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# Legal Process and Economic Development

## A Case Study of Indonesia

Cheryl W. Gray

Risk and information costs affect many characteristics of the legal process in developing countries. Two opposing models — formal and informal — show how these countries use different means to handle legal functions.

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Westerners often complain that laws are not enforced in developing countries. "Good" laws are on the books, but in reality individuals and firms evade them with impunity. For example, taxes are uncollected, bankruptcy laws unenforced, environmental controls ignored, and trade restrictions evaded. Furthermore, corruption often flourishes in government despite repeated condemnation by public leaders. How can these patterns be explained? Are the legal systems of these countries in chaos? Or do they just work in other ways, more obscure to Western eyes?

This paper tries to unravel the nature of legal processes in developing countries and explain how and why they may differ from legal processes in more advanced nations. Gray identifies

three broad functions of a legal system and introduces the central theme of the paper — how risk and information costs affect many of the characteristics of the legal process.

She next proposes two opposing models — the "formal" and the "informal" — to illustrate different means by which legal functions can be handled. While these models are presented as contrasting alternatives for purposes of exposition, neither pure prototype exists in practice. Real life is always some mixture of the two, with the balance shifting from country to country.

Gray then describes formal and informal legal processes in Indonesia, using the Indonesian tax system as a case study.

This paper, a product of the Office of the Vice President, Development Economics, is part of a larger effort in PPR to understand the regulatory and legal framework underlying market systems in developing countries. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Bilkiss Dhomun, room S9-037, extension 33765 (39 pages).

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One often hears Westerners complain that laws are not enforced in developing countries. "Good" laws are on the books, but in reality individuals and firms evade them with impunity. For example, taxes are uncollected, bankruptcy laws unenforced, environmental controls ignored, and trade restrictions evaded. Furthermore, corruption often flourishes in government despite repeated condemnation by public leaders. How can these patterns be explained? Are the legal systems of these countries in chaos? Or do they just work in other ways, more obscure to Western eyes?

This paper tries to unravel the nature of legal processes in developing countries and explain how and why they may differ from legal processes in more advanced nations. Section I identifies three broad functions of a legal system and introduces the central theme of the paper--how risk and information costs affect many of the characteristics of the legal process. Section II proposes two opposing models--the "formal" and the "informal"--to illustrate different means by which legal functions can be handled. While these models are presented as contrasting alternatives for purposes of exposition, neither pure prototype exists in practice. Real life is always some mixture of the two, with the balance shifting from country to country. Formal and informal legal processes in Indonesia are described in Sections III and IV.

## I. Introduction

### Functions of a Legal System

The legal system of any country has three broad functions. The first function is to set rules and standards by which society is to operate. Both

the feasibility of impersonal contracts in an economy and the efficacy of government regulation will depend to a large extent on the objectivity and dependability of the standards set by the legal system.

The second function is law enforcement. For governments to operate, they need a viable means for taking recourse if an individual's actions are not in line with the rules set by the lawmaking process. Enforcement need not always be active, because the mere existence of the threat will act to deter wrongdoing much of the time.

One important aspect of law enforcement is oversight of government administrators themselves, because policy can be carried out only through such third party agents. Oversight is needed to insure that an agent's actions promote the letter and spirit of the legal standards set by the principal--in this case elected officials and/or top government policymakers--rather than any divergent personal goals of the agent. Like enforcement, oversight can take many varied forms and need not always be actively pursued to be effective.

The third function is dispute resolution. Efficient procedures to handle grievances that may arise during policymaking and administration both promote the willingness to comply on the part of the public (thereby easing the enforcement function) and provide a check on agents' actions (thereby easing the oversight function). Furthermore, a means to resolve disputes between private parties is needed if private contracts are to be viable.

#### The Role of Risk and Information Costs

The central theme of this paper is that many of the characteristics of the legal process in developing countries today can be explained as direct

or indirect adaptations to risk (whether from natural, commercial or political sources) and to the high cost of information in those countries. These two variables have far-reaching effects on the legal system, influencing both its organization and its day-to-day operations.

In primitive societies

In very primitive societies, the high cost of information derives from the general lack of knowledge concerning the laws of nature (evidenced by widespread belief in supernatural forces) and the rudimentary technology available for transportation and communications. The absence of writing characteristic of many primitive societies further contributes to the costs of obtaining information, because no recourse can be made to documentation if questions arise concerning past events. Under such conditions it is difficult to determine, for example, whether a neighboring tribe is trustworthy in trade or whether a particular land transaction took place years before.

The high cost of information contributes to an atmosphere of general uncertainty. Furthermore, the lack of technology and education exacerbates risks from natural causes such as crop failure and disease that would be

present to some degree even with full access to information. 1/ Natural risk is perhaps the most prominent type of risk in primitive societies. Commercial risk is mitigated by the fact that most transactions are local and simple in form, and political risk is reduced by the traditional, hierarchical, relatively stable organization of society.

Certain common characteristics of primitive legal systems reflect adaptation to risk and high information costs. 2/ For example, collective responsibility of all members of a kin group or village for offenses committed by one member is a common theme. This promotes self-policing, placing an extra burden of control on those most likely to know the personalities and predilections of the potential offender. It also serves as a deterrent, because an individual will be less likely to commit an offense if the risk of punishment falls on others as well as on himself.

Other adaptations to risk and high information costs in primitive legal systems include:

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1/ As used in this paper risk refers both to indeterminateness that could be resolved with sufficient access to existing information (i.e. uncertainty) and to the indeterminateness of chance events whose outcome could not be known even with unlimited access to existing information. Some forms of risk, such as the risk of drought, of certain types of disease, or of political upheaval, are systematic, meaning that all members of a society are likely to be afflicted if any one member is. Insuring against systematic risk is difficult even in the best of circumstances. Other types of risk, such as the risk of accident or of death in childbirth, are nonsystematic and are therefore easier to spread across the members of a society through collective insurance mechanisms.

2/ For examples of these adaptations in Indonesian traditional ("adat") law see ter Haar (1962), and in European common law see Berman (1978) and Holmes (1881). Also see Posner (1981) for further discussion and references.

- o a reliance on collective enforcement action to increase the likelihood of detection;
- o the invocation of the supernatural to fill an information void when information on natural cause and effect is scant;
- o the use of symbols (such as gift-giving or physical identifying marks) to signal intent between strangers or physical identifying marks to provide evidence of ownership in the absence of written legal documents;
- o a heavy reliance on witnesses to insure the legal validity of transactions; and
- o a reliance on custom and legal presumptions to reduce information needs in each individual transaction.

