

Research Article

Do Minimum Wage and Economic Growth Matter for Labor Absorption in Sumatra Island, Indonesia?

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Abstract: The purpose of this study is to explore the short- and long-run influences of the provincial minimum wage and economic growth and labor absorption in 10 provinces of Sumatra, Indonesia over the period 2008-2017. Using the panel regression of the Auto-Regressive Distributed Lag (ARDL) model, the study documented that, in the long-run, the provincial minimum wage has a positive and significant effect on labor absorption in the Sumatra region, while the economic growth has an insignificant effect on labor absorption. Meanwhile, in the short-run, the provincial minimum wage has a negative and significant effect on labor absorption and economic growth has an insignificant positive influence on labor absorption. Thus, to enhance labor absorption and reduce the unemployment rate, the government should regulate a proper and just provincial minimum wage policy.

Keywords: ARDL, Economic growth, Labor absorption, Minimum wages, Unemployment

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INTRODUCTION

Efforts to advance the economy of a nation require more labor absorption into economic activities. These efforts can be made by providing adequate job opportunities to be able to compensate for the high labor force entering the labor market. Important indicators in economic development include job opportunities, quantity, and quality of labor, because it

has a function, namely: labor is a resource in the production and distribution of goods and services, and labor as a target to develop the process of market transactions. These functions will have an impact on the process of economic growth in the long run. In other words, laborers are the main driving force in the development process (Suroto, 1992).

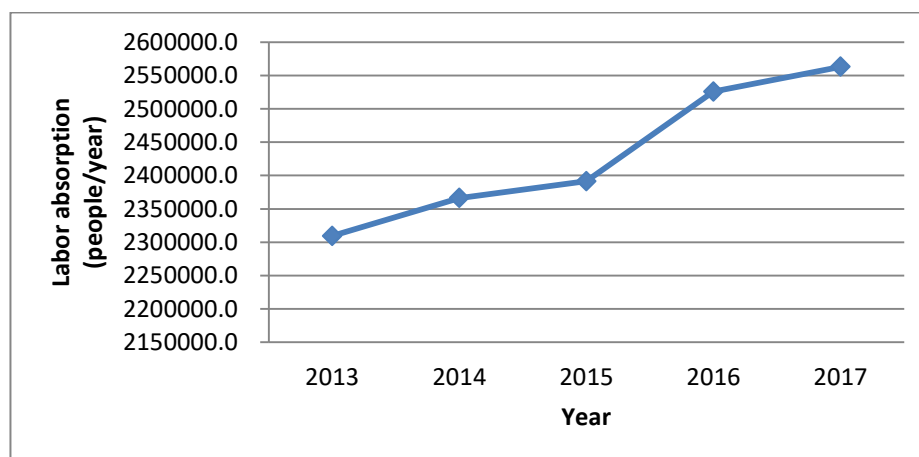


Figure 1: Number of Labor Absorption in the Sumatra Region, 2013-2017

Source: BPS-Statistics Indonesia (2018)

According to the Central Statistics Agency (BPS) – Statistics Indonesia (2011), of the five islands in the country, Sumatra that comprises 10 provinces is one of the most productive islands in Indonesia that has contributed to the national economy after Java Island. Sumatra accounts for the second-largest Gross Domestic Product (GDP) compared to other regions by 37.5% through activities in the secondary and tertiary sectors, especially in the manufacturing and trade, hotel, and restaurant sectors. The largest workforce is in the Sumatra region was the North Sumatra Province, reaching 6,743,277 people, while the lowest labor force was recorded by Bangka Belitung Province by 699,017 people. The total number of the workforce in Sumatra reaches 27,036,466 people.

As illustrated in Figure 1, the number of labor force in the Sumatra region shows an increasing trend from year to year. In 2013, the number of workforces reached 25,339,627 people, while in 2017 it rose to 27,476,239 people, showing an increase of 8.52% or an average increase of 1.70% annually. An increase in labor absorption is caused by conditions where more and more industries are developing, both small and medium enterprises industries (SMEs) that are developing in the Sumatra region so that they require large numbers of workers. In addition, the increase in labor absorption is influenced by the number of wages and a positive trend of economic growth in the region. An increasing number of labor forces need more employment opportunities, where employment opportunities will be increasingly stringent, particularly for skilled labor. This condition occurs due to high labor absorption into economic activities.

