

# CRITICISM ON THE LEGISLATIVE APPROACH TO FOSTERING CSR IN INDONESIA

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## ABSTRACT

*Since 2007, companies in fields related to natural resources have been obligated by Indonesian legislation to practice corporate social responsibility (CSR). However, in practice, CSR tends to appear voluntary. This study aims to critically review the legislative approach in fostering CSR in Indonesia and focuses on the issues of specific pieces of legislation that have resulted in making CSR practices appear voluntary. This paper presents a detailed analysis of the laws and their underlying principles and demonstrates the ineffectiveness of these rules in mandating CSR in Indonesia. The findings highlight the need for establishing specific rules for mandating CSR, the standards that can be used by companies for CSR implementation, and the need for an authorized agency to ensure legal conformity in the Indonesian context. The paper presents a clear analysis of existing social responsibility mandates and identifies shortfalls in existing regulations against the backdrop of a developing country context.*

**Keywords:** Mandatory CSR, CSR Reporting, CSR Guidelines and Standards, CSR Sanctions.

## INTRODUCTION

Corporate social responsibility (CSR) has been a well-known concept since the beginning of the 21st century (Lambooy, 2014). CSR prompts companies to be committed to voluntarily contributing to economic development while improving the quality of the local community, environment, and workforce (Bisson, 2018). Many distinguished scholars view CSR as a way for companies to be involved in human development (Demuijnck & FASTERLING, 2016; Hawkins, 2006; Hopkins, 2007). Implementing CSR is profitable for businesses and encourages good corporate governance in companies (Mullerat, 2005). Therefore, in this age of globalization, CSR cannot be ignored.

However, promoting CSR will certainly need a more decisive commitment from businesses and governments. From a political perspective, CSR promotion can be addressed by government intervention (United Nations Global Compact and Bertelsmann Stiftung, 2010). Generally, there are two approaches in which government intervention can foster the adoption of CSR practices. First, in the voluntary approach, the ways in which CSR practices can help address specific concerns and are of interest to a particular company or an industry are identified. In addition, changes in market behavior within a particular industrial sector that will foster the adoption of CSR practices by companies in that sector are simultaneously promoted. Second, in the legislative approach, laws are enacted forcing companies in a particular sector(s) to adopt CSR practices and carry the risk of financial penalties or imprisonment of companies' personnel for non-compliance (Martin, 2005). The legislative approach has played an increasing role in the development of CSR. For example, in 2016, among the 383 sustainability reporting instruments that was introduced

across 64 countries, more than two-third was made mandatory through government regulations (Bartels et al., 2016).

Although it is rare for countries to mandate CSR behavior through direct regulation, a few Asian countries, such as China, India, and Indonesia, have taken a progressive approach toward CSR implementation through company law, an area of law in which CSR has been extensively debated (Lin, 2020). In China, the obligation to implement CSR is stipulated under its Company Act 2006. In India, the Companies Act 2013 governs the obligation of a company to exercise CSR. Meanwhile, in Indonesia, the insistence of companies to adopt CSR practices is stipulated under the country's Company Act 2007.

Under Article 74 of the Company Act 2007, companies in Indonesia are mandated to operate in fields related to natural resources to practice CSR. The act states that CSR activities must aim to implement sustainable economic development to improve the quality of life of the local community and society in general. This legislative approach requires companies to set their goal not only to maximize shareholder benefits but also to contribute to the local community, the environment, and society.

The Company Act has mandated CSR implementation more than a decade ago. Nevertheless, in practice, CSR still appears to be voluntary. Many companies have not implemented CSR (Daelami, 2020) even though such practices can have a significant effect on corporate value and minimize a company's potential financial risks (Andayani & Daud, 2020; Purbawangsa et al., 2019). In addition, many companies do not seem to have understood the importance of knowing and facilitating the real needs of the community through CSR (Nayenggita et al., 2019) and that ineffective CSR implementation mechanisms and impact measurement systems do not bring about community empowerment (Retnaningsih, 2015; Waagstein, 2011). Thus far, CSR practices have been implemented only by large Indonesian companies with international markets. Worldwide, several companies practice CSR to boost their brand image, without rendering any substantive improvement in social and environmental performance (Gunawan, 2016; Hakim, 2016; Sheehy & Damayanti, 2020). Compared to global standards, CSR implementation by Indonesian companies was still generally poor when assessed in 2014–2015 (Ridho, 2018). Moreover, sanctions had not been imposed on companies that caused environmental damage (Pujiyono et al., 2016). A study conducted by the Center for Governance, Institutions, and Organizations of the National University of Singapore Business School demonstrated that companies in Indonesia have a lower quality of social responsibility (Suastha, 2016). The quality assessment criteria were based on several indicators from the Global Reporting Initiative framework, including economic, environmental and social performance, as well as corporate governance.

