

Chapter 13

Economic Growth, Labor Market Segmentation, and Labor Productivity: A Story from Indonesia

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ABSTRACT

This chapter examines economic growth, labor market segmentation, informal employment, and labor productivity in Indonesia from 1990-2015. It shows four important facts. First, Indonesia was ever among countries in Southeast Asia with the highest economic growth before the country was severely hit by the Asian financial crisis in 1997/98. In 1999, the country started to recover, and since then, the economy has performed exceptionally well until these days. Second, total employment increased continuously, although as a percentage of total labor force, it tends to decline. Second, total labor productivity also continued to increase. Third, employment is still dominated by the informal sector. This chapter also discusses labor market policy in Indonesia. This chapter concludes that there are many factors that simultaneously determine directly or indirectly the growth of labor productivity, including good macro-economic management and effective labor market policies.

INTRODUCTION

During the ‘New Order’ era (1966-1998), Indonesia was among countries with the highest economic growth in Southeast Asia. Only in 1998, when it was severely hit by the Asian financial crisis, the country experienced a negative economic growth up to 13 percent. In 1999 Indonesia started to recover, and since then the economy performed well. This was also the reason why during the 2008/09 global financial crisis, the economy was not seriously impacted, although exports of some commodities dropped as the crisis affected the economy mainly through export channel. However, economic growth has been mod-

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erated in recent years, which is expected to grow only by 5 percent by the end of 2016. This decline in economic growth rate was caused by a combination of the following factors: weakening world demand for Indonesian exports, low investment growth related, a certain extent, to lower international prices for some commodities, and heightened regulatory uncertainty and lack of infrastructure in the country. The good performance of the economy, except in 1998, has a positive impact on employment as it continued to increase; although the rate of the increase varies by sector.

The main aim of this chapter is to examine the Indonesian experience with economic growth and changes in labor market segmentation and labor productivity for the period 1990-2015. It is beyond the scope of this paper to identify links between the variables such as economic growth, market segmentation, informal employment, and labor productivity with econometric or regression analyses. Rather, the goal here is to assess changes in these variables during that particular period and to highlight the likely main causes behind the changes, and the relationship between the changes of the variables. More specific, this chapter has the following three questions to deal with:

- How was the pattern of Indonesia's economic growth during that particular period and what were the likely factors behind that?
- How was the labor productivity growth during that period and what were the likely main determinants?
- How has labor market segmentation changed since the early 1990s and what is the likely implication of labor market segmentation on the country's economic growth?

The rationale of analyzing this topic is to contribute to the understanding of economic growth, labor productivity, and labor market segmentation in a developing country like Indonesia. This topic is particularly important for Indonesian economic growth for two main reasons. First, along with accumulation in physical investment and technology progress (including innovation), labor productivity growth is also a major determinant of long-term economic growth. Thus, understanding the dynamic of long-term labor productivity growth and its main determinants are crucial. Second, like in other developing countries, the labor market in Indonesia is also segmented with a large share of informal workers, and it may have a negative impact on the country's economic growth. Therefore, understanding this labor market phenomenon in the course of continued economic growth is crucial. For this purpose, this chapter has eight sections as follows. Section 1: Introduction. Section 2: Literature review. Section 3: Review of key previous studies in Indonesia. Section 4: Economic growth during 1990-2015 in three important phases. Section 5: Labor market segmentation and the importance of informal labor market. Section 6: Labor productivity and main determinant factors. Section 7: Labor market policy. Section 8: Conclusion.

LITERATURE REVIEW

The Relationship between Labor Productivity and Economic Growth

Firms use a combination of labor and capital, called production factors, to produce their output. To increase their output, firms have three options: by increasing the number of one of their production factors (e.g. use more machines or hire more people) or both; by increasing productivity of one of their production factors (i.e. partial factor productivity) or both (i.e. total factor productivity), or by combining these two

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