INDONESIA

PRIORITIES FOR COMMERCIAL LAW REFORMS
FOR PRIVATE SECTOR DEVELOPMENT

June 29, 1990

Country Operations Division
Country Department V
Asia Region

Asia Division
Legal Department
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Meaning</th>
</tr>
</thead>
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<tr>
<td>BANI</td>
<td>Badan Arbitragi Nasional Indonesia, the National Arbitration Board</td>
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<tr>
<td>BAPEPAM</td>
<td>Badan Pelaksana Pasar Modal, the capital markets operations board</td>
</tr>
<tr>
<td>BPAN</td>
<td>Bandan Pembinaan Hukum Nasional, the National Law Development Agency</td>
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<td>BPN</td>
<td>Badan Pertanahan Nasional, the National Land Agency</td>
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<tr>
<td>EQUIN</td>
<td>Coordinating Ministry for Economics, Financial and Industrial Affairs and for Development Supervision</td>
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<tr>
<td>IAI</td>
<td>Indonesia Institute of Accountants</td>
</tr>
<tr>
<td>IKPI</td>
<td>Ikhtisar Ketentuan-ketentuan Perkantah Indonesia, Bank Indonesia manual of banking regulations</td>
</tr>
<tr>
<td>KADIN</td>
<td>Kamar Dagang dan Industri Nasional, the National Chamber of Commerce and Industry</td>
</tr>
<tr>
<td>PT</td>
<td>perseroan terbatas, a limited hability company</td>
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   Publication for Laws to be Effective
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   Improvements in Sale and Distribution of Publications
   Publication of Rule-Making and Policy-Making Procedures
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PRIORITY FOR COMMERCIAL LAW REFORMS FOR
PRIVATE SECTOR DEVELOPMENT

Summary and Conclusions

i. The Government has embarked on a major program of economic
deregulation to enhance the role of the private sector in the economy. In
response, the private sector is growing rapidly and attracting sizeable
domestic and foreign investment. In this environment, there is need for a
well-functioning commercial law system. As the private sector grows in size
and complexity, a well-functioning commercial law system will facilitate its
development by reducing costs and risks and by establishing rules for
efficient private sector activities in an administratively less regulated
economy.

ii. This Report has two main objectives: (a) to provide an
understanding of the current constraints imposed on private sector development
in Indonesia in the absence of a well-functioning commercial law system; and
(b) to define the priorities and specific directions that a commercial law
reform program should take. The principal findings and recommendations are
summarized below. A policy matrix of commercial law reforms is also attached
to this summary. It lists the recommendations made in this Report.

The Commercial Law Framework: Overall Reform Issues

iii. A good legal system needs to first of all provide confidence to
the private investor. Laws should be clear so that the private investor knows
that contemplated transactions are permitted. The effective implementation of
laws is critical to assure the investor that transactions in accordance with
the laws will be respected and enforced by the courts or other neutral forums.
A well-functioning commercial legal system is also needed for greater
efficiency in private market functioning: (a) by reducing the costs and risks
of entering into private transactions; (b) by reducing the barriers to entry
and mobility of private investment; and (c) by providing mechanisms for the
orderly exit of private businesses that fail.

iv. The existing commercial legal framework in Indonesia fails to meet
the above requirements. It suffers from three major problems: (a) lack of
up-to-date commercial laws in many areas; (b) lack of effective implementation
of commercial laws through the courts and other forums; and (c) the systemic
absence of information on laws, regulations and procedures. Many important
commercial laws in Indonesia are derived from the colonial period. For
example, the Commercial and Civil Codes date back to 1847. They fail to
adequately reflect economic efficiency requirements of modern transactions in
areas such as contract and credit and the limited liability company sector.

v. The ineffective implementation of laws through the courts and
other forums is a greater bottleneck. Inordinate delays and other
difficulties of enforcement of private agreements and commitments lead to
unusually high costs and risks of economic transactions in Indonesia. It also leads to a widespread lack of confidence in the commercial law system. The absence of systematic legal information leads to lack of transparency and inconsistent application of laws and regulations, which create a very high degree of uncertainty for the private sector.

vi. All sections of the private sector are affected by the above constraints. Of particular significance, however, are the constraints imposed on: (a) newer and smaller domestic private investors; and (b) the foreign trade and investment community. Newer and smaller private domestic investors face the highest costs of the absence of a well-functioning commercial law system, not least of all in terms of high barriers to entry in the formation of business and access to credit. The foreign trade and investment community considers it a high risk to conduct business with Indonesian firms, and perceives the Indonesian commercial law system to be a major weakness in the business climate. It is vitally important that attention is paid to the needs of these sectors if private sector development is to be broadly based and benefit from international trade and investment.

Specific Priorities and Directions for Reform

vii. The rationale for specific commercial law reforms made in this Report are described below.

A. Contract and Credit Laws

viii. A sound framework of: (a) contract, credit and security laws; (b) credit information systems; and (c) enforcement mechanisms are essential to facilitate efficient growth of credit and banking transactions. In their absence, as in Indonesia, credit transactions are made costly and difficult, access to credit is limited to only the relatively well-off and well-established individuals and businesses, and there are risks of opportunistic behavior and unforeseen contingencies. To an extent, the Indonesian commercial system has been creative and introduced some innovative credit forms to get around the problems. But they are of uncertain value, since the legal bases for credit transactions are still the old Indonesian Civil and Commercial Codes which do not recognize such forms.

ix. The credit laws and institutions in Indonesia suffer from five principal weaknesses: (a) lack of speedy enforcement and foreclosure of credit transactions through the courts; (b) lack of a wide range of acceptable security or collateral in law to back up the credit; (c) lack of standard, modern loan terms and documentation recognized by the laws and courts; (d) lack of property rights to serve as collateral, especially land; and (e) lack of property, credit and security registration/information systems.

x. In each of these areas the Report makes recommendations for reform. First, an accessible set of civil procedures must be promulgated, the possibility of summary proceedings investigated, and consideration given to the establishment of special panels of judges in Indonesia's major district courts. Second, every effort must be made to perfect and expand credit and security registration/information systems using modern computerized methods,
where possible self-financed and run by the private sector, and covering: (a) land; (b) hypothecs (mortgages) and leases for other large, easily identifiable assets such as industrial machinery; and (c) other securities (rights, pledges, guarantees, fiduciary transfers, etc.) under personal and company filing. Third, immediate action should be taken to establish authoritative versions of the law from the archaic Dutch codes. Finally, greater use of new forms of credit that do not require a great deal of collateral other than provided by the business itself should be encouraged, such as maximum amount or floating hypothecs, negotiable warehouse receipts, and back-to-back domestic L/Cs.

B. Companies Law, the Accounting Framework, and Capital Markets

xi. Most private businesses will increasingly take the form of limited liability companies ("perseroan terbatas" or PTs) in Indonesia, as in other countries. In 1990, almost 80% (and about 160,000 in number) of all business taxpayers were PTs. A sound framework of company laws, accounting and audit, and capital market regulations are essential for the development of an efficient corporate sector, but are currently missing in Indonesia.

Companies Law

xii. Existing Companies Law. The current law is contained in 21 sections of the Commercial Code and has many gaps when dealing with modern corporate structures and transactions. Formation of a PT can take over a year and the procedures are complex and costly. A company must be formed for a specific purpose and has a defined time limit, greatly limiting mobility. The rules for dissolution of a company are far from clear. And there are no accounting and audit requirements for financial disclosure, nor provisions concerning mergers and acquisitions.

xiii. The Draft Companies Law. A draft of a new Companies Law is currently under discussion. This draft has, in various forms, been circulating in Government for almost 18 years. It is highly regulatory and complex in content—the Government may exert control in several ways over the affairs of a company—reflecting the conditions that may have prevailed two decades ago. The Report recommends that the draft Companies Law be reviewed very carefully and amended appropriately to suit the present economic direction of economic policies before it is put up for legislation.

xiv. The Direction Of Required Reforms. The Report recommends a less regulatory approach that should facilitate new entry, mobility, and exit. In practice, this could be most conveniently undertaken by a division of the corporate sector into two types: (a) the closely-held corporation with a small number of shareholders for whom the laws and requirements should be kept simple; and (b) public corporations (and possibly large private corporations) where additional requirements should be imposed, especially regarding adequate accounting and audit and disclosure of financial information.

xv. Bankruptcy. The existing Bankruptcy Law of 1905 provides a theoretically workable framework of bankruptcy laws for efficient exit of private businesses that fail. However, few cases have gone through formal bankruptcy proceedings. The main problem arises from difficulties of
implementing bankruptcy through the court system. The establishment of specialized commercial (see para. xxi.) would provide a better mechanism to handle bankruptcy cases than under the existing courts.

Capital Market Regulations

xvi. There is an urgent need for prudential regulations to substitute for direct controls in ensuring the safety and stability of the capital market. The Government is currently considering the issuance of detailed regulations, and the transformation of BAPEPAM, the securities agency, into a supervisory and regulatory body. The example being followed is the United States Securities and Exchange Commission (SEC) Regulations. It is expected that these regulations will be finalized very shortly. The Report, therefore, does not contain specific recommendations on capital market regulations. However, there is a close inter-connection between the framework of companies law and capital market regulations, and consistency in approach should be ensured. In the presence of detailed capital market regulations covering the requirements for public corporations, the burden on companies law could be considerably lessened for public companies.

Accounting and Audit

xvii. In any economic system the proper accounting and audit of transactions is fundamental to its efficient operations so that the public as shareholder, investor, creditor or depositor of funds has accurate and adequate information to enable it to take decisions on investment and assess the risks. Indonesia's accounting and audit framework for private sector enterprises is inadequate.

xviii. There are three fundamental problems in development of adequate accounting and audit services. First, the present companies law does not specify requirements for proper accounting, nor for independent auditing. BAPEPAM does require audited financial statements of companies that go public, but this is a fraction of the entire corporate sector. Second, the Indonesian Institute of Accountants (IAI) has operated as an association of professional accountants, but has no statutory basis and conducts its business on small subscriptions that are inadequate to meet the needs for professional development. Third, there is an acute shortage of trained professional manpower.

xix. The Report recommends several key actions: (a) companies law and/or capital market regulations should be the main driving force for detailed requirements for proper accounting and audit; (b) a statutory body should be established the members of which, through examination and training, are qualified to provide audit opinion; and the body should set accounting principles and standards; (c) IAI can be the designated body, but needs to be reconstituted in human and financial resource terms to meet the challenges; and (d) the legal requirements for accounting and audit, and the huge market for these services should provide adequate incentives for people to enter the profession; but, in the interim, the number of expatriate accountants in public practice should be allowed to increase, to improve quality and provide on-the-job training needs which are vast.
C. Dispute Resolution: The Courts, Arbitration, and Legal Profession

xx. Investors, domestic and foreign, need confidence in the enforceability of private agreements and commitments. Indonesia could enact the most modern credit laws and companies laws, but they would be of little practical value if there are no means of enforcing their provisions.

xxi. The Court Systems. In the commercial field, the Court system is widely perceived to be inadequate in a number of ways: slow procedures with cases taking several years to resolve, little or no specialization, unreasonable difficulties in enforcing credit transactions and foreclosure, major difficulties for foreign claimants, and finally, a pervasive belief that they are not dispensing justice. Most of the actions that can be taken with regard to the court system will take time to implement. The Report recommends several measures: (a) increasing the technical competence of judges to handle complex commercial cases by a combination of training and improved compensation; (b) salary increases should be linked to anti-corruption measures, some basic measures of efficiency (e.g. targets set for courts to reach decisions speedily), and the publication of court decisions; (c) establishment of specialized courts to handle commercial disputes, or alternatively, specialization of judges; and (d) a start with such specialization would be to concentrate reform efforts on the central district court in Jakarta and other district courts with a high concentration of commercial activities (e.g. Surabaya and Medan), so that measurable improvements can be realized in a relatively short time-period.

xxii. Arbitration. Another method of resolving commercial disputes is arbitration, which has many advantages such as speedy resolution, specialist knowledge, and known procedures. Under Indonesian law all commercial disputes can be submitted to arbitration. Indonesia also has well-laid out procedures for arbitration, and an arbitration board, BANI, for the private sector. With few exceptions, the Indonesian arbitration system therefore rests on a good foundation, and also compares favorably to arbitration systems in other countries (e.g. Japan and the US). However, few cases, only 5-10 a year, go to arbitration. The Report makes several recommendations to strengthen arbitration as an alternative dispute settlement mechanism in Indonesia: (a) improve the effectiveness of BANI, or help establish a new, more dynamic arbitration association as in Japan or the US; (b) improve the quality of arbitrators by including more people from technical and business fields, rather than from the ranks of retired judges and professors; (c) take some basic steps to improve publicity about applicable laws, the place of arbitration, nationality of arbitrator, and procedures; (d) improve confidence of foreigners as well as local business by using qualified non-nationals as arbitrators; and (e) address the concerns about enforcement, by issuing regulations that courts should recognize foreign (and domestic) arbitration awards. Very recently, the Supreme Court has issued a circular (reversing its earlier stance) that foreign arbitral awards will be recognized, but this is still not widely known.

xxiii. Legal Profession. A large part of the burden of dispute settlement and interpretation of the law in other countries is carried out by a private legal profession that is well-developed. Key areas for improvement
of the Indonesian legal profession are: (a) expanded professional training; (b) expanded overseas training opportunities; (c) improved foreign language skills of the profession; and (d) allow entry of more foreign legal professionals, to improve quality and provide training.

D. Legal Information

xxxiv. The public's access to legal information is severely limited. It poses one of the greatest barriers to the effective development and implementation of the commercial law framework. The consequences of inadequate legal information are a lack of public confidence and mistrust in the legal system, high barriers to entry for private businesses, especially small businesses less able to pay for costly search for legal information, inefficient and risky economic transactions, and an underpinning for unfair practices.

xxxv. There are several reasons for the absence of systematic legal information in Indonesia. The Report recommends some important ways for improving the public's and the profession's access to legal information: (a) the Government should adopt the requirement that no laws, regulations, and procedures should be effective without publication; and such publication must be easily accessible through improvements in publishing, such as a daily gazette; (b) immediate efforts should be made to declare particular Indonesian translations of the Dutch codes to be "official" versions, or compile an authoritative version from existing translations; (c) court decisions should be written and published--there is no reason not to publish them, and the executive branches (e.g. tax authorities) have vastly improved public confidence and consistency by exposing its reasoning in publishing its decisions; (d) improve the sale and distribution of existing publications, allow the sale of Government publications, permit cost-recovery by agency responsible, and develop contract methods for private publication; (e) ensure that rule-making and policy-making bodies publish all their rules and procedures in standard and accessible fashion--by following the example of Bank Indonesia's banking regulation book; and (f) reorganize public registries in the way they collect information, and improve the access of the public to information in these registries.

Implementing Commercial Law Reforms

xxxvi. The Report has set out a number of priority areas of commercial law reforms, and the specific directions that the reforms ought to take. However, implementing the program will be a complex and difficult task. To assist the Government in developing an effective implementation program, the policy matrix attached to this summary could serve as a guide. It summarizes the recommendations and also indicates: (a) a possible time-frame of reforms; (b) the institutions and agencies that are best placed to undertake the reforms; and (c) areas where specialist international technical assistance would be valuable. Some recommendations about implementing a program of commercial law reforms are noted below:

(a) Time-Frame of Reforms. Legislative actions to implement law reforms in Indonesia, as in other countries, usually take a long time to
implement. However, most of the recommended reforms in this Report do not call for legislative actions. The reforms will, nevertheless, take time to implement. A time-frame of about five years for the entire program is proposed as an indicative guide. It should be possible to complete reforms more quickly in some key areas. In others, an early start should be made in designing and implementing a program of reforms. It would be important for the Government to draw-up an action program for commercial law reforms in the next six to twelve months.

(b) Organizational Focus Within Government. There needs to be an organizational focus within the Government for undertaking commercial law reforms. Because economic reasons are the driving force, the economic ministries may be best placed to coordinate the reform effort. The role of the Ministry of Justice would also be important in many areas, as indicated in the policy matrix. The capacity for implementing commercial law reforms in individual Government agencies is weak, although some are better staffed than others. In order to strengthen the overall capacity within Government to implement the program, it is recommended that: (a) a steering committee for commercial law reforms be formed of legal experts drawn from the different agencies within Government; (b) bring in the private legal and other allied professions into the steering committee; and (c) contract for services of private professionals to assist the work of the steering committee and individual agencies.

(c) Responsibility to Specific Agencies. Specific agencies should be given responsibility for developing a time-bound program of reforms in areas where they have the competence and specialist knowledge, and closely involve the private sector in formulating these proposals.

(d) International Technical Assistance. In many important areas, it would be important to obtain specialist international technical advice. Such sources of advice are already being provided by bilateral and multilateral sources, but in a piece-meal and isolated fashion. This Report and its follow-up might provide an opportunity for the Government to identify these areas and to make more effective use of these resources.
<table>
<thead>
<tr>
<th>Commercial Law Subject</th>
<th>Recommended Reforms</th>
<th>Time Frame of Implementation</th>
<th>Competent Agency</th>
<th>International Technical Assistance Requirements</th>
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<tbody>
<tr>
<td>I. Overall Commercial Law</td>
<td>Major overhaul; central organisational focus within Government required; driving force should be economic approach. Economic ministries best placed to coordinate efforts, establish priorities, and time-frame of reforms.</td>
<td>5 Years (1990-95) for entire reform process. Priorities and time-frame should be possible to frame within a relatively short period. Establish action program by December 1990.</td>
<td>EKUIN</td>
<td>High.</td>
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<tr>
<td>II. Contract &amp; Credit Laws, and Banking</td>
<td>Sound framework of contract &amp; credit laws, credit information, and enforcement mechanisms.</td>
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<td>(a) Enforcement of credit transactions -review civil procedures -promulgate accessible procedures -establish expedited court proceedings -establish specialized judges &amp; courts</td>
<td>1-3 Years</td>
<td>Ministry of Justice</td>
<td>Low.</td>
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<td>(b) Security Registration/Credit Information -Land registration, titling, transfer -Registration of hypothecs and leases over other easily identifiable assets -Registration of other securities (e.g. rights, pledges, guarantees, fiduciary transfers) under personal and company filing.</td>
<td>3-5 Years</td>
<td>Agraria/BPHN</td>
<td>High.</td>
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<tr>
<td>(c) Establish Authoritative Versions of laws -Modify provisions to recognise a wider class of acceptable collateral, standard forms of widely used credit transactions.</td>
<td>1 Year</td>
<td>Ministry of Justice</td>
<td>Low.</td>
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<td>(d) Strengthen Transaction Based Collateral e.g. maximum/floating hypothecs; negotiable warehouse receipts; and back-to-back L/Cs.</td>
<td>1 Year</td>
<td>Bank Indonesia</td>
<td>Low.</td>
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<td>III. (1) Companies Law</td>
<td>Adopt a facilitating, non-regulatory law, that eases entry, mobility, and exit of companies. The present Draft Companies</td>
<td>1 Year</td>
<td>EKUIN</td>
<td>Medium.</td>
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<td>Commercial Law Subject</td>
<td>Recommended Reforms</td>
<td>Time Frame of Implementation</td>
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<td>International Technical Assistance Requirements</td>
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<tr>
<td>(iii) Capital Market</td>
<td>Need for prudent regulations.</td>
<td>1 Year</td>
<td>Min. of Finance/BAPEPAM High.</td>
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<tr>
<td>Regulations</td>
<td>Consistency between companies law and capital markets regulations should be ensured. Detailed capital market regulations are expected to be issued shortly, modelled on the US Securities and Exchange Commission (SEC) laws addressing financial disclosure requirements, protection of minority shareholders, acquisitions and merger rules, and other areas.</td>
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<tr>
<td>(iii) Accounting and Audit</td>
<td>Development of proper accounting and audit framework for private sector enterprises:</td>
<td>3-5 Years</td>
<td>Ministry of Finance CAAD.</td>
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<td></td>
<td>(a) Companies law and/or capital market regulations should be driving force for detailed requirements for accounting and audit, and reporting.</td>
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<td>(b) It should also designate a statutory body for the accounting profession.</td>
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<td>(c) The Indonesian Accountants Institute (IAI) can be the designated body, but needs to be reconstituted in human and financial resource terms.</td>
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<td>(d) Expatriate accountants should be allowed to practice, to improve quality and provide on-the-job training.</td>
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## Indonesia: Policy Matrix of Proposed Commercial Law Reforms

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<thead>
<tr>
<th>Commercial Law Subject</th>
<th>Recommended Reforms</th>
<th>Time Frame of Implementation</th>
<th>Competent Agency</th>
<th>International Technical Assistance Requirements</th>
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<tbody>
<tr>
<td>IV. Dispute Settlement</td>
<td>Investors need confidence in enforceability. Laws of little practical value without prompt enforcement and dispute settlement.</td>
<td>2-3 Years</td>
<td>Ministry of Justice</td>
<td>High.</td>
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<td>The Court System:</td>
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<td>Supreme Court</td>
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<td></td>
<td>(a) increase technical competence of judges</td>
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<td>(b) improved compensation, salary increases to be linked to greater efficiency, publication of decisions, and improvements fairness of judicial process.</td>
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<td>(c) establish specialised commercial courts or judges.</td>
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<td>(d) focus court system improvements on central district court in Jakarta and other major commercial centres so that measurable improvements can be achieved quickly.</td>
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<td></td>
<td>Arbitration</td>
<td>1-2 Years</td>
<td>EXUIN</td>
<td>Medium.</td>
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<td>(a) improve effectiveness of BANI, or establish new more dynamic arbitration association.</td>
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<td>(b) improve quality of arbitrators by including on list of arbitrators people from business and profession, rather than solely from ranks of retired judges and professors.</td>
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<td>(c) take some basic steps to publicize arbitration as alternative means of dispute settlement.</td>
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<td>(d) improve confidence of foreigners by including non-nationals as qualified arbitrators, as in other countries.</td>
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<td>(e) improve enforcement of arbitration awards, specially by recognising foreign arbitral awards, and publicize the recent circular of of Supreme Court in this regard.</td>
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<tr>
<td>Legal Profession</td>
<td>(a) expand professional training</td>
<td>3-5 Years</td>
<td>Min of Justice/Prof Asstns.</td>
<td>High. Universities.</td>
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<td></td>
<td>(b) expand overseas training opportunities</td>
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<tr>
<td></td>
<td>(c) improve foreign language skills</td>
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<td></td>
<td>(d) allow entry of more foreign nationals into legal profession.</td>
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</tbody>
</table>
### V. Legal Information

The public's access to legal information is severely limited, and must be addressed for the effective implementation of laws.

