

**SELECTIVE, GRADUAL, AND PARTIAL PRIVATIZATION OF
STATE OWNED ENTERPRISES IN INDONESIA:
ANALYSES FROM MACRO AND MICRO PERSPECTIVES**

By

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To

All knowledge seekers who may benefit from this study

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List of Acronyms

APP	: Annual Privatization Program
BOC	: Board of Commissioner
BOD	: Board of Director
DPR	: Dewan Perwakilan Rakyat (House of Representative)
EMBO	: Employee Management Buy Out
GDP	: Gross Domestic Product
GSM	: General Shareholders Meeting
IDR	: Indonesian Rupiah
IMF	: International Monetary Fund
Inpres	: Instruksi Presiden (President Instruction)
IPO	: Initial Public Offering
MoF	: Ministry of Finance
MPR	: Majelis Permusyawaratan Rakyat (People Consultative Assembly)
MSOEs	: Ministry of State-Owned Enterprises
PERJAN	: Perusahaan Jawatan
PERUM	: Perusahaan Umum (General Firm)
PMA	: Penanaman Modal Asing (Foreign Investment)
PMDN	: Penanaman Modal Dalam Negeri (Domestic Investment)
POEs	: Private-Owned Enterprises
PP	: Peraturan Pemerintah (Government Regulation)
PSO	: Public Service Obligation
PT	: Perseroan Terbatas, abbreviated as Persero (Limited Liability)
ROA	: Return on Assets
ROE	: Return on Equity
SBC	: Soft Budget Constraint
SIP	: Share Issue Privatization
SOEs	: State-Owned Enterprises
SPO	: Secondary Public Offering
UU	: Undang-Undang (Law)

Certification

I hereby declare that, this thesis which is presented to the Higher Degree Committee of Ritsumeikan Asia Pacific University is the result of my own work; and the ideas presented in the thesis are my own ideas except where otherwise indicated.

Bin Nahadi
26th June 2013

Abstract

Despite their huge role and contribution to the economy, the Indonesian State Owned Enterprises (SOEs) have been considered suboptimal in their performance. Privatization as a strategy is among the key efforts that have been relentlessly made by the government to increase the performance of SOEs. Privatization has been very strategic as a principal economic policy of the government with very broad objectives, both at the macroeconomic and microeconomic level. Nevertheless, the government has been facing huge challenges in its efforts to ensure a successful implementation of privatization policies. These include constraints relating to finance, politics, and social and technical contexts that constitute critical determining factors for the success of privatization in Indonesian. In this regard, a unique strategy of privatization is inevitably needed. Although the trend of privatization at the global level has been intensified in recent decades, the government of Indonesia has maintained a conservative policy of privatization strategy.

This study aims: 1) to find out which privatization strategy that has been pursued by the government and the rationale of implementing the selected strategy, 2) to assess the effectiveness of the pursued strategy in accomplishing the objectives of privatization both at macroeconomic and microeconomic level, 3) to examine the determinants of the success or failure of the pursued strategy both at macroeconomic and microeconomic level.

Using a combination of quantitative and qualitative analytical methods, this study has come out with the following key findings. Firstly, instead of implementing massive, fast, and full privatization the government of Indonesia has consistently pursued a selective, gradual, and partial privatization. This privatization strategy is believed to have greater expected economic

benefits than aggregate socio-economic and political costs of pursuing the strategy. Secondly, the pursued strategy successfully brings about favorable impact at macroeconomic level. Privatization plays a very critical role in promoting the development of capital market, improving financial contribution to state budget, being one of the effective sources of deficit financing, and maintaining high level of employment in the SOEs. At this level, the selection of firms to be privatized, the method of privatization employed, the pace with which privatization is pursued, and the political process to be undertaken are believed to be determining factors for the success of the strategy.

