International Labour Organization

Constraints on policy making towards the Informal Economy in Indonesia

Lessons of the Current Decade

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Lessons of the Current Decade

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Foreword

This study of **Constraints on policy making towards the informal economy in Indonesia: Lessons of the current decade** was undertaken as part of an effort to draw out policy lessons learnt since the systemic shock triggered by the 1997/98 crisis, to provide a summary evaluation of the existing policy framework to lower informal workers' vulnerability to economic insecurity, and to highlight the remaining and emerging challenges. The paper provides a useful guide to monitor the implementation process of the National Mid-Term Development Plan (RPJMN) 2010-2014 in relation to the informal economy. The earlier draft was discussed in a workshop held in December 2009, where participants from Government, Workers' and Employers' representative, NGO and University actively took part. The paper benefitted considerably from the insights and policy concerns expressed during the workshop. The Employment Policy Department, Employment Sector, ILO provided the technical support, jointly supported by ILO/ Jakarta Office in implementing the study.

It emphasizes the highly diverse and heterogeneous nature of the informal economy, which entailed debate over definition and measurement, each of which cannot fully capture all the actors and situations that comprise the informal economy. This may have been constraining the government from having a clear policy on the informal economy, because it is not possible to set policy targets when the phenomenon of concern cannot be measured and concrete policy lessons cannot be learnt from other countries.

The study concludes that an overarching policy framework directed towards the informal economy cannot and need not be found, and it provides perspectives on the Indonesian policy making environment since the fall of New Order regime in May 1998. While policies had not been directed as such to the informal economy, a number of policy initiatives to contain the rise in poverty, promote employment, promote social insurance, and to reform customs regimes, to name a few, are in place. Many of the elements of such programs can facilitate the transition to formality. Further work is needed in ensuring and evaluating the implementation of such policy measures, and whether they indeed lead to reduced incidence of informality over time.

Jakarta, 28 September 2010

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I. Informal Economy as a Development Problem

Debates on the persistence, characteristics and the economic contribution of the informal sector go back to the 1960s. This was to be expected given the dominance of theories of dual economy and the politics of modernization in early post independence years in the developing world. The central problem of development was to find ways of moving the economy out of the low productivity, low growth, low income structures of production found in traditional agriculture and artisanal production to high growth paths of a modern industrial economy. A continual transfer of labour from traditional to modern sectors was evidence that development was taking place; that post colonial governments were able to deliver the goods.

But things are never as simple or as smooth as theory predicts. The urban sector often became a sink for labour migrating from the countryside to the towns, agricultural wages and productivity failed to rise in tandem with a declining supply of labour, and the urban economy often proved to be a destitute sink for new migrants waiting for their entry into the industrial economy. The economy did not move steadily from the traditional to the modern, from the rural to the urban, from low growth to high growth paths. The conclusion drawn by later dual economy models was that the most effective way to deal with the proliferation of shanty towns and peripheral pools of labour was to deal with the problems at source. This could be done by discouraging the migration to urban areas by providing rural employment opportunities and raising the productivity of the agricultural sector through new technologies conveyed to the farming population by large scale extension services.

Such complexities of the technological and cultural transformation of traditional societies and the stubborn persistence of the traditional/subsistence forms of production in most developing countries inevitably generated interest in the structure and characteristics of these sectors. Persistence of subsistence became as intriguing a subject for theoretical inquiry as the dynamics of transformation. The study of the informal sector, often defined as what was left over once formal sector employment and output was subtracted from total employment and GDP, therefore came into its own.

Much statistical effort and much theoretical dissection have gone into study of informal employment and informal enterprises over the last four decades. Even the subtle renaming of the informal "sector" as the informal "economy" is evidence of the widening interest in the operation of the non-formal areas of the economy. Policy makers continue to wonder how they should deal with large pervasive domains of economic activity which only yesterday were expected to wither away as stable and higher rates of economic growth took place but which now seem to be a constant feature of the political and economic landscape.

Democracy and globalization have only served to add further layers of complication and confusion to this already difficult policy terrain. The former gave voice to the majority of the population trapped in low income jobs and uncertain micro enterprises. Democracy demanded attention to the plight and interests of the majority. Halted economic transformations and pervasive poverty did not provide a winning formula at election time. Global capital markets, falling transport and communications costs and the surge in international trade all served to distribute the benefits of global prosperity to a few countries technologically and geographically well placed to benefit from this acceleration of global economic growth.

Rising inequality of investment flows across countries and a growing inequality between skilled and unskilled labour in countries most integrated into global commodity and capital markets further complicated the tasks of reducing poverty and improving the lot of those trapped in the informal economy. In the simplest closed dual economy model, labour transfers from the subsistence to the modern sector would also tend to reduce wage differentials across sectors, e.g. from agriculture to industry or from rural to urban, as tightening labour markets would raise wages in the former.

The highly open markets of the globalizing world not only provide an international pool of migrant labour but also reduce the policy flexibility of developing country governments in setting public expenditure choices and targets, in the structure of revenue and taxes and the rules governing foreign direct investment and capital market transactions. If this were not enough, the policy domain has been further narrowed by the decline of redistributive ideologies which justified asset redistribution on grounds of economic justice and fairness. Land reform, asset nationalization and highly progressive taxation are hardly ever a central part of the development policy platform, despite the current resurgence of similar philosophies in parts of Latin America. Governments are increasingly caught in an ever growing contradiction between the need to reduce poverty and lower income and social inequalities on the one hand and the narrowing policy space and a smaller number of policy instruments to do so. Emphasis has shifted from growing faster to growing better, from quantity to quality, from growth poles to economic advance across the board, from the big push to a series of "smart" interventions on many fronts.

II. Informal Economy: the Indonesian Context

This growing complexity of policy making in the globalised, democratic and, at times an increasingly decentralized or localized, world on the one hand and the narrowing policy space driven by investor preferences and international trade agreements on the other has renewed investigations into the functioning of the informal economy and in the welfare of those livelihoods through which the majority of the work force survive. A natural consequence of this growing interest in the informal economy is that its overall size, structure, variation across geographical locations and types of activity are much better understood today than ever before. As the discussion of Indonesian data on the informal economy in Nazara (2010) discussed below demonstrates, statistical definitions and surveys of the informal economy have gradually expanded in coverage to include several categories of occupations ranging from employers and own account workers to small unregistered businesses and contracted temporary work for large formal enterprises.

What is less clear is the policy response by the government to the informal economy in its most critical dimensions: the enhancement of productivity and skills, the incubation of entrepreneurship, the alleviation of destitution and the reduction of economic insecurity and the resumption of labour transfers to more productive and more rewarding occupations in the formal economy. Just as critical is to work out if and the degree to which policy interventions towards the informal economy should vary across regions, communities and income groups.

Policy interventions also bring new problems in their wake. Targeting the poorest of the poor promotes administrative classifications among an already very poor set of people. The poorest of the poor today may not be the poorest tomorrow if commodity prices swing in their favour, if a relative finds a job in the city or in the international labour market and remits a part of such income back home, if an earning member of the family falls sick or if economic activity comes to an abrupt end due to violent conflict. Lowering health and safety regulations in the work place may see the expansion of new businesses which result in death or injury as well as reductions in productivity. Providing subsidies to budding entrepreneurs may simply lead to inefficient businesses and carry an opportunity cost in terms of alternative programs of social assistance.

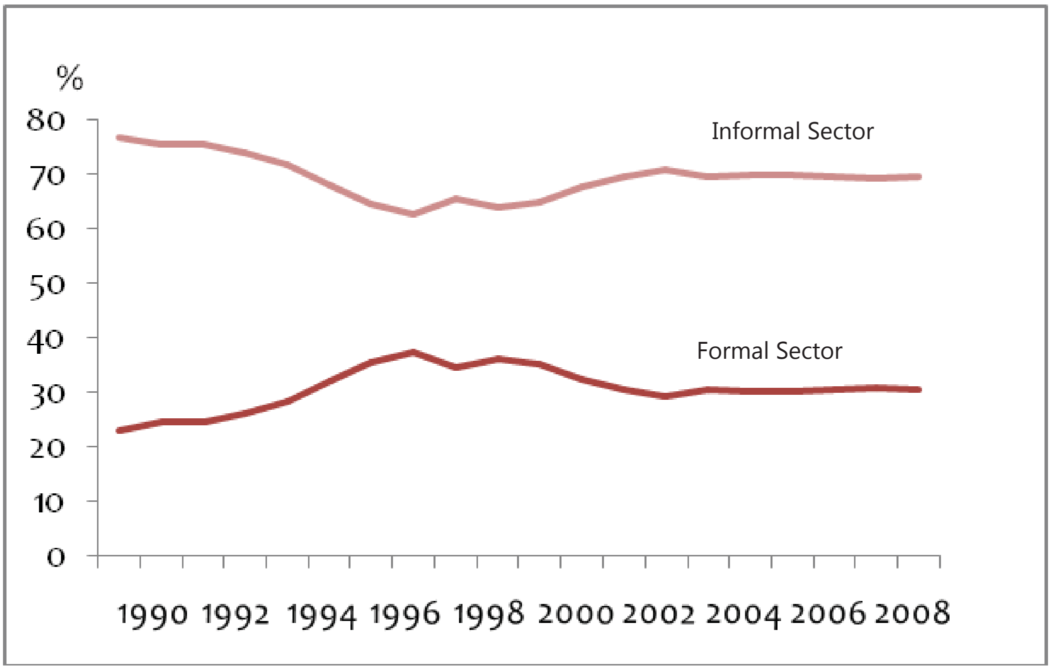
This does not abrogate the need for a policy response to many of the problems and difficulties faced by workers and entrepreneurs and the unemployed in the informal economy. Since the weight of the informal economy in total employment and in many cases in total output is very large, the absence of a policy response would mean the absence of a development policy altogether. A more interesting question is whether the significant economic and social weight of the informal economy calls for some "grand, overarching response" or a series of small steps which will improve the welfare of those who live and work in the informal economy. In these days of "holistic" policy approaches the latter may be taken as an instance of "too little too late" while a "grand architecture of policy towards the informal economy" might seem to be amorphous and utopian.

Perhaps it is for these reasons that the statistical debates over definition and size of the informal economy have generated more controversy and debate than the desired policy responses to the persistence of the informal economy even in high growth economies in the developing world. Policy attention in the Tiger economies of South East Asia for much of the high growth period up to the Asian financial crisis focused not on policies towards the informal economy but policy measures designed to boost the share and growth of the formal economy.

In the case of pre-1997 Indonesia, high growth, low initial levels of income inequality, and consistent overall declines in the percentage of the populations below the poverty line created a psyche of government and investor confidence which felt little need for a dedicated policy response towards the activities in the informal sector. Macro economic fundamentals and open markets captured the attention of most policy makers. The economic miracle unleashed in the last quarter of the 20th century across the economies of South East Asia seemed to promise hope of the end of informality, the world's first development transition on such a grand scale.

The policy picture has changed significantly since the advent of the Asian Financial and Economic Crisis. In many countries, such as Indonesia, informality was a public response to an unprecedented output shock. Collapsing banks and leading industries left the working population and their dependents to their own devices. Crashing exchange rates and rising inflation robbed the public of vital purchasing power at a time when consumer confidence was vital to economic revival. Traditional modes of social assistance in the form of food and fuel subsidies were threatened by conditions set by international agencies and bilateral donors, political instability and in some cases, such as Indonesia, political implosion left a much wanting administrative structure attempting to cope with a systemic collapse of historical proportions.

Figure 1. Proportions of formal and informal sector Indonesia, 1990-2009



Source: quoted from Nazara, *The Informal Economy: an Indonesia Case Study*, 2010

Interest in Indonesia's informal economy, as noted by Nazara (2010), has been heightened by the observation that trends in informal economy have undergone significant shift before and after the Asian Economic Crisis. The picture presented by the data is clear enough. Prior to the Asian financial crisis Indonesia seemed to have followed the familiar pattern of rising formal employment mirrored by an equivalent fall in the proportion of the labour force engaged in informal employment. The picture after the Asian Crisis was rather mixed. Between 1998 and 2003 employment in the formal sector fell while it rose in the informal sector, a reversal of the pattern before the crisis but still hardly surprising. Indonesia suffered the most severe output fall in its entire post independence history. Output fall was concentrated in the urban banking, manufacturing and construction sectors. As was to be predicted, the result was a rise in informality and a fall in formal employment.

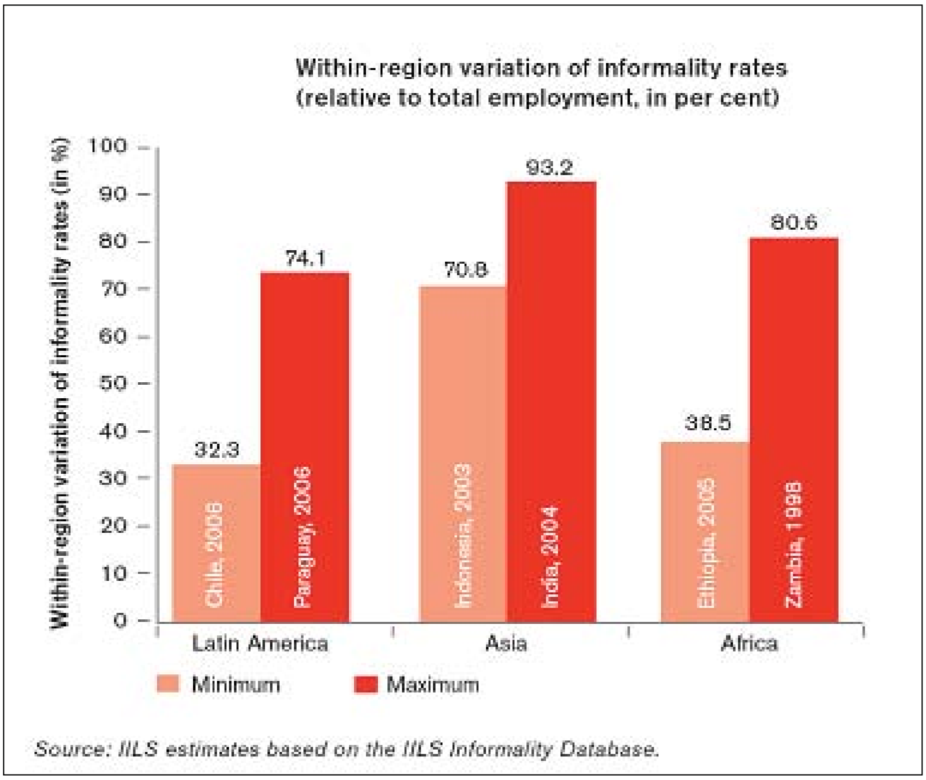
It is not clear from the data used in Nazara's analysis if the logic behind the trends of formal and informal sector employment after 2003 were also in any way different to what had happened before. 2003-2008 employment trends show a slight rise in formal employment and a slight fall in informal employment, not very different from what one would expect especially given the fact that formal and informal employment are mirror images of each other if only because what is not formal was described in the data as informal.

Perhaps what was worrying observers was the fact that economic recovery which had begun in some earnestness by the end of 2005 did not seem to generate the substantial declines in open formal employment that had been expected.[1] However, even this logic does not automatically provide cause for concern since the magnitude of the output fall, the massive shift in relative prices caused by exchange rate collapse and the inflation that followed, and the reduction of oil subsidies under pressure to maintain macroeconomic stability is likely to have shifted the structure of production in the country. The resultant change in the employment elasticity of growth and its behavior in specific industries should have been the subject of detailed study during the early years of the crisis. It was not. The focus instead was on the social costs of the crisis and the ways to alleviate the distress of sharply rising class of the absolute poor. Informal employment and informal enterprises may have grown but the reasons were likely to be found in the shifting structure of production and services.