<table>
<thead>
<tr>
<th>Recommended Reforms</th>
<th>Time Frame of Implementation</th>
<th>Competent Agency</th>
<th>International Technical Assistance Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) requirement should be placed that no laws, regulations, and procedures can be effective without publication; such publication should be easily accessible, such as by publishing a daily gazette.</td>
<td>1 Year</td>
<td>(Presidential Decision)</td>
<td>Low.</td>
</tr>
<tr>
<td>(b) declare particular Indonesian translations, or compilations from different sources of the original Dutch Codes as &quot;official&quot; versions.</td>
<td>1 Year</td>
<td>Ministry of Justice/BPHN</td>
<td>Low.</td>
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<tr>
<td>(c) require court decisions to be written and published (similar to that by tax authorities).</td>
<td>1 Year</td>
<td>Ministry of Justice</td>
<td>Low.</td>
</tr>
<tr>
<td>(d) improve the sale and distribution of Government laws, regulations, and procedures, permit direct cost-recovery by agency responsible, and develop private contracting to publish laws, regulations, and procedures.</td>
<td>1-2 Years</td>
<td>EKUIIN/Ministry of Justice</td>
<td>Medium.</td>
</tr>
<tr>
<td>(e) ensure that rule-making and policy-making agencies publish all their rules and procedures in standard and accessible fashion (e.g. Bank Indonesia's rule-book).</td>
<td>2 Years</td>
<td>Different agencies</td>
<td>Medium.</td>
</tr>
<tr>
<td>(.4) reorganize the public registries to make information in them easily accessible.</td>
<td>1-2 Years</td>
<td>Different agencies</td>
<td>High.</td>
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CHAPTER 1
ECONOMIC DEREGULATION AND THE COMMERCIAL LAW SYSTEM

Introduction

1.1 The economic imperatives for commercial law reforms for the efficient development of the private sector in Indonesia are urgent. The private sector has undergone a remarkable transformation in recent years as a result of economic deregulation, but the commercial law system has lagged behind. In spite of weaknesses of the commercial law framework, the private sector has grown very rapidly, is competing more effectively with the rest of the world, and is attracting sizeable foreign investment. This underscores the importance of market (i.e. self-enforcing) mechanisms. However, beyond a certain point, and as the private sector increases in size and complexity, the absence of a well-functioning commercial law framework will result in growing constraints to efficient market functioning.

1.2 In a market-oriented system emphasizing decentralized private economic decision-making, the commercial legal framework will need to play an increasingly important supporting role. Indonesia's commercial laws are old, many dating back to 1847, and they, as well as their implementation through the courts, are perceived to be inadequate. This perception is common to foreign investors, and bankers, who are important for Indonesia's economic development, and to domestic investors and bankers, who are vital for broadening economic development.

1.3 The first section of this Chapter briefly discusses the shift to market-oriented economic system since 1985 as a result of economic deregulation and reforms in the administrative law framework. The second section discusses the economic imperatives for and the importance of an economic approach to commercial law reforms. The third section briefly discusses the main gaps in the existing commercial legal framework, the constraints and costs they impose on private sector activity, and the required direction of future reforms. The last section of the Chapter outlines the rest of the Report.

I. Deregulation and the Administrative Law Framework: The State and The Private Sector

1.4 Deregulation. Two major external shocks in the early 1980s, a sharp drop in oil prices and a large rise in external debt, provided the impetus for economic deregulation in the 1980s. The background, the specific measures adopted, and the response of the private sector to deregulation are described in Annex 1 to Chapter 1 of this Report. In summary, the direction of the deregulation measures has been toward: (a) a central role for the private sector in the economy; (b) a major re-orientation of the incentive regime towards more internationally competitive activities; (c) a significant reduction of barriers to entry and mobility of private sector economic activity; and (d) far-reaching improvements in the efficiency of the supporting framework for private sector development.
1.5 The response has been a surge in exports, accelerated economic growth, and a surge in new investment activity by the private sector. It has increased many times in size and in the scope of its economic activities. It is strongly outward oriented, competing more effectively with the rest of the world, and attracting sizeable direct foreign investment. The private sector is now much less regulated and controlled by Government and is the main source of overall economic growth.

1.6 The Administrative Law Framework. The Government has been able to successfully undertake the wide-ranging economic deregulation measures largely because of the importance of the administrative law framework. The legal basis for these actions have rested on the wide powers delegated to the executive branches of Government to issue detailed regulations and to enforce them. In Indonesia, the administrative law framework has acquired even greater force than in other countries because of the practice that the Laws contain fairly general provisions. The Government, especially the economic ministries, have effectively used their administrative powers to repeal earlier restrictive regulations speedily and flexibly. In areas where it was important to enact new laws, such as Tax Laws, it has acted relatively quickly, and is now considering the enactment of new Banking and Financial Market laws.

1.7 To permit the private sector and markets to play a more effective role there are some remaining areas not highlighted in the text of this Report, but where it is important for the Government to complete the process of economic deregulation. These areas are laws and regulations at the level of local government; in critical infrastructure services such as road transport, domestic trade, power and telecommunications; and in regard to private property and land, investment, banking and financial markets, capital markets, and labor. These issues are discussed in more detail in Annex 2 to Chapter 1 of this Report.

II. The Commercial Law Framework: Issues and Concepts

Main Issues

1.8 Indonesia's infrastructure of commercial laws, institutions, and professional services is inadequate for the market to work efficiently. In what ways does the lack of a sound commercial law framework constrain the efficient development of the private sector? And what are the directions and

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1Typically, through Presidential Decrees, Governmental and Ministerial Regulations, and administrative decisions and circulars.

2One of the distinctive features of Indonesian statues is their general character. Even ordinary statutes can be remarkably free of detail, leaving all significant law-making to Government Regulation or Ministerial Decree. Thus, implementation involves considerably more executive law-making discretion than is the case in many western legal systems. The "general" rule mirrors the "consensus" nature of Indonesian society. The western legal system focuses on the written law. In the Indonesian system less emphasis is placed on the written basic rules and more on the manner in which the broad rule is implemented.
priorities for reform? These are the two central issues now facing the Government.

Box 1.1: The Importance of Commercial Law in Economic Development

The commercial law and institutional infrastructure in developed countries is often taken for granted, but has been central to their economic development, and has been built up over centuries. In economies such as Korea, Singapore and Taiwan the development of an efficient private sector has been closely related to the early attention they paid to the development of a sound commercial legal system. Korea, for example, introduced a comprehensive Western law system on their own initiative and new civil and commercial codes were adopted in 1958 and 1962, modeled largely on the German civil and commercial codes, but with significant modifications.

1.9 In contrast to relatively rapid recent changes in the regulatory regime, the commercial legal system, i.e. the laws relating to business entities and transactions, the implementing institutions such as the courts, other administrative bodies, and the legal and allied professions, has evolved gradually and been slow to change. Most of the existing commercial laws in Indonesia, for example, are still largely derived from those in the colonial period.

1.10 An important reason for this lag is that the economic imperative for reforms in the commercial law system has been weak. For a long time, the private sector played a relatively small role in the economy. Permitted activities were directly guided by the Government. Consequently, a prospective investor was concerned with obtaining the necessary permits and licenses from the various agencies of the Government, i.e. his relationships with the State rather than with market forces and transactions with other private sector actors. The administrative law framework, i.e. State-directed economic activities, rather than the commercial law framework, i.e. market-directed economic activities, provided the main elements of legal certainty and predictability to private economic transactions. The result was that the demand for better commercial laws, efficiently functioning implementing institutions and allied professional services was weak. The institutions and professions atrophied during this period of isolation from market demands. The Ministry of Justice, directly responsible for the development of the commercial law framework, had many other priorities for law reform, e.g. the criminal law system, and the family law system.

The Purpose of Commercial Laws

1.11 Commercial laws and institutions provide a framework of rules that govern private market transactions and provide independent and neutral forums to settle disputes and interpret such rules. The distinction between the role of Government regulation and commercial law is crucial: Government regulation
of private markets largely pertains to issues which involve the public interest, while commercial law largely relates to the efficient conduct of economic transactions between individual private transactors.

1.12 The use of an economic approach is a powerful one in regard to the development of commercial law system. The combination of the economic need and the usefulness of an economic approach to commercial law reforms provides a framework that will be adopted throughout this report.

1.13 Lawyers, especially practicing commercial lawyers, like to define the purpose of commercial law framework in terms of somewhat different concepts from economists: certainty, predictability and confidence. By this is meant that economic transactions should have certainty in law, i.e. the laws should provide clear rules and assure that contemplated transactions are permitted; and that the legal consequences of economic acts are predictable, i.e. private transactions in accordance with the commercial law will be respected and enforced by the courts or other forums. Such a legal framework then provides the degree of confidence required by the private sector to enter into economic acts. These are key concepts that lawyers employ when advising clients on the legal consequences of economic transactions. For example, when a foreign investor seeks advice on forming a joint venture in Indonesia, the lawyer will look to the framework of foreign investment and company laws to determine that the investment is in fact permitted and what risks are involved because of uncertainty of the law. The lawyer will also look to the court system to advise the client what are the chances of a predictable outcome in the event of a dispute with the local partner. If these elements of certainty in law and predictability in enforcement are missing, the chances are the lawyer's advice to his client will emphasize the substantial risks involved in the transaction.

1.14 The legal approach contrasts in several ways to the economic approach. A set of foreign investment and company laws may be certain and predictable in legal terms, but may still be highly inefficient in economic terms. Foreign investment laws may be certain but impose restrictions so as to deter long-term investment because of divestiture requirements. Company laws may by detailed clauses on permitted company forms, add a great degree of legal certainty but be overly restrictive and regulatory and raise transaction costs that pose barriers to efficient entry. Finally, the predictability of the legal framework may be sought to be assured by direct intervention by Government decisions in the event of dispute, but such a system may permit access to only a small class of investors. Economic efficiency is thus not

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3The economic approach has been criticized on grounds, amongst others, that economic efficiency is not the only objective of society; that there are other powerful explanations for the legal system as it operates in practice; and for ignoring “justice”. On the other hand, there are important reasons for using the economic approach--economic efficiency may not be the only objective of society, but it is a very important one to clarify conflicts in law; there are other social explanations for the legal system as it operates, but the related theories are not as advanced as economics to guide the development of law; and finally, economic efficiency is one important and common meaning of “justice” (e.g. against the taking of property without fair compensation).
access to only a small class of investors. Economic efficiency is thus not synonymous with a legal system that is certain and predictable. The legal concepts of certainty and predictability will be important in the design of a commercial law system, but will need to follow economic efficiency considerations.

1.15 The specific issues of economic efficiency are complex and vary according to particular areas of commercial law, such as contract and credit laws, or company laws, or legal enforcement and dispute settlement under study. These areas are discussed in later Chapters of this Report. A few key general economic efficiency objectives that the legal framework should achieve are: (a) reduction of legal barriers to efficient entry and mobility of private investment and private transactions; and laws and rules that are facilitative and responsive to efficient growth of market activities; (b) reduction of costs in market transactions, by providing standard contract terms and increasing access to information; (c) sanctions for infringement of well-defined rules of efficient market functioning; and (d) reduction of costs (time and money) and raising the technical and economic efficiency of dispute settlement procedures.

III. Main Gaps and Priorities For Reform of the Commercial Law Framework

Lack of Modern Laws

1.16 In most important areas, the existing commercial laws are outdated. The Commercial and Civil Codes, both adopted in 1847, cover such important topics as: laws relating to limited companies, partnerships, and other business entities; commercial intermediaries; commercial paper; insurance; transport; contracts and credit transactions; sale and exchange of goods; and other areas. Bankruptcy is governed by provisions of the 1905 Bankruptcy Law, as well as by provisions in the Commercial Code relating to the dissolution of limited companies. Under the transition provisions of the Constitution, all laws adopted during the colonial period were considered to continue to apply, unless repealed or amended by subsequent legislation. Thus, the Commercial and Civil Codes and other commercial laws adopted in the colonial period continue to be in force with little modification since then.

Principal Gaps in Laws

1.17 There are two critical areas where the absence of modern commercial laws are perceived to be major bottlenecks to the efficient development of private sector activities. The first is contract and credit laws, and related laws on mortgages, which apply especially to banking transactions. The second is company laws, and related accounting laws, and capital market laws. 4

4There are many additional perceived gaps in laws: no law of trusts, which hinders the development of the underwriting and securities market; antiquated laws on bankruptcy; lack of a firm statutory basis for various modern business activities, such as factoring, leasing, venture capital, electronic banking, and credit cards; and minimal regulation of anti-trust and unfair business practices.
Credit transactions are an essential ingredient of the production and exchange process, and are a special form of contract: a non-simultaneous exchange where the lender makes available credit for repayment with interest. Contract and credit transactions are made costly and difficult in Indonesia because of a number of gaps in the relevant laws: hypothecation is not permitted for a broad class of collateral; there is no reliable system of registration of collateral; and land ownership is restricted to Indonesian individuals. As a result use is made of legal fictions to transfer ownership. Enforcement of credit transactions and foreclosure is difficult because of long delays in the court system. As a result there is excessive reliance on collateral, high barriers to credit, restraints on lending, and frequent abuse or technical defaults by borrowers.

An easily enforceable law of contracts is essential to deter people from behaving opportunistically, e.g. reneging on promises, and to make costly self-enforcing measures, e.g. excessive collateral, unnecessary. Banking is a specialized institution that makes supply of credit available at low cost, by intermediating between borrowers and lenders. But in the absence of sound credit and security laws, and easy enforceability, the banking sector's functioning can be seriously jeopardized.

The critical importance of a modern company law is that most private businesses will take the form of limited liability companies. There are already some 160,000 such companies in Indonesia, the largest part of corporate taxpayers. A modern company law is important to efficiently guide their economic conduct in a standard fashion and thereby lower transaction costs for suppliers of risk capital. The Indonesian law on limited liability companies, however, fails to provide easy entry and exit or sufficient flexibility for owners.

The limited liability company is a means of shifting risk to lenders of finance. Such shifting of risk is difficult without adequate requirements for accounting and audit of the financial records of a company. Good accounting practices, public auditing requirements, and disclosure of financial performance together serve as an invaluable tool for efficiency in financial transactions, but are missing in Indonesia. The private company sector in Indonesia has no general requirements for accounting and audit. The basic requirements are the General Provisions and Procedures of Taxes (1983) under which the Minister of Finance is empowered to issue regulations as to accounts to be filed by companies for tax purposes. The private accounting profession is also undeveloped, with only some 400 registered public accountants.

Finally, a comprehensive set of capital market regulations is at present lacking, but is expected to be issued shortly to strengthen the development and prudential regulation of the capital market. While these would be expected to address many of the existing gaps in company laws and accounting framework, they would be applicable only to companies already listed or expected to list themselves in the securities market. Capital market regulations must be consistent with laws for the company sector as a whole, so that there is a broadening of the company sector's development over time.
Principal Gaps in Implementation of Laws

1.23 The Court System. The most important bottleneck in the efficient implementation of existing laws is the court system, because of long delays, and the perception that decisions are arbitrary and not transparent, and that there is a bias against creditors and foreigners. The courts are a form of public monopoly on enforcement of laws, and when there are failures in the court system, the entire commercial law framework comes to a halt. Purely voluntary mechanisms for settling disputes are available as an alternative, such as arbitration, but for a variety of reasons, they have not worked well in Indonesia.

1.24 Legal Information and the Legal Profession. When laws are unclear, they result in legal uncertainty, posing barriers to efficient conduct of economic activity. The efficiency of the courts and legal process depends to a great extent on access to accurate and up-to-date legal information. The distribution of legal information is particularly poor in Indonesia. Improvements in access to legal information are essential and would have major benefits in helping to reach a consistent application of the laws.

1.25 Strengthening the legal profession is also essential for the commercial legal framework to function efficiently. The profession has been cut-off from international economic and legal developments, and from modern methods of training and education. The failure to keep up with changes in legal thinking has affected all aspects of the profession: private practitioners, Government attorneys, judges and notaries.

Other Issues

1.26 Treatment of Foreigners and Foreign Investors. Foreign claimants face considerable obstacles under the Indonesian judicial system: foreign arbitral awards have only recently been recognized by courts despite Indonesia's accession to the New York Convention on Foreign Arbitral Awards; courts have ruled as illegal international sales contracts governed by foreign laws, refusing to enforce the related foreign arbitration award; foreign creditors have failed to obtain favorable judgments in credit disputes before the courts, even where the credit transaction was in the form of an acknowledgement of debt which is supposed to lead to automatic enforcement; and foreign banks, in particular, have had difficulties with enforcement of credit transactions. This pattern has resulted in a firmly-held perception in the foreign trade and investment community that doing business in Indonesia is a high risk, and that the Indonesian commercial law framework is one of the least supportive in East Asia, and in comparison to other developing countries. Given the importance of foreign trade, foreign borrowing, and foreign direct investment for efficient growth of the private sector and the economy, it is of vital importance that reforms in the commercial law framework pay particular attention to equitable treatment of foreigners by the judicial system.
IV. CONCLUSIONS

1.27 This Chapter has emphasized the importance of the economic approach and the economic imperatives to commercial law reforms. The central purpose of commercial law reforms should be to put into place a framework of rules that ensures greater efficiency in private market transactions, and to provide for independent and neutral mechanisms to enforce the laws.

