Give Them a Break

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How Indonesia can reboot its labour market and attract more FDI

- Indonesia punches way below its weight in attracting foreign direct investment into the country, which is crucial for lifting growth above 5%.
- While the Jokowi government has made some headways in improving infrastructure and cutting red tape, labour rigidity still detracts investors. Tackling that requires the buy-in of unions and spades of political capital.
- Jokowi can limit the cost by borrowing a page from behavioural economics: entice the workers with upfront increase in leave days, in exchange for lower severance pays.

Not enough likes

Indonesia not only has one of the world's largest population at 260 million but also one of its youngest with a median age of below 30 years old. Combine that with an abundance of raw materials, it should have had an easier time attracting foreign direct investment, especially for labour-intensive manufacturing sectors. This is even more so given how global manufacturers have been getting queasy about their China exposure due to building cost concerns and ongoing trade spat with the US.

Alas, even though the latest investment board's data shows some nascent signs of improvement, the country still punches way below its weight in the FDI fight. Indonesia has nearly three times Vietnam's population and more than four times its GDP but could only garner the same amount of manufacturing sector FDI in H1 this year as Vietnam.

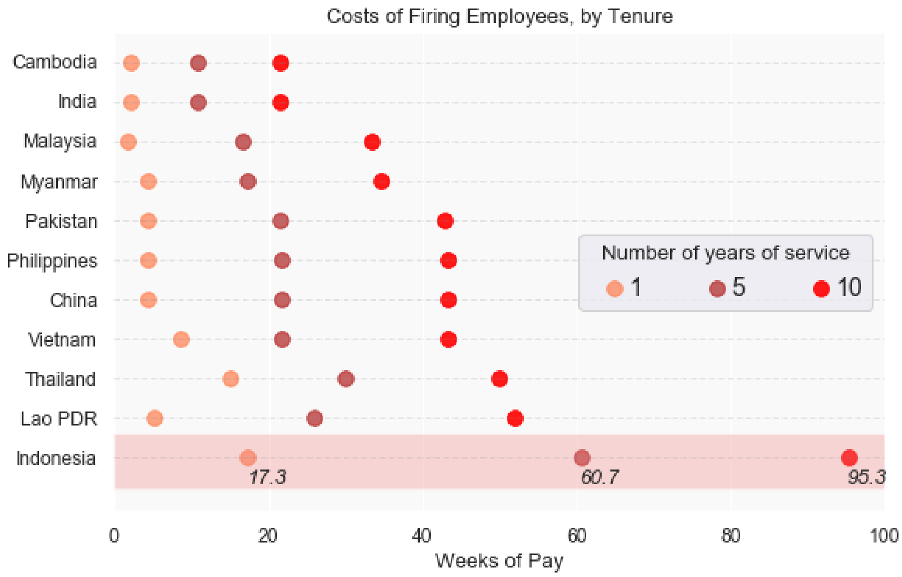
Indonesia's lack of competitiveness has also been laid bare in surveys of investors from key countries. For example, according to AmCham Singapore, US businesses across ASEAN identified Vietnam as the top country for further expansion, followed by Thailand and only then, Indonesia. A similar shortfall can be seen among Japanese investors. In its most recent survey, Japan External Trade Organization found that only 49.2% of its respondents are planning to expand their interests in Indonesia in the next 1 to 2 years, compared to 69.8% for Vietnam and 52.2% for Thailand.

It pays to get fired

Why has Indonesia fallen so short and what can President Jokowi do?

While infrastructure shortfall and bureaucratic red tape are familiar issues, the president has, to his credit, made some headways in his first term in office in tackling them. Ultimately, however, where Indonesia had shot itself in the foot in its quest for labour-intensive manufacturing is in the area of labour regulations.