Thirdly, unlike what mainstream theories propose and what most empirical studies report, partial privatization is found to satisfactorily bring about positive impact on the performance of firms despite the absence of two success factors of privatization as believed by mainstream views, i.e. transfer of control and the presence of well-established capital market. The impact can be seen in the short term and even it is much stronger in the long term. The study reveals that the government governance in the form of improved monitoring through reduced political engagement and enhanced incentive system through stock-based remuneration scheme plays a significant role in the success of partial privatization. Despite its relative marginal contribution compared to the contribution of other factors, the role of capital market governance shows increasing importance in the long term following the development of stock market. Lastly, product market competition also plays very critical role through its direct impact on improved monitoring and performance incentive; also through its relation to financial market and government governance.

Keywords: partial privatization, state-owned enterprises, government governance, capital market governance, product market competition, Indonesia

Chapter 1

Introduction

1.1 Research Background

The economic development of Indonesia, as a developing country, has relied significantly upon the effective functioning of the public enterprises. With almost 150 firms, worth more than IDR 2,500 trillion in total assets and almost a million employees, SOEs undoubtedly play a very central role in the economy. Despite their huge financial and non-financial contribution, the significance of the SOEs has been considered suboptimal. Therefore, the government has attempted to increase the performance of firms through several efforts. These efforts include a robust implementation of restructuring programs toward public firms over the last two to three decades. Part of the strategy is to privatize dozens of the SOEs that meet a set of requirements established by the government. Privatization in Indonesia has been undertaken since 1991.

Consistent with the description of the characteristics of privatization in the developing world by Boubakri et al. (2005), privatization in the Indonesian context is employed as a primary economic policy reform applied within the structural adjustment programs. Privatization in the developing countries can be multifaceted purposes with the enhancement of firms' performance may not be the only pursued goal.

As mentioned in the main regulations guiding privatization in Indonesia, in Law Number 19 of 2003, privatization has been carried out with several aims, namely to improve the performance and the value of the enterprises, to increase benefits for the state and society, as well as to broaden share ownership to society. In this regard, the objectives of privatization can

be classified into two different levels: the macroeconomic level and microeconomic level. The objectives of privatization at the macro level include, among others, financing budget deficit, generating revenue for state budget, maintaining high level of employment, as well developing capital market. The objective of privatization from the microeconomic point of view is mainly to improve the performance of divested firms. This is not to imply that the macro and micro objectives of privatization are mutually exclusive; there is in fact a close relationship between them.

Taking into consideration the multifaceted aims to be accomplished, privatization occupies strategic position in the Indonesian economic policy, as part of grand economy policy arrangement of the country with expected positive impacts not only on privatized firms but also on the economy as a whole. Like other developing countries as observed by Coburn and Wortzel (1986), Indonesia has also been facing several challenges in the implementation of privatization policies. These are:

- a. Economic/Financial Barriers. While there are a large number of prospective SOEs to be privatized, the private capital available, especially from local investors, to take over these firms is much below the market value of those enterprises. While capital from foreign investors might be abundantly available, it could be politically unacceptable due to sovereignty considerations. Included in this category of constraints is the absence of a developed and efficient capital market.
- b. Political Barriers. This aspect may arise from several issues such as constitutional and ideological concerns. Indonesia has a chapter and articles in the constitution stipulating that the state is mandated to control land, water, natural resources, and several sectors considered vital for society and the lives of the people. In the absence of detailed definition of the

phrase of “vital and affect the life of the people”, the constitution could provoke strong resistances and oppositions toward the idea of privatization in the country. Groups of people in Indonesia perceive privatization and liberalization as elements of colonialism. Included in this category of constraints are inefficient political market and rampant rent seeking activities. Due to all of those possible reasons, even if massive-scale privatization were financially feasible, it is hard to believe that such a program would be politically practicable in many developing countries.

- c. Social Barriers. Some people relate privatization to the issue of unemployment and labor welfare. There are apprehensions from society about the effectiveness of privatization with respect to income distribution and the likelihood of widening income inequality (the concentration of economic wealth in very few private hands). The fear of the unknown syndrome (xenophobia) is also a perceived peril by society with regard to privatization, a concern that could be exacerbated by lack of adequate public knowledge.
- d. Technical barriers. Privatization in Indonesia, which were specifically carried out before the Law on SOEs was enacted in 2003, had been facing some technical barriers: 1) the lack of firmly instituted criteria to determine which SOEs are to be divested, 2) the absence of rules of the game regarding what form of privatization to pursue in different situations, 3) the absence of definitive institutions in the government established specifically to oversee privatization; 4) the lack of clearly set procedures prescribing the mechanism and process of privatization, 5) the absence of clearly set objectives, scope, timing, as well as the result of the program.