Generally, the ineffective implementation of CSR is the result of weak internal management within the company and the absence of government intervention. However, prior studies have not evaluated the ineffectiveness of legislation. Hence, this study aims to provide an overview of the different approaches to encouraging CSR practices, and it specifically critiques the legislative approach in fostering CSR in Indonesia.

Using a doctrinal legal research methodology, the study focuses on the issues contained in pieces of legislation concerning the environmental and social responsibility of companies that make CSR practices appear voluntary, such as the Company Act 2007, the Investment Act 2007,

and the Government Regulation Number 47 of 2012 concerning Environmental and Social Responsibility of Limited Companies. This paper presents a detailed analysis of these rules, identifies how each rule is connected, and discusses the legal meaning underlying the principles to examine their weaknesses in the implementation of CSR.

### **Understanding the Concept and Approaches to CSR**

Scholars and development agencies define CSR in different ways, and there is no commonly accepted definition. Each has a different concept and prioritizes different aspects of CSR; according to one's particular background and views, CSR might be considered an economic theory, an ethical aspiration, a legal regulation, a market tool, or a management risk instrument, among others (Kadyan, 2016; Mullerat, 2005; Omran & Ramdhony, 2015). Carroll (1979) states that CSR is about how companies manage their business operations to generate positive impacts on society; this encompasses the economic, legal, ethical, and discretionary aspects of business performance. CSR is an act of concern by a business organization to serve the interests of the people and to benefit the organization; such an approach indicates that companies integrate social concerns into their business activities and their interactions with stakeholders be based on volunteerism and the principle of cooperation (Schermerhorn, 1993). Moreover, CSR is a commitment from businesses to always be ethical, operate legally, and improve the quality of life of their workers and their families while simultaneously enhancing the overall quality of life and contributing to the level of economic development of their local communities (World Business Council for Sustainable Development, 1999). In addition, CSR is a mechanism by which companies pay attention to the impact of their business activities on society (International Labor Organization, 2006).

A more comprehensive definition of CSR is provided by Blowfield and Frynas (2005): 1) company activities have social and environmental impacts, and, thus, the company has a responsibility for those impacts, which occasionally extend beyond legal obligations; 2) the company is responsible for the actions of its business partners (e.g., in the supply chain); and 3) the company needs to manage its relationship with the community for business purposes, to increase the value of the community or both. These factors are in line with the general developmental goals of a society, which include improving the standard of living, which is carried out through activities to eradicate poverty, and improving the standard of health and education of the community (Declaration on the Right to Development, 1986). Achieving these development goals requires commitment and cooperation among all parties, including companies, which are key development initiators. The strength of their capital and desire to continuously generate profits facilitate companies' engagement in CSR (Hopkins, 2007).

Freeman et al. (Freeman & Velamuri, 2006) argued that, in the concept of CSR, the relationship between the company and a society is rooted in ethical or moral values; ultimately, the company must accept CSR as an ethical obligation, above other considerations. This is for three reasons: (1) the company is formed and managed by individuals from civil society, (2) the accumulation of wealth within companies would not have existed without civil society being their market, and (3) the company's activities have an impact on a society (Wheeler, 2007). This indicates that the company must carry out its business activities to the best of its ability not merely

to avoid having a negative impact on society and the environment, but rather to create a better and more prosperous society. The importance of building good relationships with the community through the implementation of companies' CSR programs encourages the government to promote and further develop CSR. The government's position is to raise awareness and build CSR capacity among companies and stakeholders, for instance, by engaging in standard-setting through the provision of policy frameworks, which encourage companies to improve their performance beyond minimum legal standards (Kinnear, 2018).

As previously mentioned, CSR implementation can be pursued by the government through voluntary or legislative approaches (Dave, 2017; Martin, 2005). The voluntary approach implies that CSR practices are discretionary acts that go beyond what is prescribed by law and are guided by the ethical values or vested interests of the company, with governments playing a minimal role (Dentchev et al., 2015). The aim is to promote changes in market behavior that stimulate companies to adopt CSR practices, which requires gaining the trust and respect of a society's most influential participants. In accepting new rules that dictate their relationship with a society at large, companies are convinced to become agents of change, and others feel obliged to follow the companies' lead, thus proving that change is not beyond their means (Martin, 2005).

