favor. If a committee judges a dismissal to be “justified,” the worker gets no severance, else, he/she gets the legally required severance. A system can be conceived so that the two parties stand to lose from going to mediation, encouraging them to settle privately. This can be accomplished by moving in the following direction:

- (1) Recognition of “economic reason” as a motive for dismissal.
- (2) Settlements through official channels must involve predetermined compensation.

- (3) The two parties must stand to lose something if they go through official settlement.

5.2 The question of representation and conflict resolution

As Figure 5 shows, the normal pattern in Indonesia has been one where strikes are of very short duration --around 10 hours on average--. The incidence of strikes declined from 1981 to 1989, and has risen in the 1990s. According to employers' declarations, in a number of these cases, public protest is the first step in the negotiation process between "unorganized" workers and managers. A significant proportion of these strikes take place outside of any process of negotiation, and among unorganized workers, that is, workers who are not affiliated to the official union or to workers' councils.

Figure 5

Source: Ministry of Manpower

This changing trend can be explained at least in part by workers' attempts to win better working conditions at their place of employment. This more aggressive attitude is encouraged, to a significant degree, by favorable market conditions; and to a significant degree, by the more active government involvement in setting wages. To the extent that these claims take place outside of negotiations between elected workers' representatives and managers, they cannot be resolved before the representation question is settled. It can be argued, therefore, that another motivation for the strikes may be to get an opportunity to elect a union.

Improving the Economic Impact of Unions

Unions generally become the vehicle of worker's voice in large industrial establishments where many workers perform similar tasks and face similar working

conditions. Experience indicates that unions (or workers' organizations) contributions to workers' well being is enhanced by a competitive products market, and by a regulatory framework that protects the right of individuals to make choices including that of joining or not joining unions.

In Indonesia, employers are obliged to negotiate with official unions affiliated with SPSI. Recent change in the legislation (PER01/MEN/1994) gave workers the right to negotiate through independent organizations (SPTP). However, it is the prerogative of the employer to recognize an independent workers' organization SPTP for collective bargaining purposes. In the absence of "duty to bargain," collective bargaining with independent organizations is voluntary for employers, and puts the burden of persuasion on workers.

The new law states that in order to gain representation, a prospective organization must get support from 50% of the workers in a company. One of the important steps in securing the implementation of Decree #1 of 1994 is to find an accepted procedure for voting toward unionization in a company. For example, this procedure may rely on secret balloting in the presence of an independent observer. Clear procedures are essential because all parties involved (workers, employers, the public in general, the Ministry of Manpower) must recognize that there will be successful as well as unsuccessful attempts to gain collective representation. Since there are costs and benefits associated to organizing company unions, a low level of unionization should not be interpreted as a sign of weakness of the labor movement or as an effort of the government to suppress unions, but rather as a sign that unions are a preferred way of bargaining for some but not all workers.

If Indonesia wants to continue its economic transformation, it has to be prepared for further expansion in employment in modern enterprises where personnel management and incentive structures within firms are important elements in establishing a comparative advantage. Pay scales, hiring, promotion, and firing decisions are central in performance evaluation and also in competitive strategy. Individual and collective bargaining are at the center of labor-management relations in a given enterprise, and industrial action (or the real threat of it) is generally part of any negotiation strategy. By eliminating this step and by requiring public intervention instead, negotiations will fail to be influenced by market conditions.

Labor Regulations and Industrial Relations

Disputes and conflict emanating from dismissals or any other breach of contracts are to be resolved in accordance with Act #22 (1957) and #12 (1964). If either party intends to take action against the other (strike or lock-out), their intention has to be notified in writing to the other party, and to the chairman of the regional committee (art 6 Act #22, 1957). While these steps take place, any suspension of activities by employers requires them to pay salaries, and any absence of workers from work will represent a loss of wages. This is clearly stated, and internalizes the costs of disputes to the parties. After six days of unjustified absence from work, individual contracts can be terminated, and

unless otherwise agreed in a collective agreement or stated in company policy, workers can be dismissed without severance. This means that the strength of workers and employers positions in collective bargaining is strongly determined by labor market conditions.