In fact the data from WTO and ILO (2009) quoted in Nazara (2010) suggests that the measurement of informal employment is not robust enough to draw strong conclusions from the labour force data from 2003-2008. India has a larger manufacturing sector than Indonesia while Ethiopia has almost no manufacturing at all. Yet, the former recorded a staggering 93.2% employment in the informal sector while the latter reported only 38.5%.

1 The aggregate open unemployment rate did decline after 2005 (see appendix, figure A.3), but the expectation that the aggregate unemployment rate would be halved by 2009 did not materialise.

Figure 2. Within Region Variation of Informality Rates (relative to total employment in per cent)



Source: quoted from Nazara, *The Informal Economy: an Indonesia Case Study*, 2010

Table 1. Indonesian informal sector (in million workers), 2001-2009

	2001	2003	2006	2009
Urban informal	13.93	14.83	15.85	17.97
Rural informal	41.88	43.61	44.92	46.87
Male informal	33.07	37.05	38.48	38.56
Female informal	22.74	21.40	22.29	26.28
Total informal	55.81	58.45	60.77	64.84
Total workers	90.81	90.78	95.18	104.49
Share of informal using narrow definition (% of total workers)	61.5	64.4	63.4	62.1
Share of informal using broaddefinition (% of total workers)	67.7	70.8	69.8	69.5

Source: quoted from Nazara, *The Informal Economy: an Indonesia Case Study*, 2010

Table 1 actually reports not a rise but a fall in the proportion of the labour force engaged in informal employment, from around 64.4% in 2003 to 62.1% in 2009, using the revised BPS definition and even less from 70.8% to 69.5% using the old definition. The fact that informal employment in 2009 as a share of the total work force was still larger than in 2001 in both definitions should not come as a surprise either, given the fact that the early phase of the recovery till around 2007/8 was characterized by economic growth led by consumption and later by inventory depletion as capacity utilization improved. Investment ratios began to rise only very recently, to be halted suddenly by the onset of the global economic crisis. It would be the resumption of investment which would be expected to restart the engine of job creation rather than a fuller utilization of labour actually on the company books.

The above provides a small sample of the kinds of observations and arguments that inform thinking about the structure and the operation of the informal sector and the informal economy in Indonesia today. This is the starting point of this working paper which aims to focus on the policy considerations, dilemmas and solutions to the stubborn persistence of the informal economy in Indonesia as it begins to recover from its second major economic shock in a single decade.

The argument of this paper unfolds in three following sections. Section 1 explores the inevitable confusions and uncertainties of defining and demarcating the dimensions of the informal economy and its movements over time. The second argues that if the current estimate of the informal employment in Indonesia were to be expected (around 70%) policy towards the informal sector would in fact be tantamount to the whole of development policy. In that sense it is meaningless to talk about a "policy" for the informal economy. Problems in the informal economy therefore have to be tackled on many different fronts: some through social insurance and poverty alleviation and some through economic diversification, economic growth and a sharp rise in labour productivity. In this context, the umbilical link between many forms of international investment and enterprise and local outsourcing tiny enterprises might well provide one avenue to link the fortunes of new informal enterprises to future foreign investment that produces for the global market. This tendency is already evident enough in many economies in Asia including India and China but is insufficiently explored in the Indonesian context.

The third section below discusses the present direction and scope of government policy towards the informal economy. As is to be perhaps expected, the Indonesian government has no specific policy towards the informal economy. What policy there is must of necessity be gleaned from different sources and ideas floating within central and regional governments. However, taken together existing measures to alleviate poverty, promote investment, raise skills and education standards among others point to a relatively large number of policy steps which collectively might have a bearing on the future trajectory of informal employment and informal enterprise.

In a way that takes us to where much of the debate on the informal economy began, that the best policy on informality is to focus on ways to expand formality. And that brings us back to dry issues of definition and delineation. If legal regulation and registration, even when these are needed to provide assistance and economic security, is the defining feature of informality then a rule driven market economy would tend to follow the historical path of economic development accompanied by a reduction of informal and non-contractual relationships. The time period for this to happen might vary from economy to economy and between governance systems but the logic of the change would still be expected to prevail. This would especially be so if the state were to play a major role both in the regulation of tax and credit systems and in the provision of key public services and infrastructure which continue to provide an encompassing environment for informal enterprise and informal labour.

III. Barriers to policy making on the informal economy

Pitfalls of definition and measurement

By all accounts the informal economy is the largest source of employment and a significant contributor to national income in almost all developing countries. The obvious question is why given its economic and its social importance, policy making towards the informal sector ranges from benign negligence to outright hostility. An important part of the answer lies in the deep rooted problems of concept and definition embedded in the very notion of informal sector and informal economy.

The absence of precise definitions is not always a barrier to policy formulation. Some problems can be recognized without having to be accurately defined. Corruption and poverty are two such examples. Poverty was recognizable well before it was encapsulated into headcount ratios and poverty severity indices. Field research followed by conceptual advancement allowed governments to put into place fairly far reaching poverty eradication policies without waiting for precise definition.

In the context of the informal economy however, arguments about definition and delineation continue to play an unusually critical role. Despite over four decades of debate the picture is not much clearer today. GTZ/Bappenas (2008) summarize the current situation as follows:

> "Even though the concept of the informal sector was already introduced in 1972, today there is no consensus on how to theoretically define and empirically measure the informal sector. The definitions and conceptualizations of this term vary over time, space, field of application and organization. Around some thirty items including survival sector, non-structure sector, non-observed economy etc. have been and/or currently used to describe the informal sector making it a somewhat fuzzy concept. The same is true for its potential causes, relevance and persistence. Over time, major changes in conceptualizing and understanding the informal sector has occurred." (p. 86)

The complexity of definition embedded in the concept of the informal sector is explored in Swaminathan[2] (1991), Henley et al (2006), Maligalig (2008) and Ruffer and Knight (2007) among many others. In early studies the complexity of the informal sector was itself evidence of the usefulness of the research since

2 The variety of types of activity and workers invoked by the term informal sector is well described in Swaminathan (1991) thus: "the term "informal sector" is today widely used in writings on both developing and developed countries. It is invoked to refer to street vendors in Bogota, shoe shine workers in Calcutta, specialized knitwear workers in Modena and producers of fashion garments in New York City. What these activities to have in common is a mode of organization different from the unit of production most familiar in economic theory, the firm or corporation. These activities are also likely to be unregulated b the State and excluded from the standard economic accounts of national income" (p.1)

it provided a basis for understanding why surplus labour transfers posited in the early dual economy models from rural to urban areas had not proceeded as quickly or as smoothly as had been predicted. The informal sector continued to survive for many quite distinct reasons: because it provided a survival mechanism in times of crisis, because it was a stepping stone to a job in the formal sector, because it provided a means of earning higher incomes, as in the case of some skills in high demand, to home workers than in the formal sector, because it provided for entrepreneurship and establishment of new businesses without the restrictions of state regulation.

Despite the rich empirical detail provided by the large volume of surveys and micro studies, the central dilemma ever present in the characterization of the informal sector, as being a foundation of dynamic enterprise on the one hand and a sink of reserve, low income labour on the other was never really resolved. Research tended to focus on three repeated themes of informal sector classification; the form of ownership, the nature of employment and the regulation by the state.[3]

In early studies by the ILO key characteristics of the informal sector relevant to the design of a job friendly development strategy were identified as being the following:

- Small scale of operation
- Family ownership
- Reliance on local resources
- Labour intensive activity, locally appropriate technology
- Non-formal education skill base
- Ease of entry into the activity
- Operation in unregulated competitive markets

As Swaminathan (1991), from which the above list is taken, rightly points out that these characteristics were used to distinguish formal from informal enterprises. They were heavily weighted towards organizational aspects of the enterprise compared to the technical dimensions. The result is that distinction between formal and informal enterprise is based on organization rather than product characteristics or technology such that the same goods and the same production technology can exist both in the formal and the informal sector.

The prevailing wisdom for much of the 1970s and 1980s on the delineation of formal from the informal was influenced by the work of the Joshi and Joshi (1976) which described the distinction between the two sectors in the following terms:

> "Unorganised or informal activities were defined as those using an indigenous and labour intensive technology, operating in competitive markets and having no relation with government. By contrast, the organized sector typically comprised large firms operating in oligopolistic markets, with capital intensive technology, a protected work force, and enjoying access to government."

This description follows the lines of the ILO distinction with the important addition that informal activities lay outside state intervention.

3 Ibid hal. 7

The consequences of attempting to classify an extraordinarily diverse set of activities, employment arrangements and enterprises on the basis of a few generic factors such as ownership, size, production methods and technology is the constructions of a large, but not unexpected, number of rather arbitrary definitions of the informal sector. Two complications arise. First the reliability and frequency of the generalizations regarding the informal sector itself. Second the difficulties of defining "enterprise size' where "size" is an integral of what it is to be informal. Studies revealing that the informal sector is not always defined by ease of entry or by competitive markets, that many informal enterprises are highly dependent on imported inputs or that family owned enterprises often employ non family labour soon began to illustrate that few if any generalizations were possible across the diverse field of activities and production forms contained in some generic description of the informal sector.

Measuring the size of business activity or enterprise was also fraught with empirical imprecision caused by arbitrarily selected demarcation lines. The definition of "small" enterprises could be done on a number of criteria: employment, capital stock, energy consumption, or the type of technology used.[4]

Further complications arose when informal enterprises were interlinked with formal ones. As Breman and others have argued, the informal sector may not be independent of the formal one but highly dependent, subordinate or complementary to it. Putting out or sub-contracted work from large formal enterprises to informal ones all over Asia are good examples. So are marketing arrangements through groups of street vendors who hawk goods produced by formal enterprises in the textile, foot wear, kitchen utensils and other mass consumption businesses.

Another key finding of research into the informal sector activities was the considerable segmentation which existed within the sector itself. Ruffer and Knight (2007) provide a comprehensive review of the workings of the informal sector in developing economies and examine several types of labour market segmentation along wage differentials by firm size, along rural urban fault lines, and as the cases of China and South Africa show, according to the nature of the state and the rate of economic growth achieved.

Henley et al (2008) highlight the arbitrary nature of classification of enterprises as 'informal' by raising the obvious conceptual question of how large an enterprise has to be before it graduates from the informal to the formal sector. Moreover, some definitions of informality exclude some industrial groups and not others e.g. professional services. While these are all determined attempts at trying to distinguish formal from informal activities they still represent very rough and ready approaches to the determination of the size and scope of informal activity. For example, it excludes cases where small enterprise workers do have employment contracts and may pay towards social insurance. On the other hand large enterprises may not always provide registered contract employment or pay legally mandated contributions to social insurance. Moreover, both employees and employers might collude in non contractual working arrangements if there are economic incentives for doing so. The most frequent reason cited for large formal enterprises employing non-contracted casual labour is the significant lay off costs if a formal contract is terminated. Economic incentives therefore support the collusion between employers and employees to evade labour regulations established by the state.

4 Henley et al (2008) illustrate the scale of the problem thus:
"'Small' or 'micro' is defined arbitrarily and may depend on questionnaire design. For example, from recent research with makes use of such a definition of informality Pradhan and Van Soest (1995, 1997), and Maloney (1999) use a definition of fewer than six employees for Bolivia and Mexico respectively, Funkhauser (1996) uses fewer than five employees for an analysis of five Central American economies; Marcoullier et al (1997) uses fewer than six for Mexico and Peru; Cohen and House (1996) use fewer than 20 for Sudan; Livingstone (1991) uses fewer than 10 for Kenya." Ibid, p. 7

Despite so many varied attempts to define and measure the size of the informal economy both in terms of employment and enterprises, going back to the early 1970s, Ruffer and Knight rightly conclude that despite the political and academic interest in informality, the subject remains suffused with a significant lack of clarity. The point is effectively summarized as follows:

> "Academics, policy makers and commentators have argued extensively about the nature and the size of the informal sector, its welfare implications and the appropriate policy responses. The debate is often obscured by the fact that the term informality is ambiguous theoretically and hazy empirically. Informality often means different things to different people. Moreover the informal sector has different characteristics in different countries. These differences arise not only from the nature of these economies but also from the nature of the interventions by the state. Generalisations about the informal economy are therefore likely to be misleading in any particular context: an analytical taxonomy is required which can be applied to each economy."[5]

Given such problems of concept and definition, it is not surprising that the measurement of the size of the informal economy tends to generate widely varying estimates of both informal employment as well the contribution of the informal economy to overall GDP. Moreover Ruffer and Knight's evaluation that each country needs its own analytical definition of informal economy would imply that little would be gained from cross country studies of the informal economy. This is a severe limitation since it is just these kinds of comparisons which provide policy insights and test cases.[6]

Measurement problems with respect to the informal sector/economy arise not only from problems of definition and comparability across countries. They also arise from the lack to regular surveys designed to estimate the weight of the informal economy in terms of its share in GDP and total employment. Maligalig (2008) emphasizes the implications of such weak measurement on policy formulation as follows:

> "Since data on the informal sector and the informal employment are not available regularly, if at all, the national accounts statistics cannot cover this sector, resulting in distorted estimates of the structure of the economy. This lack of information also hinders the understanding of policy makers in government, the private sector and the public about many social and economic issues related informal sector activities, such as the lack of social protection; limited access to credit, training and markets; and differentials in wages and working conditions. As such policy interventions that are formulated and implemented to reduce poverty by generating decent work might not result in the desired outcome."[7]

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5 Ruffer and Knight (2007), p. 2.

6 Measurement problems in the informal economy were so severe that the United Nations appointed a specialized group (the Delhi Group) in 1997 to examine ways of improving international comparability. The 15th and 17th International Conferences of Labour Statisticians in 1993 and 1995 attempted to define the informal sector and informal employment so as to ensure their inclusion in the National Account Statistics but the estimates of the size and employment in the informal sector as well as informal employment in the formal sector across countries and over time remains highly problematic.