However, in reality, describing CSR as voluntary is misleading. The adoption of CSR policies by businesses has occurred in a quite specific context. Since its inception, "voluntary" CSR has been driven socially and economically, and it has been a response to market pressure and reputational risk in most cases. Hence, the assumption of the voluntary nature of CSR is flawed (McBarnet, 2009). In the voluntary approach, companies are given too much leeway in exercising CSR, and they are not mandated to make periodic reports on their CSR initiatives (Justo, 2019). Moreover, this approach generally lacks transparency concerning the CSR activities carried out and the formal system of sanctions used by governing institutions to enforce legal conformity (Gatti et al., 2019; Seeger & Hipfel, 2007). Thus, such disadvantages of the voluntary approach necessitate the need for a legislative approach (Leighton, 2002). This approach aims to make CSR enforceable and legally binding. It involves establishing precise rules that companies must adhere to, along with strict sanctions in case of disobedience (Cominetti & Seele, 2016). This approach can raise awareness, prioritize CSR policy, and enable the establishment of regulated CSR indicators (Gatti et al., 2019). Recently, as CSR implementation has developed as a trend, it has also evolved into a legally binding domain (Justo, 2019; Lin, 2020).

### **Legislative Approach to CSR in Indonesia**

CSR is a comprehensive contribution of the business world toward sustainable economic, social, and environmental development. Started as a voluntary initiative (Wibisono, 2007), CSR implementation has grown rapidly across the globe, including in developing countries, such as Indonesia. It is viewed by the business world as an opportunity to improve competitiveness and riskmanagement for the sustainability of business activities.

In mandating CSR practices through the Company Act 2007, the Indonesian government has chosen a legislative approach to ensure CSR implementation. Article 74 of the Company Act 2007 states that companies doing business in fields related to natural resources must implement CSR, with due attention to appropriateness and fairness, and those companies failing to fulfill the obligation may face sanctions in accordance with the provisions of the legislative regulations.

According to the government and legislators, CSR has been mandated through a law provision to limit the irresponsible behaviors of many multinational companies operating in Indonesia toward the environment and the community. Among the European Union countries, for example, many have adopted the EU legislation on the disclosure of non-financial information. In these countries, CSR is legally assessed by capital markets authorities, in addition to public judgment (Hąbek & Wolniak, 2016). In other words, CSR is an instrument used to reduce unethical business practices and is a way to minimize the negative impacts caused by business operations. Therefore, implementing CSR mandatorily is beneficial, and its assessment must be conducted by parties inside and outside the company.

According to the former Chairman of the Constitutional Court of the Republic of Indonesia, the country, companies, and community organizations must comply with the 1945 Constitution of the Republic of Indonesia (Asshiddiqie, 2010). Each company bears an important responsibility toward the community. Formal support for the mandatory nature of CSR was provided by the Constitutional Court, which rejected a petition for judicial review on Article 74 of the Company Act 2007, filed by the Chamber of Commerce and Industry and the Indonesian Employers Association. According to the Court, Article 74 does not conflict with Article 28D(1) (right to equal treatment), Article 28I(2) (right to protection against discriminative treatment), or Article 33(4) (implementation of the articles will be regulated by law) of the Constitution of the Republic of Indonesia (Verdict of the Indonesian Constitutional Court No. 53/PUU-VI/2008). The Court argued that CSR is a state policy that becomes a shared responsibility for cooperation among the country, business actors, companies, and society. By mandating CSR, it is expected that companies can contribute to the welfare of society. In particular, Indonesia's economic system is not an individual liberal economic system; it is structured as a joint venture based on the principle of family. The resources of the country are for the prosperity of the people. Therefore, it was declared that the state, which has authority over the land, water, and other natural resources, not only has the authority to levy taxes but should also be given the power to regulate how companies aid in environmental and social issues.

Indeed, CSR obligations have been introduced in several laws prior to the Company Act 2007, but they have not been properly enforced (Rosser & Edwin, 2010). Examples of such laws include the Oil and Natural Gas Act 2001, Water Resources Act 2004, and Investment Act 2007. The Oil and Natural Gas Act 2001, which obligates a joint cooperation contract between a business entity and a government agency regarding the exploration and exploitation of oil and gas, contains provisions on the need for the development of surrounding communities and guarantees the rights of the communal society. The Water Resources Act 2004 stipulates provisions regarding principles, methods, functions, and prohibitions on water resource management, and it provides for sanctions on any business entity that causes destruction or pollution to water sources. Meanwhile, the Investment Act 2007 mandates that every investment must implement CSR by maintaining a harmonious, balanced, and suitable relationship with the local community's neighborhood and respecting their values, norms, and culture. However, these pieces of legislation are only applicable to particular sectors. Mandating CSR implementation via the Company Act 2007 was expected to reach all companies and obligate them to comply with their social responsibilities.