#### In developing countries

The costs of obtaining a specific item of information generally fall as development proceeds, because education and technology improve and written records become more common. The degree of unavoidable risk associated with natural phenomena such as disease and crop failure is also likely to decline as the accumulated knowledge of a society grows and technology improves.

However, as the scope and sophistication of human interaction increases, the complexity of the information demanded increases as well, and the forms of risk multiply. In addition to risk from natural causes (such as disease and crop failure), new forms of commercial risk emerge as circles of commercial and political interaction expand beyond the family, clan, or village. Political risk is also likely to increase due to the accelerated rate of political change characteristic of modernizing societies and the resulting political instability. The premise of high risk and high



information costs is still likely to apply in many developing countries today, particularly when compared to developed countries where political systems tend to be more stable and means of risk spreading more developed.

Specifically among the factors exacerbating the high cost of information in today's developing countries are the following six:

1. Compared to more advanced economies, developing countries still face a shortage of physical capital for investment in transportation and communications equipment. Furthermore, the low level of per capita income inhibits demand and thus restricts the scale of capital investment. Roads are likely to be poor, telephone lines unreliable, and mail service slow. More remote areas may be entirely unreachable through modern means of transport and communication.

2. Governments in developing countries also face a shortage of human capital. The educational system is poor, lacking a sufficient number of well-trained instructors and adequate funding for staff, facilities, or supplies. Poor education restricts the ability of civil servants to process information accurately and efficiently. It also limits the ability of the members of the society to carry out relevant research and to accumulate a stock of knowledge to lower the costs of obtaining and processing information in individual cases.

3. The "watchdog" professions, such as accounting and journalism, are still in relative infancy. In Indonesia, accounting standards are not well-developed, the number of well-trained accountants is limited, and the accounting profession is not effectively regulated by itself or by outside parties. Although the press is not explicitly controlled, its freedom is limited in practice by government licensing practices.

4. Because of limited facilities and training, the investigative machinery of the state is not as efficient as in developed countries.

5. Reporting requirements do not exist or are not regularly followed by companies in developing countries, in part because of the absence of credible enforcement tools.

6. The public sector does not have a well-developed tradition of recordkeeping and reporting. For example, no Indonesian court other than the Supreme Court publishes its decisions, and the Supreme Court has only begun to publish cases recently. Furthermore, the reports that are prepared are not readily available to outsiders. Accounting firms typically hire tax officials to "leak" important documents, such as copies of advisory opinions interpreting regulations or even the regulations themselves.

For these and other reasons, developing countries face higher information costs than developed countries.

## II. Two Models of the Legal Process

Two contrasting models of a legal system illustrate the far-reaching impact of risk and information costs on the legal process. Most Westerners are likely to be most familiar and feel most comfortable with the first model, but the second is more likely to approximate reality in much of the developing world.

### The "Formal" Model

An independent and well-functioning formal legal system provides the underpinnings for the first model of the legal system, the "formal model".

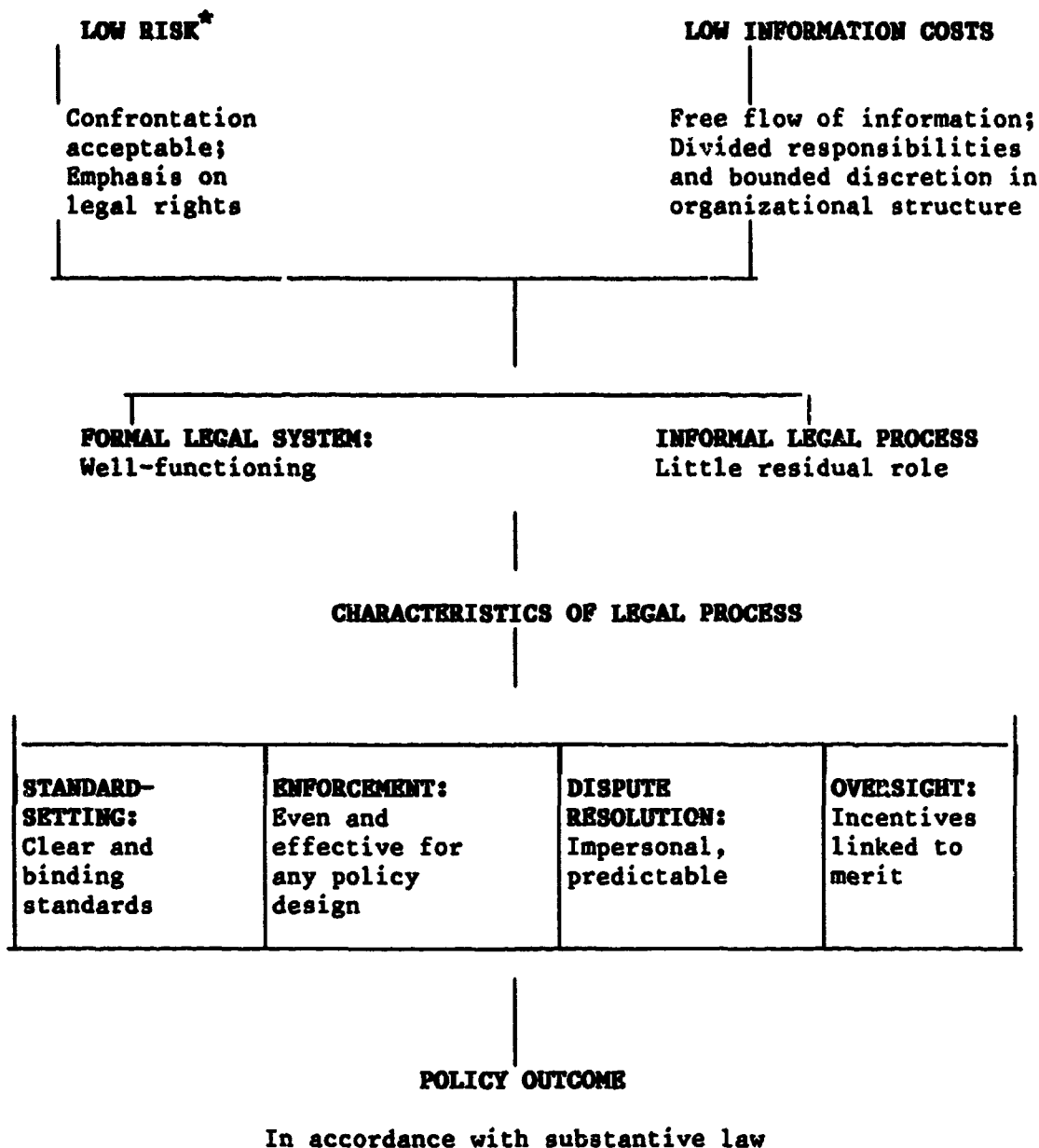
This model reflects in large part Max Weber's ideas on the ideal type of bureaucratic organization. <sup>3/</sup> Furthermore, it tends to reflect the system of government pictured in the formal constitutions and laws of many countries, although it may differ markedly from actual practice in these countries. The formal model exists nowhere in perfect form, although elements of it may be found in most countries, particularly in developed countries where lower information costs and more impersonal mechanisms for the spread of risk increase its feasibility. When Western advisors work in nonwestern countries helping to design policies and draft laws, this model often forms the basis, whether consciously or unconsciously, of their hopes and expectations concerning the role of the legal system in public administration. It is presented here primarily to provide a contrast with the informal model described later.

