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Labour Reforms in Indonesia: Essential but Political Economy Challenges Remain

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The Context

Indonesia, Southeast Asia's largest economy, with GDP (Gross Domestic Product) at current prices of USD 1119 Billion in 2019 (0.93% of the global GDP, 16th highest globally), and GDP in PPP (Purchasing Power Parity) terms of USD 3737 Billion (7th highest in the world) [1], is attempting to utilize the COVID-19 pandemic crisis to undertake structural reform in product and factor markets, to attract inward FDI (Foreign Direct investment), and to make the economy globally more competitive.

According to the World Bank, Indonesia's GDP per capita at current market rates in Indonesia was USD 4451 in 2019, equivalent to 35% of the world's average. The GDP per capita in PPP terms was USD 11, 812 in 2019.

According to UNCTAD's (United Nations Conference and Trade Investment World Investment Report 2020, FDI investment in Indonesia increased by 14% between 2018 and 2019, achieving USD 23.4 billion; while FDI stock reached USD 232 billion in 2019. As with most countries, Indonesia's inward FDI is expected to be lower in 2020 as compared to 2019 [2].

IMF in its October 2020 analysis of the Asia-Pacific Region, estimated Indonesia's real GDP growth at negative 1.5% in 2020, and positive 6.1% in 2021[3].

In 2019, World Bank ranked Indonesia in the 73rd position out of 190 countries, a significant improvement over2014 when it was ranked 120th[4].

The Theme

Among the key reforms being pursued by the Indonesian government led by President Joko Widodo (popularly known as Jokowi), are the labour market reforms, with are a part of the Omnibus Law on Job Creation passed by the parliament in early October 2020.

But as with many countries where there are entrenched interests around current labour market arrangements, the policymakers are finding it challenging to implement them.

Indonesia's experience, particularly highly negative association between severity of labour laws, including severance pay, and the level of compliance, may have implications for other middle-income countries.

An Overview of the Omnibus Law on Job Creation

The Omnibus Law on Job Creation, passed by the Parliament in early October 2020, has revised a multitude of existing laws and regulations concerning employment, business licensing processes, and investment. The Law is hundreds of pages long, due to the fact that it is amending as many as 79 laws with more than 1200 clauses. The Omnibus Law is 905 pages long.

The Omnibus Law provides a legal structure for the removal of the multiple layers of regulation at various levels of government that potentially impede investment.

The Omnibus Law includes the Labour Law, the Spatial Planning Law and Environmental Management Law.

Nearly half of Indonesia's population of 270 million is under the age of 30. The policymakers argue that the current labour utilizing its young population. This benefit will diminish substantially within next three decade. Time is therefore of essence.

The Law includes significant revisions to the 2003 Manpower Law with the aim of reforming functioning of the labour markets in Indonesia. Indonesia's labour market regulations have been considered by most academic analysts and the World bank, IMF, Asian Development Bank and other institutions who have large loan exposure to Indonesia, as among the most stringent, and in need of urgent reform.

Table 1 summarizes the key changes in the labour market regulations under the October 2020 Omnibus Law.

- Severance Pay

A 2011 study concluded that:

"…*severance pay (and job protection in general) of developed countries poses less restrictions on employers as the one of developing and transition countries: it offers less generous payments, it is simpler to administer (and hence it generates less costs), and it is often not mandated but determined by collective bargaining or firm level decisions. This is another indication that in a globalized world, improving labour market outcomes and increasing 42% productivity by the creation of a more flexible labour market – among others by liberalizing overly restrictive employment protection legislation – is inescapable.*"

Robert Holzmann, Yann Pouget, Milan Vodopivec, and Michael Web, 2011. "*Severance Pay Programs around the World: History, Rationale, Status, and Reforms*" Institute for the study of Labour (IZA), Bonn. Germany, DP No. 5731 [5]

The official estimates in Indonesia are that less than 10% of firms comply with the legal severance pay provisions. This is both inequitable and counterproductive for job creation and economy. This creates a strong rationale for the changes stipulated in the Omnibus Law.

The Omnibus Law leaves the severance pay compensation of two months' salary for over 24 years of service, among the most generous in the world (most countries provide half a month to one-month salary), unchanged. But it deletes the coverage for housing and medical expenses (Table 1).

The Omnibus Law introduces a new unemployment fund (JKP), which effectively suggests that the government will bear part of the company's cost when they lay off their workers.

According to the Law, employers could pay a maximum of 19 times the monthly salary, and an additional six times the monthly salary will be paid by the government through the JKP scheme.

The JKP scheme will be managed by the Workers Social Security Agency (BPJS Ketenagakerjaan).

The above creates a contingent liability on the government, affecting its fiscal position, which needs to be estimated.

The above changes in the severance pay provisions reduce the cost of severance to the employer moderately.