In short, in Indonesia workers have the right to strike although they face the risk of losing their jobs. This is also the case in other countries, where employers can replace striking workers temporarily or permanently. Without the expectation of intervention, employers and workers would have a more precise estimate of the potential costs and benefits of prolonging a dispute, and rational behavior typically would lead the parties to no industrial action.

While there is no need for the Ministry of Manpower to intervene in disputes, a number of disputes have arisen over matters of regulations such as dismissal procedures, or enforcement of minimum wages. Indeed, the increased involvement of the Ministry of Manpower in the determination of wages (after doubling the minimum wage between 1988 and 1995) is an invitation to intervention in dispute resolution over wage setting. When public authorities intervene in the resolution of disputes, strikes tend to become objects of political battles for or against the government. In the case of Indonesia, for example, workers can try to get a wage increase by pressuring the government to increase the minimum wage.

Moving towards a situation where conflict resolution is influenced mainly by labor market conditions requires scaling back of intervention in matters such as wage determination, and more appropriate regulation to handle dismissals.

5.3. Social Security Contributions

Social security contributions are currently a small proportion of labor costs. However, unless further improvements are made to ensure financial discipline, and guarantee a link between individual contributions and individual benefits, social security contributions can become a tax. The evidence from other countries is of critical interest here (see World Bank, 1994).

Payroll taxes tend to increase labor costs and to reduce real wages with a negative effect on employment. If there are weak links between social security contributions and social security benefits, contributions are transformed into a tax. Workers and employers will try to evade the tax by changing their employment status or simply by underreporting their earnings. For example, a study of the Brazilian social security system found evidence of workers staying in the informal sector as long as possible, and switching to formal employment only to meet the requirements of the pension system.

Moreover, since the liability of the pensions system remains, these problems surface in the form of public sector deficits after some time. There is evidence of very low compliance with the current Indonesian system and in the absence of change, the

government runs the risk of having to finance pensions, accidents insurance and health care for a growing uninsured population.

5.4 Other challenges

The analysis behind Figure 1 assumes that workers evaluate employment options, and take jobs that offset their opportunity cost of time. If the opportunity cost of an individual's time is equal to the social cost, the choice made by individual workers is the best choice from the point of view of social welfare. But, there are at least two cases where this assumption may not be appropriate; "unsafe" jobs and child labor. In both these cases, workers' benefit from taking the job falls below the actual salary they receive, and therefore, the employment choice is welfare reducing. This is why it is considered appropriate labor policy to intervene in efforts to promote safety, and in efforts to eradicate child labor. The main question that each country must deal with is: How to intervene? and, What policy instruments to use?

Safety on the job Addressing the diverse types of safety and health hazards that result from a wide range of industrial activities goes beyond the realm of an organization such as the Ministry of Manpower alone. In Indonesia, there are four clearly identified groups motivated to act in this area; employers, workers, Astek, and the Ministry of Manpower. Employers are interested in avoiding interruptions in their operations and minimizing production costs. If unsafe practices lead to costly operations or delays, they will pursue safer methods. Workers are interested in preserving their health and safety to the best of their ability. Therefore, information that persuades them that a safer practice will free them from risks will encourage the adoption of safer practices by them. Astek manages reimbursements for expenses associated with accidents involving workers covered by insurance. The Ministry of Manpower is in charge of monitoring the enforcement of safety standards established by law, as well as encouraging safe practices through enterprise committees. There is room for improvement in terms of encouraging safer methods.

Astek has a monopoly on mandated workers' insurance programs. Monopoly power reduces Astek's incentives to develop a "fair" insurance system. In other words, it is possible that the contributions from the insured companies are unrelated to the costs of reimbursements to the injured workers or their families. Attention to links between contributions and benefits (incomes and expenditures) would come naturally to a competitive market for insurance, and that would help encourage sector-specific and company-specific safe practices. In the case of the Ministry of Manpower's role, more attention to impact will improve policy making. A shortcoming of the current role of the Ministry of Manpower in the safety area, is that its work and collected information in terms of compliance does not feed any data base, and does not seem to be used to conduct research linking safety practices and the incidence of accidents. In order to direct attention towards impact, the Ministry must keep records on accidents, and examine the impact of safety monitoring on the incidence of accidents.