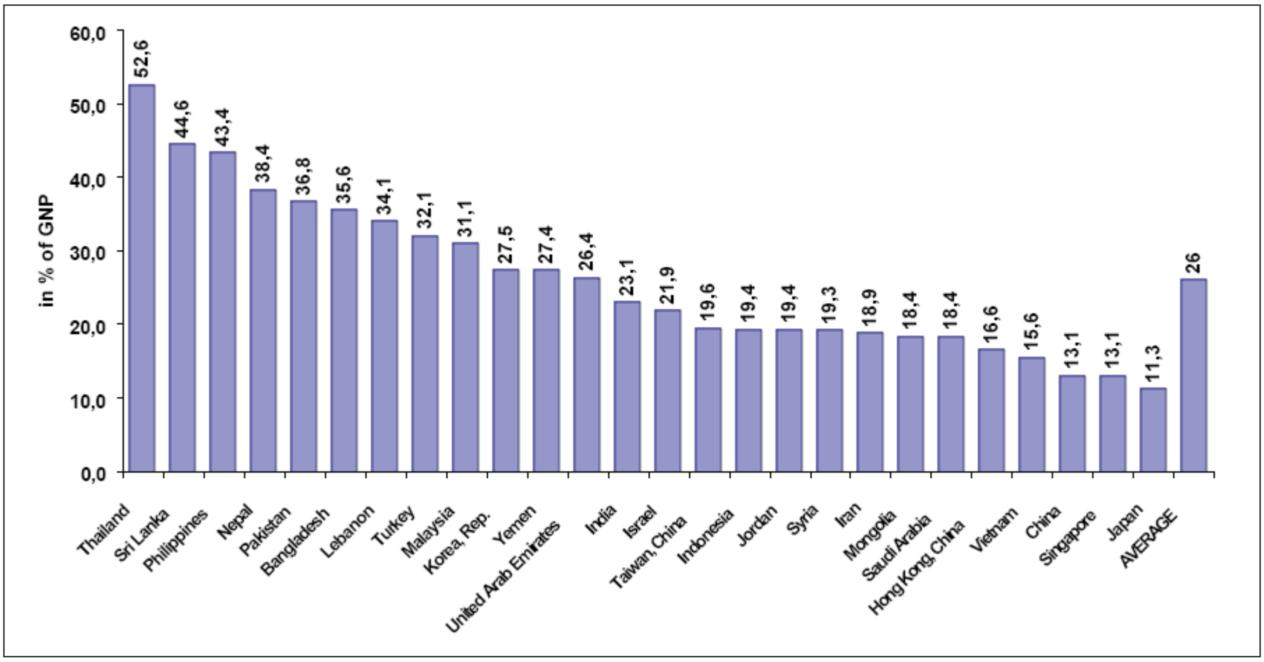
Despite the continuous attention devoted to the definition and measurement of the informal sector (i.g. informal production units/ enterprises and employment in the informal sector and informal employment including casual employment by formal sector enterprises) the overall contribution of the informal sector/economy to GDP and to total employment remains, as mentioned above, rather vague till today. For a good account of some of the most glaring measurement problems see Maligalig (2008).

7 Maligalig (2008), p. 1

8 Measurement problems are discussed in Maligalig (2008), Henley et al (2008) and Charmers (2006) among many others.

Of course, weaknesses in the data base covering the informal economy have generated many attempts to address problems of definition, data coverage, measurement[8] and international comparability. However, the general conclusion that while much is known about the workings of a given production unit or a particular type of work undertaken outside the formal economy, the information base remains too weak for effective policy making. Moreover the problem would be even more severe in those economies which are presumed to have very large informal economies since it is precisely in such cases that policies intended to promote decent jobs and labour productivity might be expected to be the most serious.

Figure 3. Asia – Shadow Economy in % of GNP 1999/2000

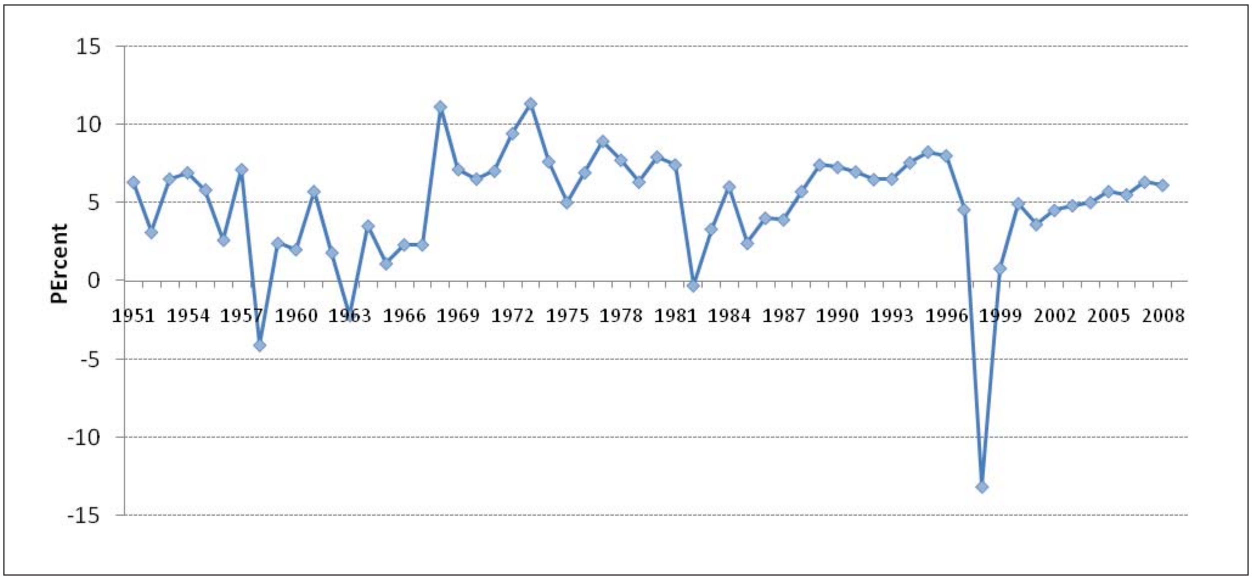


Source: quoted from Schneider, *Size and Measurement of the Informal Economy in 110 Countries around the World*, 2002

These difficulties have not precluded recent research from attempting cross country comparisons of size of the informal sector both in terms of contribution to GDP as well as employment. Schneider (2002) estimates the share of the informal sector in total GDP for 110 countries around the world including 26 countries in Asia (Figure 3). The share of the Indonesian informal economy at 1999/2000 prices is estimated to be around 19.4%, significantly lower than both Thailand and Sri Lanka but higher than China or Vietnam. It is less than half that of the average for developing countries taken together where it was 41%. In fact, the size of the informal sector in Indonesia is a little more than the average for OECD countries (18%), a rather surprising finding given both the difference in levels of industrialization and the relative effectiveness of regulatory institutions in the OECD compared to Indonesia.

8 Measurement problems are discussed in Maligalig (2008), Henley et al (2008) and Charmers (2006) among many others.

Figure 4 Indonesia's GDP Growth 1951-2008



Source: IFS, BPS and Bank of Indonesia

1999 was a year of high economic crisis in Indonesia having just experienced a close to 13.4% of output fall in just one year. In fact the Asian economic crisis set off the worst output fall in recent economic history (Figure 4). If, as is often argued, the collapse of the Indonesian economy triggered a sharp increase in informal employment and production, Schneider's estimates for Indonesia would be higher than in non-crisis years. Normal year contribution of the informal economy to total GDP in Indonesia it can be argued would have been significantly lower, closer to a Vietnam or a Hong Kong or China on the one hand and a Canada or an Australia on the other.

This would be surprising without detailed explanations as to how Indonesia, on the basis of a number of factors affecting the strength of the informal economy such as levels of industrialization, levels of urbanization, and labour regulations, stands in relation to neighbouring countries such as Thailand on the one hand and the Philippines on the other. However if the estimates in Schneider (2002)[9] are to be believed the contribution of the informal economy even in a period of economic collapse in the formal economy was less than one fifth of total GDP. What is even more striking is that the share of the informal economy to GDP in Indonesia in the middle of its historic economic crisis was only marginally higher than the average for the Western European OECD countries, representing some of the most industrialized and efficiently regulated economies on the globe (Table 2).

Estimates of the share of the informal economy in GDP are thus complicated exercises both due to the shortage of reliable data as well as problems of definition and modeling. Measurement of informal employment would seem to be easier. But unfortunately such estimates also suffer from formidable conceptual and measurement problems. Ceuvas et al (2008) and Maligalig et al (2008) and Trebilcock (2005) provide good accounts of pitfalls of measuring informal employment. The first problem is the distinction between employment in the informal sector and informal "employment" which can cut across all sectors, including casual work in formal enterprises.

9 Schneider's estimates are based on an indirect method of assessing the size of the informal economy based on electricity consumption, currency demand (following Tanzi's assumption that informal transactions are done in cash and therefore are likely to result in an increase in local currency demand) and a model for estimating variations in the informal activities based on tax rates, inflation rates and the degree of regulation in the economy.

Table 2 Average Size of the Informal Economy for Developing, Transition and OECD Countries in Terms of Value-Added and of the Labor Force over two period (1999/2000)

Countries	**Average size if the Informal Economy - Value added in% of official GDP 1999/2000** *Currency Demand and DYMIMIC method (number of countries)*	
Developing Countries: Africa	42 *(23)*	48,2 *(23)*
Central and South Amerika	41 *(18)*	45,1 *(18)*
Asia	29 *(26)*	33,4 *(26)*
Transition Countries	35 (23)	-
Western OECD Countries - Europe	18 (16)	16,4 (7)
North American and Pacific OECD Coutries	13,5 (4)	-

Source: quoted from Schneider, *Size and Measurement of the Informal Economy in 110 Countries around the World*, 2002

The second is that even labour force surveys, such as the Sakernas in Indonesia, contain only a few questions which allow the work done for informal activities. Thus Ceuvas et al concluded that the Sakernas questionnaire actually limit the ability to identify whether a particular kind and duration of work should be classified as being an informal activity. As they show, only 1 out of 27 questions in the Sakernas was directed at the "nature" of employment. Thus only question IV B, 10a which identified the status in employment, was able to distinguish workers engaged in informal employment. On the whole, according to Ceuvas et al, "the questionnaire lacks the items which can help separate formal from informal workers as well as to distinguish workers in the informal sector from those in informal employment outside the informal sector such as registration status, presence of written accounts and employment benefits." [10]

Table 3. Temporary Classification of Nature of Employment

Informal	Mixed
Casual employees in agriculture	Own-account workers
Casual employees in non agriculture	Employers assisted by temporary/unpaid workers
Unpaid workers	Employers assisted by permanent workers
	Employees

Source: quoted from Cuevas, *Informal Employment in Indonesia*, 2009

10 Ceuvas et al (2008), p.6

Given problems with the data set, Ceuvas et al propose employment classification in terms of informal and "mixed" (Table 3). The approach was to identify workers in the pure informal category and classify the rest in the mixed category. The informal contained casual employees (either in agriculture or in non-agriculture sector) and unpaid workers. Others, including own account workers, employers and employees, fall in the mixed category.

The above discussion provides a small sample of the measurement problems inherent in estimating the contribution of the informal economy in national income and employment. That alternative definitions and measurement approaches lead to very different results is illustrated by the case of Brazil where Henley et al (2006) found that the share of the informal economy in national income according to one definition was 64% while it was 40% if three alternative criteria were used i.e. employment and contract registration, social security protection and employer/employee characteristics. They also found considerable segmentation within the informal sector, a point noted also by Chen (2004).

Tables 4 and 5 present estimates for informal employment in Indonesia based on an informal/mixed activity distinction and Figure 5 based on the usual results of the Sakernas contained in Nazara (2010). Two conclusions follow. First, the share of informal employment shows a dramatic variation from around 29.1% in the ADB (Ceuvas et al) and Nazara (2010). Second, informal sector employment also exhibits large inter-provincial variations, from a minimum of 27.3% in Jakarta to 81.0% in Nusa Tenggara Timur. However, given the wide variations in the size of the formal economy and of different degrees of urbanization one would expect the difference between the "purely" informal and the mixed employment categories to show even larger variations across provinces.

The presence of such large variations in estimated size and employment in the informal economy raises the suitability of informal sector/informal economy categories for effective policy making. An important outcome of policies towards the informal economy would be to monitor its movement and structure over time. Another would be to be able to target segments of it for government assistance and/or registration or regulation. Where estimates show overwhelmingly large shares of informal employment, such as close to 90% for India for example, they raise an additional but fundamental question over the any meaningful distinction between a policy oriented towards the informal economy and a development policy in general. It is therefore not surprising that it is difficult to find a policy towards the "informal economy/sector" in most developing countries. Rather the size and the structure of the informal economy is the outcome of the sum total of a range of development programs and policy choices made by the government. In such a context, movements in the share of the informal sector in national income and employment can be seen as no more than monitoring devices which illustrate a number of different characteristics of the development process e.g. employment conditions or the growth of new types of entrepreneurial activity.

Table 4 Frequency and Percentage Distribution of Employed Population

Employment Status	Frequency	Percent
Employed	97,583,141	90.2
Either Formal or Informal	69,232,610	70.9
Own-account worker	18,667,332	19.1
Employer assisted by temporary workers/ unpaid workers	20,848,535	21.4
Employer assisted by permanent workers	2,847,692	2.9
Employee	26,869,051	27.5
Informal	28,350,351	29.1
Casual employee in agriculture	6,278,470	6.4
Casual employee not in agriculture	4,267,064	4.4
Unpaid workers	17,804,997	18.2
Urban	38,676,852	39.6
Rural	58,906,289	60.4

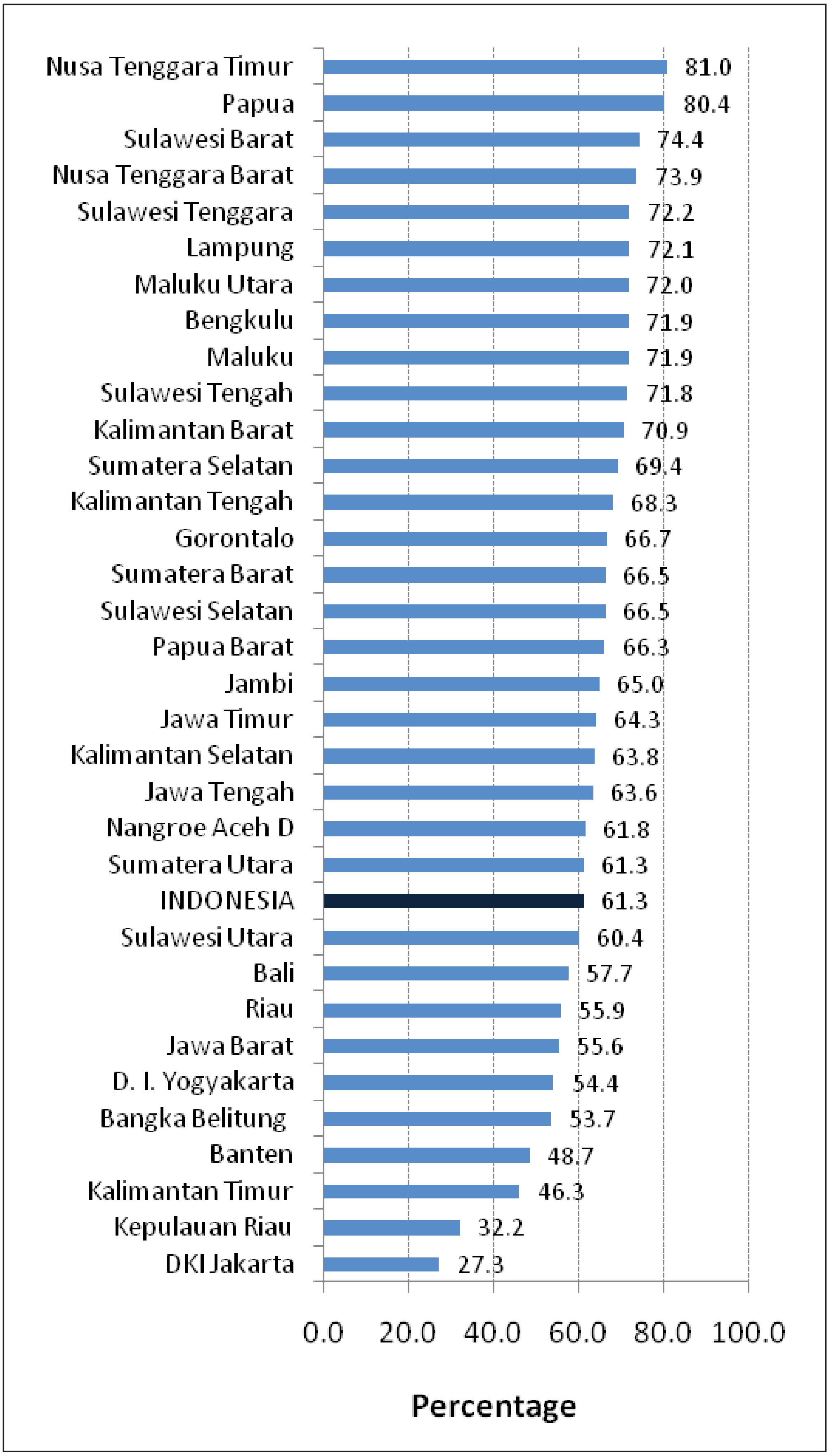
Source: quoted from Cuevas, *Informal Employment in Indonesia*, 2009

