LABOR ABSORPTION UNDER MINIMUM WAGE POLICY IN INDONESIA

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Abstract
This study analyzes the impact minimum wage policy and some economic factors on labor absorption in Indonesia. For this purpose, this research used provincial panel data for the period of 2006 to 2013. The study reveals that minimum wage policy across provinces has created unemployment trap in this period. It can be inferred that minimum wage policy failed to support the local economy to better and more stable society welfare. This research also found an unexpected result regarding to the role of economic growth to labor absorption. Economic growth across provinces has not contributed yet to the increasing employment rate in the local economy. Moreover, this finding reveals that provincial labor absorption was also affected by geographical factors. The provinces which are located at the west Indonesia tend to have high empolyment rate. This phenomenon indicates the existence of unbalanced development in the country.
Keywords: wage, employment, policy, investment, economic growth
JEL classification: C21, J23, J30, J31, J38

1. Introduction

The issue of employment is an important problem in developing countries such as Indonesia. Especially in a global market which is growing fast as today, a flexible labor market is needed by some countries to encourage the economy (Rajeev, 2009). Employment serves as a vehicle to put humans in a central position of national economic development. Through its work, the worker derives remuneration in the form of wages and some kind of salaries. In Indonesia, the wage provisions across provinces were referred to the Provincial Minimum Wage (UMP). Wages in all provinces are determined by the government through a minimum wage policy which is expected to be a proper remuneration received by workers. At a higher minimum wage, workers are expected to pay for a better economic and social life. The success of the local government to encourage economic growth is also a good indicator for employment prospects in the province. A high local economic growth will ensure local government in encouraging the entire business sector to increase its ability to absorb labor in each region of the country.

During the past ten years, Indonesia has faced some challenges regarding to the labor force issues. The main issue was a high unemployment rate which spread across all provinces in the country. The domestic labor market has been characterized by turbulence and structural change. These issues were caused by shifts in the industrial and services sectors as well as occupational composition of employment. Labor market conditions in the nation have improved which was followed by some problems regarding to quality of human resources and manpower (Harmadi, Setyonaluri, & Iswandono, 2008).

In the last decade, Indonesia has also experienced a rapid economic growth as well as social change that might affect the dynamic of labor force. However, this fast economic growing was interrupted by a moderate economic and financial crisis in 2008. After experiencing recession and stagnation that caused the slowdown of economy, it is expected that economic growth will rise again to around 5.5 percent in 2010s. In such situation, employment rate in all economic sectors are not enough to accommodate the increasing of

labor supply. Furthermore, labor absorption in formal as well as informal sector tends to decrease.

The structural change of the labor force in the country reflected the character of the structural in the both national and local economies. Labor force growth as well as employment rate is the result of significant changes of economic sectors especially the industrialization process (Harmadi et al., 2008; Squires & Tabor, 2007). In development process, a larger percentage of labor force was dominated by agricultural activities. Meanwhile, most of developed countries are usually characterized by rapid economic growth in which the labor force tends to move from primary sector into the secondary and tertiary sectors. Consequently, the labor force participation will automatically change consistently following these sectors' contribution to the total economy. As a result, these trends make the industrial and services sectors will become the primary economic sector in term of labor absorption.

In fact, the local governments intensively concerned to the labor absorption from a large labor force which always increase yearly in the labor market. As a big issue, unemployment potentially becomes a burden of the development process in the country. This is the main reason of this research to provide an empirical model of labor absorption using provincial data. Therefore, this study considered several factors that may affect the labor absorption in Indonesia.

2. Literature Review

The minimum wage policy is one important government instrument which is basically used for achieving justice and equality rights of workers in order to meet their needs (Mrnjavac & Blazevic, 2014). The effect of minimum wage on employment in a region can be categorized into two types. First, increasing in the minimum wage would reduce employment as businesses become reluctant to use new workers. The research about impact of minimum wage policy on cost was conducted by (Wang & Gunderson, 2012) as well as (König & Möller, 2009). They found a positive relationship between minimum wage and unemployment rate. In addition, some papers observed more significant negative relationship between minimum wage and employment (Kalenkoski & Lacombe, 2008; Partridge & Partridge, 1999). This means that higher minimum wage will reduce labor absorption.