Nevertheless, the evidence from other countries is not conclusive in terms of the role of safety and health standards on the promotion of safe work habits. This is an area of policy making that becomes very complex, and where monitoring and implementation costs are very steep. Yet, it is clear that the promotion of worker's safety cannot rely solely on more inspectors under the Ministry of Manpower.

Programs that provide compensation for work-connected injuries and occupational illnesses have a long tradition in the world. There are two basic types of systems: (1) social insurance systems utilizing a central public fund and (2) various forms of private arrangements required by law. About two-thirds of the countries that provide compensation operate through a central public fund and risk premiums are typically set by industry, meaning that all construction companies pay the same contribution towards workers' accidents risk. Among the countries that rely primarily on private arrangements, about 20 countries, including the United States, require employers to insure their employees against the risk of employment injury. In about half of these countries, only private insurance is available. In the remainder of the countries, a public fund does exist, but employers are allowed to opt out of the public system.

Private or mutual insurance companies charge premiums for work injury protection that vary according to the past experience of work accidents in different industries and even in the same firm. Thus, the cost of protection varies widely. In most countries the social security system deals with (legally established) compensations and medical expenses associated to workers' accidents. Safety standards are often the responsibility of the Ministry of Labor, and the consequences of accidents on the job are the responsibility of the social security system.

In most countries where workers' the risk of accidents insurance is covered by insurance policies provided by a competitive market, insurance agencies try to link safety practices to insurance premia. In case of an industrial accident, ultimately, the question of liability is determined by the extent to which accidents occur in spite of compliance with safety standards or in violation of the same standards. In other words, there is a system of incentives that encourage insurance agencies to push for strict standards, and employers to comply with those standards. The work of the Ministry of Labor in keeping records of safety inspections is a way to certify (as an independent arbitrator) that certain procedures are followed or not followed, which in turn, shifts the risk of accidents to enterprises or insurance agencies. In the case of Indonesia, the data on inspections could be used by Astek to determine insurance protection. Further links between the work of these two institutions can help internalize the costs of unsafe practices.

Child labor According to official estimates, there are about two million child workers between the ages of 10-14 years in Indonesia.² The prevalence of child labor is

² Other estimates put the number of children working in the industrial and informal sectors alone (i.e., in factories and on the streets) at 2-3 million.

linked to poverty and to poor quality or availability of education. Thus, as Indonesian incomes have risen and as education has spread, child labor has declined. According to official estimates, between 1986 and 1994, the total number of working children declined by about a quarter. What is worrisome, however, is that during this period, the number of children working in urban areas has doubled. This rapid urbanization of child labor is disturbing since it is more likely to be associated with exploitative forms of child labor. Children working in urban areas work much longer hours than those in rural areas. A quarter of all urban working children work more than 45 hours a week and a third of these work more than 60 hours a week. These kinds of working hours will not allow these children to obtain an education and are likely to trap them in a lifetime of poverty.

Since poverty is the main cause of child labor, there are no simple solutions for dealing with this complex problem. For example, banning child labor outright might only serve to further increase the poverty of the families involved. However, an effort needs to be made to tackle the problem of child labor since this, in turn, causes future poverty. The Ministry of Manpower recognizes that legislation alone, even if it could be fully enforced, will not be able to solve the problem of child labor. Tackling this difficult problem will require a concerted and cooperative effort by various government and non-government agencies. In particular, DEPNAKER will work with other Government agencies that administer programs that have an impact on basic education (Department of Education) and poverty alleviation (such as the IDT program administered by BAPPENAS), to try and tailor these programs to the needs of working children and to provide incentives to parents to withdraw their children from the workforce and to give them an education instead. In its efforts to eradicate child labor in Indonesia, the Ministry of Manpower seeks the help and cooperation of all partners, including NGOs and donor agencies.