Table 5 Distribution of Workers, by Employment Status, Industry, and Informal/Mixed

Industry	Mixed				Informal		
	Own-Account Worker	Employer Assisted by Temporary Workers/ Unpaid Workers	Employer Assisted by Permanent Workers	Employee	Casual Employee in Agriculture	Casual Employee not in Agriculture	Unpaid Family Worker
Agriculture, hunting, and forestry	18.69	68.41	3.78	9.12	31.31	0.00	68.69
Fishing	48.98	17.93	5.41	27.68	54.35	0.00	45.65
Mining and quarrying	35.33	8.27	4.90	51.49	0.00	65.20	34.80
Manufacturing	14.24	11.69	4.37	69.70	0.00	42.96	57.04
Electricity, gas, and water supply	8.51	2.10	3.03	86.35	0.00	79.22	20.78
Construction	14.98	5.44	10.98	68.60	0.00	88.92	11.08
Wholesale and retail trade, repairs, etc.	46.95	24.73	5.05	23.27	0.00	9.32	90.68
Hotels and restaurants	26.56	28.19	7.07	38.19	0.00	4.16	95.84
Transport, storage, and communications	57.51	3.03	2.94	36.52	0.00	82.96	17.04
Financial intermediation	1.86	0.00	0.59	97.55	0.00	90.67	9.33
Real estate, renting, and business activities	19.82	5.36	8.51	66.30	0.00	59.71	40.29
Public administration and defense, social security	0.00	0.00	0.00	100.00	0.00	0.00	0.00
Education	2.03	0.48	0.24	97.26	0.00	37.96	62.04
Health and social work	13.44	1.76	2.08	82.72	0.00	68.98	31.02
Other community, social and personal services	42.33	6.95	4.76	45.95	0.00	76.90	23.10
Private households with employed persons	26.97	3.12	2.08	67.83	0.00	86.09	13.91
Others (extraterritorial organizations/bodies)	10.18	0.00	0.00	89.82	0.00	0.00	0.00
No answer/unclassified	83.90	6.24	0.00	9.86	0.00	72.79	27.21
All	26.96	30.11	4.11	38.81	22.15	15.05	62.80

Source: quoted from Cuevas, *Informal Employment in Indonesia*, 2009

Figure 5 Employments in Informal Sector across Provinces, 2008



Source: BPS

From informal economy to decent jobs

One outcome of the thirty seven year old search, since Hart (1973) for the holy grail of "informal sector" definitions and estimation formulae and its distance from the day to day application to policy making is to quietly abandon this search in favour of a more policy relevant approach. Concern with understanding and influencing the laws of motion of the informal sector gave way to a concern with 'decent jobs deficits'. Following the 2002 ILC the concept of the informal 'sector' was replace by the informal 'economy'.[11]

The implications for policy making on the informal economy following from the 2002 ILC deliberations are considerable. The change in direction is stated clearly by Lim's commentary on the conclusions of the 2002 ILC. The quotation below illustrates the degree to which the old, analytical and rather economic concept of the informal sector had given way to governance, human rights and juridical concept of the informal economy and the decent job deficit.

> "It might be useful to remind ourselves of the implications of the decent work approach. Very importantly it has enabled us to break away from what was previously termed the 'dilemma' of the informal sector and from the tensions and confusions surrounding a goal couched in terms of 'formalizing the informal'. It is no longer an either-or dilemma of rights and social protection versus employment creation. It should help to allay the concern of some of our constituents that the aim is to destroy jobs in the informal economy. The Conclusions noted that 'to promote work, it is necessary to eliminate the negative aspects of informality while at the same time ensuring that opportunities for livelihood and entrepreneurship are not destroyed, and promoting the protection and incorporation of workers and economic units in the informal economy in the mainstream economy".[12]

The Decent Work approach adopted at the ILC (2002), brings to a close over four decades of research and policy dilemmas involved in distinguishing the formal from the informal sectors. While this revised approach is now widely discussed in the new literature on poverty and the factors which increase the vulnerability of households from falling into absolute poverty due to among other things lack of access to assets, job insecurity, ill health and other types of unexpected disasters, labour force data as seen in the Indonesia case are still conducted into the mould of the pre 2002 concepts.

However, the appendix box shows, the emphasis is still on finding a dividing line between formal and informal employment using alternative definitions and survey methods. If anything the distinction between a mixed and purely informal set of activities as used in the ADB studies might be more in tune

11 The 2002 ILC Committee clarified the use of informal economy as compared to the informal sector as follows:
"All economic activities by workers and economic units that are –in law or practice-not covered or insufficiently covered by formal arrangements. Their activities are not included in the law, which means that they are operating outside the formal reach of the law; or they are not covered in practice, which means that – that although they are operating within the formal reach of the law, the law is not applied or not enforced; or the law discourages compliance because it is inappropriate, burdensome or imposes excessive costs"
The point is made sharply by Lim(2003) who outlined the degree to which thinking had shifted by the time of the 2002 ILC as follows: "Another significant feature of the new conceptual framework is that it depicts a continuum of production and employment relations. *It does away with the idea that there are distinct formal and informal "sectors" without direct links and instead stresses that there are "linkages, grey areas and interdependencies between formal and informal activities*." (emphasis added)
Hence, the framework views formal and informal enterprises and workers as co-existing along a continuum, with decent work deficits most serious at the bottom, unprotected, unregulated, survivalist end, but also existing in some formal jobs as well, and with increasingly decent conditions moving up towards the formal protected end. By highlighting the dynamic linkages between formal and informal activities, we can frame the policy issue more realistically: *the issue is not whether informal workers or informal units have direct ties with the informal economy—clearly they do—but whether those ties are benign, exploitative or mutually beneficial*. The policy concern should be to enhance the positive linkages and to ensure that there is decent work all along the continuum" (ILO 2002, p.38 quoted in Trebilcock (2005), p. 3. (Emphasis added).

12 Quoted in Trebilcock (2005), p.3.

with the spirit of the ILC (2002) than those which make a rigid distinction between formal and informal. For the purposes of policy, governments could then focus on the purely informal employment activity and units, as an overall part of its poverty reduction and economic security driven programs.

If that were the case it is time to move away from measuring informal employment in ways such as to exaggerate the overall weight of the informal sector to an overwhelming share of informal employment and income. The case of India is a good example. The fact that over 90% of the workforce is found in the informal sector can not only be questioned in terms of several structural aspects of the economy such as the size of the secondary sector, the size of the public sector, etc, but also in terms of the policy message. If 90% of the workforce finds their livelihoods in the informal sector, what then constitutes a policy towards the informal sector? The answer is simple. Policy towards the informal sector in such cases is nothing less than the universe of development policies altogether. It can be argued that the informal economy concept adds very little to policy formulation in the Indian context. To do that we would need to focus on the continuum between informal and formal activities. Policy on some grand scale aimed at formalizing the informal is a thing of the past. The focus has shifted instead towards bringing units and activities which fall below some internationally recognized standard of decent work into appropriate legal regulation and review.[13]

This is a long cry from the Latin American cases a la De Soto which reveled in the absence of state controls and regulation precisely because they set limits to entrepreneurial risk taking. More suited to the new statist flavor of development policy of today, the emphasis has moved subtly to regulation and control, to empowering the poor and to finding ways of striking a fair bargain between employer and employee, between the compulsions of the market and the demands of social justice. How that is to be done in a world characterized by global capital flows, by a growing dominance of international enterprises and by governments competing for foreign investment and resources is still a matter for philosophical conjecture and political experimentation.

13 This approach is not that dissimilar to Swaminathan (1991) who argued that the only tenable approach to identification of the informal sector was the absence of legal regulation and state recognition. To quote Swaminathan’s perceptive conclusion:

“It was argued that informal sector enterprises could be identified by the absence of regulation of the status of an enterprise. A specification in terms of the pattern of ownership of an enterprise was found to inadequate to identify enterprises belonging to the informal sector. An absence of regulation of employment conditions was used to define informal employment. Definitions based on the form of employment such as self employment were also shown to be inadequate characterizations of informal employment. An exception to this is the distinction based on casual labour versus hired labour which corresponds directly to differences in the regulation of labour contracts.” (p. 29)

IV. Dealing with the informal economy in Indonesia

Absence of an overarching policy towards the informal economy in Indonesia

However we choose to define and measure it, one thing is certain. The informal economy contains the largest pool of labour and accounts for a very large share of GDP in most developing countries. The precise numbers may vary. The share of informal activity may rise and fall under changing market and policy conditions. But in much of the developing world it is likely to remain a fact of economic life for several decades to come. The question is what governments can or should do with respect to the informal economy. The importance of the informal economy seems to suggest that government should have a policy to address issues of viability, productivity, and persistence of such a critical part of the economy. It should also find some way, as Trebilcock (2005) mentions, to mitigate its worst features (low wages, poor working conditions, and chronic economic uncertainty) while enhancing its best ones: risk taking, entrepreneurship, hard work and mobility.

If the mere existence of a large sphere of informal activity is the primary rationale, then every developing country government and many developed ones with large informal economies would already have mainstream policies and programs for the informal economy. Yet in reality the situation is quite the reverse. Few governments have a clear and pronounced policy towards the informal economy. The above discussion points to some of the reasons for this rather paradoxical situation. Endemic problems of definition and measurement are clearly one hurdle to policy making on the informal economy. It is difficult to target what one cannot define or measure with any degree of precision. Without cross country comparisons and analyses it is difficult to assess what constitutes a reasonable or feasible rate of progress in key target indictors of specific informal economy characteristics.

This is even more of a limitation on policy formulation when time series data on informal employment, its distribution across sectors and regions, and the linkages of informal businesses and workforce with those outside it are hardly ever available. Similarly it is difficult to estimate let alone model the dynamics of the informal economy in terms of production, trade and technology when much of this economy is hidden from the view of government if only because informal enterprises often remain unregistered, untaxed and unregulated. All these difficulties serve to ensure that while everyone seems to agree about the importance of the informal (or hidden) economy in developing countries, there is little agreement as to what can be done to influence its productivity, growth and evolution over time.

The inevitable conflict between the efficiency/growth dimensions of informal economy policy and its social justice/fair distribution aspects merely compounds a government's policy dilemma. If it gives free rein to the entrepreneurial spirit of the informal economy, it risks undermining national health and safety regulations, its tax and revenue laws with little assurance that tiny and small enterprises will grow into larger sustainable ones. If it aims to promote decent working conditions, regulate minimum wage levels and enforce health and safety standards it risks putting many microenterprises out of businesses. It can also be attacked by business lobbies which see minimum wages and labour regulations concerning hire and fire or compulsory payment of social insurance premia by employers as imposing an excessive business cost. Such business lobbies could also argue that if these costs are deemed to be higher than neighbouring countries, they provide a priori grounds for investment relocation or discourage green field investment in the country.

These are all relevant if rather general questions governing the formulation and the impact of a mainstream policy on the informal economy. The more interesting question is, apart from problems of identification and measurement, why such a policy continues to elude most governments. In what follows below, it is worth examining the reasons why despite a large informal economy, which by all accounts became larger in the aftermath of the sharp output fall triggered by the Asian Economic Crisis of 1997/98, Indonesia did not introduce an overarching policy towards the informal economy.

Moreover, ten years later with little change in the size of the informal economy Indonesia is still unable to formulate an overall policy towards the informal economy. The latest five year plan (the RPJM) and other policy documents of relevant government departments fail to indicate any coordinated approach to the informal economy. The informal sector is often in the news: the use of infected meat in street cafes, the removal of street vendors by force from city centers, the unscrupulous extortion of such businesses by the police and municipal authorities not to mention the unusual rags to riches story, but today Indonesia does not possess any thing approaching a policy recognition let alone a set of integrated and monitored programs on the "informal economy".

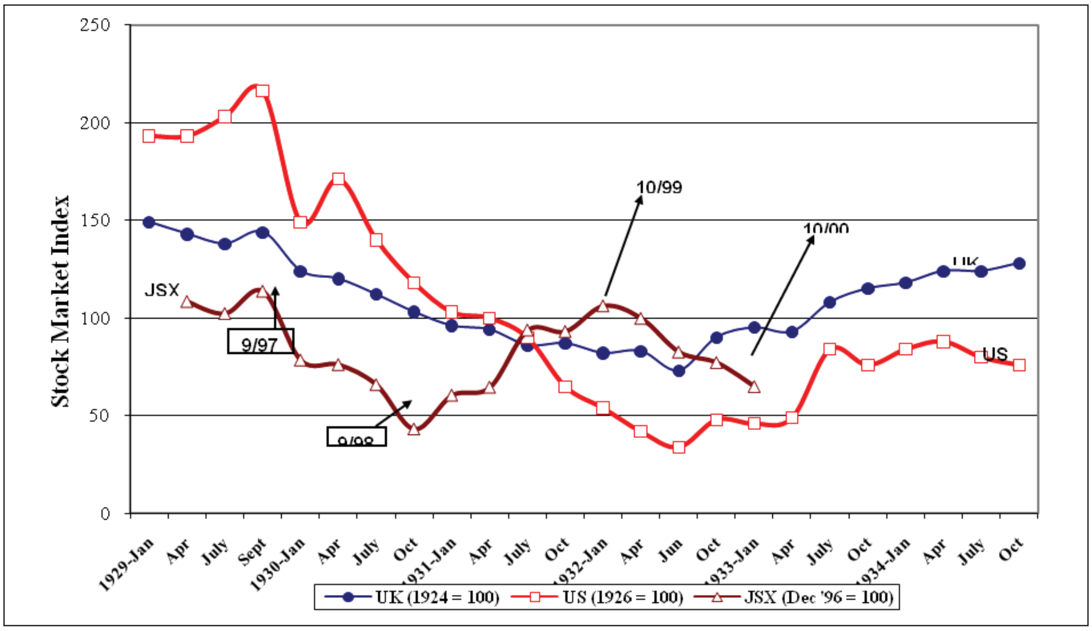
The question is whether this is an indication of a fundamental deficiency in government policy making which is to be expected given the context in which economic and social policies continues to be made in Indonesia. Moreover, is there any merit in formulating broad policy towards the informal economy at the present state of Indonesian development or is a piecemeal approach to informal economy directed programs (poverty reduction and social insurance, micro credit, health and safety minimum standards and technical assistance in following such guidelines, skill formation and marketing assistance) will do just as well. Yet, if the latter works just as well as the former in the current Indonesian context, one wonders what is the policy relevance of the analytical categories such as the informal economy, hidden economy, informal sector, informal activity and so on.

The answer to these questions lies in a deeper understanding of the political and the economic context of policy making in Indonesia over the last decade when it navigated not one but two major economic, and at least one systemic shock, in less than ten years. Only such a perspective allows a more comprehensive appreciation of the constraints on economic policy making which the government has faced over this remarkable period and which allows an understanding of why an overarching policy towards the informal economy may not still be on the cards.