Thrown together when President Megawati Soekarnoputri was grasping for support from the labour unions, the 2003 Labour Law enshrined such generous provisions as 95 weeks' worth of severance pay for workers with 10 years of service – easily double the level in Vietnam and triple of Thailand's. Even if they are not thrown off from setting up operations and hiring people altogether, firms are incentivized to employ workers on short-term contracts to avoid the potential penalty. This hurts productivity growth, as any accumulated experience is constantly lost.



Source: World Bank, OCBC.

Apart from the onerous severance pay, would-be investors also face legislative clauses that are curiously detailed. If a worker is on leave, for instance, bosses need to check precisely why to determine the level of compensation: 3 days' pay for wedding, 2 for a child's circumcision or baptism, 1-2 for mourning in the household, depending on whether the deceased is related by blood or not. You get the idea.

They tried before

The policymakers have long realized that amending such an unwieldy and rigid law is a necessary ingredient to attract FDI in scale. For one, Jokowi's immediate predecessor, Susilo Bambang Yudhoyono, tried to muscle through changes halfway through his first term in 2006 and, again, in the aftermath of 2008 Global Financial Crisis. Both times, however, he was forced to kowtow to labour union's protests.

Can it be any different this time round? A cursory look would suggest that, since Jokowi has a clear majority in the DPR, as Indonesia's lower house is called, he can push through tough legislations. But the reality is SBY had a rainbow coalition too and it did not help him much.

What matters more ultimately is not how Jokowi manoeuvres in "*DPR Senayan*" but how he convinces the "*DPR Jalanan*", in Bahasa's parlance. The former refers to the area where the actual parliament is located in Jakarta. The latter would translate to the main streets where, metaphorically, opinion is formed and where, literally, demonstrators could stage mass protests if they feel strongly against the amendment.

Grandfather stories

President Jokowi understands that convincing the main street is crucial. To that end, in a recent Bloomberg interview, for example, he brought up the idea of grandfathering of existing labour contracts and applying any new terms solely on new employment.

On the surface, this should help to contain the angst of labour unions, since their members would be mostly privileged by the old contracts. However, the very perception of unfairness may in itself lead to protests by another powerful group: students. Those who are about to enter the workforce for the first time would feel particularly short-changed by the new terms. Here, it is worth recalling it was student-led protests which started the chain of events which led to the unseating of strongmen Sukarno in 1966 and Suharto in 1998.

Moreover, grandfathering also risks creating deadwood workforce, impeding labour mobility and hurting the dynamism of the economy. After all, armed with older contracts with favourable terms, few would want to change jobs and lose those perks.

Psychological plays

It is much better to take a page out of the behavioural economics playbook, which introduce concepts such as present bias and hypothetical discounting to demonstrate people's preference for rewards that are concrete right here, right now rather than a potential one down the road even if, rationally speaking, the latter might be worth more in present value terms.

Specifically, the government should take note that, as unfriendly to employers as the existing labour law may seem, there is a hidden gem. While Indonesia's annual leave provision of 12 days is about average in ASEAN, it is lower than 14 days in Vietnam and as many as 21 days in Cambodia.

This allows some room for the government to craft a trade-off for existing workers to choose from. They can either keep the existing contracts with lower leave days but higher severance pay, or opt for new ones that will grant them the immediate gratification of more annual leave days of, say, 14 days or even more for those with longer service, at the cost of lower potential severance pay which have an unknown probability of materializing anyway.

The grandfathering might still be given to placate them upfront, but over time, as the older workers start to see their millennial colleagues posting about exciting holiday destinations on Facebook and Instagram, they might be tempted to join in on the fun too. Give them the flexibility to choose.

They are coming

This is by no means a panacea, and merely a tool in helping to persuade the country of the urgent need for reforms.

It is now or never. For one, there is the obvious window of opportunity to be captured given how multinationals are actively looking for alternatives to China.

More importantly, there is a threat that lurks darkly on the horizon. That is the potential for labour-replacing automation that risks nullifying any competitive advantage that Indonesia has now. Indonesia must get the FDI investors to come in droves before the robots do.

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