The National Child Labor Conference in 1993 brought together a number of agencies to discuss child labor for the first time, and a plan was developed with clear goals and deadlines. In the first two years, the Government insisted that the program focus on child labor in the informal sector only, and it was also recommended that ILO-IPEC should work exclusively with NGOs with a religious affiliation. In conjunction with National Education Day in May 1994, the Government officially announced the nine-year universal education program (7-15 years of age). Although not specially designed for working children, this program is one of the few government programs that attends to their needs. (see ILO, 1995).

Starting with a measurable goal, paying attention to progress, and seeking the cooperation of all partners involved would allow Indonesia to show that the country is effectively addressing the problem of child labor.

6. Lessons from the experience of other countries

The experience of the United States, that of Chile in the Latin American context, and that of Malaysia are of particular interest for this Indonesian study. The case of the United States is illuminating because, since the late 1930s, the legal framework has guaranteed voluntary affiliation and encouraged collective bargaining in good faith. This case helps to illustrate the implications of voluntary affiliation. In fact, union affiliation in the United States reached a peak in 1954 at an unexpectedly low rate of 25 percent, and since 1975 union affiliation has been in the decline. This experience can be contrasted with that of Latin American labor laws, which gave governments tight control over the labor movement.

The case of Chile is of special interest because of the major reform in the legislation on collective organizations and collective bargaining that took place in the early 1980s. By mid-1979, the Pinochet regime decided to legalize collective bargaining and to eliminate a series of restrictions imposed on the labor movement. Under pressure from the international labor movement, led by the AFL-CIO, the government had a change of heart and decided to lift restrictions on the labor movement. However, this time, labor policy had to be consistent with a market-oriented economy that was trying to compete in the exports market, and collective bargaining had to be a vehicle for better labor relations and increased productivity rather than being a vehicle of political opposition.

Malaysia's experience with industrial relations can be particularly relevant to Indonesia, given that it is a newly industrialized country in East Asia, it is rich in natural resources, and it has experienced rapid export-oriented growth. In order to simplify the comparative analysis, the rest of this section is divided in two parts --first, a discussion on workers organizations and collective bargaining followed by a sub-section on statutory rights.

6.1 Collective Bargaining

United States The National Labor Relations Act (NLRA) of 1935 is the essence of the United States' system of collective representation and union bargaining, as it guarantees the right of workers to form unions and to bargain collectively with their employers. Under the NLRA, public power would be used to compel and facilitate bargaining in good faith but not to dictate results. When the NLRA was passed, it was widely expected that virtually all of the major branches of industry and commerce would be more or less rapidly unionized. Collective bargaining would therefore become the usual or predominant form of industrial relations. While this expectation was not realized, for roughly three decades from around 1945 to the mid-1970s, collective bargaining served as the principal source of worker's rights.

During the 1947-75 period working conditions improved for most workers, irrespective of their union status. How can this fact be explained? Some would argue that non-union workers benefited indirectly from the work of unions in two ways: through emulation and through statutory extension. Emulation took place when employers made concessions in order to avoid unionization or to keep up with the market. Statutory extension took place as benefits became widespread and workers and their representatives lobbied for the enactment of laws. For example, the national Occupational Safety and Health Act grew directly out of union campaigns about lung diseases. The growth and problems of private pension plans eventually generated public support for regulation that led to the passage of the Employee Income Security Act in 1974 (Edwards, 1993).

An alternative explanation is that working conditions improved because market conditions permitted them to do so, in essence, because there was a rapid expansion in labor demand that supported wage increases. Unions were a positive form of organization that gave a voice to some workers but were not attractive to all workers. Without a significant change in the legal framework, the decline in unionization after 1975 appears to be a manifestation of workers' preferences. In other words, non-unionized workers simply do not see unions as being effective agents on their behalf.

Latin America As early as the 1920s, Latin American governments introduced legislation that guaranteed workers' rights, and at the same time, established public controls over the resolution of labor conflicts. This legislation often controlled the right to strike before it regulated individual contracts. In the following decades, further legislative changes gave individuals guarantees, the most important of which was that of job security.