The changes in labor absorption might have a relationship to the increasing trend of the provincial minimum wage in the Sumatra region. Over the period 2013 to 2017, it has increased by 12.0%. This might spur a higher workforce and affect labor absorption due to the high wages that must be borne by the company. This condition is in line with the spirit of the provincial minimum wage where the reference to the provincial minimum wage can improve the economic conditions of the labor community in Indonesia, especially in the Sumatra region. Therefore the increase in the provincial minimum wage has an impact on the absorption of labor because of the large budget that must be spent by companies to meet the provincial minimum wage limit. However, this condition is contrary to the current labor conditions, where the amount of the provincial minimum wage set by the government is not proportional to the number of living costs incurred by labor workers in Indonesia, especially in Sumatra.

In addition to the provincial minimum wage factor, labor absorption is also greatly influenced by macroeconomic conditions such as inflation (Majid, 2007a; Majid, 2007b; Majid, 2007c; Majid and

Musnadi, 2010; Majid and Kassim, 2015; Dewi *et al.*, 2018; Naqsadiqa *et al.*, 2019; Jayanti *et al.*, 2019; Majid *et al.*, 2019; and Sani *et al.*, 2019). The rate of inflation in Indonesia has been very volatile that affects the cost of living of the people. With a high level of inflation, the purchasing power has decreased, so workers will propose an increase in the provincial minimum wage to their companies. In addition, the company will make efficiency by reducing the number of workers. This condition results if workers are unable to fulfill their daily needs, while if the company is met they will suffer losses due to low purchasing power so they cannot cover the cost of production. Therefore the economic growth condition of a region is influenced by employment.

BPS – Statistics Indonesia (2018) reported that the highest GDP growth rate was recorded in the South Sumatra Province by 5.51%, while the lowest was recorded by the Province of Riau Islands by 2.01%. The difference in the rate of economic growth is influenced by the geographical conditions of each province, natural resources, human resources, government spending, regional original income, and other economic activities in each of these Provinces. The economic growth in Sumatra has also been very volatile over 2013-2015. On average, in 2013, the economic growth in Sumatra was 5.36% and it decreased to 3.91% in 2015. However, in 2016, there was an increase of 4.50%, while in 2017; it again declined to 4.41%. Both micro- and macro-economic economic factors are believed to have caused the changes in the rate of economic growth in the Sumatra region.

Based on these facts, thus it is interesting to explore the changes in macroeconomic determinants, particularly the provincial minimum wage and economic growth on the labor absorption in 10 provinces in the Sumatra region, Indonesia. The findings of this study are hoped to provide important guidelines for the government in designing wage minimum and macroeconomic policies to reduce unemployment by increasing labor absorption.

The rest of this study is structured as follows: Section 2 provides the selected literature reviews, followed by the discussion on the research method in Section 3. Section 4 provides the findings and their discussion and Section 5 provides the concluding remarks.

LITERATURE REVIEW

Minimum wages have gained momentum among policymakers as a way to control increases in wages and income inequality (Neumark, 2015). Many argued that this policy is centered on whether to increase the minimum wage, but at the same time to increase the potential loss. This is related to what is appropriate to weigh the potential work costs from a

higher minimum than wages against benefits paid for other workers.

The minimum wage reduces job growth is higher than the effect when increasing employment with additional companies (Meer and West, 2013). This effect is most pronounced for young workers and industries with a higher proportion of low workers. Pereira (2013) showed that the effects of work concentrated in companies are more likely about changes by law. Pratomo (2011) also stated the same view where an increase in the minimum wage issued by the closed sector, as predicted by the standard competition model.

Concerning the economic growth, it is also evident that it found a representative relationship with long-term integration between variables of economic growth and labor utilization (Meyer's study, 2017). Besides this economic growth and repo rates cause changes in employment. Ziyadaturrofiqoh *et al.* (2018) found that the wage rate played a significant role in promoting economic growth in Jambi Province, Indonesia, while the minimum wage has an insignificant effect on economic growth.

In his study, Fachreza (2017) found that population, economic growth, and minimum wage have a positive effect on employment. Meanwhile, Azaini (2014) found that economic growth, minimum wages, and investment affected employment. These findings are also supported by the study of Aryani *et al.* (2015) who recorded a significant positive influence of small-medium enterprises, economic growth, and investment on employment in the City of Madiun, Indonesia. Similarly, Wihastuti and Rahmatullah (2018) found that the minimum wage has a significant negative effect on employment, while economic growth has a significant positive effect on employment. Likewise, Faraha (2018) found that economic growth had a positive impact on employment opportunities in the industrial sector, but real wages had a positive impact.

