MERGERS AND CORPORATE GOVERNANCE, REFORMS OF THE STATE-OWNED ENTERPRISES IN INDONESIA

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Abstract

The Government of Indonesia has maintained its ownership of the State-Owned Enterprises (SOEs) to achieve various, and sometimes contradictory, economic and political objectives. Although there have been efforts to improve the efficiency and productivity of the SOEs, the performance of the enterprises has remained unsatisfactory for some decades.

The study explored how mergers have been used as one of the strategies to improve the efficiency and productivity of the state enterprises in 1988 and 1998. The case study approach allowed the researcher to examine the relationships between various factors that influenced the plantation company, PT Perkebunan Nusantara VIII's performance. Management reforms, the implementation of the mergers, international commodity pricing, and the ambivalent policies of the government were among the factors analysed.

Merger is a well-known strategy to expand businesses and create shareholder value. However, there is much controversy about its efficacy. The research found that the mergers had mixed outcomes. Mergers had positive impact upon the plantation company's performance, until government employment policies were introduced, with the consequence that profitability was depressed. The government's intervention to determine the plantation companies' economies of scale was not based on an economic analysis, rather on the government's desire to create larger state plantation enterprises of comparable size to the private plantations and conglomerates.

The government recognised the need to accelerate the reform and strengthen all state enterprises. Consequently, since 2002, the state enterprises' managements have been required to comply with good corporate governance practices, as these have been determined by the government.

The study found that the merger of the SOEs did not change government ownership as sole shareholder, nor did mergers decrease the government's intervention into the running of its enterprises. If anything the government tended to intervene in the management of state enterprises more frequently to fulfil its sometimes contradictory economic, social and political objectives. The Indonesian government was reluctant to cede the greater autonomy to the management necessary for effective reform.

The author believes that there is a need for further research in Indonesia on government policies in regard to the ownership and government's treatment of the SOEs. Further research is needed to address such questions as: Does the government have a role to play in maintaining strategic economic assets in Indonesian ownership?

Declaration

"I, Iwan R. Prawiranata, declare that the Master by Research thesis entitled Mergers and corporate governance, reforms of the State-Owned Enterprises in Indonesia, is no more than 60.000 words in length, exclusive of tables, figures, appendices, references and footnotes. This thesis contains no material that has been submitted previously, in whole or in part, for the award of any other academic degree or diploma. Except where otherwise indicated, this thesis is my own work".

Signature,

Date, 19 July 2005

[redacted]

Iwan R. Prawiranata MIB (Melb)

Acknowledgements

When I began with my research, I was challenged by the questions: did I know how to do research and could I finish that complicated tasks on time? When the thesis was completely written, then I did understand how I had learned of a research and convinced that it was the process not the end result as the measure of success in this production.

I had found this study was extremely satisfying both in term of outcome achieved and skills I had developed. This study would not have been possible without the continuing guidance and frequent stimulating from a number of committed and highly professional individuals.

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May God bless all of you.

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Abbreviations and Glossary

AVB	Algemene Volkscrediet Bank, General Bank for Small Credit, the legacy bank of Bank Rakyat Indonesia
Bapepam	Badan Pengawas Pasar Modal, Indonesia Capital Market Supervisory Agency
Bapindo	Bank Pembangunan Indonesia, Indonesian Development Bank
Benteng	fortress, benteng policy is a government policy to support the development of indigenous entrepreneurs in 1950s
BMD-PTPN	Badan Musyawarah Direksi PTPN I-XIV, Join Meeting Board of the Board of PTPN I-XIV
BNI	PT Bank Negara Indonesia Tbk.
BPIS	Badan Pengelola Industri Strategis, Strategic Industries Board
BPK	Badan Pemeriksa Keuangan, Supreme Audit Agency
BPKP	Badan Pengawasan Keuangan dan Pembangunan, State Audit Agency
BPPT	Badan Pengkajian dan Penerapan Teknologi, Agency for Research and Application of Technology
BUMN	Badan Usaha Milik Negara, State Owned Enterprise (SOE)
CCCPC	Central Committee of Communist Party of China
Cultuur stelsel	cultivation system
Dapenbun	Dana Pensiun Perkebunan, PTPN Employees' Pension Funds
Dewan Direksi	Board of Directors
Dewan Komisaris	Board of Commissioners
Dwi Fungsi ABRI	dual function of Indonesian Army
Erfpacht:	long lease land
FSP-BUN	Federasi Serikat Pekerja Perkebunan Nusantara, Federation of Labour Union of PTPN
GAPENSI	Gabungan Pemborong Nasional Indonesia, Central Association of National Contractors
Gouvernments Land-bouw Bedrijven	plantation companies owned by the Dutch government
HIPMI	Himpunan Pengusaha Muda Indonesia, Central Association of Youth Indonesian Entrepreneurs
Indonesianisasi	Indonesianisation, Indonesia economic nationalism, transfer of ownership into Indonesian hands
KADIN	Kamar Dagang dan Industri, Indonesian Chamber of Commerce and Industry
Kebun inti	core estates owned by the SOPE or PBSN to support small-holders plantations
Kebun rakyat	small-holders plantations
Candak Kulak	types of small loans
KKN	Kolusi, Korupsi dan Nepotisme, collusion, corruption and nepotism

KNILM	Koninklijke Nederlandsch-Indische Luchtvaart-Maatschappij, Royal Netherlands Indies Airlines
Koperasi	cooperative enterprise
KPB	Kantor Pemasaran Bersama PTPN, PTPN Join Marketing Board
Malari	student protests on 15 January 1974 at Jakarta
Mono-loyalitas	single loyalty of the bureaucracy to the government
NCCG	National Committee for Corporate Governance in Indonesia
NIAM	Nederland Indische Aardolie Maatschappij
OECD	Organisation for Economic Co-operation and Development
PANSUS	Panitia Khusus, Temporary Committee in Parliament established for a special case
PBSN	Perkebunan Besar Swasta Nasional, privately owned big plantations
PDBI	Pusat Data Bisnis Indonesia, Indonesian Business Data Centre
PELNI	Pelayaran Nasional Indonesia, State-Owned Shipping Enterprise
Pembangunan	economic development
Perjan	Perusahaan Jawatan, government agency, a social service corporation
Persero	Perusahaan milik Negara berbentuk perseroan terbatas, government limited liability company, a commercial operation
Perseroan Terbatas Perkebunan XI, XII dan XIII (Persero)	State Owned Plantation Enterprise XI, XII and XIII, government limited liabilities
Perseroan Terbatas Perkebunan Nusantara VIII (Persero)	PTPN VIIII, SOPE Nusantara VIII
Pertamina	Pertambangan Minyak dan Gas Bumi Negara, State-Owned Oil Enterprise
Perum	Perusahaan umum milik Negara, public corporation, a mixed business which generate income while providing public services
Perusahaan Negara Perkebunan (PNP) XI, XII dan XIII	State Owned Plantation Enterprise XI, XII and XIII
PMA	Penanaman Modal Asing, foreign investment policy of 1967
PMDN	Penanaman Modal Dalam Negeri, domestic investment policy of 1968
PN	Perusahaan Negara based on Law no. 19/1960, Government Owned Companies

PNP	Perusahaan Negara Perkebunan, State Owned Plantation Enterprise
PPN ANTAN	Perusahaan Perkebunan Negara Aneka Tanaman, State-Owned Plantation Company with Variety Crops
PPN Kesatuan Jawa Barat	Pusat Perkebunan Negara Kesatuan Jawa Barat, Government Estate Company, Unit of West Java
PPN Lama	Pusat Perkebunan Negara Lama, Old Centre of Government Estate Company
Pribumi	indigenous
Propenas	Program Pembangunan Nasional, National Development Program 2000-2004
PTP	Perseroan Terbatas Perkebunan/Persero, State Owned Plantation Enterprise, limited liability
Rentabilitas	profitability
Repelita	Rencana Pembangunan Lima Tahun, Five Year Plan
SOE	State-Owned Enterprise
SOPE	State-Owned Plantation Enterprise
Tri Dharma Perkebunan	Three Missions of the SOPE
VOC	Vereenigde Oost-Indische Compagnie, United Dutch East Indies Company

Chapter I
Introduction

A. The Study

1. The issues pertaining to the study

Beginning with the introduction of nationalisation in 1958, the government of Indonesia controlled the State-Owned Enterprises (SOEs). The government used the threat of nationalisation to put pressure on the Dutch to give up West Irian. The nationalisation of the Dutch enterprises in 1958 did not change Dutch policy on West Irian, but it gave the government much greater control over the economy. Although with regime changes different economic and development policies were introduced, the government continued to make use of the SOEs to achieve its various economic objectives. For this crucial role, the government needed financially sound and efficient SOEs that were developed through a process of reform.

From a financial point of view, the performance of the SOEs was basically unsatisfactory. For a period of fourteen years, from 1979 to 1992, the return on assets of the state enterprise sector was in the 1.5 to 4.6 per cent range (Hill, 2000) and from 1987 to 1995, was in the 1.7 to 3.1 per cent range (Ministry of Finance, 1993, 1995, 1996). In 1997 it was 2.3 per cent (Ministry of SOE, 2002) and the average return on assets, before tax from 1999 to 2002, was 3.3 per cent (Ministry of SOE, 2003). Such a low return was below the interest rate over that period and would have been unacceptable from a private investor's point of view. During those decades there were efforts to improve the efficiency and productivity of the SOEs, but no significant improvement was achieved. Influential bureaucrats and military and government leaders resisted the restructuring program initiated by President Suharto. During the presidencies of BJ Habibie, Abdurrahman Wahid and Megawati Soekarnoputri, the government managed a program of SOE reform that included mergers in conjunction with privatisation and established principles of good corporate governance for the benefit of the SOEs. As part of the economic reform and privatisation, there were programs held and a commitment made to promote a more efficient use of government resources.

The patrimonial political economy was a constraining factor in determining the level of performance of the SOE sector. The management of the SOE sector was subject to conflicting and competing government policy objectives. Within the bureaucracy, the senior military officials and political parties competed to control the sector. The slow pace of the restructuring and the continuing low performance of the SOEs, indicated the challenge posed by the political and bureaucratic environment and the ambivalence of government attitude towards reform. In monitoring the performance of the SOEs post reform, the government had to consider not only the profitability of the individual companies but also their role in the achievement of macro economic and non-economic objectives. As the role of SOEs is still significant in the economy, several aspects of their operations, particularly their investment, employment, price and wage policies, appear to affect the realisation of their economic target.

The impact of the economic crisis on the SOEs was a sharp decline in the return on assets in 1998, the biggest loss being 43.6 per cent (Ministry of SOE, 2002). The higher return on assets in 1999 indicated that some of the export producing SOEs gained significant benefits from their export proceeds due to the depreciation of the rupiah. Reform was the solution and the government had affirmed that privatisation was the main objective of the reform. Until 2002 there were 25 of approximately 190 SOEs that had been partially privatised, but progress was very slow. The government wanted to float 25 and 35 SOEs in 2000 and 2001 respectively. It was an unrealistic and ambitious program as the government lacked expertise and experience and the share market had a limited capacity to absorb such a number of initial public offering (IPO). It also needed to conduct a public education program and needed to mobilise strong political support for the privatisation of state assets. A five-year plan to develop the SOEs was established in February 2002 and a projection of return on assets for 2001-2006 was targeted between 3.60 and 4.47 per cent (BUMN, 2002). This is likely to be below projected market interest rates.

In 1999 the government recognised the urgency for good corporate governance in the business sectors and SOEs had to comply with a good corporate governance code from 2002. A necessary process involved building a commitment between owners, commissioners, directors, all employees and other stakeholders. The SOEs had to apply the corporate governance principles as stated in the Decision of the Ministry of SOE no. KEP-117/M-MBU/2002. The implementation is supervised by the State Audit Agency (*Badan Pengawasan Keuangan dan Pembangunan/BPKP*).

2. The aims of the study

The aims of the study were the significance of a process of reform of the SOE sector in achieving efficiency and financially strong enterprises, with a focus on merger options and an understanding of the measure of success and difficulties involved. In order to achieve these aims four areas were examined:

1) The history and role of the SOEs.
2) Government efforts to reform the sectors.
3) The reasons why reform had been so difficult.
4) A case study of the merger and the success or otherwise of good governance.

3. The significance of the study

The SOEs are still a large and important sector in the Indonesian economy. Reform of the SOEs, through mergers and the introduction of good corporate government practices together with full or partial privatisation, influenced Indonesia's capacity for broader economic change. This research contributes to an understanding of the reform process and the development of good corporate governance in the SOEs through an integrated approach, combining economic and political analysis with a detailed business study.

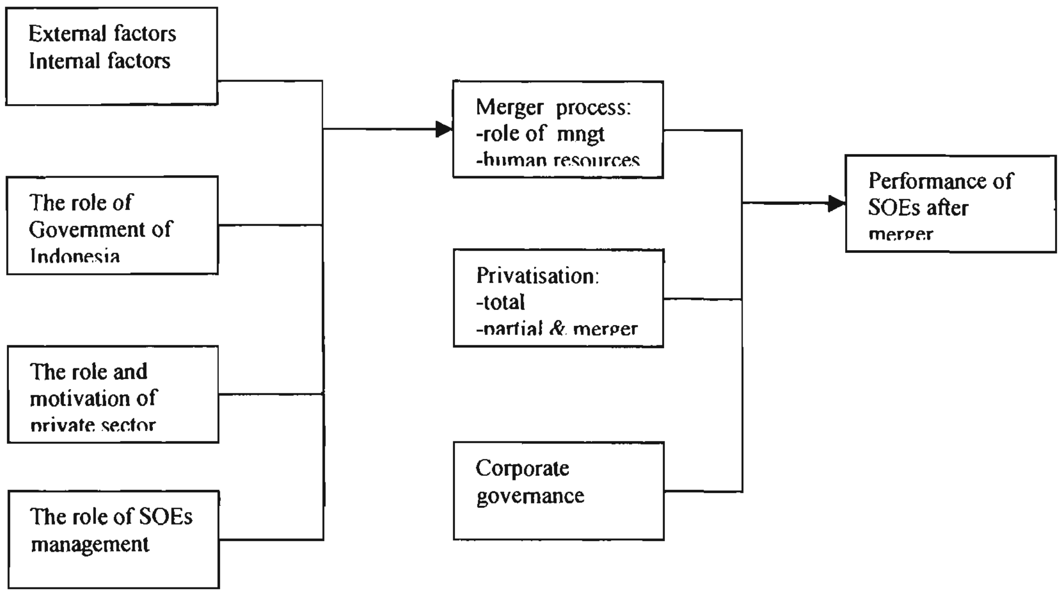
4. The research questions

The following research questions were used as a guide to fulfil the aims of the study:

1) Why was government policy on reform of the SOE sector so ambivalent?
2) What were the core problems that needed to be reformed?
3) How did good corporate governance support the merger policy?
4) What were the differences between the merger policy before and after the 1997-1998 financial crises?
5) What were the impacts of the merger on the performance of PT Perkebunan Nusantara VIII?
6) What conclusions could be drawn on how mergers in the SOEs should be managed?

B. The Theoretical Framework

The effective implementation of mergers in the SOE sector was dependent on changes in the political situation and, ultimately, on regime change. In assessing the development of the SOEs, the research identified two main criteria for the evaluation of SOEs, namely, government policy reflected in government regulations and the financial performance of the SOEs.



The framework diagram shows the relationship between the external and internal factors influencing reform of the SOEs and the assessment of reform after merger or privatisation.

1. The external factors

The study analysed the following features of the macro environment (Daft, 2004; McKenna, 1999):

1) Political-legal element: the different legal government systems within which an organisation operates.
2) Economic system: the system of production and distribution of goods and services and how this may directly or indirectly influence the organisation.
3) Socio-cultural system: the ethnic backgrounds, beliefs, values, relationships and behaviours of the people of the particular area/country where the organisation operates.
4) Technological element: the technology on which an organisation was dependent or which could potentially impact on the organisation's domain.
5) International context: the events originating from other countries with the potential to influence the organisation.

The external motivation reflected and related to general business conditions, as discussed by, among others, Gaughan (2002); DePhampilis (2001); Schuler & Jackson

(2001); Habeck et al. (2000). Efficiency and profits were the goals as determined by the share valuation. Different dynamics operated in the public sector. For the government, mergers and privatisation became attractive when the benefits of efficiency were seen as more important than the advantage derived from the SOEs, in terms of patronage and revenue. The future ownership of the privatised enterprises was also politically sensitive. The SOEs' mergers were also motivated by other internal factors such as the need to minimise loss, to turn the company around and to avoid bankruptcy (Peel, 1990; Davis, 1988).

Changing ideologies concerning the role of the state in the economy and ownership of the enterprises also played a part. It seemed that control by the market and international competitiveness had become the priorities. Because of the impact of globalisation, the Indonesian Government realised the existence of strong market pressures. Meanwhile, Indonesia committed itself to international institutions, such as the International Monetary Fund, the World Bank and the Asian Development Bank, to reform or privatise the SOEs (Government of Indonesia's Letter of Intent to IMF of 15 January 1998). The strategy of mergers was part of a restructuring process to strengthen the competitiveness of the SOEs, to achieve economies of scale, to focus on their core capabilities and to strengthen their core competence. Until 2002, there were 51 SOEs (23 in the plantation sector and 28 in trading, industry, pharmacy, services, banking) merged into 21 new SOEs. From a financial point of view, the result of these mergers was not adequate.

The next step in the reform process was to consider the alternatives of partial privatisation or full privatisation. The latter related to transferring of state ownership through the capital market mechanism or through private placement with strategic partners. For the private sector, the discrepancies in valuation between insiders and outsiders provided a motivation for a purchaser to buy or merge a company. Auerbach (1988) states that the purchaser believes the current price is lower than the replacement costs, where the investment flow involves the creation of the plant and equipment. These factors are related to competition in the private sector. For private-owned companies operating in a market environment, maximisation of profits for higher share values is a common goal. Their basic hypothesis is that mergers are undertaken for capital gains through appreciation of the acquiring company's stock. However for the SOEs, under government ownership, the basic hypothesis is that mergers are undertaken for efficiency and effectiveness and to improve their performance for government and public interests. The merger also embodied good corporate governance issues so as to strengthen new companies. Good corporate governance was used as a tool for extracting value from under-performing, under-valued companies (Corporate Governance, 2001).

2. The internal factors

Two variables of strategy and process were studied. It was the task of management to understand the linkage between external factors and their business to determine the strategic position of their organisation. This might be a position of strength and influence or one of weakness and dependence on the environment that could make the strategic choice and actions that followed would be quite different (Daft, 2004; McKenna, 1999). The study identified the choice and actions taken by the SOEs management as they were challenged by the dominant role of the government as sole owner.

The term 'process' was used to refer to those flows of management activities that aim to create profitable products and services. Processes have no clear boundaries, have no names and are unknown, definitions are inadequate and each organisation can define a process according to its needs (Davenport, 1993). The study identified the management of the SOEs' work procedures in the merger process that faced various external factors and different government policy. The process of corporate reform in the SOE sector had two phases. After SOEs had been merged, there was an evaluation of subsequent performance of the merged entities together with political considerations before a decision was made to privatise, either fully or through a partial float.

C. Methodology

1. Research design

The researcher engaged in an exploratory study using a qualitative research methodology. This method was considered appropriate as the study sought to delve into the complexities of process in which little information exists (Marshall & Rosman, 1999). The challenge was to study the development of the SOEs since the Dutch period and the political ideology and economic policies that influenced government policies on the SOEs.

The study benefited from qualitative research, as this method allowed for well-grounded, rich description and explanations of the process in identifiable contexts. With qualitative data it was possible to preserve the chronological flow to see precisely which events led to which consequences (Miles & Huberman, 1994). Chronological flow of the policy on the SOEs since the Dutch period, the Old Order, the New Order and the Reformation Order, was important in identifying the stream of government treatment that led to a particular outcome of the SOEs' performance.

The other advantage of qualitative research was the possibility for the researcher to go beyond asking the 'what' questions to asking the 'how' and 'why' questions and to be able to assess causality as it was actually played out in this particular setting (Miles & Huberman, 1994). It allowed for exploration and discovery and showed how the variables under study impacted on each other.

However, in contrast to a quantitative method, qualitative research methodologies have their disadvantages; here a researcher cannot always specify the exact outcome (Punch, 2000). Qualitative research is commonly criticised as being too impressionistic and subjective. Bryman argued that it was impossible to generalise, to know how the findings could be generated in other settings and how just one or two cases could be representative of all cases (2001). Miles & Huberman (1994) suggested the wisdom of linking qualitative and quantitative methods to strengthen the overall research design and to give clearer interpretation of the findings, to elaborate or develop analysis and to provide richer detail. The study combined the qualitative data with financial analysis and the findings are useful in highlighting comparative relationships between sets of data and trends.

2. Data collection

Information was collected from primary and secondary sources. The primary sources consisted of observation, interviews and a questionnaire. The secondary sources consisted of documents such as government publications, earlier research, census and personal records (Kumar, 1996).

2.1 Primary sources

The research interviews were used as a method to collect information, data or opinion from the persons involved. Interviews were conducted to explore complex situations and accumulate in-depth information. However, the interview method had some weaknesses.

It was not only time consuming and expensive, but also the quality of data depended on the quality of interaction occurring and on the quality of interviewer and interviewee, both of whom might introduce their bias.

Table 1.1
Distribution of respondents

Respondent from:	Number contacted	Number responded
The ex Ministry of Finance	2	1
The ex Ministry of Agriculture	4	2
The ex PT Perkebunan	1	1
The Ministry of Agriculture	3	1
The Ministry of SOE	6	6
The World Bank Jakarta Office	1	1
The Jakarta Stock Exchange	1	1
Join Marketing PT Perkebunan	2	2
PTPN VIII	7	7
PT RNI	1	1
PT PPI	1	1
The West Java Regional Government	1	1
Total	**30**	**26**

The respondents were selected from a purposive sample as they had expertise and experience and had been involved in the process of policy making and the merger process. Some of the respondents had retired, while others were still working in areas relevant to this study. Direct appointments were arranged with retirees, but the government officers engaged in bureaucracy procedure within their internal organisation and the interviewees, were appointed by senior staff in their organisations. Approximately 87 per cent of the people contacted responded to interviews and data collecting.

2.2 Secondary sources

Secondary data collection was available from several sources. Documents that related to the Indonesian Government policy on the SOEs and corporate governance, including laws, presidential decrees, presidential instructions, government regulations, ministry decisions, Bank Indonesia regulations, company reports, financial reports, audit reports, newspapers and magazines, were the main resources to understand the dynamics of the macro environment, socio-cultural, political and economic change and the influence of international institutions on Indonesia. The understanding of the chronological flow of policy on the SOEs was supplemented by interviews. The researcher assessed the government treatment of the SOEs, impacts of government policy on the performance of the SOEs and efforts at improvement.

3. The case study

This study investigated the impact of merger as an option in SOE reform policy since 1988 that worked hand in hand with implementation of good corporate governance. Secondary sources and interviews with retired and current officials of the company involved in this case study were part of the research investigation.

Mergers were conducted in 1996 with the State-Owned Plantation Enterprises (SOPEs). One of the merged plantation companies PT Perkebunan Nusantara (PTPN) VIII was chosen as the case study. The purpose of using the case study method was to illuminate decisions taken: why the decisions were taken, how they were implemented and the results (Yin, 2003). The merger of 28 SOPEs into 14 new companies was a centralised government policy and was implemented simultaneously, with the same model applying to all of the SOPEs. It meant that any new merger company had the same probability to be selected as a sample case. PTPN VIII was selected as the case study, a merged entity of three state plantations, PT Perkebunan XI, XII and XIII. PTPN VIII produced palm oil, cocoa, cinchona, gutta percha, tea and rubber. Prior to the merger, 80 per cent of their production consisted of tea and rubber and was subject to volatile changes in the world market. Two of the enterprises suffered from loss prior to the merger.

Eight people were selected to participate in the interview, a retired senior officer of PT Perkebunan and 7 from PTPN VIII: a commissioner, members of the board, Department of Accounting, Internal Auditors and Human Resource officers. They also supplied company documents on business activities, annual reports and financial conditions prior to the merger in 1994 until 2002, State Audit Agency reports, documents on corporate governance, personnel reports, the corporate plan and the program to establish a Strategic Business Unit. The information, data and interviews were the sources for the case study.

4. Data analysis

Qualitative data derived from interviews usually took the form of unstructured material and it was not straightforward to analyse (Bryman, 2001). The approach to data analysis and interpretation was to integrate the findings and connections between them. Miles (1994), developed a framework for qualitative data analysis with three components: data reduction, data display and drawing and verifying conclusions. Data reduction refers to the process of selecting, focusing, simplifying, abstracting and transforming the data that emerges from the fieldwork (Miles & Huberman, 1994). The collected data is reduced and transformed by way of summarising or paraphrasing. Data display is an organised assembly of information that permits conclusion drawing and action taking. The reduced data is displayed in the form of matrices which are designed to assemble organised information in an immediately accessible, compact form. The final step is conclusion drawing and verification. At this stage, the researcher found meaning by noting regularities, patterns, explanations, possible configurations, causal flows and propositions.

5. Limitation of the study

There were some limitations in the methodology employed in data collection:

1) As the government had changed to the Reformation Era, some retired officials declined to be interviewed as they preferred not to be involved in discussing the New Order's policy. Active officers stated that they were not in charge of those matters as they were engaged in a new policy of privatisation. They preferred to provide data rather than discuss the process of policy making.
2) There was a movement of government machinery between the ministries and a transfer of control from the Ministry of Finance to the Ministry of the SOE. The changes meant that the information from the 1988 reform, from both officials and files, was scattered in many organisations and it was difficult to follow the decision-making process and flow of information at ministerial level.
3) The researcher had no control over the selection of the respondents. Some lower staff with good understanding and perception of the issues may have been excluded and interviews depended on availability of senior staff in the organisation.
4) Although the researcher had assured the interviewees' confidentiality, some of the respondents tended to discuss issues in general, without much description.

D. Overview of the Research

This section outlines the contents of the thesis.

Chapter I presents the main issues of the SOEs and the aims and significance of the study. The merger of the SOEs occurred in dynamic conditions where external and internal factors influenced the process. The methodology of the research is explained, which includes the limitations of the study.

Chapter II presents a review of the related literature. It discusses the role of the SOEs, a theoretical framework of mergers, for the public sector and the private sector and the motivations and arguments for why merger was used as an option. The other part of the chapter explains the approach to the study of SOEs in Indonesia, the government initiative to reform and the need for good corporate governance. The SOEs in China are examined as a comparative study with Indonesia's.

Chapter III describes the historical background since the Dutch period and the performance of the SOEs until 1988. This background is important for an understanding of why the government used the SOEs as political and economic development instruments and the impact of government intervention on the SOEs' performance. The government's ambivalence to reform and the reason why the government established the reform policy in 1988, is explored. Interconnection between merger and privatisation is also explained in this chapter.

Chapter IV examines the implementation of the reform policy in 1988, the public debate and evaluation on the effectiveness of restructuring, which includes a discussion on the challenges of the slow process of reform. A new concept for SOEs' reforms emerged in 1998 that was different from the 1988 policy. Efforts in restructuring after the economic crisis and the basic policy of restructuring and privatisation stated in Law 19/2003 are also discussed.

The focus of this thesis is the mergers of SOEs in Indonesia and the significance of good corporate governance on the effectiveness of these mergers; therefore Chapter V discusses mergers in more detail, together with the challenges, accountability, issues and problems and the financial effect after merger in some companies. Good corporate governance is examined in this chapter—not only the reason why corporate governance was needed in Indonesia, but also the results of its implementation in 16 SOEs, as audited by the State Audit Agency. How good corporate governance supported the merger policy is also discussed in this chapter.

Chapter VI introduces and discusses the case study of PT Perkebunan Nusantara VIII, in the context of the State-Owned Plantation Enterprises, to show the impact of the merger, implementation of corporate governance and ambivalence of government that influenced the performance after the merger.

The concluding chapter presents the summary of the researcher's findings together with recommendations and possible areas for future research.

Chapter II

Literature review

This chapter discusses the literature in areas related to the study, that is, the role of the SOEs, merger and corporate governance.

A. The role and performance of the SOEs

1. The establishment and role of the SOEs

State-owned enterprises were established for a variety of different reasons, often in response to a combination of political and socio-economic problems. In many developing countries that won political independence after World War II, the SOEs were part of the inheritance of colonial rule, and their existence was acceptable and mainly due to the necessary transformative role of the state (Cook & Kirkpatrick, 1995). They further argued that the new government, through state ownership, was expected to preserve economic independence, secure strategic commodities, and counter balance capitalist power in anticipation of the emergence of neo-colonialism in the post independence period.

Dinavo (1995) argues that pragmatic factors, rather than ideology, had been the major rationale for defending the presence of the SOEs. In a country where the private sector was small, fragmented and under capitalised, with limited ability to handle public utilities, the SOEs played a crucial pioneering role in promoting weak, poorly developed sectors and infant industries.

Meanwhile, Hall (1986) states that the establishment of the SOEs was generated by a lack of faith in private enterprise. To ensure that the public would benefit from such monopolies further necessitated the establishment of the SOEs. It is also claimed that the SOEs played important roles in the fulfilment of certain social objectives, which would have been extremely difficult for the private sector to undertake.

The SOEs were used as instruments for state intervention in the economy and they were intended to correct failure. It was the counter balance to the ideology that market mechanisms were superior to bureaucratic control. Stiglitz (1986) stated state intervention was justified and was expected to correct market failure.

After Indonesia gained political independence in 1945, the new state initiated the rehabilitation of infrastructure and public utilities as the way to development. Under the

Soekarno presidency with its dominant socialist ideology, from 1951 the government established new SOEs—an *Indonesianisasi* process—to support the economy (Robison, 1986). The rapid growth of the SOEs occurred after 1958 when the Indonesian Government nationalised the Dutch and foreign companies, mainly for political and ideological reasons (Golay, et al. 1969). Economic development and public prosperity were the imperative duties of the newly established government. The government used the SOEs to implement the constitutional mandate in article 33, to control the elements of the economy that related to public needs. The government had direct control of the SOEs operation. The government intervention in the SOEs was reflected in various policy statements, regulations, instructions, directions, and 'suggestions' about what to do and what not to do.

The SOEs in Indonesia played an important role in politics and the economy after their nationalisation (Hill, 2000). However, the problem was that the government imposed a multiplicity of objectives on the enterprises. Many of the objectives were non-commercial in nature or under special missions and social responsibilities. Moreover, the commercial autonomy of senior management was so severely restricted and bureaucratised that this made the SOEs performance inherently inferior to that of private firms. The absence of effective reform to improve profitability was testimony to the presence of the powerful vested interests opposing such measures.

Robison explains that during the guided economy of President Sukarno the state enterprises were a failure and indicated the decline in Indonesia's existing capital stock (1986). The failure of the SOEs meant that they could not support the process of capital formation. The SOEs not only faced management and efficiency problems, but political self interest was also damaging. Decisions affecting operations were not made on a commercial basis, but were intended to provide finance for political power centres and individual officials.

Dick (2002) states that the SOEs were developed in the 1950s, as the government put high priority on achieving economic sovereignty or Indonesianisation (*Indonesianisasi*) of the economy to compete with Dutch firms at the commanding heights of the economy. Indonesianisation could have achieved impressive results, but the pace was too slow to assuage nationalist aspirations. After nationalisation, ex Dutch companies were reconstituted as state enterprises under Law no. 19/1960: their performance rapidly worsened as the impact of a lack of credit and foreign exchange, and bad management weighed in. Under guided economic policy, the SOEs were used as the vehicle for the importation of essential goods and the development of state-owned basic industries, especially fertiliser, cement, paper, chemicals, textiles and shipbuilding.

State-owned enterprises in this period played a central role in the Indonesian economy. They were the main investors in public infrastructure, public utilities, industries, financial services, plantation estates and trading (Abeng, 2001). They were important in business, but were challenged by problems that prevented them from becoming more competitive and profitable. Abeng stated that excessive government intervention, overly bureaucratic organisation, the quality of management, and weak auditing mechanisms were the drawbacks (2001). He also explained that reform was needed but there had been strong political resistance (2001).

Sukardi (2002) states that SOEs were the main players in the national economy. Involved in various business enterprises supported by their networks all over the country, the SOEs provided goods and services to the Indonesian people although their services were not at an optimal level. After many decades, the quality of their services had not improved significantly, and only benefited certain groups. Sukardi explained that the SOEs suffered from leakages of assets and revenue and were sources of collusion, corruption and nepotism *(KKN)*. He argued that reform was needed to maximise the benefit for the stakeholders and he was convinced that privatisation, partial or full, was the best solution for the government (2002).

The above review of literature indicates that the SOEs in Indonesia played an influential role in politics and the economy, but were part of a patrimonial political economy. It is clear that government policy and practice with respect to the SOEs was ambivalent and ambiguous. Consequently, the SOEs as government tools to create wealth for Indonesians, did not operate as expected. The SOEs were burdened with political and social costs and unprofessional management in order to service their patrimonial relations. Maintenance of conflicting interests and objectives by the SOEs tended to weaken their performance and create a lack of capital formation. It meant that reform of the SOEs was a challenge within the bureaucracy and the government itself needed strong political support. This dilemma was resolved in 2003 when the SOEs were equipped with Law no. 19 on state-owned enterprises, which stated that the SOEs worked for profit except when the government stated different objectives.

2. The performance of the SOEs

The 1970s were characterised by major world-wide expansion of the state in the economy through the SOEs. In many countries government intervention was related to the state's intention to influence, regulate, plan, produce and distribute goods and services (Hanke, 1987). However, Hanke saw that in the mid-1980s, a number of governments world wide began to reconsider the state sector. The large and growing nature of this sector indicated to them that state intervention in the economy might have gone too far, especially when the growing state sector did not manifest good economic performance.

Supported by his empirical study of public sectors in Asian countries, Tanzi (1987) identified several factors contributing to the low productivity of public investment: (1) the choice of unprofitable investment projects for political and other reasons; (2) less emphasis on efficiency than on objectives such as employment, redistribution of income and regional development; (3) low capacity utilisation; (4) poor pricing policy; (5) managerial staffing based more on political consideration than on managerial ability; (6) the absence of discipline imposed by competition and profit motives; (7) the fall in commodity prices in recent years.

Ayub & Sven (1986) describe the problems of poor performance as a 'vicious circle': (1) a lack of managerial autonomy and accountability; (2) poor financial management; (3) poor investment choices, low productivity, excessive leverage; (4) financial losses justified by social objectives; (5) deteriorating morals, further reduced financial stability; (6) financial crisis; (7) less managerial autonomy and accountability; (8) further strengthening of central controls and decision making.

The result of SOE operations was reflected in the financial reports. Financial analysis was very common and was used to compute data in performance evaluation (Gaughan, 2002). It was understood that much non-financial information was needed to interpret the figures, as the SOEs had multiple objectives. The concern over the their performance also came at a time when governments were experiencing a financial crisis, and this made governments realise that the SOEs had become obstacles to the resolution of macro economic problems, such as huge budget deficits, extensive foreign debt and high inflation. The situation had led to the reduction in size of the state sector, and to the elimination of government regulations and controls (Cook & Kirkpatrick, 1990).

As the financial problems accelerated, governments intensified control over the operation of the SOEs and were involved in rescue operations by injecting massive amounts of capital into the SOEs. However, recovery was not sufficient to maintain the survival of the economy, especially in the long term. All too often, these objectives were mutually contradictory. The competing forces in government tried to find trade-off solutions, combining a certain amount of each. Governments had therefore initiated reforms focusing upon enterprise restructuring and privatisation (Upper & Baldwin, 1995). However, it was not only economic and business matters, but also political reasons that forced governments to consider a new policy to maintain their economies, namely to reform the SOEs. The performance problems faced in many countries also challenged Indonesia. Reform of the SOEs was the way to improve financial performance by using the criteria of profitability, solvency and liquidity, stated in the Ministry of Finance Decree no. 740/KMK.00/1989.

From the above mentioned studies and in order to assess the SOEs for this research, various criteria were used:

1) The historical background of colonial rule prior to their establishment had created a strong political sentiment regarding ownership.
2) The government used the SOEs to legitimise its political role and control of the economy.
3) The SOEs were utilised as vehicles to pioneer and run the economy, as the private sector was often incapable of undertaking this task.
4) The government exploited the SOEs to control the market.
5) Generally, the SOEs had lower performance in comparison with the private sectors' earning capability or the market rate.
6) Since 2003 in Indonesia, the SOEs have been run on a profitable basis, unless directed otherwise by the government.

B. Review on mergers

Since 1988 the Indonesian Government has chosen mergers as a strategy to restructure the SOEs sector. Mergers and acquisitions are an economic phenomenon. It occurs not only at a national level, but it is currently an international trend.

Marchildon (1991) states that the term 'merger' is generally restricted to mergers by consolidation while the term 'acquisition' encompasses all mergers by acquisition. Merger by consolidation implies the combining of two or more firms, submerging their identity into a new corporate entity, whereas acquisition involves the purchase of one or more firms by a company which retains its corporate identity.

Schuler & Jackson (2001) clearly state the difference between mergers and acquisitions. They describe a merger as two companies coming together, creating a new entity. With acquisitions, one company buys another and manages it consistently with the new owner's needs.

Gaughan (2002) elucidates a different way to explain a merger as a combination of two corporations, in which only one corporation survives and the merged corporation no longer exists. A merger differs from a consolidation, which is a business combination whereby two or more companies join to form an entirely new company. All the merging companies are dissolved and only the new entity continues to operate. It means that Gaughan clearly defines a merger by acquisition as a merger and a merger by consolidation as a consolidation.

Despite the growing number of mergers (Gaughan, 2002), many of them appear to fail (DePhampilis, 2001; Brouthers, et al. 1998). This raises following questions: what are the reasons for encouraging firms to merge and by what criteria are success or failure measured? Authors have different answers to these strategic questions; in general they state that the reasons for mergers and acquisitions in the private sector are for higher profits and better share value, however there are some key arguments.

Schuler & Jackson (2001) state that a merger is used to strengthen and maintain a position in the market place, create fast and efficient expansion into new markets, to incorporate new technologies and strengthen competitiveness in the global economy, as companies must be fast growing, efficient, profitable, flexible, adaptable, ready for the future and have a dominant market position.

There are also strategic motives such as synergy, global expansion, pursuing market power, acquiring market power and new resources and improving the competitive environment (Brouthers, et al. 1998). As a merger is a way of maximising profits, there are other arguments when a merger is used as a solution to minimise a loss. How to turnaround a company as a company rescue effort, is explained by Davis (1988). He argues that a merger is a policy decision taken by the shareholders, to restructure and reorganise companies with the same line of business and under the same ownership, followed by clear strategies and rescue action programs to redevelop the business.

Bankruptcy avoidance is noted by Peel (1990). It is a strategy in exploring the possibility of bankruptcy avoidance by the distressed firm as a reason for the merger.

Measuring merger performance has been the difficult problem. Most merger performance studies use one of two standard financial measures: changes in profitability or changes in shareholder value and share price (Lubatkin, 1983). However, the measurement has been disappointing or ambiguous in many cases, and does not adequately measure the true performance achieved. Lubatkin explains that the measure of performance used may be incorrect because (1) only one measure of merger performance was used and management was attempting to achieve multiple motives; or (2) the measure used (an economic measure) was not one of the merger motives of management and therefore would not reflect merger performance; or (3) merger of different size enterprises was thus mixing high performing smaller enterprise with low performing larger enterprise.

Meanwhile, Brouthers, et al. 1998, recommend a new methodology for evaluating the success or failure of merger activities, based on three key concepts:

1) The fact that managers have multiple motives for participating in a merger is recognised. Therefore, the new model contains 17 of the most widely cited motives for merger activity.
2) Performance should be measured against the goals and objectives set by management, not necessarily against financial results. It recommends the use of key success factors as performance measures.
3) Merger can create performance improvement in a number of areas of the firm's activities. Therefore it is prudent to utilise multiple measures of performance. The success and failure of mergers will be discussed in Chapter V.

A merger initiative in the private sector usually comes from the owners or shareholders due to their legal and financial responsibilities, but a merger may occur as a manager's initiative. It is because the managers seek personal benefit, increasing prestige through increasing sales and firm growth, or increasing remunerations through increasing sales or profitability (Brouthers, et al. 1998). The merger is not finalised by signing the contracts. It is only the beginning of how a theoretically sound merger can be effectively operated and how that hypothesised result can be delivered. The integration process in a merger is a critical management process; it begins long before and continues long after the formal merger. An integration manager plays a vital role in the integration process

(Schweiger, 2002; Hitt, et al. 2001; Habeck, et al. 2000). The process must be supported by understanding how decisions are made and how firms are integrated (Haspeslagh, 1991). This process is important to achieve better performance after the merger.

In the literature there is a well-known example of a success merger by acquisition. This was the case of the General Electric Company (UK) that took over Associated Electrical Industries (AEI) in November 1967 and English Electric in September 1968, developing efficiency in the electricity industry. The merger increased the GEC equity from 58.6 million pounds sterling to 136 million pounds sterling, plus 15.6 million pounds sterling in cash. In return, sales of the GEC groups were increased from 180 million pounds sterling to 900 million pounds sterling (Jeremy, 1998). As a mergers' historian observed (Jones & Marriot, 1970), the GEC paid the equivalent of 140 per cent of its shareholders' equity for the merger, however, as a result GEC increased the group's sales by 373 per cent.

The initiative for a merger of the SOEs originates from the government as owner. There are three necessary conditions; reform or merger must be politically desirable, politically feasible and reform must be credible (World Bank, 1995). The Indonesian concept of merger in the legal sense is a legal action where two or more corporations establish a new entity and the component corporations cease to exist (Government Regulation no. 27/1998). There is no liquidation of the component corporations prior to the merger. After the merger, the shareholders of the existing corporations will be the share-holders in the newly merged entity and the assets and liabilities of existing corporations will be transferred to become the assets and liabilities of the new corporation. Merger has to consider the interest of the creditors and it must be approved by the shareholders' meeting of the existing corporations.

Research on merger in Indonesia is relatively rare. It does not mean merger activities are not in the market and some are related to:

1) Merger within groups of companies or family enterprises.
2) Between state-owned enterprises in conjunction with reform policy.
3) Between banks under a government recapitalisation policy.
4) Merger prior to the initial public offering to comply with stock market requirements.

Research on the merger of SOEs can be assessed through policy formulation, process of implementation and its financial impact. The impact on individual state-owned plantation enterprises was not an effective monitoring of whether mergers were successful or not. This area is accessible for future research.

C. Good corporate governance

The Cadbury Report (The Report of the Committee on the Financial Aspects of Corporate Governance, 1992) defines corporate governance as the system by which organisations are directed and controlled. It identified three fundamental principles of corporate governance as openness, integrity and accountability. It is a set of rules that define the relationship between stakeholders: shareholders, managers, creditors, the government, employees and other internal and external stakeholders with respect to their rights and responsibilities. Basically, corporate governance is related to a system, process and set of rules between stakeholders, and in 'a narrow sense' to organise relationships between shareholders, commissioners and directors to perform the functions of the organisation.

In SOEs the government has all the powers associated with ownership of the capital. The government holds the position of a single shareholder and authorises the appointment of all board members and commissioners and approves the business plan. The objectives of public corporation are defined via the political process, and transferred through the state's own administrative structure to management. In applying good corporate governance principles, the government has devised a productive and commercial system providing day to day management with sufficient independence (OECD, 1998). The SOEs have to follow all the regulations on corporate governance that private companies do, and to effect a balance between stakeholders' satisfactions and company objectives (Harrison & Freeman, 1999; Berman, et al. 1999). Their governance is complicated by the fact that there are insufficient market incentives and disciplines. There are no market mechanisms to control corporate behaviour and no monitoring of performance due to the lack of economic motivation and no credible threat of bankruptcy (OECD, 1998).