Indonesia has a population of 270 million, with a large informal sector, estimated to account around two-fifths of employment. The lowering of the severance costs in the formal sector may help reduce informality. But this needs to be confirmed by well-designed empirical studies.

Table 1

Indonesia: Changes in Labour Regulations under Indonesia's Omnibus Law on Job Creation, October 2020[6]

	Existing Rules	New Provisions
Severance Pay	Payment for recognition of service period (UPMK) based on employment duration, from two months' salary for over 24 years' service.	Unchanged
	Compensation of rights (UPH) for unredeemed annual paid leave, transportation costs. Reimbursement for housing and medical expenses up to 15 percent of the severance pay or UPMK. The rest is covered in the work contract or corporate rules.	Deleted the coverage for housing and medical expenses
Labor's scope of work	Subcontracted workers are prohibited from doing tasks related to core businesses of the firm. They can be hired for supporting functions.	The relationship between subcontracted workers, their agencies and the firms that hire them will be further regulated in a government regulation (PP).
Remuneration	(N/A)	Labor intensive industries have separate minimum wage calculations that will be determined by the governor of the respective regions. Further stipulations are to be regulated in a separate PP.
	(N/A)	Micro and small businesses are exempt from minimum wage stipulations but must pay their workers above poverty line levels.
	(N/A)	If a company goes into bankruptcy or is liquidated, labor rights are to be prioritized before payments to creditors.
	Award money for tenure of service capped at 10 months of wages for 24 years of service.	Unchanged

Labor rights	Unpaid leave for workers who get married (3 days), whose children are being circumcised or are getting married (2 days), whose wives are in labor or have had a miscarriage (2 days), whose family members pass away (1-2 days)	Unchanged
Layoffs	Existing Rules	New Stipulation in Omnibus Law
	(N/A)	Compensation funds for workers with a minimum of one year of service are to be regulated in a separate PP.
	(N/A)	Layoffs can occur for reasons including mergers, acquisitions, divestments, efficiency, business closures after two years of uninterrupted losses or due to force majeure, debt restructuring, bankruptcy, five years of worker absence etc.
	(N/A)	Workers are still entitled to wages and other rights – including work responsibilities – during dispute settlements at the industrial relations court.
	Companies can lay off workers over “serious mistakes” such as fraud, theft, money laundering, false statements that cause losses to the business, drunkenness, use of narcotics or other addictive substances in the workplace, etc.	Deleted

- Labour’s Scope of work

The Omnibus Law stipulates that the relationship between subcontracted workers, their agencies and the firms that hire them will be further regulated in a government regulation (PP).

This is likely to end the restrictive practice of subcontracted workers not being able to do tasks related to core businesses, potentially rationalizing the labour force and lowering overall labour costs. This in turn is likely to improve business competitiveness.

- Remuneration

The Omnibus Law makes three major changes labour remuneration.

First, Labour intensive industries, with employment potential, will have a separate minimum wage determined by the governor of the province. This suggests that the sectoral minimum wage (UMSK) is abolished, and only the provincial minimum wage (UMP) and regency or municipality minimum wages (UMK) are to be recognized.

Second, micro and small businesses are exempt from minimum wage stipulations, but their wages need to be above the official poverty line levels. This is well intentioned, but would be difficult to enforce.

Third, if a company goes out of business, labour rights are to be prioritized before payments to creditors. This is a necessary provision in an economy with large concentration of power, and inadequate business borrower discipline.

- New Stipulations

As with remuneration, these are designed to make labour intensive sectors more competitive in domestic and global markets.

First a Compensation Fund is to be set up for workers with minimum one year of service, and regulated separately.

- Conditions under which layoffs can occur have now been specified (Table 1).
- During dispute settlement with the industrial relations court, worker rights are protected.

As brief summary of the Omnibus Law on Job Creation suggests, it is a very complex Law requirement much higher level of organizational capacity and competence by the relevant labour, investment, business approval, and environment organizations of the Indonesian government at all levels.

Moreover, the Law requires good coordination among different government Ministries and organization, traditionally not their strong trait.

The above suggests that for the Law to lead to desired outcomes, focus on enhancing organizational capacity of those implementing the Law should receive explicit recognition, with adequate resources and longer-term focus. Public support would also depend on the competency with the law is implemented.

Managing Political Economy

While the Omnibus Law on Job Creation has been welcomed widely, there are some opposition party groups, labour unions, and who call themselves civil society and environmental groups, have been protesting against the Law.

It is hoped that judicial process, if resorted to be those opposing the Law, would not be prolonged.

It is hoped that the judicial review would recognize the benefits in job and livelihood creation, greater ease of investment, and therefore potentially higher growth, and improved competitiveness, while protecting rights of workers appropriate for the emerging digital economy and Indonesia's needs.

The indications are that strong rationale for the Law, and popularity President Jokowi, are likely to be able to manage those opposing the Law.

But even greater competence (and some luck) in managing the COVID-19 pandemic by the authorities will be needed.

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