In a nutshell, the above empirical evidences showed that high real wages provide more labor absorption. Furthermore, the small industrial sector has been more vulnerable to labor shortages if economic growth declines. Based on this, this study focuses more on analyzing the influence of the minimum wage and economic growth across 10 provinces in the Sumatra region.

RESEARCH METHODS

The panel data used in this study comprises time series data over the period 2008 - 2017 and cross-section data covers 10 provinces (i.e., Aceh, North Sumatra, West Sumatra, Riau, Jambi, South Sumatra, Bengkulu, Lampung, Bangka Belitung Islands, and Riau Islands) in Sumatra region, Indonesia with number of observation of 100 samples. The data are gathered from the Central Statistics Agency, BPS – Statistics Indonesia. The variables used in this study are employment, minimum wage, and economic growth. To analyze the data, this study used a model of Autoregressive Distributed Lag (ARDL). This study estimated the ARDL model based on the following equation:

$$\begin{aligned} \Delta \ln LO_{j,t} = & \alpha_{0i} + \sum_{i=1}^n \alpha_{1i} \Delta \ln LO_{i,t-1} + \\ & \sum_{i=1}^n \alpha_{2i} \Delta \ln MW_{i,t-1} + \sum_{i=1}^n \alpha_{3i} \Delta \ln EG_{i,t-1} + \\ & \beta_{11} \ln LO_{j,t-1} + \beta_{21} \ln MW_{j,t-1} + \\ & \beta_{31} \ln EG_{j,t-1} + u_{j,t} \dots \dots \dots (1) \end{aligned}$$

Where LO is labor absorption, MW is the provincial minimum wage, EG is the economic growth, α_{ii} is the short-term coefficient, β_{ii} is the long-term coefficient, t is the year 2008-2017, j is the region of 10 provinces in Sumatra, i is the lag-length, and u is the error term.

However, before the panel ARDL model is estimated the panel unit root tests of LLC, IPS, ADF-Fisher, and PP-Fisher are conducted. After ensuring the stationarity of the data based on the unit root tests, the cointegration test in the proceeded using the Pedroni and KAO ADF techniques.

FINDINGS AND DISCUSSION

Table 1 reports the findings of stationarity based on the LLC, IPS, ADF-Fisher, and PP-Fisher tests. The table shows that each variable has a different level of stationarity. The variable of labor absorption is found to be non-stationarity at the level, but it becomes stationarity at the first difference using all unit root tests. Similarly, the minimum wage is found to be non-stationary at the level, but became stationarity at the first difference based on the LLC test, while economic growth stationarity at the level and first difference based on all unit root tests. For the variable increase in labor at the level does not indicate the level of stationarity or unit root but increases stationarity at the first level of difference by requiring LLC, IPS, ADF-Fisher, and PP-Fisher.

Table 1: Findings of the Panel Unit Root Tests

Variable	LLC	IPS	ADF-Fisher	PP-Fisher
Labor absorption	0.334 (0.631)	2.394 (0.991)	11.729 (0.925)	9.621 (0.974)
Minimum wage	3.850 (0.999)	4.707 (1.000)	1.693 (1.000)	0.068 (1.000)
Economic growth	-6.056 (0.000)	-3.241 (0.000)	49.516 (0.000)	98.598 (0.000)
Δ Labor absorption	-5.314 (0.000)	-2.588 (0.004)	44.796 (0.001)	111.492 (0.000)
Δ Minimum wage	-2.950 (0.001)	0.086 (0.534)	16.423 (0.690)	18.503 (0.554)
Δ Economic growth	-8.154 (0.000)	-6.376 (0.000)	81.920 (0.000)	143.427 (0.000)

After testing the stationarity, the Predoni and KAO ADF panel cointegration tests are conducted, where its findings are reported in Table 2.

Table 2: Findings of the Panel Cointegration

Cointegration Test	Statistic	Weighted Statistic
Predoni Panel v-Statistic	-0.970 (0.834)	-0.721 (0.764)
Predoni Panel rho-Statistic	-0.262 (0.396)	0.215 (0.585)
Predoni Panel PP-Statistic	-7.158 (0.000)	-4.363 (0.000)
Predoni Panel ADF-Statistic	-4.048 (0.000)	-3.170 (0.000)
Predoni Group rho-Statistic	1.416 (0.000)	
Predoni Group PP-Statistic	-6.228 (0.000)	
Predoni Group ADF-Statistic	-2.817 (0.002)	
KAO ADF	-1.909 (0.028)	

Note: Figures in the parentheses are the p-values.