Moreover, privatization in Indonesia has been conducted in an environment of lack of a well-established institutional architecture for implementing corporate good governance. This is a

typical problem in the developing countries documented by numerous previous works (Denis and McConnell, 2003; Klapper and Love, 2004). In any country, the state of the institutions is a critical determining factor as to whether a privatization policy will work effectively or not (Boubakri et al., 2005, D'Souza et al., 2005).

1.2 Problem Statement

Globally, the trend of privatization has been intensified in recent decades. Given the abovementioned constraints, however, the government of Indonesia has maintained a conservative policy on privatization. Although the government of Indonesia has undertaken privatization since 1991, the number of SOEs privatized is relatively insignificant compared to the number of public firms existing in the country. The number is also relatively very small in comparison with other developing countries. With regard to the mode of privatization, the government of Indonesia has pursued partial privatization rather than full privatization. Among the very limited number of SOEs divested, there is only one that has undergone full privatization in the sense that the state acts as minority shareholder (<50% of ownership). Furthermore, to sell/transfer such a minority ownership the government has often not carried out any one-off privatization. Instead, they have frequently been undertaken gradually, on a piecemeal basis. In short, the government of Indonesia has implemented a unique privatization strategy in response to prevailing barriers.

Given the complexity of the barriers prevailing in the economy and the variety of objectives to be accomplished, one may say that the government of Indonesia has confronted complex challenges to make privatization work successfully. To overcome these challenges may greatly depends on the choice of approach to privatization.

At macro level, one may question the effectiveness of selective and gradual privatization in generating national revenue for financing state budget expenditure, resolving the problem of budget deficit, and promoting the development of capital market. With regard to the determining factors of privatization, it is reported that macro-economic and institutional factors are very critical for privatization to be successful in developing countries. However, it is claimed that the institutional setting in the developing countries are generally poor and less developed (Denis and McConnell, 2003, Klapper and Love, 2004). Taken together, those findings are in line with other researches done by Ramamurti, 2000; Dyck, 2001 contending that the primary determinant of either the success or failure of privatization program is the institutional development of the countries. In turn, the institutional situation mirrors the implementation of corporate governance reforms. In other words, the failures of privatization in developing countries are mostly caused by poor institutional and economic infrastructure. Undoubtedly, this makes privatization highly challenging as an economic development policy, if not impossible to implement in the developing countries like in Indonesia in comparison with developed countries.

At micro level, partial privatization chosen by the government as a strategy is even more doubtful according to mainstream view. Mainstream theories in this respect such as public choice theory, property right theory, and soft budget constraint theory tend to understate the possibility of partial privatization to succeed. Most of the theories consider the presence of government as the main cause of poor monitoring and inadequate incentive scheme. On the other hand, partial privatization leaves the government as remaining control holder so that it would not make any significant changes in terms of the probability of government engagements, government assignments and other forms of government interferences. Hence, existing mainstream

perspective seems to fail in explaining the reason why partial privatization can bring about favorable impact both at macro and micro aspects of privatization.