The Cadbury Report states that the concept of corporate governance is related to the system in which organisation is directed and controlled, and to organise relations between stakeholders and management so that they achieve the objectives of the organisation. There are two concerns that stakeholders might have with management. First, managers might tend to run the firm to some extent to benefit themselves, rather than stakeholders in general. Second, they might run the firm to benefit some stakeholders at the expense of others. But the other stakeholders demand is that the management has to make the firm perform for profit. It means good corporate governance is not only there to arrange the relationship between stakeholders and management, but it also requires achieving the corporation's primary objective. The stakeholders are certain individuals or groups that have a legitimate interest in, or claim on, the operation of the firm. They are stockholders, employees and customers, and also include competitors, suppliers, the community, special interest groups, the media, and society or the public at large (Carroll & Buchholtz, 2003). For the SOEs, both pre and post partial privatisation, Indonesia also maintains the above mentioned definition (BPKP, 2003; Ministry of SOEs 2000; BUMN, 1999b).

While there may be some debate in the academic literature about the impact of corporate governance on corporate performance, the views of respected business groups and recent research and academic commentary, is that improved corporate governance can positively impact on overall corporate performance (OECD, 1998a). OECD Principles of Corporate Governance (1999), state that corporate governance is one element of improving efficiency. In studies of corporate governance it has been shown that good corporate governance practices are related to high profit margins (Armstrong & Francis, 2000) and with investment decisions (Armstrong, et al. 2001). Armstrong & Francis (2004) state that good corporate governance ensures that the board of directors develop, implement and explain policies to increase shareholder value; lower the cost of capital; reduce financial, business and operational risk; ensure there is a real depth of management capital, and address reasonable shareholders' concerns. This discussion implies that corporate governance also has 'a broad meaning', not only in organising the relationship between stakeholders and management, but is simultaneously connected to the operation of the corporation. For the SOEs, the Indonesian Government adopts this broad meaning of corporate governance.

The author supports the proposition that corporate governance is directly related to management capability. Corporate governance is not a neutral position. The other side of the corporate governance 'coin' is corporate performance. Corporate governance contributes to improvement in performance and is able to increase investor trust (Newell & Wilson, 2002). There have been many studies carried out to investigate whether there is a relationship between good corporate governance and corporate performance, and it has been shown that there is a positive impact on performance (Syakroza, 2002; Berman et al. 1999; OECD, 1998a). The literature on corporate governance in Indonesia for the SOEs and private sectors focuses on the relationship between good corporate governance and company performance, company recovery and corporate failure, board decision making and corporate and board reputation (Tjager, et al. 2003; Hinuri, 2002).

Many studies have been undertaken to explore the correlation between corporate governance and company performance. Large scale investigations of UK (CBI, Deloite & Touche, 1996) and US (Daily, et al. 1998) corporations revealed that a majority of respondents felt that the heightened focus on corporate governance had no positive impact on financial performance. Hence, the feeling that sound financial performance excused poor governance practice was widespread (Pic, 1997). Research revealed that institutional investors identified a key investment criterion to financial performance and growth potential. Corporate governance was ranked as being towards the bottom with respect to information delivered by the companion management remuneration (Pic, 1997). Moreover, US research suggests that there was no systematic relationship between the level of institutional holdings and a firm's financial performance, nor was it more dominated by institutional investment to achieve a better investment performance (Daily, et al. 1998; Pic, 1997).

Agrawal (1996) states that investors who pursued a value strategy and invested in under-valued or stable companies, were willing to pay for good corporate governance. He believes that a company with good corporate governance will perform better over time and that it can reduce risk and attract further investment. The importance of good corporate governance and its relationship with company performance was reported by the findings of McKinsey (2002), who argues that the investors put corporate governance on a par with financial indicators when evaluating investment decisions. The majority of investors would be prepared to pay a premium to invest in a company with good corporate governance. The premium for Indonesian companies was 27 per cent in 2000 and this had decreased to 25 per cent by 2002 (McKinsey, 2002). This indicated that Indonesia was in a position to improve on the implementation of good corporate governance.

Nesbit (1994) reported positive, long-term price returns to firms targeted by CalPERS. Millstein & MacAvoy (1998) studied 154 large, publicly traded US corporations over a five year period, and found that corporations with active and independent boards appeared to have performed much better in the 1990s than those with passive, non independent boards. However, the work of Dalton, et al. (1998) showed that board composition had virtually no effect on firm performance, and that there was no relationship between leadership structure (CEO/Chairman) and firm performance. A comprehensive review of the literature relating to the link between corporate governance and performance states that the survey did not present conclusive evidence of such a link (Patterson, 2000). In the editorial of Corporate Governance, 2001, 'Corporate Governance and the Bottom Line', explained that corporate governance may be used as a tool for extracting value for shareholders from under performing and under valued companies. It was used for Lens Inc, CalPERS, Hermes and Active Value Advisors. It was also to be used as a key to help restore confidence in markets that had experienced financial crises in Malaysia, Russia and Japan.

The key features of these changes were improving transparency and accountability. Companies with good corporate governance were identified as being more capable of controlling internal elements and understanding aspects of their external environment that could negatively affect business. It was the role of corporate governance to generate economic returns to its owners and stakeholders. Part of generating economic returns included the ability to adapt to and confront periods of financial distress. Parker, et al. (2002), argued that the corporate governance environment influenced the ability of firms to recover from such financial distress. Parker et al. operationalised the corporate governance environment by testing whether insider turnover, creditor involvement and ownership structure were associated with the ultimate survival of financially distressed firms. Specifically, they measured the impact over time of various corporate governance attributes on the survival likelihood of distressed firms and re-examined financial indicators as determinants of firm survival. From the research they concluded that corporate survival largely depended on the discipline placed on managers. Discipline can come from the marketplace or it can come from the inside through corporate governance structure.

Good corporate governance required the directors to be more actively involved in the strategic decision making process of the corporation. Passive directors and inside directors did not have the incentive to ensure that corporate governance policies were followed. A study undertaken by Scherrer (2003) indicates that the involvement of directors was necessary to assure the reliability of data about the corporation, to protect the shareholders and provide them with accurate financial information. As the directors endorsed the accuracy of financial information it was believed that they should be involved in the strategic decision making process. It was known that shareholders had expressed great concern about business failures and the accuracy of financial information prior to these setbacks. Scherrer concluded that to comply with the wishes of the shareholders, investors, pension funds and all stakeholders, the board should be involved in the strategic decision making process. Further, the boards should be audited by an audit committee to ensure compliance with corporate governance requirements and the audit committee should be composed of non-board members. Finally, the board and audit committees should maintain their independence and objectivity.

Indonesia only started to organise corporate governance in 1999 and established the National Corporate Governance Committee in 2000. In March 2001 this committee issued the Code of Best Practice to serve as a guideline for the implementation of good corporate governance by companies in Indonesia. A special guideline based on the Ministry of the SOE Decree no. KEP-117/M-MBU/2002 was designed for the SOEs, and application in their day to day business activities was compulsory. The State Audit Agency (*Badan Pengawasan Keuangan dan Pembangunan/BPKP*) designed a study to be carried out simultaneously with its audit process for 16 SOEs in 2002 to implement good corporate governance using designed measurements as best practice guidance. The result indicated that seven were classified as good and the rest were sufficient. This method of assessment was also used in the case study for this research.

D. SOEs in China

There were approximately 300,000 state-owned enterprises in China, of which 102,300 SOEs dominated the non-agricultural sector of the Chinese economy (Watkins, 2003; China Embassy, 2002). This was reflected in the high output produced by the state-owned firms, employment in the state sector, fixed assets owned by state firms and the role of the state budget in allocating resources. The state dominated manufacturing, construction, transportation and retail sales (Lardy, 1998).

In the context of China's transition from a centrally controlled economy to an economy more open to market forces, the dilemma was that the government could not prevent support of the SOEs because of the their strategic role as employers and with the problem of excessive security for employees, numbering 112 million in 1996, comprising

65 per cent of the urban labour force. The low productivity growth of state-owned industries, low profitability and increasing losses and fiscal subsidies to loss making enterprises and unfunded pension liabilities, were ongoing problems faced by the SOEs (Lin, et al. 2001; Lardy, 1998). The government was also burdened with large stocks and was not able to service the non-performing loans of the SOEs to the state commercial banks. Meanwhile, China needed to change as the traditional development strategy was unsustainable and there was a widening economic gap between China and the developed countries, so it needed to catch up with western countries by leaping forward (Lin, et al. 2001).

In the first two decades—the first phase in 1979 and the second in the mid- 1980s—SOEs reform focused on incremental changes that reduced the scope of planning, expanded the enterprises' managerial authority and increased the role of market forces. This represented changes from physical output targets to enterprise financial performance, but still using a uniform market determined by the government. The third stage began in 1993 when the government (the Chinese Communist Party's 14th Congress) endorsed the creation of a modern enterprise system. It gave approval to the development of diversified forms of ownership that would compete on equal terms in the market place, and the introduction of a framework for modern corporate governance of the SOEs (Howe, et al. 2003).

Under the slogan *zhuada fangxiao* (retain large SOEs and release small ones), the government articulated a clear plan to limit the scope and size of traditional state enterprises. Most small SOEs were privatised by converting them into various forms of non-state and non-collective ownership businesses. Medium and large SOEs were converted into limited liabilities or shareholding companies with the objective of separating government from that of business function. It was meant to create an incentive structure to ensure managers were consistent with the interests of owners and that management elected by shareholders would optimise capital structure (Lardy, 1998). These were also other slogans, including *zifu yingkui* (take responsibility for both profit and loss) and *zhengqi fenkai* (separation of government from enterprise) (Rawski, 2000).

The new Chinese leadership, under Zhu Rongji, advanced this capitalist development in China. The banks were to be transformed into more autonomous commercial institutions and there were more bankruptcies of inefficient SOEs (Gabriel, 1998). Mergers were encouraged and the redeployment of labour forces was promoted.

Many SOEs were sold off to both domestic and foreign buyers (Development Gateway, 2002). In 2003 large-scale mergers and acquisitions in the reform process emerged, involving the SOEs, domestic private capital and foreign investment (*New Guangdong*, 13 August 2004).

Under the slogan *zhengqi fenkai* (separation of government from enterprise) the SOEs were restructured into corporate entities governed by a board of directors and managed by professional managers. Under such conditions, the government or the owners were required to establish a governance structure to control the management and provide an assurance for the development of greater efficiency. The government confirmed that China had to comply with OECD Principles of Corporate Governance as a benchmark in developing a Code of Corporate Governance by the Securities Regulatory Commission. In this process of corporatisation, rights and equitable treatment of shareholders, the role of stakeholders, transparency issues and the role of the board of directors were all part of the reform program. The priorities were to improve transparency and strengthen the role of the board of directors (OECD/ADB/DRC, 2000).

In the implementation of the reform there were three critical problems: financial crises, social conflict and global competition (So, 2003). China suffered from three financial crises: bad loans in the state banks, losses in state enterprises and government budget deficits (Holz & Zhu, 2003). Those problems were an explosive element in the reform process, which created a gap in wealth, enterprise bankruptcies and unemployment. About 10 million workers were expected to be laid off in the state sector in the first five years and these lay offs carried the risk of triggering urban political turmoil. China entered the World Trade Organisation (WTO) in December 2001, and that accession was likely to produce significant competitive pressures to the agricultural sector. It indicated that three million jobs would be lost but other government reports estimated that there would be 20 million jobs lost. The membership of the WTO did more harm than good to Chinese industry in telecommunications, banking, steel production, automobiles, shipbuilding, railways and petroleum (Howe, et al. 2003).

In fact, the reform did not create a total separation between government and business enterprises. Lin, et al. (2001), discusses the impact of these reforms on SOEs performance and on government. While the SOEs increasingly obtained more autonomous rights, the state's interest could not be safeguarded. The rate of contribution by the SOEs to the state was declining. Lin indicated declining ratios between state-owned industrial enterprise and savings in GNP and the deficit between savings and investment. There was deterioration in the assets of the SOEs because of the increased ratio in expenditure for wages and excessive claims in benefit for managers' and workers' welfare. Other results were reflected in an increasing number of loss-making SOEs and the rise in the amount of loss. In 1995, 44 per cent of the SOEs lost money, but at the same time the government had to subsidise them. The assets dissipation impacted on the government as assets had been undervalued in the process of transformation of SOEs into shareholding companies as they were sold (Lin, et al. 2001: 65-7, 69).

This review of the literature on SOEs in Indonesia and China suggests some comparisons. The role of the SOEs in Indonesia was important to the economy, while in China they completely dominated the Chinese economy. Reform in China was needed, not only to create an efficient economy but also to modernise the SOEs in order to avoid a catastrophic collapse of the economy and thus, preserve the power of the government (Watkins, 2003). For this reason, Indonesia and China have similar motives to maintain support for the economy and politics of the government. China started with an incremental strategy of reforms before the actual implementation in 1997 as a top priority with a forward leap in agriculture, industry and other areas supported by general policy development in politics and the economy (Howe, et al. 2003). In Indonesia, reform tended to be 'micro' efforts with a management improvement approach stressed. The need for capital through privatisation and foreign and private domestic capital, concerned ownership matters that related to political support from the parliament. Indonesia was constrained by public opinion and political parties. China clearly opened to foreign and private capital to participate in the SOEs (*News Guandong*, 13 August 2004). Attempts to prevent government intervention in Indonesia and China were not easy as continuous interference by the state hampered the activities of the SOEs (Lin, et al. 2001).

The above mentioned discussion on reforms in China was important to this study because of the similarities, but strategic differences between the two countries should be noted. Reform of the SOEs in 1979 was part of the four modernisations of agriculture, industry, defence, and science and technology that began in 1966. It was a long preparation process, and there was political controversy, but in the modernisation of the economy and reforms of the SOEs, the government was strongly supported by the Central

Committee of the Communist Party of China (CCCPC). Reforms of the SOEs were not only for the benefit of the SOEs, but also for socio-economic and political development. In Indonesia, reform was a government policy that needed stronger political support; it was a micro and incremental approach under case-by-case support from the parliament.

Chapter III
The Indonesian SOEs, development of government policy and the process of 1988 restructuring

In discussing the issues associated with reforms of the SOEs it is necessary to understand the process of the historical development of the SOEs and government policies towards them. This chapter will focus on several questions, such as why did Indonesia develop such a big number of SOEs in various sectors of the economy? To what extent has government policy determined the role of the SOEs? What has been the impact of government control on their performance and why did the government need to reform them?

This chapter presents an overview of developments in the state-owned enterprises' sector until the end of 1986, when the President's decree was introduced to reform the SOEs. The implementation of reform policy on Presidential Instruction no. 5/1988 will be discussed in Chapter IV.

A. Government policy and the role of the SOEs

1. The establishment, Indonesianisation and nationalisation

Direct government intervention in economic activities in the Netherlands Indies began in 1830 when the Dutch colonial government had to manage the forced cultivation of coffee in Priangan (Suroyo, 1996). It continued the cultivation system (*cultuurstelsel*) after the liquidation of the United Dutch East Indies Company (*de Vereenigde Oost-Indische Compagnie/VOC*). The direct state intervention in the economy continued with the Ethical Policy (1901). The Ethical Policy had, as its ideal, to raise the prosperity of the Indonesian population under the slogan of irrigation, education and emigration. Numerous government bodies were created or reinstated: the departments of agriculture, industry and trade (1904), public works and education (1908) as well as specialist agencies, such as the public health service (1911) and the people's credit banks (1912) (Dick, 2002). Some state-owned enterprises were established, including the Balai Pustaka (publishing company), the State Water Company, the State Bus Transportation Company and the State Electricity Company. Other established companies were the State Pawnshops, the Salt and Soda Company, the State Printing Company, the Post, Telegraph and Telephone Company, the Railways Company, the Surabaya Port Authority and the Bangka Tin Mining Company. The colonial authority had placed the important infrastructure under direct government control.

The modern sector of the economy was dominated by Dutch private companies with their head offices in Holland and branches in Indonesia. Companies from other foreign countries also invested in the economy. Dutch and foreign businesses established plantations, banks, trading companies, mines, oil rigs, sea transport, construction industries, printeries, publishing houses, car assembling plants, mills and factories manufacturing paper, cement, rubber products, textiles, ships, ice, furniture, tobacco, soap, margarine and tyres. There were about 630 Dutch government-owned and private firms when they nationalised in 1958 (Hadianto, 1994).

After independence the colonial economic structure still continued. However, there was a widely held opinion that the Indonesian Government should own and control industry, trade and commerce. The government wanted to control what had been viewed as the natural monopoly industries, such as telecommunications, the railways and electricity generation; these industries in the colonial era had been controlled by government enterprises. This policy was consistent with Cook & Kirkpatrick's (1995) arguments that through state ownership the government was expected to preserve economic independence and secure strategic commodities and services in the post independence period. The government's intention was also to have control over the banking industry and the entire sale trade (Booth, 1997). Strong nationalist sentiments insisted on centralised government control over all parts of the economy.

Under the concept of 'socialism ala Indonesia', the Indonesianisation program, which meant a greater role for the government over the SOEs, was launched. Government efforts put high priority on achieving economic sovereignty through Indonesianisation of the economy in order to compete with the Dutch firms at the commanding height of the economy. This was Dick's observation in 2002. *De Javasche Bank*, the central bank of Indonesia which became Bank Indonesia, was taken over in 1953. Garuda Indonesia Airways (GIA) was established in 1954 by acquiring the assets of the Royal Netherlands Indies Airlines *(Koninklijke Nederlandsch-Indische Luchtvaart-Maatschappij/KNILM)*. Then came the government established banks. Bank Negara Indonesia (BNI) was established in 1946 and Bank Industri Negara (BIN) in 1951. The BNI had been the official bank in the national revolutionary government and funded the credit for the *pribumi* (indigenous) community. Formerly BIN was the Rehabilitation Bank *(Herstel Bank),* originating in May 1948 and was later to become the Indonesian Development Bank *(Bank Pembangunan Indonesia/Bapindo).* The government took over the Bank Rakyat Indonesia, formerly Bank Koperasi Tani dan Nelayan (*BKTN*). It was the legacy of the *Algemene Volkscrediet Bank (AVB),* established in 1898, with special objectives to finance individual, small, rural Indonesian businessmen and industrialists. The purpose of the government's involvement in these banks was to support the indigenous entrepreneurs to develop their role in the economy. Thirty-nine per cent of all credit granted by the foreign exchange bank in 1955 were routed to indigenous businesses, as compared to zero per cent in 1950 (Anspach, 1969).

The government also developed special credit institutions to provide loans to indigenous businessmen who would otherwise not have had appropriate qualifications. Such institutions included the Credit Foundation, the Co-operative Service, the Small Industry Credit Service, the Smallholders' Estates Service and the Bureau for National Reconstruction.

To compete with the Dutch trading houses, the government established trading companies, such as the Central Trading Corporation in 1947. It was a subsidiary of BNI and established Usindo in 1956. Semen Gresik was established in 1953 and Natour in 1957 followed by the establishment of a shipping enterprise *Pelayaran Nasional Indonesia (PELNI).*

The issue of developing the *pribumi* (indigenous) as a message of independence was compounded by the absence of a strong, indigenous Indonesian entrepreneurial class. To indigenise the economy the government established the *Benteng* (fortress) import license's program, introduced in April 1950 in an effort to generate indigenous capital accumulation through import facilities that would sustain the expansion of indigenous capital into other sectors (Robison, 1986). The program was designed to develop indigenous business rather than state-owned enterprises, but it also created a future relationship between the state and the indigenous private sector. Only a few companies were established and survived. Enterprises like the Bakri Brothers, the Sudarpo Corporation and the Tehnik Umum achieved their present positions as the result of the *Benteng* policy. In practice, the program was a failure and was abolished in 1957. In that period the government experienced a foreign exchange crisis with a severe government deficit and high inflation rates (Pangestu & Habir, 1989).

The nationalist sentiment demanded strong centralised control of all aspects of economic activity and the government was pushed to assume economic authority itself. In addition, its political legitimacy was hampered by the fact that the status of West Irian (Papua) was the focus of an intense struggle between the Netherlands and the Indonesian Government. In 1958 when Indonesia was under martial law, the government nationalised the Dutch enterprises, to put pressure on the Netherlands to give up West Irian. Under martial law the military was given administrative responsibilities and it also took control of the management of many SOEs. This nationalisation represented a massive increase and leap forward for the national economy and the military officers took over the roles of the commissioners and board members of newly nationalised enterprises. After nationalisation, the Indonesian Government had enlarged its share of estate ownership to approximately 90 per cent of total plantation output, with 60 per cent of foreign trade and some 246 factories and mining enterprises. In modern banking, Indonesian banks increased their portion of bank loans from about 50 to 75 per cent and only four, non-Indonesian commercial banks survived (Golay, et al. 1969).

Following this massive nationalisation, the government had to simultaneously handle the serious problems of ownership, regulation and control as well as manage the SOEs. The government faced human resource difficulties, as an insufficient number of Indonesians were trained to take over the daily operations and management of the nationalised companies. As Indonesia was under martial law, military officers were assigned together with civil servants to replace the Dutch managers and workers, but most of them had little or no entrepreneurial background. In management there was the problem of inefficiency. Panglaykin & Thomas (1967) argue that there was a lack of trained managers and the government faced political pressure to secure the economic interests of the bureaucracy, the military and political parties. As a consequence, the state-owned enterprises became sources of revenue for those appointed to manage them. Business decisions were not made on a commercial basis, but were intended to provide finance for political interests that controlled them.

As an impact of this unqualified management and control system, the operation of the SOEs became similar to the inefficient government offices; the SOEs were not treated as business entities. At that time patronage was pre-eminent throughout the overstaffed public sector and most national companies were expensive to operate and generally suffered losses or recorded very low profit, despite enjoying monopoly rights and protected markets (Pangestu & Habir, 1989). These factors led to the SOEs being less effective than intended.

Another impact of nationalisation was that direct foreign capital was reduced drastically. Indonesianisation and nationalisation were the avenues to create government ownership; the indigenous power represented by state sector ownership had emerged as a commercial power centre. However, state-owned enterprises and government bureaucratic structures were not flexible enough to adapt themselves to many problems, such as government intervention, disintegration of business organisation and bureaucracy in management and control. State-owned enterprises also faced ambiguity in trading policy, a lack of capital and capabilities and the challenge of hyperinflation. Indonesia failed to build its own national capitalist economy through either a domestic capitalist class or state-owned capital (Robison, 1986).

Under the 'Guided Economy' policies of President Sukarno, economic conditions as a whole declined sharply. The new rupiah was introduced as the equivalent to 1,000 devalued old rupiah. Domestic petroleum prices increased 250-fold and Indonesia ceased to meet foreign exchange commitments (Hill, 2000). Exports of principal commodities, not including petroleum in 1958 was US$477.9 million, and this increased to US$620 million in 1960 but decreased to US$360 million in 1966 (Robinson, 1986). Some key indicators between 1951 and 1966 reflected a mixed economic performance. The real Gross Domestic Product (GDP) increased from 90 to 139 (index 1938=100). GDP per capita increased from Rp2,126 to Rp2,271, the money supply grew sharply from 16 per cent to 763 per cent, inflation increased drastically from 65 per cent to 898 per cent, and reserves decreased from US$511 million to US$23 million. The guided economic policy was not successful. Soekarno's presidency was launched with high hopes but was brought to its downfall by economic crisis, fear and a bloodbath (Dick, 2002).

2. De-bureaucratisation of the SOEs

The establishment of the New Order Government of President Suharto created drastic changes in economic policies. The new regime's economic policies emphasised stabilisation and development. *Pembangunan* (development) was the basis for the government's legitimacy in politics and economic and social policy and was designed to meet the rising expectations for higher standards of living (Surbakti, 1999). There was a structural change in economic policy, a reform from a price control system to a more market-oriented approach, from government protection to government facilitation, from monopoly to free competition. Private individuals or companies were free to choose their own business in non-vital and non-strategic fields and they had the right to obtain assistance, service and protection from government. Basically, the new government policy was to discourage state intervention in the economy. Excessive state intervention over two decades had resulted in poor performance in the state sectors. The government's approach was consistent with Hanke's (1987) opinion.

That major economic reform was carried out based on the Decision of the Provisional Consultative Assembly no. XXIII of 5 July 1966. Article 40, stated that to develop the economy the government had to emphasise the supervision of direction of economic activities, rather than the maximisation of ownership of economic activities. This was the message from the Assembly and it represented an idealistic assessment of the New Order's economic policy. But on the implementation of the SOEs, the government continued to manage those enterprises and did not carry out a de-bureaucratisation of the supervisory system. The government affirmed the important role and involvement of the private sector, including domestic and foreign investors in the development. As stated in article 33 of the Constitution of 1945, the government had to determine which sectors were vital for the economy and the public. It meant more business activities could be opened and were eligible to be in the private sector, but as the SOEs were important to the economy, government intervention in the SOEs still occurred. Some actions were taken. First, some nationalised enterprises other than those that were Dutch-owned, were returned to their previous owners and foreign investment was protected from being nationalised for thirty years. Second, the government released the Foreign Investment Law (Law no. 1/1967) and the Domestic Investment Law (Law no. 6/1968) and third, the government encouraged Indonesian Chinese capitalists to support the development of the national economy and recognised them as part of the national assets.

The new economic policy on stabilisation was evident in some specific measures, such as economic liberalisation, tax collection, monetary renewal, foreign aid and investment. But the main influence on the SOEs was the requirement for a balanced budget and the policy of delegation of authority. Although the balanced budget principle rested on politico-economic arguments (Hill, 2000), to achieve a balanced budget the government had to reduce various unnecessary expenditures, including subsidies to state-owned enterprises for working capital, new investments, government transfers and loans. Under the de-control policy the government had to reduce its interventions and let SOEs operate under the influence of the markets.

In the beginning of the New Order Period, government intervention declined. The SOEs had to operate efficiently, competing with domestic private and foreign enterprises and the government had to carry out de-bureaucratisation of supervisory systems, diminishing interventions and changing the management–government relationship. To implement the above-mentioned policy, the Cabinet Presidium issued Instruction no. 21/EK/IN/11/1966 to all ministers. The instructions were: to stop subsidies and adopt de-control and de-bureaucratisation of SOEs, the management of SOEs should be improved and their autonomy should be guaranteed. All ministers were forbidden to finance their extra budgetary activities from the funds of state-owned enterprises and the ministries had to change from a system of direct control to indirect control, by eliminating the ministries' involvement in management. Autonomy in determining the price of goods and services had to be granted to management, except for prices on oil, electricity, local transport and drinking water. As a consequence, the SOEs had to operate efficiently and make a profit without government intervention. The SOEs were to function like private enterprises, where profitability was the measure of success.

The SOEs previously only had one legal basis, namely in *Perusahaan Negara* (Law no. 19/1960). Under this law the SOEs had multiple objectives, not only commercial but also public or political goals, where profits were not the main objectives. To facilitate the rational new requirements of the performance of the SOEs, the government converted the status of each enterprise from a *Perusahaan Negara* into one of the three following types: *Perusahaan Jawatan/Perjan* (government), *Perusahaan Umum/Perum* (public corporation) and *Perusahaan Perseroaan/Persero* (government limited liabilities) as stated in Law no. 17/1967. The importance of conversions to the new forms should be considered with reference to article 33 of the Constitution of 1945. Those state-owned enterprises that were not vital and in *Persero* form, were to be measured as a private enterprise.

However, the process of delegating authority of these enterprises to the management of the SOEs, did not run smoothly and proceeded with delays and problems. The first reason was that the Technical Ministries were reluctant to transfer their authority over these enterprises to the Ministry of Finance. They wished to retain their specialised ability to control the technical matters of SOEs based on the previous Law no. 19/1960. They also had a vested interest in the enterprises; after so many years of the guided economic system, those state-owned enterprises functioned as financial resources for the ministries and revenue for individual officials.

The second reason was that the rapid changes in the private sector and the idea of efficiency provoked controversy. The critics argued that the government had to consider the impact of the domination of foreign and Chinese enterprises. The small and medium sized indigenous enterprises were hit by the high rate of credit interest of up to 60 per cent per year as an impact of the stabilisation process. However, the private sector was mostly Chinese enterprises and through their overseas network and kinship they were able to access cheaper sources of funds. Incentives under the Domestic Investment Law of 1968 gave Chinese enterprises favourable conditions and together with foreign investment, they dominated the economy.

The government was challenged by various issues of the above nature; some of these dominant foreign influences were interpreted by locals as the exploitation of the Indonesian economy (by Japanese, Chinese and other foreign investors). The military, too, had a strong hold on the economy. Corruption in the army, the bureaucracy and the SOEs was associated with this pattern of business operations to the disadvantage of a small and weak indigenous sector. Also there was tension between technocrats and nationalists on the issue of an open economy protection continued. Although the SOEs were not very effective regarding management and control of finances, they were needed to balance the dominance of Chinese and foreign enterprises and to support and protect small and medium size indigenous businesses. The government designed various programs to build networking in business with the SOEs supported by a financing scheme for small businesses and co-operatives (*koperasi*).

After the January 15, 1974 disaster (*Malari* protests, especially against Japanese investors), a major change to investment and credit policies was made to limit the access of foreign capital, leading to a fundamental shift in the balance between domestic and international capital.

The third reason was the resistance to change and reform of SOEs from within the bureaucracy itself. Military officers, who were the managers of many of the enterprises, were opposed to reform and privatisation.

In fact, the revival of Chinese and foreign companies and the difficulties faced by small and medium size Indonesian companies forced the government, as Sukarno did, to use state-owned enterprises to balance the situation. The de-bureaucratisation policy for SOEs was continuously under pressure, until the government changed the free market and open door policy in 1974 and used the SOEs to control the economy and support government development projects.

3. The SOEs and government intervention

As already mentioned, the deregulation policy shifted the domination of the economy from the state to the private sector and foreign enterprise. The shift provoked strong criticisms and public controversy as well as creating political, economic and social unrest. The government's new economic approach, with the greater involvement of the SOEs and indigenous entrepreneurs, was evident in a number of spheres and could be tracked in some areas:

1) After the *Malari* protests, there was an increasing role for indigenous Indonesians in foreign and domestic investments. Indonesian partners had to be the majority partners in joint venture companies and all foreign investment projects entered into a joint venture with indigenous Indonesian partners.

2) Small credit schemes, *KIK, KMKP, KINPRES, Candak Kulak*, were established to promote small indigenous businesses. All state owned banks had to support the programs and played a dominant role in providing credit.

3) There were two development priorities in the Second Five Year plan: the expansion of the manufacturing base as part of a program of industrialisation and the development of the agricultural sector. With the oil revenue, the government used state-owned enterprises to develop these sectors.

There were large resource projects which linked industrial developments, such as oil refining, LNG production, petrochemicals, fertilisers, hydroelectricity and steam power, mineral processing, steel and paper mills and engineering works. The SOEs were directly involved as the operators of these projects. Most of the private sector was not in a position to participate, as the investments required were large, long-term and high risk. However, some multinational corporations and multilateral agencies were involved.

In the agricultural sector, state plantation enterprises played a primary role in developing new areas and new processing plants for palm oil, rubber, tea and cocoa and they also supported small plantation holders. The finance for the agricultural sector was channelled through state owned banks, mainly Bank Bumi Daya and Bank Ekspor Impor Indonesia for state plantation enterprises, and Bank Rakyat Indonesia for small credit loans to peasants in rural areas.

Since SOEs by means of oil revenue were intended to be instrumental in the development process, the policy of de-bureaucratisation and delegation of authority was effectively undermined. The policy made the SOEs more dependent on government subsidies for their investments and working capital, yet their economic performance remained unsatisfactory. Government attempts to deregulate the SOE sector lost much of its momentum.

4. After the oil boom and deregulation policy

In 1982 the oil price declined from US$36 to US$28 per barrel and continued to collapse from US$25 in 1985 to US$13 in early 1986, while prices of other primary products also fell. As a consequence, Indonesia's commodity terms of trade suddenly worsened by 34 per cent, resulting in a five per cent decline in national income (Wie, 2002). Thus, the balance of payment turned into a deficit, and the budget deficit of US$1.58 million in 1981/82 increased to US$1.80 million in 1982/83, which became US$3.61 million in 1983/84 (Hendrawan, 1996). The increasing deficit undermined the balance budget policy, as the oil revenue provided approximately 70 per cent of the total budget revenue and funded 65 per cent of government spending.

When government expenditures for subsidies and development programs had to be adjusted, there were political and economic consequences. The significant government subsidies were for food, domestic oil, fertiliser and capital participation for state-owned enterprises. The first three subsidies were the most important, as they were used to stabilise the price of nine basic commodities for all Indonesian people. That was the determinant factor for political stability in Indonesia. Other subsidies in the form of capital participation had been increasingly transferred to the SOEs, to support the program of industrialisation since the oil boom period and to maintain the role of SOEs as agents of the development. During the *Repelita* II (Five Year Plan) (1973/74 to1978/79), it was Rp713.1 billion and in *Repelita* III (1979/80 to1983/84), increased three-fold to Rp2,138 billion. However, after the oil price collapse in *Repelita* IV, the subsidy was reduced by half to Rp1,295 billion. Table 3.1 details the decreasing subsidies by the government during 1984/85 and 1988/89, as compared to 1983/84.

Table 3.1
Government capital participation in SOEs, 1983/84 to 1988/89
(in Rp million)

Sector	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
Industry	253.7	130.0	362.2	12.9	10.2	83.6
Mining	151.1	19.1	3.6	6.8	0.6	11.1
Banking	65.2	30.3	22.2	52.3	11.4	0.0
Public Service	59.0	67.0	9.9	9.0	21.3	27.8
Finance	52.5	77.0	14.4	8.5	12.8	2.5
Agriculture	10.2	12.6	0.0	1.1	1.1	0.0
Total	591.7	336.0	412.3	90.6	57.4	125.0
%Growth to 1983/84		(43.21)	(30.31)	(84.68)	(90.29)	(78.87)

Source: Anwar, 1994

Meanwhile, the government shifted the economy from protectionism and government control towards more of a market mechanism approach to improving national efficiency and reduced subsidies. The government also sought more foreign aid and borrowing and increased non-oil exports. It postponed forty-eight large government projects, increased domestic non-oil revenue through tax reform, cut government expenditure and planned mobilisation of domestic savings (Robison, 1986). The impact of these new policies for the SOEs was as follows:

1) Reduced control over state banks: Banking deregulation emerged in 1983 to increase the efficiency of the banking system and mobilisation of domestic funds.
2) Re-phased investment in several SOEs: PT Krakatau Steel, Pertamina, PLN, PT Telkom, PT Garuda Indonesia and the government enforced stricter accountability.
3) Reduced capital participation as shown in Table 3.1. Although the subsidy was decreased every year, industrial enterprises still received substantial subsidies.
4) Although the banking sector was deregulated in 1983, the non-banking sectors remained unchanged. The government's continued subsidies and protection for strategic industries such as PT IPTN, PT PAL, PT Krakatau Steel, fertiliser, cement, and telecommunications caused controversy.
5) In trading there was an increase of government support. The approved importers system was launched to restrict importers. More goods were authorised to be imported, but only by state trading enterprises.

The second oil price collapse in 1986 forced the government to further deregulate the economy and state apparatus. There was banking liberalisation in 1986 and 1988, trade and industrial deregulation in May 1986 and also in December 1987. Deregulation was demanded by other sectors to support economic growth, thus removing the monopoly held by state-owned enterprises, including electricity, toll roads, telecommunications, airlines, airports and seaports.

Although the oil boom period ended, the government developed deregulation in many sectors of the economy (Hill, 2000). It continued to assign to state-owned enterprises multiple social, political and national economic objectives, as well as the task of generating revenue. They were also used as a means for government intervention to moderate the impact of economic fluctuations and political and social stability. This occurred in many areas, such as policy on small credit schemes that were supported by revenue sharing from all state-owned enterprises. Examples of this approach included the instructions in 1987 and 1991 to all state banks (*gebrakan Sumarlin*/Sumarlin shakes) to transfer the funds of the SOEs in state-owned banks to Bank Indonesia), and direct market intervention to control certain commodity prices (palm oil, kerosene, cement, fertilisers, pesticides, rice, sugar). The policy followed Stiglitz's (1986) arguments on the effectiveness of government policy to reduce the market price of some strategic commodities that influence the rate of inflation and stability of the Indonesian economy. Meanwhile, Dinavo (1995) argued, the SOEs were needed to support their pioneering role in promoting weak, poorly developed sectors and infant industries. The SOEs had to undertake pioneering operations in remote areas (air transport by Merpati Nusantara and sea transport by PELNI) and investments in the eastern part of the country in plantations and fisheries. Some of the SOEs were involved in rice self-sufficiency programs (Sang Hyang Sri, Pertani and fertiliser enterprises), to consolidate security against communism and prevent border crossings in critical border areas by development of state plantations in north Kalimantan–Malaysia (PT Perkebunan V) and in Irian Jaya–Papua New Guinea (PT Perkebunan II). As Hall (1986) stated, the SOEs were needed to run the high risk businesses, high tech-industries with high capital and technology and also those that were related to national security that could not be run by the private sector. For these reasons, SOEs were assigned to manage so called strategic industries under the supervision of *Badan Pengelola Industri Strategis (BPIS)*. Cowan (1990) put forward a political rationale for government involvement, namely, that political exigencies required the government to find jobs in the modern economy for the new urban population and at another level, to provide management and board sinecures in return for past political favours or military service.

Under the New Order government considered that state-owned enterprises should help the government to fulfil its promise of development for the benefit of more people in Indonesia. The multiple and conflicting objectives the government established for the SOEs were a challenge to the enterprise managers. Consequently, revenue from state-owned enterprises declined. Ramanadham (1991) stated that their financial adversity flowed from the nature of business activities undertaken, lower profit margins and non-commercial activities. However, liberalisation and deregulation had adverse effects upon the very existence of state-owned enterprises as they were not competitive with the foreign and Indonesian Chinese enterprises. At the end of 1986, the government started to focus on ways to strengthen SOEs—a long process to formulate a new policy of reform— finalised in October 1988 and implemented in June 1989.

B. The contribution and performance of the SOEs

The importance and performance of SOEs, in particular, was a reflection of their complex involvement in various development programmes. They played an important role in the economy, in the Gross Domestic Product (GDP), as a source of revenue for the state budget and they also provided employment. Much of their role, such as that of supporting the public service, community development or government administration, could not be quantified. However, from a commercial point of view they had to assess their performance as a whole.

The following section of the chapter discusses the financial contribution of SOEs to the GDP and government revenue and their performance prior to 1988, when Suharto issued his Presidential Instruction to restructure the state-owned enterprises' sector.

1. The contribution of SOEs

1.1 The contribution of the SOEs to Gross Domestic Product

The important role of the state-owned enterprises in the macro economy was reflected in their contribution to the GDP and their role in supporting economic activities. Their contribution to the total GDP during 1983-1989 ranged between 12 and 16 per cent of the gross added value and their contribution to the national budget during 1987/1988 ranged between 43 and 59 per cent of corporate taxes (Mardjana, 1999). During the late 1980s, government entities contributed to 30 per cent of the GDP and almost 40 per cent of the non-agricultural GDP (Hill, 2000). These figures indicated the important role of state-owned enterprises in the industrial sector, which strongly influenced rapid structural changes in the Indonesian economy. The SOEs supported economic growth and Indonesia's economy experienced remarkably rapid structural change. Agricultures' share of GDP had more than halved since 1966 and by 1992, it was just 36 per cent (Hill, 2000).

The changing business environment, increased competition, the lack of capital and managerial expertise, together with multiple and conflicting government objectives, resulted in the decline of financial performance in the agricultural sector. Although there were some efforts to improve efficiency and productivity, no significant improvement was achieved. During the nine years from 1979 to 1988, the contribution of sales of state-owned enterprises to GDP was at an average rate of 26.9 per cent with a return on assets of SOEs in the 1.5 to 4.5 per cent range (Hill, 2000).

1.2 The role of government revenue, taxes and dividend paid by the SOEs

The SOEs were sources of revenue for the budget. Table 3.2 indicates the increasing contribution of taxes paid by the state-owned enterprises. This relates to rising sales and profits during the same period as shown in Table 3.3. The average share in corporate tax paid by SOEs was 54.11 per cent and 42.96 per cent for non-corporate revenue. Total non-tax revenue during that period was Rp2,578.4 million (Anwar, 1994). The state banks were the highest contributors with 54.01 per cent, followed by services with 16.81 per cent, agriculture and forestry with 6.69 per cent and industries with 5.79 per cent. The banks were the biggest contributors as their total assets covered approximately 60 per cent of all state-owned assets.

Table 3.2
Corporate tax and non-tax revenue of the SOEs, 1983-1988

(in Rp million)

Fiscal year	Corporate Tax	SOEs corporate Tax	SOEs share (%)	Non tax revenue	SOEs dividend	SOEs share (%)
1983/84	757.4	357.0	47.13	519.0	171.2	32.99
1984/85	1,237.1	719.6	58.17	687.0	265.7	38.68
1985/86	1,132.2	670.8	59.25	1,386.0	625.0	45.09
1986/87	1,419.7	828.4	58.35	1,147.0	583.7	50.89
1987/88	1,671.9	799.9	47.67	1,976.7	932.8	47.19

Source: Anwar, 1994

2. The financial performance of the SOEs

Table 3.3 indicates the growth of total assets, total sales and total profit since 1983, after the oil boom until 1988.

Table 3.3
Total assets, total sales and profit of the SOEs, 1983-1988

(in Rp billion)

Year	Total assets	Total sales	Total profits	Total sales/ Total assets (%)	Total profit/ Total assets (%)	Total profit/ Total sales (%)
1983/84	72,661	20,873	2,271	28.73	3.12	10.88
1984/85	87,197	25,445	2,118	29.17	2.43	8.32
1985/86	99,224	27,434	2,393	27.65	2.41	8.72
1986/87	118,966	28,269	1,811	23.76	1.52	6.41
1987/88	140,100	37,293	3,036	26.62	2.17	8.14

Source: Anwar, 1994

Within five years the total assets growth doubled from Rp72 trillion in 1983 to Rp140 trillion in 1988. That growth was followed by a growth in total sales and total profit of 1.78 times and 1.4 times. But the profitability ratios also decreased during 1985 to 1988. The lowest ratio was in 1987 in the range of 1.52 to 6.41 per cent. That was the lowest profitability, as the weighted average deposit rate at state owned banks was 12 per cent and in private banks it was 18 per cent per annum (Binhadi & Meek, 1992). The decreasing return on assets and an increase in total sales in Table 3.3, basically indicated a poor performance as the rate of inflation during 1983 to 1988 was at an average of 8.5 per cent and the exchange rate was 994 rupiah/US$ in 1983 and 1,731 rupiah/US$ in 1988 (Warr, 1992). SOEs produced a poor performance during these years due to the impact of the bureaucracy, management, a lack of capital and government intervention.

2.1 The bureaucracy and compliance on policy

The state-owned enterprises were part of Indonesia's economic system. Their status was based on article 33 of the Constitution of 1945, which stated 'Branches of production essential to the state and governing the life and living of the public shall be controlled *(dikuasai)* by the state'. This article was to provide a constitutional basis for *Badan Usaha Milik Negara/BUMN* (SOEs), legitimising public enterprises as a policy tool for promoting the welfare of the society (Marjana, 1999).