1.28 The two important substantive areas of Indonesian law that need to be revised are: (a) contract, and credit laws, especially related to secured transactions; and (b) the set of laws relating to the limited liability company sector, the accounting framework, and capital markets. Reforms in these areas are urgent priorities, because contract and credit transactions lie at the heart of the efficient functioning of private markets and the banking sector, because the company sector is the fastest growing and most important institutional form of organized private sector business. The specific issues and direction of reforms are discussed in Chapter 2 (Contract and Credit Laws, and Banking Transactions) and Chapter 3 (Company Law, Accounting Framework, and Capital Markets) of this Report.

1.29 An even greater priority is reforms in the implementation of commercial laws. New laws may not be required, but changes are needed in the court system, and in areas of voluntary dispute settlement. These areas of reforms, including a brief discussion of the development of the legal profession, are set out in Chapter 4 (Dispute Settlement). Chapter 5 (Legal Information) discusses ways of improving access to legal information.
CHAPTER 2

CONTRACT AND CREDIT LAWS

Introduction

2.1 This chapter discusses the importance of a sound framework of contract and credit laws, credit information systems, and enforcement mechanisms to facilitate efficient growth of credit and banking transactions in Indonesia. The first section provides the economic approach to the role of contract and credit laws. The second section discusses the reasons why contract and credit transactions are made difficult and costly in Indonesia. The third section recommends specific reforms to address these shortcomings.

I. The Role of Contract and Credit Laws

2.2 Credit laws are a special category of the law of contracts. It is important to understand the precise role that contract and credit laws and related institutions play in ensuring greater efficiency in markets, before we discuss specific problems in Indonesia. Voluntary exchange activities (i.e. contracts) lie at the heart of market-functioning, and are efficient. When two self-seeking individuals enter into a voluntary exchange, it is presumed to make both of them better-off economically. The parties to a contract are presumed to best know their self-interests and relative value they assign to property or services being exchanged when entering into a contract.

2.3 The contract theory is simple, powerful and has pervaded recent legal literature. Such a contractual viewpoint, i.e. the limited role of the law and the efficiency of market functioning under private contracts, obtained an important start from an article in 1960 (The Coase Theorem), which stated that, under certain circumstances, parties to a contract may have incentives to bargain around contractual provisions which are required by law, with the effect that such provisions become ineffective. The market would negate or dominate the law, if inefficient.

The Importance of Transaction Costs and Risk

2.4 The key assumptions that lead to the above are principally that: (a) there are no transaction costs in contracts; R.J. Coase, of course, was the first to raise the issue of transaction costs in economic literature in a 1937 article. In the 1960 article, he illustrated the proposition that laws can be ineffective, for example, where there are no transaction costs and (b) the future is perfectly predictable. These assumptions, of course, do not hold in a real world of limited information and incomplete (futures or contingent) markets. The information gathering and contracting costs of any transaction can be very significant, arising from the costs of learning and haggling over

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the terms of a contract. Where the contract also involves future obligations, as virtually all contracts do (other than the simplest one of simultaneous exchange), the added problems of opportunistic behavior and unforeseen contingencies arise. Repeated learning and haggling must take place to revise the terms of the contract. In an ideal world, parties could always write long-term contracts specifying every conceivable situation. In practice, the negotiation and enforcement costs would make this prohibitive, and few complex market transactions would be possible.

The Role of Law in Contracts

2.5 Critical institutions have developed in law in market economies to lower these transaction costs and risks and allow markets to develop. These institutions are (a) a body of contract laws that provide standard forms of contracts; (b) speedy enforcement of contracts; (c) a neutral forum to re-interpret the contracts in the event of unforeseen contingencies; (d) information systems; and (e) insurance mechanisms.

The Effects of Absence of Well-Developed Laws and Institutions

2.6 In the absence of well-developed contract and credit laws, and related institutions such as speedy enforcement, information systems, and insurance markets, a large number of efficient private transactions cannot take place. The market for many essential economic activities does not develop. And even if the market does develop, formally or informally, access is limited and the costs are high. Credit transactions are made particularly difficult, and the formal banking sector's role and efficacy is particularly affected. In the absence of access to credit and high costs, a wide range of potential production activities become infeasible. The equity effects are particularly damaging. Only the relatively well-off, and well-established individuals and businesses are able to enter into credit transactions. The central point here is that social mechanisms will be used to obtain access to credit rather economic mechanisms, thus favoring certain groups over others. Even this will become difficult as credit markets expand and borrowers become more anonymous in a complex economy.

II. Main Gaps in Credit Laws and Related Institutions in Indonesia

2.7 To an extent, the Indonesian commercial and legal systems have been creative and introduced some of their own concepts and legal "fictions" to assist in modern transactions: concepts such as "fiduciary transfer of ownership" and "power of attorney" are frequently employed to give a lender more confidence that his money will be repaid. However creative as they are, these methods give little real comfort to the lender because they have an uncertain foundation in the Law and Codes. The relevant Law and Codes were drafted long before the complex transactions of today and do not address many of the issues that arise in modern transactions. The legal bases for commercial transactions are the Indonesian Civil Code and Commercial Code,

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both of which were enacted in 1847. An additional uncertainty is added to the element of age, because these two Codes are formally regarded as mere commentaries on the Law until such time as Indonesia enacts replacement legislation consistent with the Constitution of 1945. The main gaps in credit laws and related institutions are described below.

Credit Enforcement

2.8 Money lenders, from the largest, most sophisticated commercial banks to the smaller, informal lenders, are concerned about getting their money back. The greater the risk that their loan will not be repaid on schedule, the higher the rate of interest, the shorter the period of credit, and the greater the extent of credit rationing. In Indonesia today, these risks are unusually high because of lack of credit enforcement. Two basic methods of improvement in the area of enforcement are the court system and the alternative dispute settlement system. (See discussion in Chapter 4). It is sufficient to say that the Indonesian court system is not an effective instrument for recovering debts. The debtor enjoys a strong position. Enforcement of credit transactions may take several trials and many years before the courts issue an order of execution. In practice, therefore, the creditor must rely on the value of collateral.

Range of Security and Legal Foundations

2.9 Another method of reducing the risk of non-repayment is to look to some other “security” or “collateral” to back up the loan. If the borrower defaults, the lender can take the security and realize its value. In Indonesia, the types of security are limited. The Supplement to this Chapter describes in more detail the various forms of security used in Indonesia and their inherent problems in law, enforcement, and documentation. Hypothecation (mortgage) is a standard form of security in credit transactions in Indonesia, but is only permitted for immovables and ships. A wide range of assets, such as industrial machinery (large, high cost, and easily identifiable);

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3The contract of lending and borrowing money is regulated in the Thirteenth and Fourteenth Chapters of Book Three of the Civil Code in Sections 1754 through 1773.

4A complicating factor is a Supreme Court circular of 1963 stating that the Codes should be used only as a guide. Notwithstanding this circular, the Codes are cited as being current law.


6The “acknowledgement of debt” which is a notarized document acknowledging debt and agreement by borrower to expedited enforcement has been a widely used procedure by creditors. Registration of the document is supposed to be equivalent to a court order. However, since 1985, the Supreme Court has set stringent conditions on its use. Government has created special machinery for collection of money owed to government -- the Agency for Settlement of Debts Due to the State (BUPN) -- with special powers equivalent to that of Courts. No similar agency exists to assist private creditors.
receivables; stock in trade; and monetary assets, are not permitted to be mortgaged. Without the ability to mortgage such assets, the lender uses other methods to collateralize loans. Pledges are one form, but are impractical because the law requires physical possession by the lender. Businesses have innovated by using legal concepts such as the fiduciary transfer of ownership, and powers of attorney, but the foundation of these concepts in law, and enforceability, is uncertain. In the end, the lender is forced to adopt multiple forms of security and overcollateralize loans.

2.10 In Indonesia, individual loan agreements set out comprehensive contractual provisions about the establishment and administration of the loan. Much time and expense is involved because it is thought prudent to have all loan documentation, including ancillary documents, take the form of a notarial deed, providing an authoritative version of an agreement. Despite use of such precautions, Indonesian courts may refuse to enforce an agreement that is unusual or of a complicated structure. (See Box 2.1 - Transaction and Documentation Costs in Indonesia)

**BOX 2.1: Transaction and Documentation Costs in Indonesia**

The types of problems of structuring a modern credit transaction in Indonesia because of the complexities of the commercial legal system are provided below:

First: problems relating to the complex corporate structure of the borrowers. In a recent actual transaction there were four borrowers and four guarantors owned, in mostly horizontal fashion, by the same individuals. A more rational, predictable corporate law framework might have encouraged the investors to be more transparent, and efficient, in their business structures.

Second: problems relating to the titling. Title to a given piece of property which serves as collateral is frequently held by interconnected corporate entities, often through individuals, making transactions almost impossible to document.

Third: problems with the requirements of notarial form for documents for evidentiary purposes. Many documents have to be in notarial form, greatly increasing the cost and adding delays to the transaction: in addition to the costs of the notary, there are printing costs (using special paper and paging), adding recitals, using words instead of numbers, and reading documents in full aloud.

2.11 Land is a valuable and widely held form of private property. In many countries the easy transfer and mortgage of land serves as a major way to finance and securitize credit transactions. However, there are formidable barriers to the transfer and mortgagibility of land in Indonesia, leading to its less than optimal use. Only private citizens can own full title to land. For others, they can only lease or hold title to land for specific purposes and for relatively short periods of time.
Lack of Property, Credit, and Security Registration/Information Systems

2.12 There are no reliable information systems, i.e. systems of registration of property, security and information on credit status of individuals and businesses in Indonesia. A land registration system exists, but procedures are complex and costly and only a small part of land is titled and registered. There are no existing systems to register other valuable forms of private property that could serve as security, such as industrial machinery, guarantees, and other security.

2.13 The requirements for registration of deeds and documents serve little practical purpose, but merely raise costs, as these deeds and documents are not identifiable or accessible. It would be much more valuable to have a system of personal filing, where significant property, credit and security interests could be filed against names of borrowers. The existing company registration system is also neither adequately enforced nor accessible. No private or public credit information systems can develop in the absence of such registration systems. Banks are restricted by the banking secrecy laws in their operation of a credit/security registration system.

Excessive Reliance on Collateral

2.14 In the absence of the critical requirements of well-functioning credit laws and institutions, creditors and banks are forced to fall back upon a system of personal and corporate guarantees, excessive collateralization, and most importantly, the reputation and business links of well-established borrowers. Banks must accommodate a higher level of administrative staffing and expense, to handle the large amount of paperwork and documentation involved in each transaction, all of which contributes to the high cost of lending in Indonesia. Likewise, enterprises seeking credit must be prepared not only to bear the cost and administrative burden of handling loan and security documentation, but also to seek the support of third parties to guarantee the performance of obligations. The effect is to create an additional rent on economic activity in favor of that class of persons and companies able to act as guarantors, i.e. the wealthy urban dweller.

2.15 These heavy demands on borrowers to supply collateral lead to abuses where the same asset may be pledged twice. Any borrower with more than one source of financing is likely to be in technical default under the loan agreement and accessory security agreements, not only encouraging disrespect for the specific contractual provisions but also forcing borrowers to rely on repeated negotiations rather than well-administered, and less costly, compliance to meet their obligations to creditors.

High Barriers to Credit Worthiness

2.16 Many firms in Indonesia belong to business groups. Despite recent rules limiting the amount of loan exposure of banks to related companies, the ownership of a bank in the business group, or the reputation of the business group, is a valuable resource for obtaining credit. Rather than the economic viability of an enterprise determining its credit worthiness, access to collateral or third party support becomes the determining factor, placing emerging, independent or small-scale enterprises at a considerable disadvantage in obtaining funds. These high barriers not only exacerbate
income disparities within the economy, by consistently favoring established businesses over small-scale or newly-formed companies, but also are a major disincentive to new economic activity and innovation.7

Restraints on Securitized Lending

2.17 Securitized lending whereby loans are transformed into financial instruments which may be sold to investors, has not developed in Indonesia because of the numerous uncertainties of enforcement and the high risk involved in heavily collateralized lending. Leasing transactions are rendered difficult because of the absence of registration of collateral, absence of mortgages over movables other than ships, and the risks attendant to leased property located on immovable property. The success of recent initiatives to foster the establishment of financing companies, including factoring companies and leasing companies, depends to a large extent on the legal system's ability to fashion more adequate and straightforward forms of security and security registration.

7The recent Presidential directive that State Banks provide loans to small traders without collateral is responsive to this problem, but will not have a long-term, sustained impact unless the underlying legal structure is modified.
BOX 2.2: Access to Credit for Small and Medium Businesses in Taiwan

A case study of Taiwan’s credit system provides a good example of why in the absence of well-developed formal legal systems and institutions the informal system can be used to provide credit for small entrepreneurs.

Taiwan’s economic success is largely attributable to the dynamic performance of small and medium businesses, and ease of entry and exit of such businesses. For decades Taiwan’s formal financial system was heavily repressed, government-owned, and regulated, and was not an important source of finance for the small sector. Yet the small sector was dynamic and able to access credit, essential for success.

The formal financial sector had a tremendous problem of credit intermediation. Small and new firms are high risk and do not have credit information. Taiwan solved the problem by allowing, and assisting, the development of a curb market. A dual financial system was created which segmented borrowers into “full-information” borrowers, which dealt with the formal financial systems; and “information-intensive” small borrowers, which got credit from curb lenders.

In the curb market, the most important instrument facilitating de facto intermediation was the post-dated check. A negotiable instruments law was adopted, making it a criminal offense, punishable by two years in jail, to fail to honor a post-dated check. The majority of criminal cases processed through courts had to do with these violations. A secondary market in post-dated checks also quickly emerged. The Government also assisted the curb market through other means. By the late 1970’s, however, the instrument declined in importance: the formal system had grown; the curb market experienced scandals; and criminal penalties were abolished in 1987 as a burden on the courts.

Indonesia, too, in the early 1960’s widely relied on post-dated checks, and criminal liability but this is no longer used. With deregulation of financial markets Indonesia need not go Taiwan’s route of segmentation, but the central message is clear. Indonesia must, as an urgent priority, overhaul its credit and security laws, information systems, and enforcement proceedings, so that the formal financial sector can extend credit to the small and medium business sector, especially new entrants.

(“Financing the Emergence of Small and Medium Enterprise in Taiwan,” T.S. Biggs, USAID, 1988.)
III. Recommendations for Reform

Authoritative Versions of the Codes and Modification of Credit and Contract Laws

2.18 Immediate action should be taken to establish an authoritative version of contract and credit laws in the Indonesian language. The existence of an authoritative Indonesian translation will facilitate subsequent modification of the provisions and will also assist the courts in defining and applying the rules found in the codes. Contract and credit laws should be modified to recognize a wider class of collateral and security, standard forms of widely used credit transactions, and expedited civil procedures.8

2.19 Consideration must also be given to the establishment or designation of special panels of judges in Indonesia’s major urban district courts to handle commercial and credit disputes (See recommendations of Chapter 4).

Security Registration and Credit Information Systems

2.20 The ability of Indonesia to extend credit to small-scale and rural enterprises and to new enterprises in development areas with high growth potential will in large part depend on bringing increasingly more of the country’s land under the land registration system. Much of the economic advantage currently enjoyed by urban groups can be traced to their long-standing access to credit based on the hypothecation of registered land. Every effort must be made to expand and perfect existing registration systems, particularly the land registration system. A longer-term objective is to carry out several basic actions with respect to the Basic Agrarian Law (Law No. 5 of 1960) so that land will be brought under a uniform registered system of title: carry out cadastral surveys; clarify what can be mortgaged under the Basic Agrarian Law of 1960; and, in order to reduce the cost of land registration and mortgages consider imposing a flat fee rather than a fee based on the amount of the loan.9

2.21 A simple, effective and readily accessible system of security registration should be put in place as soon as possible. It would provide a major improvement in the present system.10

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8An accessible set of civil procedure rules in the Indonesian language must be promulgated to create certainty and accountability in the system. Possibly the greatest defect that exists in the system with regard to contracts, credit and security are the delays, costs and legal uncertainties of the court system. Serious attention needs to be given to the institution of summary proceedings, particularly for the enforcement of security rights.

9The World Bank has recently begun a study of the issues involved in land management in Indonesia and that study will go into these topics in more depth.

10A system of registration such as that available for land and for ships, would be valuable for other assets which are large, easily identifiable and of high cost, such as aircraft, industrial machinery and equipment subject to lease. Such a system could follow the model of the ship’s mortgage by using the site
2.22 In addition, a registration system for collateral based on a personal filing system is required, whereby rights, pledges, guarantees, fiduciary transfers of ownership and other securities would be registered and recorded under the name of the borrower. Efforts are already underway to set up a National Credit File within Bank Indonesia. This File will have as its primary purpose assistance to Bank Indonesia in its central banking tasks, but may also have some indirect benefits concerning registering security interests. A private system might be feasible and would avoid some of the problems of the Bank Indonesia system. Commercial banks could set up an interim registry with the agreement of their customers concerning disclosure, avoiding secrecy problems. The value of such a registry would be directly proportional to the number of private lenders who choose to participate, and it would be in the interests of the banking community to encourage participation. If there is truly a concern by lenders they should be more than willing to participate, and to assist in covering costs, as it is in their interest to have the system run efficiently and to include as many transactions as possible. The company registration system should be strengthened and made publicly accessible, especially to ascertain mortgages charges and loans on the company (See recommendations in Chapter 3).

New Forms of Credit/Security for Borrowers

2.23 Short of providing credit without collateral, changes to the law on hypothecation to allow for maximum amount hypothecs and floating security could be introduced, which would greatly enhance the flexibility of lenders in fashioning appropriate financing for borrowers, by creating valid security for advances up to a certain specified amount. The recent initiatives of Bank Indonesia in establishing the framework for negotiable warehouse receipts should be expanded upon to allow for the greater use of possessory securities, such as pledges, over raw materials, finished products, and stocks of completed goods, through a system of secured warehousing. Such secured warehousing authority could be granted to warehouses located in industrial estates or adjacent to industrial zones. In Korea and Taiwan back-to-back domestic letters of credit have been successfully utilized to help larger firms provide bank credit to subcontractors and suppliers in exporting activities. A well-established manufacturer uses the export L/C as a purchase order, to create a domestic L/C, in the case of a purchase order, a bankers acceptance favouring his suppliers, which in turn is used by the small subcontractor as collateral for working capital loans. The domestic L/C system has been introduced by Bank Indonesia, but it is very rarely used. The principal reason is that commercial banks do not use a transaction-based approach to lending to exporters, but extend lines of credit based on past performance and reputation of borrower. A shift to a transaction-based system of credit and use of domestic L/C system would facilitate greater access to credit for small, indirect exporters. Greater publicity of the domestic L/C system by Bank Indonesia is required.

of the pertinent registry as the site of the hypothec, enabling the expansion of the present system of hypothecation for security purposes.

11Although there are several unresolved questions, including that of bank secrecy laws and whether Bank Indonesia is appropriately staffed to handle this sort of duty, the idea is worth pursuing.
SUPPLEMENT TO CHAPTER 2
Forms of Security used in Indonesian Credit Transactions and Problems with their Effectiveness

1.1 Many, if not most, collateral arrangements in Indonesia are complex, requiring time, expense and effort by notaries and lawyers without reducing the risk very much. A common characteristic of the methods of creating a security interest is that they are structured to avoid going to court for enforcement. Court proceedings dealing with credit transactions involving two Indonesian parties can take from three to seven years before an executable order is issued. When non-Indonesians are involved the process of collection and enforcement is likely to be even longer. Indonesia has entered into very few bilateral conventions concerning recognition of foreign judgements. There are none with any western European country or the United States. Before a foreign judgement can be enforced, it must be endorsed by the Indonesian courts. The endorsement is an ordinary court proceeding in which the court is entitled to readjudicate the case on its merits: not an efficient, or predictable task, in view of the manner in which the court system operates in Indonesia today.

1.2 Hypothecs/mortgages\(^1\) -- are security interests on real property or on land rights as a freehold interest (hak milik) and the right to build (hak guna bangunan).

a. This is the most dependable and reliable form of security, but also the most costly. The costs are calculated as a percentage of the value of the land concerned.\(^2\) To avoid some of the costs, it is common to issue creditors powers of attorney to establish a hypothec as part of a security package, thus leaving it to the creditor's discretion whether to register or not. But without registration the security of hypothecation is not created, and hence its value and dependability are reduced.