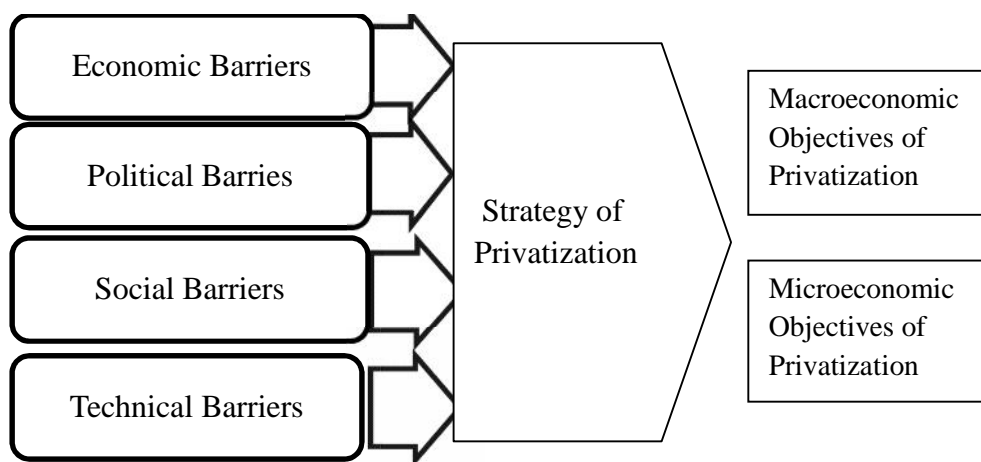
Furthermore, theoretically there are two governance mechanisms to bolster the performance of enterprises. These are internal and external governance mechanisms. Internal governance mechanism roots from the ideal ownership structure, the desirable composition of BOC and BOD, and the adequate remuneration scheme. Since the control of firms is still held by government through majority ownership, it is argued that internal governance mechanism is less likely to arise from partial privatization. Meanwhile, external governance mechanism lies on the function of the capital market in disciplining the behavior of managers through takeover threat. Based on the conventional argument, the only potential source of performance improvement in the case of partial privatization is stock market. Unfortunately, Indonesia, like most of the developing countries, has not got a well-established stock market. Consequently, external governance mechanism is believed to be very marginal in fostering the performance of privatized firms. Even, if well-established capital market exists the impact of takeover threat is less intensified. The presence of government as majority shareholder will effectively prevent the ultimate takeover threat to occur.

The government of Indonesia is probably in dilemma regarding what privatization strategy should be adopted to enhance the performance of SOEs. Considering the SOEs' poor performance, full privatization can be the best option to cure the acute problem. Considering the very critical role of SOEs in the economy, however, pursuing full privatization may remove all of the potential benefits in exchange of one-time revenue. Moreover, under high uncertainty due to poorly established economic infrastructure, it would be very risky for the government in the developing countries to undertake full privatization. On the other hand, expecting total success

from partial privatization by relying solely on the function of stock markets as argued by Gupta (2005) is also almost impossible. This is because most of the capital markets in the developing countries have not yet developed adequately.

The challenges faced by the government of Indonesia in carrying out privatization in the country is depicted in Figure 1.1

Figure 1. 1 The Challenge of Privatization in Indonesia



1.3 Research Questions and Research Objectives

As emphasized in the preceding section, given the complexity of the barriers prevailing in the country and the variety of the aims of privatization to be achieved, the government of Indonesia appears to face uneasy challenges in implementing privatization policy in Indonesia. Moreover, the strategy of privatization imposed by the government is also considered less likely to succeed by theoretical and empirical mainstream arguments. Therefore, this thesis raises three main research questions to be discussed throughout the study:

- 1) Given existing several major hindrances, what privatization strategy has been employed by the government? What are the reasons/justifications behind the implementation of such privatization strategy in Indonesia?

- 2) What has been the impact of the privatization strategy pursued at the macroeconomic level?
What are the determining factors of privatization success/failure at this macroeconomic level?
- 3) What has been the impact of the privatization strategy pursued at the microeconomic level?
What are the determining factors of privatization success/failure at this microeconomic level?

To answer these fundamental questions, this thesis is aimed at answering the following accompanying questions:

1. What is the main strategy pursued by the Indonesian government to make privatization work successfully amid ideological, political, economic, and social constraints? What are the rationale/justifications for the selected strategy?
2. Employing selected privatization strategy, can macroeconomic objectives of privatization be successfully accomplished? What are the determining factors in this regard?
3. Employing selected privatization strategy, what is the impact of privatization in Indonesia at microeconomic level? Can partial privatization still bring about positive impact on the privatized firms' performance despite the nonexistence of control relinquishment from government to the private sector (less possibility for the presence of improved internal governance mechanism) and the absence of well-established capital market (less possibility for the presence of satisfactory external governance mechanism)?
4. How do mainstream arguments appear to inadequately explain the phenomenon in question 3 above, including understating its determinant of success? How is the impact of partial privatization and its determinants explained by using an alternative analytical framework as complementary to existing argument?