In fulfilling the three legal functions of standard setting, enforcement, and dispute resolution, the formal model is characterized by "rule by law", divided responsibilities, bounded discretion, and merit-based incentives. Because of the successful fulfillment of these functions, substantive results mirror the goals embodied in the laws passed by the legislature. The model is pictured in Figure 1 and the characteristics of the legal process envisioned in the model are described below.

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<sup>3/</sup> Weber (1947), p. 330.

Figure 1 The formal model of the legal process



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\* Or efficient market mechanisms for risk-spreading.

Standard-setting: "rule by law".

In the formal model, standards are set by the legislature and the courts through the passage of laws and the resolution of cases. Government policy and substantive law are synonymous, in that the law reflects the policy, and no policy is to be implemented except as provided by law. For example, a law providing for a tax rate of 35 percent means that such rate has been decided upon as the proper policy and will be applied in practice to the extent possible. Laws function as clear directives and are taken seriously as guides to administrators, the judiciary, and the public. Laws are intended to be applied consistently and universally.

Enforcement and dispute resolution: divided responsibilities and bounded discretion

Administration of governmental functions is organized hierarchically in the formal model, with responsibilities over discrete tasks divided among personnel to promote specialization and expertise. Policymaking is carried out by the legislature and is clearly divided from administration. "Legal" functions of enforcement and dispute resolution are assigned primarily to separate formal legal bodies, including courts, the police, and the public prosecutor's office.

Each official position carries with it a specified and limited sphere of competence regardless of the person occupying it. Clear and orderly procedures specify how tasks are to be accomplished. The discretion of officials is limited in the formal model by the clear standards set in the substantive law and court decisions and by the checks and balances provided by internal and external oversight procedures. No individual has a total monopoly over a decision, without possibility of review by another, and final

review rests with the top level of the formal legal system. Access to information is dispersed to accommodate review.

The nature of standards: a focus on substantive concerns

Standards set by laws and regulations in the formal model reflect the substantive concerns of the public and its elected leaders. For example, the tax law reflects the legislature's decisions as to the optimal amount of revenue, degree of progressivity, and incentive structure produced by the tax system. Administrability is not a central concern of legislators; they presume that whatever substantive provisions they decide on will be implemented by the tax administration as directed by law.

Oversight: incentives linked to merit

The rewards and sanctions applied to administrators (including officials carrying out legal functions such as law enforcement) in the formal model are directly related, at least in part, to their performance in furthering the attainment of policy goals. The incentive system is finely-tuned and reliable.

Candidates are selected on the basis of technical qualifications. Once selected, they are subject to authority only with respect to their official obligations, and they owe allegiance not to an individual but to an impersonal order. In the office there is a spirit of professionalism, of "formalistic impersonality", without the intrusion of personal concerns.

Official service is a career, the sole (or at least primary) occupation of the incumbent. Promotion is dependent on the judgment of superiors in the officially-defined hierarchy, and is based at least in part on merit. Although internal procedures determine rewards and sanctions in the

first instance, such determination is subject to review by external oversight bodies, including the formal legal system.

Results: In accordance with substantive law

The outcome of policymaking in the formal model is the attainment of policy goals through the full enforcement of the letter of the relevant law. For example, because of effective enforcement, oversight, and dispute resolution, the passage of a new tax law results in the collection of the potential revenues due given the provisions of the new law. Similarly, new regulatory initiatives direct and/or restrain business activities along the lines laid out in the laws. Because results closely match expectations, careful quantitative analysis of the impact of proposed legislation is warranted.

What are the implications of this model of public administration for the fulfillment of legal functions? In essence it implies that legal standards are clear, that enforcement of written laws is complete, that oversight of officials is effective, insuring the fulfillment of professional responsibilities, and that disputes between government and private parties are resolved fairly and efficiently by specialized organizations, primarily the formal legal system.

The Effect of Risk, Uncertainty, and Information Costs

The critical shortcoming of the formal model of the legal system is its reliance on the easy availability of information and on impersonal means of risk spreading. It implicitly assumes all participants are informed about the contents of the substantive law, about the activities, performance and motivation of other civil servants, and about the effects of government

actions. No question is raised as to how such knowledge is arrived at or to what resources must be used in attaining it. Furthermore, because impersonal means are assumed to exist to spread risks, individuals need not depend on each other for security and can thus interact on an entirely objective and professional basis.

The formal model does not describe reality in either developed or developing countries. That the reality of government administration in the United States is different from this model is clear to most Americans. Many laws on the books are not enforced in practice, either because the laws no longer fit society's conceptions of right and wrong or because full enforcement would be prohibitively expensive. For example, minor drug offenses are often overlooked by the police, not all taxes owed to the government are in fact collected by the IRS, and speed limits are not rigorously adhered to by the population. Furthermore, loafing on the job, personal favoritism, and outright corruption are all present to varying extents in U.S. public administration.

The divergence of reality from the formal model is even more pronounced in developing countries such as Indonesia. The weakness of formal legal protections and corresponding reliance on patron-client ties for security enhance the subjective nature of personal relationship both within the civil service and between government officials and private citizens. The high cost of information inhibits the operation of oversight mechanisms that serve to limit monopoly and discretion within government offices. The resulting reality is more likely to approximate the second model of the legal system and policy administration, the "informal model."



The "Informal" Model

An assymetric distribution of both information and risk aversion, with resulting principal-agent problems, underlies the informal model of the legal system depicted in Figure 2. In contrast to the Weberian formal model described above, the informal model of the legal process has the following characteristics.