As illustrated in Table 2, the study found a significant cointegration between labor absorption, provincial minimum wages, and economic growth. This showed there was a long-term relationship existed among the investigated variables. This finding implies that the variables move together toward long-run equilibrium. Any movements of variables could be predicted by using other variables investigated in the study as the variables were found to be cointegrated.

Next, Table 3 reports the findings of the panel ARDL estimation, showing both short- and long-run effects of minimum wage and economic growth on labor absorption across 10 provinces in the Sumatra region, Indonesia. As shown in the table, there was a long run significant positive effect of the provincial minimum wage on employment in the Sumatra region with a coefficient value of 0.3867. This indicates that any increase in the provincial minimum wage of IDR100 has caused an increase in the absorption of

labor work of 39 people. Meanwhile, economic growth has an insignificant effect on employment, showing no effect of economic growth on labor absorption. This could be due to a lower economic growth rate in the region over the last few decades.

As for the short-run effect, economic growth is also found to be insignificant in affecting labor absorption, while the provincial minimum wage is found to have a significant negative significant effect on labor absorption. Specifically, an increase in the minimum wage by 1%, it has caused the labor absorption reduced by 0.53%. In other words, when the minimum wage increases by IDR100, it resulted in a reduction in the total labor absorption by 53 people annually. This means that when the provincial minimum wage increases, there would be a decrease in the amount of labor absorption because companies cannot afford to pay workers' wages as it causes an increase in production costs.

Table 3: Findings of the Panel ARDL

Estimate	Variable	Coefficient	t-Statistic
Long Run	Economic growth	20.323	1.1194 (0.276)
	Minimum wage	0.387	35.319 (0.000)
Short Run	Constant	22.383	2.3477 (0.023)
	Δ Economic growth	61.559	1,432 (0.157)
	Δ Minimum wage	-0.5311	-2.9781 (0.004)
	ECT(-1)	-0.8095	-3.5770 (0000)

Note: Figures in the parentheses are the p-values.

When viewed from the short-run effect of changes in the provincial minimum wage on labor absorption, it has been responded by the company to reduce the labor absorption as it will increase the swelling of company spending that leads to an increase in the costs to increase labor welfare. This is in line with the study conducted by Wihastusi (2018), who found that the provincial minimum wage has a significant negative effect on the absorption of labor. This study discusses the provincial minimum wage policy which has been a challenge for the creation of courts in the labor market because it creates price stickiness. These results provide predictions for policy needs to be more careful in determining the amount of the provincial minimum wage so as not to destruct the main development goals that create public welfare. Similarly, Sulistiawati (2017) found a significant effect of minimum wage on labor absorption, as the higher wage rate caused the labor struggle to enter into the labor market. The unproductive labor would have a higher tendency to be retrenched by the companies as the companies are only willing to employ labor with higher productivity to compensate the wages paid for their labors.

From the long-run perspective, the company would map and design the payment scheme according

to company needs and their available budget. Our finding is supported by the study of Waisgrais (2003) who recorded that the minimum wage policy had a positive influence on labor absorption. In the long-run, the companies would be easy to adapt to the minimum wage policy implemented by the government due to their ability to generate sustainable profit. Thus, in the long-run, the objective of minimum wage policy designed by the government to enhance labor welfare would be realized in a competitive economy (Ziyadaturrofiqoh, 2018).

Finally, Table 4 reports the findings of short- and long-run cross-section relationship between minimum wage, economic growth, and labor absorption across 10 provinces in the Sumatra region, Indonesia. As shown by the table, economic growth has a negative insignificant effect on labor absorption in the provinces of Aceh, West Sumatra, Lampung, and Bangka Belitung Islands. This showed that economic growth in each of these provinces did not contribute toward an increase in labor absorption and reducing the unemployment rate. Increased economic growth causes companies to choose to increase the work productivity of workers with high skills and terminate those unproductive workforces. Thus, economic growth has no positive influence on employment in the provinces.

Table 4: Findings of Short- and Long-Run Cross Section

Province	Δ GDP	Δ PMW
Aceh	-12.773 (0.999)	-0.741 (0.000)
North Sumatra	35.829 (1.000)	-1.723 (0.487)
West Sumatra	-38.757 (1.000)	-0.801 (0.017)
Riau	41.891 (0.999)	0.120 (0.375)
Jambi	13.444 (0.999)	-0.341 (0.345)
South Sumatra	10.127 (0.999)	-0.218 (0.075)
Bengkulu	23.634 (1.000)	-0.259 (0.000)
Lampung	-15.745 (0.999)	-1.110 (0.105)
Bangka Belitung Islands	-14.828 (0.998)	-0.030 (0.036)
Riau Islands	14.150 (0.999)	-0.205 (0.000)

Note: Figures in the parentheses are the p-values.

