"Jobless growth" and individual earnings in a developing economy: Indonesia

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Conventional growth models predict that labor productivity rises as an economy develops. When those models are extended to include heterogeneous sectors and international trade, they typically return some form of the Stolper-Samuelson prediction that in labor-abundant developing countries, increased exposure to trade also raises real labor earnings. Yet in Indonesia, rapid GDP growth in the first decade of the 21st century was accompanied by real wages that were flat on average, and declining for a large fraction of workers. During the same decade, the Gini measure of inequality rose by one-third, from a historically stable value of ~0.33 up to an unprecedented 0.47.

In this paper we explore this seemingly paradoxical labor market trend using the 2000 and 2007 waves of the Indonesia Family Life Survey (IFLS), a panel data set. Changes in the sectoral structure of production and labor demand, specifically the relative decline of manufacturing and rise of a variety of service sector activities, has a clear connection to changes in sector and occupation for individual workers. Lower labor earnings may therefore be partly due to losses associated with sector-specific skills, as found in studies of other countries. But there is also a strong association with movement from formal to informal modes of employment. We find that the 2007 earnings of workers who had formal jobs in 2000 but informal jobs in 2007 were lower, on average, by about one-third relative to workers who changed jobs within the formal labor market—and by more than half, relative to formal workers who remained in their original jobs.

Displacement to informal employment is almost certainly part of the explanation for the Indonesian paradox, but a rigorous causal connection remains to be established. More work is needed to identify and control for worker characteristics that may predict job displacement. At a labor market level, moreover, the apparent displacement of workers from formal sector jobs has several possible driving forces—among them overall income growth, trade-induced changes in production structure, and a domestic policy trend toward tighter labor market regulation. Distinguishing among these is an important future task. In this paper we survey the issues and relevant literature, report some initial findings, and lay out an agenda for subsequent research.