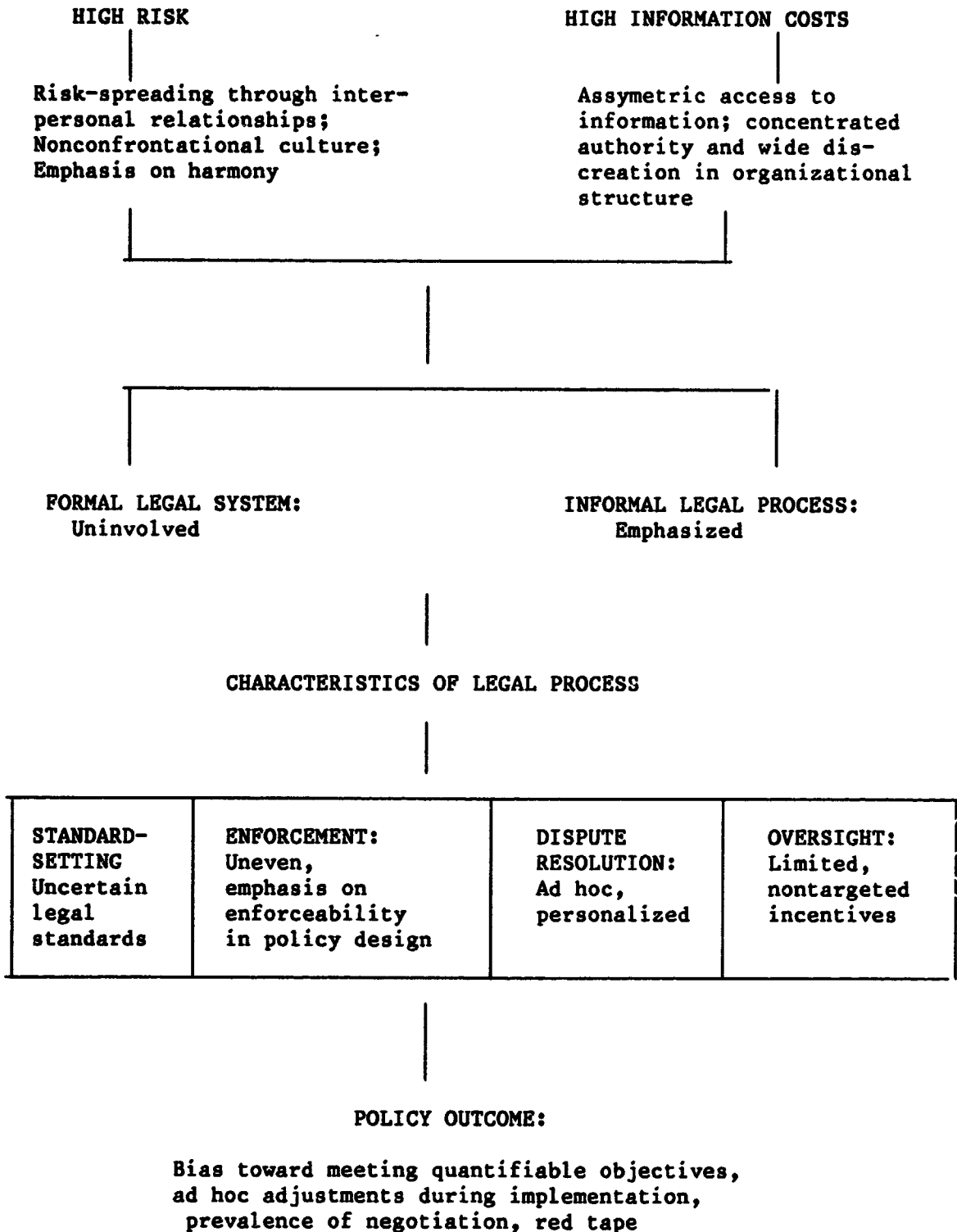
Standard-setting: uncertain standards

Clear legal standards are conspicuously absent in the informal model. Although the legislature may have the task of setting standards through the passage of laws and the judiciary may have the task of setting standards through the resolution of disputes, neither has sufficient expertise, authority, or access to day-to-day information needed to carry out the standard-setting function. As "agents" for the legislature, government ministers may or may not follow the letter of the law in issuing decrees and regulations. As "agents" for the ministers and the courts, lower-level officials may or may not follow laws, decrees, regulations, and court decisions in carrying out their official duties. Inconsistent standards for the public at large result from these multiple levels of principals and agents within the government hierarchy.

Enforcement and dispute resolution: concentrated authority and wide discretion

The distribution of authority among governmental organizations in the informal model reflects the high cost of information. This high cost sets limits on the extent of information exchange and leads officials to avoid delegation of power to agents whenever possible. With regard to the

Figure 2 The informal model of the legal process



horizontal distribution of authority among supposedly equal branches of government, rather than divide the responsibility for various functions among the different branches (which would require a constant exchange of information), authority over any particular substantive area tends to be concentrated within one office. Not only policymaking and administrative functions but also legal functions of enforcement and dispute resolution tend to be monopolized by the administrator with first-hand access to relevant information. Therefore, administrators rather than formal legal institutions become the primary legal actors in the informal model.

With regard to the vertical distribution of authority among administrators, delegation of authority to agents is avoided whenever possible because of the difficulties of monitoring their activities. The high cost of information inhibits centralization in certain instances, however, placing significant practical authority at lower levels of the bureaucracy.

Because of limited oversight capability, officials have wide discretion as they carry out enforcement and dispute resolution functions. The result can be personalized, ad hoc and rather arbitrary legal procedures. Discretion is limited only by cultural adaptations to risk, namely the highly subjective nature of interpersonal relationships and the emphasis placed on the avoidance of confrontation.

The nature of standards: a focus on enforceability

Because of the monopoly position of officials with access to information, day-to-day standard-setting is closely intertwined with the administration of such standards. Therefore, the substance of policies is more oriented toward administrative concerns than in the formal model.

Without outside bodies (such as courts) to assist reliably in enforcement, policy makers try to facilitate enforcement by setting up "roadblocks" and interlocking requirements in an attempt to force private parties to reveal information and comply with legal requirements. Five common characteristics of such policies--the stress on preventive screening, on linkages between administrative systems, on third-party responsibility, on presumptions, and on simplicity in policy design--are illustrated in the Indonesian case in Section IV below.

Oversight: non-targeted incentives

In contrast to the merit-based incentives of the formal model, incentives and oversight in the informal model are not necessarily tied directly to merit. High information costs and cultural adaptations to risk impede oversight for several reasons.

First, setting clear objectives and measuring their degree of attainment is difficult. Multiple and often ill-defined monetary and social objectives tend to exist. Readily identifiable and measurable objectives can be expected to take priority in practice, while those that are more obscure or harder to quantify fade into the background.

