THE INDONESIAN PERSPECTIVE ON LAW REFORM*

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Pembaharuan hukum ekonomi merupakan syarat mutlak bagi Indonesia dalam mengantisipasi kawasan perdagangan bebas APEC dan dalam rangka menghadapi perdagangan bebas dunia (GATT). Pembaharuan hukum, termasuk hukum ekonomi saat ini menjadi prioritas Pemerintah Indonesia. Dalam perkembangan ekonomi Indonesia 25 tahun mendatang (Pembangunan Jangka Panjang Tahap II) Indonesia memerlukan suatu sistem hukum yang memungkinkan negara ini dapat bersaing secara Internasional dan memberikan iklim yang kondusif bagi kegiatan ekonomi swasta.

Theoretical approach:

The economic law reform strategy of Indonesia is based upon the theoretical work of two Nobel Prize winning economists. They are Douglass C. North and R.H. Coase who have developed the theory of transaction costs and the structure of economic institutions. Douglass C. North opines: "The state can lower the costs of transacting through the development of an impersonal body of law and enforcement. Since the development of law is a public good, there are important scale economies associated with it. If a body of law exist, negotiation and enforcement costs are substantially reduced since the basic rules of exchange are already spelled out".[1]

Likewise, R.H. Coase writes:"In order to carry out a market transaction

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* Based on oral Presentation to Indonesia - Netherland Economic Law Dialogue in Jakarta on June 29, 1994.

[1] Douglass C. North, *Structure and Change in Economic History* p. 37 (New York: W.W. Norton & Co, Inc. 1981) [recipient of 1993 Nobel Prize in Economics].

it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, and to undertake the inspection needed to make sure that the terms of the contract are being observed. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost".[2]

Upon the premise of economic postulates as introduced by both North and Coase, the writer will examine the law reform perspective within the context of private sector activities in the Indonesian economy.

Legal Reform

Indonesia has hosted the November 1994 Asia Pacific Economic Cooperation (APEC) conference in Bogor. In addition, Indonesia is also a contracting party to the GATT. These conferences inevitably justify economic law reform policy set up by the government. The Government of Indonesia is committed to improving the environment for economic activity in the country and the process of economic reform is well underway. In addition to the need for sound economic policies, however, a strong consensus has developed in both the public and private sectors in Indonesia that modernization of the economic system requires extensive legal and institutional reforms.

As a matter of fact, there are some practical problems of doing business in Indonesia due to very complex and very old fashioned legal system. Although the Indonesia Civil and Commercial Codes are over one hundred years old, they continue to provide the foundation for commercial legal system. While these Codes are based on the Dutch Civil and Commercial Codes, the Codes enforced in Indonesia have not been revised (as have those of the Dutch) to keep pace with the changing demands of modern economic activity.

Empirical experience has shown that this leads to additional costs and risks for conducting business in Indonesia. It can be noted how many long hours must be required to secure a particular government permit - and how those hours might be more profitably spent on either production or sales

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[2] R.H. Coase, *The Firm, The Market, and the Law*, p. 114 (Chicago: University of Chicago Press, 1988) [recipient of 1991 Nobel Prize in Economics].

activities. It is also known how many Indonesian jobs might be lost if major contractual commitments cannot be counted upon. In addition, it should be realized that the increased costs of debt capital in those cases in which collateral cannot be counted on as security.

Past Achievements

Despite its antiquated commercial laws, Indonesia has achieved a great deal since the Government announced the first long-range economic plan over two-and-one-half decades ago. The achievements have included an average economic growth rate of 7% a year, one of the highest in the world. The per capita income of the Indonesian people have increased from a mere $50 a year in the mid-1960's to about $730 today. Many people, both in and out of Indonesia, believe that we may further achieve a per capita income of some $1,000 annually by the year 2000. Once a net importer of rice, Indonesia has achieved self-sufficiency in basic foodstuffs and has quietly laid the groundwork to become the newest member of that elite club known as the Asian Economic Dragons.

Despite these accomplishments, as we enter our next stage of economic development, Indonesia will need a legal system which is both internationally competitive and more conducive to private economic activity. While Indonesia has been hailed recently by members of the international press and business community as Asia's next big growth market, other individuals intimately familiar with the Indonesian market have become less optimistic.