In addition to these mandatory provisions, since 2010, the government has encouraged companies to implement CSR by providing incentives, such as tax deductions. According to

Government Regulation No. 93 of 2010, expenditures for CSR activities can be eligible for an annual tax break of up to 5% of the net income earned during the previous fiscal year, which is deducted from the gross income of the current fiscal year. However, companies' CSR initiatives have been predominantly limited to contributions made in the following areas: national disaster management, research and development institutions, educational facilities, sports, and social infrastructure.

## DISCUSSION

According to the Company Act 2007, companies are obligated to carry out CSR activities that improve the environment and quality of life that is beneficial to the company, the local community, and society and work toward the aim of achieving sustainable economic development. In implementing CSR, the company would be able to achieve profit optimization and carry out its social mission to benefit society. Moreover, the law emphasizes that, to ensure CSR implementation, activities that are carried out, with due regard to appropriateness, must be budgeted and calculated as company costs and included in the company's annual report. The law provides four regulatory areas that must be considered postimplementation: reporting, supervision, sanctions, and enforcement.

Article 74(4) of the Company Act 2007 states that further provisions regarding mandatory CSR will be enacted through government regulation. This indicates that the regulation would govern more specific provisions on how mandatory CSR should be exercised, including reporting, supervision, sanctions, and enforcement. To impose mandatory CSR, the government issued Government Regulation Number 47 of 2012 concerning the Environmental and Social Responsibility of Limited Companies (hereinafter referred to as GR No. 47/2012). The aim of issuing GR No. 47/2012 was to increase companies' awareness of CSR, meet the developing legal needs regarding CSR in society, and strengthens the CSR provisions already regulated in various laws and regulations. Some of the provisions of GR No. 47/2012 address the category of companies that are required to implement CSR, parties responsible for exercising CSR, issues that must be considered in preparing CSR activity plans and budgets, CSR reporting, and sanctions.

Under Article 3 of GR No. 47/2012, CSR must be exercised by companies whose business activities involve exploitation and management of natural resources (e.g., businesses in forestry, oil and natural gas, geothermal energy, water resources, mineral, and coal mining, and electricity generation) and those whose business activities impact the functions of natural resource capabilities. Further, this provision stipulates that CSR should be exercised both in the internal and external environment. However, a company's obligation to implement CSR is not differentiated based on firm size.

Article 4 of GR No. 47/2012 states that CSR must be implemented by a company's board of directors based on the company's annual work plan, which details the activity plan and budget required for the initiatives. Article 5 mandates that CSR activity plans and budgets pay attention to appropriateness and fairness. The elucidation to Article 5 defines "appropriateness and fairness" as a company policy that is adjusted for the company's financial capacity and potential risks. Thus, the CSR borne by the company must be in accordance with its business activities. Article 6 stipulates that CSR initiatives must be included in the company's annual

report and presented to shareholders. Finally, Article 7 states that companies that do not exercise mandatory CSR will be subject to sanctions in accordance with the provisions of the laws and regulations.

Unfortunately, this legislation could not confirm the mandatory nature of CSR. Although the CSR law appears imperative, there is a lack of specific rules, guidelines, and standards regarding reporting and monitoring, and sanctions in implementing CSR are still quite vague to be operational (Andrini, 2016). GR No. 47/2012 was expected to provide detailed rules regarding the CSR mandate, but it has proven to be inadequate. It merely instructs the directors of a company to carry out CSR without determining what activities are appropriate or fair (Chang, 2018).

The government requires companies to report their CSR activities even though the reporting is only directed toward shareholders. However, companies still find it difficult to meet this obligation as there is a lack of specific rules, disclosure guidelines, and standards concerning the following areas: category of companies required to establish a CSR fund; CSR activities allowed, such as only in the field of environment, socio-economic development, education and training, and health and sports; and forms of prohibited CSR investments, such as contributions to political campaigns, promotion of discriminatory activities, and activities that are against the national and public interest. However, Article 74 of the Company Act 2007 and Article 5 of the GR No. 47/2012 both explain the principle of “appropriateness and fairness” concerning CSR activities, which can be used as a tool for creating guidelines and standards.