Our findings are in line with studies of previous studies. For example, Ioan (2014) showed that an increase in employment growth rates involves high economic performance, mainly expressed by high employment performance levels and especially the development and diversification of the service sector.

Whereas at the global level, Kapsos (2005) found that for every 1% additional GDP growth; total employment had grown between 0.03-0.38% over the three periods between 1991 and 2003.

While economic growth in the provinces of North Sumatra, Riau, Jambi, South Sumatra, Bengkulu, and Riau Islands had a positive significant effect. This is in line with the study by Soylu *et al.* (2018) who documented that unemployment was positively influenced by economic growth. A 1% increase in GDP will reduce the unemployment rate by 0.08% in the Eastern European Countries. Daud (2017) found that the growth of primary and secondary sectors directly affected the absorption of labor, while the service sector does not affect employment. The growth of the secondary sector and the service sector directly affected the welfare of the community, but it indirectly affected the welfare of the people through employment.

The provincial minimum wage was found to affect negatively and significantly employment in the provinces of Aceh, West Sumatra, Bengkulu, Bangka Belitung Islands, and Riau Islands. These findings are in line with studies by Riley and Bondibene (2016) and Ham (2018). Riley and Bondibene (2016) found that the increase in the National Minimum Wage (NMW) led to an increase in the average cost for companies that tend to employ low-paid workers, both after the introduction of NMW and more recently after a severe recession when many workers experienced freezing of wages or wage cuts, but NMW continues to increase. Ham (2018) also found that in the State of Honduras some employers complied with the stipulation of the minimum wage and they responded positively to an increase in wage employment, in addition to the increase in the wages of employers also increased their non-compliance by raising higher wages to formal (legal) workers but reduced in number and increased the number of informal workers (illegal) with a minimum wage so that the increase in wages does not affect economic growth and formal employment.

The minimum wages in the provinces of North Sumatra, Jambi, South Sumatra, and Lampung has a negative and insignificant effect on labor absorption, similar to those of Meer and West (2013). In their study, Meer and West found that the minimum wage has reduced the growth of clean jobs, mainly through its effect on job creation by expanding companies. This effect was most pronounced for younger workers and in industries with a higher proportion of low-wage workers. Besides, Ten and Wang (2017) also reinforced that higher minimum wages have increased unemployment rates for young workers (ages 15-19 and 20-29 years old) or those who have no higher education, but did not have a significant impact on adult workers (age 30+ years old) or those who are highly educated.

Finally, the minimum wages in the province Riau has a positive and significant influence on labor absorption. This positive effect is in line with Bazen (2007) who found a significant effect of increasing minimum wages in New Jersey fast-food restaurants on the economic profession. They found that an increase in

the minimum wage actually increased employment. In addition, Bazen (2007) stated that, in addition to the positive impacts, there were also negative impacts, namely during the 1980s and 1990s periods where an increase in the federal minimum wage did hurt youth employment while the state level increased. As happened in New Jersey in general, this shows that their findings could not be generalized to the point where it is possible to conclude that there is no negative effect of minimum wages on employment in the United States.

CONCLUSION

Based on the above discussion, it can be concluded that overall in the short- and long-term, the provincial minimum wage and economic growth have a significant effect on labor absorption in the Sumatra region, Indonesia. However, when compared to the effect of economic growth and the provincial minimum wage on employment during the short- and long term in the region, the effect is found to greater in the short-run. This is because, in the short-run, the increase in the provincial minimum wage affects decreasing employment, while economic growth has a positive but insignificant effect; the increase in the provincial minimum wage has a positive effect on employment in the long-run.

The increase in the provincial minimum wage theoretically affects the cost of production of companies, one of the costs of production is wages, and therefore, in the short-run the increase in the provincial minimum wage causes companies to suppress production costs by reducing the amount of labor so that labor absorption is reduced.

To further reduce the unemployment rate in the region, it suggested that the government to design more proper policies in controlling the level of the provincial minimum wage as the minimum wage policy has a positive effect on increasing labor absorption in the long-run. The government is also expected to be able to continue to boost and develop new economic growth sectors to increase overall economic growth, thus contributing to providing more job opportunities.

For further studies on this issue, it is recommended to consider more variables in the proposed estimated model, so that they can provide better research results. These variables include education, disposable income, and so on. The sample of the study and data types such as quarterly should be extended its year range.

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