

How Does Decentralised Minimum-Wage Setting Affect Informality? A Quasi-Natural Experiment for Indonesia

Margherita Comola
Paris School of Economics

Luiz de Mello
OECD Economics Department

Abstract

The Indonesian labour market is characterised by widespread informality and comparatively high unemployment. To some extent, these outcomes can be attributed to a sharp increase in the real value of the minimum wage since 2001, when minimum-wage setting was decentralised to the provincial and local governments.

This makes Indonesia an interesting case for empirically testing how minimum-wage legislation impacts the informal labour market. To shed light on the issue, we use labour-force survey (*Sakernas*) data for 1996 and 2004 and treat the change in minimum-wage setting in 2001 as a quasi-natural experiment. In particular, we investigate whether or not – and, if so, the extent to which – an increase in the minimum-to-mean wage ratio has driven workers out of the formal sector and into informality. This displacement effect would be consistent with the predictions of standard dual-economy models of labour market segmentation (Welch, 1976; Gramlich, 1976; Mincer, 1976; Brown, Gilroy and Kohen, 1982).

We find that, if the relative value of the minimum wage is hiked, informality increases and formal-sector employment falls, which is in line with previous empirical evidence for Indonesia. But a more interesting finding is that a minimum-wage hike is associated with a net increase in total employment: the increase in informality more than offsets the corresponding loss of jobs in the formal sector. This study contributes to the existing literature in two ways: *first*, to our knowledge, it is the first paper to estimate jointly the effect of minimum-wage setting on formal-sector employment, informality and overall unemployment using a SUR specification, in order to take into account the interdependencies in the effect. *Second*, we focus on the local governments, rather than the provinces, as the units of observation, while all previous literature (Rama, 2001; Suryahadi *et al.*, 2003) focuses on provincial-level data.