\(^1\)Governed by Civil Code Articles 1162 -- 1232. The formalities of establishing a hypothec are governed by regulations under the Basic Agrarian Law (No. 5 of 1960), including Government Regulation No. 10 of 1961.

\(^2\)At least 0.6% of the amount of the hypothec. In addition, the Land Registry Office in some locations will request further cost reimbursements prior to registering the hypothec. These extra costs are often considerable, and although they do not have a clear legal basis, payment is usually unavoidable.
b. The hypothec only becomes effective on completion of registration with the Land Registry Office\(^3\) of a deed which has been prepared by a licensed Land Deeds Official.\(^4\)

c. In theory, enforcement should be easily achieved. The Certificate of Hypothecation, with the Deed of Hypothecation affixed to it, constitutes a *grosse acte* with executorial effect, that is to say the Certificate and Deed constitute instruments which, at least in theory, afford the same status as a final judgment of a court and can be executed without further court proceedings. In practice, however, the debtor enjoys a strong position and procedures for obtaining realization of execution may involve trials at three levels and last from six months to over three years. Lenders are understandably reluctant to expose themselves to these protracted enforcement proceedings.

d. Further expense and inefficiencies arise because companies cannot hold rights of ownership of land under the Basic Agrarian Law. To circumvent this restriction the ownership of land is often vested in a company's directors or shareholders who then grant to the company rights of use, construction, and exploitation. The directors or shareholders having the ownership are then in a position to hypothecate the land as security for the debts of the company.\(^5\)

1.3 **Fiduciary transfer of ownership** -- is widely used, and is generally more practical than the pledge. The borrower transfers to the lender, in writing, the right of ownership in respect of tangible movable assets. After-acquired assets may also be included. Possession of the assets remains with the borrower.

a. No specific provision for this popular form of security is found in the Civil Code; it developed through case law and usage in the Netherlands.\(^6\)

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\(^3\)Indonesian Civil Code, Article 1179(2).

\(^4\)Ordinarily a notary, a local government official or official of the National Land Agency (*Badan Pertanahan Nasional*).

\(^5\)For foreign investors, this procedure emphasizes the importance of joint ventures with an Indonesian company, the directors of which can hold rights of ownership in land utilized by the enterprise.

\(^6\)The Dutch have begun a major revision of their Commercial Code. The need for the concept of "fiduciary transfer" is expected to be eliminated by creating a right of pledge without possession.
b. The lender has a prior claim to the property over all subsequent lenders.

c. Non-performance allows the lender to claim possession, liquidate the assets and apply the proceeds to the debt. There is some uncertainty here as the liquidation of assets is not regulated by law. The operating assumption is that the provisions applicable to the liquidation of pledges apply -- that is, a public sale or auction. Some lenders put into the loan documentation specific authorization for a private sale, but it is not clear if the authorization is valid.

I.4 Receivables -- can be validly assigned to a lender, as can future receivables which originate from an existing contractual relationship between borrower and payor at the time the assignment is made. Nevertheless, the value of the assignment is reduced because it is difficult for lenders to collect receivables unless they are expressly named as the payee in the debt instrument.

I.5 Powers of Attorney -- is an alternative to the hypothec which allows the lender to sell the property and apply the proceeds against the debt.

a. Powers of Attorney are used in practice to provide the lender with the power to sell property without going through court proceedings. This avoidance of the courts has not been tested in the courts themselves. It is a real possibility that a borrower could successfully argue that the Power is invalid and contrary to Indonesian Law as it usurps the authority of the courts.

b. Several other uncertainties remain about a Power of Attorney: such as whether it is revocable or not; how long it will last; and will it survive insolvency of the grantor? The value of a Power of Attorney is also reduced by the fact that it will not prevail against a third party who has acquired an interest in the property in good faith.

I.6 Guarantees -- reduce a lender’s risk more in a commercial sense than a legal sense, as they are no stronger than the creditworthiness of the

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7Indonesian Civil Code Article 613.

8Although Article 1813 of the Civil Code provides that the power of attorney will expire in the case of the demise, trusteeship, bankruptcy or insolvency of the grantor, it is a debated question whether the provisions are mandatory or not. The Supreme Court has ruled that the provisions are non-mandatory (December 16, 1976, No. 731/K/Sip/1975) but the practitioner, and the investor, is still not entirely comfortable with the idea.
guarantor. The lender must first exhaust all legal remedies against the debtor before seeking payment from the guarantor. 9

1.7 Pledge -- is a fixed charge on specific assets and entitles the lender to take action in case of non-performance in preference over other lenders with respect to the pledged assets.

a. Although a pledge may be made in respect of intangible assets, such as shares, receivables, debentures and patents, the practical value of doing so is greatly reduced by the provision of the Code requiring that the pledged assets may not remain in the possession of the borrower, but must be physically transferred to the lender for the duration of the pledge. This provision makes it impractical to pledge assets that the borrower needs for business purposes, thus rendering useless one of the most valuable assets a borrower could present to a lender. This is especially hard on those borrowers without an established relationship with a lender. 10

b. Shares may be pledged but the practicality is not great, as the voting rights remain with the borrower. 11 Although Powers of Attorney granting the lender the power to exercise the voting rights during the pledge may be given, the validity of such arrangements is uncertain, especially where the grant is stated to be exclusive or irrevocable.

c. Pledged assets may not be taken by the lender, but must be sold at a public auction. 12

1.8 Documentation for the above credit transactions may, at the option of the lender, be in any of four forms: notarial, private signature, private

9Indonesian Civil Code, Articles 1820 et seq.

10Indonesian Civil Code Article 1150 et seq. For tangible property the pledge becomes effective upon physical transfer. The lender must take possession of the stock in trade, by storing the stock in a warehouse under the lender’s control. For intangibles validity of the pledge is subject to notification to the third party: the company in the case of a pledge of shares; the payor of a receivable when receivables are pledged. The Dutch are in the process of changing their rules and shortly should allow a pledge without possession which could be registered.

11Indonesian Commercial Code Article 54, section 1. Some lawyers are of the opinion that such arrangements are valid and enforceable if coupled with an interest or consideration.

12Indonesian Civil Code Article 1155.
notarized signatures, or private signature with witnesses. The only exceptions are hypothecs and Powers of Attorney dealing with real estate transfer, which must be in notarial form.  

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13 The notary, in theory, reviews all relevant corporate documents (articles, share registry, minutes of shareholders' meetings), in order to be certain that all signatories are authorized to act and to determine whether the necessary corporate approvals have been obtained. The notary keeps the originals of all executed notarial deeds.
CHAPTER 3

COMPANIES LAW, THE ACCOUNTING FRAMEWORK,
AND CAPITAL MARKET REGULATIONS

I. THE COMPANIES LAW FRAMEWORK

Introduction

3.1 A sound framework of company laws, accounting and audit, and capital market regulations, are essential for the development of an efficient corporate sector. Such a framework is, however, notably absent in Indonesia. This chapter discusses the economic issues that arise and the problems in the current framework, and makes recommendation for reform.

3.2 The chapter is divided in two parts: Part I on the Companies Law Framework; and Part II on the Accounting and Auditing Framework. Discussion of Capital Market Regulations appears in Part I.A, but is kept to a minimum. The main reason is that there is currently work ongoing in Indonesia on developing a comprehensive set of Capital Market Regulations. The example being followed is the United States Securities and Exchange Commission (SEC) Regulations, adapted to suit the Indonesian context.¹

A. The Economic Approach to Company Law

3.3 The limited liability company, a legal concept that emerged in the nineteenth century, is one of the most important institutional innovations of the industrial revolution and modern capitalism. The economic functions of the corporation are, however, still not precisely defined in economic literature, and there is considerable debate about the most appropriate form of company laws. This section outlines these issues, and suggests an approach for a developing country such as Indonesia.

Concepts and Issues

3.4 The Nature of The Enterprise. Economic theory has traditionally had a limited view of the enterprise--a set of feasible production plans, with a manager choosing outcomes of this production set that maximizes owner's profit. A different approach is gaining increasing acceptance, emphasizing transaction cost economies--a firm internalizes and economizes on transaction costs. The transaction costs approach has been recently extended by the view of the enterprise as simply a "nexus of private contracts", and the corporation as representing nothing more than a "standard form" contract characterized by limited liability, indefinite life, and freely transferable

¹Because information on the draft regulations has been restricted to a small working group in Indonesia, and because the regulations are expected to be finalized shortly, it would be inappropriate to comment on the capital markets area at this time.
shares and votes. It would be possible to create a new contract with these characteristics each time that it is needed, but as these characteristics are likely to be widely used, it is convenient to adopt a "standard form". Closely held limited liability corporations or partnerships are other forms of useful "standard contracts".2

3.5 Private Contract vs. Chartist View of Company Law. The traditional legal view of the enterprise is, however, very different. It sees the limited liability company as a creation of law, which is made by the State. Therefore, the State charters the existence of the corporation and gives it certain advantages, such as limited liability. In return, the State mandates the rules and regulations regarding company affairs that every company has to follow without deviation. The economic view would support a company law framework that deregulates, i.e. allows shareholders a great deal of flexibility in the establishment, forms of governance, disclosure, transfer and voting rights of shares. The chartist view would support a regulatory approach—mandatory laws and regulations, and a great deal of checks and balances by the State.

The Proposed Approach

3.6 The stage of development of the economy has an important bearing on the choice of a particular framework of company laws. In a highly developed economy, the appropriate choice may well be the deregulatory approach; in a developing one, it may have more chartist elements, but should ensure that the company laws do not provide major entry, mobility, and exit barriers.

3.7 The Closely-Held Corporation vs. Public Corporations. In theory this division of the corporate sector achieves the practical solution to the dilemma of whether to opt for a highly regulatory company law, or an enabling one. Closely-held corporations are those which have a small number of shareholders, most of whom directly participate in management, and often bargain out structural and distributional rules. Modern company laws often encourage this. On the other hand, stricter standards and mandatory rules may apply to publicly-held corporations, with a large number of shareholders with no direct role in management.

3.8 The Minimum Standard Contract. The essence of limited liability is to facilitate access of businesses to risk capital by investors. In principle, the main source of such funds could be bank lending. But the transaction costs and risks of such lending, especially to new firms, could be prohibitive. This transaction cost and risk is overcome by limited liability, that is, an entrepreneur admits others to the business, but their risk is limited to the capital they subscribe. The solution is the company incorporated in law, which provides the minimum standard in establishment, governance, distribution, and dissolution that all limited liability companies should follow.

3.9 Additional Requirements for Large or Public Corporations. The law may facilitate the efficient growth of the company sector through the

imposition of additional requirements for large or public companies, especially regarding accounting and auditing standards, financial reporting (with compulsory filing of annual financial statements and auditors' opinions), the fiduciary role of management vis-a-vis shareholders, and the protection of minority shareholders. The main reasons for these additional requirements are: (a) potential shareholders may not be able to access all the information about a company; (b) market institutions may not be developed enough to provide such information; and (c) limited liability shifts risks to others, such as bank creditors, and transparent accounting, audit, and disclosure become more important.

3.10 The Role of Capital Market Regulations. Given the suggested approach, the basic company law provisions, which apply to all corporations, should concentrate on the standard contract, but should also include the minimum additional requirements for large or public corporations that are desirable. The role of capital market laws and regulations would then be to concentrate on the application and enforcement of the mandatory requirements for public corporations (in addition, of course, to dealing with other issues on capital market functioning). The existence of separate capital market regulations that are comprehensive, and efficiently implemented, thus reduces the burdens on the company law. The basic company law framework can spell out the main provisions in a simple standard form, and leave to capital market regulations and its regulatory agency, its application in the case of public companies.
Box 3.1: How Company Laws Are Framed Internationally

In Germany, France, and more recently, the Netherlands, the company sector is divided into two principal types, the closely held company (e.g. Gmbh in Germany and B.V. in Holland) and the joint-stock, larger, public companies (e.g. Geseischaft in Germany and N.V. in Holland). The rules and regulations for the closely-held company are simple; and more complex for the public corporations, requiring mandatory audit and disclosure of financial information.

In the United States, individual States (e.g. New York or Delaware) frame their own company laws. These are relatively simple standard contract company laws, permitting companies to be easily formed by registration, one-vote one-share governance, with management by a board of directors appointed by and subject to shareholder's decisions. The Federal Government does not exercise much influence, except through the Securities and Exchange Commission (SEC) which establishes detailed mandatory regulations and has wide powers over the conduct of publicly-traded companies.

A third model is found in the United Kingdom which has a "boiler-plate" type Companies Act which is mandatory and detailed. Correspondingly, it does not have a SEC-type organization, but a Takeovers Commission, which excercises looser controls and relies on informal rules of conduct for publicly-traded companies.

Developing countries have tended to follow one or the other of the above approaches, depending on their historical ties and other factors. India and the Commonwealth countries have followed the UK route of detailed company acts. Korea and Japan in contrast have followed the German model. Increasingly, with the growth in capital markets, many developing countries are now experimenting with the US SEC-type approach to supplement their company laws.
3.11 In order to achieve the objective of mobilizing capital, the law relating to companies must be facilitative of the investors’ concerns, or at least it should be neutral and not add to the investors’ risks. A few of the major factors that should be considered are:

a. forming a PT must not involve complicated or lengthy procedures; ease of entry helps to ensure an efficient market by allowing competing firms to enter; ease of amendment is related as a company should be permitted to adapt to changing market conditions by expanding into new areas and products and withdrawing from others in a timely fashion;

b. the owners must have flexibility to manage and control the money they have at risk, but there must also be adequate protection for: (i) the minority shareholders so that the other owners and the managers do not unfairly take advantage of their position; and (ii) the public; the limited company must not abuse the privilege of operating with a limit on liability; such protection for both shareholders and the public can be furthered by responsible and clear disclosure and information requirements (especially accurate and timely reporting of financial information); the protection required may vary depending on whether the company is large and publicly-listed or smaller; application of other laws may be needed to completely protect the public. 3

c. exiting from the system should also be subject to clear and fair rules; although few entrepreneurs think they will fail, it removes an unnecessary element of risk if the system allows an orderly rearrangement of assets; more than failure is involved, as the law should facilitate changes in the structure of a company as the market changes, and rules about merger and acquisition should be clear.

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3 The public has an interest in preventing monopolies from arising and unfairly using their power, and in preventing a company from wrongfully using a license or permit. These concerns can best be dealt with in other rules and regulations: for example, anti-monopoly rules can be written or licensing procedures can be enforced by departments that are directly concerned with the activities and more knowledgeable about where abuses are likely to occur. The vast majority of companies function smoothly and do not run afoul of public concerns. The Law governing them should not unnecessarily be burdened with details best left in other regulations.
Box 3.2: Developments in Company Law in the Netherlands

Developments in company laws in the Netherlands have an important bearing on Indonesian practice, since Indonesia has derived its Codes from the Netherlands. The Netherlands company law has undergone several changes over the years. The draft company law prepared in the 1970s in Indonesia follows quite closely the revisions made in 1971 to the Netherlands company laws.

In the Netherlands, the 1971 revision of the Commercial Code (after a revision in 1928) brought about the creation of two types of companies, B.V. (closely-held company), and the earlier N.V., which now had to disclose financial information following a European Economic Community directive--thus ensuring consistency with other European countries. The creation of the B.V. was welcomed to escape from mandatory publication of financial information--during 1972, 40,000 N.V.s were converted into B.V.s. In practice, however, there has not developed a great difference between the regulatory regimes governing B.V.s or N.V.s. In 1971, another Law was passed for large companies for which an additional supervisory board was made compulsory and given broad powers, bringing a shift in powers from the general meeting to the supervisory board. The supervisory board is largely unknown outside a few European countries.

The year 1971 also saw new enactments in the Netherlands concerning the annual accounts and investigation of companies in cases of mismanagement. The new law for N.V.s had articles on annual accounts, including definitions of who could be auditors, i.e. must be members of Netherlands Institute of Registered Accountants, and how accounts are to be prepared. The law broadened the class of persons who could ask for investigations, and the sanctions that could be applied.

B. Present Status of Companies Law in Indonesia

3.12 Companies Law governs the activities of "limited liability companies". In Indonesian these companies are known as perseroan terbatas, or PTs. A limited liability company is a legal person that has been established separate from its owners, and the owners' (the shareholders') liability is limited to the amount invested in their shares. The limited liability company allows large sums of capital to be mobilized in an efficient manner.

3.13 In Indonesia, the limited liability company is already the most important form of organized business activity in the private manufacturing and commercial sector, and its role will become progressively more important in the future. In 1990, almost 80% of all corporate taxpayers were limited
liability companies. Although the PT structure is probably the most useful to investors, the Indonesian legal system provides a variety of options and structures from which an investor may choose.⁴

3.14 The Indonesian law on limited liability companies is contained in 21 sections of the Commercial Code.⁵ These sections date from the pre-Independence Dutch law, and contain many gaps when dealing with modern corporate structures and transactions.⁶ Many of the modifications needed to fit modern conditions are made not by Law, but by the entrepreneurs themselves when drafting Articles for their own companies, incorporating changes they believe valuable even if such changes have not yet been sanctioned in the Code.⁷

3.15 Many of the basic required elements are not present in Indonesia's Company Law today:

a. Entry -- on paper, forming a PT is relatively simple but requires receiving the approval of the Ministry of Justice; in practice, formation normally takes between 3 and 6 months and may even take over a year. During this time the directors and promoters have unlimited liability. Thus, the law discourages them from engaging in activity before the incorporation process has become final.⁸ A

⁴ Other forms include: the cooperative, which is common among small entrepreneurs such as farmers; the limited partnership (perusahaan komanditer) in which one or more silent partners may be responsible for obligations only to the extent of their capital participation; the full partnership (firma) in which all partners are personally liable for all obligations of the enterprise, and is used mainly by small organizations; sole proprietors (perusahaan perseorangan) in which the owner is personally liable for all obligations of the firm

⁵ Indonesian Commercial Code Sections 36 -- 56.

⁶ In Holland, the rules and regulations surrounding the Code, as well as the Code itself, have been updated more frequently than in Indonesia, and there is a more complete set of interpretations by Dutch legal authorities.

⁷ To some extent this is a laudable trait and the flexibility gives each individual business enterprise the chance to adapt Articles to the enterprise's own situation. In practice, however, these flexible features may significantly delay receiving the incorporation certificate.