Under Sukarno's regime that was highly centralised and executive dominated, it restricted political rights in the name of national stability and unity (EAAU, 2000). Its economic policy was the policy of Indonesianisation of the allocation of production, investment and distribution, to be brought under the control of the central government. It was the government's belief that under collective economic planning and centralised control, greater social welfare could be achieved. In the New Order period, the bureaucratic-authoritarian political system was committed to economic development. The policy on state-owned enterprises reflected the political imperatives and ideology of the government. As a consequence, the SOEs were supervised under political control through bureaucracy, by the Parliament, the Supreme Audit Agency *(Badan Pemeriksa Keuangan/ BPK)* and the State Audit Agency *(Badan Pemeriksa Keuangan dan Pembangunan/ BPKP).* They were also supervised by the Technical Ministries and the Ministry of Finance. Internally, they were controlled by the Board of Commissioners.

2.2 The poor management and government–management relationship

A lack of authority, poor managerial capabilities and stressful working relationships between the government and the management of the SOEs were the reasons why management was not at its maximum capacity. The state-owned enterprises were responsible to the relevant ministries for the achievement of their objectives. Government Regulation no. 3/1983 identified seven purposes and objectives for the *Persero, Perum* and *Perjan* as the measurements. Those multiple objectives combined commercial and financial viability with the characteristic of being a 'public enterprise' (Ramanadham, 1991). The term 'public enterprise' signified that the organisation should represent a synthesis of the characteristics of 'publicness' with those of 'enterprise'. The essential problem that confronted the SOEs was the combination of commercial orientation with managerial autonomy and managerial accountability with public interest, public control and government accountability.

The management as the operator and the government as the owner were facing the ambiguous nature of the enterprise imperative and the public interest. The management tended to emphasise the enterprise imperative more than the government. As they had different interests they viewed the operation asymmetrically with hazardous results. The multiple objectives of the enterprises were established by the government. The management could not focus on the commercial objectives and poor financial performance resulted. To make the management–government relationship clear, a contractual arrangement between the management of the SOEs as an agent and the government as the principal, should be designed. This should involve the government agreeing to conditions by providing incentives to the management of the SOEs and they, in return, serve the interests of the government.

2.3 A lack of capital formation

The government was the main source of capital for the state-owned enterprises and this was in the form of equity, grants and loans. Internal capital formation was generated from the result of business operations. Profits were reserved for capital or reinvestment, so the funds were dependent on the profits and dividend policy of the government. Government equity in state-owned enterprises was related to national development objectives. New investment was based on contributions from the state budget. The total government investment in SOEs from 1969 to 1980 was Rp1,524 billion or the equivalent of US$3.4 billion at the average rate of exchange US$/Rp447 (Warr, 1992) and from 1981 to 1988, the amount was Rp2,426 billion or the equivalent of USD$2.7 billion (Hill, 2000).

Government investments in state-owned enterprises grew strongly when the oil price rose and the industrialisation policy was promoted. During the first oil shock in 1973 and 1974 the amounts during those years were Rp73 billion and Rp91 billion. This increased sharply in the second oil shock in 1979-1980 at Rp253 billion and Rp477 billion and this increased again to Rp592 billion in 1983. At the time of the third oil shock, when the price decreased in 1984-1986, government investments in SOEs were reduced from Rp336 billion in 1984 to Rp86 billion in 1986 and Rp57 billion in 1987.

Capital formation was a crucial point for the state-owned enterprises and when the subsidies from government expenditure were reduced from 18.5 per cent in 1980 to 10.6 per cent in 1984 to 3.3 per cent in 1988 (Asher & Booth, 1992), the SOEs had to operate with higher costs of capital from non-government resources. Given the inefficiency of management, the SOEs performed poorly.

2.4 Government intervention and regulations

As the government centralised the economic policy, government intervention was reflected in various regulations that tied state-owned enterprises to the strong bureaucracy. Some regulations impeded the flexibility of the business and caused the SOEs difficulties in their rivalry with the private sector. Under government control and with multiple objectives and conflicting interests, the SOEs had to comply with government regulations and within the bounds of limited autonomy, making them inefficient. The SOEs had to operate within a high costs structure.

Until 1988, there were regulations that hindered the enterprises from becoming efficient operators and that conflicted with commercial objectives. These regulations included the Presidential Instruction on transfers of government assets, the Presidential Decree on international borrowing, the Government Regulation on mechanism and control of the SOEs, the Presidential Instruction on utilisation of foreign export credit and the Presidential Instruction on the procedure for purchasing goods and services. In addition, as an agent of development, the SOEs were assigned to special government policy in finance, pioneering of business, provision of employment, developing strategic industries and supporting community development that was not part of the private sector.

C. The need for reformation

1. Reform to strengthen the SOEs to better performance

The role of the SOEs was important in the economy and their poor performance was an obstacle to economic development. Table 3.3 shows the low rate of profitability and the total profits to total assets at 3.12 per cent in 1984 and this decreased to 2.43 per cent and 2.41 per cent in 1985 and 1986. At about the same time, according to the Indonesian Business Data Centre (*Pusat Data Bisnis Indonesia/PDBI*), the rate of investment of private enterprises reached four times that ROI of the SOEs. The low profitability coincided with the decline in the price of oil. At the same time the government faced increasing interest payments on foreign debt, with a current account deficit from 1981 to 1988, a low rate of GDP growth from 1982 to 1985 and decreasing terms of trade from 1983 to 1988 (Warr, 1992). With the deterioration of economic conditions and the state budget, the government was not in a position to support the poor performance of the SOEs any more. It was a challenge for the government to immediately reform the SOEs for their survival and to continue to support the economy.

2. Reform to reduce government control and extend financial access

The purpose of the reform of the SOEs was to re-establish the system of government control but at the same time, reduce government intervention in their business of SOEs. It was to be significant in redefining the role of management of the SOEs and their objectives to encourage more involvement in the market mechanism. Government intervention was directly related to its ownership; meanwhile, the ownership issue emerged as an opportunity for the private sector to participate in full or partial ownership and also in management. Reform on ownership was important to strengthen management and create a wider access to financial markets.

3. Reform to reduce government financial and legal risk

Government ownership inherently carried financial responsibility for government to provide capital investment, additional working capital or subsidies that should be planned in the state budget. Furthermore, the government also dealt with the financial and legal risks derived from business of the SOEs. In general, the performance of the SOEs was not satisfactory, but it did not mean that all SOEs were in a poor condition. Reforms were needed to select which SOEs should be maintained and developed and which should be closed or sold out. It was a process directly related to a complexity of matters, such as the political issue of the ownership of state assets, reforms methodology, and the criteria of selection, business opportunities and interest groups. Further, the reforms should be transparent and accessible to the public.

Chapter IV
Reform of the SOEs, a process towards performance

The reform of the SOEs was motivated by the need to enhance efficiency. This transformation began with the Presidential Instruction no. 5/1988. However, the Minister of Finance delayed the implementation of the presidential guidelines. The President then had to intervene to ensure that the respective Minister carried out his plans (Decree no. 740 and 741/KMK.00/1989).

A. Presidential Instruction no. 5/1988

1. Strategic guidelines

There were some key points in the Presidential Instruction no. 5/1988. First, it was a political decision that involved all related Ministries and the bureaucracy and accommodated all competing interests. Second, the instruction sought to expose the SOEs to market mechanisms: privatisation was identified as an alternative solution. The Minister of Finance was given responsibility for the implementation. Privatisation remained a very sensitive political and economic issue and invited controversy. In his decree, the Minister of Finance used the term 'restructuring' instead of privatisation, although this was part of the Presidential decree. Third, in terms of the tensions between the Ministry of Finance and the Technical Ministries, the new guidelines directed the Technical Ministers to improve the performance of the SOEs. The Ministry of Finance had to give an account to the President about the progress of the reforms. The degree of soundness of a SOE was determined by the Minister of Finance, but the restructuring option was decided by the Technical Ministers in consultation with the Minister of Finance. Fourth, the Presidential Instruction no. 5/1988 created the opportunity for any enterprise, either entirely or partially state-owned, to receive equal government treatment. A partially state-owned enterprise could take the form of a joint venture between central government and a regional government, with other SOEs, or with national, private or foreign companies and their subsidiaries, but always with a minimum government share of 51 per cent.

The Presidential Instruction was issued after President Suharto had been in power for 20 years. The delay in implementation was reflected in his overriding desire to balance competing interests within the bureaucracy, the military, and among business cronies and his own family, along with public opinion. The result was a much-compromised set of reforms that were difficult to implement. Suharto's policies on small

Table 4.1
The Presidential Instruction no. 5/1988 – the guidelines

Soundness level	Restructuring methods
Very sound and sound	Consolidation Merger Go public Direct placement Joint operation Joint venture
Less sound	Capital restructuring Improvement and simplification of organisational structure Consolidation and merger between state enterprises or between state and private enterprises Splitting up Public participation through direct placement Management contract
Unsound	Improving the health level through the above mentioned restructuring methods Selling to the private sector Liquidation

Source: Part II attachment of Presidential Instruction no. 5/1988

business and strategic industries had a somewhat different approach and objectives. The government sought to support small indigenous businesses with funds from the Ministry of Finance (Decree no. 1232/KMK. 013/1989), provided by 1 to 5 per cent per annum from the profits of the SOEs after tax. President Suharto supported the nationalist economic orientation in the cabinet through transferring the ten state strategic enterprises to Habibie's Agency for the Development of Strategic Industry (*BPIS*). Through policies of this nature Suharto sought support from the Moslem and indigenous business communities in the run up to the presidential election in 1993.

However, as Milne (1991) points out, there were two main objectives to reform of the SOEs. First, the reform actually promoted more growth of Indonesian Chinese businesses, but gave less opportunity for indigenous economic advancement. Second, the reform should have reduced the state monopoly but, in fact, it increased the opportunity for the family's closest business associates to step in. These problems indicate the ambivalence on the part of the government during the reform and this caused hesitant management of the SOEs and slow implementation of reform.

2. Bureaucracy and privatisation

State-owned enterprises by their very nature are government institutions and, as such, can only be reformed by government. Any government will only reform if it sees that the political benefits outweigh the political costs. This can occur when there is a change in the leadership of government or when an economic crisis forces the existing government to respond (World Bank, 1995).

Riggs (1964) explains that governments are subject to control by political organisations such as political parties, parliament, public opinion, popular suffrage and interest groups. Under the control of these organisations the bureaucracy has the task of implementing policies. The bureaucracy is supposed to be politically neutral and it does not participate in policy determination. In the New Order period, Indonesia maintained a unique relationship between political parties, parliament and the government. The government bureaucracy enjoyed a dominant position and political organisations were not strong enough to exercise any control. So Indonesia's bureaucracy model departed from Riggs's ideal model. The bureaucracy was a creature of the government and the government was supported by complete loyalty (*mono-loyalitas*) from the bureaucracy. Riggs argues that the bureaucracy in countries like Indonesia tended to be over centralised. Senior officials are powerful but their ability to achieve efficient outcomes is limited (280). Their power enables them to carry out the government's objectives but with higher costs. The degree of administrative efficiency of a bureaucracy varies inversely with its autonomous power (263). Bureaucratic power is often beyond the control of outside forces (262). Riggs calls senior officials 'bureaucratic capitalists'. They abuse their power to make a government enterprise advantageous to themselves and become involved in making contracts on behalf of government agencies. They influence public corporations to further their own personal interests (190). Rigg's model helps explain the behaviour of the bureaucracy in Indonesia. The attitude of the technical ministries and the military was to maintain strong control over the SOEs to raise funds to support their basic needs and operations. The exploitation of bureaucratic power also involved alliances between senior bureaucrats and private enterprises. President Suharto's instruction reflected the government's awareness of the need to reform the public sector by applying new approaches to public corporate management. Suharto's reform initiative was influenced by agendas of corporate reform developed by the private sector (Poliit & Bouckaert, 1990). What President Suharto sought was to overcome an inefficient bureaucracy through deregulation and privatisation.

In the literature, there is considerable diversity in the interpretation of privatisation owing to varying practical experiences, expert opinions and academic views. Privatisation is the partial or total transferring of the assets, organisation, functions and activities of an enterprise from public to private ownership (Bos, 1991; Cowan, 1990). As such, it is the exact reverse of nationalisation. Bailey (1987) states, it is a transfer of the operation or production of goods and services, through the selling of public assets to a private organisation, while the public sector remains responsible for providing those goods and services. Privatisation means moving from greater to lesser public sector involvement in the production or delivery of goods and services (Kurtz, et al. 2001). It can be viewed as one of the steps toward deregulation and the liberalisation process by reducing the role of the state in the economy (Bienen & Waterbury, 1989). Privatisation is marketisation or bringing the enterprise under market discipline (Ramanadhan, 1991).

As privatisation is the transfer of economic power from bureaucrats and policy-makers to private shareholders, there are two arguments that can be discussed. From the ideological point of view privatisation can be regarded as a means of democratisation as shares are offered widely (Bos, 1991). Waltz (1959) argues that state involvement in the economic sphere might lead to the erosion and eventual destruction of the democratic process. Power in the economy is reallocated by replacing the government's sole ownership with broad-based private ownership. It can improve the redistribution of resources by promoting broad-based ownership of state assets throughout the society (Hanke, 1987). This is important in developing countries as high income groups are often the principal beneficiaries of many government subsidies because they have better access to government policy.

From an economic point of view the privatisation of public companies is expected to increase efficiency, redistribution of income and stabilisation. Many empirical studies comparing private and public firms confirm that private enterprises are more efficient than public enterprises producing the same goods or very close substitutes, given the same or very similar technology, regulatory constraint, and financial capabilities (Bos, 1991). This efficiency is also supported by management behaviour, as the government is no longer able to intervene and the dynamic of capital market to which the management has to pay special attention to. However, Biersteker (1991) reminds us that privatisation cannot guarantee a short term increase in efficiency, and carries a long-term social cost. The claim that private firms tend to be more efficient is undeniable, but state-owned ownership does not necessarily cause the SOEs to perform poorly. Milward & Parker (1983) state that there is limited satisfactory statistical evidence of those SOEs that has lower levels of efficiency than private firms operating on the same business scale. Greater efficiency and profit orientation in privatised firms will typically lead to higher profits than before and therefore the total sum of capital income will increase. Privatisation reduces the involvement of bureaucrats in business, the abuse of power in the economy and it also protects businesses from power seeking individuals, rent seeking behaviour, and bureaucrats who pursue their own interests, rather than the interests of the public (Roth, 1987; Buchanan, et al. 1980). Privatisation can support the government budget, since government is no longer obliged to subsidise the losses or reserve additional capital for the previous state-owned enterprises. Hence, it reduces the political pressure on the budget deficit (Bos, 1991).

The government obtains revenue from selling the assets of SOEs and from taxes and non-taxed income generated by the privatised company. Privatisation supports a cleaner government by reducing the involvement of bureaucrats in business, avoiding an abuse of power in the economy and preventing some forms of corruption and collusion (BUMN, 2002; BUMN, 1998). It is a crucial point and challenges the government under political, economical and public opinion pressures. The Indonesian Government has always been ambivalent about privatisation, but committed itself to privatisation as part of SOE reform. Privatisation was expected to overcome the problem of poor performance of the SOEs, as stated by Ayub & Sven (1986) and Tanzi (1987) in the previous chapter. The reforms were intended to introduce decentralisation, greater organisational flexibility and good governance practices as seen in the private sector. There was also a need for more capital to strengthen the SOEs and this was realised through partial or full transfer of ownership to the private sector. However, the full or partial sale of SOEs proved to be beneficial to Suharto's cronies and his family.

3. Public debate on privatisation

Deregulation and privatisation of the SOEs as instructed by President Suharto in January 1986 prior to the Presidential Instruction no. 5/1988, produced various public reactions. Ruchyat Kosasih, a government official in the State Audit Agency (*BPKP*), argued that there were many inefficiently managed SOEs producing poor financial results. Because it was the task of the SOEs to produce goods and services to meet the public demand and to process natural resources in order to enhance public prosperity, Kosasih thought that they that did not comply with the government's objectives should be privatised (*Kompas*, 3 February 1986). In contrast, Mar'ie Muhammad, Director of Development of SOEs in the Ministry of Finance, described their impressive growth. The total assets of 215 SOEs in 1979 were Rp.26.3 trillion and these had increased sharply to Rp.76.7 trillion in 1984. The asset value of the SOEs had increased by an average of 24 per cent. In the same period, annual sales increased from Rp.6.5 trillion to Rp.20.5 trillion and the profit increased from Rp.1.2 trillion to Rp.2.2 trillion (*Kompas*, 3 February 1986).

The editorial observed that the officials' opinions were contradictory and created confusion in the minds of the public (*Kompas*, 3 February 1986). Knowing that the SOEs were not audited by public accountancy standards, people tended to doubt their financial stability. *Kompas* asserted that the SOEs should be transparent and accountable to the public. It was timely at that point to evaluate whether government ownership should continue.

The idea of privatisation or joint venture was strongly supported by the Indonesian Chamber of Commerce and Industry (*Kamar Dagang dan Industri/Kadin*). It was Mohammad Sadli, the chairman of *Kadin*, who stated that government ownership was appropriate only for vital companies, but not as monopolies to make them efficient in business. The government was not in a position to support the SOEs with capital and facilities, however the SOEs could not operate efficiently due to a lack of autonomy and flexibility to do business in the same manner as the private sector (*Kompas,* 4 February 1986). Suhardiman, the vice-chairman of the Development Faction in the Parliament, was opposed to privatisation. He believed this would make the economy more capitalist and he doubted whether the private sector was more efficient than the SOEs. He proposed to improve management of retained SOEs through professionalisation and the formation of a new ministry to supervise them (*Sinar Harapan*, 6 February 1986). Opposed to the sale of non-strategic enterprises, Danial Tanjung, a member of the Parliament from the United Development Faction, asked for the conversion of inefficient enterprises into co-operatives. In his view, this was in accordance with article 33 of the Constitution 1945, which stipulated that economic democracy should be based on family principle, and the vital production sector should be managed and controlled by the government (*Berita Buana*, 8 August 1986).

In its editorial *Merdeka* explains that the privatisation of SOEs was not a proper policy because they were sanctioned by the constitution (9 August 1986). This argument was also supported by Sri Edi Swasono, a lecturer from the University of Indonesia, Ekie Syahruddin, a member of Parliament and Managing Director, Pan Asia Research, Reinaldo Thamrin from the Central Association of National Contractors (*Gapensi*), and Ridwan Helmi from the Central Association of Youth Indonesian Entrepreneurs *(Himpunan Pengusaha Muda Indonesia/ HIPMI)*.

The opponents of privatisation in parliament accepted the necessity for reform of the SOEs; in their view, reform alongside a capitalist path was unacceptable, as profit oriented enterprises would abandon low prices to the detriment of the community. The term 'privatisation' used by reformers enjoyed little popularity in Indonesian society which had been socialised with an anti capitalist, anti foreign and pro state ideology. The reformers began to use the term 'restructuring' instead of privatisation to avoid further political opposition and soften ideological differences (Vatikiotis, 1993).

Some officials opposed the idea of privatisation. Rachmat Saleh, the Minister of Trade, stated that if privatisation was a remedy for inefficient state-owned enterprises then it was not the right method. He rejected the possibility of privatisation under his administration as the important role of the SOEs under his ministry was to support the flow of trade *(Suara Karya,* 20 February 1986). Radinal Mochtar, Secretary General of the Department of Public Works, disagreed with privatisation and alternatively proposed diversification and improvements in efficiency (*Suara Karya*, 6 February 1986). Midian Sirait from the Department of Health (*Kompas,* 18 February 1986), pointed out the weaknesses of the private sector and stated that privatisation based on profitability was unacceptable as the SOEs, under the Department of Health, had to support the public health function.

In its editorials, *Suara Karya* (3 February, 21 May & 14 August 1986) supported the immediate removal of bureaucratic interference into the management of the SOEs and the professionalisation of management, but opposed the transfer of ownership from the public to the private sector, since that would contravene the constitution. The same ideas were expressed in *Merdeka's* editorials (4 February, 12 February & 5 and 6 August 1986). *Kompas* (11 February & 4 August 1986) proposed the selective privatisation of those enterprises whose existence was no longer in accordance with the spirit of the 1945 Constitution.

The privatisation debate of the SOEs gradually produced some consensus around the objectives of greater efficiency, more prudent management and the idea that the Technical Ministers had to pay more attention to the performance of SOEs under their administration. Privatisation as part of the restructuring policy was beginning to be regarded not as a taboo or a controversial, foreign inspired ideology, but a means to improve the system of management. Reform needed to be supported by changes in administrative culture in the Technical Ministries and in political culture in general. The military had been involved in the management of the SOEs since nationalisation. It had a strong vested interest to maintain the flow of funds to its budgets for the welfare of the soldiers or for individual officer's interests (Samego, 1998). The military, represented by Suhardiman, a senior retired army officer with long service in the management of SOEs, opposed privatisation and doubted whether it would achieve better performance (*Sinar Harapan*, 8 February 1986). The military also had a strong vested interest in the control of the SOEs. Their concern was that privatisation would threaten their control and remove the funds that enabled the purchase of weapons and other goods and services necessary to maintain military functions. Meanwhile, corporate reform usually meant cost reductions and this meant that employees of the SOEs worried about unemployment and redeployment.

B. The concept and implementation of the SOEs restructuring of 1988

Following the Presidential Instruction no. 5/1988, the Ministry of Finance issued two decrees on 28th of June 1989, setting out the implementation of the Presidential Instruction. 740/KMK.00/1989 related to improvement of the efficiency and productivity and 741/KMK.00/1989 focussed on annual programs and the decision making process.

1. Restructuring of the SOEs, Decree no. 740/KMK.00/1989

1.1 Privatisation part of the SOEs restructuring

Decree no. 740 described what the government wanted to do to maximise benefits from its ownership and control of SOEs, to expose the enterprises to market conditions and minimise losses, either by selling or liquidation. Table 4.2 indicates that full privatisation in terms of selling SOEs to the private sector or liquidation, will only be applied if other available methods of reform fail and with reference to Table 4.1, selling to the private sector shall only be applied to unsound state enterprises. 'Go public' was used as a means of restructuring sound companies as it created a higher 'share value'. It was clear that privatisation of the SOEs was meant to go no further than partial transfers of government ownership to the private sector through capital markets, direct private placement or joint venture. Joint operation and management contracts did not involve any transfers of ownership and were more related to business practice.

1.2 Independent management and supervisory boards

Independent management was one of the main instruments to improve the efficiency of SOEs. The option of a change of legal status was important, especially if a SOE was to become a *Persero*. A *Persero* increased the autonomy of state-owned enterprise management and flexibility in diversifying business and entering capital markets.

Table 4.2
Methods of restructuring –Minister of Finance Decree no. 740

Methods	Definition	Objectives
Changing the legal status (Art. 6)	Converting *Perjan* (government agency) to *Perum* (public corporation) or *Perum* to *Persero* (government limited company)	To accelerate efficiency and to improve public service
Joint operation or management contract (Art. 8)	Joint operation is cooperation between two or more parties to Undertake activities for agreed Goals Contract management is agreement between two parties, one party orders other party to manage the company	To increase market share, improve technology and operation, as well as efficiency in management
Consolidation or Merger (Art. 10.1)	Legal action that two or more corporations establish a new entity and component corporation liquidated	To enlarge capital, market share and competitiveness
Splitting-up (Art. 10.2)	Dividing one company into two or more under different legal entity	To improve efficiency, strengthen internal control and improve service
Going public (Art. 12-13.1)	Share ownership transfers through capital market	To improve capital structure, support business development and broaden public participation in ownership and control of the SOEs
Direct placement (Art 13.2)	Direct share ownership transfer without capital market Intermediary	To improve capital structure, support business development and broaden public participation in ownership and control on the SOEs
Joint venture (Art. 15)	To establish a new legal entity with one or more companies	To increase market share, technology and operational capability and improve return on capital
Selling off (Art. 17)	To sell the company under existing regulations	Applicable if restructuring is impossible
Liquidation (Art. 17)	To close the company under existing regulations	Applicable if restructuring is impossible

Source: Minister of Finance Decree no. 740/KMK.00/1989

Limited liability enterprises under independent management were mostly welcomed in the capital market at domestic and international levels. Access to the equity market was crucial for improving cost efficiency to allow enterprises to work with lower leverage. Since the management and supervisory board consisted primarily of independent professionals from the private sector, this avoided the intervention of the Technical Ministries and the bureaucracy.

1.3 The role of public control

Partial privatisation of the SOEs, whether they became a public company, a direct placement, a joint venture or a joint operation and management contract, made the enterprises more subject to influence from external parties such as business associations, the media and parliamentarians. The stakeholders needed to be treated professionally as they expected performance and services from the enterprises. Although the government would still be the majority shareholder, the involvement of third parties could restrain excessive government intervention in policies and operations. It also reduced the bureaucratic regulations so that enterprises could be more flexible and attractive to private partners and the market.

A parliamentarian from the Faction of Working Development (*Fraksi Karya Pembangunan Golongan Karya*), BP Messakh, supported the government policy to improve the efficiency of the SOEs. He said the enterprises should be restructured prior to their sale and that financially sound SOEs should become public companies. He also recommended that the co-operatives movement become shareholders of public companies (*Kompas*, 30 June 1989).

1.4 Performance evaluation system

Articles 3, 4 and 5 of the Ministry of Finance Decree no. 740/KMK.00/1989 established the performance evaluation system to test efficiency and productivity to determine the financial soundness of SOEs. This decree also presented the restructuring options stated in Table 4.1. The performance evaluation measurement used three financial indicators: profitability *(rentabilitas),* liquidity and solvency, with a calculation method stated in the attachment of the decree.

1) Profitability or Return on Equity: that is the profit or loss before tax divided by equity (article 5.2). It determined the capacity of the company to generate profits. The reference level was 12 per cent.

2) Liquidity: the computation of current assets divided by current liabilities that is the measurement of the firm's ability to satisfy its current obligations. The reference level was a minimum of 150 per cent (article 5.1).

3) Solvency: this refers to the ability of assets to meet financial commitments as they fall due. It is a short term solvency, by way of comparison of the total current assets to total current liabilities and was usually expressed as a ratio. The reference level was above 200 per cent (article 5.1).

These indicators are normally used in financial analysis to understand financial achievement from different points of interest. The three indicators are integrated to calculate the degree of soundness and the final degree of performance of the SOEs. Degrees of soundness (article 4) were listed as very sound (vs), sound (s), less sound (ls) and not sound (ns). The balance sheets and profit and loss statements from three years were referred to as a source of calculation. Each performance indicator had a different weight: profitability 75 per cent, liquidity 12.5 per cent and solvency 12.5 per cent. As profitability contributed to its highest point it revealed that profits were the main objective of the enterprise and the SOEs had to rely on their own financial capacity. The Technical Ministries objected to the uniformity of weight and profit orientation measurement. They argued that every business had different needs for liquidity and solvency and many enterprises that were still part of the public service were non-

Table 4.3
Soundness level and calculation method

Soundness	Profitability	Liquidity	Solvency	Total value
Weight in %	75	12.5	12.5	100
Very sound				
%	> 12	> 150	> 200	
Value	> 75	> 12.5	> 12.5	> 100
Sound				
%	> 8 – 12	> 100 - 150	150 – 200	> 68 – 100
Value	> 50 – 75	> 8.33 - 12.50	> 9.38 - 12.50	
Less sound				
%	> 5 – 8	> 75 - 100	> 100 - 150	> 44 – 68
Value	> 31.25 – 50	> 6.25 - 8.33	> 6.25 – 9.38	
Not sound				
%	< 5	< 75	< 100	< 44
Value	< 31.25	< 6.25	< 6.25	

Source: Attachment to the Minister of Finance Decree no. 740/KMK.00/1989 commercial in nature and could not be assessed on a pure cost and benefit measurement. These issues were addressed in the Minister of Finance Decrees no. 826/KMK.013/1992 and no. 198/ KMK.016/1998. The revised measurement consisted of evaluation on a detailed ratio in financial performance, operational aspects and administration aspects. Marketing was an additional operational measurement that emerged in the decision of the Ministry of SOE Decree number KEP-100/MBU/2002 of 4 June 2002. The management was responsible for implementing the guidelines.

2. Strategic planning and the decision making process, Decree no. 741/KMK.00/1989

All state-owned enterprises were required to work under the guidance of a strategic plan for the next five years within the reform framework of the SOEs and this involved an annual working plan and a budget. Article 2 of Decree no. 741 stated that the long-term plan had to be submitted to the Commissioners/Supervisory Board and approved by the Ministry of Finance. The Board of Directors was responsible for the operations and target achievements as planned. The annual plan and budget were approved by the Commissioners/Supervisory Board which served as an evaluation mechanism for management. However, the appointment of the directors and commissioners remained unchanged. The reform policy did not change the role of military and police officers on the boards of management and commissioners. Their positions were not based on professional competency but rather justified by reference to the military's doctrine of the dual function *(Dwi Fungsi ABRI)*, under which the military had political and economic responsibilities.

The guidelines established benchmarks for the evaluation of management (article 4). The benchmarks were an incentive for management to take the necessary actions in every aspect of management and business to improve the performance of the enterprise. In article 6 the Minister of Finance delegated his authority as shareholder to the General Meeting. This simplified the process of decision-making and gave the management greater autonomy and flexibility. It was understood that to improve their performance the SOEs needed: 1) access to capital markets to strengthen equity and capital, 2) management flexibility and autonomy, 3) profit incentives to attract private investors.

Furthermore, the government freed the SOEs from all regulations that constrained them from conducting business with private sector principles. Government Regulation no. 55/1990 gave full autonomy and abolished many restrictive regulations. One of the important outcomes of that regulation was the removal of Government Regulation no. 3/1983 that made the SOEs become an autonomous unit of business. This regulation meant that the Technical Ministers could no longer use the SOEs as instruments of the ministry and as extra budget sources of revenue.

3. The implementation of the restructuring policy

3.1 Open market policy

The Presidential Instruction no. 5/1988, and the Minister of Finance Decrees no. 740 and 741 as discussed above, were the guidelines to reform: 1) the relationship between the government represented by the Ministry of Finance and the Technical Ministries as supervisory ministries regarding SOEs, 2) the legal structure of the enterprises, 3) the business operation to achieve profit maximisation. The government initiated a corporatisation process to strengthen the SOEs. Ferlie & Ashburner (1996) state that corporatisation of state bodies is a means to reform the internal operations of public organisations. Corporatisation introduces private sector management practices and processes (new managerialism) to public sector organisations, and the operation of these enterprises according to market mechanisms through a change in the formal legal and institutional structure.

The government initiative should be supported by a conducive macro economy climate and a good business relationship. What the government had to do was establish a government–market relationship. The government had to give the same opportunities for business to the public and private sectors by reducing the barriers for private entry into economic and business activities such as banking, trade and manufacturing and by eliminating monopolies in public utilities. The government deregulated the market in sectors of the economy previously closed to the private sector. However, Suharto's family and its crony business interests were able to take advantage of deregulation. The domestic airline market, previously monopolised by the state-owned PT Garuda Indonesia, was now infiltrated by PT Sempati, owned by Hutomo Mandala Putra

(Suharto's youngest son) through his Humpus business group. The toll roads of the Ministry of Public Works previously managed by PT Bina Marga now acquired a new business partner PT Citra Lamtoro Gung Persada, a business group of Siti Hardijanti Rukmana (Suharto's eldest daughter). In addition, Siti Hardijanti Rukmana formed a joint venture education television station with the National Television (*TVRI*), under the Ministry of Information. The business group Bimantara, owned by Bambang Triatmojo (Suharto's son), penetrated the telecommunication industry and took over the satellite operations of Palapa that had previously been operated by PT Telkom, under the Ministry of Communication. PT Bimantara Bayu Nusa, of Bambang Trihatmojo and PT Baja Hitam Perkasa owned by Hasjin Djojohadikusumo, constructed the steam generator at Paiton to supply electricity for the state electricity enterprise PLN. In 1991, PT Bimantara entered into a joint venture with PT Intirub, a tyre producer managed by the Department of Industry. The electricity market and the telecommunications industry— previously the preserve of the SOEs—was thus opened up to private enterprise.

3.2 Implementation of restructuring

In the period from 1989 to 1997 the implementation of the 1988 Presidential Instruction and related decrees, can be summarised as follows:

1) Data from the Indonesian Business Data Centre (1995) indicated that there was a change in the legal status of 32 SOEs. It seemed that the Technical Ministries were not reluctant to change their legal status as the ministries retained the legal right to intervene in these companies.

2) Privatisation and the partial transfer of ownership had been implemented by some Technical Ministries.

PT Leppin, under the Department of Industry and by Government Decree no. 12/1990 was sold to Employee Co-operative and PT Industry Marmer Tulungagung by Government Decree no. 38/1990. In 1991, PT Intirub, a tyre producer under the Department of Industry, established a joint venture by selling 70 per cent of its shares to PT Bimantara Citra. It was a partial sale, but nevertheless, it was related to crony capitalism.

The Minister of Industry, Hartarto, stated that from 55 SOEs under his department 10 enterprises had made losses in 1991. For these enterprises his ministry would help to find private investors without investing additional government funds (*Merdeka*, 31 January 1992). Four paper factories owned by the Ministry of Industry were sold to the private investors. In May 1992, 55 per cent of PT Kertas Padalarang's shares were sold to a French paper company, Arjo Wiggins Appleton, and to a domestic private investor, Risjadson. The government also sold 90 per cent of PT Kertas Basuki Rakhmat and PT Kertas Blabak shares to the same investor in June 1992. The same policy was applied to PT Kertas Gowa which was sold to the Sinar Mas group.

PT Angkutan Pertambangan, owned by the Department of Mining and Energy, was sold to an Employee Co-operative in 1992. In the same year, 25 per cent of PT Wisma Nusantara shares, owned by the Ministry of Finance, was sold to the private sector, making the government the owner of 28 per cent of the shares (Indonesia Business Data Centre, 1995). Basically, these SOEs were not classified as less sound in condition and the price was determined by the Minister of Industry and Trade.

3) Liquidation and merger was the reform option chosen for some SOEs by the Technical Ministers in consultation with the Ministry of Finance.

PT Pusat Perkayuan Marunda was liquidated in 1990 followed by PT Karya Mina and Perum Batubara. PT CRMI and PT Krakatau Baja Permata were merged with PT Krakatau Steel in 1991, a company previously under the Ministry of Industry which shifted in 1989 to the Strategic Industries Board (*BPIS*) under Minister Habibie. PT Gita Karya was merged with PT Pradnya Paramita in 1991, both companies under the Ministry of Information. In 1992 four shipyards, PT Galangan Koja Indonesia, PT Dok and Perkapalan Tanjung Priok, PT Pelita Bahari and PT Dok and PT Galangan Kapal Nusantara, were consolidated into a newly established company PT Dok dan Perkapalan Koja Bahari, under the Ministry of Industry.

In 1992, 40 per cent of government shares in PT Philip Ralin Electronics and PT Perkebunan XIV were transferred to PT Rajawali Nusindo.

In 1993 PT Perkebunan XVII was liquidated and merged with PT Perkebunan XV-XVI and in 1994, PT Natour was merged with PT Hotel Indonesia. In 1994 government shares in PT Rekayasa Industri were transferred to PT Pusri and PT Pupuk Kaltim (Indonesian Business Data Centre, 1995). In 1996 the Department of Agriculture merged 28 plantation companies into 14 newly established PT Perkebunan Nusantara. The merger of these plantation companies will be examined in Chapter VI.

4) Some Technical Ministries appointed professional managers to lead the SOEs under their control.

It was hoped that these professionals would improve management. For example, Cacuk Sudaryanto, the vice executive president of IBM Jakarta, was assigned by the Minister of Tourism, Post and Communications to be the president director of PT Telkom in 1989. Kuntoro, an officer of the Ministry of Mining was appointed by the Minister of Mining and Energy in 1990 to restructure PT Tambang Timah, a state-owned tin enterprise in poor financial condition. Surbakti, managing director of PT Perkebunan XXI – XXII was selected by the Minister of Agriculture to reform PT Perkebunan XXVI (*Swa*, 1990). As an incentive for improved management, the salaries of managers and board members were increased and a performance-based salary system was established for members of the SOEs' boards by the Minister of Finance Decree in July 1990.

5) 'Going public' through the placement of shares on the capital market was one of the options stated in articles 12 and 13 of the Finance Minister Decree no. 740.

The partial privatisation of the SOEs started in 1991 when 27 per cent of the government's shares in PT Semen Gresik were sold for 406 billion rupiah. In 1994 there was an IPO for 10 per cent of the shares in PT Indosat for 2,537 billion rupiah. 25 per cent of PT Tambang Timah came on to the market in 1995 for 511 billion rupiah. In the same year, PT Telkom released 10 per cent of the new shares issued and 23 per cent at total proceeds of 5,058 billion rupiah. The state-owned bank, PT BNI, transferred 25 per cent of its new shares at a value of 920 billion rupiah in 1996 and in 1997; PT Aneka Tambang entered the market by selling 35 per cent at 603 billion rupiah (BUMN, 2002). The SOEs that were able to place a portion of their shares on the capital market were in a relatively sound financial position. Table 4.4 shows the financial position of these SOEs one year prior to the placement of their shares on the market and their financial performance for three years afterwards. The figures show the high performance of these companies that have become the blue chip stocks of the Jakarta share market. PT BNI suffered losses in 1998 and 1999 as a consequence of the banking crisis in 1998.

Table 4.4
Financial ratio of SOEs in the capital market

SOE	Year	Profit/sales %	RoE %	RoA %
PT Semen Gresik Tbk	1990	186.45	79.07	62.27
	1991	6.17	14.93	14.57
	1992	71.31	17.35	13.26
	1993	33.83	10.75	7.66
	1994	18.86	8.09	5.79
PT Indosat Tbk	1993	53.20	65.19	54.98
	1994	47.23	29.01	11.83
	1995	58.20	34.03	30.36
	1996	57.54	27.52	24.75
	1997	59.99	29.10	24.71
PT Telkom Tbk	1994	18.69	23.07	8.93
	1995	25.22	17.42	8.09
	1996	40.81	23.36	11.65
	1997	27.45	16.83	8.12
	1998	21.58	13.56	5.97
PT Timah Tbk	1994	37.31	48.47	31.81
	1995	32.75	29.49	21.90
	1996	36.18	32.28	26.13
	1997	38.39	32.78	23.09
	1998	36.39	58.52	43.62
PT BNI Tbk	1995		25.40	1.28
	1996		19.20	1.38
	1997		14.79	0.87
	1998		-106.98	-84.60
	1999		-1,439.52	-15.12
PT Aneka Tambang Tbk	1996	34.77	16.46	14.95
	1997	18.01	7.21	5.06
	1998	37.29	27.69	19.28
	1999	32.13	21.11	14.91
	2000	34.98	31.30	21.77

Source: Jakarta Stock Exchange, 2003

The partial privatisation of SOEs through the placing of shares on the stock exchange was a very time consuming process: an average of one company per year. However, these partially privatised companies demonstrated an improved financial performance. The lessons that could be drawn from this process were: select those with good financial prospects use sufficient time and effort in corporate reform to raise the value, obtain political support from the parliament and mobilise public opinion before the stock is marketed.

6) The Minister of Finance Decree no. 740 indicated two measurements of performance, efficiency and productivity and the financial soundness of individual enterprises. The first measurement commonly used financial report ratios and the second used a degree of soundness, based on the technical methods as stated in Table 4.3 and its amendments.

Table 4.5 shows the financial ratios and results of SOEs in the period from 1987 to 1995. With reference to Table 3.3, the average ratio of returns on assets from 1983 to1989, prior to the 1988 Presidential Instruction to restructure the SOEs, was 2.49 per cent. From 1990 to 1995 the average return on assets increased slightly to 2.62 per cent. For the same periods of time, the average profit to sales ratio increased from 8.93 per cent to 9.92 per cent. In comparing the performance of all SOEs in Table 4.5 and those that were partially privatised in Table 4.4, it must be borne in mind that although the latter performed better they had a sound financial status prior to privatisation. The number of

Table 4.5
Financial ratios and SOEs indicating profit and loss, 1987-1995

Year	Profit/Sales %	RoE %	RoA %	SOEs with profit	%	SOEs with loss	%	Total SOEs
	1	2	3	4	5=4:8	6	7=6:8	8
1987	9.74	3.71	2.27	141	77.05	42	22.95	183
1988	9.91	5.26	2.85	150	80.21	37	19.79	187
1989	8.57	5.32	2.85	156	83.42	31	16.58	187
1990	10.09	5.97	2.98	160	86.02	26	13.98	186
1991	9.94	4.00	2.51	159	85.48	27	14.52	186
1992	9.57	11.48	3.07	153	83.15	31	16.85	184
1993	9.21	10.58	2.76	152	83.98	29	16.02	181
1994	9.29	9.55	2.77	159	88.33	21	11.67	180
1995	11.43	5.55	1.66	162	85.71	27	14.29	189

Source: Ministry of Finance, 1993-1996

SOEs that generated profits in 1989 was 156 out of 187 enterprises or 83.42 per cent, which meant 31 were still making a loss. In 1995, 27 out of 189 enterprises made losses and 162 SOEs, or 85.71 per cent, generated profits.]Six years after the Presidential Instruction there were more SOEs making profits but there was no substantial improvement. The growth of total assets from 140.100 billion rupiah in 1988 to 285.948 billion rupiah in 1994 (Ministry of Finance, 1994), the rise of returns on assets of 0.14 per cent and profits to sales of 0.99 per cent, together with an additional 2.29 per cent of the SOEs with profits, showed progress.

The effectiveness or otherwise of the reform program could also be examined by considering the financial soundness of the SOEs. At the beginning of the reform program

Table 4.6
Degree of soundness of SOEs

Year	Very sound	Sound	Less sound	Not sound	Total
1987	40	27	28	88	183
1988	45	32	34	75	186
1989	**53**	**41**	**32**	**61**	**187**
1990	58	45	27	58	188
1991	50	44	28	65	187
1992	43	46	39	58	186
1993	43	38	38	64	183
1994	49	35	34	64	182

Source: Ministry of Finance, 1993-1995

there were 53 'very sound' SOEs and 61 classified as 'not sound'. In 1994 the number of 'very sound' enterprises had declined to 49 and the 'not sound enterprises' had increased to 64. The 'not sound' enterprises were mainly under the control of the technical ministries of industry (13 decreased to 12); agriculture (13 increased to 16); finance (3 increased to 6); transport (5 constant at 5); public works (8 decreased to 6); trade (5 decreased to 3); mining and energy (2 constant at 2); telecommunication (2 increased to 3); information (4 decreased to 3); BPIS (5 constant at 5).

The other important problem was employment within the SOEs. In fact, the total number of employees remained unchanged. In 1987 the number of employees was 1,058,491. The SOE workforce increased to 1,149,951 when the program of reform was launched and decreased to 1,057,124 by the end of 1994. The issue of human resources was crucial in any restructuring program. Expected opposition from the labour unions against redundancy made managements uneasy; any cost cutting measure which involved reduced productive labour would be extremely difficult to implement. These results from the reform process were less than what had been hoped for. From a policy point of view, the reform of the SOEs was a necessary and logical measure and Presidential Instruction no. 5/1988 represented a modern vision. But there were complications with its implementation:

a) The restructuring program was implemented at a sluggish and gradual pace. The financial performance of the SOEs did not show any significant improvement (Tables 4.5 and 4.6). But the partial privatisation of seven SOEs (Table 4.4) demonstrated a significant change in their financial capacity in the capital markets.