Private Investment: A Quick Turn-Around, Yet Continuing Cause for Concern

One measure of the private sector's confidence in and satisfaction with Indonesia's economic environment is the attitudes of foreign and Indonesian business persons who conduct business in Indonesia. In this regard, the writer was very interested in reviewing two recent phenomena: *First.* A recent annual survey of one such group[3] concluded that economic law reform should be given a high priority if Indonesia is to continue its impressive past achievements in economic development. *Second,* the truly

[3] Summary Report of Result and Findings of the 1993 AmCham Indonesia Business Survey.

staggering figures showing an increase of foreign investments during the first part of 1994. Such investment has been reported to be up to US $ 22 billion with several months yet to go in 1994, as opposed to US $ 9 billion in all of 1993.

Both the 1993 survey and the increased investment figures following the recent GOI deregulation package in Government Regulation No. 20 of 1994,indicate the sensitivity of private investment to legal and regulatory reform.

A few of the items of the 1993 AMCHAM survey: shed light to the legal ramification of doing business as highlighted below.

It is disappointing that 1993 was the first time that there was a comparative decline in the perception of the overall attractiveness of the Indonesian business climate. In 1991, 47% of the respondents thought that Indonesia's business climate was either "better than average" or "among the best". That number in 1993 has dropped to 25%.

Other key points in the report related to what the members considered as the major impediments to business success in Indonesia and the most important areas to develop in order to improve the business climate:

* While the Number One impediment was said to be a shortage of managerial/professional talent, virtually every other of the remaining five perceived impediments related to economic law or institutional reform: (i) bureaucratic red-tape, (ii) an uneven playing field and (iii) infrastructure bottlenecks could all be realistically included as weaknesses of the legal system.
* When asked for suggestions to improve the business climate, improving the legal system ranked number three as a priority, behind only liberalize conditions for 100% foreign ownership and improve the tax system.

The outcomes of the survey confirm our own observation that the overall institutional, legal and regulatory environment is perceived by the business community and investors to be a major constraint to their activities in this country.

The constraints are especially difficult for small and medium sized investors and foreign investors. These groups often do not have the familiarity nor the established business connections with the Indonesian legal and business community which are often necessary to conduct business here. In the absence of a transparent, accessible legal system, personal connections and established reputations often take the place of legal rules which would otherwise provide for a more level playing field. We in the Indonesia government are convinced that the principal sources of such constraints are:

(1) the absence of an adequate economic law and related institutional frameworks for the efficient conduct of private to private transactions; and
(2) the overregulation and institutional bottlenecks in private to government transactions.

These two sources of constraints impose high costs and risks on private transactions.

Economic Costs and Risks/Reasons for Reform

Two main costs faced in private to private transactions in Indonesia are capital costs and legal costs. Collectively referred to by economists as "transaction costs"[4], these costs are important determinants of the economic efficiency and attractiveness of our domestic market.[5] Firstly, the capital costs that businesses face in our market are influenced by the effectiveness of our commercial legal system. Banks and other financial institutions will set interest rates and loan fees in accordance with the perceived risks and costs associated with making loans here. If lenders do not have adequate security mechanisms available to them for recovery on bad debts or if an effective system for the registration of security instruments does not exist, interest rates and loan fees will be higher than they otherwise should be. These simple economic principles are particularly relevant for Indonesia today. More legal certainty and security is needed in our legal system to permit banks and other financial institutions to reduce lending rates and fees, facilitating investment and capital formation in our economy. Secondly, if investors and businesses face cumbersome bureaucratic processes or frequent and lengthy delays in their economic transactions in Indonesia, capital

[4] See North, Douglass C., *Structure and Change in Economic History* (New York: W.W. Norton & Co., Inc., 1981) and Coase, R.H., *The Firm, the Market, and the Law* (Chicago: University of Chicago Press, 1988).

[5] According to Oliver Williamson, "Transactions, which differ in their attributes, are assigned to governance structures, which differ in their organizational costs and competencies, so as to effect a discriminating (mainly transaction cost economizing) match." Efficient "government structures" can be standard or specifically tailored, and range in form from market sales to vertically integrated corpotations. The law enchances efficiency to the extent it promotes flexible private structuring of transactions, in which the contracting parties determine the acceptable level of transaction cost associated with negoitation, safeguards, monitoring, adjustment, and enforcement. Williamson, O., *The Economic Institutions of Capitalism*, p.387-9 (New York: The Free Press, 1985).

formation and our standard of living will suffer; productive investments will be deterred or businesses will increase prices to recover their high transaction costs. Moreover, if unnecessary legal barriers make it difficult and costly to form, expand, and dissolve business entities in Indonesia, competition and efficient microeconomic decision-making are distorted.