Secondly, the higher in the minimum wage will lead to increase employment. Some papers noted that the effect of minimum wages on employment is positive (Bhorat, Kanbur, & Mayet, 2013; Cuesta, Heras, & Carcedo, 2011; Persky & Baiman, 2010). These studies generally explained that minimum wage might stimulate the economy as a whole. Since wage rate is an important factor for worker, a positive impact of minimum wage on output demand also positive. This mechanism is likely reasonable to business expansion in which the labor demand increases. Finally, employment will improve as the consequence of business expansion.

Related to investments, some studies found that foreign direct investment (FDI) has positive effect on employment. For example, a research conducted in Italy found such phenomenon (Imbriani, Pittiglio, & Reganati, 2011). The preliminary result of this research supports the statement although it still depends on the kind of each sector. Another paper also pointed out that more foreign investment in Belgium caused higher employment in industrial sector (Cuyvers & Soeng, 2011). Not only in developed countries, an employment rate rises as a response of the increase in FDI also emerged in developing countries (Lipsey, Sjöholm, & Sun, 2013).

As well as foreign investment, domestic investment as an investment instrument which comes from domestic source also play an important role to employment although it is still limited number. Most of the papers describe indirect relationship between domestic investment and employment rate (Mohamed, Singh, Singh, & Liew, 2013; Psaltopoulos, Skuras, & Thomson, 2011). Mohamed, Singh, Singh, & Liew, (2013) found the presence of two-way causal relationship between domestic investment and economic growth which potentially lead to increase employment rate. Moreover, for the same reason, positive relationship between FDI and economic growth are examined by Srinivasan, Kalaivani, & Ibrahim, (2011). Consequently, a higher economic growth will bring into more labor

absorption. In addition, Psaltopoulos et al., (2011)found that private investment in southern Europe countries has a positive effect on employment.

Furthermore, the study of linkage between economic growth and employment rate has a various results. (Kareem, 2015) measured the positive impact of economic growth on employment. Increasing in economic growth then indeed create jobs, as well as an increase in employment can accelerate economic growth (Nayyar, 2014). It was also noted by Seyfried, (2014) which states that during the crisis in Spain, the decline in economic growth is characterized by a decline in GDP had an impact on the employment decline.

However, several previous papers studied the determinants of labor absorption in the scope of countries. This study attempts to observe the dynamic of labor absorption regarding to provincial perspective. For this purpose, this research analyzes various factors may affect labor absorption using panel data for all provincial governments in Indonesia. Furthermore, this research develops labor absorption model as a function of several economic and geographical factors as independent variables refers to the previous related literatures. The simple model is proposed as follows:

$$LABOR_{it} = f\ (MW_{it},\ FI_{it},\ DI_{it},\ EG_{it},\ D_i) \tag{1}$$

The dependent variable is poverty rate (LABOR) in each province. Meanwhile, four main independent variables are minimum wage (WE), foreign investment (FI), domestic investment (DI) and economic growth (EG) in the provincial level. These variables are assumed as main important variables that might influence the labor absorption rate. For addition, this paper also observes the effect of location of the provinces which are expressed by two dummy variables. First dummy variable (D1) indicate the impact of different location between west (Java and Sumatera) and east provinces (others), meanwhile the second dummy variable (D2) represents the different impact of provinces which are located at Java and non Java to labor absorption.

3. Research Method

3.1. Data and Variables Measurement

This study analyzes a model of labor absorption and its determinants using data of 33 provinces for the period of 2006-2013 in Indonesia. Labor absorption is defined as a number of labor forces which is absorbed in labor market in each province annually as reported by provincial Statistical Board Office. Four independent variables in the model, namely minimum wage (MW), domestic investment (DI), foreign investment (FI) and economic growth (EG) are explained as follows. The data of these variables are also collected from various edition of the report of Central Statistical Bureau Office.