Second, the value of individual performance in furthering group objectives is often difficult to measure accurately. Factual information on individual actions may be hidden by the organizational forces--nondelegation, monopolization of tasks, intentional restriction on outside access to records--identified earlier. In addition, cultural adaptations to risk inhibit the flow of information on performance, as people are hesitant to upset interpersonal relationships by criticizing each other. Furthermore,

setting objective performance standards is difficult when government's output is a public good because of the lack of competition from other "producers."

Third, overseeing supervisors tend to be hesitant to assert authority. They often lack accurate information on the actions of employees and the impact of such actions. In addition, they hesitate to disrupt personal relationships and sometimes fear that applying sanctions will rebound to their own personal harm, give the possibility of reprisal from powerful persons against which the formal legal system provides no protection. Furthermore, the authority to apply sanctions against one person is of questionable legitimacy in the minds of many civil servants in developing countries, given low official salaries and the fact that many other people may appear culpable as well.

In addition, while asymmetric information in the employer-employee relationship points to the need to place greater risk on the employee by linking rewards more closely with performance, asymmetric risk aversion points in the opposite direction. Lower-level civil servants generally have limited means and are risk-averse, while employers (superior officials) have wider responsibilities and are likely to be less risk-averse with regard to the actions of any particular employee. Placing greater risk on the employee--the party with greater access to information--would therefore not necessarily be the most efficient solution to the oversight problem. 4/

Because of these barriers to merit-based incentives, salary and promotions in the informal model are based exclusively on noncontroversial and

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4/ For an analogous argument in another context, see Joseph E. Stiglitz, "Incentives and Risk Sharing in Sharecropping," Review of Economic Studies, April 1974, pp. 219-225.

easily measurable indices, such as educational background and seniority. Such nontargeted incentives do little to motivate civil servants to achieve particular policy goals. They can also lead to adverse selection, attracting less capable or less honest persons to the civil service. More capable and/or honest persons may be unwilling to work if the compensation offered is less than their worth to the organization.

Results: ad hoc adjustment, negotiation, and red tape

The combination of unclear and loosely applied standards, monopolized authority, wide discretion, and nontargeted incentives leads to a relatively undisciplined bureaucracy in which negotiation is commonplace. Rather than lobby primarily at the lawmaking stage, private parties potentially affected by policy change can wait until a general law is enacted and then lobby administrators for individualized relief or additional benefit. Without effective oversight, administrators as well as private parties stand to gain from such negotiation. Only highly visible and quantifiable public interest goals have a chance of being met. Other public interest goals are likely to be submerged in a sea of private interest concerns.

Outlined above are two contrasting models of the legal process, one (the "formal") dependent on the assumption of low information costs and the other (the "informal") characterized by adaptation to high information costs and the absence of impersonal means for risk-spreading. Although many Westerners may expect to find the formal model in operation in Indonesia, the informal model of the legal process is the more applicable of the two in that environment, as is evident from the case study described below.

### III. The Role of Formal Legal Institutions in Indonesia

While the legal functions to be filled in a complex economy may be similar from country to country, the methods used to fill them vary tremendously. Western democracies tend to depend relatively heavily on courts and formal administrative procedures, although this dependence is by no means exclusive. The power and independence of the Western judiciary grew out of complex cultural, historical, economic, and political developments, and it is by no means preordained that a similar place for formal legal institutions will evolve in all societies.

In practice the role of the formal legal system in Indonesia is far less prominent at the national level than its corresponding role in advanced Western countries, 5/ although on the surface it is structured much like those systems in the West (with a Constitution, a commitment to "rule by law", three branches of government, three tiers of courts, judges, prosecutors, and lawyers). 6/ Access to courts or other formal means for enforcement and dispute resolution 7/ is expensive, proceedings are time-consuming, decisions are unpredictable, the power and prestige needed to enforce decisions is lacking, and corruption is widespread. Few Indonesians turn to the formal

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5/ See Moertono (1963), Lev (1965, 1972, 1978), Feith(1962), and Makarim (1978).

6/ For a description of the Indonesian formal legal system, see Damian and Hornick (1972).

7/ These include official administrative channels for enforcement (such as the seizure and auction of property for tax collection) or for dispute resolution (such as internal administrative appeals mechanisms within government departments).

legal system for assistance in resolving disputes involving business or related issues of economic regulation or public administration. 8/ Furthermore, as discussed below, the legal functions of standard setting and overseeing public officials are often carried on outside formal administrative and judicial channels.

Part of the explanation for the minor role of the formal legal system in Indonesia lies with history. A few entrepreneurial personalities, the most notable in recent years being President Sukarno, decisively influenced the course of legal development. Other directions might have been taken under the influence of different personalities and events. 9/

The economic forces at work in the environment, particularly adaptation to risk and high information costs, also help to explain the minor role of the formal legal system. The Indonesians (particularly the Javanese) have always preferred compromise and conciliation to the strict adherence to an impersonal concept of legal right. The emphasis on harmony helps to assure the proper functioning of the collective insurance mechanisms that spread

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8/ It should be noted that at the local village level Indonesians do turn to courts (often Islamic courts) for assistance in mediating certain types of civil disputes, such as divorce, land matters, criminal cases, and the division of estates. Land disputes often go before courts precisely because of the oral culture; without written records, the intervention of a mediator is necessary to resolve a dispute. This discussion of legal processes is concerned, however, not with these local noncommercial disputes, but rather with legal issues involving business and government regulation at the national level.

9/ Makarim (1978). The course of historical development has not necessarily led to an optimal equilibrium. The process of change in the legal system is slow, and only a limited number of configurations can be tried in the course of history. Those in power typically have a vested interest in maintaining power, thereby further slowing the process of change and experimentation that could lead to improvement.



risk. It also helps to protect a society with a high population density, such as Java, from the risk of violence and disruption that can arise from the clashing of personal interests. Such cultural adaptations to risk serve to lessen the importance of the adversarial proceedings typical of courts.

The role of the formal legal system is further diminished when information costs are high. The accuracy of court or other formal administrative proceedings depends on the ability of all parties concerned to accumulate facts about the case. This is particularly difficult when the investigative ability of the government is weak and the means available to private parties to gather information are limited.

Furthermore, the problems of high information costs and weak formal legal procedures tend to reinforce each other. Some information-gathering devices, such as depositions, can work only when the legal system has enough credibility to force disclosure. In addition, judges and administrators must have the training and ability to understand both the underlying law and the facts presented. Tax law, antitrust law, environmental regulation, trade policy, and other areas of economic regulation can all involve great complexity. In a developing country where skills are particularly scarce, a legal system without great prestige or power is unlikely to attract the people most able to grasp these difficult subjects.