⁸ The establishment procedure follows Dutch practice, and this "gap" in liability exists in Dutch law yet is not perceived to be a problem in Holland. Of course, a "gap" of several months or a year, common in Indonesia, is not the norm in Holland. This is an example of how similar laws can have quite different legal and economic consequences, depending on the circumstances of the implementing country. More importantly, however, the procedure is relatively unique in Europe. The "gap" is not a problem in many European states, as failure to publish in the official Gazette does not result in personal liability of the directors but usually in a moderate administrative fine. Generally, this degree of government involvement in company formation is regarded as unnecessary and inconsistent with free trade principles by other European governments.
long period of inaction means that market opportunities that an investor hoped to capture may have changed. To minimize the period of exposure, some creative investors have their Notary arrange directly with the State Publishing Office to issue a "notice of publication" in which the date that the Articles will eventually be published is specified. It is not clear that the issuance of this Notice will relieve directors of liability, but the procedure often has the beneficial effect of accelerating the date of publication. Even though acts done during this period can be ratified after the fact by the shareholders, there are significant risks involved.

b. Owners' flexibility -- (i) Companies may only be formed for specific purposes and for defined time periods. This causes great difficulty in mobility, e.g. Ministry of Justice approval is required for any changes to the scope of a company's articles. The lack of indefinite life causes problems in many areas, e.g. uncertainty of continuity of activity and transfer of shares. In addition, the Law protects minority shareholders, which is a good idea, as long as the minority interests do not control the majority owners unfairly. The law allows the company to choose between two voting possibilities -- one share one vote; or some voting limitations depending on the number of shares issued -- if over 100 shares are issued, no shareholder may cast more than six votes; and (ii) in an effort to protect the public, the present law restricts the owners by allowing third parties to initiate proceedings if a decision allegedly harmful to the third party is reached: for example, a creditor can challenge the decision of the company to continue operating if the creditor believes there has been a violation of the 75% rule (see "Exit" below).

c. Exit -- The present rules as they apply to leaving the system are far from clear: (i) a PT may be liquidated by an order of the Minister of Justice; or after having obtained the recommendation of the Supreme Court to a resolution of a meeting of shareholders; or if it is declared bankrupt; (ii) "liquidation" also results from a violation of Article 47 of the Commercial Code. This Article provides that if a company's losses are 75% of its authorized capital, it is dissolved. However, there is heated argument over whether the provision is "self-executing", that is, whether the PT is dissolved by operation of law, automatically invalidating its operating licenses and also exposing its directors to unlimited liability; or does it only cease to be a legal entity upon completion of the liquidation process? The issue is not academic, for if a company wants to list shares on the stock exchange, and at any time in the past has reached the 75% limit, its status is unclear. If dissolution is automatic, then the company was dissolved and is without any valid operating licenses. Such a company could hardly float shares on the exchange; (iii) there are no clear provisions concerning how a company can merge with or acquire another concern; and (iv) there
is a Bankruptcy Ordinance (enacted in 1905) that deals with restructuring and exiting the system. This ordinance is similar to existing laws in the Netherlands and provides, theoretically, a workable set of bankruptcy rules. However, there are no precedents available to make firm judgements, and its implementation depends greatly on the courts and court appointed officials. The steps involved in a company being declared bankrupt are:

-- one or more creditors, the public prosecutor or the debtor may petition the court to declare the debtor bankrupt; upon declaration a judge-commissioner is appointed to supervise the bankruptcy and a receiver is appointed; the bankruptcy must be announced in the Official Gazette and a newspaper;

-- pending decision of this issue the court may order the estate sealed;

-- the debtor has the right of appeal within eight days;

-- a committee of creditors may be appointed if warranted;

-- the receiver must make an inventory of the estate;

-- within 14 days of the declaration of bankruptcy the judge-commissioner must determine the latest date of registration of debts;

-- the debtor may offer the creditors an agreement and the judge-commissioner must submit it to the court for ratification; if no agreement is reached or the court fails to ratify the agreement, the receiver proceeds with the liquidation of the assets under the supervision of the judge-commissioner;

-- the bankruptcy ends with the final distribution of proceeds and the announcement thereof in a newspaper.

Very few cases have used formal bankruptcy procedures. The main difficulty may lie with the implementation of such procedures in the courts, given their lack of specialization and familiarity with bankruptcy and general problems with the court system (See recommendations in Chapter 4, Dispute Settlement).
Throughout this study there are numerous references to "gaps" in the Indonesian legal infrastructure. The reader must keep in mind, as the authors have tried, that "gaps" may also exist when a law is designed on one set of cultural assumptions and is applied to a people with a different set of cultural assumptions. Law and society are intricately connected, and suggestions from outsiders may have consequences not easily foreseen.

In the 1860's the Liberal Party in Holland argued that the Dutch government was ruining the economy of the Indies by choking off the free play of economic forces. Few doubted that what was best for the Indies should be worked out in Holland and not Java. The Dutch Government ended the monopoly of spices; and the forced cultivation of tea, indigo and tobacco was halted. Parliament funded a study of lend problems, but before the study was completed Parliament passed a new Agrarian Law. The Liberal Party, believing in "freedom of contract," repealed compulsory labor laws. It could not, however, repeal the hierarchical structure of Javanese culture--the plantation managers recruited labor in the same way they always had--they worked through traditional authorities. But desa law had no concept of a labor contract, and the laborer did not understand that he could refuse the terms offered and demand higher rates. His labor was an obligation, not a negotiation.

In many aspects, the changes introduced by the Liberal Party to bring prosperity to a wider group of people served merely to divert profits to private Dutch capitalists instead of the Dutch government. The Indonesians were not the major beneficiaries of these well-intentioned efforts.

The Draft Companies Law

At present a draft of a new Companies Law is under discussion in the government. This draft has, in various forms, been circulating in the government for almost 18 years and we have reviewed a few of its provisions. It is generally well-crafted and is an improvement in many areas over the existing law: for example, the no objection letter must be in writing; the option is given to allow an unlimited life company (although some restrictions are placed on this option); and provision is made for bearer shares. However, at first glance, there are still several inconsistencies in the draft that should be dealt with: for example, if only one shareholder is permissible, why are two founders required (Article 4); the liabilities of directors if issued shares are not paid is differently treated (Articles 14 and 26); several provisions relative to bearer shares (Article 28, 57 and 63); and the provisions providing that shareholders may not be obligated to make payments other than as required by Articles 26 and 27 appear inconsistent with Articles 18, 32, 34 and 38.
3.17 More importantly, the draft Law appears to be more regulatory than the Dutch model on which it has been patterned. By "regulatory" we simply mean in many areas the government may exert significant control over the activity involved. Keeping in mind, that each system and culture has its own needs and manner of working, we have undertaken a brief summary of a few of the draft's provisions:

a. **Entry** -- establishing a company is as complex and time-consuming as under the existing laws; the Ministry of Justice must issue a declaration of "no objection" before a limited company comes into existence; there are so many PTs being formed, and waiting to be formed, it is almost impossible for a government agency to give a comprehensive and informed review to each application. When this draft was originally prepared 15-20 years ago, the Indonesian economy was smaller and fewer applications were submitted for review.\(^9\) What may have been possible then, might even be harmful if adopted now. If the reason to have the "no objection" is to protect the public, then the government ought to be certain that those who issue the "no objection" are fully aware of the complex activities that modern companies need to undertake. The most informed parts of government would be the Ministries of Finance, Industry and Trade. In the United Kingdom, for example, the relevant Ministry is the Ministry of Trade and Industry. In Germany, it is filed with the local court in the district of the company's headquarters. An overriding question remains, however: why put the burden on the government at all? Why not let other rules and enforcement mechanisms operate if things go wrong?

b. **Owner's flexibility** -- (1) the draft provides for a pattern of corporate governance in the case of large companies that seems to be cumbersome and somewhat inflexible; it insulates the management from the owners to a large degree, and creates a potential for significant government oversight; the relevant sections create a potentially confusing overlap of authority and responsibility between the directors, the commissioners and the owners; for example:

(1) directors may not be appointed for a specified term, and they may be terminated by the owners (shareholders) only if they act contrary to the articles of association or against the company's interest (Articles 12 and 83);

(2) up to 50% of the Commissioners may be appointed from candidates nominated by the government (Article 92);

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\(^9\)A text written almost 20 years ago, "Credit and Security Indonesia, The Legal Problems of Development Finance", S. Gautama et al., noted that "the present law governing business organizations in Indonesia is inadequate for the scale of development now taking place, and a new company law is therefore in preparation." That law and its mechanisms are even less adequate now.
for large companies a minimum notice period of 21 days is provided making it difficult for the majority owners to react quickly to urgent situations (Article 101); and

a 10% shareholder may bring an action against a director, but only with the permission of a judge, not only limiting control by the owners, but also the rights of the minority holders;

All these aspects may discourage new investors from using the PT form; and (ii) several other sections limit the scope of the owner's flexibility in the interest of protecting the public, but it is not clear how well the provisions will succeed in the protection although they will raise concern with the investor:

(1) despite shareholder ratification and regardless of knowledge or fault, directors and commissioners are individually liable for losses suffered by third parties as a result of misleading accounts (Article 77), this seems unduly harsh on a director without giving any true protection to the public -- how could a director have prevented something he did not know (this is different from requiring that the director exercise reasonable judgement to find out about the audited accounts); and

(2) there are broad powers over company affairs that are given to the judiciary and outside "experts" (the judiciary in Articles 18, 19, 54, 55, 117 -- 128, 130, 133, and 134; and "independent financial experts" in Article 66) but it is not clear that the legal infrastructure will be able to supply the numbers of qualified persons that will be needed to implement these and other Articles. Although this is similar to the Dutch system, in Holland the equivalent sections rest on a sophisticated structure that affords known guidelines and procedures and will be implemented by an informed and independent judiciary. In Indonesia this supportive infrastructure is lacking and the question remains how to protect those interests most effectively.10

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10 Access to information is one excellent method, and the draft law increases the information to be made available, but there seems to be an inconsistency in the draft. Article 58 requires that a company compile a list of names and addresses of all shareholders and the amounts of money paid in by each. What is the value of this list as long as bearer shares are allowed? According to the draft elucidation one purpose is to help in respect of other areas of regulation: "furthermore in connection with the government's oversight of foreign capital investment and its granting of licenses for such investment, the government must know the names of shareholders." It would probably be more efficient, and a better protection for the public, if the requirement were in the foreign investment laws and those authorities could monitor the lists and activities.
c. **Exit** -- the provisions of the draft seem an improvement on the existing law as they provide rules for mergers and acquisitions and do not repeat the troublesome language of Article 47.

3.18 There are several areas where the draft Law gives large discretion to the Minister of Justice without clear guidelines: Articles 9 and 10 -- regulating the permissible purposes and duration of a company; Article 13 -- relating to additional conditions and application fees; Articles 48 and 49 -- empowering the Ministry of Justice to require a company to issue shares within certain time and price limits (this could severely limit a company's financing flexibility); Article 72 -- allowing Government to redetermine the limits dividing small from large companies (creating uncertainty over whether the rules applicable to a company may suddenly change); Article 82 -- dealing with the terms of directors; Article 90 -- authority to designate companies that must have a board of commissioners; and Articles 115 and 153 -- power to withhold no objection letters to amendments and to mergers and acquisitions.

3.19 In addition to the above, there are several sections of the draft Law that appear, at first glance, to be more restrictive than those applied in Holland: Article 11 -- concerning subscribed capital; Article 22 -- concerning listing shareholders; Article 91 -- has a lower age limit for Commissioners; Article 81 -- requires at least two directors even though large Dutch companies are allowed to have only one; Chapter IV (Capital and Shares) -- appears generally more restrictive than the Dutch model; under Dutch law corporations may be directors; and finally, the draft law, unlike the Dutch law, does not anticipate a separate statute for closely-held corporations.

D. **Recommendations**

3.20 A modern and understandable Companies Law is important to facilitate the mobilization of capital, but such a law should not be overburdened with too many goals. A companies law need not be the focal point of a commercial legal structure, as many other laws and regulations must interlink with it to provide a full range of protection for the public and minority shareholders. By putting too many provisions into a companies law neither the goal of protecting the public or of encouraging limited companies will be reached. To give one more example: the provisions relating to bearer securities are facilitative for the investor, but the question remains whether rules about bearer shares should be in a companies law, under direction of the Minister of Justice, or under the capital investment and marketing boards, with more direct experience in the area.

3.21 The draft Law can serve as the foundation on which to build a new Companies Law, but the draft Law must be looked at again carefully to see if its provisions are consistent with the present needs of an economic system that encourages responsible private activities and less government intervention. Adopting a new law in order to demonstrate the government's commitment to reform in the commercial law system will be counterproductive if that law is not well understood and complimentary to the emerging economic order.

3.22 In looking afresh at the draft law specifically questions should be asked about each section--does the section facilitate the mobilization of capital?
is it neutral, or does it add regulations to the structure? Certainly not all regulations are bad, but answering the question will help to focus the issue: is any government involvement warranted to protect the public or minority shareholders, and if it is warranted, is the companies law section the most effective means of giving protection? Finally, if government involvement is justified the question remains which department, or departments should be given the authority. It is not at all clear that the Ministry of Justice has the economic or business expertise necessary to make the required decisions properly and promptly. Such powers might better be placed in a Ministry with more knowledge of the specific issue, or with an agency like the Capital Markets Board which will develop an expertise in the company area.

3.23 Furthermore, the law must be clear and understandable without the need for lawyers or notaries to explain every detail. If the decision is taken to go forward with the draft law, the Government should immediately begin to prepare the legal profession about how to implement the new and complex provisions. Unless such professionals are reasonably knowledgeable about the new law they cannot convey confidence to the potential investor who is deciding how to proceed, or whether to proceed, in Indonesia.

II. ACCOUNTING AND AUDITING FRAMEWORK IN INDONESIA

A. The Role of Accounting and Auditing

3.24 In an economic system the proper accounting of transactions is fundamental to its efficient operation. Without proper accounting it is impossible to assess the success or failure of specific enterprises or of overall economic policies. Hand-in-hand with a proper accounting system is the need for the auditing of private and public enterprises to ensure that the operations have been properly accounted for and that the financial statements are fairly presented. Shareholders, investors, creditors, depositors of funds and the public need accurate and adequate information on the operations of enterprises to enable them to take decisions on investing funds and assessing risks posed by the enterprise.

3.25 To provide an effective system of accounting and auditing the first step is to provide in corporate law for this requirement. Without a legal requirement, it is unlikely that a consistent and all encompassing framework for accounting and auditing will be developed and implemented.

B. Problems with the Present Indonesian System

3.26 Indonesia's current formal system of accounting dates back to 1954 with the promulgation of a decree on the profession of accounting setting up the designation of "accountant" and the setting up of the Indonesian Institute of Accountants (IAI).

3.27 Corporate Law fails to deal with the issue. The present company law in Indonesia provides simply that adequate financial records be kept. No specified records or financial reports of companies are required and there is no requirement for independent auditing. Even the 1984 tax law does not require the taxpayer to provide audited financial statements, only that "adequate records" be kept. Many decrees have been issued by Ministries, in particular, one by the Ministry of Finance which requires companies that want
to "go public" to provide audited financial statements. Bank Indonesia has also issued decrees requiring financial institutions to file audited financial statements. The Agency for Control and Development (BPKP) has the responsibility for ensuring that the public sector enterprises submit audited financial statements to regulating Ministries.

3.28 **IAI has not been effective.** In conjunction with the legal requirements there is need for a body that can regulate the profession of accounting and auditing. The Indonesian Institute of Accountants has operated as an association of professional accountants but it has no statutory status and conducts its business on the basis of small subscriptions contributed by interested members who provide voluntary services. While it has issued some accounting and auditing standards and a code of ethics, these have not become mandatory. As a result little meaningful audit work was done on large companies until 1988 when demands by the investing public and the government for auditors' opinions on financial statements increased. IAI does not conduct the State Accountancy Examinations and has not encouraged the need for continuing professional education.

3.29 **Shortage of accountants.** The estimated number of registered accountants in Indonesia at the end of 1989 was 7000, of which about 5,000 were in government. However, the precise numbers are not known. In addition, there are a large number of university graduates in accounting who did not take the State Accountancy Examination.

3.30 The present number of registered accountants is not sufficient to meet the accounting and auditing requirements of about 160,000 limited liability companies and about 214,000 corporate taxpayers.\[^{11}\] The number of audits completed by the public accounting profession in 1989 is estimated at 3,833 of which only 675 were mandatory. These numbers indicate the size of the potential market for accountants and the shortage of registered accountants should all limited liability companies be required to provide independently audited financial statements.

C. **Recommendations**

3.31 **General Policy.** The thrust of the general policy in the area of accounting and auditing should be to put the onus on enterprises to maintain proper books of account and prepare audited financial statements. The policy is to induce the development of relevant accounting principles and auditing standards, and ensure that the required number of professionals are available to do the job.

3.32 **Corporate Law and Capital Market Regulations should be the driving force.** Despite a number of decrees, the laws are not clear and consistent. Corporate law and especially capital market regulations need to be more explicit. It particular, they should deal with the requirements for (a) maintaining proper books of accounts and preparation of financial statements; (b) defining what constitutes financial statements; (c) requiring independently audited financial statements and audit opinion; (d) defining particular methods of accounting for certain important transactions such as

\[^{11}\]In addition, there are about 800,000 individual taxpayers.
consolidation of subsidiaries and associated companies and joint ventures; (e) designating a body, the members of which, through examinations and training, are qualified to provide the audit opinion; and (f) requiring this body to set accounting principles and auditing standards.

3.33 **IAI should be reconstituted.** IAI can be the designated body referred to in the previous paragraph but it should be reconstituted. At present IAI does not have the legal backing and the human and financial resources to meet the challenges envisaged here. In the long run IAI could be a self-regulatory body run by its members through annual subscriptions. With the legal requirement for auditing and only IAI members being qualified to provide the audit opinion, IAI can be expected to grow and become self-sufficient. In the interim of up to 5 years while the new laws are being put into place, IAI could be provided funds through bilateral or multilateral assistance. It should use these funds to enable it to recruit staff, determine the number of qualified registered accountants, conduct uniform examinations for qualification as "accountant", develop accounting principles and auditing standards and encourage a program of continuing professional education. An alternative is that funding for IAI could originate from a very small fee on publically traded companies.

3.34 There should be a mandatory certification requirement to be registered as a public accountant and the members should be required to pay annual subscriptions. During the interim period, the IAI board should be constituted of senior government officials, senior qualified practicing accountants and qualified accountants in industry. A policy paper on assistance to IAI is being prepared under the Accountancy Development Project, and should address some of these issues in more detail.

3.35 The introduction and implementation of these recommendations must be gradual and their practice closely monitored. As a start, Indonesia could consider adopting the accounting standards of the International Accounting Standards Committee (IASC) which are less intricate and may be more relevant in the Indonesian context than those of developed countries.

3.36 **Qualified professionals should be increased.** The legal requirements for accounting and auditing, the professionalism required and the huge market for these services will in time provide an adequate incentive for people to study and qualify as accountants. Meanwhile the number of expatriate accountants will need to be increased. These accountants should be brought into public practice, they should be qualified and well-trained. They can be used to provide the necessary quality to the audit and for providing on-the-job training to trainee accountants.12

3.37 The combined approaches of the legal framework, a legally designated body to develop a set of standards, requirement for qualification, improved

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12A number of Middle-Eastern countries have encouraged the employment of qualified expatriate accountants for conducting the audits of private enterprises. Many of these have come from developed countries which have a high degree of quality and professionalism in this area. They have been recruited by private auditing firms who have recovered their costs through their clients and have not required any public sector outlay.
market for accountants, the demand for accountants and the expatriate element should provide Indonesia with an effective system of accounting and auditing and with the immediate and long-term requirements for qualified accountants.
CHAPTER 4

DISPUTE RESOLUTION

I. Role of Dispute Settlement

4.1 Investors, both domestic and foreign, need confidence in the enforceability of agreements and commitments. If there are unreasonable delays and high costs in enforcing laws and agreements between private parties the efficient conduct of economic activities is prevented. Indonesia could enact the most modern Companies Law, and credit and contract laws, but they will be of little practical value if there are no means of enforcing their provisions, or of efficiently and predictably resolving disputes about their meaning. Throughout, this Study emphasizes the concerns of the domestic investor as much as those of the foreigner. However, foreign claimants have faced particular disadvantages under the dispute settlement system in Indonesia. This problem merits attention given the importance of international trade and investment for Indonesia.

II. Dispute Settlement in Indonesia at Present

Court System

4.2 In the commercial law field the Court system is widely perceived by investors, domestic and foreign, to be inadequate: procedures are slow with cases taking many years to resolve; the courts are overburdened and understaffed; little or no specialization occurs with all types and sizes of cases going to general courts and judges; creditors complain of unreasonable difficulties in enforcing credit and security interests, and finally, there is a pervasive belief that factors other than the merits will decide the case. Few investors consider the formal Court system a reasonable forum for a predictable, or prompt, settlement of a problem.

4.3 The Courts are governed by the Basic Law on the Judiciary, No. 14 of 1970, which emphasizes the principle of independence and purports to prohibit all outside interference in judicial matters. In practice, however, the administration of the court system is under the jurisdiction of the Ministry of Justice, and that Ministry controls the budget, posting, transfer and promotion of judges. As in most civil law systems, judges are career civil service employees, beginning as clerks and working their way up to judges. These facts do not in and of themselves mean that the executive authorities are interfering with the judicial. In many civil law systems, the judiciary

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1Regardless of how true this is, the perception affects behavior and reduces the numbers of eligible borrowers, increases costs of borrowing and results in overcollateralization, as described in Chapter 2.