3.2. Method of Analysis

This research models labor absorption with some economic variables for the annual provincial data. For the analysis process, the model involves a dependent variable (Y) and some observable explanatory variables ($X_1...X_n$) for panel data. The panel data regression consists of 33 units and 9 years, and therefore the model has N times T observations. A panel regression model is given by

$$Y_{it} = \beta_{0it} + \beta_1 X_{1it} + ... + \beta_n X_{nit} + \mu_{it} \quad for\ i = 1,\ 2,\ ...,\ N\ and\ t = 1,\ 2,\ ...,\ T \tag{1}$$

Y_{it} is the value of Y for the province i and for the time period t; X_{1it} is the value of X_1 for the province i and for the time period t, X_{nit} is the value of X_n for the unit i and for the time period t, and μ_{it} is the error for the unit i and for the time period t. Error term in the panel regression model is decomposed into two components (Baltagi, 2001). First, a component of unobserved factors that varies across units and over time as constant effects which lead to formulate a fixed effects model. Second, the component of all unobserved factors that varies across units and time as random effects through residual which lead to form a random effects

model. The panel regression model assumes that unobservable factors for the unit i and period at t will affect constant at the empirical model.

As widely known, there are three approaches of panel data analysis, namely common, fixed effects and random effects model. A common model is a simplest model which assumes that a set of panel data has no effects based on both different units and time periods. This model states that there is no different intercepts due to individual and timer period effects. In other words, the model is considered applicable for all individuals at every time as well as in the classical linier regression. Furthermore, this model assumes that individual characteristics across unit and time variant do not affect the coefficients estimate.

A second model which is known as fixed effects model assumes that unobservable factors across units and time period of observation can be captured by differences in the constant term. In fixed effects, the estimated model has different intercepts as a result of different units and time periods. Generally, this model is widely preferable because it results different constants for each unit and time period. In other words, the model provides various effects across unit and time period.

The third model is random effects which has different assumptions with two previous models. An important assumption in random effects model is that the unobserved random effects are uncorrelated with the explanatory variables. This factor affects the intercepts through residual as random process. A random effects model covers characteristics of the data based on cross unit and time period through random effects of its error. In this model, the estimation results do not lose degrees of freedom, as is the case in and common and fixed effects.

Since this study attempts to provide an empirical model, it is important to select which the best empirical model is. To find the best empirical model using panel data, several steps of testing procedure should be conducted. Model selection among these three approaches will be conducted using F test and Hausman test. F test is used to choose which a better model between common and fixed effects is. Meanwhile, random effects against fixed effects approach will be selected based on Hausman criterion. A Hausman test is a widely accepted method to select the fixed and random effects for testing to this assumption.

The labor absorption empirical model is estimated using panel data regression using 264 unit data, consists of 33 provinces for the period of 2006-2013. A simple panel regression model is expressed as follows:

$$LABOR_{it} = \beta_0 + \beta_1 MW_{it} + \beta_2 FI_{it} + \beta_3 DI_{it} + \beta_4 EG_{it} + \beta_5 D_1 + \beta_6 D_2 + \varepsilon_{it} \qquad (2)$$

As stated before, LABOR is labor absorption as dependent variable, meanwhile the independent variables are minimum wage (MW), foreign investment (FI) , domestic investment (DI), economic growth (EG) and dummy variables (D1 and D2) which indicates the location of the provinces.

4. **Result and Discussion**

Indonesia experiences a serious problem with high unemployment rate across provincial for more than a decade. The central and local governments focus on how to improve labor absorption rate in their development programs. Generally, all provinces have been remarkable success in increasing employment rate in the several last years. Figure 1 depicts the labor absorption rate across provinces in the period of 2006-2013. Due to the increasing of labor absorption in all provinces, this period could be considered as the successful episodes of provincial government in reducing unemployment rate. However, it seems a labor absorption disparity between several provinces, especially provinces in Java Island, and others provinces. All provinces in Java Island unless Banten, have a higher labor absorption than others. Average labor absorption in the provinces which is located at the western Island is also higher than that at eastern Island. These are the reasons this study elaborated the location of the provinces in the labor absorption empirical model.