The reform process was confronted by political obstacles, the vested interests of the Ministries and their officials, extra costs, employment problems and opposition from public opinion. This situation reflects the incremental change model described by Tushman & O'Kelly III, 1999, in which policy makers concentrate on solving immediate problems that are solved step by step. Bargaining, engaging in dialogue and compromising with different interest groups are the means by which problems were solved. The process went on a case-by-case basis through various complexities in the cabinet which also involved indirect influences from the wider polity. The policy makers had to struggle through this complex process to achieve their goals.

b) The pro-market reform was also influenced by political interventions and opposition in the parliament. The critics, including the military, argued that the government was preoccupied with its profit making orientation. They believed the government had overlooked the public service functions of the SOEs, as well as the nationalist imperatives the enterprises represented. Their restructuring became part of the struggle between the reformist technocrats and the economic nationalists, led by Minister Habibie. With Habibie's successful takeover of 10 strategically important enterprises, two contradictory government decisions reflected the ambiguity of Suharto's attitude towards their reform. His continuing support for nationalist economic objectives and the central role of the state in economic planning and management were indicative of the problem.

c) Banking deregulation and the liberalisation of the capital market had widened the social and economic gap between indigenous Indonesians and the Indonesian Chinese community. Many of the Cendana family's closest business associates were Indonesian Chinese and presumably this relationship had contributed to the increased prosperity of at least some in the Indonesian Chinese community.

President Suharto was pressured by this growing disparity. To restore some balance, the indigenous and small businesses had to be supported. On 11 November 1989 the government released the Minister of Finance Decree no. 1232/KMK.013/ 1989. This decree instructed all SOEs to set aside between 1 to 5 per cent per year of their profits after tax to support weak economic groups and the co-operative movement. This decision imposed an economic burden on these enterprises to accommodate government policy. d) Presidential Decision no 44/1989 and the Minister of Finance Decree no.1232/ 1989, reflected the contradictory attitudes and objectives of government policy. The Technical Ministries often delayed the implementation of reforms through fear that they would lose control over the enterprises, once management gained more autonomy.

Under Presidential Decision no. 44/1989 on 28 August 1989, the Ministry of Research and Technology took control of ten SOEs of strategic importance and placed them under the newly established Strategic Industries Board *(Badan Pengembangan Industri Strategis/BPIS).* This new council, controlled by Minister BJ Habibie, removed Krakatau Steel, Industri Pesawat Terbang Nusantara (IPTN), Industri Telekomunikasi Indonesia, PAL Indonesia, Boma Bisma Indra, Dahana, Pindad, Lembaga Elektronika Nasional, and Industri Kereta Api from the control of the Technical Ministries. Rahadi Ramelan, as Deputy of the Agency for the Research and Application of Technology *(Badan Pengkajian dan Penerapan Teknologi/BPPT)* (*Swa*, 1993), stated that Habibie took this action because the Minister believed that the development of these enterprises had not been in the proper direction. Each enterprise had its own vertical integration and the synergies between them could not be obtained. Habibie wanted more effective co-operation among them as part of his 'leap-frogging' industrialisation strategy.

e) When President Suharto was re-elected for a sixth term in 1993, a group of reformist technocrats were removed from the cabinet and 'Habibiecononomics'—the economic nationalist ideals represented by Habibie—became influential in restructuring the SOEs. The Minister of Finance, Soemarlin, was replaced by Mar'ie Muhammad but the fate of the reform was in the hands of the President. Meanwhile, restructuring continued. The ministries were not permitted to use the SOEs as sources of extra-budgetary revenue but they had to support indigenous small business (*Republika*, 6

January 1993). The Technical Ministers were in the position to choose their preferred method and pace of restructuring (*Republika,* 14 May 1993).

Although the authoritarian government had the strong intention of reforming the SOEs to support development, the conflicting interests of President Suharto and his bureaucracy, the military and the Technical Ministries that preferred to maintain their status quo and the conglomerates that benefited from weak enterprises, meant that only parts of the reform were implemented. Privatisation as an option was ineffective as the majority of control and management was still in government hands. Privatisation was not trusted as it opened the way for Suharto's cronies, Indonesian Chinese conglomerates and foreign investors to control the business. The reforms of 1988 were clearly largely ineffective and unsuccessful.

C. Reforms and the privatisation policy of 1998

Years after the Presidential Instruction no. 5/1988 was implemented the objectives of reform remained unfulfilled. However, there was an improvement for SOEs that were partially privatised and listed on the Jakarta Stock Exchange during this period. There had been some changes of legal status, some financial restructuring and organisational and management rearrangements, but for the 180 enterprises still under government control the reforms had not produced the expected results. The SOEs were confronted with higher production costs and low profitability. Returns on assets in 1996 and 1997 were 2.6 per cent and 3.1 per cent, that is, one fourth or one fifth of private companies' profitability in the same years (BUMN, 1998). They could therefore obstruct the economy and place a burden on the state budget.

After the crisis of 1997 there were some reasons why the government needed to continue the reforms: 1) higher production costs of the SOEs and reduced profits that impeded their ability to reinvest profits, 2) less government funding, 3) banking restructuring created a new source of funds, 4) the SOEs joint venture companies had limited capability to support the reform, 5) domestic and foreign investors participated to boost market confidence (BUMN, 1999). In early 1998 the Reformation Government under Habibie's presidency, issued the new policy for reforms with the following guidelines (BUMN, 1999):

1) To accelerate restructuring and privatisation from average less than one SOE a year to 12 SOEs from 1998 to 1999.
2) To increase the option of reform not only by minority share sales but mainly by initial public offerings.
3) To transfer the authority and responsibility of reform from the Technical Ministries to the Ministry of State-Owned Enterprises instead of the Ministry of Finance.

There were some differences between these reforms in the Presidential Instruction of 1988 and those contained in the Reform Policy of 1998. First, government policy on ownership in the reformation of 1998 was that government would be a regulator not a controller, and that government would provide the same opportunity in business.

Second, instead of government intervention there were to be regulations on: 1) competition for the free flow of goods and services and reduction in cartels and monopolies, 2) protection for the consumer on the quality of goods and services and also protection on opportunity to gain profits for the investor's interest, 3) opportunity for entry for more companies and industries into various types of ownership.

Third, privatisation was stated as the objective of reform to support the state budget. The reforms—especially privatisation—stated the need for political support and involvement of the parliament.

1. The reform policy of 1998

The policy implemented to reform the SOEs after the crisis was designed to maintain efficiency, commercial achievement and broader ownership for continuity of growth, to achieve profits to support the recovery of the economy, for prosperity, and to increase the quality of service to consumers. The SOEs were challenged to support the recovery of the economy, to sustain the budget, develop capital market and redistribute wealth (BUMN, 1999a). The new policy covered a wider area than the President Instruction no. 5/1988.

The new reform policy of 1998 was based on the Decision of the Provisional Consultative Assembly no. IV/1999, followed by Law no. 25/2000 on the National Development Program *(Propenas)* 2000-2004. The policy obliged the government to improve the competitiveness of the SOEs, to reform them by developing organisation and improving professional management, and to improve efficiency by creating a good corporate culture that focused on the operations. Privatisation was an objective for non-strategic businesses with a simple bureaucracy, transparency and accountability. Reform was an urgent matter as the number of SOEs that made losses as a result of the 1997-1998 financial crisis increased from 23 companies in 1999 to 45 companies in 2002, that is, 24 per cent of their total number (Table 4.8). It created more pressure for reform to ensure the survival of state-owned enterprises, to minimise loss and to avoid bankruptcy.

2. To accelerate privatisation

Under the 1988 policy a small number of state-owned enterprises were partially privatised and listed on the stock exchange. Under the new reform policy of 1998 the government had decided to accelerate the process. There were further share placements for PT Telkom (second issue), PT Indosat (second issue), PT Aneka Tambang (second issue) and PT Semen Gresik (second issue), while IPOs were made for PT Tambang Batubara Bukit Asam, PT Pelindo I, PT Pelindo II, PT Jasa Marga, PT Krakatau Steel and PT Perkebunan Nusantara IV. The government wanted to reform the enterprises on a one by one basis, so as to utilise the capacity of the private sector (BUMN, 1998).

In addition, the government made plans for the SOEs to be restructured and privatised from 1999-2001. The government wanted to float 25 companies over 1999/2000 and 35 companies over 2000/2001 (BUMN, 1999a). It was an ambitious program given the limitation of expertise, the lack of organisation, the need for public education and the mobilisation of political support, as well as the limited capacity of the market to raise capital.

3. To increase the reform methods

The new reform policy introduced more methods of reform than the previous restructuring policy. This included going public, direct placement, liquidation, selling off, management contract, management/employee buyout (MBO/MEBO), partial assets sales, voucher schemes, concessions, and leases. Besides contracting out there were also employee share ownership plans (ESOPs) and Privatisation Trust Funds (BUMN, 1999 a).

The first five methods had been in the previous policy and with additional methods the government gave more opportunities for investors to participate in SOEs' business operations and ownership. The government considered accommodating investor preferences for their investments by giving them a greater flexibility and choice.

4. One roof ministry control

The dual ministerial control by the Ministry of Finance and the Technical Ministries since Revised President Instruction no. 11/1973 and Government Regulation no. 3/1983, had contributed to too many political controversies, disharmony and inefficiency in the working climate. Government Regulation no. 55/1990 had liberated state-owned enterprise from constraining regulations, but it only applied to those enterprises that sold their share on the capital market. It was the condition needed prior to the partial privatisation of any enterprises.

This existing dual control mechanism involving both the Technical Ministries and the Ministry of Finance was reorganised under the new reform policy. The control of the SOEs was transferred from 17 Technical Ministries to the Ministry of Finance under the Government Regulation no. 12/1998. Government Regulation no. 50/1998 then placed them under the control of a newly established department, the State Ministry of State-Owned Enterprise. The objective was to separate the regulatory function of Technical Ministries from the business operational function to be conducted by the new ministry. The government's intention was to bring both the reform and implementation policies under the responsibility of one ministry.

5. Restructuring and privatisation as regulated by Law no. 19/2003

Law no. 19/2003 of 19 June 2003 gave effect to another new policy. The objective was to improve the internal conditions of the state-owned enterprises to create better value (article 1.11), with the aim of partial or full sale of the government's shares in the *Persero* to other parties (article 1.12) through the capital market, by direct placement, or by selling to the management/employees of the enterprise (article 78). Privatisation was needed to improve the performance and value of enterprises, to increase benefits for the country and its people and to expand ownership of shares by the public (article 1.12). The important matters of privatisation were to access the equity market to strengthen financial position of the enterprises. It was the ability to generate profits (*profitisation*), a term stated in the Master Plan of SOEs (2002) as a process to increase the value of the enterprises. The term is not mentioned in Law no. 18/2003, as it is part of the technical process in restructuring.

Law no. 19/2003 had similar objectives to the 1998 policy; both sought reform of the SOEs as a means to facilitate privatisation. Privatisation meant the transfer of government ownership in *Persero* through the mechanism in capital market or direct placement. Plans for privatisation were prepared by the Ministry of the SOE. A Privatisation Committee was established to coordinate the procedures, terms and conditions of the privatisation. The Committee was responsible to the President. If an SOE was to be privatised, it had to obtain the Minister of Finance's recommendation; the support of parliament, and the public had to be mobilised. This was a long and complicated bureaucratic and political process involving the sale of government assets and the promotion of the public interest.

D. The impact of the SOEs reform of 1998

The reform of the SOEs was part of the government's efforts to strengthen them to support the economy. State-owned enterprises became more important in the economy because of the impact of the crisis on many private enterprises.

1. The implementation until 2003

Implementation in some companies was as follows:

1) The PT PLN (State Electricity) was a high priority for reform because its sales decreased sharply due to the lower consumption by industries and the over supply of power together with the weak rupiah, which increased the costs of its US$ debt repayments. The objective was to transform the PLN into a non-operating holding company to prepare multi buyer and multi seller markets. The private sector became involved in generating the electricity that was supplied to the PLN.

2) State-owned banks managed 41 percent of total assets and 53 per cent of total loans (February 1998) of the Indonesian banking system. Banking was the sector of the

economy that suffered most severely as a result of the crisis. The most crucial problems were liquidity and bad debts. Bank Negara Indonesia, Bank Rakyat Indonesia and Bank Tabungan Negara were restructured. In July 1999 there was a merger of the Bank Ekspor Impor Indonesia, Bank Bumi Daya, Bank Dagang Negara and Bank Pembangunan Indonesia to become Bank Mandiri. Bank Negara Indonesia, Bank Mandiri and Bank Rakyat Indonesia had already been partially privatised.

3) The effort to increase the profits is a continuous process in many SOEs. It is an internal effort of reorienting business activities, revenue enhancement and cost reduction. Control by process becomes control by result and the outcome that is expected is a higher return on equity and assets. Liquidation is also a way of cutting losses or merging with another company. Types of restructuring to increase profits in some enterprises are as follows:

a) PT Garuda Indonesia, the government-owned airline company, was reformed through the appointment of a new board, voluntary redundancies, the closure of unprofitable international and domestic routes, renegotiation of contracts, debt restructuring and the development of a new corporate culture. The government supported PT Garuda Indonesia to avoid bankruptcy (BUMN, 1999).

b) PT Pertani: the SOE under the Ministry of Agriculture, with interests in seedlings, fertilisers, pesticides, machinery and tools for agriculture, and rice milling. The company was reorganised, its unproductive assets were sold off and soft loans were provided by the ministry. This increased the capacity of rice mills, increased sales, partnerships with farmers and SOEs' fertiliser factories, and increased after sales service (BUMN, 1999).

c) PT Kerta Niaga, PN Lokananta, PT Perhotelan dan Perkantoran Indonesia and PT BPIS were liquidated. The 10 enterprises under PT BPIS became *Persero.* The government divested itself of PT Wisma Nusantara Indonesia by selling all of its 41.99 per cent shares to private investors. PT Industri Sandang I and PT Industri Sandang II merged with PT Industri Sandang Nusantara and the government transferred its shares in PT KTSM to this newly merged SOE (BUMN, 2003). The government converted the legal status of *Perum* Perhutani to become PT Perhutani and in 2000 it established 15 *Perjan.* Thirteen of the enterprises were hospitals, while the rest were Perjan, including

TVRI (television station) and Perjan Radio Republik Indonesia/RRI (broadcasting station).

d) Privatisation through the capital market continued in 1998. PT Semen Gresik placed an additional 14 per cent of its shares on the market in a strategic sale that raised 1,317 billion rupiah. In 1999, PT Pelindo II sold the shares of its sister company (PT JICT) at 49 per cent for US$190 million and PT Pelindo III sold shares of PT Terminal Peti Kemas, its sister company at 51 per cent forUS$157 million. PT Telkom made private placements of its shares in 1999, 2001 and 2002 for a total of 7,388 billion rupiah. In 2001 PT Kimia Farma, PT Indofarma and PT Socfindo entered the market, followed by PT Tambang Batu Bara Bukit Asam in 2002. PT Indosat had a private placement and strategic sales in 2002 to the value of 967 billion rupiah and US$608.4 million.

The impact of privatisation of PT Indofarma, PT Kimia Farma and PT Tambang Batu Bara Bukit Asam is reflected in Table 4.7. For three years prior to privatisation the average rate of RoE and RoA revealed a downfall, such as PT Indofarma at 18.36 per cent and 15.02 per cent. This company reported a negative result in 2002 due to some accounting problems and was under investigation. PT Kimia Farma was at 21.08 per cent and 8.90 per cent and PT TB Bukit Asam was at 13.58 per cent and 10.24 per cent.

Table 4.7
Financial ratio after privatisation

SOE	Year	Profit/Sales	RoE	RoA
		%	%	%
	*)	20.11	17.62	14.56
PT Indofarma Tbk	**2001**	28,58	34,43	21,67
	2002	-10.44	-18.40	-8.87
	*)	7.1	26.53	12.92
PT Kimia Farma Tbk	**2001**	13,01	25,23	15,58
	2002	3,45	7,83	5,11
	*)	32.10	14.15	10.16
PT TB Bukit Asam Tbk	**2002**	11,36	18,13	12,38

*) average rate, five years prior to privatisation

Source: Ministry of Finance, 1996; Jakarta Stock Exchange, 2003

2. The performance of the SOEs post reform

Reform of the SOEs was strongly influenced by the government's ability to improve the macro economic development. After the crisis Indonesia had to struggle with multiple political and economic problems and to regain confidence from international investors and trading partners. In this situation their performance had not improved substantially, not only in financial performance, but also in the degree of soundness. Tables 4.8 and 4.9 show the enterprises' performance to 2002 as the starting point in achieving the performance objectives established in the Master Plan, 2002–2006. The objective was that the SOEs should achieve a return on assets of 3.60 per cent in 2001, 3.68 per cent in 2002, 3.82 per cent in 2003, 3.90 per cent in 2004, 4.16 per cent in 2005 and 4.47 per cent in 2006 (BUMN, 2002).

Table 4.8
SOEs financial performance and profitability, 1997–2002

Year	Profit/Sales %	RoE %	RoA %	SOEs with profit	%	SOEs with loss	%	Total SOEs
	1	2	3	4	5=4:8	6	7=6:8	8
1997	10,31	9,56	2,29	n.a.		n.a		n.a
1998	-86.52	-21.55	-44.52	n.a.		n.a		n.a
1999	13,65	19,37	3,21	156	87,15	23	12,85	179
2000	11,63	16,04	2,69	162	84,82	29	15,12	191
2001	12,62	20,01	3,27	156	82,54	33	17,46	189
2002	15,02	13,77	3,84	143	76,06	45	23,94	188

Source: Ministry of SOE, 2002; 2003

The SOEs' return on assets during 1999 to 2002 tended to increase but the number of enterprises making a profit decreased, as shown in Table 4.8, from 87.15 per cent in 1999 to 76.06 per cent in 2002.

Table 4.9
Level of financial soundness of SOEs, 1999–2002

Year	Very sound/ Sound	%	Less sound	%	Not sound	%	Total
1999	108	76.59	22	15.60	11	7.80	141
2000	104	74.82	27	19.42	8	5.76	139
2001	94	68.61	33	24.09	10	7.30	137
2002	112	71.38	37	23.57	8	5.09	157

Source: Ministry of SOE, 2003

As a result of reform, the financial returns of the SOEs improved, but were still below the private sector's norms. However, more enterprises were not in a sound financial state in 2001 and 2002, the highest in percentage since 1987 and more SOEs also made losses. It seemed the government had to work harder to improve on their performance. The reform of 1988 basically applied a micro approach to the improvement of soundness and the enhancement of management. The enterprises had to improve their internal matters by efficiency and productivity and develop their performance without the financial support of the government. The government deregulated the market, which benefited some conglomerations but undermined the SOEs. Although the reform had stimulated some enterprises to restructure and modernise their operations, reform that was government initiated—challenged by the ambiguity of some government policies and opposed by the military, the bureaucrats and the politicians—made incremental reform slow and ineffective. It managed to improve the competitiveness of the SOEs by effective organisation and enhancing professional management. It was a policy that the enterprises had to support the government in economic development and make an effort to help the economy recover post the crisis. In the context of reform, the objective of privatisation was to support the state budget. However, the full privatisation of SOEs was not popular in the community and was only viable when the government could mobilise support in parliament.

Chapter V

Mergers, corporate governance and financial performance

A. Mergers as a method of restructuring

This chapter examines the ways in which mergers have been used to bring about reform. Government Regulation no. 27/1998 sets out the guidelines on mergers in Indonesia for the SOEs and the private sector. When the government implemented the Presidential Decree no. 5/1988, it instructed the Board of Managers to initiate state-owned enterprise mergers. The merger concept is discussed from the point of view of the private sector and government. The discussion focuses on various concepts connected with mergers, theoretical frameworks, and the impact of mergers on the subsequent performance of state enterprises.

1. Mergers, means and challenges for SOEs

The terms 'merger' and 'consolidation' were used in the Presidential Instruction no. 5/1988 and Ministry of Finance Decree no. 740/KMK.00/1989, as an option for the restructuring of state-owned enterprises. There was no specific regulation on mergers until ten years after the Presidential Instruction, when the government issued regulations on mergers, consolidation and acquisition (Government Regulation no. 27/1998, 24 February 1998). A 'merger' refers to the union of two or more enterprises into one enterprise that retains its identity while component enterprises cease to exist (*penggabungan*: Ministry of Finance Decree no. 740/1989, article 1. 17; *penggabungan,* Government Regulation no. 27/1998, article 1.1). 'Consolidation', refers to the creation of one new enterprise while all its component enterprises are liquidated (*konsolidasi*, Ministry of Finance Decree no. 740/1989, article 1. 16; *peleburan*, Government Regulation no. 27/1998, article 1. 2). Merger and consolidation, as used in government laws and regulations, are consistent with Gaughan's (2002) definitions. The term 'acquisition' as a method of restructuring was first used in the 1998 reform policy (BUMN, 1999a), referring to the situation whereby one company acquires another and manages it consistently with the new owner's needs (Schuler & Jackson, 2001). Despite the differences between 'merger' and 'consolidation' they are sometimes used interchangeably while some authors prefer 'takeover'. Although the latter can sometimes refer to hostile transactions, at other times it refers to both friendly and unfriendly mergers (Gaughan, 2002). There is no real difference between these terms with regard to their practical application and in this study I will refer to either merger or acquisition.

When Indonesia was attempting to improve the performance of its SOEs from 1981 to 1989, a fourth wave of world mergers was in progress and this was followed by a fifth international wave between 1991 and 2000. Characteristic of the fourth wave was the significant role of hostile mergers that generated very high, short-term profits (Gaughan, 2002). It was understood that this international wave of mergers correlated with stock market upturns (Mueller, 2003) and in turn this influenced Indonesian technocrats and economists. As Indonesia had specific problems with its SOEs, merger activity was more concerned with effective management and performance rather than creating larger corporations in the spirit of 'bigness was best', although bigger enterprises were needed to counter balance private conglomerations. The merger option was part of a corporatisation process whereby government retained ownership. Corporatisation of state bodies was concerned with redefining the internal operations of public organisations and this introduced private sector management practices and processes (new managerialism) into public sector organisations. These bodies operated according to market-based criteria that changed formal legal and institutional structures (Ferlie & Ashburner, 1996).

2. The merger rationale

Any enterprise engaged in a merger aims to increase revenue and profit while also reducing costs. Revenue should increase as a result of the merged enterprise's greater market power, while expenditure should decrease if the merger improves efficiency. The newly merged enterprise should create synergies and economies of scale to increase productivity. Increases in efficiency, productivity and market power were the most obvious reasons for the merger of the SOEs in Indonesia (Minister of Finance Decree no. 740/1989, article 2.1).

The following theoretical frameworks support the rationale for mergers:

2.1 Maximisation of shareholders' wealth

Under this idea the primary goal of the managers of the firm is to maximise the shareholder's wealth (Gonzales & Vasconcellos, 1997). A merger, therefore, should generate a positive economic gain for newly merged firms. Most mergers are value-maximising activities and aim to boost shareholder's wealth. If managers who engage in mergers cannot meet this company objective, they may decide not to proceed or they may reject a merger offer outright (Powel, 1997). If the firm's value increases as a result of the merger, it indicates that the firms involved in a merger are value maximisers (Asquith & Kim, 1982). Financial synergies can arise from various aspects of the merging firms, such as a reduction of default risk thus reducing costs, and diversification of equity risk for shareholders (Maquiera et al. 1998). Financial motivation and synergy effects are among factors consistent with the maximisation of value (Choi & Phillipatos, 1983).

A merger theory of maximum wealth is relevant for SOEs. The government as owner needed to take necessary steps to strengthen enterprises prior to privatisation. Mergers were conducted by boards of management with the intention of realising the maximum price for proceeds through privatisation. The merger of PT Indosat was such a case. *Kompas* (12 November 2003) reported that the extraordinary shareholders' meeting held on 11 November 2003 agreed that PT Satelindo, PT IM3 and PT Binagraha—sister companies of PT Indosat—would merge with the parent company. Their products, for example, Satelindo, Matrix and IM3 expanded PT Indosat's market share, in particular, cellular phones. This vertical merger was expected to increase the efficiency of capital expenditure by 15 to 20 per cent and operational expenditure by 10 to 15 per cent within five years. By December 2003, PT Indosat had finalised its privatisation process and realised the expected price.

2.2 Differential efficiency and inefficiency

Costs will fall if a merger increases the efficiency of the merging firm and this can occur in horizontal, vertical or conglomerate mergers (Mueller, 2003). More efficient firms will acquire less efficient ones and realise gains by improving overall efficiency. This implies that the acquiring firm has superior managerial capabilities (Weston et al. 1990). A firm hat offers similar business activities would most likely be the potential buyer if it has the managerial know-how for improving the performance of the acquired firm. The managerial synergy hypothesis implies that the company has an efficient management team with the capacity to exceed its current managerial input demand. The company may be able to utilise extra managerial resources by acquiring another inefficiently managed company. This rationale is appropriate for a horizontal merger.

Inefficient management, however, is also a merger motive. The investor sees the scenario as a response to a situation where the existing management is simply not performing to its full potential. A firm that becomes the target for merger by another enterprise might be able to manage its assets more effectively (Weston, et al. 1990; Malatesta, 1983). Several indicators, for example, poor financial performance, undervalued shares and service delivery, can be interpreted as inefficient management (Dodd & Ruback, 1977).

The Indonesian Government's preference would have been to close down and liquidate inefficient state enterprises, but had no alternative but to continue to avoid greater financial disaster, loss of assets and legal and labour problems. These enterprises were assigned to maintain specific government functions, such as conserving resources in forestry and plantations, banking and water storage and these were perceived as vital to the community. If the government merged an inefficient enterprise with an efficient enterprise as a solution, the former would weigh the latter down. Most mergers were related to this problem of inefficiency. If it was a choice between bankruptcy and merger, the latter was chosen to address the issue of inefficiency.

2.3 Operating synergy

A merger is the appropriate strategy when firms previously operating at a certain level of activity fall short of achieving their potential for economies of scale that may reflect indivisibilities and better utilisation of capacity after the merger (Weston, et al. 1990). Cost reductions may come as a result of economies of scale or a decrease in per unit cost resulting from an increase in size or scale of company operations.

The synergy, leverage or efficiency creates value by combining the strength of the two organisations to achieve strategic and financial objectives. The union of two organisations can produce something more than the sum of its parts. It must yield more than synergy based on economies of scale and elimination of redundancy (Mark & Mirvis, 1998). Thus the mergers of government-owned plantation companies such as PT Perkebunan have created effective synergies and helped avoid unproductive competition.

2.4 Financial synergy

One of the arguments advanced for mergers is the greater financial resources available after merger. The bigger firm will have better access to equity capital. If two large firms merge they create financial synergies. They have greater capital resources and equally greater capital commitments (Jervis, 1971). Financial synergy refers to the impact of a corporate merger or acquisition on the cost of capital to the acquiring firm or merging partners. To the extent to which financial synergy exists in corporate combinations, the cost of capital should be lowered (Gaughan, 2002).

2.5 The failing firm

Dewey (1961) states that most mergers have virtually nothing to do with the creation of market power or the realisation of economies of scale. They are merely a civilised alternative to bankruptcy or the voluntary liquidation that transfers assets from firms failing to prosper. As a method of transferring capital from one management to another, mergers are superior to bankruptcy or voluntary liquidation because they avoid the loss inherent in the elimination of a going concern. Peel (1990) states that a merger is a strategy that explores the possibility of bankruptcy avoidance in distressed firms. Haugen and Langetieg (1975) conclude that it is possible to minimise the risk of insolvency and bankruptcy by merging with another firm.

2.6 Growth and merger

A merger is the quickest way for a firm to grow and diversify and it is also an attractive way for managers with limited time horizons to achieve growth. The growth theory predicts diversification mergers by mature firms (Mueller, 2003). Of course, firms might undertake horizontal, vertical or conglomerate mergers for growth reasons also, but the number of these options available to any firm will be more limited than that of diversification. Growth plays a motivating role in mergers. Growth in sales and assets is, of course, positively correlated with company profits (Steiner, 1975).

2.7 To achieve economies of scale

In Pratten's view (1971), economies of scale are the reduction in average cost attributable to an increase in production scale. This occurs when the unit cost of production declines as the size of plant increases. Jackson (1998) states that economies of scale are the relationship between the volume of production and the cost of producing that volume of production. As such it is a volume–cost relationship to increase efficiency and profit. A merger can achieve economies of scale to raise the volume of production in a relatively short period of time. It reduces the average cost of production which creates lower unit costs leading to higher profitability.

3. The role of government in mergers

3.1 Government policy

As explained in Chapter IV, the existence of SOEs was important to support political and economic stability, especially for the New Order Government. They were used to maintain the price stability of nine basic commodities and were also a vehicle for the cross subsidisation of goods and services supporting government departments' extra-budgetary expenses and community development. Directly or indirectly the government used them as instruments to intervene in the economy and ensure price stability. This was thought to be essential as price stability was considered to be one of the pillars of political and economic power for the New Order Government.

State-owned enterprises faced numerous problems in their relations with government and their internal organisation. The government had established contradictory and ambiguous objectives and the enterprises suffered from a lack of capital, management and personnel skills and were over-organised, bureaucratic and plagued by corruption. The complexity of their functions was reflected in poor financial performance, especially during the 1980s, when the government was concerned that they might not be able to survive. On 30 December 1986, a meeting of the full cabinet examined all aspects of state-owned enterprises and explored the possibility of selective privatisation (Hendrawan, 1996). The objective was to strengthen SOEs and merger was the considered option. Consequently, mergers and acquisitions were presented as options of the 1988 reform and the following was decided:

1) Their ownership would remain with government.

2) Mergers would be between state enterprises.

3) There would be no valuation of shares as enterprises would not become public companies.
4) Government would adopt a pro-merger approach (Mueller, 1980) and take an active, entrepreneurial role in seeking out merger partners, encouraging companies to merge and providing tax and other merger incentives.

By the 1998 reform merger, consolidation or acquisition were stated as options (BUMN, 1999a) and SOEs were grouped in 37 clusters consisting of enterprises in the same business sector (BUMN, 2002). The authorities apparently chose mergers as a means of reform because:

1) There would be no cash outflow from the government to the merging enterprises.
2) There would be no fresh additional capital provided for the newly merged or consolidated enterprises.
3) They were based on a legal process with integration of accounts and minimum transaction costs.
4) They involved no disruption to business operations and the provision of goods and services to customers.
5) They did not constitute bankruptcy; creditors and suppliers would be paid so as to avoid any unnecessary legal actions for the government.
6) They should maintain core competence and capability.
7) There would be a reduction in unnecessary management and employees.
8) They did not constitute a change of ownership and represented a process of corporatisation under state ownership.

The government considered mergers to be a necessary step to improve performance and value of enterprises to ensure their survival and continuing contribution to the Indonesian economy. In the long term, they were also a preparation for privatisation, clearly stated as the ultimate objective in the attachment of Presidential Instruction no. 5/1988 in reform policy 1998 (BUMN, 1999a; BUMN, 1998), and in Law no. 19/2003, article 74-86.

From a business perspective, inefficient SOEs should have been closed and liquidated, but the government decided against this to avoid loss of assets, legal problems and unemployment. As mentioned above they were assigned to maintain specific government functions widely perceived to service the community as a whole. The government merged inefficient enterprises as a solution although the process would be a burden for relatively efficient enterprises.

3.2 Nature and merger process

The merger of enterprises is a complex multi-dimensional process. The motivations of decision makers and other stakeholders and the climate in which they make their decisions are affected by many variables that influence the process and associated outcomes. This section will discuss the various factors that influenced the mergers that flowed from the cabinet's decision of December 1986.

From 1989 to 1998 there were no specific regulations governing mergers, but the initiative came from the government and the decision was made either by the Ministry of Finance or by one of the Technical Ministries. A steering committee designed the procedures for the merger and this was supported by an interdepartmental working committee. Management provided information and implemented the Ministries' decisions. Financial evaluation and accounting solutions were provided by the government-auditing agency, the State Audit Agency (*Badan Pemeriksa Keuangan dan Pembangunan/BPKP*). Government officials were the principal decision makers and advisors and the use of external consultants was not obligatory. A consultant would have constituted an extra cost for the government and the mergers were considered to be an internal matter to be managed by the Technical Ministries. The merger process had not become a political issue and Parliament considered that it was the government's role to improve the productivity of the state enterprises, hence goods and services for the public. There was little discussion in the media, as long as it was perceived that the government was fulfilling its responsibility towards SOEs appropriately. The mergers impacted marginally on the public and had no impact on capital markets. They were considered a matter for internal reorganisation within the bureaucracy.

Prior to 1998 and because mergers were conducted between the SOEs, financial arrangements were made by the government. It was expected that any newly merged enterprises would have the capability to manage their component parts with greater efficiency and improved performance. No financial institutions were involved in the merger process. The focus was on the legal requirements of transactions which involved the State Secretary, the Ministry of Justice and the public notary.

The study of the merger process during this period should be viewed from two important aspects. First, since it was a government decision that existing enterprises should be merged with others, any merger decision became a complicated process because of conflicting government interests. Merger proposals led to intervention from political parties, the military, and the bureaucracy and individual officers that were involved in enterprise businesses. Efforts to improve the performance of merging companies were compromised by interest groups inside the government. The deterrents were external factors to management and this made the merger process slow and ineffective. The second aspect was the implementation of the technical processes of a merger, such as legal aspects, finance arrangements, accounting, human resources and the post merger integration process. These processes were not impeded by the stock market, speculators, public and parliament intervention or industry control and incurred low transaction costs. This revealed a relatively simple technical process although an evaluation of the merger plan was expected to be carried out with due diligence, including a clear business strategy and integration plan for newly merged enterprises.

By way of comparison, a merger in the private sector as a public company was quite a different process and technical matters had a high degree of complexity. Steiner (1975), described the multivariate nature of such mergers, including stockholders, investors, speculators, the financial community, anti trust authorities, lobbyists, the stock market, legal regulatory bodies, taxation authorities, the courts, securities law and enforcement, transaction costs, merger participants, targeted and financial institutions. It was a complicated process to manage so many variables, but the merger decision in the private sector was in the hands of management. There were external factors to consider, such as the macro economic conditions that might influence business expectations, but the merger outcome depended on the competence of management to carry it through.

After 1998, the mergers of SOEs had to follow Government Regulation no. 27/1998 on merger, acquisition and the takeover of any company with limited liability, including the *Persero*. The process involved more participation from the board of management, the board of commissioners and the government, as well as the general shareholder's meeting, public interest groups and the press. The merger process was audited by an external auditor and the participation of a respectable consultant's office helped ensure proper due diligence.

The key points of the regulations for merger proposal include the following:

1) The boards of management of merging companies would propose a merger plan. For the SOEs, the government established guidelines that provided the management framework for merger proposal.
2) It should be accepted by the boards of commissioners of merging companies.
3) It should be publicised in two newspapers and be presented to employees at least 14 days prior to the general shareholders' meeting of each merging company and to creditors 30 days before.
4) It should be approved by the general shareholders' meeting of merging companies. Although the government was the only shareholder, it was legally bound to follow Law no. 1/1955 on corporate limited liability with *persero* regulations.
5) The approved merger documents should be reconfirmed by notary deed as well as those acts of a newly established company.
6) The management of a newly merged company had to report the merger in two newspapers at least 30 days after the merger date.

The above mentioned regulations are based on the business proposal but stress the legal aspects. The business aspects, in terms of securing the most valuable merger partners, involve a different approach between the state enterprises and the private sector. Although the management of the former has the authority to propose their own merger plan, the merger or merging partners should be directed and approved by the government.

3.3 Cases of implementation of SOEs' merger

PT Rajawali Nusantara Indonesia (RNI) was a merger of SOEs prior to 1998 and PT Perusahaan Perdagangan Indonesia (PPI) followed.

PT Rajawali Nusantara Indonesia (RNI) was the new name for the Oei Tiong Ham Concern, a company established in Semarang on 1 March 1863. The company's strengths were in general trading, plantations and sugar factories. It was nationalised in 1961 and granted *Persero* status in 1974. RNI was a holding company that until 1985, controlled 10 subsidiary companies. In 1986, three small-scale companies in trading and services—PT Apotik Bima, PT Bandareksa and PT Mutiara RW—were merged with PT PIE Rajawali Nusindo, followed by the merger of the rubber plantation PT PK Cileles with PT PK Cimayak. However, the scale of the rubber business was too small and its future prospects were doubtful and in 1987, PT PK Cimayak was sold to strengthen the capital of the holding company. In 1991, PT Imaco, a management service company, merged with RNI, making RNI an operating holding company as well as a service company. In 1996, the sugar company, PT PG Rejoagung Baru, merged with PT PG Krebet Baru, a surviving company under the new name, PT Rajawali I. Merger was an option after 1986 to consolidate the RNI business and also for growth. The merger of RNI is consistent with what Brouthers et al. (1988) argue: it is a synergy that pursues market power and improves the competitive environment. In 2003 RNI dealt with service management, trading, agro industry and pharmacy in a joint venture company, property and other investments.

PT Dharma Niaga (DN), PT Pantja Niaga (PN) and PT Cipta Niaga (CN) were in the same line of business in trading that originated from three of the big eight Dutch companies of the colonial era. The government decided after the business collapse to restructure and support a trading company for domestic and international markets. On 19 June 2003 these companies were merged to become PT Perusahaan Perdagangan Indonesia (PPI). Davis (1988) explains that this merger was an effort to turn around poor performance. The government restructured and reorganised companies in the same line of business, followed by clear strategies and rescue action programs to redevelop trading activities.

As explained earlier, prior to the 1998 guidelines, the merger of SOEs was principally a legal process, initiated by government as owner. Merger within the RNI group in 1986 was in accordance with Government Regulation no. 3/1983, concerning enterprises classified as Perum, Perjan dan Persero. It was a government initiative based on the Ministry of Finance instruction no. S-236/MK.011/1986, dated 5 March 1986, that asked RNI to restructure and merge some of its affiliates. The board of directors and the board of commissioners put the necessary steps usually followed at an Extraordinary General Shareholder's Meeting into operation, including accounting set off, transfer of employment, and finalising of all legal documentation. The financial position of the merged enterprises was approved by the Regional State Audit Agency (*BPKP Daerah*). Management were not in a position to prepare the merger plan or study the merger impact. The merger was an internal reorganisation that was not officially announced to the public or company employees.

The merger regulation of 1998 was applied to the PPI merger process. It followed a legal process however the management of the merging companies initiated the merger. These companies had to propose merger plans and they had to be approved by their boards of commissioners. PPI merger plans were advertised on the 3 April 2003 with *Tempo* and *Suara Pembaruan* and *Bisnis Indonesia*, and were announced to the employees on 3 and 4 April. The merger was approved by the Extraordinary General Shareholder's Meeting on 5 June. On 19 June *Kompas* and *Bisnis Indonesia* reported that the merger was completed. Although merger initiatives were in the hands of management, the merger of PPI was controlled and guided by the government under its Team of Evaluation and Restructuring Implementation of the State-Owned Trading Enterprises from the Ministry of the SOEs, counter balanced by the Team on Technical Implementation from DN, PN and CN. The main difference between these mergers was the process of due diligence and planning. This had been introduced in 1998, but had not been used prior to 1998. The government kept an intervention policy on the merger of state enterprises in 1988 and 1998, so that the government retained control of the process.

4. The effects of mergers

4.1 Can mergers improve performance?

Mergers and acquisitions are well-known strategies in business and finance to expand business and create shareholder value, however there is much controversy about their efficacy. The evidence for shareholders of firms that have merged is not encouraging and the impact on managers and employees can be traumatic (Schweiger, 2002). Mergers and acquisitions often result in job losses as those who acquire pursue cost synergies through the elimination of redundant jobs. Post merger performance studies of private sector mergers provide conflicting evidence about the long-term impact of merger and acquisition activity. Although some studies have found a better than average chance that mergers create shareholder value, others have found that as many as 50 to 80 per cent of merged firms underperform compared to their industry peers. The diverse conclusions represented in Table 5.1 strongly suggest that evaluations of post merger returns are

Table 5.1
Post merger Performance Studies:
Return to Merged Companies versus Industry Average Return

Underperforming industry average	Approximate industry average (3 - 5 years following announcement date)	Overperforming industry average
McKinsey & Company (1990) Mangenheim and Mueller (1988) Frank, Harris and Titman (1991) Agrawal, Jaffe and Mandelker (1992) Sirower (1997) Loughran and Vijh (1997) Rau and Vermaelen (1998) Stanford C. Bernstein & Company (2000)	Mueller (1985) Ravenscraft and Sherer (1986) Bradley and Jarrel (1988)	Healy, Palepu and Ruback (1991) Kaplan and Weisbach (1992) Rau and Vermaelen (1988)

Source: DePamphilis, 2001

highly sensitive to sampling and the methodologies employed (DePamphilis, 2001). Several well-structured studies calculate that 50 to 75 per cent of acquisitions actually destroy shareholder value instead of achieving cost and/or revenue benefits (Gadiesh, et al. 2001). Five root causes of failure were poor strategic rationale, overpayment, inadequate integration, void strategic communications and cultural mismatching.

From studies of the effects of mergers and acquisitions, the reasons for their failure in the private sector are shown in Table 5.2. These reasons were internal and concerned technical business matters under management control, which required special attention in the merger process. They included inadequate due diligence, technology problems, financial conditions, cultural integration, communication, and poor strategy. These findings can be used as a reference by the SOEs, since they are challenged by a similar process and to avoid merger failure the merger plan should cover all of these areas. It was important in merger planning to describe the business after merger as the management and the government had to maintain the same objectives.

Table 5.2
Commonly cited reasons for merger and acquisition failure

Overestimating synergy	Chapman, Dempsey, Ramsdell & Bell (1998) Sirower (1997) Mercer Management Consulting (1998) Bradley, Desai and Kim (1988) McKinsey & Company (1987)
Slow pace of integration	Coopers & Lybrand (1996) Mitchell (1998) Business Week (1995) McKinsey & Company (1987)
Poor strategy	Mercer Management Consulting (1998) Bogler (1996) McKinsey & Company (1987) Salter & Weinhold (1979)
Payment in stock	Lougrhan & Vijh (1997) Sirower (1997) Sanford Bernstein & Company (2000)
Overpayment	Sirower (1997) McKinsey & Company (1987) Rau and Vermaelen (1998)
Poor post merger communication	Mitchell (1998) Chakrabarti (1990)
Conflicting corporate culture	Mercer Management Consulting (1995 & 1997) Hillyer & Smolowitz (1996)
Weak core business	McKinsey & Company (1987)
Large size of target company	McKinsey & Company (1987)
Inadequate due diligence	Mercer Management Consulting (1998)
Poor assessment of technology	Bryoksten (1965)

Source: DePamphilis, 2001

Brouthers et al. (1998) argue that merger success or failure is determined not only by financial performance but also by qualitative objectives, such as synergy and image improvement. Their methodology is based on three key propositions. First, managers have multiple motives for participating in a merger. Second, performance should be measured against the goals and objectives set by management, not necessarily against financial results alone, and finally mergers can create performance improvement in a number of areas within the firm.

From the private sector experience of merger, state enterprises in Indonesia learned two important lessons. First, the merger should follow business considerations based on proper due diligence and this should be evident in the merger plan. It was the management of these enterprises that were required to submit a merger proposal approved by the board of commissioners, as stated in Government Regulation no. 27/1998. Second, government had to clearly state the motives for merger. At the general shareholder's meeting voting on merger approval should be one of the decisions reached to provide a measurement indicating success or failure of management and commissioners post merger.

4.2 Post merger performance of Indonesian SOEs

As stated in the previous chapter some of the Technical Ministries decided to use mergers as a means to restructure state enterprises under their domain. Trends in their financial performance after 1987 are examined in Chapter III. The post merger performances of selected enterprises are shown in Tables 5.3, 5.4 and 5.5 and the year in which the enterprises were merged appears in bold print. The research findings are summarised as follows:

1) Three years post merger, the financial performance of PT Krakatau Steel (KS, steel producer), PT Koja Bahari (KB, dock yard), PT Hotel Indonesia (HI, hotel and tourism), and PT Pradnya Paramita (PP, printer, publisher and book/stationary retailer), did not show an improvement compared to the period pre merger (Table 5.3). Although businesses grew as indicated by an increase in total assets and sales, PT Hotel Indonesia and PT Pradnya Paramita made losses.