The existing guidelines, such as CSR Guidelines on Environment issued by the Ministry of the Environment in 2011, are sectoral and are not binding (Chang, 2018). Such guidelines direct the exercise of CSR in environmental issues, such as identifying the negative impacts of business operational plans on the environment, identifying any potential impacts on natural resources and the environment around the operational area, identifying the needs and aspirations of the community concerning the business, and drafting a plan for CSR activities. Nalle (2015) asserts that the absence of a central government regulation that binds companies to implement CSR shows that the government itself is hesitant in regulating stakeholder-oriented CSR.

Furthermore, the lack of universally applicable guidelines and standards for disclosing CSR allows companies to have full discretion over disclosing CSR information in their annual reports (Sabela & Yeon, 2015; Sulaeman, 2016). This makes CSR disclosure a motivation to build a firm reputation and improve public relations. A company’s motive for implementing CSR tends to be a business strategy to sustain its operations and generate profits. For instance, when a university requests donation from a bank, the bank negotiates with the head of the university to pay the employees’ salaries via their bank. Thus, it is not surprising that many companies carry out inappropriate CSR initiatives and the benefits of the CSR practices for the surrounding community are questionable (Andrini, 2016; Fajar, 2018; Ketaren, 2014; Yulita, 2018).

Therefore, legislation should introduce ways to compel companies to make essential CSR disclosures for ensuring transparency. It must establish some standards or “minimum requirements” that must be used as a basis for such disclosures. According to Crawford and Williams (Perrault Crawford & Clark Williams, 2010), setting such minimum standards will result in higher quality CSR disclosures, when compared with the voluntary ones. The standards must not impose an unrealistic burden on the businesses, as this would result in the loss of much needed jobs and investment (Martin, 2005). Moreover, CSR reporting must be made available

for all stakeholders, not just the shareholders (Holder-Webb, Cohen, Nath, & Wood, 2009). By reporting CSR practices transparently to the stakeholders, companies would gain recognition from society, and this will indirectly help them minimize their business risks and ensure sustainability (Deegan, Rankin, & Tobin, 2002; Kytte, Hamilton, & Ruggie, 2005; O'Donovan, 2002).

The lack of guidelines and standards in reporting further weakens the implementation of CSR, especially when the regulations do not stipulate the establishment of a regulatory authority. Even if CSR disclosures are made to the shareholders, the importance of an authority to ensure that the obligations have been fulfilled should not be neglected by the government. The establishment of such an agency is important to monitor and evaluate CSR compliance, ensuring that companies lead their CSR activities according to the established standards, and ensuring sustainable CSR reporting. The agency should be assigned the task of reviewing and approving the CSR programs to be funded as well as verifying the CSR reports.

The extant CSR legislation does not prescribe enforceable sanctions on defaulting companies. GR No. 47/2012 imposes no sanctions, but states that sanctions will be provided by relevant sectoral regulations. However, there is only one sectoral regulation that explicitly regulates the types of sanctions for non-compliance, namely, the Investment Act 2007. Under Article 34 of this Act, companies that do not implement CSR will be subject to sanctions in the form of a written warning, restrictions on business activities, and suspension or even revocation of permission to continue business activities. Although these administrative sanctions are issued by an authorized agency, according to the rules of law, there are no guidelines on the types of disobedience that can be sanctioned in each of the abovementioned ways. There is also no explanation of the regulation regarding which a specific agency is authorized to impose sanctions. Above all, these pieces of legislation lack an enforcement mechanism. Thus, the legislation concerning sanctions does not provide the right impetus for a firm implementation of CSR, thus rendering them nonbinding.

## CONCLUSION

Indonesia takes a legislative approach in fostering CSR, and companies must exercise the same. However, this mandate is quite vague to be operational. Even now, the implementation of CSR seems to be voluntary and tends to be used as a business strategy for improving profits. Thus, CSR programs in the country are far from ideal. CSR regulations lack specific rules, guidelines, and standards regarding monitoring and reporting concerning the CSR initiatives undertaken, as well as a formal system of sanctions to enforce legal conformity. This finding can be used by the government to establish specific rules, guidelines, and standards that can be used as a basis for companies to implement CSR and for the imposition of sanctions on non-compliant companies without burdening the businesses unrealistically. This study contributes to the CSR literature by reviewing the legislative approach adopted by Indonesia to foster CSR. Future research on the legislative approach to CSR can broaden the analysis of factors that need to be considered in formulating specific provisions, guidelines, and standards in CSR implementation.



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