Figure 1. Labor Absorption in all Provinces

Labor Absorption
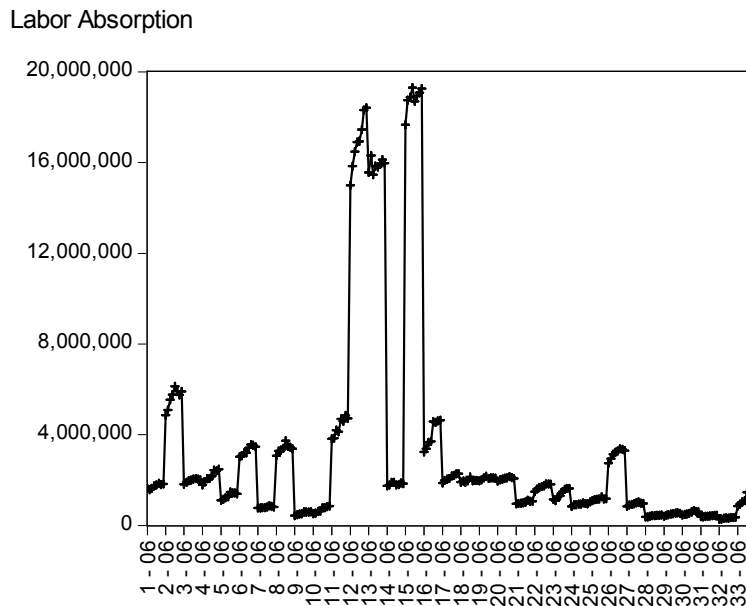
Note: 1=Daerah Istimewa Aceh, 2=Sumatera Utara, 3=Sumatera Barat, 4=Riau, 5=Jambi, 6=Sumatera Selatan, 7=Bengkulu, 8=Lampung, 9=Kepulauan Bangka Belitung, 10=Kepulauan Riau, 11=DKI Jakarta, 12=Jawa Barat, 13=Jawa Tengah, 14=DI Yogyakarta, 15=Jawa Timur, 16=Banten, 17=Bali, 18=Nusa Tenggara Barat, 19=Nusa Tenggara Timur, 20=Kalimantan Barat, 21=Kalimantan Tengah, 22=Kalimantan Selatan, 23=Kalimantan Timur, 24=Sulawesi Utara, 25=Sulawesi Tengah, 26=Sulawesi Selatan, 27=Sulawesi Tenggara, 28=Gorontalo, 29=Sulawesi Barat, 30=Maluku, 31=Maluku Utara, 32=Papua Barat, 33=Papua.

Since this paper focus on the labor absorption as an impact of minimum wage policy, it is important to discuss the minimum wage level across provinces. The behaviour of minimum wage rate based on the provincial data fluctuates across provinces (Figure 2). The annual data of minimum wage rate in all provinces tends to increase yearly. DKI Jakarta is province with the highest minimum wage comparing to other provinces, meanwhile Yogyakarta has a lowest wage rate. If these data are matched with labor absorption level presented in Figure 1, it seems that there is not causality relationship between wage rate with and labor absorption. Overall, all provinces experienced with increasing labor absorption and wage rate in this period.