Indonesia in 1997/98: Financial Shock and Systemic Collapse

Nothing illustrates the scale and the devastation caused by the impact of the 1997/98 Asian economic crisis on Indonesia as the data in figures 6 and 7. The first shows that the economic shock in Indonesia was comparable to anything experienced in the middle of the great depression in the 1930s in the USA and the European economies. The second puts the costs of mending the financial sector in comparison to large financial crises in other parts of the world notably Latin America. On both counts, what happened to the Indonesian economy was not part of a cycle of boom and bust. It represented the beginning of new era in Indonesia's post independence history.

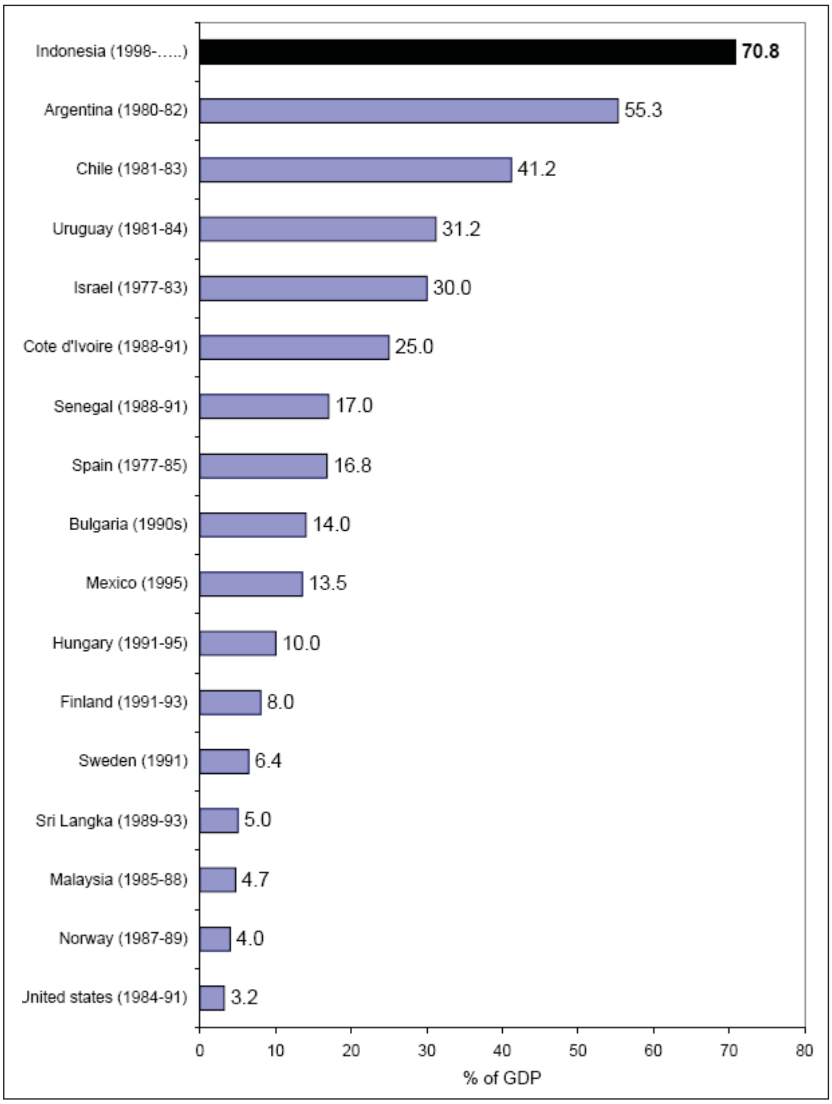
Figure 6 Stock Market Crash during the Great Depression, 1929-1939



Note: Based on quartely basis, Jan '29 until Oct '34 for US and UK, and Jan '97 until Oct '2000 for JSX (Jakarta)
Source: UK and US stock market index from Kindleberger (1986) and JSX index calculated from BI

The severity of the foreign exchange shock which sent the Rupiah into a free fall, depreciating to a pre-crisis 2400 Rupiah to the dollar to a peak of around 17,000 set off the inevitable round of bank collapses, bad debts, industrial paralysis on the one hand and the sharp climb in inflation rates on the other. The result was a total collapse of the political and governance systems. The New Order system of government collapsed. With it came the complicated but surprisingly smooth process of reforming almost every institution of government from the Presidency to parliament, from the Central Bank to the Planning Commission, from the Military and the Police to the Judiciary. In a space of five short years Indonesia transformed itself from a long lived authoritarian and centralized dictatorship to a decentralized multiparty democracy. Arguably such a systemic transition was on a scale attempted in many of the states of the former Soviet Union with greater speed, less violence and more stability than in the countries of the USSR and Eastern Europe.

Figure 7 Fiscal Cost of Banking Crises in Selected Countries (as percentage of GDP)

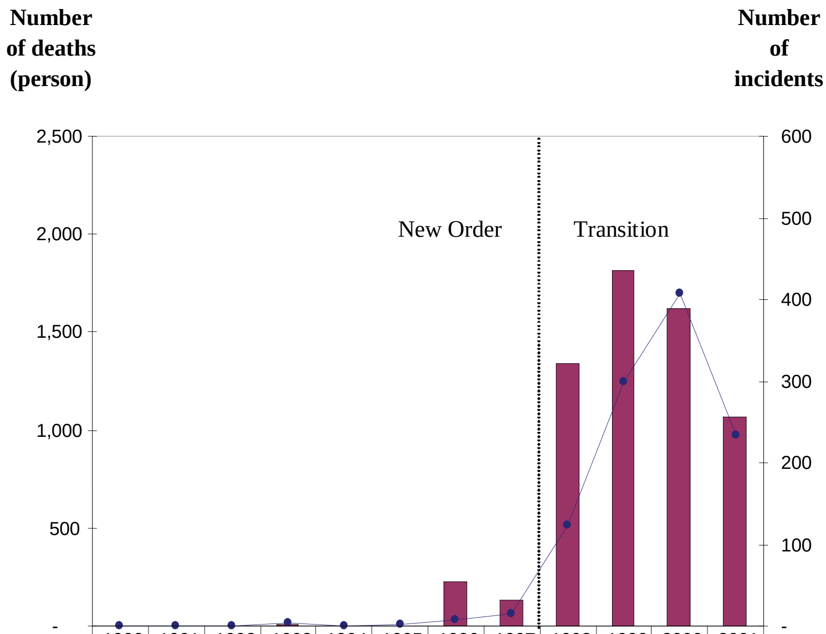


Source: Mishra, *Systemic Transition in Indonesia, UNSFIR Working Paper*, 2000, data is quoted from Caprio and Klingebiel (1996), for others countries data

A number of facts are relevant for understanding the policy making environment of the time. Two items dominated the domestic policy agenda. The first was institutional reform such as to get the military to take a back seat in national politics and thus prevent Indonesia from going down the route of a Turkey or a Pakistan with their deep rooted political tension between civilian and military authorities. The second was finding a way to protect the most vulnerable from the scourge of sudden food price increases on the one hand and livelihood losses caused by collapsing domestic demand on the other. Both of these were critical if Indonesia was not to become a cauldron of social conflict. The immediate post-Suharto years registered a sharp increase in violent conflict in many parts of the country (see figure 8).

The external agenda was dominated by debt repayment and to assure Indonesia's foreign creditors that it would not go into default or move away from its open capital markets as Malaysia had already done in 1998, and some Latin American countries had done under similar financial shocks from the 1980s onwards. Given that over half of Indonesia's external debt was in the form of private debt, an orderly working out of debt obligations itself required new policy approaches and massive government financial injection to recapitalize the banks and financial institutions. The presence of a dominant IMF supported by Indonesia's major bilateral creditors also meant much less space for independent policy thinking, consensus building and program development.

Figure 8 Social Violence, 1990-2001



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Number of death	-	-	-	10	-	2	227	131	1,343	1,813	1,617	1,065
Number of incident	-	-	-	3	-	2	8	15	124	300	408	233

Sumber: Zulfan, *Anatomy of Social Violence in the Context of Transition*, UNSFIR Working Paper, 2002.

Decentralization and the policy making process

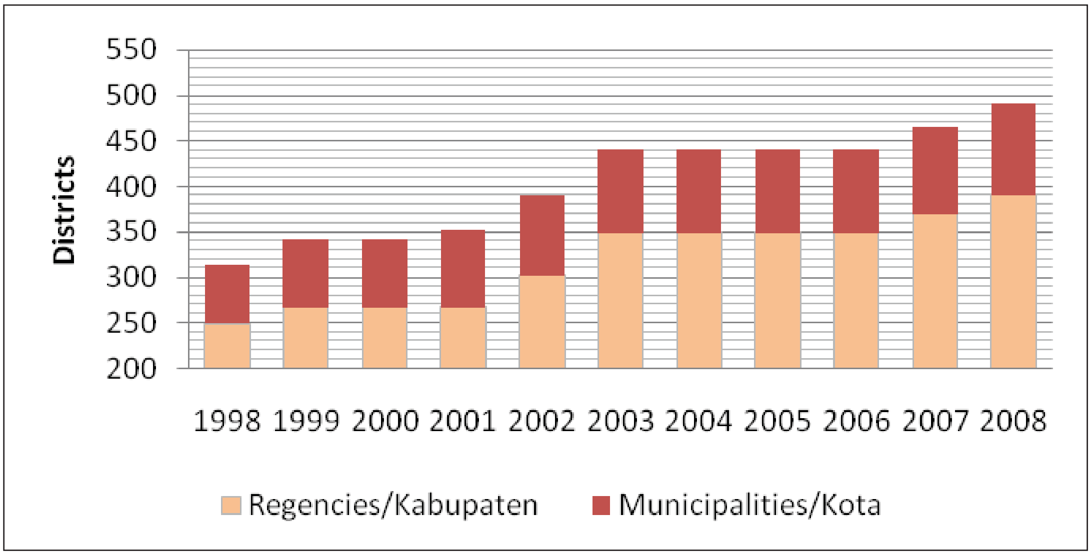
Setting the policy agenda was not the only problem for the new democratic governments of the early 2000s. The institutional capacity and the process of policy formulation was just as critical to effective policy making in government.

Indonesia's sudden decentralization created both confusion and uncertainties in the policy process. For one the laws and regulations governing decentralization were in constant evolution and debate. From the first decentralization laws (law 22 and 25 of 1999), the arrangements for Indonesia's transformation from a highly centralized to an equally highly decentralized form of government have occupied a large proportion of civil service activity. The process continues till today both due to the introduction of special autonomy regions of Aceh, Papua, Jakarta and Yogyakarta and because there is considerable rethinking of the position of provincial government in the decentralization equation. Pemekaran or the redrawing of district boundaries to carve out new districts and provinces has only added tension to uncertainty. National or even provincial policy making in areas which require enormous coordination and co-planning across a wide range of activities, industries, enterprises, labour and finance as well as different forms of ownership are difficult at the best of times. They are almost beyond reach when overlapping government structures and conflicting policy goals, (e.g. between regulation of enterprises to promote health and safety standards and ignoring them on the grounds of flexibility and ease of entry) enter the equation.

At the same time the large regional economic differences between Indonesian districts (regions) accompanied by constant boundary changes have often crowded out social welfare related public expenditure in favour of administrative costs of new government structures. (see figures 9 and 10). That and the constitutionally mandated sharp rise in educational expenditures (around 20% of the total national budget), has also left relatively little space for policy development and programs towards the informal economy.

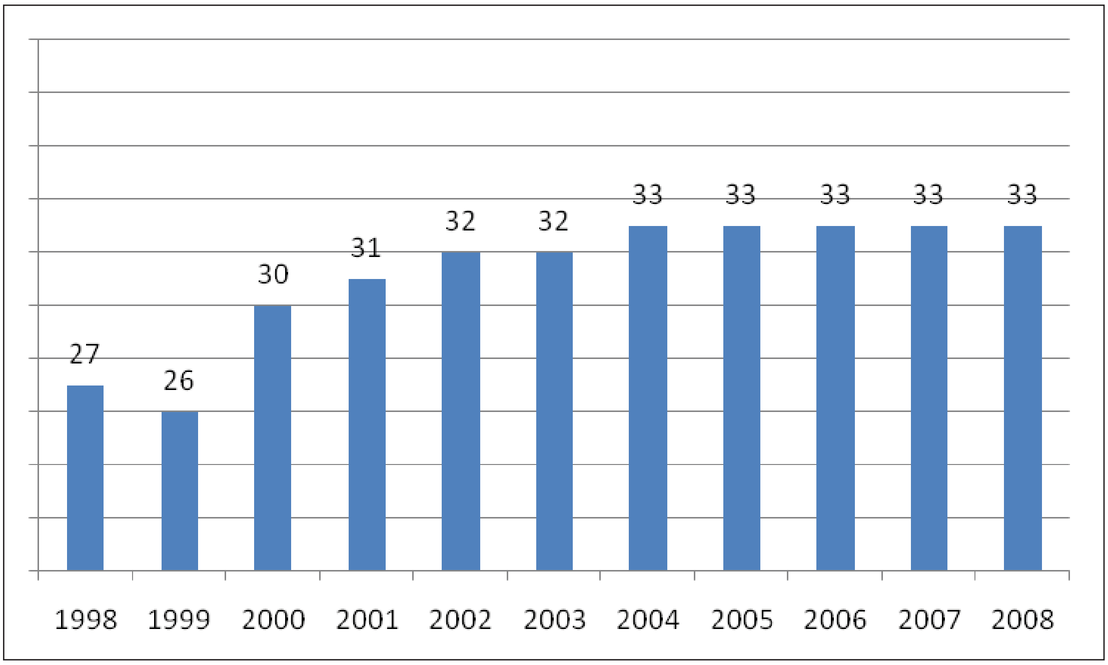
The limited planning and budgeting capacity of many of Indonesia's poorer regions (which constitute the majority of its regions) might have been supported by central government departments or specialized national commissions and independent institutions. However, line ministries such as Manpower, for Cooperatives and Small and Medium Enterprises and Social Affairs or Women's empowerment are themselves relatively weak in the policy development area and suffer from very limited budgets. So do regionally oriented Departments such as that for the development of backward regions (e.g. Eastern Indonesia).

Figure 9 Number of Districts in Indonesia, 1998-2008



Source: USAID (2009), Ministry of Home Affairs, BPS "Indonesian Statistics" (various years),

Figure 10 Number of Provinces in Indonesia, 1998-2008



Source: Ministry of Home Affairs

The result of the above is that policy making towards the informal sector/economy has suffered both from the needs of political reconstruction and economic recovery in the banking, industry and other formal activities in the urban areas. The policy process in government also suffered from the rapidity of decentralization and the pressures of boundary changes on a large scale through out the country. In the first half of the present decade neither the policy environment nor the policy institutions were conducive to policy formulation and implementation towards the informal economy. The story could have been different in the second half of the decade but the onset of a global economic crisis, simultaneous national, provincial and regional elections of both parliament and the executive and the preoccupation of the new government following the 2009 elections with anti-corruption on the one hand the bail out of Bank Century on the other have again served to divert government attention to the establishment of a some national framework for policy towards the informal economy.