Sandoval (1993) describes the evolution of strike activity from 1945 to 1989 in Brazil, a country that, like most other Latin American countries, promoted a bureaucratic union structure and where conflicts often became confrontations with public authorities. He finds that, in the period 1945-68, fluctuations in real industrial product and real wages showed moderate correlations with the frequency of strikes. On the other hand, when the 24 year span was subdivided into three periods according to the predominant type of political rule, the relationship between the variables become stronger, although it changed from regime to regime.

Latin American governments maintained a close control over collective bargaining through their role in conflict resolution until the 1970s when conditions began to experience a major transformation. A number of countries entered the phase of military dictatorships, and in this context, not only was the traditional cooperation between political leaders and the union movement ended, in many cases, unions were banned. With the restoration of democracy in the 1980s, unions were reestablished as political organizations but this time in a rapidly changing economic environment, marked by trade liberalization. In some countries, governments reconsidered their regulatory role in the labor market, and have contemplated and occasionally (in Colombia, Chile, and Peru)

implemented reforms to the labor legislation. It is perhaps not a coincidence that these three countries are the ones with the most vigorous employment creation in the region.

Labor reforms in Chile took place in the context of broad market-oriented reforms, the combination of which brought back dynamism in economic growth and employment creation. It is interesting to note that the labor reforms were implemented under international pressure and under the threat of a trade embargo proposed by the powerful AFL-CIO and supported by union representatives from the entire American continent. This pressure induced the military to restore workers' rights to unionize and bargain collectively. Moreover, in the spirit of market orientation, the new law reduced the government's role in union recognition and dispute resolution.

Figure 6

Source: Cortazar, 1995

The labor reforms introduced in Chile in the late 1970s made union representation contestable. Union affiliation became voluntary even in enterprises with union representation. More than one union could coexist in the same firm, breaking with the tradition of exclusive union representation given to a majority group. If voluntarily agreed, negotiations could take place at the sector level between sector-wide unions and sector-wide employers' representatives. Yet the reform eliminated the "duty to bargain" at any level above the enterprise. Employers were obliged to negotiate with enterprise unions only. As Figure 6 shows, employment has been growing steadily, and in particular, wage employment has increased very sharply since the mid 1980s. While wage employment has grown at an average annual rate of 3.6 percent since 1977, the overall number of unionized workers has remained at levels similar to the early 1970s, resulting in a sharp decline in the unionization rate. Not surprisingly, the structure of workers' representation has changed significantly since, and enterprise unions have become more typical, with a decline in the average membership per union (see Figure 7).

Figure 7

Source: Cortazar, 1995.

The possibility of hiring workers temporarily or otherwise to replace striking workers had been restricted in Chilean law until the reforms of the early 1980s. The reform lifted that restriction. Currently, the law gives employers the right to hire temporary replacements from the first day of a strike as long as the last offer rejected by striking workers was equivalent to the previous compensation adjusted for inflation and offered further automatic adjustments. Temporary replacements are allowed only after 15 days of a strike if the last offer did not keep up with cost of living adjustments. At the same time, individual workers are guaranteed the right to return to their jobs at the same real wage (allowing for the cost of living adjustments) after 15 days of strike in the first case and after 30 days in the second case. This law induces employers and workers to think in terms of the costs and benefits of rejecting each other's offers and brings an economic rationale to the resolution of industrial conflicts. This economic rationale encourages the parties to resolve their disputes quickly and in a bilateral way.³

In Chile, labor reforms were put in place after broad market-oriented reforms, and after the country had seen two episodes of major real exchange misalignment and high unemployment. After labor reforms, the economy recovered its economic growth and employment—particularly wage employment—has been growing steadily. Real wages rose 20% between 1989 and 1994, and strike activity has been substantially lower than in the pre-military period. Estimates of the level of labor-related conflicts for the period 1988-91 shows that they have declined to about one fifth of their 1966-70 level (OIT, 1994)

Malaysia. Unions require the prior authorization from the government in order to legally represent workers in collective bargaining. Malaysian law gives considerable authority to the Registrar and the Ministry of Labor, and to employers who have to “recognize” the unions in a rather lengthy procedure. For example only 33 percent of trade union attempts to take part in collective bargaining in 1988 succeeded outright (Nayar, 1995). Unionized enterprises in Malaysia's manufacturing sector are

³ It should be noted that there have been attempts by the union movement to eliminate this “right” from the Chilean labor law. There is also a proposal to introduce employer “duty to bargain” with unions that represent workers across enterprises. These are both efforts on the part of unions to gain bargaining power by law.

characterized by a highly structured wage determination process that leads to built-in wage increases that are downwardly sticky. Although only 17 percent of the labor force in the formal sector are members of unions, their practices have an important effect on the rest of the formal sector (Gill, 1994).