Figure 2. Minimum Wage in all Provinces
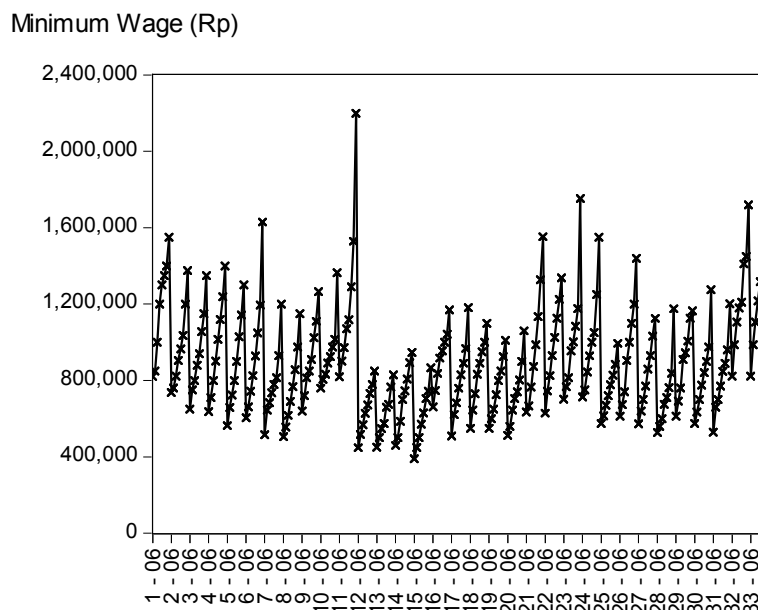
Minimum Wage (Rp)

Table 1. Statistical Indicators of Data

Statistic Indicators	Labor (Person)	Minimum Wage (Rp.000)	Domestic Investment (Rp.000)	Foreign Investment (Rp.000)	Economic Growth (%)
Mean	3,190,534	896.409	1,783.3	495.8	6.06
Median	1,774,697	842.500	381.0	71.0	6.05
Maximum	19,305,056	2,200.00	34,849.00	9.928.000	28.47
Minimum	268,117,0	390.00	0	0	-17.14
Std. Dev.	4,630,403	279.976,8	3,598.4	1178.185	3.56
Jarque-Bera	583.2456	74.117	11471.37	6684.001	3720.32
Probability	0.00	0.00	0.00	0.00	0.00
Observations	264	264	264	264	264

This research analyzes a set of panel data consisting 33 provinces for the period of 2006 to 2013. The descriptions of the data using several descriptive statistic indicators are presented at Table 1. An analysis using panel data begins with testing process of model selection among three models of common, fixed effects, and random effects. Table 2 provides a result of statistical testing between common and fixed effects, meanwhile Table 3 presents the selection testing of fixed effects against random effects model. Based on F and Chi-square statistic, it can be inferred that fixed effects model is preferable than common model. Since the fixed effect is more reasonable, the next step is to select whether the model follows fixed effects or random effects model. The result of Hausman test based on chi-square statistic shows that the corresponding effect is statistically significant (Table 3). It means that null hypothesis which states that random effects is true should be rejected. The conclusion of the test is that fixed effects model is appropriate model for this analysis. Finally, further analysis of labor absorption should be conducted based on fixed effects model.

Table 2. Result of Redundant Fixed Effects Tests

Redundant Fixed Effects Tests
Test cross-section and period fixed effects

Effects Test	Statistic	d.f.	Prob.*
Cross-section F	1781.441	(32,220)	0.0000
Cross-section Chi-square	1468.140	32	0.0000
Period F	3.739	(7,220)	0.0008
Period Chi-square	29.679	7	0.0001
Cross-Section/Period F	1563.095	(39,220)	0.0000
Cross-Section/Period Chi-square	1485.781	39	0.0000

Note: Ho: Common model is true; Ha: Fixed effect is true. * = Ho is rejected at 0.01 significance level, fixed effect is better than common model.

Table 3. Result of Hausman Test: Fixed and Random Effects

Correlated Random Effects - Hausman Test
Test period random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob. *
Period random	17.404807	4	0.0016

Note: Ho: Random effects is true; Ha: Fixed effects is true. * = Ho is rejected at 0.10 significance level, fixed effects is better than random effects.