As the economy of Indonesia becomes increasingly integrated into the global economy, the importance of law reform and the modernization of our legal institutions is magnified. Our products and services now compete in international markets, and our economic strategy is increasingly dependent upon export-led growth. To improve the international competitiveness of Indonesian goods and services, the costs and risks associated with our legal system must be reduced. In addition, competition for foreign investment has intensified in Asia and around the globe. The attractiveness of a particular market for foreign investment is now influenced by the efficiency, predictability, and fairness engendered by its domestic commercial legal system. Thus in addition to the liberalization of our foreign investment rules and regulations to improve the attractiveness of the Indonesian market for foreign investment, improvements in our commercial legal system are essential.

Indonesia is Committed to Reform

The Indonesian government is convinced that *it is now time* for commercial and economic law reform. As we "deregulate" and "debureaucratize" the Indonesian economy to improve market and productive efficiency, we have become increasingly aware of the importance of economic law reform. In order to facilitate private transactions and encourage productive domestic investment, our commercial laws and commercial law enforcement mechanisms need to be transparent, predictable, and responsive to the needs of the private sector. Investors, creditors, managers, and other economic actors need to be confident that contracts will be enforced, that economic transactions will be free from arbitrary government interference, and that investments or loans will be secured. In addition, the law should keep transaction costs and other non-essential costs to a minimum, and information about the legal system should be easily accessed.

Our goals may seem ambitious. But the will is there. The desire is real. After 25 years of political, economic, and social progress, Indonesia is ready to make the leap to the front-line, to the ranks of economically developed

and prosperous nations. We believe that economic law reform does and will play a pivotal role in ensuring the success of our economic ambitions.

The commitment to law reform in Indonesia is clear among influential individuals at the highest levels of our government. The Coordinating Minister for the Economy, Finance and Development Supervision, Dr. Saleh Affif, has himself made strong statements about the law. In his commencement address to the University of Indonesia Business School graduates, he said:

> *"We are also moving to create a more effective legal system that will further ensure that economic outcomes are consistent with our social aspirations. Indeed, the development of an effective legal framework in its broadest sense-including a strong judiciary to ensure effective and full implementation of the law, and access by all to information regarding the law and its current interpretations - will not only lower transaction costs but yield considerable external economies. More secure contractual relations will engender greater confidence by investors and consumers, domestic and foreign".*[6]

And these words have been translated into action. Consider, for example, the three latest deregulation packages in June and October of 1993, and recently PP 20 of 1994. In these packages, the government provided additional investment incentives by decreasing bureaucratic approvals, trimming the list of items closed to foreign investment, by reducing both tariff and non-tariff barriers, by creating new export production zones, and by reducing restrictions on percentage ownership by foreign concerns.

Despite their great success, efforts at economic reform like the deregulation packages are not enough. In the face of enhanced competition for international investment, we know that the time has come for a more deep-rooted change.

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[6] Prof. Dr. Saleh Affif, *Peran Sector Swasta dan Pemerintah dalam Pembangunan Indonesia*, Commencement Address, Universitas Indonesia, October 30, 1993.

Law Reform and ELIPS[7]

Law Reform, including economic laws, is now a high government priority. Several ministries, including the office of the Coordinating Minister for Economy, Finance and Development Supervision as well as the Ministry of Justice, are busy establishing a national agenda for law reform and reviewing those elements of the legal system that require urgent attention.

The National Law Development Agency, known as BPHN of the Ministry of Justice, has initiated a massive program for reviewing all existing Indonesian legislation, with many of Indonesia's best academic and practicing lawyers now offering concrete suggestions for immediate legislative action. This national legislation program aims at replacing all colonial laws while introducing new law as required by the development of the Indonesian Economy.

The "Economic Law and Improved Procurement Systems" (ELIPS) Project provides resources to Government agencies, Universities, and the private legal sector in Indonesia, as part of an on-going effort to improve the accessibility and efficacy of existing economic laws and regulations. Our objectives include improving the publicity, the clarity, the certainty, and the predictability of our laws and legal procedures.

Some fifteen to twenty fields of law will be examined in the *law development component* of the ELIPS Project. Of these, eight areas have been targeted for priority for the Project's first two years. The eight areas are *contracts, company law, secured transaction, capital markets, intellectual property, negotiable instruments, bankruptcy, and arbitration.* Project plans for each of these areas include occasional seminars to gather and dispense information on needed legal reform, as well as the drafting and refinement of proposals for new or revised laws and regulations.