2Other relevant Laws include: Law No. 14 of 1985 (Supreme Court); Law No. 2 of 1986 (Courts of General Jurisdiction); Law No. 5 of 1986 (Administrative Courts); and Law No. 7 of 1989 (Islamic Courts).
is proud of its independence from the executive branch. In Indonesia, that independence is often missing.

4.4 In order to establish a reliable dispute settlement system, the Court system needs to be looked at closely with a view to institutional strengthening. Most of actions to strengthen the Court system require time to implement or involve the legislative as well as the executive branch of Government: for example, promotions and postings could be handled by an independent authority; salaries could be raised and training improved. Some actions, however, could be taken almost immediately; for example, training is already being carried out by several smaller groups within and outside government.

4.5 Another solution sometimes considered to improve aspects of the formal court system is to create specialized courts to rule on commercial matters. The idea of a Special Court has appeal, but may end up creating a new bureaucracy, unless reforms address the underlying problem of an independent, competent judiciary. As Box 4.1 illustrates, a court that had special knowledge of commercial and trade matters, such as copyright, might have resulted in the final decision being reached with less cost. Indonesia already has separate court systems for the military and for religious matters, and has specialized boards for tax matters (the Taxation Review Board), labor matters (the Labor Tribunal), and will soon have an Administrative Court, which will allow the individual citizen to bring the Government to account for various matters. Some specialization is, thus, already present in the system.

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3 This Study focuses on commercial law aspects. Many basic and important reforms have been taken in the Court system over the recent past in other areas such as criminal law and religious law. The Ministry of Justice is justifiably proud of its accomplishments in these areas.

4 For example, the Netherlands Council for Cooperation in Legal Affairs has a program for training judges that could be built upon.

5 The Administrative Court was established by Law No. 5 of 1986. The creation of this new Court gives added importance to the discussion on Legal Information (see Chapter 5). If a citizen is to be able to participate meaningfully in the new system, he needs to know what the Laws and rules are, and have access to them in a language he can understand.
Box 4.1: Difficulties of General Courts in Deciding Complex Commercial Disputes - The Nike Case

In the mid-1980s, Indonesian Courts had difficulties in reaching a decision on a trademark matter concerning the international shoe manufacturer -- Nike. Nike brought an action claiming trademark infringement against an alleged counterfeiter in Indonesia. The District Court ruled that Nike could not challenge the unauthorized use of its trademark as the registration of the trademark by the counterfeiter had not yet been published in the Supplement to the State Gazette. The Supreme Court initially upheld this decision, but upon reflection, and international outcry, reversed the lower court and itself. It took judicial notice of the fact that publication of trademark registrations was about six years in arrears and that the legitimate owner of a trademark should be able to challenge a counterfeit use without having to wait for formal publication. (Nike International Ltd., v. Sasmito, Supreme Court Decision Reg. No. 220/Pdt/1986 (Dec. 16, 1986), reversing, Supreme Court Decision Reg. No. 294/Pdt/1984 (July 31, 1985).

Not every plaintiff has the ability to pursue a case twice to the Supreme Court or to mobilize international opinion. Nor does the fact that the highest Court reversed itself within 18 months give confidence to investors.

Other Methods of Resolving Disputes

4.6 If the Court system does not offer a reliable method of settling commercial disputes, and efforts to reach an amicable solution through conciliation and mediation are not successful, what alternatives are there? Another method of settling disputes in the commercial field is arbitration. Arbitration is an agreement by private parties that disputes that may arise will be settled in accordance with rules and procedures that are agreed to prior to any dispute arising. The advantage of arbitration is that a dispute can be settled quickly and accurately by specialists having knowledge in technical areas, as opposed to judges who are only trained in broad, general aspects of law. A further advantage is that it avoids many of the confrontational aspects of a court trial and may encourage settlement by mediation and consensus. On an ad hoc basis the parties in each agreement can set out the rules and procedures to be followed. More commonly, and efficiently, the parties can simply refer to an existing set of rules and procedures, and incorporate them into their agreement.

4.7 Under Indonesia law all disputes of a commercial nature can be submitted to arbitration including disputes with Government agencies and State
Enterprises. In fact, most contract forms currently used by government departments, agencies and State Enterprises, as well as most standard bidding documents, contain arbitration clauses. Even Pertamina requires that production sharing contractors include arbitration clauses in their sub-contracts: the usual clause calls for arbitration in Indonesia under the BANI rules (for more information about BANI, see paragraph 7 below). The location of the arbitration is not imposed by law, but logistics suggest that it be held in Indonesia, usually Jakarta. Arbitration proceedings follow procedures similar to those found in the Civil Procedure Code, but they are not required to. Any natural person who may legally act as a proxy may serve as an arbitrator. The format of the arbitral award is simple and it must be rendered within six months of submission. Enforcement of a domestic award is not elaborate and appeals are limited to certain matters.

4.8 Indonesia has an arbitration board (Badan Arbitrase Nasional Indonesia, "BANI"). BANI was established in Jakarta by the Indonesian National Chamber of Commerce and Industry (Kamar Dagang dan Industri Nasional, "KADIN") by Decision No. SKEP/152/DPN/1977 as a private arbitration institution. However, its services are not often utilized nor highly publicized. Recently it has only handled 5-10 cases a year. The failure to utilize BANI seems unusual in light to the problems with the formalized court system.

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6The authority to arbitrate disputes in Indonesia comes from Articles 615 - 641 of the Reglement op de Rechtsvordering "R.V." enacted for the Netherlands Indies in 1847. Most of the rules on arbitration from the R.V. were incorporated into modern Indonesian procedural law through the provisions of Law No. 15 of 1950 on the Supreme Court. The rules continue to apply, although Law No. 15/50 has been replaced twice, by Law No. 13 of 1965 and then by Law No. 14 of 1985.

7The fact that the arbitration takes place in Indonesia does not of itself imply that Indonesian law will apply to the merits. Indonesian law allows a freedom of choice of law to the parties.

8This excludes judges, civil servants of the Attorney General's office and court clerks; the R.V. does contain some other restrictions, such as persons under a legal disability.

9The award must state the location of the award and its date; must contain the full names and addresses of the parties to the dispute; a summary of the submissions; the decision and the reasoning; and be signed by the arbitrators. Once signed the award must, together with the document of appointment of the arbitrators, be registered within fourteen days of its date with the District Court within the jurisdiction in which the award was made. This is a non-discretionary act by the Court.

10Enforcement is not elaborate. An enforcement order is obtained from the court with which the award is registered. The enforcement order is a grosse acte which constitutes authorization to execute. In practice, however, a hearing is held. No appeal is allowed from the decision to grant an enforcement order. Complications may arise from the fact that an action to nullify the award is permissible but the grounds for so doing are limited.
4.9 In facing the prospect of settling a dispute the investor has several major concerns:

a. Speed of resolution -- arbitration is usually faster than court systems;

b. Cost -- the fees are set and are less than the cost of dealing with the courts;

c. Place of Arbitration and Applicable Law -- the parties need to feel comfortable with the place of decision (to be sure they can get there together with their documents without too much expense), and with the rules that will be applied to the dispute;

d. Qualifications of Arbitrators -- the parties must perceive that the arbitrator is more knowledgeable in the technical field than the alternatives (usually an arbitrator is more expert than a judge);

e. Nationality of Arbitrator -- the parties must believe that the decision makers will approach the dispute without bias or preconceived notions because of their nationality;

f. Enforcement of Award -- the formal court system may have a slight advantage on this point, as an arbitration award will have to be filed in a court, but usually the award is deemed to be the equivalent of a court decision and enforceable without lengthy formalities.

4.10 With but a few exceptions that are not major, the Indonesian arbitration system rests on a good foundation. A brief review of the arbitration systems in Japan and the United States demonstrates the fundamental soundness of the Indonesian system:

a. Japan:

i. The legal basis for modern arbitration procedure was established in 1890, with the enactment of a Code of Civil Procedure which follows the corresponding provisions of the German Code of Civil Procedure of 1877. In addition, Japan has concluded inter-institutional agreements with over twenty arbitral bodies, including BANI (on June 19, 1980).

ii. There are three permanent arbitration institutions in Japan: (a) the Japan Shipping Exchange, Inc. (JSE), incorporated in 1921, specializing in shipping disputes. It hears about 800 cases a year but only a small percentage actually go to arbitration, as conciliation is stressed. Its awards are publicly available; (b) the Japan Commercial Arbitration Association (JCAA), established in 1950 following the pattern of the American Arbitration Association. Its panel of arbitrators consists of about 185 individuals of whom 164 are from Japan and the rest from abroad. Of the total, about 50% are lawyers, 40%
businessmen and the rest professors; and (c) the Central and Prefectural Tribunals for the Settlement of Construction Work Disputes to facilitate the settlement of disputes arising from contracts for construction work.

iii. The rules of the three bodies are similar and provide, as is typical throughout the world that "No person having a beneficial interest in the case under arbitration shall be an arbitrator."

iv. The rules allow foreigners to be members of the panels stating only that: "No person not actually residing in Japan at the time of appointment shall, except in case where the parties have agreed otherwise, be an arbitrator."

In addition, the parties may freely determine the place of arbitration.

v. The award must be in writing and, unless the parties otherwise agree, must state the reasons for the award. When the parties request, the award may be in both the Japanese and English languages, and both texts are treated as authentic, however if there is a conflict, the Japanese text shall prevail.

vi. Arbitrators may render the decision according to commercial usage, principles of good faith, or natural justice. The decision may not, however, be contrary to public policy. The award "shall have between the parties the same effect as a final and conclusive judgment of a court." Thus, the merits of arbitral decisions are not examined by the court.11

11Art. 801(1) of the Code of Civil Procedure provides for the setting aside of the arbitral award on the following grounds: where the arbitration procedure is impermissible; where the arbitral award orders one of the parties to perform an act prohibited by law; where one of the parties was not represented in the arbitration procedure in accordance with the provisions of the law; where the parties were not heard in the arbitration procedure (unless the parties have agreed otherwise); where conditions for an action for retrial exist under Art. 420 (iv) to (viii); such conditions are -- (4) when the judge who participated in the trial has committed a crime in connection with his duties in connection with the case; (5) when the party was induced to make a confession or prevented by a criminally punishable act of another person, from producing an objection or defence which would have affected the decision; (6) when a document or other object used as evidence in the judgment was forged or fraudulently altered; (7) when the judgment is based on the false statement of a witness, expert, interpreter, or a sworn party or his legal representative; (8) when the civil or criminal judgment or any other judicial decision or administrative disposition which has become the basis of the judgment has been changed by a subsequent decision or administrative disposition.
b. United States

i. In all basic respects the rules are the same as found in the analysis for Japan: arbitrators are drawn from wide technical fields and may be of any nationality; the parties may choose the place of arbitration and the law to apply.

ii. The American Arbitration Association (AAA) not only provides services for arbitration and mediation, it also serves as a center for education, training, and research. AAA has a special expedited procedure for claims under US$25,000: in these cases, notices are given by telephone and deadlines are greatly shortened, in an effort to reduce the cost to the smaller claimant.

4.11 The main reasons for the failure of arbitration to develop as an alternative means of dispute settlement in Indonesia are: (a) weak implementation by the existing forum, BANI; (b) lack of qualified arbitrators; (c) lack of enforceability of foreign arbitral awards; and (d) lack of publicity.

III. Recommendations

4.12 As one of the most urgent priorities for commercial law reforms, the institutions responsible for formal dispute settlement in Indonesia must be strengthened:

Court System

a. Increase the technical competence of judges to handle complex, modern commercial transactions, by a combination of training and improved compensation. In the short term, salary increases could be linked to the objectives of a just and speedy settlement. In the case of the public enterprise sector, the Government has recently raised salaries several fold, near to private sector levels, with the expectation of improvements in efficiency. There is also the implied sanction that if performance does not improve, the management may be replaced, the enterprise may be closed or other actions will be taken. Sanctions in the court system could similarly be linked to measures taken to improve fairness and some basic measures of greater efficiency. In commercial cases, there could be targets set for courts to reach decisions quickly. As a quid pro quo for a salary increase, the requirement of publishing court decisions should also be made to promote consistency in judicial decisions (see Chapter 5 on Legal Information).

b. A study should be undertaken on the value of creating a specialized court to handle commercial matters, or to regularly assigning the same judges to commercial cases so that a group of judges develops knowledge in the area. This specialization might be extremely valuable in the area of Bankruptcy rules and procedures, as a group of judges could develop a competence that
would encourage greater use of the Bankruptcy provisions. With the assistance of the economic ministries, seminars for judges could be arranged on commercial law, and courses given on economics and law.

c. The Central District Court in Jakarta and a few other District Courts in areas with high concentration of commercial activities (as Surabaya or Medan) deal with more commercial cases, and more complex commercial cases, than other courts. Theoretically these judges should have more knowledge of such matters. This is the case in other commercial centers of the world, and is a natural way of specialization of courts and judges because of market forces. The Government should initially concentrate its efforts on training, selection of personnel, and performance in these selected courts. Given the importance of improving the formal court system and the long time frame and other difficulties involved in trying to reform the entire court system, concentration of reform efforts on these few selected courts, together with pilot improvements in salaries and budgets, would help to achieve more measureable short-term results.

d. Courts could declare, as a matter of private international law that they would enforce foreign judgments, provided it was on a reciprocal basis. This would be an easy way to give a positive signal to foreign investors.

Arbitration

4.13 Only a few modifications to the present Indonesian system seem necessary in order for arbitration to be an acceptable alternative method of dispute settlement. If such a method could be developed it might also stimulate improvements in its "competitor", the formal court system. In theory, the modifications needed should not be difficult as most are consistent with the laws already in effect.

4.14 The most important initial decision, however, is whether to take the existing framework of BANI, or to help establish a more dynamic arbitration association. Such an association (or a revitalized BANI) could serve as a centralized point not only for supplying arbitrators and conciliators, but also for research and training. It might also encourage trade or other groups to form their own arbitration boards, with technical assistance supplied by the main association. In any event the recommendations below could apply to either a new group or BANI.

a. Both the domestic and foreign investor are rightly concerned about the qualifications of the arbitrator. The list of arbitrators should include specialists in different areas, and people with technical and business experience. At present BANI's

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12Not only is BANI weak in implementation, but the private sector has little confidence in it. This lack of confidence may stem from the fact that BANI is an arm of KADIN, and KADIN is widely perceived to be an extension of Government with varied goals and objectives.
arbitrators, although competent individuals, are drawn mainly from the ranks of former judges and professors, in contrast to the much wider use of businessman and professionals in other countries.

b. The perceptions of foreign investors about rules with respect to the applicable law, the place of arbitration and with the nationality of the arbitrator must be addressed. Most can be dealt with by taking some basic public relations steps, such as providing more details about what Indonesian arbitration is and how it operates -- seminars, brochures and general publicity. All of this would make a new association or BANI more familiar to the international business community and would make them aware that Indonesian law does not mandate that local law applies or that the arbitration be held in Indonesia. As Box 4.2 shows, however, it may take some time before the foreigners perception of bias is extinguished.

13There are of course some practical advantages to holding the arbitration in Indonesia, not the least of which is the ability to file the award in the local District Court.
Most commercial law cases are heard in the Central Jakarta District Court. Nevertheless, a recent court decision by that Court (presently being appealed) will cause potential investors to pause when considering the risks of doing business in Indonesia.

The case involved two contracts between an English Seller and Indonesian Buyer. The contracts were in a standard form for international sales; were governed by English law; and provide for arbitration of disputes under the rules of the Refined Sugar Association. The contracts expressly provided that the Buyer was to be "entirely responsible for obtaining any necessary import license and failure to obtain such license shall not be sufficient grounds for force majeure". In 1984 the Buyer failed to perform and the arbitration began. Then the Buyer brought a suit in English courts to declare the contract invalid. In 1985 the suit was dismissed and affirmed on appeal, with the court declaring that the Buyer "was bound by the contracts". The Seller and Buyer then entered into a settlement agreement governed by English law and subject to English arbitrations. A settlement was reached; the first payment made by Buyer; then the Buyer brought a suit in Jakarta against the Seller seeking an order that the contracts were illegal on the grounds that they violated a Presidential Decree that only the Bulog could import sugar into Indonesia. The English court had expressly ruled on this point, saying that the contracts were not to import sugar but merely "required the defendant to tender llls of lading for the carriage of sugar to Indonesia". After the sugar reached an Indonesian port, the Buyer could reship it or do whatever he chose.

The Jakarta Court ruled the contracts invalid; hence, the settlement agreement was invalid; and the arbitration clauses were not enforceable because Indonesian courts always have jurisdiction to determine issues of Indonesian public order.

c. An even more important aspect would be to include a few highly qualified and respected resident foreigners on the list of arbitrators. Such an action would give confidence to the foreign investor that the government and local business community was serious about trying to settle disputes in a manner perceived to be fair by all parties. The Japanese example is representative, and the use of non-nationals as arbitrators is quite common in commercial cases throughout the world.14 The foreign investor's concern is that the hearing be impartial. Hence the arbitrator's

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14Foreigners may serve as arbitrators in Korea, Thailand, China, Japan, the Netherlands and the United States, to give but a few examples. Of course, there is the occasional restriction, such as the foreigner must be resident in the host country, but that is usually not a problem.
nationality is usually different from that of the parties. Of course, all the parties to the underlying agreement have to agree initially that a foreign arbitrator is agreeable should a dispute arise.\(^{15}\)

d. Concern about the enforceability of foreign arbitral awards in Indonesia is legitimate and cannot be resolved by an arbitration body. Until recently, Indonesian courts have refused to recognize foreign awards in spite of Treaty commitments to the contrary. By refusing to recognize a foreign award, Indonesia has been stating that the location of the arbitration must in effect be in Indonesia or it will not be enforced, contrary to what Indonesia’s own general rules of private international law would allow.

i. The problem stems from a 1984 Indonesian Supreme Court decision which concluded that Indonesia was not bound by the New York Convention on Enforcement of Foreign Arbitral Awards.\(^{16}\) Although acknowledging that Indonesia acceded to the Convention, the Supreme Court stated that "in accordance with Indonesian practice, it would still be necessary for the Government to promulgate implementing regulations. . . ." The Supreme Court concluded that pending promulgation of such implementing regulations, the courts of Indonesia could not enforce foreign arbitral awards. Most commentators disagree with the opinion. The Convention itself recognizes this issue and states " . . . each contracting State shall recognize arbitral awards as binding and enforce them in accordance with the rules of procedure in the territory where the award is relied upon, under conditions laid down in the following articles. . . ." Thus, the Indonesian Supreme Court could have held that Indonesia’s own arbitration rules -- the R.V. of 1848 -- were adequate rules of procedure and implementing regulations.

ii. By refusing to recognize foreign arbitral awards, the Indonesian system is sending an especially troubling signal

\(^{15}\)This gives some protection to the local investor who may use his bargaining power at the contract negotiations stage to insist on an Indonesian arbitrator.

\(^{16}\)United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 38 (NY Convention), effective as on June 7, 1959. Indonesia ratified the Convention with the following declaration: "Pursuant to the provision of Article I (3) of the Convention, the Government of the Republic of Indonesia declares that it will apply the Convention on the basis of reciprocity, to the recognition and enforcement of awards made only in the territory of another Contracting State, and that it will apply the Convention only to differences arising out of legal relationships, whether contractual or not, which are considered as commercial under the Indonesian Law."
to the foreign investment community. The foreign investor is especially worried, because even though Indonesia had signed the New York Convention it appears unwilling to live up to its commitments under the Treaty. The failure to follow an international convention is not only embarrassing for Indonesia but reduces the foreigners' confidence in the entire system. Recently when Indonesian wished to enter into an agreement with Freeport Mining pursuant to the Multilateral Investment Guarantee Agreement there were significant problems as a result of the failure to implement the Treaty, and the fact that foreign awards were not enforceable. In the Freeport case, the problems were resolved on an ad hoc basis, but such a case-by-case resolution is not feasible for most companies and discourages others from entering Indonesia at all.

iii. The Supreme Court has recently issued a regulation addressing this problem, which sets out a procedure for applying to the Supreme Court for recognition of a foreign arbitral award, but this procedure has not yet been used in practice.\textsuperscript{17} In order for such a circular to resolve this problem, its contents and the details of the procedure which it requires must be publicized and made known to the international business community so that business decisions and contractual provisions on dispute settlement can begin to take into account the option of using foreign arbitration. Once this circular has been put into practice by a foreign arbitral award being recognized and enforced by the Indonesian courts, this fact should be widely publicized and explained to the international business community.\textsuperscript{18}

\textbf{Legal Profession}

4.15 There is no reliable estimate of the number of practicing lawyers or notaries in Indonesia, but they probably number just a few thousand. Yet in Indonesia as in most countries, a substantial part of the responsibility of interpreting laws in commercial areas falls on the private legal profession. While the State has the major role in criminal cases, the private sector litigants, lawyers, notaries and other specialists, eases the burden in the commercial area. Properly trained, the legal professional can not only assist a court or arbitration panel in reaching a reasoned, proper decision, but in

\textsuperscript{17}Regulation of the Supreme Court No. 1 of 1990 (\textit{Peraturan Mahkamah Agung Nomor 1 Tahun 1990}).