Growth, investment climate and labour market policy

Employment and labour market issues have however continued to draw the attention of government for much of the decade but the context and the rationale have changed over time. In the early aftermath of the 1998 economic shock interest in employment trends was to understand and measure the social impact of the output fall rather than any meaningful ability to use employment targets for national policy. In fact early attempts at labour creation schemes were abandoned on suspicion of rampant corruption in favour of cash transfer and poverty reduction block grants.

The interest in labour market policy following the 1998 crisis was not so much from the perspective of creating new jobs as from preserving existing ones. Business lobbies hard affected by restricted credit and a sharp contraction of the local market argued in favour of less restrictive regulations on hire and fire on the one hand and for an elimination of minimum wages on the other. Such lobbies could rely on information cited in Table 6 to make their case. This was especially true of labour intensive industries such as textiles, garments and footwear where labour costs were higher in total costs than other forms of business as well as growing competition from labour surplus economies of Bangladesh, Vietnam and elsewhere.

This rang a bell with some policy makers and economic observers from the mid 2000s when there was a worry that Indonesia's nascent economic recovery was too dependent on consumption rather than investment growth. The relevant CGI meetings of the time place great weight on improving the investment climate and lowering the costs of doing business in Indonesia as well on rebuilding damaging or outdated infrastructure. The result of this psychology was inordinate attention given to issues of minimum wages and labour market regulations. This was despite the fact that labour market research, especially with support from the ILO, had continued to demonstrate that neither of the above had constituted a serious constraint to investment in Indonesia and was of little relevance to the investment climate. Issues of political uncertainty, law and order, social conflict, legal uncertainty and public corruption played a much more important role in investment decisions than issue of labour market flexibility, regulations on labour dismissals and minimum wages.

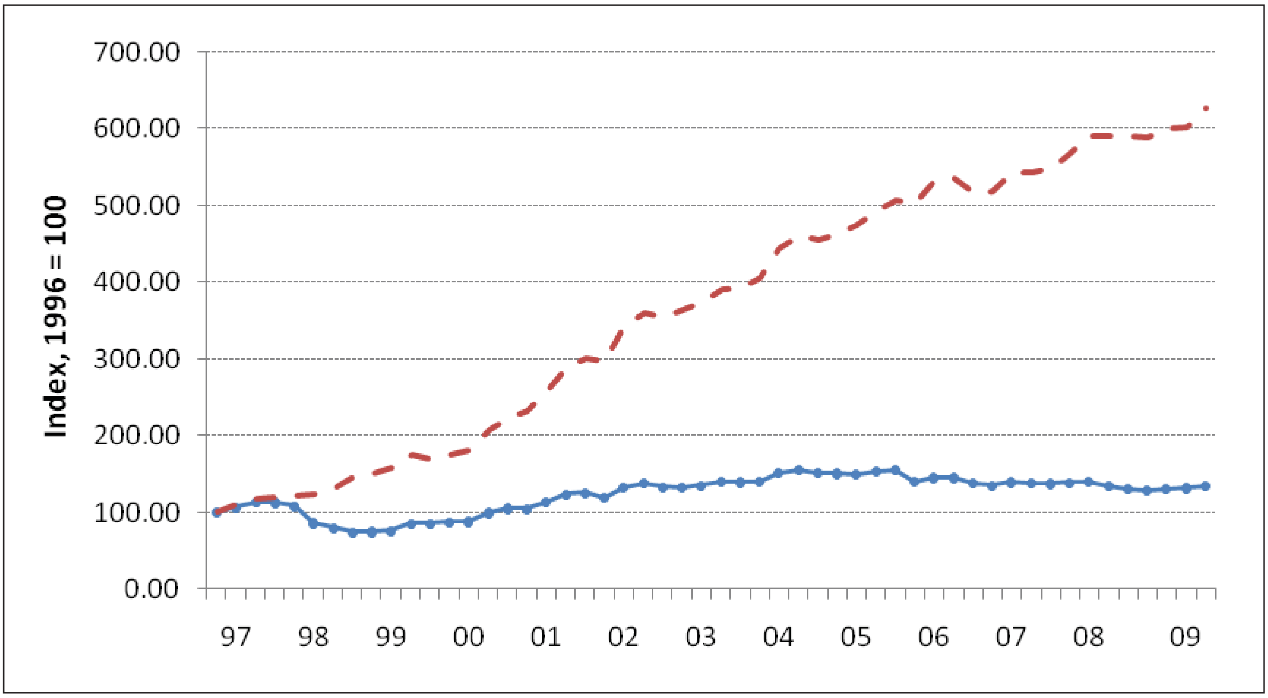
Table 6 Indices Pertaining to Employing Workers in Indonesia, 2003-2007 (100 = worst score) Seem to be Constant

	2003	2004	2005	2006	2007
Difficulty of hiring index	72	61	72	72	72
Rigidity of hrs	0	0	0	0	0
Difficulty of firing index	60	60	60	60	60
Rigidity of employment index	44	44	40	44	44
Firing costs[%salary]	10	10	10	10	10

Source: World Bank, Doing Business Survey, Available online at http://www. doingbusiness.org

Real wages did rise in the course of the economic recovery but much of this was in the form of a catch up process given the stagnation and decline in real wages since the mid 1990s.[14] In fact, as figures 11 and 12 illustrate the real wage rise for unskilled labour in a number of formal sector industries such as industry and hotels remained constant. They rose from the middle of the decade in the mining industry driven by high commodity prices, but the numbers employed in the sector remained relatively small and would have little effect on the trend in the aggregate real wage.

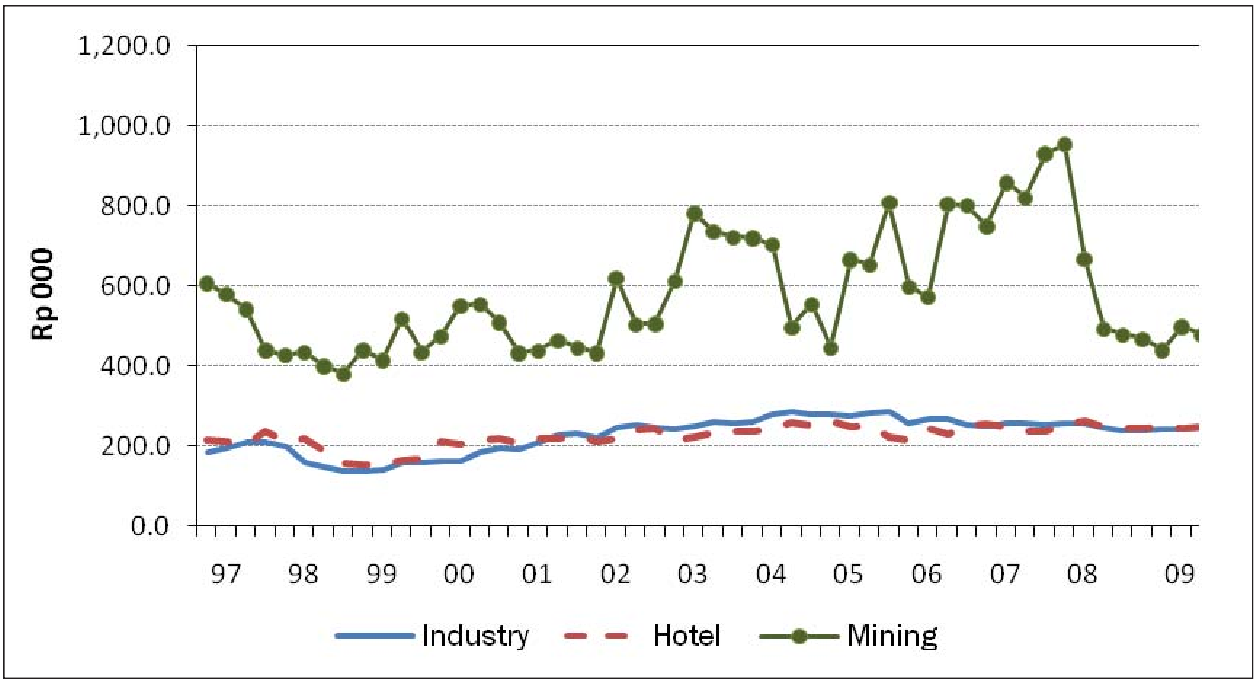
Figure 11 Index of Nominal and Real Average Monthly Salary for Under Supervisory Industrial Workers 1996 – September 2009 (CPI, 1996 = 100)



Note: Under supervisory worker is worker who is directly supervised by their supervisor during working time.
Source: Sakernas, BPS.
Available online at http://www.bps.go.id/tab_sub/view.php?tabel=1&daftar=1&id_subyek=19&notab=4

14 World Bank, Doing Business Survey, Available online at http://www.doingbusiness.org

Figure 12 Real Average Monthly Salary (Rp 000) Under Supervisory Workers from Mining, Hotel and Industry Sectors 1996 – September 2009 (CPI, 1996 = 100)



Note: Under supervisory worker is worker who is directly supervised by their supervisor during working time.
Source: Sakernas, BPS.
Available online at http://www.bps.go.id/tab_sub/view.php?tabel=1&daftar=1&id_subyek=19&notab=4

The fact remains however that despite assertions that labour regulations in Indonesia more restrictive than in other countries of the region and imposed a higher costs of business than competing destinations the fact remains that the mid 2000s onwards Indonesia did begin to experience a significant rise in inward foreign investment. Whether these flows might have been even higher if labour regulations had been less restrictive is a moot question. Research by Islam (2009) suggests that there has been little noticeable increase in the costs of doing business due to labour regulations after 2003 when economic recovery began to take hold. While there may be a need for caution in the introduction of new labour market regulation (e.g. to enforce health and safety standards) or for the removal of existing ones there is little evidence to suggest that labour regulations or minimum wages are more than a peripheral determinant variable of investment flows and economic growth in Indonesia.

Implications for policy formulation on the informal economy: the case so far

Despite the absence of a recognizable policy towards the informal economy, Indonesia has undertaken a number of policy initiatives to contain the rise in poverty, promote employment, promote social insurance, reform tax and customs regimes, reduce corruption and promote transparency in public decision making and improve public infrastructure and services. A summary of a menu of such programs and policies in contained in Tables 7 and 6. Clearly, while an overall policy on the informal economy is missing, many of the elements of a program that can facilitate the transition to formality are actually in place. The next step is to ensure that the current menu of policies are monitored and evaluated not just in terms of their capacity to reduce poverty and economic insecurity and their capacity to boost skill upgrading and promote sustainable self-employment, but also in terms of their ex-ante and ex-post implications for the evolution of the informal economy. If the current menu of policies is indeed effective, then they should be expected over time to reduce the incidence of informality.

Table 7 Government Policies that have direct and indirect relevance for the informal economy

	Programme	Program description	Status of the programme	Time started	Target and goals
RPJMN*	National Community Empowerment Programme (PNPM)	Integration of Kecamatan Development Programme and Urban Poverty Reduction Programme	Highly dependent on the level of participation by the community and implementers at the local level	2007	Employment creation and poverty reduction based on community initiative
	Health Insurance program for Community (Jamkesmas)	Targeted for the poor who doesn't have any health insurance	It will be transformed into an insurance-based social security within the next 5 years, therefore the health insurance can reach the whole community including the poor.	2005	To increase access and quality of health services either from hospital or Puskesmas
	Social Security program for Workers (Jamsostek)	PT Jamsostek (Persero) provide 5 (five) protection programs, which include Health Insurance (JPK), Accident Compensation Insurance (JKK), Life Insurance (JKM), Old Day Guarantee (JHT) and Pension Guarantee (JP) for all workers and their families.	Indonesia as well as many other developing countries develops a social insurance program funded by social security, social security is funded by the participants and the public is still limited to formal sector workers.	1992	Implementation of Law No.40 of 2004 on National Social Security System "The state develops social security system for all people and empower the weak and incapable in accordance with human dignity".
Support for Household	Hopeful Family Programme (PKH)	Implementation of conditional cash transfer policy to targeted chronically poor families with several requirements	Average transfer to poor family is Rp 1,390,000-; and capture approximately 6.5 million chronically poor households	2007	To improve recipients socioeconomic conditions, education levels, health and nutrition status and access to education and health services
Support for Individual	Job training program by the government	The program conducted independently by the Dinas Tenaga Kerja in each province. The programs were usually conducted in the Balai Latihan Kerja, where people would be able to participate freely for joining the training.	Some example of job training: ▪ Disnaker Yogyakarta: Job training on hospitality, electricity, machinery, computer skill, etc. ▪ Disnaker Bandung: Job training on business management, mobile phone technician, wedding make up, etc. ▪ Disnaker Semarang: Training for new entrepreneur	Unclear/1991	Improving labor competencies and labor market information services
Support for Enterprises	People's Business Credit (KUR)	A payment facilitation which can be accessed by SMME and cooperation mainly which have a promising business but still not bankable yet.	For the next 5 years, the government will increase budget allocation for this program	2007	Empowerment to micro and small enterprises, in order to promote job creation and poverty reduction

Note: * RPJMN is a Government framework about medium term development plan (five years development plan). The latest one is for 2010-2014 period..

Source: various publications

Table 8 Clusters in Poverty Reduction Programme

	"the fish"	"the fishing rod"	"the boat"
Target	Very Poor, Poor and Near-Poor Family	Community	Entrepreneur (Individual or Group), micro and small enterprise, who has already "feasible" but not "bankable" yet.
Programme	Social Aid and Protection	Social Empowerment/ National Self Reliant People's Empowerment Program (PNPM Mandiri)	Empowerment of Micro and Small Enterprises (UMK)
Objective:	To reduce the burden on poor family expense.	To improve the people's income and prosperity through entrepreneurship and cooperation to become more self reliant.	To provide business capital access for the micro and small entrepreneur.
2009	Targeting on 18.5 million target families (RTS) [very poor family families (RTSM), poor family (RTM), near-poor family (RTHM)]	Targeting on all of sub districts (6.408) in 465 regency/ municipality	Targeting on Rp. 24 Trillion and 4 Million Customers of Small Holder Business Credit (KUR)
	Main Program: Subsidized Rice (Raskin), School Operational Assistance (BOS), Public Health Insurance (Jamkesmas), Aspiring Family Program (PKH) including Conditional Cash Transfer, Scholarship for poor students. Others Programmes: Social Aid for Persons with Disabilities (PWDs), Elderly, children, Isolated Custom Community (KAT), etc.	Started from Kecamatan Development Programme (PPK) with its supported programmes: Generation PNPM, Poverty Reduction Programme in Urban (P2KP), Accelerated Development of Special Disadvantaged Areas and (P2DTK). In 2008, PNPM was expanded by of Social Infrastructure for Regional Economic Development Programme (PISEW),	Provision of Small Holder Business Credit (KUR) is targeted on credit under Rp. 5 Million. Plus: distribution of funding program from Ministry/Institution.
2010	As mentioned on RPJMN 2010-2014, indicative allocations for Raskin 2010 are Rp. 12.9 Trillion. Allocations are set forth for the 18.5 million target households (RTS) each 15 kilos for 12 months	The allocation of funds is assumed as many as Rp. 16 trillion for 2010. The indicative allocation for PNPM is Rp. 9.86 trillion, fell to Rp. 1.5 trillion for urban, with a target of community development in 884 districts and 8304 villages	Three-step expansion of KUR: 1. The provision of funds for KUR on the National Budget is Rp. 2 trillion per year, 2. Linkage expansion between the large national banks and regional banks, 3. Develop the role of SME by expanding One Village One Product (OVOP) and revitalizing 90 traditional markets
	Direct Cash Assistance (BLT) will not be implemented in 2010 as the Government maximizes programs that strengthen the poverty reduction of purchasing power, such as rice program for the poor (Raskin, etc)	PNPM for rural is Rp. 8.35 trillion with target of Direct Community Assistance (BLM) to be implemented in 4590 districts in 32 provinces. And the increase of community scale of rural infrastructure is Rp. 0.92 trillion in 3.224 villages in 25 provinces	

Source: Sumodiningrat, *Prospects and Challenges of Poverty Reduction in Indonesia Year*, 2010, and Strategic Asia staff researchA

V. Conclusion: Economic Crises, Globalization and the Indonesian Informal Economy

This paper has explored some of the most critical issues relating to policy making towards the informal economy in Indonesia during the present decade. It has argued that problems of definition and measurement on the one hand and the institutional characteristics of Indonesia's systemic transformation on the other have precluded Indonesia from embarking on the design of an ambitious policy towards the informal economy. By all accounts the informal economy continues to contribute a major share of output and employment in Indonesia even though precise estimates of how large this might be continue to elude economic observers and the government alike.