The companies that merged with PT Krakatau Steel demonstrated poor profitability and even PT Krakatau Steel continued to face marketing problems and high production costs. The total sales for 1989-1994 were relatively constantwith decreasing profits after 1992. PT Gita Karya suffered losses after 1987 when it merged with PT Pradnya Paramita PT Koja Bahari was created from the merger of four dock and ship yard companies. This company also faced marketing problems, slow turnover and long awaited collection periods as well as capital problems and obsolescent technology. In 1994 PT Natour was merged with PT Hotel Indonesia, which recorded negative earnings before tax during 1992 and 1993. The latter incurred added financial and marketing problems and this contributed to subsequent losses.

Peel (1990) states that the merger was designed to avoid bankruptcy. New merger companies listed in Table 5.3, with the exception of RNI, were poor performers. It was very difficult for government and management to turn these companies around, as Davis explains (1988). On the other hand, liquidation would create problems with labour unions.

Table 5.3
Financial performance and soundness post mergers

SOE	Year	Profit/sales %	RoE %	RoA %	Soundness
PT Krakatau Steel	1988	12,17	10,01	6,45	S
	1989	11,32	9,28	6,58	S
	1990	15,12	12,24	7,28	S
	1991	14,43	6,00	5,02	S
	1992	5,92	2,51	1,81	LS
	1993	5,91	2,46	1,65	LS
	1994	4,32	2,09	1,45	LS
PT Pradnya Paramita	1988	166,19	19,57	14,31	VS
	1989	5,07	0,63	0,43	NS
	1990	-102.36	-17.79	-14.56	NS
	1991	-37.93	-6.08	-5.08	NS
	1992	16,68	3,09	2,63	LS
	1993	9,65	2,09	1,78	LS
	1994	-1.18	-0.21	-0.17	NS
PT RNI	1989	25,27	19,83	14,99	VS
	1990	22,40	10,62	8,86	VS
	1991	19,80	10,81	9,11	VS
	1992	23,79	1,05	0,83	S
	1993	14,50	9,87	5,26	VS
	1994	17,31	14,56	7,68	S
	1995	17,04	15,63	7,99	S
PT Koja Bahari	1988	0,70	3,56	0,54	NS
	1989	1,22	6,99	0,85	NS
	1990	31,63	72,05	25,34	VS
	1991	10,52	15,78	6,92	S
	1992	1,62	2,82	0,61	NS
	1993	1,68	2,93	0,51	NS
	1994	1,86	3,66	0,68	NS
	1995	-0.04	-0.16	-0.01	NS
PT Hotel Indonesia	1991	10,83	11,76	8,49	S
	1992	3,60	4,07	2,45	LS
	1993	-16.04	-20.51	-6.75	NS
	1994	-25.86	-59.73	-13.84	NS
	1995	-28.18	-204.34	-17.13	NS
	1996	-25.84	-656.2	-7.96	NS

Source: Ministry of Finance, 1993 – 1996

The merger of four small companies within the group with total assets of less than 1 billion rupiah initiated other mergers between companies within RNI in 1986. Ten companies became three in trading, agro-industry and pharmacy. Fourteen affiliate companies also restructured and merged into seven in 1998, 1999 and 2000. These mergers were an attempt to reach overall efficiency in the holding company and to develop company synergies in the RNI group. Prior to restructuring this group demonstrated a strong financial performance. Profit on sales and returns on equity and assets in 1987 were 33.11 per cent, 25.58 per cent and 19.33 per cent, and in 1988, were 28.41 per cent, 20.80 percent and 16.88 per cent. In both years RNI was in a very sound condition (Ministry of Finance, 1993), financial ratios were better than average and the enterprises mostly doubled (with the exception of 1992), proving to be in a sound or very sound condition. From 1988 to 1998 RNI grew substantially, with total assets increasing sharply by 2,317 per cent. Equity grew from 637 per cent and total sales were boosted by 1,175 per cent. Profit before tax increased by 928 per cent (RNI, 1999). In comparison with other state enterprises, RNI showed a better financial performance and soundness as the company was already in a sound financial position pre merger. The newly merged enterprises demonstrated their ability to support these companies as well as generate profits.

RNI was in a different financial situation to that of PT Krakatau Steel, PT Pradnya Paramita, PT Koja Bahari and PT Hotel Indonesia. In this case the merged company was in financial difficulty, just as the three merging companies had been prior to the merger. The government expected RNI be able to bear its new obligation, but it only made the financial position of the new merger worse. The state enterprises were evidently merged to avoid bankruptcy and unemployment problems, but the merger failed to meet government expectations.

2) In 1996, 28 SOPEs under the name of PT Perkebunan (PTP) were merged with 14 new enterprises, PT Perkebunan Nusantara (PTPN) I-XIV. Their consolidated financial position, five years pre merger and four years post merger, is shown in Table 5.4. During 1992, 1993 and 1994, 54 per cent of plantation enterprises were reported to be in a less sound financial condition and the remaining 46 per cent financially sound.

In comparison with the average performance of SOPEs as shown in Table 4.5, the plantation companies' performance was above average, with almost twice the return on assets and one and a half times for profits on sales.

Table 5.4
Financial performance of State-Owned Plantation Enterprises pre the 1990-1994 merger and post the 1997-2000 merger

PTP 1 – 32 PTPN I – XIV	Year	Profit/Sales %	RoE %	RoA %
PTP I - 32	1990	12.88	9.67	5.24
	1991	12.39	9.55	5.28
	1992	15.16	13.43	7.89
	1993	12.40	11.67	6.69
	1994	12.95	12.21	7.49
	1995	n.a	n.a	n.a
PTPN I - XIV	**1996**	n.a	n.a	n.a
	1997	16.76	17.66	10.07
	1998	41.14	51.51	29.87
	1999	12.87	15.80	8.90
	2000	9.13	12.51	6.87

Source: Ministry of Finance, 1996; Ministry of SOE, 2002

The Ministry of Agriculture confronted the challenge to improve the important role of the plantation sector in economic development by increasing efficiency through rationalising economies of scale, the size of the businesses in terms of manageable areas, financial restructuring, human resources, management and the use of new technologies. This opened the way for expansion into new markets and greater profitability (Schuler & Jackson, 2001). The efficiency drive was conducted under the guidance of the Ministry of SOEs. From a financial point of view the result of the mergers was not adequate. The exceptional results in 1998 and 1999 were mostly due to the dramatic devaluation of the rupiah against the US dollar for the export industry after the financial crisis.

3) The merger of SOEs in the banking sector was conducted under the government policy on banking recapitalisation on government costs. These mergers were complex operations involving organisation systems, human resources and management and the government wanted to maintain a role in the banking sector (Schuler & Jackson, 2001; Brouthers et al. 1998; Peel, 1990; Davis, 1988). Bank Mandiri was established in 1999 with the merger of Bank Bumi Daya, Bank Dagang Negara, Bank Ekspor Impor

Indonesia and Bank Pembangunan Indonesia (all *Perseros)*. Bank Mandiri's financial performance post merger in trillion rupiah (Table 5.5), showed impressive results and it became a public bank in 2003.

Table 5.5
Bank Mandiri's financial position postmerger

	1999	2000	2001	2002
1. Total assets	225.944	253.354	262.290	250.394
2. Total liabilities	217.059	239.088	251.511	235.956
3. Equity	8.875	14.262	10.776	14.434
4. Deposits from customers	153.405	170.480	202.973	197.006
5. Fund borrowings	24.150	28.650	18.204	13.659
6. Government bonds	163.352	176.895	153.492	148.845
7. Loans	21.881	30.522	42.239	56.346
8. Profit before tax	-67.780	2.023	3.850	5.809
9. Net profit	-67.796	1.181	2.745	3.585
10. Earning per share - Rp.		278	646	843
11. RoA = 8:1 - %	(30.00)	0.80	1.47	2.31
12. RoE = 8:3 - %	(763.72)	14.18	35.72	40.24
13. Deposit growth - %	n.a	11.13	16.01	(2.93)
14. C A R - %	n.a	31.3	26.4	23.4

Source: Bank Mandiri, 1999–2002

4) The mergers made many writers hesitant (Table 5.2) due to economic and technical reasons, but Bruhn (2001) explains that the emergence of mergers and acquisitions in the private sector was influenced by political circumstances which determine their successor failure. What Bruhn means by 'politics' is the leadership styles and personalities of top managers in merging organisations. The more centralised and dominant the decision making power of the leaders of an organisation are, the more likely that strategies for merger will be planned by and held for a few people at the top (30). Politics is an implicit factor in a merger representing both a positive and negative force. The political process enables change to occur and creates reorganised and reframed organisations that are more effective, innovative and competitive, however change can also create casualties.

The merger of SOEs is an option for restructuring and reform; a political decision made by the government. Although the results of mergers in the short term have not yet met expectations and there has been much obstruction, a policy of merger continues. Some findings are as follows:

a) The Indonesian Government's pro-merger policy (Mueller, 1980; Chiplin & Wright, 1987) was enunciated in the Minister of Finance's Decree no. 740. Through the decree the government sought greater efficiency and enterprise growth to contribute to Indonesia's economic development. Theoretically, growth could be achieved either through investment in additional new or second-hand equipment by the firm (internal growth) or by the acquisition of existing going concerns (external growth). A firm will choose between internal and external growth according to which is the most profitable (Penrose, 1980). Efficiency could thus be improved if merged enterprises used the assets of merging enterprises more effectively than previous managements through greater economies of scale or transaction costs. A merger needed a strategic alliance between internal and external factors, and the government could not solve the problem without macro economic circumstances and political support to created opportunities for state enterprises to improve their performance.

As owner the government expected that the net cash flow of merged enterprises would be larger than the sum of the constituent parts as separate entities. Such gains accrue through synergies and the elimination of redundancy, whereby the combining of activities results in cost savings or higher output for the same input. This is known as the '2 + 2 = 5' effect (Marks & Mirvis, 1998). This was a challenge for the government because, as examined above, the financial condition of SOEs was generally poor and there was no substantial change in their financial soundness after company merger.
Meanwhile, RNI achieved better financial performance, soundness and growth by cutting unprofitable businesses drastically, reorganising management, creating diversification and reducing business risk. The growth and financial results of Bank Mandiri showed some prospect of a sound banking business but this was at the cost of huge, government capital support that was never available to other merging enterprises.

b) Although enterprises own have been restructured since 1989 and reform policy has been implemented since 1998, their financial performance in general has only improved marginally. During 1998-2000, 90 per cent of total sales were contributed by 42 SOEs, while the remaining 103 produced only 10 per cent. A master plan for SOEs from 2002-2006, will establish an average of four per cent RoA and RoE as the target, which is still below private sector norms (BUMN, 2002).

5) A strategy designed to improve performance mergers is expected to create a new culture for businesses and empowering human resources, turning round poorer SOEs.

a) A merger is the way to break the culture of the old companies and build a new corporate culture for business purposes and behaviour to support expected company performance. A new culture should be developed and a cultural fit between merging organisations should be designed to offset unresolved cultural conflicts that produce merger failures (Bruhn, 2001). The SOEs that have survived since independence have had their own beliefs, values, customs, internal bureaucracies, behaviours, cost consciousness and management styles. The government expected the merger to change negative culture and create a new and positive culture to support enterprise business. The findings indicate that enterprise culture is inherited and continues for generations. The government however does not change the way it operates and management feels comfortable with the existing culture, therefore the culture in newly merged SOEs remains unchanged.

b) A merger is expected to empower human resources and companies can select people based on not only their physical assets, but also intellectual capacity (Clemente & Greenspan, 2000). In the process, management has the opportunity to rearrange employees in roles that are appropriate to company direction. In enterprise mergers reduced employment is a crucial point, but it is costly and also a very sensitive government issue. With the merger of PT Perkebunan, PT RNI, PT Krakatau Steel, PT Hotel Indonesia, PT Koja Bahari and PT Pradnya Paramita, all merging employees were transferred. Bank Mandiri and PT PPI made a selection based on age and job requirements but incurred huge funds for employees' separation payments. Bank Mandiri recruited new people for management and new officers after 1999, but the empowering of human resources and employment costs continued to create problems.

c) The merger policy was implemented to halt the decline of enterprises. In practice, this meant that all assets, liabilities and claims including those of the employees, were transferred to the newly merged company. The burdens of the old constituent companies were imposed upon the newly merged company, with the government expectation that the new company could and would sustain the burden. The fact that many of these new companies could not support this inherited burden was one of the reasons for failure. Many state enterprises bring with them a haphazard structure and inefficiency. Mergers are expected to rationalise structure, especially for declining industries, companies that continuously suffer from loss, small scale production and limited markets and companies without any prospects. The merger reform was used to support the survival of financially ineffective and fallen commercial institutions.

6) The government and parliament gave strong support for state enterprise mergers. The political imperative was to strengthen the economy without changing ownership. The government wanted to lessen competition between the enterprises, promote integration to reduce costs and develop technology, without injecting more capital. It hoped that the mergers would create greater synergies and capacities and stronger enterprises would, in turn, create new capital. The government supported the mergers to improve competitive capabilities and enlarge the market for SOEs, however there were some factors that obstructed the mergers. Enterprise management and commissioners could delay the approval and implementation of the merger plan. The Technical Ministries, like the management and commissioners of the enterprises, were concerned that mergers and reforms would mean that they would lose control of the benefits these commercial institutions afforded them. Employees and the labour unions were concerned about the loss of employment and working conditions and this slowed the merger process.

B. Corporate governance and its role in SOEs' performance

1. The meaning of corporate governance

The Cadbury Committee, established in the United Kingdom in 1992, introduced the term 'corporate governance' as a system by which organisations were directed and controlled. The Report of the Cadbury Committee on Financial Aspects of Corporate Governance introduced a code of best practice that sought to determine a set of rules defining the relationship between shareholders, managers, creditors, government, employees and other internal and external stakeholders, with respect to their rights and responsibilities. The Cadbury Committee recommended that all listed companies in the United Kingdom should adopt the code.

Initiatives for corporate reform were also evident in the United States in the early 1990s. Since then the Organisation of Economic Cooperation and Development (OECD) has published principles for good corporate governance and the World Bank has worked in partnership with the OECD in disseminating these principles (Baird, 2000). In a practical way it states that corporate governance is about the way particular businesses are run. Baird states that it is the process by which the enterprises are directed and controlled in response to the rights and wishes of shareholder's and other stakeholders (2000). Codes of good corporate governance seek to regulate the relationships between boards of directors, shareholders and other parties with a legitimate interest in company activities. The objective of good corporate governance is to create added value for stakeholders and is a key element in improving economic efficiency (OECD Principles). Governance problems arise as a result of the separation of ownership and control. Good corporate governance is needed to safeguard against both unintended and intentional transfer of resources away from company objectives. The concern is not only with how the internal governance mechanism functions, but it is also to do with how society views corporate accountability. Accountability is a crucial element of corporate governance, which should be recognised as a set of standards that aim to improve the company's image, efficiency, effectiveness and social responsibility (Kendall & Kendall, 1998). These standards are used to regulate the corporation's system of accountability and control. They are based not only on legal restraints, but on systems of self-regulation, best practice and business ethics.

The Cadbury Report, the open global market, the impact of the economic crisis of 1997-1998 (Tjager, et al. 2003) and the relationship with international institutions (Government of Indonesia, Letter of Intent, 22 July 1999), all strongly influenced the Indonesian Government. The principles of best practice were adopted by management in private corporations and the public sector and in terms of good corporate governance the principles were relevant to development and reform. This is evident in the following measures:

1) The SOEs' policy in 1998 stated that one of the pillars of reform was Corporate Governance and Ethics (BUMN, 1999). The Ministry of SOEs designed the guidelines on Corporate Governance and Corporate Ethics in 1999 (BUMN, 1999b).

2) In August 1999, the government decided that the national policy on good corporate governance should be expanded to support corporate restructuring of the economic recovery process, and to increase efficiency for domestic and international competitiveness (Coordinating Minister for Economy, Finance and Industry, Decree no. KEP-10/M.EKUIN/08/1999). The National Committee for Corporate Governance was established in 1999.

3) The National Committee for Corporate Governance issued the Code for Good Corporate Governance (*Pedoman Good Corporate Governance*) for corporations in Indonesia in March 2001.

4) The government pays special attention to implementing good corporate governance. It is compulsory to apply governance based on the Ministry of SOEs Decree no. KEP-117/M-MBU/2002 and the Law of SOEs, no. 19/2003, article 5.3.

The structure of corporate governance has been described by Farrar (2001) as consisting of: 1) legal regulations, 2) stock exchange requirements and statements of accounting practice, 3) codes of conduct, guidelines for best practice, and 4) business ethics. This structure indicates that legal regulation is the primary issue, but principles of good corporate governance need to be incorporated as part of the corporate culture. The latter will be much more effective than any law or set of regulations. No matter how much regulation is enacted, if good governance is not part of the corporate culture little change will be effected. Shareholder activism, together with good corporate governance, can reduce the opportunities for management to engage in activities that may have a negative effect.

2. Issues and problems

As examined in the previous chapter, during the New Order period, Indonesia shifted from tight government control of the economy to deregulation, partial privatisation of 13 SOEs and more selective intervention. The shift was, in part, the government's response to fluctuations in export commodity prices, especially for oil. The increase of non-oil exports and diversification of industrial structure, together with liberalisation in the financial sector and capital market, delivered growth that averaged 7.0 per cent per annum for more than a decade before the 1997 financial crisis.

The era of the open global market which formally started in 1994 when the World Trade Organisation was established, challenged government and the business community in Indonesia. The close relationship between government, conglomerates, monopolies, protection and market intervention accounted for the lack of competitiveness in the business sector. The latter could not compete with imported goods and services when a global and free market regime started. A multi-faceted crisis, including a crisis in currency, banking, systemic finance and foreign debt together with (Djiwandono, 2001) an environment of collusion, corruption and nepotism (*Kolusi, Korupsi and Nepotisme/ KKN*), made business and industries volatile and liable to a sudden withdrawal of confidence. During the crisis Indonesia's economic growth decreased dramatically from an average of 7 per cent per annum to minus 13.1 per cent in 1998 and 0.79 per cent in 1999. It then increased to 4.92 per cent, 3.44 per cent and 3.66 per cent in 2002 (World Bank, 2003; *Statistical Year Book* of Indonesia, 2002). This was still a low rate of economic growth and was not sufficient to reduce the high unemployment rate. The absence of good corporate governance and high levels of *KKN* were the main factors facilitating the economic crisis in Indonesia. The McKinsey & Co. survey on Global Investor Opinion in 2002 stated that corporate governance was at the heart of investment decision. In emerging markets like Indonesia, governance remained more important than financial considerations and investors would pay for a well-governed company at a premium of 27 per cent in 2000 and 25 per cent in 2002. The McKinsey survey also indicated that in good corporate governance, Indonesia was deemed to be at the lowest level in comparison with Malaysia, Thailand, South Korea, Taiwan and Japan. Seventy-five per cent of respondents in McKinsey's investigation stated that in Indonesia, government and political issues were more important than financial problems (*Kompas*, 20 June 2000). Indonesia was also criticised as a country with a high incidence of corruption (Global Corruption Report index 88 – 91 from 100, Political and Economic Risk Consultancy index 9 from 10 and Corruption Perception Index 88 – 89 from 100) with high country risk, group 5 index 40 – 49 after the lowest index of 30 – 39 (Sukardi, 2002).

A previous discussion indicated that SOEs were continuously challenged by government intervention and management interests. Good corporate governance was intended to be the solution to protect enterprises from unintended actions by the owner and management and to guard stakeholders' interests. Transparency and control by the public were motives for strengthening state enterprises by partial privatisation. After the financial crisis, 13 of the bigger and better managed enterprises were successfully listed on the stock exchange (Ruru, 2003), and these partially privatised firms have performed well, whilst the remaining 148 are still struggling.

A study of the Jakarta Stock Exchange (Sato, 2003) identified structural change in ownership patterns that occurred after the crisis, with a decline in family or individual ownership and a rise in state and foreign ownership. The rise in state ownership in the financial sector was the most conspicuous, resulting from an injection of government capital into banks. Listed companies were previously owned by mostly Chinese conglomerates and were commonly controlled by the leading families. Sato found that in 1996, 78 per cent of the ownership of listed companies was in the hands of families/ individuals but after the crisis in 2000, family/individual ownerships declined to 58 per cent. The most notable change was a decrease in the presence of commissioners as shareholders in companies, especially in the business group-affiliated listed companies. The weight of shareholder members in the Boards of Commissioners *(Komisaris)* of these companies dropped from 55 per cent to 38 per cent, and family or individual shareholders in *Komisaris* dropped from 41 per cent to 25 per cent. In the group-affiliated companies, the weight of shareholder-directors in the Boards of Directors *(Direksi)* also decreased from 35 per cent to 29 per cent. This shows the trends that occurred after the crisis when owners of large business groups tended to withdraw from management boards or commissioners of publicly disclosed affiliated companies.

Although there were some changes in ownership patterns in the private sector post crisis, ownership continued to be a critical issue. Indonesian corporations are predominantly family-owned, even when they are publicly listed. The government is still an important player in the business sector; few individual share holdings are seen and then only as minority shareholders. For partially privatised enterprises independent commissioners who represented 20 per cent of the shareholders were appointed to strengthen control of the corporation. The audit committee, an independent body responsible to the Board of Commissioners, completed the company. Research from July

2000 to June 2001 on 52 publicly listed companies in the Jakarta Stock Exchange held by the Indonesian Institute for Corporate Governance (IICG), indicates that most companies understand the importance of corporate governance. However in implementation, 65 per cent of respondents explained that they complied with the regulation in order to avoid the penalty and only 30 per cent applied corporate governance as part of their corporate culture. This represented a low level of commitment to good governance and needed to be improved (Sodiq, 2002). The State Audit Agency (*BPKP*) had audited 16 SOEs on their implementation of good corporate governance practice (BPKP, 2003) and the Ministry of SOEs selected another 35 as models in achieving governance (*Kompas*, 1 April 2003).

After the crisis there was another trend, namely towards more institutional shareholdings, domestic or international, and with them came a problem in the separation of corporate management, as well as ownership. This meant that managers might seek to maximise their own self-interest at the expense of shareholders. This separation might lead to a lack of transparency in the use of funds in the company and proper balancing of shareholders' interests, including minority shareholders and managers. Meanwhile, the business community was facing problems of corruption and bribery, corporate social responsibility and ethics, public sector governance and regulatory reform and SOEs were challenged by the same situation. The government had to avoid failing management at all costs so it asked the enterprises to implement good corporate governance as a compulsory measure.

In addition, Indonesia needed good corporate governance because of: 1) the need to protect minority shareholders, 2) managers and directors being largely immune from stakeholder accountability, 3) banks being ineffective monitors of corporate managers, 4) a weak judicial system in relation to bankruptcy, 5) government intervention in enterprise business decisions, and 6) the role of regulators *Bapepam* (Indonesia Capital Market Supervisory Agency) and the Jakarta Stock Exchange was not strong enough to compensate for the weak judiciary system (Baird, 2000). For these valid reasons good corporate governance was urgently applied to SOEs.

The economic crisis was a lesson that some modification of ownership was needed. Although there were some changes in Chinese conglomerate ownership, more domestic and institutional ownership and increasing public participation in some enterprises, nevertheless, family-owned companies were still important. Meanwhile the role of the capital market increased and the government used the capital market as a source of funds for partial or whole privatisation of SOEs. The belief held by many economists was that the corporations—either private or state-owned—needed to apply good corporate governance, especially after the crisis. First, it is used as a tool for extracting value for shareholders from under performing, under valued companies. Second, in markets that have experienced financial crisis it is used as a key to help restore investor confidence by improving transparency and accountability. Good corporate governance helps corporations realise their value and creates a competitive advantage. Without this both corporate performance and investor's money could well be at risk.

3. Structure and principles of good corporate governance

The Indonesian Government declared that good corporate governance was compulsory for Indonesian corporations that were either private or state-owned. This was the way to maintain a business climate conducive to economic recovery and as a way of attracting investors. In 2001, the National Committee for Corporate Governance (NCCG) established the Code for Good Corporate Governance in Indonesia as a guide to maximise corporate and shareholders' value by enhancing transparency, reliability, accountability, responsibility and fairness, in order to enhance competitiveness and support investment. Basically, what Indonesia produced was in line with the OECD (Organisation for Economic Co-operation and Development) Corporate Governance Principles issued in 1999. The Code for Good Corporate Governance covers 13 areas:

1) The rights and responsibilities of the shareholders.
2) The functions and responsibilities of the commissioner.
3) The functions and responsibilities of the board.
4) The audit systems, role of external auditors and the audit committee.
5) The functions and responsibilities of a corporate secretary.
6) The right of stakeholders and access to information.
7) Timely and accurate disclosure.
8) Confidential requirement for the board and the commissioner.

9) Prohibition on insider information and abusive self-dealing.
10) Business ethics.
11) Prohibition on political donations.
12) Compliance with applicable regulations on health, work security and the environment.
13) Equitable work opportunity for employees.

Indonesia has been equipped with sufficient institutions and regulations to support the implementation of good corporate governance. With reference to Farrar (2001), the imposition of good corporate governance occurs through various principles and organisations as follows:

1) Legal regulations:
   a) Company Law no. 1/1995.
   b) Capital Market Law no. 8/1995.
   c) Indonesia Capital Market Supervisory Agency *(Bapepam)* Rules.
   d) Bankruptcy Law no. 1/1998.
   e) Minister of SOE's Decree no. KEP-117/M-MBU/2002 on implementation of good corporate governance.
   f) State-Owned Enterprise Law no. 19/2003.
2) Stock Exchange Listing Requirements and Statement of Accounting Practice regulations:
   a) Jakarta Stock Exchange Listing Rules.
   b) International Federation of Accountants (IFAD).
   c) Jakarta Stock Exchange (JSX) and Surabaya Stock Exchange (SSX).
3) Codes of Conduct, Guidelines, Best Practice:
   a) Corporate governance and corporate ethics, Ministry of SOE, 1999.
   b) Code for good corporate governance, March 2001.
4) Business ethics regulations:
   a) Corporate governance and corporate ethics, Ministry of SOEs, 1999.
   b) Code for good corporate governance, March 2001.
5) The structure of governance is supported by Governance Organisation Groups:
   a) The National Committee for Corporate Governance (NCCG).

b) Forum for Corporate Governance in Indonesia (FCGI).

c) The Indonesia Institute for Corporate Governance (IICG).

d) The Indonesian Institute of Accountants (IIA).

The above mentioned principles, regulations and organisations constitute the framework for Good Corporate Governance in Indonesia that all state enterprises must observe. Indeed, the government established special provisions for the enterprises, namely the Ministry of SOE's Decree no. KEP-117/M-MBU/2002, since they must be transparent and comply with best practice accepted by government. Principles of governance and the above mentioned strategic areas are explained in the articles of the decree.

Principles of good governance (article 3) are as follows:

a. Transparency

The enterprises good corporate governance decree stated that transparency was an essential element in the decision making process and required disclosures of information relating to material matters regarding the corporation. There should be provision for fair, timely and cost effective access to relevant information. Transparency was very important for Indonesia because a strong disclosure regime was needed to attract capital and restore confidence in the capital market. Insufficient and unclear information could hamper the ability of markets to function, increase the cost of capital and result in a poor allocation of resources. The enterprises had a long, poor record in making public disclosures about their financial circumstances. Internally, board members should act on a fully informed basis, in good faith and with due diligence and care, in the best interests of the company and government. The decree was consistent with OECD principles that timely and accurate disclosures should be made on all material matters regarding the corporation, including its financial situation, performance, ownership and governance.

b. Independence

The decree determined that state enterprises should be managed professionally and be free from conflict of interest transactions, with a prohibition on self-dealing and vested interests. The management should ensure compliance with applicable law and take into account the principles of good corporate practice and behaviour.

c. Accountability

Management responsibility should be achieved through effective oversight of company activities based on a balance of power between management, shareholders, commissioners and auditors. The principle of accountability was to be reflected in timely reporting through the company's financial statement. The board of directors and commissioners were responsible for submitting a timely and accurate annual financial report to the General Shareholder's Meeting, as stated in Company Law no. 1/1995. Approved financial statements should appear in two newspapers (articles 56, 57, 58 and 60).

Management had to establish the audit and risk committee to support commissioners' functions and also must comply with the management contract, handle disputes, apply compensation with a reward and punishment system and appoint the professional external auditor (Decree no. 117, article 14).

d. Responsibility

The SOEs' board should ensure compliance with applicable laws and sound corporate principles. The board should ensure that the enterprise maintains a high level of social responsibility, good faith, professionalism and a good business environment, as well as avoidance of an abuse of power.

e. Fairness

Corporate governance should ensure the equitable treatment of all stakeholders. This fairness principle would be reflected in company regulations based on management commitments and law to protect minority shareholders, control corporate conduct and behaviour and prohibit self-dealing and conflict of interest transactions.

The above mentioned 13 areas of interest can be found in various articles of Decree no. 117. Through this Decree, the elements of corporate governance for state enterprises are clear and well stated for implementation. Since August 2002, in the first stage of implementation, each enterprise designed its own regulations on governance, including the code of corporate governance, a statement of corporate intent and a code of conduct. Thirty-five *Persero, Perum* and *Perjan* were selected as models of corporate governance implementation and those enterprises committed themselves to develop governance under intensive supervision by the Ministry of SOEs over three years

(*Kompas*, 1 April 2003). This program was a government effort at additional enterprise implementation. Sixteen enterprises had previously applied corporate governance and were audited and reviewed by the State Audit Agency (BPKP, 2003). This application together with restructuring and privatisation are the three pillars of enterprise reform (Ruru, 2003).

4. Good corporate governance

The absence of appropriate corporate governance among market participants and the lack of transparency in governance were widely regarded as factors that contributed to the severity of the crisis in Indonesia. Most SOEs and the corporate sector, in general, were in a weak financial position and could not withstand the contagious effects of the 1997-98 crises. This poor performance had continued since nationalisation. Although the government had introduced reforms in 1988 and 1998, good corporate governance was not frequently practiced, thus it did not have any beneficial influence in strengthening the financial position of enterprises. However, the notion that their management consisted of select people was generally assumed. Their educational background, training programs, career paths and the selection process for promotion were expected to provide most board members with sufficient knowledge and experience to run the businesses.

4.1 A case on governance

As discussed in the previous chapter the combination of government policy, politics and atronage relationships influenced management behaviour. The case of Perusahaan Negara Pertamina (*Pertambangan Minyak dan Gas Bumi Negara*) from 1969-1978 demonstrates the role of these factors together with the absence of good corporate governance (Bresnan, 1993).

The Pertamina crisis

In 1966 the national oil company, Pertamina, was created from a merger of three state oil companies: Permina, Pertamin and Permigan. Pertamin was previously PT Permindo (Pertambangan Minyak Indonesia), originating from NIAM (Nederland Indische Aardolie Maatschappij, Netherlands Indies Oil Company), a fifty-fifty joint venture of the Royal Dutch company and Shell. It was nationalised in 1958 when Indonesians assumed management control and Shell provided technical assistance during the transition period. Pertamina monopolised every aspect of Indonesia's oil industry, including exploration, exploitation, refining, processing, transportation and marketing. In February 1966 under President Sukarno's 100-member cabinet, Ibnu Sutowo, an army general, was made minister for oil and gas and elected president of Pertamina.

In November 1969 *Indonesia Raya*, a newspaper under the editorship of Mochtar Lubis, published a series of articles and editorials claiming that Pertamina, under Ibnu Sutowo, was rapidly developing into a conglomerate whose activities had little to do with either the oil business or the government's economic plan. Pertamina became a focus of political controversy, especially for the student movement which viewed it as a case of government corruption.

President Suharto appointed the Commission of Four in January 1974 to investigate Pertamina. It was headed by Wilopo, along with Kasimo, Johanes and Anwar Tjokroaminoto. The Commission reported much neglect of and deviation from the Minister of Mining's regulations. Specifically, Pertamina was obligated to pay 55 per cent of profits to the government, but had not done so in nine of the previous 11 years and had also not paid its corporate tax obligations. JAC Mackie, with reference to the Commission of Four (Bresnan, 1993), argued that the Commission did not reveal the fact that a large part of Pertamina's oil revenue had not been paid into the state treasury, but had remained under the control of Ibnu Sutowo who used it to provide extra budgetary finance for the armed forces and other parts of the government, for Pertamina projects or for his own purposes. In addition, Pertamina or Ibnu Sutowo had personally provided substantial funds during previous years for all sorts of social welfare and semi-political projects.

In February and March 1975, Pertamina failed to repay a short-term loan of $US40 million to the Republic National Bank of Dallas and $US60 million to the Canadian Bank Group. The scale of the problem was unknown to government. Pertamina had several separate systems of accounts and company officials were unable to provide the government with reliable data on its borrowings. In May 1975, Sadli, the Minister of Mining and chairman of the Pertamina Commissioner's Board, stated that Pertamina assumed a large financial obligation without government during Pertamina's activities were not economical and were void of a direct relationship with the basic functions of Pertamina as the state oil company.

In May 1975, Maj. Gen. Piet Harjono, budget director in the Ministry of Finance, was appointed as financial director of Pertamina, with presidential authority to overrule Ibnu Sutowo in financial matters. The President appointed him as president director in early 1976. In July 1978, the Attorney General, Ali Said, announced that all investigations carried out had found that Ibnu was 'not involved' in criminal activity (Bresnan, 1993).

Pertamina epitomised the absence of good corporate governance at that time. A special law, Law no. 8/1971, regulated the company. Pertamina's management structure differed from that of other state-owned enterprises; it had a Council of Government Commissioners whose function related to company and management control. It consisted of three members, with the Minister of Mining and Energy as chairman, the Minister of Finance as vice-chairman and chairman of *Bappenas* (the National Development Planning) (article 16). In 1974, based on article 16.4, the President appointed two additional members as Government Commissioners – the Minister of Defense and Security and the Minister of Industry. The Council was responsible to the President. The Board of Directors of Pertamina was required to meet at least once a month and its decisions were to be reached by a unanimous vote (article 17). It was understood that for important decisions the management would consult and receive Council approval. In the event that Council failed to reach agreement, the problem was to be taken to the President for a final decision. The regulation on article 17 of Pertamina Law no. 8/1971 could be interpreted as the President having the final and supervisory jurisdiction over all matters, especially if the Council could not reach a unanimous vote. This condition weakened the Council's position but most importantly, Council members and ministers were subordinated (Soelistiyo, 1981). In many cases Ibnu Sutowo maintained direct contact with the President and because the latter had great confidence in him, he was confident of the President's support. The President was reported as always being ambivalent when it came to decisions about Pertamina (Bresnan, 1993).

As stated in Presidential Decree no. 59/1972, international borrowings should have been approved by the Minister of Finance, the State Minister of the National Development Planning and the Governor of Bank Indonesia. Pertamina's huge international loans however did not comply with this decree and this came as a big surprise to the government which assumed responsibility for Pertamina's loans and this drained Indonesia's foreign exchange reserves.

When considering accountability, Pertamina did not manage its accounting and reporting systems properly. It neglected its obligations to pay tax on time. There was not a lack of cash flow, but rather, the intention was to misuse oil revenues for another purpose, either Ibnu Sutowo's personal interests or as a means of political patronage. Pertamina's central role was to supply oil needs, provide revenue and support the development of high technology industries. Although company management had a special relationship with the army and even with the President himself, government regulations should have been honoured. Pertamina's disregard of government regulation and accountability created a crisis that was a disaster for the entire country.

The case of Pertamina indicated how important the management of SOEs was in following the rules and ethics of business practice in order to keep the trust of the market and to avoid inefficiency, loss and crisis. It was a battle for control of oil revenues between civilian technocrats who were trying to enforce a central economic strategy on the nation, and army entrepreneurs who controlled the enterprises and were determined to strike out on their own. It showed how difficult the situation was for Suharto as oil was the main source of revenue for development to strengthen the role of government in the economy and powerful foreign interests and army officers also lined up for their share. The close friendship between Suharto and Ibnu Sutowo delayed the dismissal of Ibnu. It was only after Widjojo and Ali Wardhana submitted a series of reports about their findings regarding Pertamina that Ibnu was viewed as a nationalist by comparison. The President had always aimed for balance in a political relationship (Bresnan 1993).

Pertamina is a good example of Rigg's models on bureaucratic politics and capitalists that exploit their power to go into business on their own account and exploit their control over government agencies to forge contracts for their own interests. It was the former Minister of Mining, IB Sudjana who explained that Law no. 8/1971 on Pertamina gave the President absolute power over and direct access to its operations (*Kompas*, 24 July 1999). He stated that corruption in Pertamina had to do with past practices and officials. Inefficiency occurred as many of Pertamina's activities were handed to other companies, although Pertamina was still able to carry out those activities autonomously. The practice of employing many contractors occurred when Ibnu Sutowo controlled Pertamina in the 1970s. Sudjana stated that the increased use of contractors took place after the entry of Suharto's children's companies into Pertamina (*Kompas*, 21 July 1999). The condition of collusion, corruption and nepotism (*KKN*) was a great disadvantage for Pertamina and Sudjana confessed that the mafia' network in Pertamina and in the Ministry of Mining was so strong that it had become difficult to detect. He experienced difficulties in controlling the company as the enterprise was directly responsible to the President.

It was understood that *KKN* apparently influenced internal Pertamina organisations and proved a big challenge to urgently implementing good corporate governance. The government began to reform Pertamina to make it comply with sound business practice and to regulate the company to supply sufficient oil and gas to Indonesians and provide revenue for the state budget. This was implemented as follows:

1) The parliament formed a Special Committee (*Panitia Khusus/Pansus*) to investigate *KKN* in Pertamina (*Kompas*, 29 September 2001). Many names of former government officials, company officers and related private companies appeared in the parliamentary sessions (*Kompas*, 8 March 2003). The parliament also asked the Attorney General to take legal action on many Pertamina *KKN* cases reported by the board and the public (*Kompas*, 3 August 2001, 17 June 2003).

2) Law no. 8/1971 on Pertamina was abolished by the Law on Oil and Gas no. 22/2001. In 2003 the legal status of Pertamina was converted into a *Persero* to strengthen its capital through strategic partnership. It will be reformed in 2005 by mergers, acquisitions, partnership and investment and privatisation will follow through an initial public float in 2006 (*Kompas*, 9 October 2003).

3) The government appointed Laksamana Sukardi as chairman of commissioners of Pertamina and this invited controversy, as he was also in the Ministry of SOEs and a politician. His appointment was suspected to be political as Indonesia was facing a general election for members of parliament, the president and vice president in 2004.

However, his assignment indicated the serious efforts made by the government to support governance in that particular enterprise, to control its finances and supply of oil. The Minister of Finance and the Minister of Mining were appointed as advisers to the commissioners (*Kompas*, 28 June 2004).

4) The government has frequently changed the Board of Directors and Commissioners since 2000. The President Director's position, which was Faisal Abda'oe, changed to Martiono Hadianto and finally transferred to Baihaki Hakim in February 2000. In September 2003 Ariffi Nawawi was appointed as a president of Pertamina but his appointment continued for less than a year and in August 2004, Widya Purnama replaced him. Widya was assigned to develop Pertamina from a bureaucracy into a commercial corporation with good governance and to crush the 'oil mafia' within Pertamina organisations (*Kompas*, 13 August 2004).

4.2 Some good governance problems

Even if it is assumed that SOEs' managements wanted to implement good corporate governance, they nevertheless confronted a number of difficulties, including:

1) The enterprises were dependent on government as owner, policy maker and regulator and government assigned the Ministry of Finance and the then Ministry of SOEs to control them. The relationship of government with enterprises should be viewed as a principal–agent link, an agreed relationship or contract between two parties – one party referred to as the principal and the other as the agent (Aharoni, 1985). It was concerned with the design of incentives for efficiency under conditions of asymmetric information (Vickers & Yarrow, 1991). A contractual agreement was needed to bring the agent into collaboration with the principal. The principals agreed to provide incentives to the agent and the agent agreed to behave in the best interests of the principal. With reference to the above principal–agency theory, the Ministry should be the principal and the management should play the role of agent. In practice, the government was the principal and the Ministry assumed the agent's position. As a result, management and commissioners appointed tended to act as a 'sub-agent' of the Ministry.

2) The enterprises were used as tools for political and economic interests and were given divergent and competing objectives. Their public and commercial functions were blurred and profit imperatives were not determinant factors in management decision making.

3) Collusions, corruptions and nepotism (*KKN*) led to the diversion of their resources for the benefit of personal and institutional gain.

4) The government, the bureaucracy, politicians and the military intervened in enterprise decision making.

5) This decision making was not transparent and the enterprises were not accountable for their financial performance.

6) Weakness in internal control and control by the government audit agency tended to compromise the work of the auditor. In the case of Pertamina, the former Minister of Mining stated that the State Audit Agency (*BPKP*) had always assessed Pertamina as normal (*Kompas*, 21 July 1999).

The government had been aware of such enterprise governance for many decades. It required regime change—the fall of the Suharto government and the beginning of the democratisation process—before a new legal framework of reform was created in the Provisional Consultative Assembly Decision no. X/MPR/1998, Law no. 25/2000 on the National Economic Development Program 2000-2004 (articles IV B-12 and 28), the Decree to implement the good corporate governance no. 117/M-MBU/2002 and the Law on State-Owned Enterprise, no. 19/2003 (article 5). The government enacted a number of policies designed to support good enterprise governance:

1) Law no. 19/2003 clarified the relationship between government and management. The Ministry, in this case the Ministry of SOEs, represented the government as owner and shareholder (article 1.5). The enterprise was operated by management as agent of the Ministry, the latter acting as principal. This meant that management was separated from the owner. This approach is consistent with the agency theory that asserts the importance of separating day-to-day enterprise management from ownership, as discussed above. The purpose of separation was to create efficiency and effectiveness in managing enterprises; hiring professional agents to do so or outsourcing was another alternative to appointing qualified managers.

2) Concentration of ownership in government hands had been a long-standing issue since nationalisation. The ideology of wholly government-owned enterprises has since changed. The option of privatisation through the capital market of enterprises that were not directly related to public service provision was created by Law no. 25/2000, National

Development Program (*Propenas*), article IV B-28. This law was followed by privatisation guidelines in articles 74-86 of Law no. 19/2003). Law no. 19/2003 (articles 72-73) on enterprise reform provided for corporate restructuring of SOEs to strengthen and improve their performance before privatisation. Reforming the relationship between government as regulator and enterprises as agents was another principle of good corporate governance introduced by this law (article 73 b.2).

4) Multiple objectives established by the government had long been used to excuse poor financial performance. In Law no. 19/2003 the government clarified that *Persero* enterprises were commercial operations with profit maximisation as their objective (article 12) and that only *Perum* enterprises had public service functions (article 36). However, the government retained the discretion to assign the enterprises to special public service functions. This type of government management intervention had to be approved by the general shareholders' meeting or the Minister of SOEs for the *Perum* enterprises (article 66.2). The government assignment for *Perum* should be in the framework of functions and objectives (article 66.2). It was clearly stated that both *Persero* and *Perum* should be managed by their respective boards of directors and supervised by the commissioners or boards of supervisors, based on good corporate governance principles (articles 5-6).

5) The mechanisms of internal and external control to avoid malpractice were set out in articles 67-71 and these were consistent with principles of good corporate governance. There was a strong impression that SOEs were not open to public scrutiny. In fact, the *Persero* enterprises did publish annual reports, including financial reports, balance sheets and income statements and copies could be obtained from company offices. Since 1983 state-owned financial institutions—mostly banks—were required to release their financial reports and these were published by the media.

The press has played a critical role in facilitating public scrutiny of enterprises since the fall of the Suharto government. The government also provided online internet access at www.bumn-ri.com and most enterprises had their own web sites. Information on SOEs was also available on www.bumnreview.com. Some public scrutiny had also been exercised by international governance groups, such as the Asian Corporate Governance

Association, the Asian Development Bank, the World Bank and domestic organisations such as FCGI, IICG and the Indonesian Institute of Accountants.