The right to strike is very restricted and, in fact, the Minister of Labor has substantial powers to intervene in the dispute resolution process. A strike, to be legal, must be called by a registered union on behalf of its members and must receive two-thirds majority in a secret ballot. There is a cooling off period of 7 days after the Registrar has been notified of the intention to strike, and a strike must be suspended if the Minister calls an investigation or if the matter is being examined by the industrial court. Malaysian law does however specify that workers that have gone on a legal strike cannot be dismissed on grounds of absenteeism and workers may be represented by organizations other than a registered trade union in the industrial court. Workers may not strike over the enforcement of a collective agreement, since disputes over agreements recognized by the court should be dealt with in court. Strikes cannot take place over issues considered “managers prerogative” as collective bargaining over these is not permitted. (Nayar, 1995).

6.2 Statutory Rights

Listing the specifics of statutory rights in every country is an exhausting task. Here, we focus our attention on the most basic issue: Are statutory rights an effective tool to achieve their principal stated purpose? Edwards (1993), in his analysis of the United States case, put the question in exactly the same terms. He concluded: “No single assessment fits all protective legislation” yet a pattern emerges. The most successful legislation is that which regulates the simplest aspects of the workplace, but even with the most successful regulations, it is very difficult to ensure adequate compliance. If a law attempts to regulate behavior where moral authority is weak or enforcement is difficult or costly, it is likely to be ineffective.

For example, the right to a minimum (hourly) wage involves a straightforward, easily understandable aspect of employment, as long as its level is kept at or below market equilibrium. In contrast, the right to a safe workplace is more complex. If compliance is difficult to detect or enforcement requires the intervention of technical expertise, the practical justification for statutory regulation weakens, and its impact tends to fade (Edwards, 1993)

Figure 8: Average Weekly Hours Worked in Manufacturing. United States, 1890-1991

United States The first statutory rights were the minimum wage and overtime provisions of the Fair Labor Standards Act, which became fully effective in 1940. Note that this is five years after the NLRA which guaranteed the right to unionize and bargain collectively. Because the set standard made the 41st hour of work much costlier, it was expected that the use of overtime would decline. As Figure 8 shows, after 1940, average weekly hours in manufacturing converged around 40. Recently, however, costs for medical insurance, social security contributions, and other benefits have become a much bigger percentage of the typical wage bill, thus reducing the impact of overtime premium on the choice of hours.

There are several factors that explain the effectiveness of overtime provisions. First, the law did not force a major change in practice since, as the figure shows, average hours worked had declined before the passage of the law. Second, the right created under the law seems to be an accepted practice, is unambiguous, reporting is minimal, and enforcement is straightforward. In addition, workers have an incentive to abide by the law, since overtime represents an increase in their pay.

In spite of the fact that the minimum wage and the overtime premium regulations are easy to enforce, there is evidence of non-compliance in the United States. The most frequent violators of the minimum wage rule are in retail trade, where, in 1979, an estimated 12 percent of establishments broke the law. The most frequent violators of the overtime provisions were services (29 percent), wholesale trade (25 percent), and retail trade (24 percent) (Edwards, 1993).

The regulation designed to safeguard the pensions of workers enrolled in private-employer pension plans is a long and complicated statute, and so far it can be considered to have been only moderately successful. The provision of workers' rights by other federal statutes has produced mixed results. These include the 1988 WARN act, which requires employers to give advanced notice in case of dismissals, the Civil Rights Act of 1964, which gives legal protection against discrimination on the basis of gender, color, or age, and the Equal Pay Act of 1963, which guarantees equal pay for equal work to men and women. The most complicated statute concerned with workers' rights is the Occupational Safety and Health Act, which attempts to ensure so far as is possible safe and healthy working conditions. The authority for administering this Act lies with the Ministry of Labor, which in turn delegates it to an agency (OSHA) within the Department of Labor.