\textsuperscript{18}The problem of adequate implementing regulations is not unique to Indonesia. Thailand recently faced the problem, and rewrote its entire arbitration rules, passing new legislation. Such drastic action may not be needed in Indonesia, but the Thai action gave a strong signal to the foreign investment community that Thailand was serious about providing predictable, reliable methods of settling commercial disputes.
many instances can prevent the issue from reaching court, thus saving the client, and the system, significant extra cost.

4.16 We recommend an action program be implemented by Government, in cooperation with the private sector and universities to: (1) give lawyers and law students better training in relevant subjects outside the law; (2) expand opportunities for overseas training; advanced degrees abroad would expose lawyers to a wide variety of international ideas and thinking. As it has in the economics profession, the constructive interaction with other ideas in the "market" will help the profession to understand international best practices and adapt them to Indonesia's culture and problems; (3) improve the foreign language skills of the profession. Without an ability in other languages the professional cannot know and understand developments that are occurring at a rapid pace in the profession worldwide; and (4) allow entry of more foreign legal professionals, by easing the strict work permit system. The ability of foreign legal professionals to work in Indonesia would increase the foreign investors' confidence in the system; help train local professionals; and give greater access to international best practice in commercial law, hence improving the quality of professional advice.\footnote{The ongoing Accountancy Development Project of the World Bank might be an example for starting to strengthen the legal profession in Indonesia.}
CHAPTER 5

LEGAL INFORMATION

Introduction

5.1 The public's access to legal information in Indonesia is severely limited. It poses one of the highest barriers to the effective development and implementation of the commercial legal framework. There are two sets of problems. First, many laws, regulations, judicial decisions, procedures, and other legal information are simply not available. Second, although considerable thought and effort goes into fashioning legal rules and procedures, the effort is fundamentally undermined by the way that they are presented to the public: there is no official method of bringing regulations into existence within a reasonable time; and the body of laws and regulations in any given area consists of numerous decisions, regulations, and circulars which must be read separately without a single method to reconstruct them into a rational whole. As a result, entrepreneurs, practitioners, professionals in the administrative and judicial system, and the public at large, reach their own conclusions about what the laws are, and how they should be applied.

I. The Importance of Legal Information

5.2 A central concept of the economic theory of law is that it must be public. If the law became known only after the event to which it was applicable, the existence of the law could have no effect on the parties subject to it. The economic theory of law is also a theory of law as deterrence, and a threat that is not communicated cannot deter. Because of the deterrent effects of widely known laws in a well-functioning legal system few economic transactions go to formal courts and administrative forums for dispute settlement and decisions. Finally, the economic theory of law emphasizes the cost of information. The value of a commercial legal framework is that it economizes the search for information by individuals. In the absence of public information, the costs of information related to economic transactions rise to such an extent as to deter many efficient economic activities that might otherwise be feasible.

5.3 The legal effectiveness of the commercial legal framework also depends fundamentally on easily accessible and certain laws. When the laws and procedures are unclear they result in legal uncertainty and inconsistent application. The efficiency of the court system and legal processes also depends to a great extent on legal information. Widely known laws and their interpretation, as well as the publication of judgments, help ensure the consistent application of laws. Better access to legal information allows legislators, economic policy makers, and government legal bureaus to know and master the existing laws and rules, helping them avoid inconsistencies and contradictory policies in the development of the law.

5.4 The consequences of inadequate legal information are a lack of public confidence and mistrust in the legal system, high barriers to entry for private businesses, especially small businesses less able to pay for a costly
private search for legal information, inefficient economic transactions, and
an underpinning for unfair practices.

II. Constraint on Public Access to Legal Information

Lack of Authoritative Versions of Major Commercial Codes

5.5 Any discussion of the present status of legal information in
Indonesia has to begin with the facts that (a) major components of the formal
legal system remain in Dutch, a language that fewer and fewer Indonesians can
understand or master; and (b) there is no official version of such laws in the
Indonesian language. Such a situation is in itself a major impediment to a
coherent economic law framework in Indonesia and results in problems of
understanding, adherence and enforcement. It also effectively prevents
efforts to keep the Codes up-to-date to accommodate changing economic and
social conditions. 1 Except for the Code of Criminal Procedure, all major
Dutch colonial codes remain in effect on the basis of Article II of the
Transitional Provision of the Indonesian Constitution of 1945, which
stipulates that all existing laws continue in force until replaced by new laws
issued under the Constitution. Rules governing contracts, credit and security
transactions and corporate entities continue to be come from the 19th century
Codes. 2

5.6 In order to deal with this problem, Indonesian universities mounted a
major effort shortly after independence to compile Indonesian-language
versions of the Codes. These unofficial translations remain in circulation
today and are relied on to understand the Dutch codes. While often excellent,
the translations are frequently descriptive rather than precise, and more
importantly, have never been enacted as official Indonesian language versions
of the Codes. In 1989 a new set of translations was published by a private
publisher, Ichtiar Baru-van Hoeve. These translations are based on an earlier
set of translations last published in 1960 (Himpunan Peraturan Perundang-
undangan Republik Indonesia; Disusun menurut Sistem Engelbrecht). Like the
earlier version it is not an official translation.

5.7 More recently, attempts to draft new Indonesian language Codes for
civil law, criminal law, commercial law, civil procedure and private
international law have been undertaken by the Badan Pembinaan Hukum Nasional
(National Law Development Agency). Progress has been made in compiling
working drafts of such new, revised codes. There is nevertheless a great

1 New legislation must either replace an entire code, as was done for
Criminal Procedure in 1981, or must replace or amend particular provisions
without a clear frame of reference or a precise terminology. Debates can
continue endlessly on the topic of “partial” versus “complete” codification. In
the meantime, transactions go on and the public suffers as efforts to update the
Codes are held in abeyance until the issue is “solved”.

2 This covers the Civil Code, 1847; the Commercial Code, 1847; and the Code
of Civil Procedure, 1941. Many other pieces of major legislation in the fields
of government budgeting and accounting, bankruptcy, company licensing and
transportation, remain in effect as Dutch ordinances by virtue of the
Transitional Provisions.
reluctance to enact new, untested codes in their entirety, and a decided preference to proceed by enacting particular provisions of law, when the need arises. Often, portions of the older Codes are replaced by lower level decisions and regulations. At first glance, this may seem to give people a new standard to rely upon, but in fact legal uncertainty increases because it is not clear to what extent a lower level regulation can replace a Dutch code provision which has the status of Law.³

Lack of Publication of Laws and Regulations

5.8 The highest level laws and regulations are published in the Lembaran Negara Republik Indonesia (the State Gazette), which in many ways, is a reliable and well organized publication.⁴ Yet even the State Gazette is published in limited numbers (a few thousand copies). The majority of the published copies are reserved for distribution to senior government officials, with the remainder available for subscription if some rather bureaucratic procedures are followed. Most law libraries, to say nothing of the general libraries, do not receive copies of the Gazette as part of the official distribution, and many have experienced difficulty maintaining a subscription even if they can afford it.

5.9 In addition to the State Gazette which contains Laws (Undang-undang), Government Regulations (Peraturan Pemerintah), and Presidential Decisions (Keputusan Presiden) pertaining to international treaties and agreements; there are three other gazettes;

- Tambahan Lembaran Negara (Supplement to the State Gazette) which contains the official elucidations of the Laws and government regulations published in the State Gazette;

- Berita Negara (State Reports) which contains official notices, such as name changes, naturalization, and statutory notices. Although some departmental decisions and regulations, together with the full text of the decision are announced in the State Reports, such publication is not mandatory and has no official status;

- Tambahan Berita Negara (Supplement to the State Reports) consists of several series which are published as separate volumes, the

³The lack of official translations is also unsettling for its broader effects. The pragmatic approach to law reform meets the day-to-day needs for new rules, but has the effect of slowly dismantling the basic structure of the Code system inherited from the Dutch, without giving any certainty in the remaining areas not covered by the new regulations. As Dutch language skills in the population decline, the public and legal professionals are increasingly unable to judge and interpret the basic rules of Law contained in the Dutch language codes. This lack of understanding, even on the part of the legal professional, leads to confusion and mistrust of the entire legal system.

⁴The State Gazette was made the official publication of Indonesia by Law No. 2 of 1950.
most important of which contains the Articles of Association of Indonesian limited liability companies, firms and cooperatives.

5.10 The State Gazette is far behind in publishing laws and regulations. In May 1990, the State Gazette for 1989 is not available, and the volume for 1988 has only recently been published. The other gazettes mentioned have had similar delays in being available to the public, and in 1968 the State Secretariat began publishing a quarterly compilation of laws and regulations known as the Himpunan Peraturan Negara (Compilation of State Regulations). It is not made available to the public, although pirated photocopied versions do exist, and it does reach the desks of senior officials sooner than the State Gazette. Thus, it better serves the officials' need for accurate and up-to-date information on prevailing regulations, but does not reach the public or legal practitioner.

Inaccessible Information on Rule-Making and Policy-Making Procedures

5.11 Obtaining accurate and up-to-date information about the higher ranking Laws and Regulations is quite difficult. However, when it comes to learning about departmental decisions and regulations such as Keputusan Menteri (Ministerial Decisions) or Peraturan Menteri (Ministerial Regulations), no person or agency knows with certainty what regulations have been issued or are in effect. Government departments and agencies are requested to send copies of their regulations to the Cabinet Secretariat in Jakarta, and many agencies, but not all, follow this instruction, and thus it is not very reliable. The private sector has attempted to fill this gap by publishing the text of newly-issued regulations, and most businessmen and lawyers rely on these publications for an awareness of current rules. However, the versions that appear are not officially authorized, and the newsletters often edit out portions of the rules because of space limitations. Nevertheless, the private newsletters Warta CAPI and Business News have been relatively reliable in the areas of trade, investment and communications, which they cover closely, usually attaching full texts of regulations. In areas such as mining, forestry, estate crops, and fisheries, they are less

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Others include -- the Supplements containing the Articles of Association of Indonesian foundations and associations; and the Supplement containing registered trademarks.

Although periodic gazettes are issued during the year, even fewer people have access to them.

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The scope of the Himpunan Peraturan Negara (Compilation of State Regulations) is broader than the Lembaran Negara (State Gazette) as it includes Keputusan Presiden (Presidential Decisions) not found in the State Gazette as well as Instruksi Presiden (Presidential Instructions).

Even the Ketetapan Majelis Permusyawaratan Rakyat (Peoples' Consultative Assembly) does not have a place or procedure for officially promulgating its Decrees.

See for example Presidential Instruction No. 15 of 1970 on the procedure for preparing draft Laws and draft Government Regulations.
reliable, and they are not very reliable in the fields of education, agriculture, labor, and social affairs. Finally the usefulness of these publications is hampered by the fact that they are not indexed, making locating specific regulations difficult.\(^{10}\)

5.12 Many government departments issue rules and policies in the form of a series of separate decisions, *Keputusan* or *Surat Keputusan* (Decisions or Decision Letters) and *Peraturan* (Regulations). They then elaborate or explain the rules in a series of letters circulated to interested parties, call *Surat Edaran* (Circular Letters). In any given area of the law there is an extensive body of such decisions, regulations and circulars which must be read, compiled and understood. Although the format is relatively standard, many regulations raise more questions than they answer when read together with other regulations in the same sector. As a result, even the experienced lawyer will spend many costly hours trying to unravel or assimilate the secrets of the regulations. When not reading the numerous regulations, the lawyer or the investor-client will spend time going from department to department in a costly effort to learn what regulations will apply to a contemplated transaction. The lack of transparency in the system is also burdensome on the officials who must spend time with the information-seekers.

**Restricted Access to Court Decisions**

5.13 If the dissemination of legal information by the Executive and Legislative branches of government leaves much to be desired, the Judicial branch fares little better. The Supreme Court publishes, annually, selected decisions in *Yurisprudensi Indonesia* (Indonesian Jurisprudence), and the Ministry of Justice has undertaken to publish selected District and High Court decisions in a semi-annual series called *Himpunan Putusan-putusan Pengadilan Negeri* (Compilation of Court Decisions). These efforts are a good start, but they suffer from the common problems of too few copies, ineffective distribution, and untimeliness.

5.14 Indonesia has not attached as much importance to court decisions as a source of law as it does to legislation and governmental regulations. As such there has not been any major effort devoted to the collection and publication of court decisions. It is recognized throughout the world that it is impossible to practice as a lawyer without careful study of court decisions in the various branches of the law: for example, in West Germany, France, Belgium, Austria, Italy, Brazil, Argentina, Thailand and the Netherlands, to

\(^{10}\)Some Government Departments, in cooperation with the *Pusat Dokumentasi Hukum* (Legal Documentation Center) of the University of Indonesia, the *Badan Pembinaan Hukum Nasional* (National Law Development Agency) and the *Sistem Jaringan Dokumentasi Dan Informasi Hukum* (National Legal Information and Documentation Network), have begun to catalog and index their regulations. In some cases they even publish lists of recently issued regulations and provide limited information services to the public through their law bureaus in Jakarta. In addition, the monthly catalogs of titles and subjects published by the Legal Documentation Center, known as *Informasi Peraturan Perundangan Republik Indonesia*, can serve as an index for the experienced user. Annual compilations which are made by many government departments are beginning to provide a good historical record, but they are not distributed widely.
name a few, there are legal journals which publish commentaries on case law, and often publish the actual text of judicial decisions, or state where lawyers can find the texts. In most of these countries, the Supreme Courts, wanting to be internally consistent, publish selected judgements. The distinction between the emphasis placed on court decisions in civil law and common law countries is overstated. Stating that courts are not bound by their own decisions is of little practice value -- one might as well say that statutes are not a source of law because parliaments can amend them. Technically all the statement means is that a court cannot base a decision exclusively on the authority of a previous decision. Lower courts in the Netherlands, as elsewhere, can choose not to follow a decision of the Highest Court if they are convinced of its inaccuracy; but judgments derive their authority from the strength of their reasoning not from the level of the judge who pronounces them.\textsuperscript{11} Without publication it is impossible to tell the strength or anything else about the reasoning, which is why libraries of practicing lawyers around the world are full of collections of judicial decisions.

**Restriction on Sale and Distribution of Government Publications**

5.15 The present system does not make it easy for information about laws and regulations to be distributed, whether by the Government or by private sources. The State Printing Enterprise, does not have the authority to print, sell or distribute all government publications. As a result, each department tries to handle its own printing and dissemination activities. Government publications are treated under Indonesian auditing rules as government property, and as such, cannot be sold. Even when arrangements are made to allow a sale, the proceeds must go to the State Treasury's general funds, not contributing to the cost recovery of the publication concerned. Some agencies have tried to overcome the restrictions by contracting with private publishers, foundations or cooperatives of government employees to produce and sell books based on government prepared compilations. Recently, the Supreme Court began a program of publishing the *Yurisprudensi Indonesia* through a private publishing house, so the problems are apparently not insurmountable. There are, however, no guidelines governing this practice, and many areas remain uncertain such as royalty requirements, authority for publication, and responsibility for errors.

\textsuperscript{11}Section 12 of the Dutch Code of General Provisions reads as follows: "Judges are forbidden to adjudicate cases by prescribing general rules or regulations." While this was the original legislative plan, the practice has strayed far from it. The study and analysis of systematized court opinions are an integral part of Dutch legal education and practice. Dutch judges do not usually cite the decisions of higher courts on which they base an opinion, but from the language of the judgments one can easily derive the arguments and formulas used by higher courts in similar cases. The Highest Court has even adopted the practice of deciding appeals by examining whether the decision of a lower court conforms, not to the instruction of the Code, but to one of its own previous formulas.
Inaccessible Information in Public Registries

5.16 In many countries there are numerous public registries which allow the public, and the practicing lawyer, to have access to important legal information. Although Indonesia, too, has a number of registries, the current methods of managing such registries does not contribute to certainty in the legal system. Law No. 3 of 1982, for example, provides for mandatory registration of companies. The registry was established at the Ministry of Trade to collect and manage information on the current status of economic enterprises, and covers such areas as capitalization, fields of activity, licenses, current directors and commissioners. The stated purpose of the registry is to allow the public to be better aware of the business enterprises with which it deals. However, the public is only given limited access to the information in the registry. Those seeking information must submit a written request to the Ministry of Trade, stating the exact information required and the reasons for the request. The written request for specific information must be made before looking at the registry and the data within it, effectively preventing meaningful inquiry. As there is little benefit to the public from this registry, it has become simply another burden on companies to file data. 12

5.17 As a result of the failure to publish court decisions there is little accountability for judges' actions. Another consequence of the lack of reliable and timely information about the law and regulations is that discussion of legal issues in Indonesia tends to be vague, without examples, and is often doctrinaire or philosophically biased. The infrastructure does not provide materials which would enable lawyers and scholars to develop disciplined methods of analyzing applicable legal rules and regulations.

III. Recommendations for Improving Legal Information

Publication for Laws to be Effective

5.18 Today numerous rules and government policies governing economic activity cannot be ascertained with any satisfactory degree of accuracy even by interested parties and their lawyers. The Government should make clear that no implementing decision or ancillary regulation will be in effect until it has been gazetted in an officially authorized publication available to the public. In common with the vast majority of other legal systems, the principle should be that publication is a necessary component of the effectiveness of a rule or regulation. This principle could be set out in a regulation or law, and implementation might be approached in a number of ways. Regardless of what method is used, the publication must be easily accessible.

12However, in comparison to other registries, such as the land registry, the Company registry is rather open. All inquiries to the land registry must be made through a notary or local official, even about the status of a particular plot. This involves substantial expense, discouraging many inquiries. It is not hard to understand why there is such uncertainty with respect to land titles, as the public does not have ready access to accurate information on which to base decisions.
a. Establish a daily government Gazette as part of the State Gazette system to accommodate the publication of such decisions and regulations. It could include all Presidential Decisions and Instructions, Ministerial Decisions and Regulations and other decisions of government departments and agencies. Such a publication would not only have the value of producing timely rules, but would also give the official and accurate text.

b. In addition, the scope and number of pages of Berita Negara (State Reports), now published twice a week, could be expanded. A new supplement series could be added to either Berita Negara or Lembaran Negara (State Gazette).

c. There ought to be sanctions for failure to publish. An appropriate sanction might be that a decision or regulation cannot be enforced if it has not been properly published. The soon-to-be-functioning Administrative Courts might be an appropriate forum for enforcement.

Authoritative Translations of Commercial Codes

5.19 Specific Indonesian translations of the Dutch codes and ordinances should be declared the "official" translations and published. Either an existing translation could be chosen, or a team of translators and scholars could be formed to select the best combination of translations. This latter option would have to be strictly limited in time, as the purpose of the effort is to bring some more certainty into the field, not result in academic debate for months on end. This work could be handled by the National Law Development Agency which has carried out a similar task for the official Criminal Code.