From a regulatory point of view, the government has now incorporated principles of good corporate governance in its laws. These laws should encourage better financial performance, free from government intervention and the *KKN*. This new legal framework should also enable enterprises to provide better goods and services for the public, restore investor confidence and the market. By using these guidelines, 16 SOEs audited by the BPKP in 2002 on corporate governance indicated that the process of governance was in progress, and this included 35 additional enterprises since 2003 that were implementation models. The result of improvement on governance will be detected in financial performance and the 2003 annual report to be published in 2004.

5. Good corporate governance as an effort to support performance

5.1 Implementation of corporate governance in 16 SOEs

Under the Minister of SOE's Decree no. KEP-117/M-MBU/2002 of 1 August 2002, enterprises were obliged to follow corporate governance regulations (article 2) in order to maximise profit and optimise service delivery. Every enterprise was required to produce certain instruments of governance: namely, a code of corporate governance (article 2), a code of conduct (article 32) and a statement of corporate intent (article 19). In 2003 the government established a model for good corporate governance for 35 enterprises. A statement of corporate intent for a three year program was signed between management and the Minister of SOEs. The program should be introduced in all 162 enterprises in stages (*Kompas*, 1 April 2003).

The Ministry of SOEs asked the State Audit Agency (*BPKP*) to assess the implementation of governance in some enterprises. The Agency reported that regarding the implementation of these principles in 16 enterprises in 2002, seven were judged as 'good': PT BNI Tbk., PT Pelindo II, PT Asuransi Ekspor Indonesia, PT Krakatau Steel, PT Perkebunan Nusantara VIII, PT Surveyor Indonesia and PT Adhi Karya. Its implementation in other enterprises was considered 'sufficient', including: PT Kereta Api, PT Pelni, PT PLN, PT Jasa Marga, PT Sarinah, PT Kimia Farma Tbk., PT Danareksa, PT Timah Tbk. and PT Hotel Indonesia Natour (*BPKP*, 2003).

1) The assessment of implementation of corporate governance in 16 enterprises is shown in Table 5.6. The overall result of the State Audit Agency (*BPKP*) evaluation of corporate governance indicated a 'sufficient' level of implementation.

Table 5.6
Scoring on implementation of good corporate governance

Governance criteria	Best Practice	Actual performance	Value
Commitment	100	48.66	Worst
Shareholders meeting	100	87.84	Good
Commissioners	100	71.00	Sufficient
Board of Directors	100	77.19	Good
Supporting function on governance	100	82.36	Good
Relationship with other stakeholders	100	82.16	Good
Average		73.92	Sufficient

Source: BPKP, 2003

The criteria for governance covered the following activities (BPKP, 2003):

a) Commitment: Having corporate governance regulations (code of corporate governance, code of conduct, statement of corporate intent), active dissemination and comprehension to all employees, implementation and reporting to stakeholders.

b) Shareholders' meeting: Effectiveness of the meeting in its performance evaluation of the board and commissioners, whether their planning was timely and accurate and met budget approval, and was carried out by an external auditor.

c) Commissioners: their qualifications should conform with their ability to perform the division of work between commissioners, effectiveness of supervision function, attentiveness to risk management and succession and human development issues, and effectiveness and regularity of commissioners' meetings.

d) Board of Directors: Effectiveness of the role of board, commitment and implementation of corporate governance supported by sufficient personnel, regulation on the degree of responsibility and management responsibility of subordinates, mistaken decision making, after audit improvement, planning, strategy and implementation, communication with commissioners and employees, improvement on integrity and mechanisms to avoid self-interests, qualifications of board members, regularity, effectiveness and well-documented board meetings.

e) Supporting function on governance: Effectiveness of the corporate secretary to maintain communication with stakeholders and completion of audit committee with qualified personnel.

f) Relations with other stakeholders: Covers health and safety in the workplace, a remuneration system, a human resource development plan, product and service information for consumers; provision of information on key issues relevant to employees and other stakeholders, and community development relations.

However, of the six governance criteria examined, level of commitment by management to governance was considered 'worst'. This was reflected in SOEs' efforts to establish rules on governance. From 16 enterprises, four had codes of corporate governance, seven had codes of conduct and only two had statements of corporate intent. This was considered to be a low level of compliance. Although some enterprises had governance instruments, it was believed that enterprises had been run by routine commercial practices. Governance instruments in writing was required as a standard of best business enterprise practice. The findings indicated that boards of management and commissioners handled their governance voluntarily instead of considering good governance as an imperative. Good corporate governance was a new way of doing business and not all enterprise managements recognised and implemented governance.

2) The commitment to good corporate governance was measured by the efforts of management and commissioners to disseminate governance principles to all employees and support their implementation. The board had to ascertain that the decisions of their subordinates were consistent with governance principles and that mechanisms of accountability were indeed functioning. A case of non-compliance of good corporate governance regulations and governance mechanisms emerged in the case of PT Bank Negara Indonesia Tbk. (BNI). *Tempo* magazine publicised malpractice in documentary credit transactions (*Tempo*, 2003) and the case of PT Bank Negara Indonesia Tbk. follows:

The BNI Kebayoran Baru Branch (BNI Branch) provided its customers, the Gramarindo and Petindo groups, with credit facilities to finance the export of quartz, sand and residue oil to African and Middle East countries. From July 2002 to July 2003, based on export documents presented by customers, BNI paid US$ 154.4 million and Euro 56.1 million. Instalments from customers were US$ 63.0 million, a total outstanding customer debt to BNI of US$ 94.4 million and Euro 56.1 million. The responsible branch officer disclosed that these transactions were reported to the International Division at BNI Head Office. Although the transactions were few in number, Bank Indonesia supervising officers reminded BNI management of these transactions. The BNI Branch neglected management notification letters and documentary credit payment. On August 2003, internal auditors from the BNI head office discovered huge outstanding Euro transactions. This was unusual because the value of the Euro was increasing, creating losses in Indonesian Rupiah denominations. There was also malpractice in documentary credit transactions:

1) The opening banks issuing the usance letter of credit and stand by letter of credit were BNI's non-depository correspondents, including the Dubai Bank, Kenya; the Wall Street Banking Corporation, Cook Island; the Middle East Bank Kenya Ltd., and the Ross Bank Switzerland.

2) Documents against acceptance were the cause of payment but the BNI Branch took over and paid for export documents prior to approval from the opening banks.

3) There was inadequate documentation to confirm that goods were exported. Some of the bills on landing were suspected to be fictitious or false, did not state a clear port of destination and were without an address for the beneficiary.

4) There was no intensive supervision on export documents paid and all discounted export documents were not in acceptance from the issuing banks.

5) On the due date, some of the usance letter of credit was paid by customers instead of the issuing banks.

Although BNI received the highest assessment of good corporate governance of the 16 enterprises examined by the State Audit Agency (*BPKP*), this assessment did not guarantee that the bank was free of malpractice. As revealed by *Tempo*, the BNI's

Branch had not practiced good corporate governance, nor did regional officers and management, with the consequence of huge potential losses:

1) The branch officers had not assessed the customers' credibility nor had they checked their bona fide reputation.

2) For individuals or groups of customers, the BNI Branch had the authority to grant facilities to the value of Indonesia Rupiah 1.5 billion, equivalent to US$175.0 million. Although the branch reported transactions, they were approved by the branch manager or branch officers who exceeded their authority.

3) The branch was supervised by the regional office but the officer in charge was related to the branch manager and management had not understood the risks involved in such nepotism.

4) In dealing with international transactions, the bank had to refer to the regulation in the Uniform Custom and Practice for Documentary Credit (1993 Revision) and the ICC Publication no. 500. Non-compliance with these regulations entailed greater risks for the BNI.

5) The report of the State Audit Agency *(BPKP)* on governance in BNI indicated that the bank's internal control mechanisms were assessed to be at their worst level, scoring 50 out of 100. This assessment was consistent with malpractice and required more attention from the board of management.

6) This case of malpractice was made public through the scrutiny of the mass media and bank officers and customers were exposed as corrupt and criminal in their dealings.

As a solution, Bank Indonesia as a central bank asked BNI to improve its prudent banking policy (Banking Law no. 7/1992), better risk management (Bank Indonesia Regulation no. 5/8/PBI/2003) and customer policy (Bank Indonesia Regulation no. 3/10/PBI/2001 and no. 5/21/PBI/2003). Bank Indonesia had already notified the Board of Directors and Commissioners of BNI to comply with Bank Indonesia Regulation no. 1/6/PBI/1999, on fulfilment of an internal banking audit qualification. BNI's management and commissioners were responsible. Bank Indonesia asked the Minister of SOEs to appoint a new member of the board and commissioners to solve the problems and restore public confidence. Since December 2003, a new team of management and commissioners has led the BNI with the objective of implementing good corporate governance and reducing the losses from fictitious export transactions.

3) In the State Audit Agency (*BPKP*) evaluation, 11 of 16 or 69 per cent of the Board of Directors of state enterprises possessed good qualifications, educational backgrounds and experience, with the exception of the Electricity State Enterprise (PT PLN). The delegation of authority and responsibility was mostly in the 'good' and 'sufficient' category, but there were 7 enterprises in the 'worst' category. The relationship between boards of management and commissioners was mostly 'very good' and 'good', with the exception of personnel management.

The effectiveness of the Board of Directors in maintaining the integrity of individual members was measured by 1) the existence of rules to prevent conflict of interest, and 2) the mechanism to prevent self-dealing or self-interest transactions. The average score for 16 enterprises was only 63.75 and 54.19 (66-67). This meant that the integrity of management needed to improve.

4) The Minutes of Board and Shareholder's meetings should be well administered and also reflect agreements and differences of opinion and the meeting dynamics should be disclosed. Minutes of PT PLN meetings recorded the dynamics of agreements and disagreements, and differences of opinion were also discussed. Parts of the discussion appeared in the meeting documentation of only 8 of 16 enterprises (67).

5) Relationships with employees, customers, the community, and central and regional governments were part of good corporate governance and in this respect, PT Hotel Indonesia Natour received the 'worst' assessment. Medical and health facilities, work safety regulations, career planning and salary systems were satisfactory in most enterprises. They were also consumer transparent about goods and services, although only PT Pelindo II, PT Surveyor Indonesia and PT Kimia Farma Tbk. offered consumer satisfaction programs (70-71).

From the State Audit Agency (*BPKP*) evaluation it was evident that good corporate governance remained a challenge for the government and SOEs that had to comply with regulations. Most importantly their commitment to corporate governance involved not only implementing regulations, but changing their mindsets. They were required to create a new corporate culture, with corporate behaviour inside a new business environment. This would constitute a new paradigm for the government and the enterprises and this would require new ways of thinking to solve new business problems. Also, the power of management was to be controlled through an audit committee, a nomination committee and a remuneration committee, under the supervision of independent commissioners.

Further, delegation of authority and responsibility was a part of corporate management that should be consistent with principles of accountability. Non-compliance with governance regulations should be prevented and post audit evaluations should be prioritised to avoid loss, collusion, corruption and nepotism. In order to fulfil their responsibility, board members were expected to obtain accurate, relevant and timely information (OECD, 1999).

5.2 The role of good corporate governance in restructuring SOEs

The restructuring of state enterprises has focused on improvement in efficiency, transparency and professionalism (Law no. 19/2003; Ruru, 2003). It was also a way of rearranging the relationship between government as regulator and management as agency. Restructuring took the form of internal reorganisation in finance, organisation, management, operations, systems and procedures (Law no. 19/2003 article 73).

The State Audit Agency (*BPKP*) report indicated that three enterprises were listed as public companies. PT BNI Tbk., PT Timah Tbk., and PT Kimia Farma Tbk., had a governance score of 74.57, compared to other non-public companies with a score of 73.71 (BPKP, 2002). This was viewed as a minor difference in the assessment of good governance. It would appear that the market had not yet successfully imposed its discipline on listed SOEs involved in the implementation of good governance and committed to its values. In this early stage of implementation, those enterprises with a better corporate governance evaluation have not transformed governance into improved financial performance. Of the remaining enterprises, 13 are in the process of restructuring, five will be privatised (PT Dana Reksa, PT Jasa Marga, PT Krakatau Steel, PT Pelindo II, PT Sarinah) and PT Kereta Api was in the process of preparing a joint operation with the private sector (BUMN, 2002). Internal restructuring was also underway in 16 enterprises, with the intention that they would eventually be privatised. The corporatisation process was designed to add value to enterprises prior to privatisation.

The correlation between restructuring, good corporate governance, efficiency and better valuation of SOEs are examined as follows:

1) Under good corporate governance principles and governance instruments, the objectives of restructuring will focus on certain restructuring methods and the approved target contained in the statement of corporate intent. A clear corporate intent removes the moral hazard between government/commissioners and the management of enterprises safeguards both the unintended and intentional distraction of resources away from agreed company objectives, thus combating *KKN*.

2) The government through the general shareholders' meeting is in a position to measure the efficiency of SOEs, reduce agency cost and business risks, provide a reference for creditors, offer a premium to get more funding from the market or banks and reduce costs. The general shareholders' meeting is an important mechanism for enterprises to legalise all management and commissioners' decisions and confirm that they are free from any legal claimant and criminal procedure, as long as decisions that include reform actions are legally administered and reported.

3) In addition, the implementation of good corporate governance will increase investors' confidence (McKinsey, 2002) as well as suppliers' and customers' confidence and will enhance enterprise status and corporate image.

4) Restructuring by implementing good corporate governance will enable enterprises to address the challenges of the new business landscape. Independence, transparency, professionalism and social responsibility represent the new paradigm. This was the key element of restructuring that commenced with the separation of ownership and management of SOEs and the development of complex relationships between management and other key stakeholders. State enterprises then have to build a conducive environment in order to continue business after restructuring.

5) During the restructuring process, boards of management have had to develop governance mechanisms between management, subordinates and employees. Involvement of all employees will build a new culture and create a synergy for efficiency.

Conclusion

The merger role as a method of enterprise reform is the main objective in improving enterprise efficiency and performance. There are various motives for merger, but basically it has been adopted by government to turn around inefficient companies, maintain ownership, and develop company synergy without additional, fresh, capital. This involves a process of corporatisation to increase profits and performance and assess the probability of partial or full privatisation. The merger of enterprises is a complex government policy as various interests, including politicians, the bureaucracy, technical ministries, the military and other officials challenge the merger process. Although it was management initiated, the government continued to play a decisive ownership role after 1998. Some enterprises showed improved performance post merger, but remained mostly unchanged due to internal and external factors, including government intervention that influenced cost reduction.

Good corporate governance as derived from the Cadbury Committee's Code of Best Practice is adopted as a set of principles to run corporations in Indonesia as private or public companies. It is a system by which a corporation is directed and controlled and also a means for enterprises to maintain a harmonious relationship with stakeholders—the government as owner/shareholder, other shareholders, commissioners, employees, creditors, suppliers and the public—with management complying with agreed objectives. The implementation of good corporate governance is necessary to avoid unintentional business practices and unjustified costs and maintain the interests of stakeholders. It is compulsory for SOEs, not only to avoid collusion, corruption and nepotism, but also primarily to create sound and strong enterprises in order to provide goods and services and support the macro policy of economic development. State-owned enterprises are currently in a position to apply good corporate governance methods under the supervision of the Ministry of SOEs and *BPKP*. Mergers supported by the implementation of good corporate governance are expected to speed up reforms and strengthen newly merged enterprises.

Chapter VI
Merger of State-Owned Plantation Enterprises:
Case study of PT Perkebunan Nusantara VIII, its merger and corporate governance

A. State-Owned Plantation Enterprises: process of reform

1. Historical background

The development of estate agricultural crops in the Netherlands Indies started with the Agrarian Law of 1870. This law marked the beginning of private investment in plantation agriculture. The Dutch state and the VOC had been involved in the cultivation of agricultural crops since the 17th century, initially with coffee in Pasundan. The law enabled Dutch private and foreign companies to obtain long leases for the development of commercial estates. A 75-year lease on *erfpacht* (long lease land) could be easily secured at what were then very reasonable rates (Barlow, 1989). The opening of the Suez Canal caused the rapid expansion of trade between Asia and Europe. Supported by more liberal economic policies after 1870 and with the availability of cheap labour, Indonesia attracted more western entrepreneurs to invest in export-oriented agricultural enterprises. This was the beginning of large-scale plantation companies that exploited Indonesian land and labour, mostly in Java and Sumatra, to produce export products such as sugar, tobacco, rubber, tea, palm oil, coffee and cocoa.

Before independence there were plantation companies owned by the government *(Gouvernements Landbouw Bedrijven),* Dutch private companies, non-Dutch private companies and plantations owned by Chinese, Japanese, Americans and Europeans. Plantation products played an important economic role during the Dutch period, but during the Japanese occupation many of the plantations deteriorated. Political and economic uncertainties after independence had a negative effect on plantation owners that hampered development. The local people, on the other hand, occupied some areas and they converted the land from plantation products into the growing of food crops.

As the result of the nationalisation, the 40 Dutch government-owned plantations were transferred to the Indonesian Government and managed by *Pusat Perkebunan Negara* (Central of State Plantation/*PPN Lama*). In 1958 approximately 500 plantation companies owned by Dutch private companies were nationalised. In 1960, all the government-owned companies were reorganised into *Perusahaan Negara/PN* (the State-Owned Companies). These companies managed government plantations and were regrouped and integrated into 88 companies based on the commodities they produced.

They operated under the name of *Perusahaan Perkebunan Negara Aneka Tanaman* (the State-Owned Plantation Company Variety Crops). In 1968 they were amalgamated into 28 *Perusahaan Negara Perkebunan /PNP* (State-Owned Plantation Enterprises/SOPEs). In accordance with Law no. 9/1969, in 1971 the *PNP* became limited liability companies, *Perseroan Terbatas Perkebunan/PTP* (SOPE with *Persero/*limited liability status). The process of consolidation continued in 1994 when these companies were grouped together under 9 boards of management. In 1996 the government amalgamated them into 14 SOPEs, *PT Perkebunan Nusantara* (PTPN) I to XIV (Departemen Pertanian, Ditjenbun, 1997).

The development of SOPEs commenced in 1969 when the government sought to strengthen the plantations with financial support from state-owned banks and the World Bank/International Development Agency (IDA). The program designated SOPEs as core estates *(kebun inti)* to develop small-scale plantations *(kebun rakyat)* for the local community around them. After 1973, the plantations were expanded to other provinces, such as Kalimantan and Irian Jaya, where there had previously been no plantations during the Dutch period. The opening of the new plantations was also connected to government policy to use the SOEs as tools to promote development in various ways, to create employment as well as support indigenous and small holders' development. Security concerns were also a rationale to develop plantations in North and West Kalimantan, close to the Malaysian border and in Irian Jaya (Arso), close to the border with Papua New Guinea.

With financial assistance from the World Bank from 1978 to 1987, SOPEs were assigned as core estates for small holders' development programs, such as the Nucleus Estates System (NES) I to VII, NES Sugar, NES Palm Oil and NES Trans IV. From 1980 onwards and financed by domestic funds, the government developed various local small-scale plantation programs (*Perkebunan Inti Rakyat Lokal - PIR Lokal* and *PIR Khusus*). Through these programs SOPEs and small holders' plantations grew hand in hand. Thus the development of plantation sub-sectors and community happened simultaneously.

The government extended the policy to promote the development of privately-owned plantations *(Perkebunan Besar Swasta Nasiona/PBSN)*. Supported by the domestic investment policy of 1968 *(Penanaman Modal Dalam Negeri/PMDN)* and soft loans from Bank Indonesia and the state banks, there were various finance schemes, including PBSN I (1977-1981), PBSN II (1981-1986) and PBSN III (1986-1990). These schemes created conglomerates in the plantation sub-sector – some with close ties to the bureaucracy and military officers. The private sector dominated related (down stream and upstream) industries that strongly influenced the Indonesian economy and were tough competitors. With the deregulation that occurred in January 1990, the program was abolished and financing was conducted on a normal commercial basis.

2. The role of State-Owned Plantation Enterprises in the plantation sub-sector

The total planted area including that developed by SOPEs, as well as small scale plantations and private domestic plantations, increased from 5,250 thousand ha in 1968 to 17,319 thousand ha in 2001 – an increase of 230 per cent. The growth rate of private plantations was 323 per cent, significantly faster than the growth of state-owned plantations (127 per cent) and small holders (225 per cent). Table 6.1 indicates that most

Table 6.1
Planted areas of SOPEs, small-holders and private plantations

In thousand ha

Crops	SOPEs			Small			Private			Total		
Perennial	**1968**	**2001**	**%**	**1968**	**2001**	**%**	**1968**	**2001**	**%**	**1968**	**2001**	**%**
Rubber	228	226	(0.8)	1,689	3,678	117	226	292	29	2,143	4,196	96
Coconut	0	8		1,590	3,742	135	62	73	18	1,652	3,823	131
Palm Oil	79	541	584	0	1,566		270	2,314	757	349	4,421	1,167
Coffee	22	42	90	299	1,200	301	31	28	-9	352	1,270	261
Tea	40	47	17	50	68	36	26	36	38	116	151	30
Pepper	0	0		43	186	332	0	1		43	187	335
Clove	0	2		76	419	4,513	15	7	-53	91	428	370
Cacao	4	53	1,225	6	657	10,933	35	56	57	45	766	1,602
Cashewnut	0	0		0	544		2	10	400	2	554	27,600
Others	4	0		186	842	353	5	10	100	195	852	337
Sub-total	377	919	143	3,939	12,902	227	672	2,818	319	4,988	16,648	234
Annual												
Sugar cane	59	65	15	43	173	302	18	107	494	120	345	188
Tobacco	0	4		141	256	82	0	0		141	260	84
Others	0	0		0	66		1	0		1	66	6,500
Sub-total	59	69	17	184	495	169	19	107	463	262	671	156
Total	436	988	127	4,123	13,397	225	691	2,925	323	5,250	17,319	230

Sources: Departemen Pertanian, Ditjenbun, 1997; Ditjen BPP, 2003

of the private plantation companies invested in palm oil: 270 thousand ha in 1968 increased sharply to 2,314 thousand ha – a rise of 757 per cent over three decades. In

2001, the private sector managed 541 thousand ha of palm oil plantations – more than four times that of government-owned plantations.

During these decades, SOPEs had a strategic role in plantation development. They were the pioneers of new developments in non-traditional regions, developing small scale plantations with local people or transmigrants, developing infrastructure, employment and generating economic activities. These were positive factors that attracted private companies to invest. The SOPEs supported new technologies as well as new management and administration systems. These innovations were transferred to private plantations and small holders all over the country and contributed to the development of human resources, research, seed supplies and consultation services. Plantation enterprises also played an important role in strengthening small holders in their production of many commodities, including rubber, palm oil, tea, sugar, cotton and tobacco.

Table 6.2
Production level of SOPEs, small-holders and private plantations

In thousand ton with growth in %

Crops	SOPEs			Small			Private			Total		
Perennial	**1968**	**2001**	**%**	**1968**	**2001**	**%**	**1968**	**2001**	**%**	**1968**	**2001**	**%**
Rubber	122	200	64	530	2,170	3,094	103	233	126	755	2,603	245
Coconut	0	8		1,131	3,024	167	2	86	4,200	1,133	3,119	175
Palm Oil &	122	1,605	1,216	0	2,753		59	4,691	7,850	181	9,048	4,899
Kernel	24	321	1,238	0	551		13	938	715	37	1,810	4,792
Coffee	7	30	328	137	526	284	6	10	67	150	567	278
Tea	30	86	187	33	42	27	13	37	185	76	164	116
Pepper	0	0		47	82	74	0	1		47	83	77
Clove	0	1		17	85	400	0	2		17	87	412
Cocoa	1	35	3,400	1	370	36,900	0	23		2	428	21,300
Cashewnut	0	0		0	74		0	1		0	75	
Others	0	0		33	421	1,175	0	0		33	421	1,175
Sub-total	306	2,286	735	1,929	10,098	423	196	6,020	2,971	2,431	18,404	657
Annual												
Sugar cane	523	239	-54	203	808	298	23	680	2,856	749	1,728	131
Tobacco	0	3		54	224	315	1	0		55	228	315
Others	0	0		0	119		0	0		0	118	
Sub-total	523	243	-54	257	1,151	348	24	680	2,733	804	2,074	257
Total	829	2,529	205	2,183	11,250	415	220	6,700	2,945	3,232	20,478	537

Source: Departemen Pertanian, Ditjenbun, 1997; Ditjen BPP, 2003

During this period the plantation area rubber was not expanded by SOPEs. Although the projected world demand for natural rubber increased from 5.2 billion tons

During this period the plantation area rubber was not expanded by SOPEs. Although the projected world demand for natural rubber increased from 5.2 billion tons in 1990 to 7.5 billion tons in 2000 and 11.7 billion tons in 2010 (Departemen Pertanian, Ditjenbun, 1997), the government wanted the small holders to produce rubber, to be developed by various loan schemes and the private sector with credit facilities from PSBN schemes. The same policy was adopted for the production of tea, cacao, coffee, tobacco and sugar cane. These commodities were subject to significant price fluctuations and it was thought that their production required the best land. Approximately 5 percent of plantation enterprises and private plantations were devoted to cacao production. The traditional crops developed by small holders and plantation enterprises were used to maintain the productive areas they had already established.

Table 6.3
Ratio of SOPEs and private plantation land productivity

Area/ha to production/ton

Perennial crops	Rubber	Palm oil	Palm kernel oil	Coffee	Tea	Cocoa	Sugar cane
1995							
Ratio SOPEs	0.80	4.05	0.95	0.65	1.78	0.62	3.52
Ratio Privates	0.67	1.94	0.38	0.34	0.81	0.30	5.42
1996							
Ratio SOPEs	0.82	4.00	0.93	0.54	2.26	0.57	4.01
Ratio Privates	0.61	1.90	0.42	0.32	1.15	0.33	4.21
1997							
Ratio SOPEs	0.83	4.00	0.94	0.91	2.05	0.58	4.29
Ratio Privates	0.66	1.82	0.42	0.33	0.97	0.36	7.50
1998							
Ratio SOPEs	0.84	3.80	0.88	0.67	1.82	0.79	3.67
Ratio Privates	0.77	1.73	0.40	0.41	1.02	0.42	4.28
1999							
Ratio SOPEs	0.83	3.58	0.85	0.67	1.76	0.62	3.48
Ratio Privates	0.74	1.62	0.37	0.41	0.95	0.36	5.66
2000							
Ratio SOPEs	0.80	3.73	0.86	0.73	1.91	0.66	3.66
Ratio Privates	0.74	1.77	0.35	0.36	0.93	0.32	8.01
2001							
Ratio SOPEs	0.88	2.97	0.59	0.73	1.83	0.66	3.68
Ratio Privates	0.80	2.03	0.40	0.36	1.00	0.41	6.36

Source: Departemen Pertanian, Ditjen BPP, 2003

In addition, plantation enterprises developed palm oil with more add on value than traditional crops. However, private plantations expanded more aggressively to invest in this commodity with the support, until 1990, of special government financing. Private plantations also expanded into sugar cane production to supply their modern sugar factories. The well-known *tembakau Deli* (Deli tobacco) was cultivated only by SOPEs in North Sumatra. Supported by domestic investment policy from 1968 with finance schemes from various banks for plantation development from 1977 to 1989, private plantation production increased dramatically, managing 52 per cent of the country's palm oil production, 4,691 thousand tons of crude palm oil and 938 thousand tons of palm kernel oil in 2001.

The data in Table 6.2 shows that the private sector produced 52 per cent palm oil and 52 per cent palm kernel oil as compared to small holders and SOPEs, producing only 18 per cent and 7 per cent respectively. The private sector and small holders were also strong in the production of sugar cane and rubber. The data indicates that plantation enterprises faced strong competition from the private sector including small holders, partly because the latter's production was channeled to private sector downstream industries.

It is also important to examine the comparative productivity of various types of plantations. With the exception of sugar cane, state plantation enterprises maintained a higher ratio of land productivity than did the private sector, including small holders. Reports from the Department of Agriculture indicated that in broad spectrum productivity, plantation enterprises were superior to the private companies. The difference in productivity between SOEs and private plantation companies related to management and capital. The SOPEs had more expertise and long-standing experience in plantations, and these were located in the best areas with respect to soil structure and climate compatibility for the commodity. They required a high investment in planting and replanting, high working capital for maintenance, processing and trading, and an extensive labour force. The private plantation companies with large areas generally lacked capital and required more equity. Loans through banks, especially for investment with a high commercial rate of interest, were not helpful for their efficiency and productivity. The private plantations also hired many retired SOPEs' managers. However, the families who owned most of the private plantations applied best practice in cultivation, maintenance, land and crop management.

Table 6.3 above shows the ratio between the total areas of planted crops in ha and the total volume of commodity produced. It was calculated by using the data presented in

Tables 6.1 and 6.2. It compares the productivity of land across commodities, between SOPEs and the private sector. The former were able to produce more from one ha than the private sector, with the exception of sugar cane, where the private sector employed more modern cultivation techniques.

Table 6.4

Production per ton and SOPEs' market share of total export

Commodity	1998	1999	2000	2001	2002
Rubber					
Production per ton	192.5	181.5	169.8	199.7	201.7
Local sales per ton	n.a	n.a	n.a	n.a	n.a
Export per ton	49.1	47.1	38.9	30.6	34.6
National Export US$	1,105.5	849.1	888.6	786.2	1,037.6
SOPEs US$	35.5	28.5	25.6	18.1	24.7
Share %	**3.21**	**3.36**	**2.88**	**2.30**	**2.38**
Coffee					
Production per ton	25.7	26.2	29.7	29.8	29.9
Local sales per ton	n.a	n.a	n.a	n.a	0.2
Export per ton	6.9	8.7	9.8	8.6	6.9
National Export US$	615.8	488.8	339.9	203.5	218.8
SOPEs US$	16.3	17.3	15.7	10.5	9.1
Share %	**2.65**	**3.54**	**4.6**	**5.16**	**4.16**
Tea					
Production per ton	91.0	86.0	84.1	86.2	86.3
Local sales per ton	3.9	4.4	3.1	3.4	9.9
Export per ton	70.0	58.5	57.6	51.5	55.4
National Export US$	108.4	92.0	108.1	94.7	98.0
SOPEs US$	103.4	59.6	63.7	50.4	55.1
Share %	**95.39**	**64.78**	**58.9**	**53.2**	**56.2**
Palm Oil					
Production per ton	2,288.5	2,285.6	2,423.7	1,926.0	1,969.5
Local sales per ton	1,579.9	1,484.5	1,698.8	1,523.3	1,041.6
Export per ton	100.2	416.8	411.8	574.8	803.5
National Export US$	745.3	1,114.2	1,087.3	1,080.9	2,092.4
SOPEs US$	39.9	116.7	97.8	120.9	243.5
Share %	**5.4**	**10.5**	**9.0**	**11.2**	**11.6**

Sources: PTPN Join Marketing Board (KPB), 2003
Statistical Yearbook of Indonesia, 2002

As the private sector produced bigger volumes of palm oil, the plantation enterprises' market share was lower and produced mostly crude palm oil. In 1997 the market share of SOPEs in palm oil export was 17.52 per cent. Table 6.4 shows that the plantation enterprises' market share for palm oil export in 1998 is 5.35 per cent, and this increases to 11.64 per cent in 2002. This was also the case with sugar cane production. Even though SOPEs' sugar factories had access to small holders' production, there was still an inadequate supply of sugar cane.

PTPN VIII played an important role in tea production in Indonesia with a market share of approximately 60 to 65 per cent. Fluctuations in production at PTPN VIII influenced the national tea output. In 1998 the national production was 91.0 thousand tons, decreasing by 5.0 thousand tons to 86.0 thousand tons in 1999. This trend reflected the impact of this decrease in production at PTPN VIII from 58.3 thousand tons in 1998 to 49.5 thousand tons in 1999 (PTPN VIII, 1999).

Table 6.5
The role of plantation products (non-food crops) in the agriculture sector and GDP without oil and gas

Industrial origin	**1993**	**1998**	**1999**	**2002**	**2001**	**2002**
Agriculture	57,964	63,610	64,985	66,209	66,858	68,018
Farm Food Crops	31,093	33,350	34,012	34,534	34,260	34,442
Non-Food Crops	**9,015**	**10,502**	**10,702**	**10,722**	**10,979**	**11,328**
Livestock & Products	6,203	6,440	6,837	7,061	7,313	7,537
Forestry	6,268	6,581	6,288	6,389	6,523	6,651
Fishery	5,385	6,737	7,146	7,503	7,783	8,060
GDP without oil and gas	341,662	341,993	345,418	363,759	378,957	393,732
% Non-Food Crops to Agriculture	**15.55**	**16.51**	**16.47**	**16.19**	**16.42**	**16.65**
% Non-Food Crops to GDP without oil and gas	**2.64**	**3.07**	**3.10**	**2.95**	**2.90**	**2.88**

Source: Statistical Yearbook of Indonesia, 1993 and 2002

Plantation products (categorised as non-food crops) have a direct impact on many other economic sectors such as employment creation, especially in rural and remote areas. These products support businesses in fertilisers and chemicals, construction, the retail trade, transportation, and finance. Plantation enterprises also support community development around their plantation areas. Table 6.5 shows the contribution of plantations without oil and gas to GDP. The agricultural industry, particularly the plantation sector, shows a strong multiplier effect, with low import content. Plantations supported employment in the regions and tended to delay urbanisation. They were also an important source of revenue for regional governments.

3. State-Owned Plantation Enterprises' government policy

3.1 Development policy and financial impact

From the beginning of the New Order Government, plantation development policy was to increase production capacity through a rejuvenation of established plantations and expand into non-traditional regions such as West Sumatra, Jambi, West Kalimantan, East Kalimantan, South Kalimantan and Irian Jaya. Although this expansion was supported by various finance schemes it was expensive as the plantations had to develop an infrastructure and transportation costs were often high. The objective of this expansion was not only to earn profits and foreign exchange, but also to create employment and maintain the environment. These were the three pillars of state-owned plantation philosophy, known as *Tri Dharma Perkebunan* (Three Missions of the State-Owned Plantation).

In addition to the development of new plantations supported by finance schemes through the World Bank, Bank Indonesia and commercial bank loans, the government used SOPEs to support small holders through various relationships between the plantation enterprises as core plantations and small holders as nurtured plantations in the transfer of technology in cultivation, processing and marketing, as well as opening up new remote areas for small holders. This created employment and supported rural incomes, providing an expanding market for the local non-agricultural sector. The government wanted the expansion of plantations to have an influential impact on local industry and services. Table 6.1 shows that the contribution of small holders' production in the total perennial and annual crop area was more than 77 per cent. Although the productivity of small holders was lower than plantation enterprises and private enterprises, small holders played an important role in Indonesia's agricultural economy since colonial times. However, Table 6.1 also shows that the privately-owned plantations supported by preferential finance schemes grew faster than SOPEs, and as commercial entities their operations had fewer social overheads.

The financial impact of the plantation policy increased the cost of investment and production as well as social overheads. The impact on the efficiency of plantation enterprises is reflected in Table 6.6 in terms of the average of profit to sale, return on equity and assets. The average efficiency ratios of 28 SOPEs were higher compared to all plantation enterprises, as shown in Table 4.5. This meant that plantation enterprises still had the capacity to generate profits.

Table 6.6
Profitability of SOPEs

in %

Year	Profit/Sales	RoA	RoE
1987	20.65	7.41	13.38
1988	22.73	9.17	16.65
1989	14.97	5.93	11.17
1990	12.88	5.24	9.67
1991	12.39	5.28	9.55
1992	15.16	7.89	13.43
1993	12.40	6.69	11.67
1994	12.95	7.49	12.21
1995	12.66	8.55	14.36

Source: Ministry of Finance, 1993, 1995 and 1996,

Table 6.7 shows that some plantation enterprises made a loss in the period from 1987 to 1995. These results suggest that the 1989 restructuring was much needed to improve efficiency and decrease production costs. PTP XVII suffered from a loss for three consecutive years and was closed in 1990. PTP XV-XVI managed a sugar factory, with 5,347 ha of land and was supported by 54,117 ha of small holders' sugar cane production. It faced problems with volumes of raw material from sugar cane and its sugar content and the company incurred losses for four years.

Table 6.7
List of loss making SOPEs, 1987 - 1995

Year	PTP	PTP	PTP	PTP	PTP
1987	**XVII**	XIX	XXVII	XXVIII	
1988	XIX	XXVII	XXVIII		
1989	IX	**XVII**	XIX	XXVII	XXVIII
1990	**XVII**	XIX	XXVIII		
1991	IX	XXVIII			
1992	XV-XVI	XXVIII			
1993	XV-XVI	XIX	XXVIII		
1994	VIII	**XII**	**XIII**	XV-XVI	
1995	VIII	**XIII**	XV-XVI	XXVII	

Source: Ministry of Finance, 1993 and 1995

PTP XIX, XXVII and XXVIII also faced serious problems with inadequate capital and poor sales and suffered financial losses continuously for many years. PTP XII and XIII experienced low prices in tea in 1994 and this continued in 1995 for PTP XIII.

3.2 Risk and economies of scale

It was not only financial problems the government had to struggle with. The SOPEs also had to manage the risks that derived from the nature of the plantation business. Tiffen & Mortimore (1990) describe the estates and their associated risks by arguing that the plantations required a minimum size to support their processing plant: 15,000 ha for sugar, 7,500 ha for oil palm, 3,000 for rubber and 600 ha for tea. A company's economies of scale were also determined by the type of crop as well as infrastructure requirements. Most plantation products required prompt initial processing and typically require large amounts of fixed capital investment, especially for tree crops, processing units, packaging plants, plantation infrastructure, transportation or special facilities in ports and housing. The crop is funneled through a single or very few intermediate marketing points for the purpose of bulk packaging, processing or standardisation before reaching consumers. Plantations need a large, permanent labour force and perennial crops require long term cultivation. These requirements reduce the possibility of rapid change in either products or processes, making them vulnerable to change, either in commodity or price factors. The high degree of risk is advantageous to companies with a strong capital base.

A due diligence study was undertaken by the Ministry of Finance and the Ministry of Agriculture in 1994 based on the 1993 financial position and this study explored the restructuring options as stated in the Minister of Finance Decree no. 740/ KMK.00/1989. The due diligence process which used a strengths, weaknesses, opportunities and threats (SWOT) analysis to evaluate risks, revealed many weaknesses and threats faced by SOPEs. Reducing their numbers through liquidation or merger followed by the regrouping of dedicated companies was the recommended course of action (Departemen Pertanian, Departemen Keuangan, 1995).

The Ministry of Finance offered guidance concerning economies of scale, that 80,000 ha to 120,000 ha (*Kompas*, 14 February 1994) was to be the optimal area of plantation managed by a PTP. The government adopted a different approach to determine economies of scale for the size of a PTP's area. The role of SOEs was important for government not only as foreign exchange earners and employment providers, but also the desired presence of bigger SOPEs to balance against private plantations and conglomerates. To achieve this objective, the government applied the idea of creating larger corporations to determine the size of a PTP's area. Accordingly, the government's judgment in relation to appropriate size was not based on an analysis of economies of scale in the manner that Tiffen and Mortimore explain. Rather, it was based on a belief that 'bigger was better' and that Indonesia needed SOEs that were large enough to compete with private sector plantation corporations. The larger state-owned plantation corporations might have been more exposed to government intervention, which was the greatest obstacle to greater efficiency.

The merger proposal recommended that the following criteria be used as a basis for the restructuring:

1) Economies of scale of plantation area should be 80,000 ha to 120,000 ha, in one piece of land or in pieces of land close to each other.
2) A variety of crops to be maintained to protect against price fluctuations.
3) Vertical integration between downstream and upstream industries.
4) Financial soundness.
5) Ability to perform as an agent of development.

4. The three alternatives

Derived from the above mentioned due diligence, three alternatives were offered for the restructuring. The first was the consolidation of all SOPEs into 11 holding companies, followed by their restructuring as sister companies within the holding companies under management contracts. The second option was to merger through groupings of some plantation enterprises for one or two years, under one management prior to being consolidated into one holding company. The third possibility was the establishment of one holding company that would cover all 35 SOEs under the control of the Ministry of Agriculture.

From the above the Minister of Agriculture decided on the second alternative. During 1994 and 1995, 28 SOPEs were gathered into 9 groups. Each group was managed under one board of directors and, finally, they merged into 14 new plantation enterprises in 1996.

5. Labour relations

The objective of restructuring was to improve financial consolidation, but this had to minimise social-political frictions and support regional stability, especially in labour relations. Labour was essential for the plantations' business and the Ministry of Finance reports indicated that most employees were working in the plantation sector.

Under the Ministry of Agriculture there were many SOEs with various activities including SOPEs. The figures in Table 6.8 show the important contribution of plantation employment towards total employment in plantation enterprises under the Ministry of Agriculture and in all SOEs. The SOPEs' ratio of employees compared to those working in SOEs under the Ministry of Agriculture during 1987 and 1993, was an average of 98.73 per cent, with an average of 45.74 per cent of total SOE employees in Indonesia working in SOPEs.

Most of the plantation workers were temporary employees and issues of employment status, minimum wages, other income, health facilities, transportation, education and lockout and pension funds were sensitive matters. The plantation labour force demanded to be treated fairly by the management. In the Dutch period there had been a long history of industrial conflict on the plantations in Sumatra's East Coast, as reported by Remrev (Breman, 1990) and in SOPEs in the same region during the Old and New Order, until 1979 (Stoler, 1995). Given this long history of exploitation, labour relations remain a sensitive issue for the government and its enterprises.

Table 6.8
Total SOPEs' employees in SOEs' agriculture and in all SOEs, 1987-1993

Employment in sector	1987	1988	1989	1990	1991	1992	1993
1.SOEs Plantation	475,988	464,779	549,789	590,195	480,752	519,751	486,565
2. SOEs Agriculture	482,956	471,563	556,652	597,696	487,161	525,395	492,311
3. Total SOEs	1,058,491	1,057,797	1,149,951	1,197,335	1,090,300	1,131,324	1,102,460
% SOEs plantation employees in SOEs agriculture 1:2	**98.56**	**98.56**	**98.77**	**98.75**	**98.68**	**98.93**	**98.83**
% SOEs plantation employees in total SOEs 1:3	**44.97**	**43.94**	**47.81**	**49.29**	**44.09**	**45.94**	**44.13**

Source: Ministry of Finance, 1993

Restructuring was always a concern for employees. Improvements in efficiency or cost reductions have often meant retrenchment. The government has endeavoured to protect the plantation labour forces. The Minister of Agriculture in 1996 (0T.210/236/Mentan/IV/96) decreed that SOPEs could not retrench workers during the implementation of mergers. In 2000 the Council of the Board of Management of all plantation enterprises gave temporary employees permanent status, the consequence being that wages and contributions to pension funds would increase.

The SOPEs were obliged to follow government labour regulations. It was expected that they would generate profits, while complying with the minimum regional wage system and other social security requirements. The Labour Law, combined with the merging of plantation enterprises, strengthened the bargaining position of the plantation labour force. The plantation managements faced increasing labour cost pressures. Theoretically, they could have moved out of estate production and into contract farming with small holders and introduced labour-saving technologies through mechanisation.

6. The merger of SOPEs and its impact on efficiency

The merger of 28 PT Perkebunan into 14 PT Perkebunan Nusantara in 1996 was expected to increase the growth of sales, assets, profitability and soundness of the companies. The financial performance of the former two years prior to merger in 1996, and the latter plantation enterprises after merger from 1997 to 2002, are shown in Table 6.9.