In sum, the present Indonesian judiciary lacks both the means to resolve complex cases accurately and the prestige to require action on its judgments from other government departments. Indonesian legal culture further diminishes the role of this and other formal legal institutions, favoring less confrontational and less formal means of handling legal functions.

#### IV. The Informal Legal Process in Indonesia

Given the nonconfrontational culture and the minor role of formal legal institutions, informal means arise to handle legal functions in Indonesian public administration. The Indonesian tax administration provides a case study of the informal legal model in practice. The national tax laws were changed in the mid-1980s with outdated colonial tax laws being replaced by new income and value-added tax laws and a new law on tax procedures. Many of the examples discussed below refer to the pre-reform situation and help to explain the motivation for the legal changes. Effective reform will take time; while changes in laws can occur overnight, old habits of administration die hard.

##### Standard-setting: Substantive Law and the Legal Process

Although in theory statutes must follow the Indonesian constitution and decrees must conform to statutes, in practice Indonesian statutes are typically written in very general terms, and the executive branch makes a large body of policy through presidential and ministerial decrees. For example, in the pre-reform tax laws ministers were granted the authority to set many tax rates and define taxable entities. Even in the new laws, which tend to be more specific than the old, such items as the power to set VAT exceptions criteria for small firms, the power to change VAT tax rates within certain bounds, and the power to name goods subject to luxury tax are all left to governmental regulation or ministerial decree, with no guidelines provided in the law.

In such a legal system ministers are in effect acting as agents for the government. Yet there is no assurance that ministerial decrees will

necessarily follow the letter of the law. Neither Parliament nor the courts have recourse to insist on the primacy of statutes. Although by law the courts have the jurisdiction to oversee the compatibility of regulations and decrees with their underlying laws, this jurisdiction is not exercised in practice. The strength of the executive branch in Indonesia reinforces the already natural tendency for all access to information to be concentrated within the administrative bureaucracy. With neither the information nor the cultural predisposition to challenge the executive branch, the legislature and the courts cannot serve a watchdog role over detailed regulatory pronouncements.

As a result, many ministerial decrees depart significantly from the spirit if not the letter of the relevant statute. For example, although the old wealth tax law specified a tax rate of 0.5 percent, this rate was changed by ministerial decree to 1.0 percent in 1982 in an attempt to increase revenues. Other past decrees have given income and/or withholding tax exemptions not supported by statute to national private banks who merge; to scientists, authors, musicians, and artists; to firms going public on the newly formed stock exchange and individuals buying those shares; to firms using certified public accountants; and to interest on demand deposits, time deposits, bank certificates, small-saver accounts, marketable securities, and Indonesian bonds sold in the international market. And although no such exemption was specified in the relevant statutes, foreign contractors and consultants working in Indonesia on projects funded by foreign aid were exempt from income and corporation tax by an even more informal means than a decree, namely a letter from the Minister of Finance to the Minister of Foreign Affairs.

The looseness with which ministerial decrees follow statutes is mirrored in the looseness with which the civil servants follow both statutes and decrees in their daily administrative activities. Noncompliance and nonenforcement are evident throughout the tax system, reflecting both the high cost of information and personal adaptation to risk.

The information needed to enforce governing laws and decrees on the public is expensive. In the area of tax law, enforcement depends on good recordkeeping by the public and accurate audits by officials; neither can be expected on a wide scale given the low average level of education in the country, the shortage of professionals trained in modern accounting techniques, and the prevalence of cash transactions in general.

In addition, the goals of a particular agent (the civil servant) may differ from those of his principal (his superiors, the legislature, or the courts). In many cases the actions of an agent may serve to reinforce a patron-client relationship that reduces personal risk rather than serving a public interest goal reflected in a law or decree. The parties concerned (both the civil servant and his patron or client) will have an interest in hiding their activities from others, making it even more difficult for superiors to trace the activities of their subordinates.

Finally, the minor role of the formal judiciary in Indonesia prevents it from taking an aggressive role in law enforcement. Other institutions must compensate if any threat of penalty is to attach to noncompliance with laws and decrees.

In sum, the Indonesian informal legal system is characterized by a lack of clear, consistent, and binding standards. Laws may be contradicted by lower-level decrees and regulations, and both may be contradicted by the

day-to-day actions of administrators. Because of the presence of high risk and the interpersonal relationships that arise to reduce it in the individual case, the motivations of agents are likely to diverge significantly from those of their principals. High information costs lead to agency problems at each level of the legal hierarchy. The concept of strict rule by law envisioned in the formal model is not feasible in practice.

Enforcement and Dispute Resolution:  
Organizational Structure and the Legal Process

The organizational structure of the Indonesian Directorate General of Taxation reflects the compartmentalization and monopolization of substantive areas likely to arise when information costs are high. The organization is divided into five Directorates along substantive lines. Relatively little interaction or cooperation exists among them in carrying out their everyday work. Different taxes are handled by different personnel, with little sharing of information or mutual assistance. For example, the Directorate of Direct Tax handles matters relating to income tax, while the Directorate of Indirect Tax is in charge of value-added tax, although similar data is needed for both jobs.

This organization is mirrored in the regional and district tax offices, reflecting the strength of vertical chains of command. However, because of difficulties in communication, each district office is by necessity relatively autonomous in carrying out the majority of its responsibilities.

Each stage in the process of enforcing tax law is profoundly affected by this organizational structure. Initial assessments and/or audits for each tax tend to be controlled entirely by a small group in a single office, without much horizontal sharing or cross checking of information. This leads

to a proliferation of steps in the compliance process, as a firm must deal separately with each group in charge of each tax. It also leads to less effective administration, as the benefits to cooperation and the sharing of information are missed.

The insulation and/or horizontal duplication of function continues as enforcement proceeds. Because of the divided responsibility for different taxes, in some district offices up to six different sections have administrative duties relating to tax enforcement. Yet all power over criminal prosecution is retained in the regional and head tax offices because of the difficulty of overseeing the district offices and the consequent hesitancy to delegate important decisionmaking power. Access to this ad hoc and discretionary system is uneven, and individualized relief for more important taxpayers who voice complaint is common. Taxpayers' grievance procedures are equally compartmentalized, with most power and discretion over important cases being retained by top tax administrators. The tax court has neither the expertise, the information, nor the credibility to deal with serious cases. Its caseload consists primarily of small sales tax matters.