Table 4. Estimates Result of Fixed Effects Models

Independent Variables	Without Dummy Variable		With a Dummy Variable		With 2 Dummy Variables	
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
Constant	10460930	8.954 [a]	8712429.	7.579 [a]	3763499.	5.205 [a]
Minimum Wage	-9.442866	-8.222 [a]	-8.892364	-8.150 [a]	-3.211226	-4.792 [a]
Foreign Investment	767.2921	3.683 [a]	576.1727	2.879 [a]	-306.6501	-1.567
Domestic Investment	604.7333	8.5261 [a]	556.8000	8.230 [a]	492.2190	8.355 [a]
Economic Growth	-44111.10	-0.657	10523.23	0.163	10271.10	0.184
D1	-	-	2284371	5.530 [a]	857859.4	2.155 [b]
D2	-	-	-	-	6062782.	9.342 [a]
Adjusted R^2	0.506287		0.559918		0.647013	
F statistic	23.492 [a]		26.612 [a]		78.512 [a]	

Note: [a], [b] = significant at 0.10 and 0.05 significance level respectively.

The empirical results of fixed effects are presented in Table 4. This study estimates three empirical models to observe the role of the location of the provinces to the labor absorption. The estimation confirms that all independent variables are individually significant for three empirical models except economic growth. The models also give high F statistic and coefficient of determination which indicate that the estimation method is valid. For addition, this analysis also involves two dummy variables which indicate the location of the provinces as explained in the previous section. As theoretically expected, minimum wage is negatively significant. Meanwhile foreign investment and domestic investment have strong positive correlation with labor absorption. The economic growth variable in all three models model are not significant indicating that economic growth has not created employment yet across provinces in Indonesia.

4.1. Minimum wage and unemployment trap

This section discusses to main issue of this research that is the role of minimum wage policy to the labor absorption. Regarding with interpretation of the empirical analysis of labor absorption rate is based on the fixed effects model. The model has positive intercept which indicates the average of labor absorption in all provinces. It means that high rate of labor absorption across provinces have positive correlation with increasing of investment but it has negative relation with minimum wage. A higher wage rate then leads to cause lower labor absorption.

As mentioned in previous papers, minimum wage policy may cause positive or negative effect to labor absorption. In other words, the relationship between these variables is debatable (Cuesta et al., 2011). Basically, wage rate is one of several important variables in determining the demand of labor. The minimum wage policy reflects the government mission to protect the worker in the labor market. It is expected that minimum wage will improve the welfare of the workers and encourage the local economy (Mrnjavac & Blazevic, 2014). However, this evidence does not support this preposition. In contrast the minimum wage has negative impact to the labor absorption which indicates increasing wage rate causes higher unemployment (Bashir & Kadiri, 2012).

Since this study results negative correlation between minimum wage and labor absorption, it seems consistent with some previous researches (Kalenkoski & Lacombe, 2008; König & Möller, 2009; Wang & Gunderson, 2012). The papers mentioned that minimum wage contributes to employment decrease in several countries. In fact, our study finds a coefficient of minimum wage to labor absorption is -3.211226. It implies an increase of a hundred thousand rupiah of minimum wage leads to decrease in labor absorption amount to 321,123 persons. This finding is reasonable where the higher wage will probably increase production cost. The phenomenon indicates a serious problem regarding with unemployment issue in

Indonesia. Moreover, negative effect of minimum wage policy to labor absorption might cause an unemployment trap in the country.

4.2. <u>Misguided economic growth and employment decreasing</u>

A contradictive result regarding to the low effect of economic growth on labor absorption is found in this analysis. Economic growth as an important economic indicator in local economy did not affect labor absorption. Based on this result, it can be inferred that such relationship may runs in two ways. First, it indicates increasing economic growth was dominated by consumption, meanwhile other factors including labor absorption is stable. Second, it could also be inferred that economic growth across provinces might affect business activities which does not encourage employment rate. This second reason is more rational and acceptable since employment mainly is provided in the private sectors.

In this study, gross domestic regional product as a measurement of economic growth fails to stimulate local economy as well as employment rate. This finding implies that economic growth in local level has not reduced number of poor people yet. In other word, local economic growth potentially misguides the local economy to the unemployment trap as well as minimum wage policy does. It means that local economic growth has not played important role yet to improve social welfare across provinces in the country. This result is not in line with Kareem, (2015) who found a strong positive correlation between economic growth and employment.