Table 6.9
Total sales, profit, assets and equity of SOPEs, 1994 - 2002

In billion rupiah

Year	Total sales	Profit before tax	Total assets	Total equity
1994	3,941	518	6,710	3,810
1995	**4,309**	**620**	**7,199**	**4,330**
1996	n.a	n.a	n.a	n.a
1997	5,906	720	9,837	5,606
1998	10,378	3,061	14,293	8,288
1999	9,447	1,345	13,191	7,636
2000	10,279	898	13,752	7,543
2001	10,648	494	14,501	7,180
2002	12,519	635	15,252	6,968

Source: Ministry of Finance, 1996; Ministry of the SOEs, 2002; 2003

After the financial crisis, total sales of SOPEs increased, as indicated in Table 6.9, mostly from increasing sales of palm oil products from $US39 billion in 1998 to $US243.5 billion in 2002. This increased their market share from 5.4 per cent to 11.6 per cent, as shown in Table 6.4. Although other commodities such as rubber, coffee and tea had a tendency to decrease, the combined sales of all SOPEs improved. However, total costs to total sales rose from 85.77 per cent in 1999 to 94.92 per cent in 2002 (Table 6.10), and consequently profits declined after the financial crisis. It would appear that the merger had not improved their efficiency as this was measured by profit.

Six years after the mergers of 1996, the result of restructuring was reflected in the significant growth of plantation companies and during this time total sales tripled and total assets doubled. In contrast, total profits before tax declined, with the exception of an increase in 1998 and 1999 due to the rupiah's depreciation. The increasing cost of goods sold, operating expenses and extra ordinary expenses affected the total increase by more than 9 per cent during 1999 to 2002, as shown in Table 6.10.

Table 6.10
Consolidated cost structure of SOPEs after 1999

In billion rupiah and %

Items	1999	2000	2001	2002
1 Total sales	9,446	10,279	10,648	12,519
2 Cost of goods sold	7,097	8,033	8,384	9,748
3 Gross profit = 1-2	2,349	2,246	2,264	2,771
4 % - CGS = 2/1	**75.13**	**78.15**	**78.74**	**77.86**
5 Operating expenses	960	1,145	1,280	1,585
6 % - Op. exp = 5/1	**10.16**	**11.14**	**12.02**	**12.66**
7 Operating profit = 3-5	1,389	1,101	984	1,186
8 % - Op. profit=7/1	**14.70**	**10.71**	**9.24**	**9.47**
9 % Production + sales + operation cost = 4+6	**85.29**	**89.29**	**90.76**	**90.52**
10 Other & extra ordn income/(expenses)	(45)	(203)	(490)	(551)
11 % - Ex.ord. exps./ (income) = 10/1	**0.48**	**1.97**	**4.60**	**4.40**
12 Profit before tax = 7 -10	1,344	898	494	635
13 % - Profit before Tax = 12/1	**14.22**	**8.74**	**4.64**	**5.08**
14 % - Total cost = 9+11	**85.77**	**91.26**	**95.36**	**94.92**

Source: Ministry of SOE, 2003

This reveals that more prudent cost management should have been applied, not only on production costs and operating expenses, but also on extraordinary expenses (item 10). There was a recognised need for additional cash outflow until 2004 to support the capitalisation of new pension funds. As the sales price for export and local sales was beyond management control, tight control on the budget was needed to sustain profits. The efficiency ratio of SOPEs before merger, from 1987 to 1995 in Table 6.6, as measured by ratio of profit to sales RoA and RoE fluctuated, remained in a reasonable position. The efficiency ratio during that period was higher than most other SOEs, as shown in Table 4.5. The average profit to sales ratio for SOPEs was 15.20 per cent, compared to an average 9.75 per cent for SOEs. The average RoE was 12.45 per cent to 6.82 per cent for the SOEs. The average state bank deposit interest at that time was 12 per cent. As a consequence of the rise in total costs (Table 6.10), the financial efficiency of plantation enterprises has declined significantly since 2000, as shown in Table 6.11. Assuming that the impact of the economy crisis on plantations had come to an end by 2000, the performance of SOPEs is shown in Tables 6.10 and 6.11 and summarised as follows:

Table 6.11
Profitability of SOPEs after merger

in %

Year	Profit/Sales	RoA	RoE
1997	16.76	10.06	17.66
1998	41.14	29.87	51.51
1999	14.24	10.19	17.61
2000	8.73	6.53	11.90
2001	4.64	3.40	6.87
2002	5.07	4.17	9.12

Source: Ministry of SOE, 2003

1) The consolidated financial performance of SOPEs after the merger declined. The merger was undertaken to improve efficiency (reflected in the ratio of total costs to total sales) and profitability (return on equity), which were the two important performance indicators identified by the government.
2) The ratio of operating expenses to sales tended to increase. The total cost of production rose from 89.29 per cent of revenue in 2000 to 90.52 per cent in 2002. Extraordinary expenses (Table 6.10, item 11) caused the total costs to increase (Table 6.10, item 14), so that SOPEs operated with higher costs. Consequently, the level of profitability was below the 'reference' by using a state bank deposit interest level of 12 per cent. Return on equity was 14.36 per cent in 1995 and this declined to 11.90 per cent in 2000, 6.87 per cent in 2001 and 9.12 per cent in 2002. The extraordinary expenses—mainly additional contributions for pension funds and other personnel costs—were responsible for the increased costs. The SOPEs had under-performed in the three to five years after the announcement of the mergers in 1996, as shown in Tables 6.6, 6.10 and 6.11. The decline in

performance following the mergers was a challenge for management and the Ministry of SOEs as the shareholder, and it was suggested that the mergers had failed to achieve the government's objective. Indeed, the plantation enterprises had become less efficient, post merger.

B. PT Perkebunan Nusantara VIII: a case study in mergers and governance

1. The background and rationale of the reforms

Since 1949, the government has managed former Dutch government-owned plantations. In 1958 the government nationalised 17 private Dutch companies in West Java, controlling 113 plantations. After nationalisation these companies were organised into 4 groups and in the next phase 113 plantations were grouped in clusters of 5 units: Unit Bandung I, II and III, and Unit Jakarta I and II. From 1960 there was a series of reorganisations of state-owned plantation companies, named *Perusahaan Perkebunan Negara/PPN*. In 1968 three were renamed *Perusahaan Negara Perkebunan* (*PNP*) XI, XII and XIII. In 1972 they were designated *Perseroan Terbatas (Persero) Perkebunan* XI, XII and XIII (State-Owned Plantation Enterprise/SOPEs, government limited liabilities). These companies were consolidated to become *PT Perkebunan Nusantara* VIII/PTPN VIII (SOPE Nusantara VIII), one of 14 new state-owned plantation companies merged by the government in 1996. PT Perkebunan Nusantara VIII was located in West Java province (*kabupaten*/districts of Bogor, Purwakarta, Sukabumi, Bandung, Garut, Cianjur, Ciamis) and Banten province (*kabupaten*/districts of Lebak, Pandeglang), producing tea, rubber, palm oil, cocoa and cinchona.

After more than three decades since nationalisation and several reorganisations of the plantation companies, the overall financial performance remains unsatisfactory. There were several reasons as to why the reorganisation during the Old Order and New Order period was ineffective. After independence, Dutch-owned enterprises faced political, economic and security uncertainties, with an outflow of Dutch capital and no new investments. The lack of proper maintenance in the plantations and factories meant they had become less efficient (Glassburner, 1971). The Korean boom of 1950-1952 briefly raised hopes that the situation in the rubber industry might improve. The export of rubber in 1950 totalling US$94.9 million increased dramatically to US$215.1 million in 1951 and US$200.6 million in 1952. The price of rubber fell and proceeds from export decreased to US$138.9 million in 1953 during a peak in production of 304.2 thousand tons (Panglaykim & Thomas, 1973).

The Dutch-owned plantations, producing rubber, tea, coffee, palm oil, tobacco and sugar had little incentive but to invest in the 1950s because they faced so many difficulties in labour relations, rising costs and hostile dealings with the bureaucracy. During this decade the plantations still made a profit, but they were more concerned with expatriating profits than reinvesting in such an unfavourable political and economic climate (Mackie, 1996). Table 6.12 shows that in 1958, although the estates suffered from a lack of replanting and investment, they still produced and exported their products.

The average production during 1960-1964 compared with production in 1958, indicated that levels for rubber were 89 per cent, tea 92 per cent, coffee 120 per cent and palm oil, 99 per cent. Six years after nationalisation the production of rubber, tea and palm oil stagnated, thus the reorganisation of plantation companies in West Java did not improve production output. The reorganisation of all plantations focused on legal and bureaucratic aspects and was less concerned with the core problems of plantation business.

Table 6.12
Crops area, production, export and export value after nationalisation

Estates products:	1951	1958	1960	1961	1962	1963	1964
Rubber							
Mature area, in thousand ha	n.a	**n.a**	315.0	n.a	n.a	n.a	n.a
Product, in thousand ton	222.5	**239.3**	212.2	219.7	206.0	205.0	219.7
Export value, in US$ million	215.1	**108.8**	133.9	122.4	101.6	94.1	98.6
Tea							
Mature area, in thousand ha	68.1	**65.9**	66.7	66.2	65.2	n.a	n.a
Product, in thousand ton	46.5	**48.5**	46.1	43.7	47.2	38.7	46.3
Export value, in US$ million	n.a	**n.a**	n.a	n.a	n.a	17.8	17.0
Coffee							
Mature area, in thousand ha	41.9	**41.7**	42.1	41.3	39.0	n.a	n.a
Product, in thousand ton	12.1	**12.6**	18.3	19.1	12.3	18.4	7.4
Export, in thousand ton	11.3	**5.7**	5.6	7.0	8.7	10.4	15.7
Export value, in US$ million	9.8	**3.8**	1.9	1.5	1.9	2.6	6.8
Palm oil							
Mature area, in thousand ha	80.1	**92.4**	88.0	88.1	89.5	n.a	n.a
Product, in thousand ton	121.1	**147.7**	141.2	145.7	141.4	148.3	160.6
Export, in thousand ton	106.2	**131.3**	108.5	117.6	100.4	109.8	133.1
Export value, in US$ million	12.2	**23.7**	20.0	21.4	17.9	20.0	26.9

Source: Panglaykim, 1967, table: 4,5,7,8 and 9

One of PT Perkebunan XII-XII's senior officials recalls that the small Dutch plantations were profitable after independence (interviewed 5 August 2003). These plantations located in West Java kept low labour costs, outsourced labour and minimalised management superstructure with modest facilities. The plantations were also supported by infrastructure built by the government. However, after nationalisation the Dutch style of plantation management changed. As a consequence of unqualified management and control systems, the new management of nationalised companies became more bureaucratic and companies were no longer treated as business entities (Pangestu & Habir 1989; Panglaykim & Thomas, 1967).

Although efficiency was always stated as the motive for reorganisation the imperative was more bureaucratic and administrative. In compliance with Law no. 19/1960 on *Perusahaan Negara* and Law no. 9/1969, government-owned companies should have been in one of three forms: *Persero* (the government limited liability company, a commercial operation), *Perjan* (the government agency, a social service corporation) and *Perum* (public corporation, a mixed business which generated income while providing public services). The regrouping to PPN Aneka Tanaman VII to XII indicated the administration's purpose; it took the form of a government-owned plantation company/*PPN*. A similar or single commodity, such as tea or rubber, kept no revenue or diversification spread for the company. Under these laws PPN Aneka Tanaman VII to XII were organised as a state-owned enterprise in *Persero* form and produced various commodities.

The government's reorganisation created plantation companies with multiple objectives. Their purpose was not merely commercial, as they also had to contribute to development programs and perform social functions. These non-commercial functions reduced the efficiency of the companies. Various vested interest groups and government officials also became involved in plantation businesses and they did not address their structural problems. The reorganisation created larger organisations with more employees that required intensive communication and complex mechanisms of control. Meanwhile, the companies faced various business problems, including technological obsolescence, lack of downstream industries, lack of capital and professional management, and an inadequate personnel structure. Although PT Perkebunan XI, XII and XIII operated on sufficient economies of scale, the plantations were scattered in many places and required better infrastructure to run a coordinated processing schedule. Plantation products faced difficult market conditions in which buyers wanted a forward contract, especially for tea and coffee with cost, insurance and freight (cif) conditions, instead of free on board (fob), which increased costs for PT Perkebunan. The enterprises dealt with increased production costs, fluctuating world market prices, unpredictable environmental events and unhealthy conditions.

The financial performance of the three PT Perkebunan from 1987 to 1995 is shown in Table 6.13. There were strong fluctuations in revenue streams due to world demand and fluctuation of world tea, rubber and cocoa prices. The local price was usually lower than the export price. In 1994, PT Perkebunan XII and XIII suffered losses. Almost 50 per cent of their area was planted with tea and 30 per cent with rubber and their production was under budget targets. The price of tea also declined after 1990, world tea production was in over supply and Indonesia's export to the Middle East (Syria and Iraq) and Soviet Union countries declined. PT Perkebunan XIII had not recovered by 1995. By way of comparison, PT Perkebunan XI produced more diversified crops, including palm oil products, but only produced 9 per cent of the tea crop. Thus, PT Perkebunan XI was still able to generate profits when the price of tea declined in 1990.

Table 6.13
Performance of PT Perkebunan XI – XII and XIII before merger

Year		PTP XI			PTP XII			PTP XIII	
%	Profit to Sales	RoA	RoE	Profit to Sales	RoA	RoE	Profit to Sales	RoA	RoE
1987	7.10	1.15	2.86	30.21	11.16	19.69	21.98	8.67	13.14
1988	10.26	2.01	5.35	30.68	12.73	22.65	18.86	8.59	13.13
1989	4.44	0.77	2.49	26.33	11.73	20.46	25.02	12.13	17.94
1990	39.95	6.76	13.52	28.25	13.34	22.25	25.22	12.71	18.38
1991	16.23	3.26	6.16	8.84	3.16	5.82	5.94	2.40	3.79
1992	13.32	3.20	5.89	14.36	5.68	10.05	1.70	0.73	1.19
1993	36.27	9.86	16.13	3.93	1.65	2.90	8.64	3.69	5.94
1994	24.07	7.55	11.86	(29.58)	(10.77)	(23.00)	(21.69)	(7.66)	(14.16)
1995	20.26	6.70	10.01	36.17	14.59	22.51	(3.18)	(1.34)	(2.76)

Source: Ministry of Finance, 1993, 1995 and 1996

This study indicates that from 1991 to 1995 the return on assets and equity of PT Perkebunan XI, XII and XIII was lower than the average for all SOPEs. The lessons to be learnt from low commodity prices, foreign exchange fluctuations and geographic risk was that a product differentiation policy and cost reduction was strategic for PT Perkebunan, especially in relation to covering inelasticity of supply of products and competition. The

Ministry of Agriculture and PT Perkebunan XI, XII and XIII adopted reform as the central policy for their business strategy.

2. The integration process, from PT Perkebunan XI-XII and XIII to PT Perkebunan Nusantara VIII

2.1 The due diligence process

In May 1994 the Minister of Agriculture announced urgent restructuring of state-owned plantation enterprises to improve their competitiveness. The Minister explained five reform criteria: 1) state enterprises were to be the means of modernisation for the plantation sub-sector, 2) economies of scale and consolidation of planted areas would be at efficient levels, that is, the planted areas should be 80,000 to 120,000 ha and should be in the same or nearby locations, 3) crop diversification would better manage commodity price fluctuations, 4) development of upstream and downstream industry, and 5) financial soundness.

The Ministry of Agriculture instruction was followed by the due diligence process on business and financial matters, organisation, human resources and competition from June 1994 to early 1995. The process was carried out under the joint supervision of the Ministries of Finance and Agriculture. The managements of some SOPEs were actively involved and supported the process with input from the regions on restructuring. The significant findings were as follows (Departemen Pertanian, Departemen Keuangan, 1995):

1) Reduced soil productivity and fertility; planted areas lacked economies of scale, with the composition of crops exposed to price fluctuations.
2) Many processing units were obsolete, especially sugar factories.
3) Lack of an upstream industry.
4) Plantation enterprises were product oriented, marketing was centralised in the Central Marketing Board in Jakarta, and SOPEs lacked marketing capabilities.
5) Inadequate organisation and lack of human resources, especially related to education and business.
6) Lack of technology for efficiency and competitiveness in the market.

The due diligence on financial conditions (31 December 1993) indicated that total assets of all PT Perkebunan were 5,939 billion rupiah, with fixed assets of 4,088 billion rupiah. The total assets of three SOPEs were more than 500 billion rupiah, 14 had less than 200 billion rupiah, and the rest were between 200 billion and 500 billion rupiah. The average return on investment for 1993 was 5.21 per cent with a return on equity of 9.36 per cent. The average debt to equity ratio (DER) was 44.90 per cent, while two plantation enterprises had the highest DER, at more than 150 per cent. The SOPEs suffered from a lack of capital and were categorised as 'very sound', 'sound', 'less sound' and 'not sound'. Three were considered 'very sound', 10 were classified as 'sound', six were 'less sound' and seven were 'not sound'. This meant that 50 per cent of the enterprises were considered unsound.

The due diligence report only offered a general evaluation. It did not give a micro level evaluation of SOPEs or provide alternative models of organisation. The guidelines for the organisation of the new merger SOEs were established on 27 October 1997. The projected model after merger with its financial impact on human resources, pre-merger culture, audit and integration, was not explained in the report. This gave an impression of an inadequate due diligence process, where the merger was simply thought of as a legal process involving the integration of assets, liabilities and equity into a new company. On the basis of these findings and the above mentioned criteria, the restructuring of SOPEs was presented as three alternatives by the Minister of Agriculture in May 1994: 1) They were to be consolidated into 11 holding companies, 2) Some would be grouped for one or two years and then established into a holding company and this meant that there would be many holding companies under the Ministry of Agriculture, 3) In 1995 under the Ministry of Agriculture there would be 35 SOEs and only one holding company would coordinate them. The government adopted the second alternative to be implemented by all plantation enterprises.

It was government as owner that initiated the mergers of the SOEs. The management of the enterprises would simply implement government policy, while the Ministry of Agriculture was responsible for its conduct. All SOPEs had to operate under the same policy framework as determined by the government, rather than on the basis of a business plan devised for the specific circumstances of each enterprise. Although managements were involved in the process, their involvement was limited to that of information provider. The decision to merge was the government's. Within this policy framework, PT Perkebunan XI, XII and XIII were required to accept the due diligence findings and implement government policies.

2.2 Three SOPEs under one management

The plantation companies' owner—the government—made the decision to merge the three companies under one holding company. It was a horizontal merger as the plantations had similar characteristics, managements and labour forces. It was hoped that the synergies between the companies would create greater efficiencies. The merger was expected to work according to the five criteria for reforms to invite the involvement of SOPEs' management during the process of evaluation.

The government, in its implementation, endeavoured to avoid failure through two measures. First, PT Perkebunan XI, XII and XIII, were placed under one board of management. The board of management of PT Perkebunan XII was assigned to manage the group, assisted by a proxy from the PT Perkebunan XI and XIII boards of management. Second, the enterprises were formed into one company under a single board of management on 11 March 1996. Between June 1994 and March 1996 preparations were made for their integration. Interviews took place with the former senior official of PT Perkebunan XII and XIII on 5 August 2003 and the Annual Report for PT Perkebunan XI, XII and XIII for 1994 and 1995, indicated a number of aspects relating to the process.

1) A products assessment included a study of the ways in which to optimise the use of land by planting crops most suitable for the local soil structure and climate, to develop technology on plant cultivation, and to find efficient methods of using fuel or wooden/waste materials in the processing units. Research was undertaken to improve productivity and some unproductive crop areas were reforested to protect water sources. Under the control of one board of management, the three SOPEs started to rationalise, create economies of scale and evaluate crop combinations.

2) A system assessment showed that the enterprises had different accounting, office administration and information technology systems. The December 1994 and 1995 financial reports also showed that they had the same pattern for their charter of accounts.

3) Organisation and personnel assessment provided a new organisational structure, which was less bureaucratic and more product-oriented. Greater authority was given to plantation managers, office employees were retrained and deployed into plantations, and newly graduated officers were invited to join the companies.

4) Financial assessment of the new management attempted to reduce costs by lowering inventories, shortening the collection period on receivables and managing liquidity more effectively.

5) Corporate culture assessment involved seminars on human resources development which were held in order for the management to build strong relationships with employees and this endeavoured to create a new corporate culture.

There were tensions during the merger process to do with the two-year period of preparation permitted by the board of management to merge the enterprises effectively. It was hoped that there would be less government intervention, creating a more autonomous and less bureaucratic organisation.

3. PT Perkebunan Nusantara VIII consolidation

The legal merger between PT Perkebunan XI, XII and XIII and the establishment of PT Perkebunan Nusantara VIII was completed with Government Regulation no. 13/1996, dated 14 February 1996 and the notary deed of Harun Kamil SH no. 41, dated 11 March 1996. PT Perkebunan XI, XII and XIII's assets and liabilities were transferred to PTPN VIII, with the exception of their development projects in the province of South Sumatra and West Kalimantan. The final accounts of the merging enterprises and the consolidated financial statement of PTPN VIII of 11 March 1996, was approved by the State Audit Agency *(Badan Pemeriksa Keuangan dan Pembanguan/BPKP)*.

The Minister of Agriculture Decree no. 398/Kpts/OT.210/5/96 of 22 May 1996, established a team to assist boards of management with the merger process (Ministry of Agriculture, 1997). Dr Soetatwo Hadiwigeno from the Ministry of Agriculture with deputy chairman, Dr Ir Andung A. Nitimiharja from the Ministry of Finance, chaired the team. They were asked to compile the opening balance for new enterprises, to review loan agreements and design planning and budgeting for 1996. The merged company's organisation structure was determined by the Minister of Agriculture in Decree no. 959/Kpts/OT.210/10/97, dated 20 October 1997 (Ministry of Agriculture, 1997a).

The role of the new owner was central to the entire merger, from the due diligence process to the appointment of the new board of commissioners and directors for PTPN VIII, and the new organisational structure. Four regional managers and 16 department heads supported the new board of management. The regional managers assisted the board to coordinate the implementation of management policy in the plantations they supervised. PTPN VIII managed 45 plantations located in 11 *kabupaten* (districts) in West Java and the new province of Banten (BPKP, 1997). The company also owned 32 tea factories, 31 rubber factories, one crude palm oil factory, two processing units for quinine, six units for cacao, one unit for gutta percha, one tea packing unit and three hospitals (PTPN VIII, 1999).

PTPN VIII was confronted by some major problems: a lack of capital, high leverage and high costs due to economic scale and accessibility, structure of labour relations, and the assignment of non-business objectives. The factors causing the financial problems are as follows:

First, the paid up capital was 270 billion rupiah, part of the establishment capital of 600 billion rupiah. The total capital at the end of 1996 consisted of paid up capital plus the reserve from legacy enterprises until 11 March 1996. The profit of 1996 and the loan to government were converted into the reserves of the newly consolidated company. PT Perkebunan XI, XII and XIII's consolidated capital prior to merger at the end of 1995 was 575 billion rupiah, of which 205 billion rupiah was paid up capital. The consolidated balance sheet of PT Perkebunan XI, XII and XIII from early December 1991 to 10 March 1996 and the opening balance sheet of PTPN VIII on 11 March 1996, indicated that the government did not provide any new capital for the merger company. This meant that there were no additional funds to strengthen its capitalisation. Although merger does not solve the problem of capitalisation immediately, the owner is given a chance by management to examine initiatives through cost reduction, efficiency and profits.

Second, the audited balance sheet and profit and loss statement of 1996 showed that PTPN VIII operated with a relatively high debt. The total debt was 197,514 billion rupiah against a capital and reserve of 377,508 billion rupiah. The debt to equity ratio was 52.32 per cent, with an operating ratio of 90.64 per cent and an underutilisation of production assets against total sales of 85 per cent. At the same time, PTPN VIII had problems of liquidity with a cash ratio of 14.12 per cent – a slow collection of receivables and high inventories.

Third, as a reflection of these inefficiencies, the level of the company's soundness from 11 March to 31 December 1996 was only 86.74 (PTPN VIII, 1996), which meant that the new company started in an unsound financial state.

Fourth, the concession areas of PTPN VIII were 123,434 ha, with planted areas of 71,146 ha (productive area 58,840 ha and planting in progress area of 12,306 ha) or 58 per cent (PTPN VIII, 1996). The planted areas had not reached their minimum economies of scale (80,000 to 120,000 ha), based on the criteria set by government. They were scattered in the province of West Java and required good accessibility and control mechanisms.

Fifth, the government instructed management to optimise human resources and design the human development program. The Minister of Agriculture forbade discharging the employees, as stated in his letter to the Management of PTPN I to XIV number 0T.210/236/Mentan/IV/96, dated 17 April 1996 (Ministry of Agriculture, 1997). The total number of employees in 1995 was 73,277, including 682 officials and in 1996, this number decreased to 72,946 employees with 681 officials (PTPN VIII, 2003). The Minister of Agriculture's decision strongly influenced the cost structure of PTPN VIII when a new structure of employee ranks and salary was established in 2000, with the board of directors PTPN VIII Decree no. SK/DI/752/V 2000, dated 25 May 2000 (PTPN VIII, 2000a).

Sixth, compared to previous years, in 1996 the total volume of exports and sales increased. Productivity, as measured by kg/ha in 1966 and in comparison to 1995, increased for tea, rubber, cinchona and cacao. Productivity of fresh fruit bunches (ffb) of palm oil was 10,447 kg/ha in 1995 and this decreased slightly to 10,113 kg/ha in 1996 (PTPN VIII, 1999).

Finally, merger is a general policy and provided an opportunity for management to implement the reform of SOPEs prior to privatisation. Although merger was carried out on the idea of improving efficiency and business effectiveness, it did not change the role of government as owner and its relationship with management. The ideology of Three Pillars of Plantations *(Tri Dharma Perkebunan)* is that state plantation businesses should be a foreign exchange earner, develop employment and maintain a good environment, and this remained the government's objectives. After the merger, the management of PTPN VIII confronted the controversial issues of government policy, profit maximisation, political and economic pressures, and social development issues.

C. PT Perkebunan Nusantara VIII, after the merger

This section examines the merged plantation company, PTPN VIII, and its progress after the merger from March 1996 to 2002. The discussion will cover production capacity and productivity and sales that reflect the growth of assets and marketing ability. It examines whether synergies of capacity were reflected in greater efficiencies in operating expenses, other income and expenses and profit levels. It will address the question of how the merger was reflected in the company's financial performance, as measured by the profits earned and computed in the ratio of profit before tax to total sales, return on assets and equity, as well as the level of financial soundness stated in the Minister of Finance Decree no. 740/1989 article 1.8.

1. Productive crops and productivity

With the merger, there were 5,168 ha of productive rubber and 965 ha of recently planted rubber previously managed by PT Perkebunan XII and XIII, transferred to PTPN VII in South Sumatra and PTPN XIII in West Kalimantan. Approximately 6,872 ha of unproductive rubber and 11,273 ha of unproductive tea crops were reforested to maintain the environment – especially for water resources.

After merger, PTPN VIII continued to cultivate tea and rubber and in 1996, of the total plantation area, 42.80 per cent was planted with tea crops and 39.60 per cent with productive rubber. This cultivation pattern was largely unchanged by the end of 2002, when the figures stood at 42.90 per cent for tea and 38.93 per cent for rubber. Cinchona occupied the same total area of approximately 3,900 to 4,000 ha during that period, while cacao was reduced from the total area planted of 5,900 ha to 3,900 ha in 2002. Palm oil cultivation increased, with production increasing from 3,941 ha in 1996 to 5,057 ha in 2002. PTPN VIII also produced small quantities of coconut and gutta percha. The average productivity/ha, from 1994 until 2002, seven years after the merger, was 2,059 kg/ha for tea and 1,126 kg/ha for rubber. This was below the guidelines, as stated in the long term development program 1999-2003, which gave an average of 2,469 kg/ha for tea and 1,268 kg/ha for rubber. In the 2001 statement of corporate intent, PTPN VIII sought to increase tea productivity to 3,000 kg/ha and rubber to 1,700 kg/ha over a ten-year period.

Table 6.14 shows the composition of each crop and the productivity of each commodity. PTPN VIII was managing a concession area of 115,098 ha with a total planted area of 70,145 ha. The lessons learned by PT Perkebunan XI, XII and XIII from 1991 to 1995 were that crop composition and differentiation and price fluctuations strongly influenced company performance. PT Perkebunan XI maintained various products (rubber, tea, palm oil, coconut, cacao and gutta percha) in comparison to PT Perkebunan XII and XIII, with rubber (35 per cent), tea (50 per cent), cacao and cinchona. The devaluation of tea during the 1990s caused PT Perkebunan XII and XIII to suffer while PT Perkebunan XI with 9 per cent tea areas, kept a steady financial performance because it was supported by other commodities – especially palm oil.

Table 6.14
Planted area and productivity of crops

Commodities in ha	1994	1995	1996	1997	1998	1999	2000	2001	2002
Tea									
1 Productive crops	28,888	29,548	25,191	24,415	25,406	25,085	24,547	23,933	23,888
2 Planting in progress	3,581	1,497	406	138	827	1,706	2,155	2,599	2,483
3 Total planted area	32,469	31,049	25,597	24,553	26,233	26,761	26,702	26,532	26,371
4 Productivity kg/ha	1,661	2,125	2,422	1,822	2,297	1,972	2,141	2,155	1,935
Rubber									
1 Productive crops	30,052	30,973	23,301	23,410	22,591	22,140	22,069	22,068	21,678
2 Planting in progress	9,123	6,927	4,601	4,038	5,632	6,941	6,810	7,618	7,100
3 Total planted area	39,175	37,900	27,902	27,448	28,223	29,081	28,879	29,686	28,778
4 Productivity kg/ha	1,113	1,161	1,163	1,068	1,148	1,117	1,146	1,106	1,115
Cinchona									
1 Productive crops	359	473	546	685	829	1,769	1,419	1,201	1,154
2 Planting in progress-	3,653	3,876	3,349	3,175	3,323	2,294	2,686	2,915	2,778
3 Total planted area	4,012	4,349	3,995	3,860	4,152	4,063	4,105	4,116	3,932
4 Productivity kg/ha	1,334	369	815	842	495	519	500	611	763
Cacao									
1 Productive crops	7,026	8,063	5,868	5,048	4,821	4,768	4,478	4,378	3,902
2 Planting in progress	2,195	896	47	42	0	0	0	0	0
3 Total planted area	9,221	8,959	5,915	5,090	4,821	4,768	4,478	4,378	3,902
4 Productivity kg/ha	337	330	574	608	370	602	427	332	457
Palm Oil									
1 Productive crops	3,959	4,020	3,941	4,019	4,120	4,254	4,795	5,057	5,057
2 Planting in progress	457	397	304	776	937	802	262	60	2,105
3 Total planted area	4,416	4,417	4,245	4,795	5,057	5,056	5,057	5,117	7,162
4Productivity FFB/kg/ha	13,633	10,447	10,113	13,816	11,862	11,373	12,515	10,374	14,682
Total in ha									
1 Productive crops	70,284	73,077	58,847	57,577	57,767	58,016	57,308	56,637	55,679
2 Planting in progress	19,009	13,593	8,707	8,169	10,719	5,793	11,913	13,192	14,466
3 Total planted area	89,293	88,670	67,554	65,746	68,486	63,809	69,221	69,829	70,145

Source: PT Perkebunan XI, XII and XIII, 1994-1995, PTPN VIII, 1996-2002

The merger created product differentiation and developed selected commodities as leading crops. Table 6.14 indicates that PTPN VIII shifted to palm oil, showing a 68 per cent growth of the total planted area during seven years, increasing its productive area by 1,116 ha or 19 per cent. PTPN VIII also improved the productivity of its palm oil crops so that they continuously increased from 10,113 kg of fresh fruit bunches/ha in 1996 to 14,682 kg of fresh fruit bunches/ha in 2002, an increase of 45 per cent. The total planted areas for tea increased by three per cent or 774 ha over 7 years, but the productive areas and productivity decreased. The same trend occurred with rubber and cinchona.

PTPN VIII also reduced the planted areas of cacao and the productive area, and its productivity also decreased after 1996. The total production of tea, rubber and cacao decreased, as shown in Table 6.16.

Table 6.14 describes the challenge that the merger represented to PTPN VIII for traditional products such as tea, rubber, cocoa and cinchona that all remained stagnant, thus the merger was not able to improve their productivity as expected. It changed the composition and area under cultivation by developing palm oil, expected to increase the stream of revenue. Palm oil cultivation was increased in Banten Province by converting areas under rubber into palm oil plantations.

2. Production and sales

Productive crops and their productivity were reflected in the total production of each commodity, while sales were influenced by price fluctuations in export and local markets for each commodity. As the productive crop areas and productivity decreased, the volume of tea, rubber and cacao produced tended to reduce every year.

Table 6.15
Average sales price, 1994 - 2002

Average sales price	1994	1995	1996	1997	1998	1999	2000	2001	2002
Tea									
1 Export price Rp/kg	2,416	2,354	2,608	4,224	15,667	7,802	10,100	10,266	9,086
2 Local price Rp/kg	1,633	1,168	1,021	2,321	4,259	3,437	4,474	5,866	6,829
Rubber									
1 Export price Rp/kg	1,979	3,286	3,111	2,843	7,721	4,108	4,893	5,937	6,350
2 Local price Rp/kg	2,031	3,080	3,213	2,841	6,430	4,743	5,400	5,945	6,725
Cinchona									
1 Export price Rp/kg	2,538	0	0	0	0	0	0	0	0
2 Local price Rp/kg	2,871	3,912	6,447	6,.124	12,839	17,629	18,952	19,056	17,131
Cocoa									
1 Export price Rp/kg	0	0	0	0	14,183	0	0	9,875	0
2 Local price Rp/kg	1,689	2,037	3,103	4,205	14,366	7,506	6,111	9,397	16,616
Palm Oil									
1 Export price Rp/kg	0	0	0	0	0	0	0	0	0
2 Local price Rp/kg	582	787	914	984	2,114	1,594	1,771	2,076	4,802

Source: PT Perkebunan XI, XII, XIII, 1994-1995; PTPN VIII, 1996 up to 2002; average effective sales price, in rupiah

From 1996 to 2002, production decreased by 15 per cent for tea, 20 per cent for rubber and 41 per cent for cocoa, whereas cinchona and palm oil fresh fruit bunch production increased by 12 per cent and 86 per cent respectively. Consequently, the decreasing trend in tea, rubber and cocoa production was followed by a decline in sales volume. Total sales of tea decreased by 20 per cent from 63,789 tons in 1966 to 49,706 tons in 2002; rubber decreased by 11 per cent and cacao by 38 per cent, while cinchona and palm oil fresh fruit bunch sales increased by 27 per cent and 103 per cent respectively. The trends in sales volume and sales value in tons is shown in Table 6.16.

Table 6.16
Production and sales value, prior to and after the merger

Productions & Sales	1994	1995	1996	1997	1998	1999	2000	2001	2002
Tea									
1 Production ton	48,472	63,040	61,805	46,365	58,365	49,455	52,565	51,575	46,222
2 Sales: export ton	38,947	47,604	51,824	43,259	42,746	39,800	37,277	34,794	34,765
local ton	8,460	10,861	11,965	7,154	8,303	14,874	10,784	18,336	14,931
3 Total sales/ton	47,407	58,465	63,789	50,413	51,049	54,674	48,061	53,130	49,706
4 Sales Rp/billion	106.9	125.2	145.2	199.3	690.3	347.9	443.0	464.7	417.8
Rubber									
1 Production ton	28,484	30,082	29,979	28,145	25,933	24,735	25,299	24,404	24,168
2 Sales: export ton	2,945	4,620	6,582	6,796	6,923	3,469	2,537	1,200	2,866
local ton	33,206	30,378	25,429	23,122	21,669	24,883	25,923	25,974	23,964
3 Total sales/ton	36,151	34,998	32,011	29,918	28,592	28,352	28,460	27,174	26,830
4 Sales Rp/billion	77.0	113.6	103.7	85.0	173.2	132.1	152.3	161.5	179.3
Cinchona									
1 Production- ton	479	350	725	1,052	808	918	710	734	880
2 Sales: export ton	221	0	0	0	0	0	0	0	0
local ton	442	835	697	792	1,133	888	673	778	889
3 Total sales/ton	683	835	697	792	1,133	888	673	778	889
4 Sales Rp/billion	1,335	2,260	4,497	4,849	7,957	15,743	12,749	14,826	15,228
Cocoa									
1 Production- ton	2,378	2,663	3,020	3,034	1,851	2,871	1,911	1,447	1,781
2 Sales: export ton	0	0	0	0	471	0	0	13	0
local ton	2,359	3,275	2,914	2,989	2,114	2,839	1,983	1,514	1,803
3 Total sales/ton	2,359	3,275	2,914	2,989	2,585	2,839	1,983	1,527	1,803
4 Sales Rp/billion	6,334	7,518	8,955	12,569	27,012	21,459	12,116	14,344	29,953
Palm Oil									
1 Product FFB/ton	53,971	41,992	39,859	55,530	48,868	48,385	60,009	52,457	74,240
2 Sales: export ton	0	0	0	0	0	0	0	0	0
local ton	24,676	14,415	18,577	25,598	17,377	11,670	19,789	29,989	37,694
3 Total sales/ton	24,676	14,415	18,577	25,598	17,377	11,670	19,789	29,989	37,694
4 Sales Rp/billion	18,485	13,711	16,591	20,951	36,812	18,766	35,044	18,042	54,947
1 Total production in thousand ton	133.8	138.1	135.4	134.1	13.,8	126.4	140.5	130.6	147.3
3 Total sales in thousand ton	111.2	119.9	117.9	109.7	100.7	98.4	99.0	112.6	116.9
4 Sales Rp/billion	210.1	262.3	237.9	322.9	975.3	539.9	656.1	674.7	697.4

Source: PT Perkebunan XI, XII, XIII, 1994-1995; PTPN VIII, 1996-2002

On the market side, tea, rubber and cocoa prices that had been declining since 1990 were still low in 1996 and management was pessimistic as to whether these commodity prices would rebound. The export price for rubber in 1995 was US$1.45/kg and this decreased to 134 cents, 107 cents and 71 cents US$/kg in 1996, 1997 and 1998 respectively. It continued to decrease to a level of 63 cents and 71 cents US$/kg in 1998 and 2000. The export price for tea in 1995 was US$1.06/kg and this increased to 112 cents, 150 cents and 161 cents US$/kg in 1996, 1997 and 1998 respectively. It then decreased to 120 cents and 138 cents US$/kg in 1999 and 2000 (PTPN VIII, 1999). Although after the merger, the total area allocated for traditional commodities (tea, rubber, cacao and cinchona) decreased and total sales increased from 191.7 billion rupiah to 642.5 billion rupiah, representing a growth of more than 235 per cent. When the economic crisis occurred in 1997 and 1998, PTPN VIII was still able to produce 43,259 tons and 42,746 tons of tea respectively for export, compared to 51,824 tons in 1996, with 6,796 tons and 6,923 tons of rubber for export, compared to 6,582 tons in 1996. The sales value increased sharply in 1998, due to the rupiah's depreciation during the crisis. This depreciation provided the company with a windfall profit from the export of tea and rubber during and after the crisis. Currency devaluation and export prices were external factors, but they have greatly assisted the company's survival and profitability. PTPN VIII's total sales value was vulnerable to price and currency fluctuations which meant the company had to maintain tighter control of the cost structure of production, sales and overheads. In fact, one of the government's objectives in merging its plantation companies was to create a business with economies of scale and diversity of commodities, sufficient to withstand fluctuations in world market demand and export prices.

3. The results of restructuring

This section examines how PTPN VIII implemented the restructuring as determined by the Ministry of Finance Decree no. 740/KMK.00/1989. The result of restructuring was reflected in financial performance and measured by the following criteria:

Efficiency: the ability of the enterprise to produce targeted outputs using the minimum input and this was reflected in the costs of producing and selling the output (article 1.6).

Productivity: the ability of the enterprise to maximise output by using a certain amount of input. This could be reflected in the total output by using one unit of production capacity (article 1.7). Productivity was to be judged by how effectively resources were used.

Degree of financial soundness: the performance assessment of efficiency and productivity (article 3.2). The level of soundness was 'very sound' (vs), sound (s), less sound (ls) and not sound (ns). These levels were derived from profitability, liquidity and solvency factors listed in article 5.

The measurement of financial soundness was controversial as the guidelines were too general and did not consider the particular business sector with specific characteristics in operations and risk. In 1992, under the decision of the Ministry of Finance no. 826/ MK-013/1992 dated 24 July 1992, an adjustment was announced and additional points were granted on productivity, cost of production and administration cost on sales. In 1998 the financial soundness regulation was changed with reference to the Ministry of Finance no. 198/KMK.016/1998, dated 24 March 1998. The new measurement consisted of an evaluation of financial performance, operational aspects and administration. Marketing was an additional measurement as part of the operational aspect that emerged in the decision of the Ministry of SOEs, no. KEP-100/MBU/2002, dated 4 June 2002.

3.1 Efficiency

Cost reduction was a crucial concern in the enterprise. Total costs included costs directly related to production, sales and direct operation activities (Table 6.17, items 2 and 5), on one hand, and indirect costs on the other (Table 6.17, item 10). PTPN VIII's indirect costs consisted of consultant fees, contributions to the plantations association, reserves for unproductive assets, hospital operation costs, foreign exchange losses on transaction with affiliates, legal fees, security costs on land and crop protection and costs relating to human resources, such as pension contributions, jubilee, bonuses, separation payments and medical expenses. Table 6.17 shows that the merger of PT Perkebunan XI, XII and XIII had a positive impact on efficiency levels. Direct costs decreased from 96.66 per cent of sales in 1994 to 90.64 per cent in 1996 and after merger this trend continued, declining to 84.16 per cent in 2002 (item 9). Total operating profits increased sharply each year from 1996 by 22.2 billion rupiah at a rate of 9.53 per cent to 110.4 billion rupiah at 15.83 per cent in 2002 (items 7 and 8). This was a positive impact of the merger. The highest operating profit in 1998 was an extraordinary situation, but nevertheless, much to the advantage of PTPN VIII. Between 1996 and 1999 indirect income was higher than indirect cost and this was also a positive impact after merger. In contrast to previous years, from 2000 to 2002, PTPN VIII's indirect expenses increased sharply in comparison with that of indirect Income (items 10 and 11) and this pushed the profitability down, resulting in declining profits.