Discretion in assessment and enforcement is constrained not primarily by law but by cultural and political norms. Three major constraints are the cultural aversion to open confrontation, the hesitation of officials to challenge politically powerful taxpayers, and the questionable legitimacy of official action given the widespread view that civil servants are as much to blame as taxpayers for the country's revenue problems.

In sum, the distribution of authority and responsibility for enforcement and dispute resolution in Indonesian public administration is influenced by the high cost of information. This high cost sets limits on the

horizontal exchange of information and leads officials to avoid delegation of power to agents whenever possible. Administrators rather than formal legal institutions are the primary legal actors, and the informal legal process becomes relatively ad hoc, discretionary, and personalized when compared with more formal legal processes.

#### The Nature of Standards: Policy Design and the Legal Process

Given the concentration of legal authority discussed above, what is the rationale behind the policies that emerge from the standard-setting process? Indonesian tax policy is heavily influenced by the desire to gather information to promote enforceability. Five common characteristics of tax design and administration can be attributed to the combination of high information costs and cultural adaptations to risk.

#### Preventive screening

The tendency to depend on ex-ante barriers to enforce reporting requirements and avoid later confrontation can be seen in the reliance on universal tax assessment under the old income tax laws. While under the self-assessment system in the United States a taxpayer is assumed to be following the law unless an audit proves otherwise, under the system of universal assessment a taxpayer is not assumed to have complied with the law until an assessment has been issued and paid and a final tax clearance has been received from the tax department. Every taxpaying firm and individual must pass through the assessment "barrier", pursuant to which books and record must be submitted and one's business premises may be searched by tax authorities for further information. Further disputes rarely arise once this barrier has been crossed, because both parties have had the opportunity to express their

views and reach an acceptable compromise during the assessment stage. The new Indonesian income tax law provides for self-assessment, although the impact of this legal change on actual practice is uncertain.

### Linkages

Interlocking requirements serve to enforce tax laws and regulations by raising the price of evasion and increasing the number of officials involved directly or indirectly in enforcement. Again, this tends to be a relatively nonconfrontational means of enforcement and therefore congruent with customary methods of spreading risk.

For example, a taxpayer identification number must be obtained before applying for an investment license, applying for credit from state banks, or passing imported goods through Indonesian customs. Therefore, evasion of taxpayer registration requirements legally disqualifies one from making investments, obtaining state-bank credit, or importing, while officials of these various government organizations are enlisted in checking that tax requirements have been met.

### Third-party responsibility

The extensive reliance on withholding of tax by third parties is in some sense analogous to the principle of collective responsibility common in primitive legal systems. The withholder is in a better position than an official to have information concerning the tax liability of the taxpayer. He is therefore given the responsibility of seeing that this liability is fulfilled by withholding tax from amounts paid to the taxpayer.

Withholding on salaries and wages is prevalent throughout the world and has long been the backbone of income tax enforcement. In Indonesia, over



half of individual income tax collections result from employer withholding. But in Indonesia withholding is extended far beyond salaries and wages. Under the new income tax law, tax must be withheld on payments of interest, dividends, rents, royalties, technical assistance fees, consulting fees, and pensions.

The value-added tax has become a popular form of sales tax throughout the world for several reasons, not the least being the increase in enforceability arising from the conflict of interest between buyer and seller. Each seller must collect tax from the buyer, who then can offset this tax already paid against payments to the state treasury of tax collected on its sales. Each seller becomes in effect a withholder of tax, and each buyer wants to assure that a tax invoice is issued by the seller for each sale so that he can in turn use such tax as a credit against his own future tax liability. The VAT, which on April 1, 1985 replaced the previous turnover sales tax in Indonesia, is more enforceable than other types of sales taxes because of this reliance on third party responsibility and the conflicts of interest created.

#### The use of presumptions

A fourth technique used in the design of tax policy to increase enforceability is the reliance on presumptions. When specific factual information is costly, approximations may serve the purpose adequately at a much lower cost.

The Indonesian tax administration relies heavily on presumptions to establish tax liability. In the new income tax law, for example, any small firm (defined as one with annual turnover of less than Rp. 60 million) may

choose to be taxed using assessment norms. These norms, calculated by officials and published regularly, represent average profit margins for various types of businesses. They can be used to calculate the taxable income of small firms if multiplied by actual turnover figures kept by such firms. This eliminates information requirements that would be onerous on both small businessmen and tax administrators.

### Simplicity

Perhaps more than any other characteristic, simplicity is crucial when information costs are high. The major aim of the Indonesian tax reform was to simplify the structure of tax laws and regulations so they would be easier to understand and administer. Both the new income tax and the new value-added tax are among the simplest in the world, with few rates and few exceptions or exemptions.

These characteristics of tax policy in Indonesia--preventive screening, interlocking requirements, third-party responsibility, the use of presumptions, and an emphasis on simplicity--enhance the enforceability of tax laws and regulations. The same enforcement-enhancing elements of design also characterize other economic policies, both in Indonesia and in other countries. One example in some countries is investment licencing, which relies heavily on preventive screening, interlocking regulatory requirements, and third-party responsibility to regulate investments with the purported aim in part of preventing industry monopolization in the absence of legal antitrust remedies. In addition, it could be argued that countries favor quotas or import bans over tariffs in part because of their relative transparency and heightened enforceability. Bans are particularly easy to

enforce. This possible benefit must of course be weighed against the economic distortions that tend to result from quantitative restrictions.

In sum, administrative concerns can never be entirely separated from substantive ones, particularly in developing countries in which administration is hampered by high information costs.

### Incentives and Oversight

The problems of incentives and oversight in the informal model described in Section II are all evident in the Indonesian civil service. The first is the difficulty of defining objectives and the resulting priority given to readily identifiable and measurable ones. One example of this tendency is the reliance of the Indonesia tax system on monetary tax targets as indicators of achievement, with other harder-to-measure objectives (such as an equitable distribution of the tax burden, a minimization of tax-induced distortions, and a minimization of administrative and compliance costs) fading into the background.

The second problem noted in Section II is the difficulty of valuing individual performance. Given this difficulty, governments such as Indonesia's adopt incentive systems that are dependent upon easily measurable and noncontroversial valuables. In the Indonesian tax administration neither salary level nor promotion is directly linked to performance, but is linked instead primarily to educational background and years of service. Such an incentive system is unlikely to motivate the type of performance that leads to efficiency, effectiveness, and neutrality in tax administration.