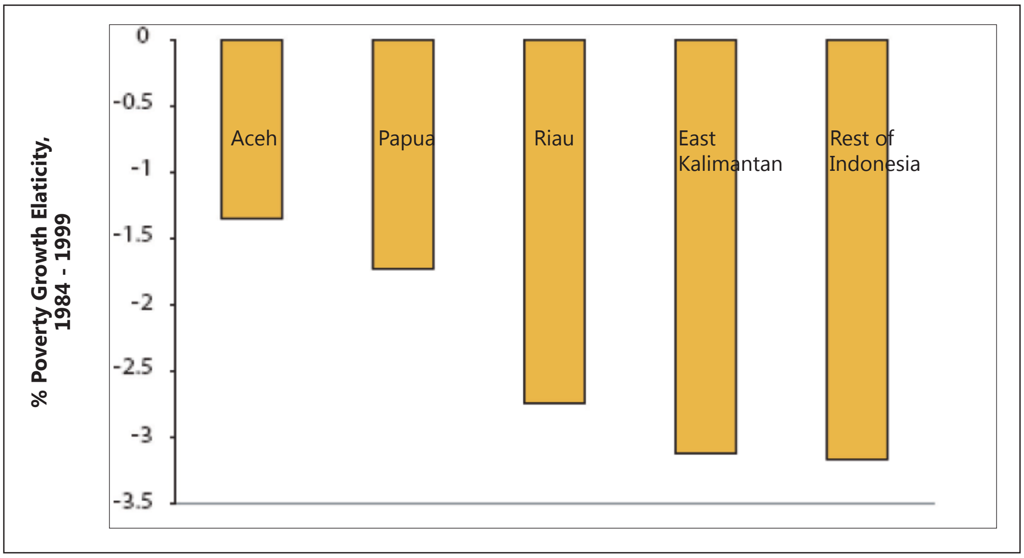
A key conclusion of this paper is that one cannot find an overaching policy framework directed towards the informal economy. This is not necessarily a weakness.

The reason is simple. Indonesia has been hit by two major economic shocks in less than a decade although the second has been less severe than the first. The impact of the current global economic crisis on Indonesia has also been much less than had been earlier expected both due to the earlier wave of banking reforms as well as its relatively lower dependence on export markets. Faster than expected recovery in China and now in India has also helped to ease the uncertainties of a regional economic contagion. Despite Indonesia's good fortune in current economic recovery, there has already been much learning by doing from the 1998 Economic Shock and the kinds of mass poverty alleviation programs which were introduced in its wake. The presence of an infrastructure of poverty reduction programs such as the PNPM and KPH have allowed the government to maintain domestic demand by injecting community block grants and household cash transfers at a relatively fast pace into the economy. (Box A.2 in Appendices)

At the other end of the spectrum, an expansionary fiscal policy combined with the willingness of banks to raise private sector credit has cushioned the shock of the global economic crisis on the domestic economy. Growth continues to recover and is now predicted to be 4.5% for the 2009 calendar year.

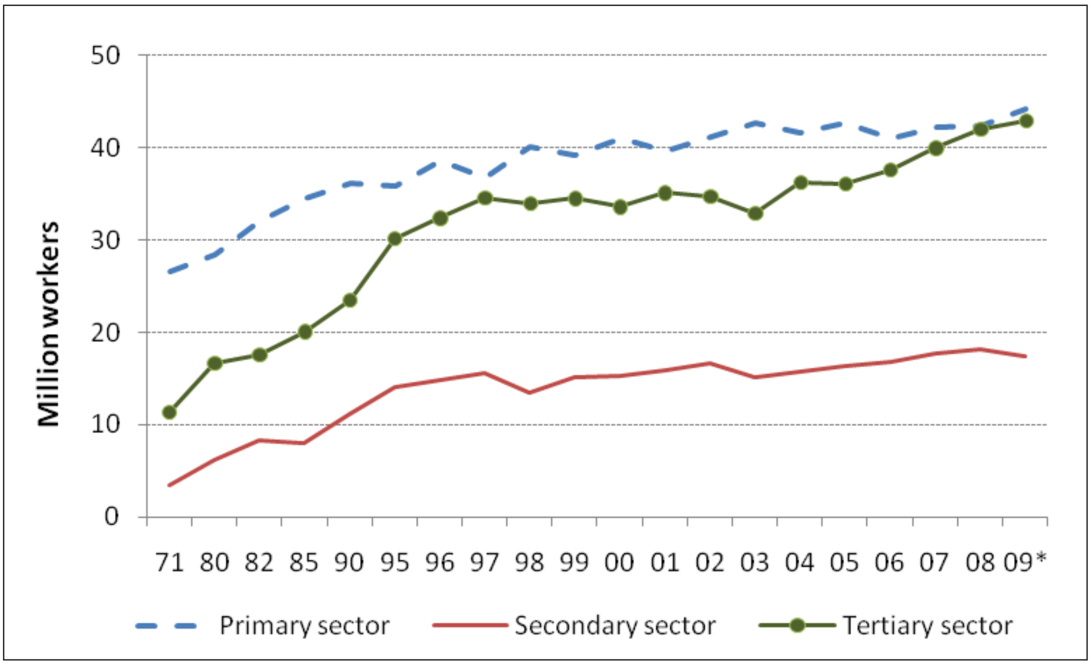
All this is good news and over time is likely to continue to reduce poverty, lower economic uncertainty and raise the inter-linkages between the formal and the informal sectors. The fact that the government has moved towards the principle of universal social insurance under Law Non 40/2004 defines a new universal, human rights based approach to social policy which should also benefit workers in the informal economy. Putting the intention of the law into effect might require targeted programs for informal sector workers given the fact that standard social security programs may not be able to reach everyone in the informal economy. Nevertheless, the principle of universal social insurance is important and is likely to underpin the overall aim of providing decent jobs for all.

Figure 13 Poverty Growth Elasticity in Selected Indonesian Provinces



Source: BPS and World Bank staff calculations

Figure 14 Employment Structural Shifts in Indonesia, 1971-2009

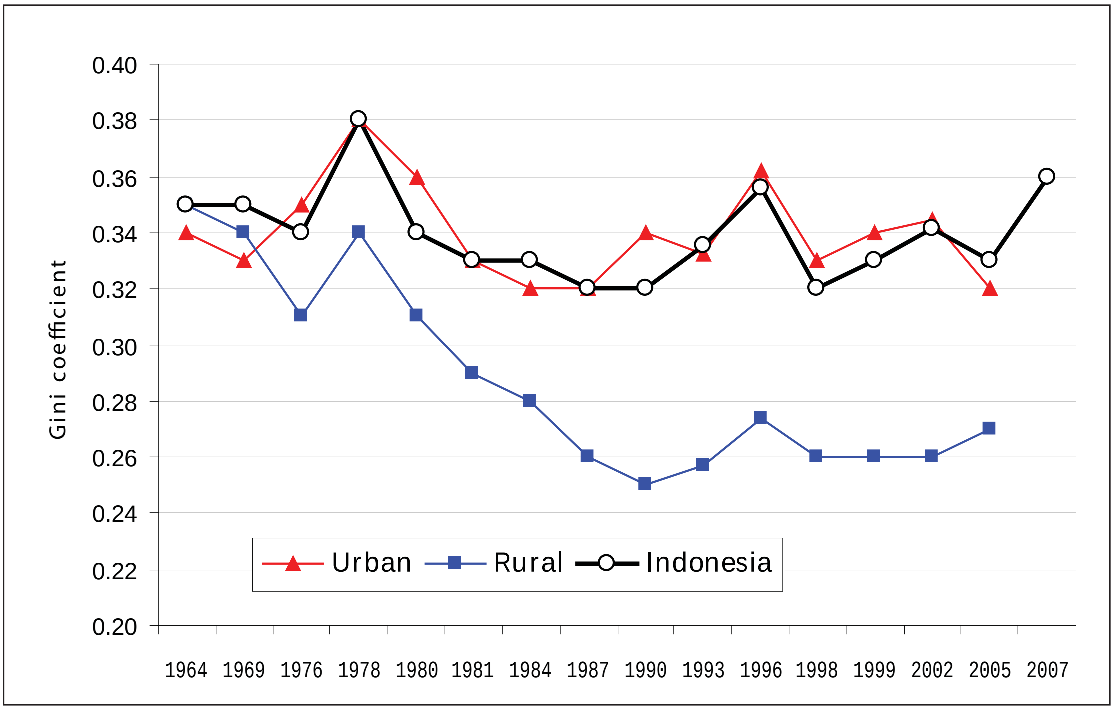


Source: BPS, Sakernas. Various years

Notes: *) data for February 2009

Primary sector: sector 1-2; secondary sector: sector 3-5; tertiary sector: sector 6-9

Figure 15 Gini Coefficient in Indonesia, 1964-2007



Source: BPS, series of Susenas data.

Notwithstanding the general direction of policy in a democratic Indonesia towards a robust economic recovery accompanied by universal social protection and lower vulnerability to economic insecurity, structural changes in the Indonesian economy continue to signal new problems on the horizon. The continued stagnation of manufacturing industry, the low elasticity of poverty reduction to economic growth in some of Indonesia natural resource intensive provinces (Figures 13 and 14), and the expected increase in regional and inter-household economic inequality (Figure 15)are all likely to pose major challenges for development policy making in the future. To address these challenges effectively in the future Indonesia, like many other developing countries of the region, may have to move away from interminable debates on the importance of the informal economy towards debates over when and how much policy to introduce in an already crowded agenda. May be the greatest gain in the transformation of the informal economy is likely to emerge from a deeper understanding of what government should seek to change and what it should leave alone when venturing into the precarious analytical terrain of the informal economy.

Appendices

Table A.1 Percentage of informal workers in total workers by province, 2005 and 2009, and poverty rate 2009

Province	Share of informal workers		Poverty rate
	2005	2009	2009
N. Aceh Darussalam	69.4	60.9	21.8
N. Sumatra	64.8	63.0	11.51
W. Sumatra	63.0	67.3	9.54
Riau	53.3	53.2	9.48
Jambi	65.6	63.9	8.77
S. Sumatra	76.6	69.8	16.28
Bengkulu	76.8	77.0	18.59
Lampung	77.9	72.3	20.22
Bangka Belitung	53.1	56.3	7.46
Riau Archipelago	-	33.7	8.27
DKI Jakarta	26.6	26.4	3.62
W. Java	57.0	56.9	11.96
C. Java	65.1	64.2	17.72
DI Yogyakarta	59.9	57.9	17.23
E. Java	66.0	65.8	16.68
Banten	52.7	49.5	7.64
Bali	56.9	56.5	5.13
W. Nusa Tenggara	73.5	72.2	22.78
E. Nusa Tenggara	88.3	83.3	23.31
W. Kalimantan	71.7	70.2	9.3
C. Kalimantan	76.5	68.5	7.02
S. Kalimantan	66.4	60.9	5.12
E. Kalimantan	45.6	47.8	7.73
N. Sulawesi	60.0	61.2	9.79
C. Sulawesi	77.3	70.7	18.98
S. Sulawesi	72.6	68.4	12.31
SE. Sulawesi	76.3	70.7	18.93
Gorontalo	71.1	71.0	25.01
W. Sulawesi	-	72.9	15.29
Maluku	71.2	73.7	28.23
N. Maluku	79.2	74.2	10.36
W. Papua	-	61.4	35.71
Papua	79.8	82.4	37.53
Indonesia	**63.9**	**62.1**	

Source: quoted from Nazara, *The Informal Economy: an Indonesia Case Study*, 2010

Table A.2 Open Unemployment rates by location, 1976-2007 (% of labour force)

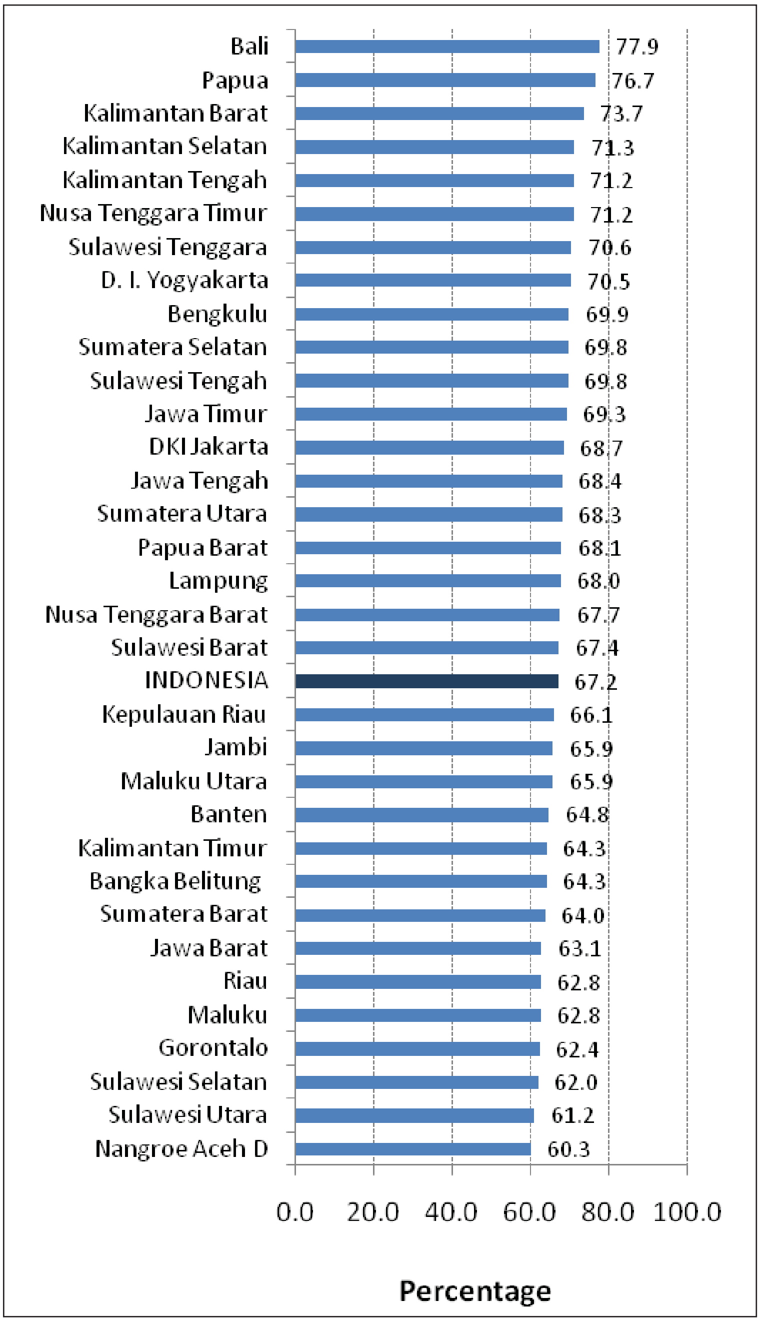
	1976-79	1986-89	1990-93	1994-97	1998-00	2002-07
Perkotaan	6.4	7.1	5.7	8.2	9.7	12.8
Pedesaan	1.7	1.4	1.5	2.9	3.7	7.8
Jumlah	2.5	2.7	2.7	4.6	6.0	9.9
Laki=laki	2.9	2.8	2.5	4.1	5.6	8.2
Perempuan	1.7	2.7	2.9	5.6	6.6	12.7