Table 6.17
PTPN VIII consolidated cost structure prior to and after merger

In rupiah/billion and %

Items	1994	1995	1996	1997	1998	1999	2000	2001	2002
1 Total sales	215.2	263.0	237.9	322.9	1,026.6	539.8	656.0	674.7	697.3
2 Cost of goods sold	183.3	218.5	195.6	235.9	368.8	425.6	459.9	507.9	536.7
3 Gross profit = 1-2	26.8	44.5	42.3	87.0	657.7	114.2	196.1	166.7	160.7
4 % - CGS = 2/1	**87.52**	**83.08**	**82.21**	**73.06**	**35.93**	**78.85**	**70.10**	**75.28**	**76.96**
5 Operating expenses	19.6	20.2	20.0	24.9	36.3	50.7	63.7	69.1	50.2
6 % - Op. exp = 5/1	**9.14**	**7.71**	**8.43**	**7.73**	**3.54**	**11.91**	**9.67**	**10.25**	**7.20**
7 Operating profit = 3-5	7.1	24.2	22.2	62.0	621.4	63.4	132.4	97.6	110.4
8 % - Op. profit = 7/1	**3.30**	**9.20**	**9.53**	**19.20**	**60.53**	**11.75**	**20.18**	**14.47**	**15.83**
9 % Production + Sales + operation cost = 4+8	**96.66**	**90.79**	**90.64**	**80.79**	**39.47**	**90.46**	**79.77**	**85.54**	**84.16**
10 Other& extra ord. income/(expenses)	(34.0)	19.6	26.9	17.4	45.9	55.3	(25.0)	(33.7)	(76.9)
11 % - Ex.ord. exps./ (income) = 10/1	**15.80**	**(7.45)**	**(11.31)**	**(5.39)**	**(4.47)**	**(10.24)**	**3.81**	**4.99**	**11.03**
12 Profit before tax = 7-10	(26.9)	43.8	49.1	79.4	667.3	118.7	107.4	63.9	33.5
13 % - Profit before tax = 12/1	**(12.46)**	**16.66**	**21.67**	**24.60**	**65.00**	**19.48**	**16.42**	**9.48**	**4.81**
14 % - Total costs = 8+10	**112.46**	**83.34**	**79.33**	**75.40**	**35.00**	**80.52**	**83.58**	**90.52**	**95.19**

Source: PT Perkebunan XI, XII, XIII, 1994-1995; PTPN VIII, 1996-2002

The audited report of *Badan Pemeriksa Keuangan/BPK* (the Supreme Audit Agency) on PTPN VIII's financial position for 2001 and 2002 (BPK, 2002) indicated an increase of pension costs from 13,403 billion rupiah to 27,292 billion rupiah, and the new contribution for the PTPN Employees' Pension Funds (*Dana Pensiun Perkebunan/Dapenbun*) was 51,381 billion rupiah in 2002. The hospital costs rose from 14,990 billion rupiah in 2001 to 16,280 billion rupiah in 2002, and additional separation payments were 2,258 billion rupiah.

The employees of PTPN were basically classified into three categories: permanent employee/officer (*karyawan golongan* IA-VIIB), monthly employee (*karyawan bulanan golongan* 1-8) and daily employee (*karyawan harian tetap*). Each category had different regulations regarding salary rates of pensions, bonuses, other employment welfare and social security that had long been a conflicting issue between employees and management. During the Reformation Era when labour had more opportunity to claim their rights, the Labour Union of PTPN asserted the need for improved working conditions. In 1999 a Joint Working Agreement (*Kesepakatan Kerja Bersama*) was signed at the Joint Meeting Board of the Board of PTPN I-XIV (*Badan Musyawarah Direksi PTPN I-XIV/BMD-PTPN)* and the Federation of Labour Unions of PTPN (*Federasi Serikat Pekerja Perkebunan Nusantara/FSP-BUN*). The agreement was renewed and signed on 28 November 2001 and was officially registered at the Ministry of Labour and Transmigration. It was an agreement based on Law no. 21/1954 on labour agreements between labour unions and work providers and it was automatically valid for all PTPN in Indonesia.

One of the strategic issues in the agreement was the employees' inclusion in the *Dana Pensiun Perkebunan/Dapenbun* (Plantation Employment Pension Funds) pension scheme. Under the 1999 and 2001 working agreement, three categories of employees were reclassified as permanent at levels IA to IVD and they were covered under PTPN pension regulations and various social security schemes. The PTPN had to pay additional contributions to *Dapenbun* for pension scheme employees at specified levels. On implementation, the board of directors of PTPN VIII issued a decision to reclassify the rank and salary of employees through Decree no. SK/D.I/752/V/2000, dated 25 May 2000 (PTPN VIII, 2000a). The impact of the policy was to increase indirect costs for the PTPN VIII, as the work provider had to make additional contributions to the *Dapenbun* to support its capitalisation and also make a monthly payment for employees' pensions. The new policy on employees' welfare was approved by the Board of Commissioners and the General Shareholders' Meeting, including the pension scheme that had been accommodated in the annual budget since 2000.

The employee status decision was not the result of the merger of PTPN. Meanwhile, there were two government decisions that influenced SOPEs' cost structure: the Minister of Agriculture, Decree no. OT.210/236/Mentan/IV/96, dated 17 April 1996 (Ministry of Agriculture, 1997) and Law no. 21/1954. The government merger policy to increase the efficiency of SOPEs, including PTPN VIII, clashed with government policy on labour that created additional costs for merger enterprises. This was evident in the government's contradictory policies and management was in a position of having to implement both conflicting policies, thus undermining the objective of the merger.

3.2 Productivity

Company productivity is measured by its ability to produce a given quantity of each commodity from each ha under cultivation. Table 6.14 shows the productivity of tea, rubber, cinchona and cacao measured as final product, and of palm oil, quoted as a raw material in the fresh fruit bunch (ffb). The productivity of tea, cinchona and cacao fluctuated and tended to decrease since 1996, while palm oil productivity has increased. Productivity on rubber has been relatively constant at a level of 1,100 to 1,200 kg/ha throughout.

Table 6.18
Realisation of productivity targets

Productivity%	1996	1997	1998	1999	2000	2001	2002
Tea	95	82	86	106	93	90	92
Rubber	99	96	97	102	95	99	89
Cinchona	111	52	53	77	71	120	101
Cacao	94	94	153	67	69	123	120
Palm oil /FFB	56	96	90	124	115	142	99

Source: PTPN VIII, 1996-2002

The target for productivity was always stated in the annual budget. It was the tool to control management with new planting, fertilising, pest control and harvesting, through to transporting and processing. Every phase needed to be controlled as every phase of production was subject to costs. Reports since 1996 indicated that climatic changes had influenced productivity. As a result, the productivity of tea and rubber was mostly below target, whereas cinchona and cacao had strongly fluctuated and palm oil improved. Assuming the cultivating, caring, fertilizing and harvesting of crops have been properly carried out, productivity will be strongly determined by climate factors. Table 6.18 shows the realisation of productivity against targets set in the annual budget.

3.3 Degrees of financial soundness

The degree of financial soundness was assessed by the overall results of financial performance. The ratios employed are not an exact measure, but they illustrate the trends and patterns of change, as well as facilitating an analysis of the business risks and opportunities for PTPN VIII after merger. There was a difference in perspective on financial soundness between the board of PTPN VIII as management, government as owner, and the lenders or creditors. The Ministry of Finance decree identified three financial indicators: profitability or *rentabilitas*, liquidity and solvency, with which to assess the result of the SOEs' restructuring.

The government was concerned about return on its investment. The key indicators were the return on equity (RoE) as measured by profit before tax against equity invested. Tax was also included as this was projected income for the government. Management's performance was measured by the return on assets, calculated from profit before tax against total business assets (RoA). Again, tax was included as it was earned by the enterprise and subject to transfer to government. Total sales were the source of income constituting the end result of the business operation. This performance could be measured from ratio profit before tax to total sales (Profit/Sales). Table 6.19 shows the trends in

Table 6.19
Profitability during consolidation 1994-1995 and after merger

Profitability	1994	1995	1996	1997	1998	1999	2000	2001	2002
RoE - %	(7.70)	11.07	13.01	19.75	80.27	16.96	15.53	9.44	5.16
RoA - %	(4.20)	6.53	8.54	14.33	57.58	14.25	12.43	7.08	3.68
Profit/Sales - %	(12.51)	16.67	20.64	24.61	65.00	22.00	16.38	9.48	4.82

Source: PT Perkebunan XI, XII, XIII, 1994-1995; PTPN VIII, 1996-2002

financial performance and profitability during consolidation and after the merger. The measures of profitability after the merger show a positive trend until 1999, with a peak in 1998 when the rupiah strongly depreciated. During this period PTPN VIII achieved a better performance than during the merger consolidation in 1994.

Table 6.20
Financial soundness level of PTPN VIII

Items	1996	1997	1998	1999	2000	2001	2002
Main indicator:							
Profitability	42.00	63.00					
Liquidity	7.00	8.91					
Solvency	9.26	10.41					
Additional indicator:							
Productivity / ha	9.59	8.50					
Production cost / kg	9.78	9.15					
Administration cost/sale	9.10	10.07					
Financial aspects			67.50	37.50	62.00	50.50	39.00
Operational aspects			12.00	12.00	14.00	15.00	15.00
Administration aspects			10.00	13.88	15.00	15.00	15.00
Total value	86.74	110.04	89.50	63.38	91.00	80.50	69.00
Soundness level	Not Sound	Very Sound	Sound AA	Sound AA	Sound AA	Sound AA	Sound A

Source: PTPN VIII, 1996-2002

However, in 2001 and 2002, PTPN VIII expended more in indirect costs and extra expenses, which decreased profitability from 15.53 per cent in 2000 to 9.44 per cent in 2001, and 5.16 per cent in 2002. Profitability measures in 2002 were less than half of those prior to the financial crisis figures at the time of the merger in 1996. The return on assets and the profit sales ratio for 2002 showed that the company confronted a financial situation that was not that much different from what it faced six years earlier. The restructuring was able to maintain the soundness of PTPN VIII, although there was a decrease in total value, as shown in Table 6.20. The above mentioned achievement after restructuring should challenge management and shareholders to develop a long-term policy and short-term strategic action to increase revenue and reduce costs.

3.4 Benefit to others

After the merger PTPN VIII produced higher profits before tax, but this decreased in 2002 to a lower level compared to 1996. PTPN VIII delivered more government revenue in terms of dividend and corporate tax as shown in Table 6.21 and employees got their bonuses following PTPN VIII's application of the human resources regulation. Funds for supporting small business activities and community development were set aside to fulfill the social function of the enterprise.

Table 6.21
Government revenue, bonuses and funds for social development

In Rupiah billion

Items	1996	1997	1998	1999	2000	2001	2002
Profit before tax	49.1	79.4	667.3	118.7	107.4	63.9	33.5
Dividend	n.a	0.8	10.7	186.7	33.9	35.4	16.0
Corporate tax	12.6	15.4	162.8	4.8	27.7	17.7	6.1
Government revenue	**12.6**	**16.3**	**273.6**	**230.6**	**61.7**	**53.1**	**22.1**
Bonuses	3.7	0.9	4.3	58.3	12.9	5.8	0.3
Funds for small business	n.a	0.6	4.4	4.6	1.7	1.0	0.6
Funds for community development	n.a	1.1	0.3	n.a	0.9	1.0	0.6

Source: PTPN VIII, 1997-2002

3.5 Reorganisation and human resources development

After the merger a new organisational structure was designed. The three component companies were integrated into one organisation consisting of 16 departments, later reduced to 12. Each department was at unit one level under the Board. The new structure of organisation was arranged by the Minister of Agriculture, Decree no. 959/Kpts/OT.210/10/97. Some planted areas were integrated into a wider area of cultivation to create better economies of scale and crop composition was reviewed to create greater flexibility to respond to market changes.

PTPN VIII developed programs for recruitment, training and promotion through selection, psychological testing and assessment tests that sought to improve human resources capability to manage and compete in the plantation business. It sought to create a more professional management with a better understanding of cultivation, production and marketing of crops, as well as personnel development and business management. However, the company was expected to meet new requirements for social security and welfare for employees. After the merger, the number of employees was relatively unchanged. At the end of December 1996, the total number of employees was 73,277 and this figure increased marginally to 73,427 in December 2002, including 39,389 non-permanent employees. Under the new employment scheme, huge additional contributions had to be made by the company to cover the new pension funds capitalisation, with future payments required.

4. Good corporate governance

In an endeavor to improve the SOEs' performance, the government introduced principles of good corporate governance for government enterprises, Minister of SOE Decree no. KEP-117/M.MBU/2002, dated 1 August 2002. This section examines how PTPN VIII implemented the government's principles of good corporate governance, the effectiveness of the implementation and influence on company performance. An interview for this research was conducted with the Internal Control Department (*Bagian Pengawasan Intern*) of PTPN VIII on 5 August 2003, regarding the implementation of good corporate governance with reference to the Audited Reports of PTPN VIII for 2001 and 2002 (PTPN VIII, 2001; PTPN VIII, 2000) and the State Audit Agency (*BPKP*) reports on corporate governance implementation in 16 SOEs and PTPN VIII (BPKP, 2003; BPKP, 2003a).

4.1 What PTPN VIII actually did in good corporate governance?

PTPN VIII recognised that good corporate governance principles were required to strengthen the responsibility of the commissioners and board members and also to increase the involvement of all employees in the day-to-day operations of the company. PTPN VIII established a Code for Corporate Governance, an ethical code that included reward and punishment regulations, as well as a Statement of Corporate Intent. Through these principles of good corporate governance, it sought to create greater transparency, professionalism, accountability, responsibility and fairness.

The protection of the stakeholders' interests was covered in various regulations, including the act of establishment of PTPN VIII, no. 41/1996. It covered the involvement of the employees' union in personnel welfare, standard operating procedures for the supply of goods and services, and regulations to support small enterprises and people living around plantations to safeguard the environment.

The General Shareholders' Meeting had begun to function as intended; shareholders had direct and open right of entry to any internal company matters and the meeting was prepared and ran properly as regulated, making strategic decisions for management implementation.

The commissioners of PTPN VIII had been involved in strategic planning and supervision of company implementation of the plan and its evaluation, reporting to the General Shareholders' Meeting. The Board of Commissioners was structured to represent the stakeholders and personnel had access to company data and company reports.

The board of directors occupied the central position in corporate governance implementation. Their authority and responsibility to run the business of PTPN VIII was stated in a company act, which included job descriptions and the code of good corporate governance. The Board designed the business plan and business strategy. It established a structure with key managers, formulated policy and made decisions to apply strategy according to the law and regulations, developed effective communication with the Board of Commissioners and arranged regular board meetings. It also appointed external auditors, internal auditors and an audit committee to support the Board, which took action to maintain good relations with stakeholders and maintenance of customer satisfaction was also developed, as well as relations with regional governments. Programs to maintain employees' welfare were effectively applied with respect to working conditions and the maintenance of health facilities. The salary structure was based on the minimum regional wages and the company developed pension fund programs, designed transparent planning, conducted training and created a complaint service for employees. PTPN VIII has continued to support community development programs, especially for those people living close to the plantations.

4.2 The effectiveness of implementation

4.2.1 Commitments

PTPN VIII was committed to the principles of good corporate governance by having the Code of Corporate Governance and the board of directors' endeavour to familiarise and inform all levels of the organisation of the meaning and need to fulfill the code. The Board has committed itself to improve company's profits and pay attention to stakeholders' interests. PTPN VIII was in a position to implement the governance regulation, as stated in part (a), and it appointed officers to supervise its overall implementation.

Although the commitment to governance was evident, the reward and punishment system in governance implementation and the Statement of Corporate Intent needed to be published as public documents. Annual Reports were also to be compiled according to good corporate governance principles. The function of the Board of Commissioners, the presence of an independent commissioner and a management risk system, should be clearly stated and fulfilled.

4.2.2 The General Shareholders' Meeting

The General Shareholders' Meeting has been running smoothly according to regulations stated in Law no. 1/1995 on limited liability companies. It means that governance in the shareholders' meeting is good, although documentation of the meetings should be better organised and transparent. However, the government must complete the regulations for the appointment of the Board of Commissioners so that this process is transparent and establishes a system of performance evaluation for the Board of Commissioners and the board of directors, as individuals and as a team. During the General Shareholders' Meeting, PTPN VIII indicated that there was a need for the involvement of experts from the Department of Agriculture.

4.2.3 The Board of Commissioners

Board members were qualified to carry out their roles due to their reputation, leadership, experience and education (BPKP, 2003a). The Board was well structured to protect the interests of the owner and represent stakeholders fairly and has effectively supervised and advised the management of PTPN VIII, especially with respect to strategic planning. It has had access to information from the board and company officials and communicates its policies to management and government. The decision making process has been prompt and effective meetings have been held, supported by the Board of Commissioner's office.

Corporate governance for the Board of Commissioners was at a sufficient level, although there were some weaknesses (BPKP, 2003a), for instance, the need for an independent commissioner; for terms of reference for the Board of Commissioner's job description and a self assessment review of Board performance. One of the commissioners was also a President Director of an affiliate of PTPN VIII and the BPKP recommended that a change should be made to avoid any conflict of interest. The commissioners had established the Audit Committee (*Komite Audit*) as stated in article 14 of the SOEs' Corporate Governance Regulation, no. KEP-117/M-MBU/2002. Meanwhile, the Nomination Committee (*Komite Nominasi*), the Remuneration Committee (*Komite Remunerasi*) and the Committee on Insurance and Business Risk (*Komite Asuransi dan Risiko Usaha*) had not been established and the commissioners undertook these functions.

4.2.4 The Board of Directors

The Board had a structure and regulations that facilitated fast and effective decision-making. It had developed a strategy for the enterprise and supervised its implementation. It evaluated the business operations and reaffirmed compliance with laws and regulations and it also maintained effective communication with the Board of Commissioners. On implementation of good corporate governance, the board of directors was rated 'good' based on ten indicators used by the *BPKP* (BPKP, 2003a). The BPKP identified the following areas for improvement in the company's performance:

1) Strategy formulation for planted area units and business units.

2) Detailed action plans of every aspect of PTPN VIII's strategy.

3) Relevant benchmarks to be designed to measure the growth of enterprise prosperity and yardsticks for financial and non-financial aspects. Key indicator performance should be designed to cover relevance, appropriateness, comprehensiveness and fairness.

4) Management contracts for all members of the board of directors should include performance evaluation.

Some other findings of the BPKP included:

1) All members of the Board were appointed from within the company, although article 16.2 states that a minimum of 20 per cent should be appointed from other SOEs.

2) Conflict of interest transactions by the Board, Decree no. 117, article 20 states that members of Board were not permitted to make a transaction that has a personal conflicting interest with his/her responsibility, that their only income was salary and other allowances decided by the General Shareholders' Meeting, and they were responsible to the Commissioners or the General Shareholders' Meeting. An appropriate mechanism should be established.

3) There are risks inherent in the plantation business and article 22.2.b, Decree no. 117 states that a system of risk management should be established. The BPKP recommended that this part of the internal control system be instituted.

4) A corporate secretary, as required in article 24, had not yet been appointed. The secretary was to be one of the board members.

4.2.5 External and internal auditor, financial report

In the BPKP's judgement, the implementation of the three aspects of corporate governance was excellent (BPKP, 2003a).

1) The General Shareholders' Meeting had appointed an external professional auditor for PTPN VIII, who was independent. The internal auditor had a supporting function supervising and evaluating as well as consulting with management, which was satisfactory.

2) PTPN VIII implemented the generally accepted accounting principles in presenting its financial report to the management and the public.

3) The quarterly reports were discussed with commissioners and were accessible to employees, shareholders, creditors, banking and the tax office, in keeping with transparent principles of good corporate governance.

4.2.6 Relations with other stakeholders

According to the audit report, stakeholder relationships have been managed properly (BPKP, 2003a) using the criteria of customer satisfaction, relationships with central and regional government, human resources development and the role of PTPN VIII in community development. With regard to human resources development, it was found that the employees' average income was above the minimum regional wage level and PTPN VIII's employees had been organised under a Labour Union (*Serikat Pekerja – SP Bun*).

The workplace agreement between PTPN VIII and their employees was subject to renewal every two years and supplemented by the employee's complaint mechanism. All employees were covered under the pension fund's scheme.

There were some additional mechanisms that the BPKP thought should be implemented (BPKP 2003a):

1) Voluntary or mandatory mechanisms of recommendation from officials to the Board of Directors relating to stakeholder matters.

2) Mechanisms for follow-up on how the board of directors should proceed to the Board of Commissioners on the above mentioned officials' recommendation.

3) Due process in the event of employees wanting to buy company shares in privatisation.

4) A method to quantify and measure employees' satisfaction.

The BPKP's evaluation provides some insights as to how far the PTPN VIII has implemented good governance provisions. Best practice would have earned the board of directors an evaluation of 100 points. The score award to PTPN VIII by the BPKP was 77.83, which indicated that the company was on the right track with its implementation of good governance and that it took its obligations seriously (BPKP, 2003a). The management and company officials recognised, however, that PTPN VIII's good corporate governance practices were under pressure from external elements.

Plantations required effective risk management to cope with a turbulent business environment. Business planning and strategy development was easily challenged by short term, quick fix decisions. In order to be transparent the board's decisions should be signed and recorded in an orderly fashion upholding legal and financial requirements. Logistics supporting housing, cars, office needs or crops should be based on priority and fairness to promote efficiency.

5. The influence of good corporate governance on performance

The good corporate governance mechanism placed the Board of Directors of PTPN VIII in a crucial position to move the company forward and motivate employees to work together for better performance. Good corporate governance created involvement for more people in the company, the objective was clearly stated and the process was transparent. In financial and operational matters good corporate governance was supported in order to achieve required performance levels. The company's achievements in creating greater efficiencies in operating expenses and production and sales costs are shown in Table 6.17. In 2001, when the good corporate governance code was introduced, the operating expenses ratio (item 8) was 10.25 per cent and this decreased to 7.20 per cent. This trend was also evident in the ratio of total production costs, sales and operating expenses to total sales (item 9), which was 85.54 per cent in 2001 and this declined to 84.16 in 2002. Two years is a short time frame to make an assessment, but the trend is encouraging with costs decreasing. The decline in profitability in 2002 was mainly due to increasing personnel costs, especially with additional contributions for pension funds.

The principles of good corporate governance for the SOEs, that is, transparency, professionalism, accountability, responsibility and fairness, were the guidelines used by PTPN VIII. The overall operational results of PTPN VIII, as presented in the annual reports of 2001 and 2002, reflects the implementation of these principles. These reports were presented quite differently to those of previous years. They detailed the activities of the Board of PTPN VIII and their achievements, including the areas where the company did not reach its targets. The company explained its operational problems, the relationships with its affiliates and the ongoing restructuring program.

The company's response action taken from the external auditor's findings, the guidance and advice from the Board of Commissioners and the decisions made at the General Shareholders' Meeting, were clearly explained in the report. The company's future plans and direction were also explained and the annual reports provided the basis on which the board of directors' performance could be assessed and their plans for the future evaluated.

Conclusion

Since nationalisation, there have been several attempts at reorganisation of state-owned plantation companies. The rationale for reorganisation was more to do with bureaucratic administration than operating efficiency, and more of a legal effort was made to follow up government regulations. The policy was centralised in the government's hands and implemented by the board of management.

The government had supported the development of SOPEs since 1969. Although the private sector grew faster and bigger, plantation enterprises played an important role as foreign exchange earners, providing employment, supporting related downstream industries, transferring plantation technology, supporting small holders, and they were also a source of government revenue. They had a higher efficiency ratio than average SOEs, but they were challenged by the downturn in world prices for tea, rubber and coffee, and consequently their profitability declined from 1989 to 1993.

The urgency in restructuring to improve their competitiveness was exposed in 1994 by the Minister of Agriculture. The Ministry of Agriculture and Finance conducted a due diligence process for developing synergy, economies of scale and product differentiation. As plantation enterprises had the same character in their production and marketing, a horizontal merger was the government's choice for reform. Prior to the effective merger, the government regrouped the PT Perkebunan in an effort to conduct integration between merging enterprises.

A lack of capital was a chronic problem, although government argued that it was unable to provide new capital to develop PTPN VIII business. The company struggled against the risks derived from the character of the plantation business; production of leading crops was stagnant and the company was unable to improve productivity as expected. The total production and total volume of sales remained unchanged. The crop development to palm oil with higher added value and productivity occurred, but the growth of planted areas was slow.

Product differentiation was a valid argument for the PTPN VIII merger. The increasing production and sales of palm oil during 1996-2002 determined PTPN VIII's revenue. Meanwhile, the world market price for rubber, tea, cocoa and palm oil from 1998 to 2002 was relatively lower than 1997, but total sales increased sharply as the value of the rupiah depreciated.

Good corporate governance to support a better performance was the emerging issue since 2001. The Board and officials of PTPN VIII were in the process of implementing their commitments. Their business reputation was expected to be maintained and they decided to avoid decisions that brought about unnecessary cost and loss for the company.

The government's contradictory policy was an issue in the merger. To avoid employees' unrest, the Minister of Agriculture forbade discharging the employees of merging companies in 1996. This prevented management from being able to adjust to the size of the workforce needed. Meanwhile the relationship between labour and the work provider was legislated by Law no. 21/1954. These government policies challenged the previous merger policy regarding better financial outcomes and created an additional indirect cost that severely reduced the profitability of PTPN VIII.

To improve company performance, a new policy was designed for the regrouping of crops under a manager with a delegation of authority on the production process with an approved budget. The plantations were organised under a Strategic Business Unit and the manager was authorised to make informed decisions. This was intended to shorten the line of bureaucratic command from the board of directors to improve product and cost efficiency. Four Strategic Business Units (SBU) with palm oil, tea and rubber as the principal products were expected to emerge by the end of 2004 (PTPN VIII, 2003).

Chapter VII

Conclusion

A. Government objectives in owning and controlling State-Owned Enterprises (SOEs)

Government-owned state enterprises were established after independence under the policy of Indonesianisation in 1946 to support economic development. The desire for political legitimacy and nationalist sentiment demanding control of all aspects of economic activity pushed the government to nationalise Dutch private enterprises in 1958, and also applied pressure on the Dutch to relinquish West Irian. Following nationalisation, the government managed various businesses, including banking, plantations, wholesale trading and various industries and services under SOEs. The large enterprise sector gave legitimacy to the government's role in the economy as well as enhancing its political authority.

Under Sukarno's economic policy, these enterprises were the backbone of the economy. They enabled the state to control pricing and the supply of basic necessities and generated revenue for development. Government bureaucracy and the military controlled state enterprises. Along with their role in enhancing economic development state enterprises were used to bring about reforms in the colonial structure of the Indonesian economy. They were at the centre of a network of conflicting interests and patrimonial relationships between enterprise managers, their directors and various groups within the government, including the military.

Although the regime changed, the Suharto government stated that it would continue the policy of the previous government regarding the use of state enterprises to boost the nation's economy. Under Suharto's presidency, nationalist and capitalist elements were accommodated in economic development plans to support the role of state enterprises and the private sector. In the Reformation Era, their role continued, but the government considered the option of privatisation and this decision was taken to support the state budget and improve efficiency.

The SOEs were assigned multiple objectives. They were bound to implement government policy but had to negotiate objectives that often conflicted in government investment, labour relations and financial efficiency policies. State ownership of commercial enterprises has been a controversial issue. Proponents of state ownership have argued that state enterprises supported economic development and economic legitimacy based on the Constitution of 1945, maintaining state assets and social stability. Others have argued that these enterprises have been inefficient. In their decision making, commercial considerations have been overwhelmed by bureaucratic and vested interests represented as economic development imperatives. The contradictory nature of government policies has made it difficult for state enterprises to concentrate on business. This has been reflected in their long-term, poor financial performance.

Government reforms in 1988 and 1998 sought to improve their efficiency and productivity. There were widely differing perspectives of what constituted appropriate *pembangunan* (development) and this was reflected in the conflicting expectations of those who introduced the reforms. Issues of ownership, profit versus public service, efficiency versus labour welfare and community development versus cost reduction, challenged reform policy. Further, policy was slow and the government's attitude was ambivalent.

These reforms have been unable to achieve government objectives, including efficiency, productivity, financial soundness and effective privatisation. There are also some unresolved issues relative to the role of government and state enterprises. The dynamics of the market challenge the role of government and raise questions as to whether the presence of state enterprises give legitimacy to government to manage the economy and supply goods and services to the people, as has happened over past decades. Does the government simply need them to fulfill nationalist objectives as expressed in the constitution, or is it possible for the government to intervene in the market through state-owned enterprises? For many decades the government used SOEs as commercial centres to maintain the balance of economic power between indigenous entrepreneurs and small businesses, Chinese conglomerates, military businessmen, the families of Cendana's related groups and foreign investors, to support social and economic stability. Is government support still needed in order to achieve a balance of power and, indeed, is the SOEs' role still needed?

As the enterprises manage state assets, the government uses them as cash 'cows', that is, a source of revenue for the budget. Meanwhile the government has to maintain employment and good labour relations, but this comes at a cost to enterprise profitability. These conflicting interests make it difficult for the government to decide on a clear and firm ownership policy. What the government does is maintain its ownership, impose restructuring to control its interests and permit the management little autonomy in decision making. Thus, the merger implementation has proved to be ineffective. There was a decline in performance following mergers and they failed to achieve government objectives. Indeed, state enterprises have become less efficient post merger.

The SOEs' reform has focused on the SOPEs, using PTPN VIII as a case study.

B. PT Perkebunan Nusantara VIII: a case study

Prior to merger, the plantation companies PT Perkebunan XI, XII and XIII, experienced structural problems. Low yields maintained unproductive tea and rubber crops involving high maintenance costs. The production of tea and rubber was subject to volatile price fluctuations on the world market. The plantation companies faced increasing production costs as well as marketing and operating expenses. The findings from the case study are as follows:

1. Productivity

As shown in statistics that were presented earlier, the productivity of tea fluctuated and tended to increase. Cacao productivity increased from 337 kg/ha to 457 kg/ha and palm oil showed the greatest increase. Cinchona decreased from 1,334 kg/ha to 763 kg/ha (Table 6.14). The productivity of rubber, however, remained unchanged. The climate that produced fog in the mornings with continual rain, was the principal reason for fluctuations in production.

Although PTPN VIII's planted areas occupied the most suitable land and the company maintained best practice cultivation methods, the merger did not strongly influence productivity. This also depended on high levels of investment for planting, working capital, seed stock and high labour inputs and the merger provided an opportunity for the company to diversify its crops to include palm oil, with increasing productivity.

2. Total planted area and production

PTPN VIII maintained the same area for tea and rubber cultivation and dominant crops as in 1996, but the total production decreased as more replanting was in progress (Table 6.14). The cultivation of palm oil gradually increased from 6.28 per cent to 10.21 per cent and this constituted slow growth over six years. Palm oil played an important role in PTPN VIII as its production and sales value sharply increased, compensating for the decreased production in tea, rubber and cocoa. Although the production of tea, rubber and cocoa decreased, their total sales value increased due to better prices and the rupiah's depreciation (Table 6.16). The company's approach was conservative. There were opportunities to increase palm oil production and to cover costs by sales volume and it was the shareholders who approved the required research and capital to enable the expansion of palm oil crops.

3. Human resources

Plantation agriculture is, by its very nature, a labour intensive business activity. Wages and employment conditions were crucial matters, not only for the SOPEs, but also for government. On a national level the plantation sub-sector contained approximately 44.13 per cent of all SOEs' employees (Table 6.8).

The merged company PTPN VIII was required to follow the direction of the Ministry of Agriculture in 1996 to maintain existing levels of employment. The number of total employees remained almost unchanged, from 73,277 in 1996 to 73,427 in 2002, including 39,389 non-permanent employees. Meanwhile, Labour Law no 21/1954 required the joint board of directors of state plantation companies, PTPN I-XIV, to reclassify the status of their employees in accordance with the collective work agreement with the Federation of Labour Unions of PTPN. They were reclassified as permanent employees and ranked IA to IVD. As a result, company expenses increased because of the additional pension contributions and pension fund capitalisation required. The policy to improve employment conditions was not directly related to the merger. There was strong labour union pressure during the Reformation Era to improve the conditions of the workers in SOPEs. The effect of the new labour agreement was that the efficiency benefits of cost reduction that should have flowed from the merger were harder to achieve. The plantation companies were particularly affected as their operations were labour intensive and many employees had not previously been permanent.

4. Cost structure

The research has shown that PTPN VIII was able to control its direct costs of production, sales and operations. Although production costs increased, this was compensated by a sharp increased in value of total sales. Operating expenses were effectively controlled, with total direct costs reduced to 6.58 per cent in 2002 in comparison to 1996 (Table

6.17). With reduced direct costs, the company increased its total operating profit in the six years after the merger and the merger produced the expected result, succeeding in reducing production and sales costs and operating expenses (Table 6.17, item 9).

PTPN VIII faced increased indirect costs in 2000 as a direct result of policy implementation to support employees' welfare. The policy required yearly pension contributions, jubilee awards, bonuses, contributions for new pension memberships, hospital allowances and separation payments. These costs continued to increase in 2001 and 2002. From the impact of changes to the cost structure, the study found that assets and equity returns and profit sale ratios decreased drastically after 2000 to just half the 1996 ratio. The company's diminished performance was reflected in the assessment of its financial soundness by the Ministry of Finance, from 91.00 (AA rating in 2000) to 69.00 (A rating in 2002).

PTPN VIII's management from a business point of view had endeavoured to improve the company's efficiency after 2000 (Table 6.17, until 1999), but the impact of government policies increased indirect costs (Table 6.17, 2000-2002). It was evident that as a business enterprise, the company was successful in becoming more efficient, but with government intervention it had become more difficult to operate profitably.

The merger thus failed to achieve the expected rise in profitability. PTPN VIII confronted constant government intervention and the board of directors had little or no autonomy in decision making. This research suggests that in its present financial condition, a more appropriate policy should be applied to PTPN VIII. The value of the company should be improved by continuous restructuring to shift the composition of crops to higher add on value products; this would allow for more effective reorganisation and reduce unnecessary expenditure.

5. Ownership of PTPN VIII

The merger of all SOPEs including PTPN VIII did not change the ownership of government as sole shareholder. As owner, the government through its representatives in the shareholders' meeting, authorised PTPN VIII's long term and annual business plan and budget, and also approved the reports of yearly business and financial results. The endorsement from the shareholders was very important as it legalised the board of management policy and its executive actions, as long as they were stated in the business report. This ratification was important, not only to fulfil the act of establishing PTPN

VIII, but also as a legal protection for board members, commissioners and employees. The general shareholders' meeting also determined and legalised the financial result and distribution of profits based on related regulations, such as the dividend for the state budget, taxes, retained earnings for small businesses, general reserves for PTPN VIII and company bonuses.

The merger of 28 SOPEs into 14 new PTPN meant that fewer enterprises were controlled by the Ministry of Agriculture and were subject to Ministry intervention. The merger did not change the relationship between the company and the government; the autonomy of management only existed within the scope of the approved business plan and budget.

Meanwhile, government policies that impacted on business operations were beyond management control and could have changed at any time with the owner's discretion. This research has found that the government's labour policies implemented in 1996, 2000 and 2002, increased the costs of operation and reduced the efficiency of the plantation company. The government's labour policies made the achievement of government objectives in the merger of PTPN VIII more difficult to achieve. Good corporate governance principles were implemented, but government as owner used its powers to intervene.

6. Others benefits

The merger of PTP VIII did produce some benefits. From 1996 until 2001, profits before tax increased, but then decreased below the 1996 level in 2002. As a result, the government earned financial benefits from dividends and corporate tax payments from 1996 to 2001, but in 2002 government revenue from dividend and taxes decreased to the 1997 level.

The merger reduced the number of board members. PT Perkebunan had been managed by four members of the Board of Directors and four members of the Board of Commissioners. This meant that there was a total of 24 officials administering three merging PT Perkebunan. After the merger in 2003, PTPN VIII was managed by five directors included a president director and supervised by five commissioners included a chairman and this reduced costs for remuneration, logistics and various social securities.

The employees as stakeholders have benefited indirectly from the merger as the increased company profits allowed for improvement in their employment conditions.

The employees also received bonuses and various social facilities and benefited from government labour policy to secure their employment. The employment conditions agreement in 1999 changed employment status and provided pensions, at a significant cost to the company.

PTPN VIII has supported regional development through employment and the purchasing power of its employees, multiplier effects, taxation revenue, and social stability through community development programs. The company has also supported various financial schemes for small enterprises, co-operatives and community development. PTPN VIII has been actively involved with local communities in preserving natural resources and environment and revegetation programs in unproductive areas (*Program Tanaman Kelestarian Lingkungan – Takeling*). *Kerja Sama Operasi*, otherwise known as the Co-operative Operation, has developed unproductive lands within communities around company plantations.

7. Corporate governance

The research concludes that PTPN VIII implemented the principles of good corporate governance, including greater transparency, professionalism, accountability, responsibility and fairness. The disclosure of its financial position and its company profile and information about business products were available to the public. The matters disclosed were not merely those required by law, but also those of material importance to the decision making of institutional investors, shareholders, creditors and other stakeholders. Human resources development was part of the open policy concerning professional and career development, working conditions and remuneration and the pension scheme covered all employees.

All disclosures appeared in Annual Reports in 2001 and 2002 in a format different from that of previous years. They contained the external auditor's findings, guidance and advice from the board of commissioners and decisions from the general shareholders' meeting. The company's future plans were also discussed and the reports showed the public and stakeholders how the board of directors performed its duties, identified company risks and planned for company challenges. PTPN VIII was acting on the findings of the State Audit Agency and advice on the implementation of good corporate governance.

C. Mergers and good corporate governance as a means of SOEs' reform

There were some government policies implemented for the benefit of the public or the government, but this came at a cost to the SOEs. The government needed their professional support, but state enterprises did not generate sufficient financial return. Their activities were not attractive for normal business purposes and were assigned by the government, despite requiring the risk of a higher cost for lower revenue, thus strongly influencing financial performance. Some examples were the pioneering of sea and air transport to remote and uneconomic areas, employment creation in remote areas, maintaining border security, research, small business development and community development policy. Reform was desirable to avoid government intervention and to hold the SOEs to their commercial objectives.

Reform in 1988 was an effort to improve performance, but the policy was focused on internal restructuring, company efficiency, productivity and soundness of financial performance. However, government interference in SOPEs continued to accommodate the interests of employees, including employment status, remuneration and social security. The government's employment policies also imposed increased costs, which reduced profitability.

The conclusion of SOEs' reforms by mergers and implementation of good corporate governance are as follows:

1. Motives for mergers

In the private sector, the objectives of merger were to maximise profits and increase the value of the merged company for the benefit of management and owners. Mergers were usually motivated by the dynamics of the business, initiated by management and owners. They sought to maximise shareholder value, efficiency, operating and financial synergies, expansion or avoid bankruptcy. It was hoped that the mergers would increase the volume of sales while decreasing overhead costs, thereby reducing the output cost per unit.

Mergers in enterprises owned by the government were different in relation to decision-making dynamics, objectives and motives. The study found that the merger objectives for state enterprises were not always to maximise profits, but rather to maximise benefits for the government and other stakeholders, restore the business reputation of state enterprises or support those that were failing. Other reasons for mergers are similar to those in the private sector, for example, promoting the synergy of assets and capabilities, or avoiding bankruptcy. Corporate reform through mergers was thought to be a preparation for possible privatisation.

2. Resistance to mergers

The merger of state enterprises occurred under government control and was managed by the responsible departments. This threatened the interests of particular individuals within the companies themselves and associated bureaucracies. The resistance to these interests resulted in mergers becoming a long bureaucratic procedure. Mergers were supposed to involve processes of due diligence, but often emphasis was placed on procedures and legal aspects instead of financial dimensions.

3. Continuing government intervention and contradictory policy

Mergers did not change the relationship between government and management. The merged plantation companies continued to be affected by directives issued by the Minister of Agriculture, for example, to maintain existing levels of employment after merger. The Minister's instruction inhibited management ability to restructure human resources and create efficiencies and cost reductions. Thus management was not in a position to reduce its workforce and was bound by government guidelines on employment matters. This evidence points to a crucial consequence of the reform that was not covered by the Minister of Finance Decree no. 740.

4. Merger as a process of corporatisation and privatisation

The research identifies the contradictory elements in government policies towards SOEs since nationalisation. Successive governments have sought to improve the commercial performance of the enterprises, as well as requiring them to perform other functions. Government ownership of the enterprises has also involved a variety of civilian and military bureaucratic vested interests in their management and control. The study shows the poor performance of the enterprises, especially the return on assets (Tables 3.3 and 4.5), which indicate that they had become stagnant.

The 1988 reform policy supports my argument that the government wanted to maintain the multiple functions of SOEs as commercial enterprises, public service institutions and instruments to promote national economic development. There were two stages of policy reform. First, there was a corporatisation process to strengthen the enterprises to make them more efficient, transparent and professional. Merger was one of the options in the corporatisation process. The case study demonstrates that along with corporatisation, PTPN VIII's efficiency levels improved significantly. In the reform process, the government remained the owner and continued to directly intervene in the business operations of its enterprises. In relation to plantations in the case study, government labour policies impacted significantly on the profitability of the company. The decrease in profitability, the stagnation of traditional crops, prospective palm oil businesses and labour cost structures, were determinant factors in exploring the possibility of shifting crops composition and privatisation. This opens up an area for further research in understanding government policy on plantation ownership, including related labour policy. Second, there was the option of privatisation to expand the ownership of the enterprise, either partially or wholly owned by the public, as allowed by the reform of 1988 and 1998. Privatisation could increase performance and add value to the enterprise, with public involvement in ownership. The government had indirect control through regulations and laws that applied to all listed companies. Partial privatisation of some SOEs made them more profitable. The results of privatisation of government banks; PT Bank Mandiri, PT BNI and PT BRI, telecommunication companies; PT Indosat and PT Telkom and mining companies; PT Tambang Timah and PT Aneka Tambang, gave them greater access to capital markets, professional management, better corporate governance and accountability.

Ownership is a central issue for government and SOEs and the former must explicitly determine what it wants to do with them. The study indicates that steps should be taken to resolve this issue through transparent policy and process. This begins with corporatisation to select enterprises which expect to do good business and then carrying out restructuring to improve their performance. This will determine their strategic role and inform government and the public as to whether the enterprise should be partially owned or sold.

5. Ineffective implementation

Five basic criteria for SOPEs' restructuring were developed in 1994, with a strong business focus followed by due diligence process. Modernisation, consolidation of planted areas, product differentiation and downstream industry development, were problems identified. The companies were constrained by a lack of capital, competition with the private sector, inefficiency and lack of management autonomy.

The merger process attempted to integrate and develop synergies between merging enterprises. Mergers were bureaucratic from the top down and the legalistic process did not address the problems of individual SOPEs. Production and productivity remained unchanged, inefficient operations continued and no additional capital was forthcoming from the government. A lack of capital meant that the merged companies were unable to finance sufficient investment to improve existing production capacity. The merged companies, still government-owned and controlled, were not able to follow cost reduction and rationalisation policies that would normally follow such mergers in the private sector. Government intervention meant that strategic policy implementation was less effective than it otherwise could have been.

6. Good corporate governance and its implementation

From 2002, Codes of Corporate Governance and Statements of Corporate Intent were introduced. The Boards of Management and Commissioners were responsible for implementing these codes to maximise the value of enterprises and maintain professional, transparent management.

The Ministry of SOEs appointed 16 enterprises, three partially privatised and 13 non-privatised, as a model for implementation. The State Audit Agency *(BPKP)* audit report on these enterprises indicated a score rate of 74.57 and 73.71 respectively: a sufficient level for the implementation of good governance. This meant that public companies and non-public companies had much the same capability to implement good corporate governance.

The study shows that transparency principles on governance were implemented and disclosure of important or extraordinary transactions were discussed during shareholders' meetings. Accountability principles were also implemented with timely reporting of financial statements to comply with the authority and responsibility of management, commissioners and shareholders. A conflict of interest transaction, safety regulations, environment maintenance and taxation regulations were also implemented. Fairness measures to ensure equitable treatment of employees, suppliers and customers were also implemented. This assessment of good corporate governance is based on the understanding that its implementation is recent, however a more thorough evaluation should be carried out over an extended period of time.

D. Recommendations

Three recommendations are made from the research findings, as follows:

1. The Indonesian Government should consider granting greater autonomy to the managements of State-Owned Enterprises, if the government wants its reform measures to be effectively implemented so that SOEs will eventually become more profitable.
2. The Ministry of SOEs should decide which enterprises are to be privatised and which ones should be retained and fully or partially owned by the government. This decision would be based on a policy recommendation that those enterprises which are strategic for the economy should be privatised, and those which are vital for the government's social and developmental needs should be retained.
3. Closely related to the second recommendation is a need for the government to conduct a thorough review of its policies relating to SOEs. Such a review might address the following questions: What role does the government envisage for state-owned enterprises in an increasing competitive regional and global economy? What is the role of government as owner of the means of production? Does the government have a role to play in maintaining strategic economic assets in Indonesian ownership?

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