Fostering formal sector job creation to further improve living standards in Indonesia

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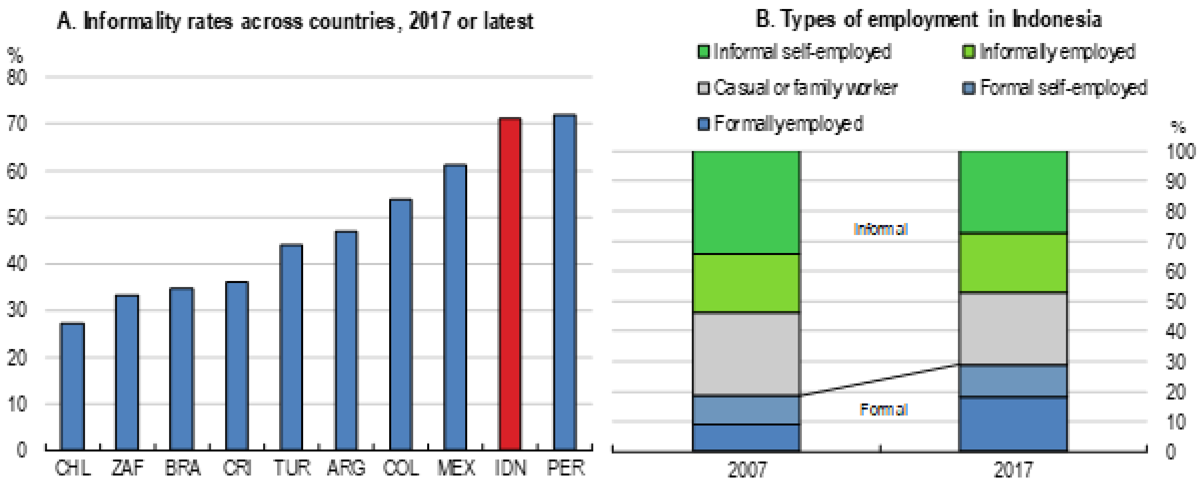
The Indonesian economy has grown solidly in recent years, which together with helpful government policies has raised incomes and brought down poverty rates to record lows, as highlighted in the latest OECD Economic Survey of Indonesia (OECD, 2018). Prudent macroeconomic policies have contributed to economic stability, muted inflation and limited government debt. Even with the more challenging external environment, GDP growth is expected to remain around 5¼ per cent in 2018 and 2019.

Indonesia's youthful population represents an opportunity to lift future growth and living standards. In contrast with higher-income countries, the working-age population share is rising and will likely continue doing so for another decade (United Nations, 2017). OECD estimates suggest that over the next decade this demographic change alone is expected to boost trend GDP growth by around 0.3% on average (OECD, 2018; Guillemette and Turner, 2018).

Indonesia's favourable demographics could provide a bigger boost to growth if a larger share of employment consisted of high-quality jobs in the formal sector. Informality is usually associated with insecure jobs with lower pay and fewer training opportunities (OECD, 2015; Allen, 2016). Although the rate of informality has fallen in Indonesia, it remains pervasive. The OECD estimates that around half of all dependent employees and 70% of all workers are informally employed, compared to 35% in Brazil or around 55% in Colombia

(Figure 1). Growing the share of formal sector jobs would increase incomes and, by raising government revenues, would allow better services to be provided for future generations.

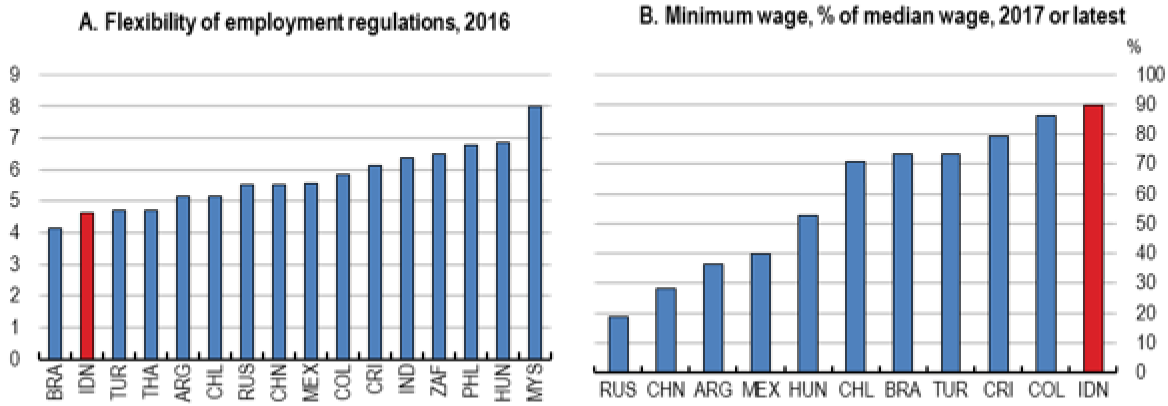
Figure 1. The rate of informality is still relatively high



Note: Estimates are based on the ILO definition of informality and may differ from national sources due to definitional differences. In general informality is defined as employees without social security and self-employed who do not pay social security contributions or whose business is not registered (depending on data availability). For Indonesia, informality is based on the ILO definition for employees and the Statistics Indonesia proxy for identifying informal self-employed workers (based on employment type and occupation) due to data availability for the self-employed. The estimate of informality in Indonesia published by Statistics Indonesia is based on employment status. By this estimate informal employment is 58% of total.
Source: OECD calculations based on the EPH for Argentina, the PNAD for Brazil, the CASEN for Chile, the GEIH for Colombia, the ECE for Costa Rica, the SAKERNAS for Indonesia, the ENOE for Mexico, the ENAHO for Peru, the QLFS for South Africa and the HLFS for Turkey.

There are different reasons for informal employment so tackling it requires a multi-pronged approach. Stringent employment regulations, including high dismissal costs and minimum wages, limit firms' ability and incentive to hire formal employees (Figure 2). The *Survey* recommends trialling easier employment regulations and a discounted wage for youth in special economic zones and extending these reforms if they are successful. Continuing to simplify business regulations and to improve the new online submission system for licensing would help reduce barriers to businesses operating formally.

Figure 2. Employment regulations are relatively strict



Note: Flexibility of employment regulation is from the Economic Freedom Indices calculated by the Fraser Institute and ranges from 0 (low economic freedom) to 10 (high economic freedom).
Source: Fraser Institute, *Economic Freedom of the World Index*; OECD, *Going for Growth Database*; Statistics Indonesia, *SAKERNAS*; OECD calculations.

Low skill levels combined with a relatively high minimum wage also limit the growth of formal sector employment. Only half of all Indonesians aged 25-35 have completed upper secondary school. The OECD PISA test results show that many 15 year-olds still lack basic skills in maths and reading. Improving the quality of education can be difficult but it is crucial for improving the prospects of future generations. Reforms should focus on improving teacher quality in schools and better linking vocational education with employers to ensure students graduate with the skills they need to find good jobs and continue developing over their career.

References

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