Source: data for 1976-2000 cited from Dhanani (2004), data for 2002-2007 from Sakernas survey, BPS

Notes:

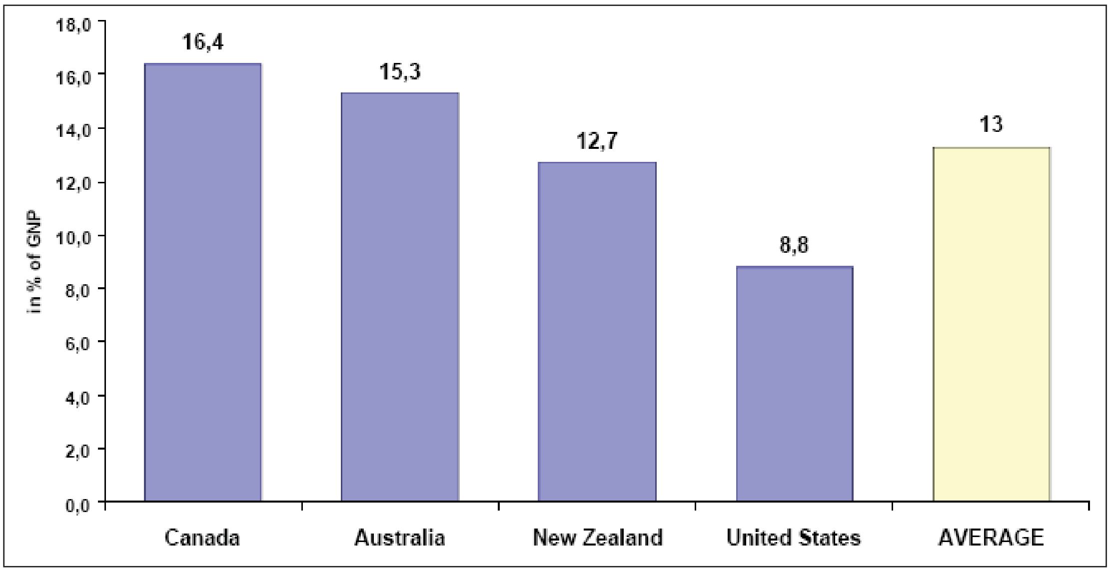
1. Period average
2. Number of unemployment divided by total labor force for each group
3. Reference period for looking for work changed from "previous week" to currently" between 1993 and 1994. Figures for open unemployment rates are this not directly comparable before and after 1993.

Figure A.1 Labor Force Participation Rate across Provinces, 2008



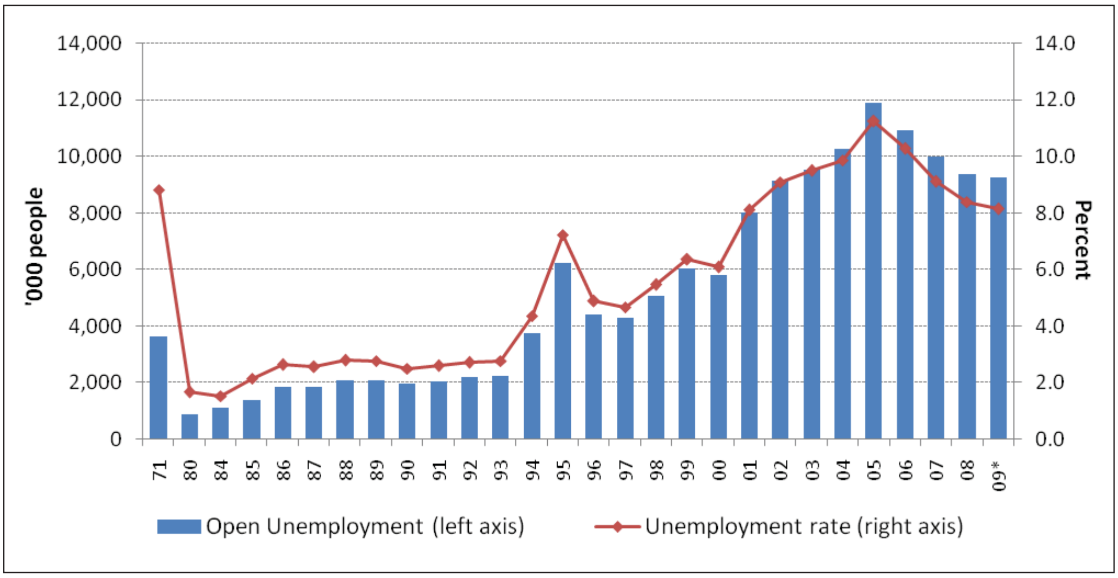
Source: BPS

Figure A.2 Shadow Economy in % of GNP 1999/2000 - Canada, Australia, New Zealand and United States



Source: quoted from *Schneider, Size and Measurement of the Informal Economy in 110 Countries around the World*, 2002

Figure A.3 Open Unemployment in Indonesia, 1971-2009

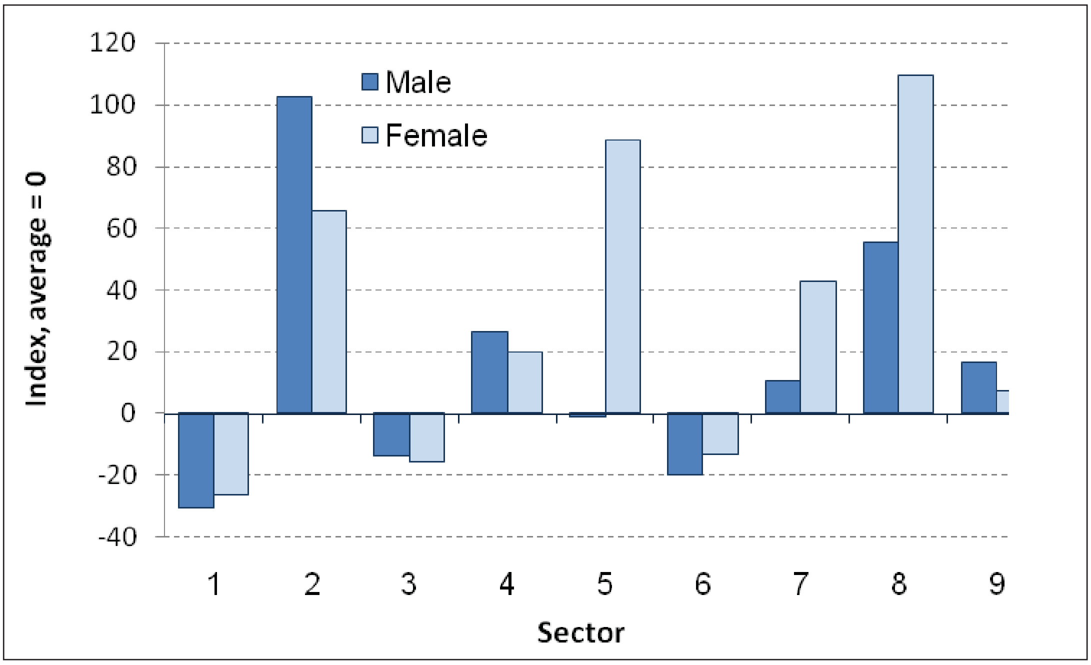


Source: Sakernas, BPS

Notes:

1. *) data for February 2009
2. Reference period for looking for work changed from "previous week" to currently" between 1993 and 1994. Figures for open unemployment rates are this not directly comparable before and after 1993.

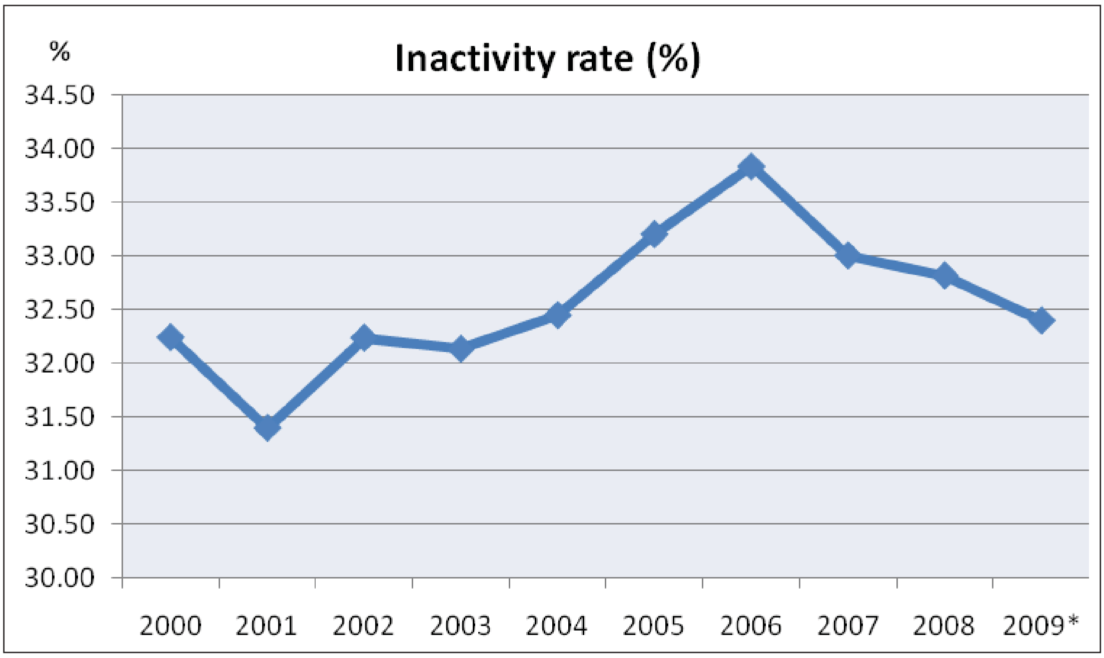
Figure A.4 Average Monthly Salary (Index) by Gender and Economic Sector 2007



Source: Ministry of Manpower and Transmigration

Notes: 1=agriculture; 2=mining and quarrying; 3=manufacturing industry; 4=electricity, gas and water; 5=construction; 6=trade, hotel and restaurant; 7=transport and communication; 8=financial services; 9=services

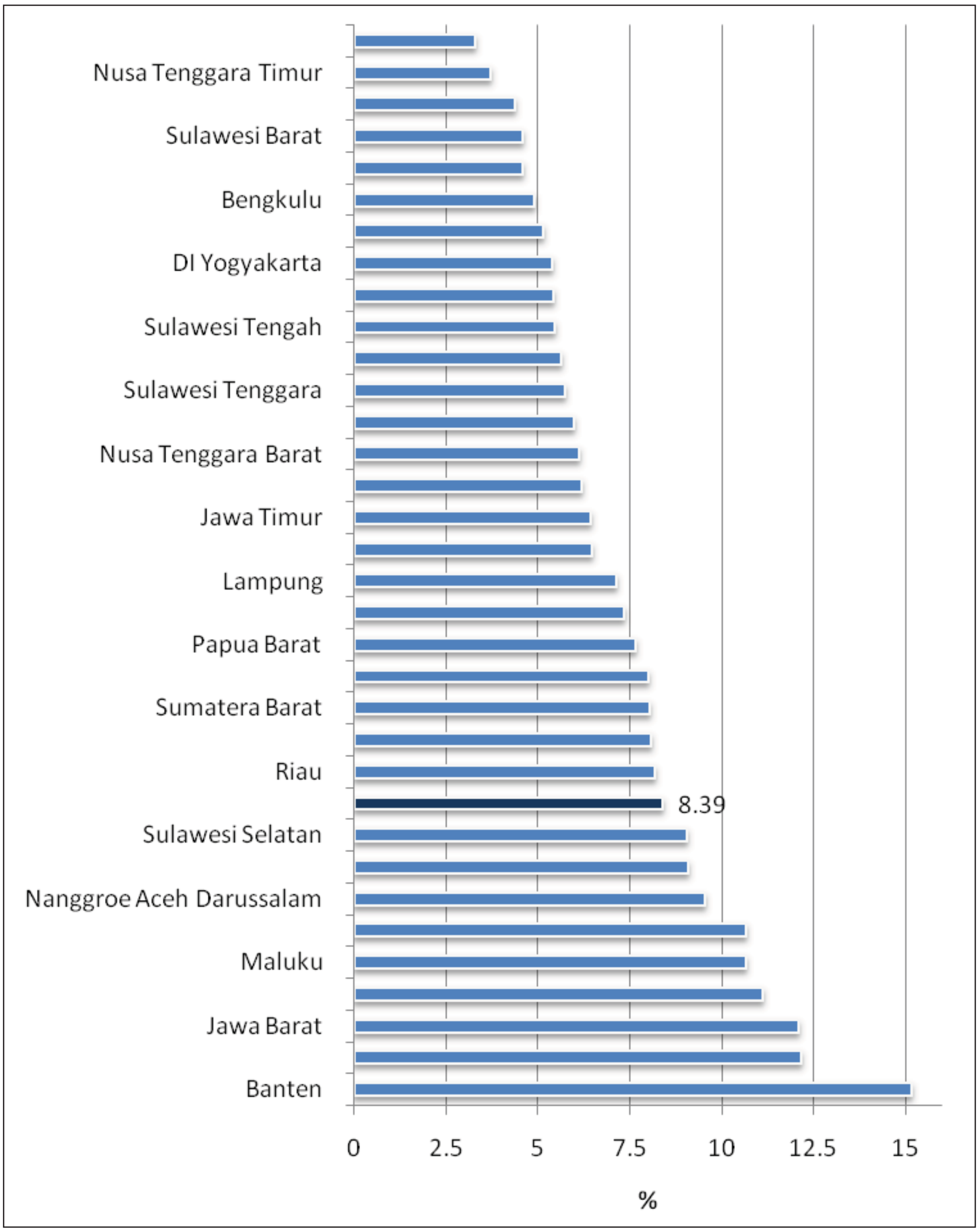
Figure A.5 Inactivity Ratio, 2000-200



Source: Sakernas, BPS

Note: People not in labour force divided by economically active population (above age 15)

Figure A.6 Unemployment rate by Province, 2008



Source: Trends of the Selected Socio-Economic Indicators of Indonesia, March 2009

Table A.3 Components of the Indonesia stimulus package

Tax cut	
- Tax cut for companies, workers and individuals	Rp. 43 trillion
- Tax subsidies and import duties exemption	Rp. 13,3 trillion
Infrastructure project and empowerment programmes for people living in rural areas	Rp. 12,2 trillion
Diesel and electricities subsidies as well as loans for rural empowerment	Rp. 4,8 trillion
Total	Rp. 73,3 trillion
Sumber: Government of Indonesia	

Sumber: as cited by ILO. *Labour and Social Trends in Indonesia*, 2009.

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