Further discussion, this study also demonstrates a positive relationship between both domestic and foreign investment to unemployment reduction as well as noted by Imbriani et al., (2011). Since the local investment was limited, the rising of investment that might come from central government and other countries lead to bring the local economy expand to higher scale (Lipsey et al., 2013; Squires & Tabor, 2007). In addition, due to the low fiscal capacity in the local government, investment growth in Indonesia was generally dominated by private sector. In this case, private investors have participated to boost developing local economy to a better quality of life of society. This result suggests the government policy imposes some policies relating to the investment growth. Local governments should improve their public investment for providing public infrastructure as well as encouraging the private investment. This result points out that private sectors have contributed well to reduce unemployment rate in Indonesia.

4.3. <u>Unbalanced spatial development</u>

The second model which is added with a dummy variable as attribute of western and eastern provinces indicates that west provinces absorb more labor than east provinces. This result confirms the hypothesis of unbalance development in Indonesia. The last model which has two dummy variables informs that these variables are significant. From this result, we can conclude that unbalance development is not only between west and east provinces, but also between Java and outside of Java provinces. This analysis notes that location has important role to the employment rate which could be inferred as a result of development process in the local level (Kalenkoski & Lacombe, 2008). Some possible factors may be addressed why west provinces record more labor absorption than that in east provinces. These are investment growth, public facilities, number of human resources, financial assessment and other social and economic factors.

As a final point, regarding with labor absorption analysis, minimum wage policy and spatial factor play important role to the employment rate. The empirical models are able to explain the determinants of labor absorption across provinces in Indonesia. For addition, the empirical estimation using fixed effects model also provides variation effects of its intercept due to cross section and time period. Figure 3 presents empirical estimates which contain heterogeneity effects due to cross section unit. All provinces which are located at Java Island have higher effects than others. Meanwhile Jawa Timur has highest effects which mean this province recorded highest autonomous labor absorption. Figure 4 depicts the volatility of the heterogeneity effects of labor absorption caused by time variant. Overall, more than 80% provinces in Indonesia have negative cross effects. It means these provinces recorded lower employment rate than its average in all provinces. This figure describes the difference of labor

absorption level between the year of 2006 and 2013. As noted that 2009 is the cutting point of the time variant effect of unobservable factor into intercept. Furthermore, the average of labor absorption across provinces tends to achieve at a higher rate after this year.