The weakness of performance evaluations in the tax department is evidence of the third problem--the hesitancy of supervisors to assert

authority. A promotion is theoretically supposed to be supported by indicators of merit, as measured by evaluation letters prepared by direct supervisors and counterchecked in turn by their superiors. Such evaluations are prepared every year for each employee. Most officials are unwilling, however, to write unfavorable evaluations. They would rather give a favorable evaluation to a poor subordinate than risk confrontation, offense, and possible reprisal. All evaluations become homogenized and therefore of little worth as indicators of productivity.

The same factors mentioned above in relation to internal oversight inhibit the assertion of authority by external Indonesian organizations with formal oversight jurisdiction. First, the information needed for effective oversight is lacking, hidden in part by organizational barriers in the absence of judicial means to force its production. Second, oversight is hampered by the requirement that the overseer also be an expert in the field. For example, because of the need for expertise, all of the persons hired by the Inspectorate General to investigate tax officials are former tax officials themselves, and some may return to the tax department after a few years of service in the Inspectorate General's office. A serious conflict of interest results. Such officials may be willing to carry out cursory investigations, but it is very difficult for them to point an accusatory finger at a former (and perhaps future) colleague.

Third, oversight is hampered by the deep cultural respect for hierarchy. To carry out thorough oversight operations would involve the investigation of higher-level as well as low-level officials, and low-level overseers would be loathe to investigate their hierarchical superiors.

Fourth, the motivation for active oversight is lacking. Publicity concerning public abuse of power can embarrass the government (of which these oversight agencies are a part), lead to fragmentation in the cohesive support system it provides, and risk inviting retaliation. Given the nontargeted incentive system, which applies to the judiciary and the Inspectorate General as well as operational departments such as the tax department, productive work on the part of oversight personnel does not necessarily carry a promise of higher income or promotion.

Finally, the legitimacy of strict oversight is questioned. Punishing one official for incompetence or dishonesty is considered unfair if others--particularly officials at higher levels--are guilty.

As a result of these constraints, oversight by external groups, whether the Inspectorate General, the judicial system, or other governmental or nongovernmental bodies, is weak in Indonesia. When combined with the likelihood that internal incentives are not targeted to performance, the result is a vacuum of oversight, a failure to fulfill this important function of a modern legal system.

#### Improving the Outcome of the Legal Process

As noted in the description of the informal model, the combination of unclear and loosely applied standards, fragmented and monopolized authority, broad discretion, and nontargeted incentives leads to a relatively undisciplined bureaucracy that pursues only the most quantifiable objectives. Given the widespread uncertainty and discretion and the shortage of objective legal protections characteristic of the informal model, negotiation can be expected even when policymakers and administrators are

acting exclusively in the public interest. But private-interest concerns can also easily flourish in this environment because of the lack of oversight. The extensive reliance on negotiation in Indonesian government administration is readily summed up in the commonly-heard phrase, "All taxes are negotiable."

Improving the legal process in developing countries such as Indonesia is a long-term challenge. The cultural and economic roots of the existing informal system are strong and slow to change. Yet efforts to lower the cost of information to policy makers, administrators and the public can help. Better socioeconomic data can help policymakers gauge the impact of public policies on individuals and on economic activity. Better information on the activities of individual administrators and members of the private sector can help officials oversee performance and enforce compliance more effectively. And improving technical expertise among government officials can help them make better use of whatever information is available. Several concrete steps that could be taken include, for example,

- providing monetary support, technical assistance, and training to central statistical services;
- training more administrators and overseers in specific technical fields, such as corporate tax law and auditing;
- investing in simple information-processing technology for the storage of data (such as taxpayer files) that could then be readily accessible to users and overseers alike;
- improving the organization and accessibility of government laws and decrees;
- publishing regulatory rulings and legal cases to serve as forms of precedent;

- tailoring incentives (such as salaries and bonuses) more closely to the achievement of group objectives, and

- stressing simplicity in the design of government regulations to reduce the time and level of expertise needed to comply with them.

All of these steps except the fourth were undertaken to some extent in the Indonesian tax reform; the question of incentives for civil servants remains a difficult issues in Indonesia as in other developing countries.

#### V. Summary and Conclusions

The efficiency of public administration and private market activity in any country depend heavily upon the ability of the country's legal system to set and enforce standards, resolve disputes, and oversee the actions of civil servants. This paper has analyzed several important characteristics of the legal process in Indonesia. In so doing it has attempted to explain many of the problems of public administration that affect the government's efforts to improve tax administration and promote economic development in general. Among the most important conclusions are the following five:

1. The characteristics of the legal process in any country are heavily influenced by the cost of information, the extent of risk in everyday life, and the mechanisms used by the society of that country to spread such risk.

2. The way legal processes are handled in developing countries such as Indonesia has little to do with the way the formal legal system operates. Studying the formal legal system alone will provide little insight into the nature of the actual legal system. Because of high information costs, legal processes--separably identifiable in more advanced countries--tend to be

inseparable from general policymaking and administrative functions in developing countries.

3. Although progress in economic development may require a legal system that provides objective standards, reliable enforcement of such standards, and procedures for the efficient resolution of grievances and the oversight of civil servants, high information costs and high risk in developing countries inhibit the development of such a legal system. Legal development may be a major constraint to economic development.

4. Certain forms of direct regulation and government policies of intervention in the marketplace in developing countries can be seen at least in part as substitutes for an independent, well-functioning legal system.

5. Lowering the cost of information and enhancing the development of impersonal market mechanism for the spreading of risk will promote legal and economic development in developing countries.

These conclusions have operational relevance for both businessmen and policy advisors working in developing countries. Businessmen used to Western legal environments may need to operate quite differently in developing countries such as Indonesia. Confrontational tactics, including formal litigation, are generally counterproductive in cultures that depend on interpersonal relationships for risk-spreading. Furthermore, legal standards are likely to be quite fluid. Written laws and regulations should be seen as general guidelines but not considered as necessarily final or binding under all circumstances. A rigid search for legal certainty can well lead to frustration. Flexibility, an ability to locate the locus of decisionmaking



power (not always readily obvious from official organization charts), and a willingness to cultivate personal ties are likely to be important characteristics for success.

Policy advisors must be extremely sensitive to questions of administrability and enforceability when considering policy options in this legal environment. A progressive income tax and a value-added tax to the retail level may be optimal fiscal policy tools from a theoretical perspective, but one must also consider issues of administrability and enforceability which may well inhibit the working of such tools. Furthermore, some policy tools (such as licensing) that appear unduly restrictive to Westerners might be explained at least in part as efforts of government to reduce the costs of information. Indeed, they may be the only policy tools that have an impact in an environment in which information costs are high. This does not necessarily justify their use, but it does call for a consideration of the administrative dimension when designing policy.

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