Yet the approach we are taking to law reform in Indonesia is not limited to the improvement of our written substantive laws. We also understand that an effective modern legal system requires human, institutional, and technological resources that will foster efficient commercial transactions. Thus in addition to a law development component, our law reform program incorporates a *legal training component, a legal information component, and an improved procurement systems component.* With the assistance of Indonesian

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[7] ELIPS is an economic law reform project undertaken by the Indonesian Government sponsored by the office of the Coordinating Minister for Economy. Finance and Development Supervision (EKKU dan WASBANG) with financial assistance from us Agency for International Development. The project will run through 1996.

and international experts in each of these four areas, the ELIPS project has become an important force for economic law reform in Indonesia.

Human Resources - Legal Education and Training

Thus we realize that in addition to efforts at substantive law reform, much work must be done to improve the implementation, application, and dissemination of our laws. In Indonesia, we need lawyers, professors, and judges who have a sophisticated knowledge of economic law and commercial legal transactions. These legal professionals will then be able to apply our commercial laws consistently and fairly and our dispute resolution mechanisms will be more responsive to the demands of private commercial activity. Our current methods for economic law training and the dissemination of knowledge about international commercial legal norms and practices need to be improved. To promote these objectives, the legal training component of the ELIPS project is very important. At ELIPS, we are working to enhance the knowledge of Indonesia's current and future economic law professors and practitioners. Through seminars and study tours, the knowledge base of the Indonesian legal community in economic and commercial law is improving.

Availability of Law - Legal Information Systems

In addition to promote the efficient functioning of our economic system, information about the law needs to be clear, reliable, and accessible. Hence, all our laws, regulations, and legal decisions should be published, and this legal information should be readily available and in a form that is easily accessible to all participants in our economy. The ELIPS legal information team is making progress collecting and organizing our disparate laws, regulations, and legal decisions, and an effort is underway to transfer this to enhance the administration and implementation as well as the accessibility and reliability of our commercial legal system.

Substantive Law Reform - Law Development

Nevertheless, any effective legal system must start with a sound written legal framework. If the laws themselves do not promote efficient economic

activity, their implementation and application are unlikely to do so. The review and improvement of this legal framework in Indonesia is the objective of the ELIPS law development component. I would now like to elaborate on four areas of commercial law that I alluded to earlier in which the private sector has encountered problems. These areas are company law, arbitration law, capital markets law, and the law of secured transactions.

Company Law

The company law of Indonesia, based on Articles 36 to 56 of our Commercial Code, poses a number of problems for efficient private economic activity. While some of the unproductive costs and delays associated with our company law are due to difficulties in effective implementation, other costs stem from a lack of clarity and comprehensiveness in our company law. For example, while it is generally understood that the formation of a limited liability company requires (1) the filing of a notarized deed with the Ministry of Justice, (2) the approval of the deed including the purpose, duration and authorized capital of the company by the Minister of Justice, and (3) the publication of this approval in the State Gazette, it is not clear in the law when a limited liability company is, in fact, established nor who is liable for the actions of the company in the interim periods between filing, approval, and publication. These problems create uncertainty and unnecessary legal costs for newly established entities; and because the delay between filing a deed and publication in the State Gazette can be between one and two years, the potential liability exposure can be substantial. Directors and stockholders must, therefor, assume joint and several liability for company activities before official approval or publication, or investment plans may be delayed until limited liability is assured.

In addition to the uncertainty and cost associated with business formation, our company law lacks adequate rules for efficient, inexpensive business expansions, merger and acquisition, and dissolution. For example, all changes in the purpose, authorized capital, and duration of companies in Indonesia must be filed with the Minister of Justice by notarized deed. This results in the additional costs and delays associated with Minister of Justice approvals. In addition, our company law lacks merger and acquisition provisions so that companies now must transfer assets from one corporation to another and dissolve the prior entity to accomplish the desired result. Moreover, our company law lacks bankruptcy provisions for private receivership and the law has stipulated that upon a 75 percent loss of authorized capital

the corporation is automatically considered dissolved. These problems have limited the efficiency of microeconomic decision-making in the private sector and increased the barriers to entry, expansion, and exit from our market.

Arbitration

To facilitate private economic transactions, an important mechanism for the resolution of commercial disputes is arbitration. While Indonesia currently has a National Arbitration Board, known as BANI, its effectiveness has been limited. This has been due to a number of factors. First, there has been a lack of knowledge, information, and awareness about the concept and potential advantages of arbitration in Indonesia. Second, there is a fear that arbitration awards cannot always be enforced here. This fear stems from the unwillingness of some losing parties to voluntarily comply with arbitration awards and the willingness of the court to re-examine the substance of arbitration decisions. Third, existing legal provisions on arbitration contained in the current law are out of date and ambiguous and thus do not sufficiently guarantee legal certainty. Finally, while the BANI arbitration rules are fair and even-handed, BANI's arbitration panel is comprised only of Indonesian nationals. Both foreign and local businessmen have expressed some concern that Indonesian arbitration may be subject to political or economic pressure in rendering their decisions. All of these factors have limited the confidence of businessmen in the reliability and enforceability of their private arbitration agreements in Indonesia, increasing legal uncertainty and the need to develop other means for enforcing commercial agreements in our market.