The United States' experience suggests that statutory rights are a limited instrument for achieving social policy goals. Legal statutes tend to be most effective when they deal with the most basic aspects of work and when they address practices that are generally accepted. This is very important because enforcement depends on all the parties involved. In short, the search for better ways to achieve social policy goals cannot begin nor end with the introduction of a legal mandate.

Latin America. Minimum working standards include minimum working age, minimum wage, normal work schedule, and overtime premium. In most countries in Latin America, labor legislation goes beyond these basic legal rights, and establishes detailed conditions for all workers in the economy (such as limits to temporary contracts, legal barriers and employer's liability in case of dismissal, vacation days, other fringe benefits).

Throughout the region, social security systems generally entitle workers to pensions, health care services, and accidents insurance. These systems were initially planned to be funded by employee and employers contributions, but they eventually resulted in very large deficits. Benefits were very attractive in the early years of the programs, but as they have aged, access to benefits has occasionally been rationed, contribution rates have been raised, and benefits have been reduced with the stroke of a pen. Gradually, contributions have become a tax, and the benefits are considered to be an entitlement. In many countries as pension programs have become financially insolvent, funding for health care has been reduced, and eventually the unfunded liability has been imposed on the rest of the economy.

A number of countries in the region are trying to replace this current pay-as-you-go pension regimes with a combination of individual capitalization accounts and minimum

services insured by the government (see World Bank 1994). This type of system has been in operation in Chile since the early 1980s, and is currently in the process of being implemented in Argentina, Colombia, Peru, and Mexico. Reforms of the health care system are taking longer to be defined, but are also under consideration. Both can have a very important effect on the efficiency of the labor market if they reduce payroll taxes, and their distortionary impact.

Latin American labor legislation has a long tradition of protecting job security. Measures include severe limitations on temporary hiring and substantial costs—in the form of severance payments—for dismissals without “cause”. The labor market impact of employment protection laws largely depends on how firms and workers perceive them. If severance is seen as a delayed payment scheme, its effect on hiring and other decisions is minimal. But, in most cases, severance payments are directly related to the worker's tenure in the firm, typically in the form of “x monthly salaries per year of service”. This legislation uses one policy instrument to address two policy objectives --penalizing wrongful dismissals and providing unemployment insurance. The problem is that neither objective is well served. Firms devise ways to reduce the costs associated with mandated severance payments, and employees attempt to transform voluntary quits into dismissals in order to be eligible for severance payment. The law has the effect of transforming labor into a fixed factor. Because of this, hiring and firing decisions are subject to delays and temporary contracts are informal (see Cox Edwards, 1995).

Reducing the payoff associated with litigation, and transforming severance payments into a deferred compensation scheme would greatly increase the degree of efficiency of Latin American labor markets. Reducing litigation payoffs requires defining employer's liability in case of dismissal for economic cause as well as in the case of dismissals without “cause.” Argentina and Chile have allowed this distinction in their legislation. Some countries have begun to transform severance payments into deferred compensation plans. Reducing the payoff associated to litigation, would put benefits in the hands of workers quickly, when they are most needed, and induce employers to make hiring and firing decisions without delays, helping the dynamism of the economy.

Malaysia There is no minimum wage in Malaysia. There is a contribution-defined provident fund system financed with workers and employers contributions, and managed by the public sector. Contributions to retirement provident funds have more than doubled between 1950 and 1994. Payroll contributions in Malaysia are already between 20 and 25% of total labor costs. Fringe benefits (some of them mandated by law, and many negotiated voluntarily) are an important component of labor costs. One of the issues that comes out at high levels of payroll taxation such as in Malaysia, is the definition of taxable wage, because imaginative formulas of compensation are devised in attempts to get around taxation.