Publication of Court Decisions

5.20 In order for confidence to grow in the system it is important that all participants know on what bases judicial decisions are reached. The seemingly simple requirement that selected court decisions be written and published would go a long way to achieving that goal. In order to avoid the civil law/common law arguments, it could be explicitly stated that they were not precedents, but merely guides for the purpose of knowing how courts interpret various laws. Publishing the decisions would expose faulty reasoning and inconsistent treatment of cases contributing to a more predictable enforcement of laws. The practice of publishing court decisions in official gazettes is a common practice in most civil law systems. Box 5.1 provides an example of how the Directorate General of Taxes has improved public confidence and consistency in the application of tax laws by publishing case decisions.
BOX 5.1: The Directorate General of Taxes and Publication of Tax Decisions

In 1983 the Directorate General of Taxes began a practice of accepting requests for rulings on particular questions of tax law and of publishing such rulings and the facts on which they are based, in the form of publicly available circular letters. Such rulings differ from the usual circular as they are based on real problems in the implementation of the tax laws, rather than merely restating the Government's understanding of a law. This practice has contributed a greater degree of certainty about the meaning and application of tax rules, and has been well received by the business community, and the legal and accounting professions. More importantly, the practice has increased public respect for, and confidence in, the tax authorities and in their ability to apply the law competently and conscientiously. The example of the Directorate General of Taxes in inviting inquiries, publishing rulings and circulating answers could be followed with good effect by other agencies, for example: the Capital Markets Board; the Investment Coordinating Board, which frequently answers questions on what types of investment will be allowed and what rules will be applied, but does not publish its answers; and the Ministry of Manpower, which frequently rules on responsibilities of employers, but does not publish rulings.

Improvements in Sale and Distribution of Publications

5.21 Another important task should be to improve the distribution systems of existing publications. Requiring that public and law libraries be included on official distribution lists would be a small start.13 No fully satisfactory solution can be reached, however, unless arrangements are put into place (a) to allow for the sale of government legal publications, and (b) to ensure that adequate funds are available for continued production and updating. As usual, there are many ways of approaching this problem: the State Printing Enterprise could be upgraded or private publishers could be officially designated. In any case the Government should prepare and issue guidelines concerning contractual arrangements and rules on payment of royalties, responsibility for errors and the like. If the printers are responsive to public needs and demand, the royalties and fees ought to cover the costs to the Government.

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13 The Draft Law on the Obligation to Deposit Printed and Recorded Works will solve this problem for the National Library, but additional steps are still required to ensure public availability throughout the country.
Publication of Rule-Making and Policy-Making Procedures

5.22 Key regulatory agencies, such as the Investment Coordinating Board, the Capital Market Authority, and the Ministry of Manpower should be provided support to enable them to compile and maintain consolidated restatements of their existing rules and regulations, in a book following the example of Bank Indonesia’s IKPI (Box 5.2). Support for these and other selected agencies should go beyond the usual budgetary efforts, and include some recognition of the importance the Government is beginning to place on accurate legal information: for example, those undertaking the task could be given a new title, say, "legal information specialist", and the role of the law bureaus participating in the National Legal Documentation and Information Network could be given a more formal status through the issuance of a Presidential Decision on the Network.

BOX 5.2: Bank Indonesia’s Regulation Book

The multiplicity of rules and supplementary regulations causes great problems in reaching a minimal level of certainty in the system. Bank Indonesia has overcome many of these problems with its occasionally-updated manual of banking regulations known as IKPI (Ikhtisar Ketentuan-ketentuan Perbankan Indonesia). This publication contains all the various laws and government regulations dealing with banking. The rules are restated in a systematically organized book, with references to the source of each rule. Such a book enables (1) users to find easily all rules which apply to a particular aspect of banking; and (2) regulators to identify more clearly possible gaps and inconsistencies in the existing regulations and hence focus on priority areas for action. If it were decided to place all the banking rules into one regulation, such a book would be the basis therefor. A concordance could be done by private scholars, but IKPI is more authoritative because it has been compiled by Bank Indonesia itself. IKPI has some of the distribution and timeliness problems that hinder other publications, but on the whole it is an excellent publication.

The Capital Market, especially, is the type of area which requires the clarity and certainty of a rule book rather than the confusion generated by a series of decrees and regulations. Other departments or agencies responsible for managing complex sets of rules, such as the Investment Coordinating Board, the Directorate General of Taxes, the Directorate General of Customs & Excises, the Ministry of Manpower, the Ministry of Forestry, the Ministry of Trade and the Ministry of Mines and Energy would be well served by a compilation which follows Bank Indonesia’s example.
5.23 In a similar effort to improve access to understandable materials, and to avoid hours of tedious and repetitive work in researching problems, efforts are already being made to put legal materials onto a computerized system. These efforts should be supported, not only through budgetary efforts, but also by public recognition of the importance of the task. Instrumental in these efforts have been the University of Indonesia’s Legal Documentation Center, the National Law Development Agency, and the Law Bureau of the Ministry of Finance. In addition a standardized system of manuals for the documentation of legal materials has been developed as part of the National Legal Documentation and Information Network. Based on these manuals a standardized system of computerization of legal information, known as /KHAIDAH/, has been devised.

Access to Public Registries

5.24 Public registries should improve their methods of obtaining and filing information, and in the way the public is given access to the information. Currently registries are not serving as information sources, but exist as official evidentiary depositories of documents. In view of the technical, detailed nature of improvements needed, and of the availability of modern methods already existing in other countries, we recommend that a pilot project with international technical assistance should be undertaken to assist existing registries in formulating policies and procedures to enable them to better serve the public by improved access to and dissemination of the information in the registries.
Deregulation and The Changing Role of The Private Sector

Background: Economic and Enterprise Regulation till the Early 1980s

1. Indonesia experienced rapid industrial and economic growth between the late 1960s and early 1980s. But certain characteristics of the growth process made it a high-cost and unsustainable growth path. The incentive policies of import substitution industrialization behind high tariff and non-tariff import barriers resulted in a low export-orientation of economic activities. There was also a very high degree of Government regulation over private investment through a detailed investment licensing system and other restrictions, together with a relatively large role for the public sector. These served to introduce major barriers to entry and mobility of private investment. Financial sector policies, such as the dominance of State-owned banks and subsidized and direct credits, also acted to reinforce the incentives for import substitution industrialization and create additional barriers to entry and mobility. A wide range of other enterprise regulations were also employed to guide and control private sector development.¹ Attendant on these restrictions and controls were a wide variety of rent-seeking activities that served to increase the costs of doing business.

2. The result of these policies was a private sector that was highly inward-oriented, heavily regulated and controlled by Government, and relatively small in size and scope.

Deregulation and The Private Sector, 1983-90

3. Two major external shocks, the sharp drop in international oil prices,² and a large rise in external debt³ provided the impetus for deregulation in the 1980s. The Government undertook strong macro-economic stabilization measures between 1983-85 in response to the fall in oil prices

¹For example, local content programs, import licensing requirements, export restrictions, bans on investment in small-scale sector, minimum local ownership and divestiture requirements for foreign investment, labor restrictions, restrictions on land ownership, and access of foreign firms to markets and domestic financing.


³Caused in part by depreciation of the US dollar vis-a-vis other currencies since a large part of external debt was denominated in currencies other than the US dollar.
and revenues. Subsequently, since 1985, it has continued strong stabilization measures, but this time accompanied by far-reaching economic deregulation to enhance the efficient role of the private sector in the economy.

4. The directions of the deregulation measures have been a major re-orientation of the incentive regime towards more internationally competitive economic activities; a significant reduction of barriers to entry and mobility of private investment; and far-reaching improvements in the efficiency of the supporting framework for private sector development. A description of the main deregulation measures is provided in Box A.1.

Footnotes:
Box A.1: Economic Deregulation Measures in Indonesia: 1983-90

**Incentive Regime Change:** The most important change has been a large, about 55%, real exchange rate depreciation between 1981-89, and an actively managed float of the Rupiah. In addition, four major trade policy reform packages were undertaken between 1985-89 addressing three principal areas: (a) greatly increased access to duty-free imports for exporters; (b) a significant reduction in average (unweighted) nominal import tariff-rates, from 37% before 1985 to 27% in 1989; and (c) a sharp reduction in the coverage of non-tariff barriers to imports, from 41% of domestic production in 1986 to about 29% in 1989, especially concentrated in manufacturing.

**Entry and Mobility of Private Investment:** Three distinct and successive phases of reforms were undertaken starting in 1983 to deregulate private investment activity: (a) streamlining investment approval; (b) opening up more fields and room for expansion to private investment; and (c) shift to a small negative investment list since 1989, thereby permitting private investment, both domestic and foreign, in the vast majority of all investment areas. In addition, the Government has reduced many of the restrictions on foreign investment, by relaxing ownership controls and divestiture requirements, reducing the differences in treatment of domestic and foreign firms in access to markets and financing, lowering minimum investment requirements, and removing restrictions on the employment of expatriates, especially for export-oriented firms.

**Supporting Framework For Private Sector Development:** Many far-reaching deregulation measures have been undertaken. In the financial sector, the Government deregulated interest rates and replaced credit ceilings by a system of reserve money management in 1983. Subsequently, a major reform package was undertaken in 1988 eliminating barriers to entry for private banks and non-bank financial institutions, and encouraging the growth of capital markets, amongst other measures. This was followed in 1990 by the virtual elimination of directed and subsidized liquidity credits. Cumbersome customs procedures and port operations were earlier a source of high costs in private sector trade and exporting. A related barrier was the high costs of maritime shipping. In 1985, a major package of reforms were undertaken that abolished and/or simplified many of the customs procedures and handed over inspection services to a private organization for shipments over US$ 5000. It also reorganized port operations, deregulated freight-forwarding and other services, and opened up all major ports to foreign-flag shipping lines. In 1988, the Government introduced further sweeping reforms of maritime transport, to reduce and simplify licensing requirements and further reduce barriers to entry. Local content programs have also been made more flexible in recent years, to allow manufacturers to raise efficiency in domestic production. Finally, under a new policy for industrial estate development since 1989, the private sector has been permitted entry, and under lease terms that effectively extend lease rights on land to about 80 years, instead of an earlier 20 years. A similar approach has been extended to new investments in agricultural plantations since 1990.
The Private Sector Response

5. The private sector has responded effectively. The most important response has been the re-orientation of production for exports. Non-oil exports, mostly undertaken by the private sector, have increased several-fold in value, fully offsetting the fall in oil exports. Led by export growth, the manufacturing sector has accelerated its growth to over 12% p.a., and overall economic growth has been in excess of 5% p.a. The effects on employment growth and real wages have also been positive. Finally, there has been a surge in new investment activity by the private sector in response to the deregulation measures (see Box A.2).

6. The private sector in Indonesia has, thus, undergone a marked transformation since 1985. It has increased many times in size and in the scope of its activities. It is strongly outward-oriented, competing more effectively with the rest of the world, and attracting sizeable foreign direct investment. It is also now much less regulated and controlled by Government, and is the main source of overall economic growth.
Box A.2: The Private Sector Response to Deregulation in Indonesia

Exports: Non-oil exports, mostly undertaken by the private sector, have increased in value from US$ 3.9 billion in 1982/3 to over US$ 14 billion in 1989/90, fully offsetting the fall in oil exports, and increasing the share of non-oil exports in total from 21% in 1982/3 to 61% in 1988/9. The ratio of non-oil exports to GDP has also increased from about 6.8% in 1980 to about 15% in 1988.

Manufacturing Growth: The strongest source of growth in non-oil exports has been the manufacturing sector. A diversified bundle of new manufacturing exports (i.e. other than textiles and wood products) has, in turn, been the most important source of growth. The effect of export-led growth has been an acceleration in manufacturing growth to over 12% p.a. since 1986, one of the fastest among developing countries, and economic growth in the non-oil sector in excess of of 7% p.a..

Employment and Wages: Growth in employment in manufacturing has expanded by an estimated 10% p.a. since 1985, much faster than in any other period, partly as a result of fast output growth, but more importantly, as a result of the shift to labor-intensive manufactures for exports. Real wages have increased significantly since 1981.

Investment: After falling between 1983-85, annual domestic investment approvals picked up and rose by 230% in 1987, and another 43% in 1988, reaching a record level equivalent to US$ 8.7 billion. Foreign investment has responded equally strongly, with annual investment approvals rising by 300% in 1988, to reach a level of about US$ 4.4 billion. These trends of rising investment approvals have continued into 1989. A distinctive feature is that nearly two-thirds of new investment proposals have been in exportable sectors, instead of in importable sectors, in contrast to the situation prevailing earlier. There are also indicators that show a marked rise in the efficiency of investment at the enterprise-level and in aggregate since 1985.

Financial Markets: A mirror to the greatly increased real role of the private sector since deregulation is found in the recent growth of financial and capital markets. Since 1988, there has been a dramatic increase in competition in banking, with 28 new national banks, 11 joint ventures with foreign banks, and 140 secondary banks having been licensed. More than 1300 new bank branches have been opened, nearly doubling the previous number of branches. Gross assets of the financial sector has more than quadrupled between 1982-89, and private savings intermediated through the financial system as a proportion of total national savings have increased from 16% during 1978-82 to 38% in 1989. There has also been a surge in activities in the capital markets, with stock turnover in the Jakarta Stock Exchange rising from US$400 thousand a day in July, 1988 to US$ 6 million a day in December, 1989. Capitalization has risen from US$ 300 million in 1988 to US$ 3.3 billion in end-1989. And 89 stocks are now listed, with another 85 companies in the pipeline, compared to only 24 listed stocks before 1988.
A. Deregulation and Administrative Law Framework

1. The Government has directly exercised important law-making, interpretation, and enforcement functions in Indonesia through the administrative law framework. Under such a system, wide powers have been delegated to the executive branches of Government, through umbrella legislation (e.g. Basic Laws), to issue detailed regulations, and to enforce them. In Indonesia, the administrative law framework has acquired even greater force than in other countries because of the practice that the Basic Laws contain fairly general principles. It has been particularly important in macroeconomic areas i.e. in regard to laws setting out the basic economic powers of the State, in defining the relationship between the State and the private sector, and in defining the scope of economic activities of the private sector.

2. The Government has been able to successfully undertake the recent wide-ranging economic deregulation largely because of the importance of the administrative law framework. The Government, especially the economic ministries, have effectively used these powers to repeal earlier restrictive regulations speedily and flexibly. In areas where it was important to enact new laws, such as in taxation (and in banking and capital markets now under consideration), the economic ministries have also been able to act relatively quickly.

B. Some Remaining Issues in the Administrative Law Framework

3. Nevertheless, some issues remain outstanding. The requirements for various licenses and compliance with a large number of regulations are still large, especially in the case of local government level licenses and regulations. Inadequate information regarding numerous regulations and possible inconsistencies between them are other areas requiring attention. Continuing administrative and regulatory reforms are therefore important. In critical infrastructure service areas such as road transport, domestic trade, power, and telecommunications, the private sector's role could also be considerably enhanced by legal and regulatory reforms. In addition, there are issues outstanding with regard to some basic areas of private sector functioning.

4. Land. Among the first Basic Laws enacted in the 1960s was the Basic Agrarian Law (1960), wherein the right to own land was restricted to

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1Typically, through Presidential Decrees, Governmental and Ministerial Regulations, and administrative decisions and circulars.
individual citizens and the State, and all others, including corporations and foreigners were only allowed lease rights of varying tenure, usually for relatively short periods, and for specific purposes. The 1960 Agrarian Law was very important in ending the duality of land laws (between customary and national laws), in recognizing private property rights to land (the most widely held and valuable form of private property), and in setting out the intent to title and register these rights. Land reforms were also an important agenda. However, because land reforms were difficult to implement, it contributed to a slowdown in the subsequent implementation of the Government's intent to title and register all land. As a result, Indonesia still faces formidable difficulties in regard to the functioning of private land markets. The short leases on land held by business entities, although they are transferable and mortgageable, have constituted another major barrier to private development of land. However, in recent years, the Government has adopted a pragmatic approach to land ownership, titling, transfer, and lease problems. Policies are being considered to improve the functioning of institutions dealing with land, which might lead to more effective implementation of the titling and registration of lands. Lease terms for industrial estate and agricultural plantations have already been extended by changes in regulations. The Basic Law appears to provide an effective framework, and the main issue for the future is effective implementation that will allow land markets to work efficiently.

5. **Private Investment.** Another critical area in the relationship between the State and the private sector is laws governing private domestic and foreign investment. The Parliament passed the Foreign Investment Laws in 1967 (amended in 1970), and the Domestic Investment Laws in 1968. These two Basic Laws still provide the umbrella legislation governing investment activities by the private sector. Reflecting the stance of economic policies at the time, these laws give wide delegated powers to the Government to direct and control private investment. Subsequent deregulation of investment controls, as described in the previous section, have considerably diluted restrictions on private investment activity in the economy. It has also succeeded in attracting a sizeable investment response. The regulations/laws therefore do not represent major bottlenecks for private sector economic activities, at least in the near future. But in the longer-term, a revision of the laws and regulations may be called for since there are still considerable restrictions in the overall framework, for example, in regard to divestiture requirements for foreign investors, and restrictions on small-scale sector investments.

6. **Taxation.** A third important area is taxation. In 1984, new Tax Laws were legislated that adopted many features of a modern economic tax system, by eliminating a wide variety of tax-exemptions and loopholes, simplifying the tax structure, relying on relatively low tax rates, and extending the tax base. These reforms have resulted in major gains in domestic resource mobilization, and efficiency and equity.

7. **Banking and Financial Markets.** Banks and financial institutions play a larger role than most market organizations in the economy, because they hold an important part of the money supply, create money, are the main instruments of implementing monetary policy, and are in the nature of trusts sanctioned by Government to intermediate between savers and investors. Consequently, the regulation of banking and financial markets by Government is considered to be
essential. Three sets of different banking laws were legislated in the 1960s: (a) the 1967 Central Banking Act which set out the functions and obligations of Bank Indonesia; (b) the 1969 Banking Act which set out the functions and obligations of the commercial banks; and (c) various laws enacted at different points of time establishing individual state-owned banks. At the time that these laws were adopted, the banking sector was almost wholly state-owned. The principal task was seen to be to mobilize resources and direct credit towards preferred sectors and purposes. Wide powers were also delegated to the Government to achieve these objectives. Since 1983, and as described in the previous section, the Government has deregulated the financial sector permitting entry and expansion of private banks and providing for a more market-oriented and competitive banking sector.

8. **Capital markets** have operated without an umbrella legislation. However, under the powers delegated to the Government in the banking and financial markets laws, the Government has been delegated authority to formulate regulations for the development of capital markets. Both in regard to the banking sector and in regard to the capital markets, with the recent deregulation there has been very rapid expansion of the market and institutions. As a consequence, there is an urgent requirement for prudential banking regulations and for capital market regulations to substitute for direct controls in ensuring the safety and stability of the financial system. The Government is currently considering enactment of new banking laws, as well as insurance laws, and new laws/regulations covering capital markets that are expected to address these issues. It is of some urgency that these new laws and regulations be implemented and institutions strengthened to implement their regulatory functions.

9. **Intellectual Property.** The Government has enacted a Copyright Law in 1987, and a Patent Law is being reviewed by the Parliament and is expected to be legislated shortly. These are expected to address the concerns of the foreign community with regard to adequate protection of intellectual property rights in the framework of laws in Indonesia.

10. **Labor.** Indonesia enacted a comprehensive Labor Law in 1969. The intent of the law is to provide extensive protection to workers, and considerable powers are delegated to the Government to ensure the objectives. The basic framework of labor laws are sound, and the main problems facing the private sector are the excessive reporting requirements and formalities imposed, and lack of flexibility in implementing regulations, particularly in regard to working conditions, minimum wage and overtime requirements, termination of employees, and employment of foreigners. The regulations are not observed and/or often evaded by employers. They have also not been strictly enforced by the Government. The Government has also adopted a pragmatic approach, for example, by relaxing the strict restrictions on employment of foreigners in export-oriented activities. As a result, labor laws and regulations have not so far proven to be a deterrent to employment and private sector activities. Very recently, however, the Government has sought to tighten the enforcement of labor regulations--by prosecuting employers for violation of minimum wage laws and other regulations. This heightens the importance of a review of the existing labor regulations, to ensure that strict enforcement of rigid labor laws do not end up in constraining employment and distorting the functioning of labor markets.