Capital Markets Law

The capitalization of the Indonesian stock market may be negatively affected by the absence of disclosure requirements in a capital markets law. As a result, domestic and international investors are less able to collect complete, reliable information on the companies in which they would like to invest and the pace of market capitalization is slowed. While increases in the voluntary disclosure of financial information by domestic companies has resulted in the growth of our market capitalization, legal disclosure requirements in a capital markets law may significantly facilitate further growth. These disclosure requirements should be simple and inexpensive for smaller enterprises and more extensive for larger publicly-held companies. While our

stock market capitalization grew to $34 billion in 1993, Indonesia continued to trail the capitalization of our ASEAN neighbours Thailand (at $150 billion) and Malaysia (at $230 billion).[8]

Secured Transactions Law

Similar to the problems encountered in our company law, the establishment of security instruments under current Indonesian law has been problematic. A security interest in "immovables", called a hypothec, is a principle form of security interest officially recognized in our Commercial Code; unfortunately, its creation can be a costly and lengthy process. It is only possible to establish a hypothec for land, an aircraft, or a ship. Because only Indonesian citizens can own land, the most common object of a hypothec, companies and foreign individuals have lacked sufficient means for securing their debts. While fiduciary transfer have been used in practise for security in movables in Indonesia, there is no system for their registration or the notification of their existence to creditors. Creditors are often unaware of the existence of previous fiduciary transfers placed on property and execution of these security instruments can result in multiple, conflicting claims and potentially costly litigation. In addition, it is not clear whether the law will recognize hypothecs which are secured for buildings which are built on land that is not owned by the debtor, a common dilemma for foreign and domestic investors. The uncertainty and risk which is associated with loan transactions secured by such instruments may result in higher interest rates, over-collateralized transactions, or inadvertent under-collateralization and multiple, competing security claims. All of these outcomes increase the costs of doing business in Indonesia and depress our potential economic growth.

While a system exist for the registration of hypothecs at local land registration officers, its use has not been free from uncertainty and unproductive costs. A hypothec requires the registration of a notarized deed with the local land registration office. A land book is then prepared and a dated hypothec certificate is issued; the date determines the rank of the security interest in that property. The hypothecation process can take two or three months and involve substantial legal costs. The hypothec certificate is then given to the creditor to serve as an "execution instrument" if a default occurs. In practice, however, execution must be authorized by a court and

[8] Jakarta Post, June 2, 1994, p.9.

this often results in delay or litigation. Moreover, there have been substantial problems with the issuance of multiple, "semi-official" land certificates used to obtain hypothecs which are either not registered with the land office e or are completely fabricated. Business News reports that there have been "thousands of such cases of double certificates".[9] Such problems of registration and verification of security interests increase the uncertainty and risk encountered by creditors in the Indonesian market; interest rates and other costs of credit for investors thus increase commensurately. Because effective, reliable security instruments are essential for the efficient transfer and productive use of capital, the improvement of our current secured transaction law is a high priority for the Indonesian government.

Conclusion

While other problems exist with our company law, arbitration law, our capital markets law, secured transactions law, and other commercial laws, these examples have hopefully given us an idea of the type of practical economic law reform problems we face today in Indonesia. Through our current comprehensive effort at economic law reform, we are modernizing our commercial law system to facilitate private and public investment, improve productivity, encourage innovation, and augment our international competitiveness. In addition, a more reliable, accessible, and predictable legal system will support the activities of smaller and newer firms in our economy.

Thus our objectives for law reform in Indonesia are, indeed, ambitious. Through comprehensive and continuous economic and commercial law reform, we hope to increase employment to keep pace with the growth of our work force, improve the transfer and absorption of technology into our economy, increase the value-added by our companies, reinforce our growing export base, and improve the living standards of all of our citizens.

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[9] Business News, June 1, 1994, p.2. Business News reports that "more difficult cases involve 'semi-official' (aspal) certificates using genuine forms, seals and signatures but they may not be registered. Or they may be registered with no account taken whatsoever of the fact that certificates have previously been issued for the same land".