7. Conclusions

The central challenge for Indonesian policymakers is to reconcile an effective and representative industrial relations system with the requirements of economic stability and growth. Apart from mounting pressure on the international front to raise labor standards, two additional factors have added a sense of urgency to this challenge. First, the civil rights movement sees workers' rights as a way to advance human rights. Second, there is a widespread perception in Indonesia that workers have not shared sufficiently in the benefits of economic development, and many hold the view that an increase in the minimum wage would result in rising wages at the bottom of the wage scale and declining wage differentials.

In response to these concerns, the government has increased workers' statutory rights and removed obstacles to voice and representation. Minimum wages doubled in real terms between 1988 and 1995. In 1994 the government repealed a controversial decree authorizing employers to ask the military to intervene in labor disputes, and Decree #1, 1994 of the Ministry of Labor legalized a new form of representation at the level of the firm. Meanwhile, the Ministry of Manpower has begun to more strictly enforce government regulations such as the minimum wage.

Unlike in earlier periods, when statutory rights applied to a minority of workers who were in modern public sector enterprises, the expansion of manufacturing employment has meant that a much larger proportion of workers are covered by these statutes, thus expanding the job of the Ministry of Manpower. The Ministry of Manpower does not yet have the capacity to perform its new role effectively, however, since traditionally it has played a mediation role.

This paper has argued that voice and representation have grown considerably since the early 1990s. There has also been an increase in workers' statutory rights and in the minimum wage. The government should now aim to close the gap between statutory rights and voluntarily agreed conditions. This requires some correction to the legal standards, lessening government intervention in labor disputes.

The regulatory system should ideally exist to facilitate voluntary agreements between employers and workers, and it must recognize that any attempts to force alternative outcomes would have an enforcement cost and requires a non-trivial implementation effort. There are three areas where current labor regulations in Indonesia inhibit constructive discourse between employers and workers: dismissals, dispute resolution mechanisms, and social security contributions. In addition, there are two important areas of social concern where legislation is insufficient and where additional actions need to be considered: safety on the job and child labor.

The Indonesian job security legislation can be improved by allowing the termination of contracts by the unilateral decision of the worker or the employer, and possibly by establishing a minimum compensation for dismissal. The question of workers representation has been addressed with the passage of the 1994 Decree #1 of the Ministry of Manpower. The challenge now is to implement this new law.

If Indonesia wants to continue its economic transformation, it has to be prepared for further expansion in employment in modern enterprises, where personnel management and incentive structures within firms are important elements in establishing a comparative advantage. Pay scales, hiring, promotion, and firing decisions are central in performance evaluation and in competitive strategy. Individual and collective bargaining are at the center of labor-management relations in every modern enterprise, and industrial action (or the real threat of it) are generally part of any negotiation strategy. By inviting public intervention rather than allowing this mechanism to operate, negotiations become isolated from market conditions. This is detrimental for all sides in the long run, because it contributes to a misallocation of resources.

The legislation in most countries does allow the possibility of industrial action, which is an instance where the seriousness of workers' demands is measured against the seriousness of the employer's refusal. What is the role of the public sector authority in countries where strikes and lock-outs are real options? It is generally not the obligation of governments to intervene on behalf of either side. Without intervention, employers and workers have a more precise estimate of the potential costs and benefits of prolonging a dispute, and rational behavior typically leads them to take no industrial action, in spite of the freedom to take such action.

The retirement program established in 1992 appears to be well defined on paper but lacks the discipline of competition on the fund-management side. The health and workers' compensation programs have an inherent problem, which is the fact that they do not seem to rely on co-payments from beneficiaries. So far, contributions are being paid into a fund, and Astek reimburses expenses to those enterprises that make use of the program. However, who is deciding on the type of services that are covered? How is the question of "normal fees" resolved? In essence, this system has to be built up to make sure it does not become a source of financial deficits for the government through Astek's budget deficits.

There are two areas where the Ministry of Manpower needs to cooperate with several agencies to advance social goals. These areas are safety in the work place and child labor. In the particular case of safety, the responsibility of the Ministry of Labor in inspecting establishments has to be linked to a goal and requires funding. Successful reforms to labor policy are a critical component in ensuring continuity in the social and economic development of Indonesia.

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