Figure 3. Cross Effects of Labor Absorption across Provinces
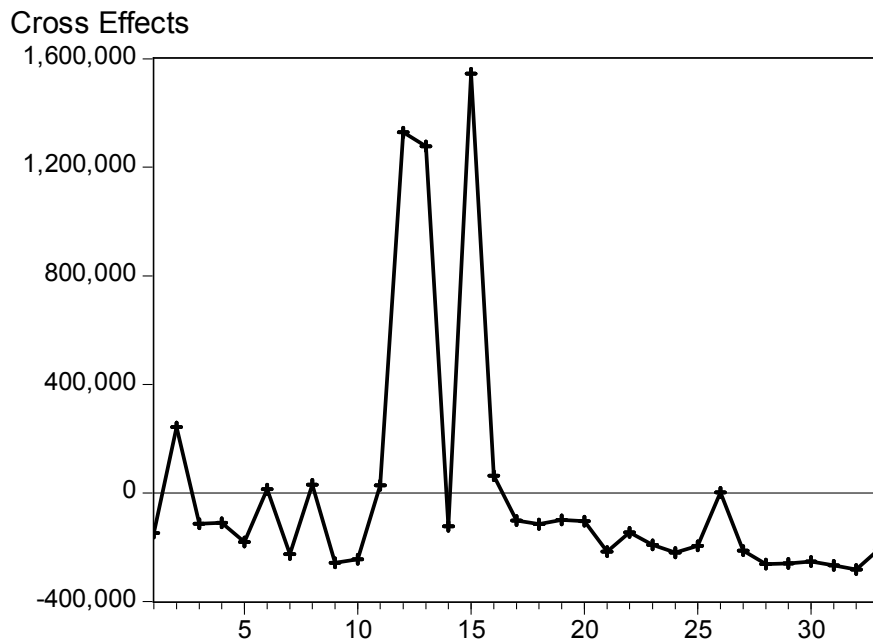
Figure 4. Period Effects in 2006-2013 of Labor Absorption
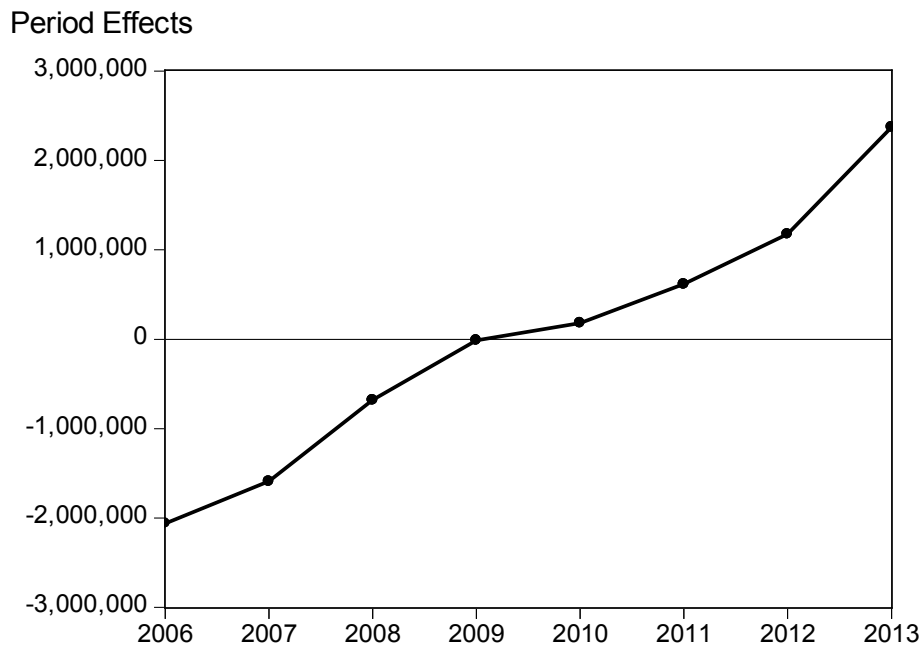
5. <u>Conclusion</u>

This study highlights the relationship between minimum wage and labor absorption across provinces in Indonesia. The empirical model using panel data analysis provides important result regarding with the role of wage minimum policy to labor absorption. This research found that minimum wage has negative effect to labor absorption across provinces. Other economic variables, these are domestic and foreign investment contribute positive role to employment rate. Unexpected result was recorded due to the insignificant impact of economic growth to the labor absorption. In addition, spatial factor which is characterized by location of provinces also has significant effect to the employment rate across provinces. It

concludes an unbalance development between west and east provinces as well as between Java and outside of Java provinces.

Some specific findings in this research reveal the weaknesses of economic policies in the country. Basically, minimum wage policy in Indonesia aims to protect the worker from the poverty challenge. However, this policy has brought the local economy on serious unemployment trap at the last decade. In addition, local economic growth could not reduce unemployment rate. Moreover, this study also reveals the existing spatial unbalanced development caused by geographical factors. Labor absorption at west Indonesia was higher than that at the eastern provinces. Some provinces at the Java Island also recorded more employment rate than other provinces did.

This research attempts to recommend central government to improve labor absorption in the local economy through some policies. In other hand, provincial governments need to emphasize some programmes on reducing unemployment. Some key elements might be mentioned in policy planning related to increase employment rate: (a) Increasing domestic and foreign investment relating to more productive economic projects; (b) Encouraging local government investment through increasing the local fiscal capacity; (c) Empowering human resources through some training and skill development programmes; (d) Improving the quality of local economic growth considering to absorb more labor force at the local economy.

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