5. Using proposed analytical framework in question 4, what are the determinants of partial privatization success in Indonesia in enhancing the performance of privatized firms?

Hence the grand objective of this study is to offer analytical and empirical evidences as to how privatization strategy employed by the Government of Indonesia can possibly bring about positive impact not only on individual performance of privatized enterprises but also economic performance at the macro level despite the existence of some imperfections in the economy. To realize this primary objective, the following sub-objectives have been pursued:

1. To investigate the strategy implemented by the Indonesian government in pursuing privatization policy amid ideological, political, economic, and social constraints. To find out the rationale behind the implementation of such strategy;
2. To examine the impact of privatization in Indonesia at macroeconomic level and to find out the contributing factors of the success/the failure;
3. To investigate the existing literature in explaining the impact of privatization on the privatized firms' performance and identify their limited applicability;
4. To propose an analytical framework to explain how partial privatization pursued in the absence of well-developed stock market is still likely to be successful;
5. Using Indonesia as a context, to undertake an empirical analysis showing the applicability of the proposed analytical framework in explaining how partial privatization can positively bring about positive impact at micro economic level;

1.4 Data and Research Methodology

The data used in the study are categorized as follows:

- a. Secondary data

These consist of financial and operational information gleaned from annual reports of selected SOEs. The data mainly comprise accounting figures from pre and post privatization of divested SOEs. The figures are obtained from associated agencies such as the Ministry of State Owned Enterprises (hereafter referred to as MSOEs), Ministry of Finance (henceforth called MoF), Indonesian Stock Exchange, and State-Owned Enterprises (hereafter called SOEs).

b. Primary data

These are gathered from interviews carried out with key persons involved or well-informed with the topic. This primary data are mostly intended to elucidate the “how” and “why” of the pre-set research questions.

To realize the aims stated in Section 1.4, this study employs both qualitative and quantitative approaches. Qualitative approach is mainly employed, firstly, to critically review the existing literatures in shedding light on the root causes that differentiate the performance between public and private ownership. Secondly, to decisively review the existing literature explanations about the way privatization brings about positive impact on the performance of firms and the limitation in its applicability. The limitations are used as a rationale behind the necessity of proposing a conceptual framework explaining specifically how partial privatization pursued in the absence of well-developed stock market is still likely to be successful. Qualitative methodology through “institutional” approach is also employed to identify possible determining factors that can make partial privatization work successfully. In this regard, the study aims to shed light on the structure of rules and regulations to understand the effectiveness of the monitoring and incentive system undertaken by the government toward privatized firms in the mode of partial privatization. Due to the problem of data unavailability, qualitative approach is also used to support the argument in some part of empirical investigation.

The quantitative approach is mainly used in performing empirical tests to show the impact of privatization uniquely undertaken by the government of Indonesia at both macro and micro point of view. In this part, several quantitative techniques, such as, descriptive analysis, Wilcoxon signed ranked test, and panel data analysis, are employed. Descriptive analysis is mostly employed to examine the impact of partial privatization from macroeconomic point of view. It is done by simply comparing the means of several indicators on data taken from several years pre and post privatization. On the other hand, the Wilcoxon sign ranked test is non parametric test employed to investigate whether the performance of individual privatized firm significantly change after partial privatization is carried out. Meanwhile, panel data analysis is employed to confirm the impact of privatization on the performance of individual firms and to identify key factors affecting the success of the privatization strategy.

The two approaches above are considered more adequate than just applying only single technique separately. By combining both approaches simultaneously the argument resulted is expected to be more solid.

1.5 Significances of the Study

The thesis has made significant theoretical and empirical contributions to the existing body of knowledge. Firstly, the study provides several evidences pertaining to the feasibility of selective, gradual, and partial privatization in the countries facing several political, economic, and social constraints. Secondly, it clarifies the mainstream arguments that understate the possibility of partial privatization success. Mainstream theorists argue that privatization may not bring about a significant positive change on the divested firms' performance unless it is carried out in nations with well established stock market and followed by control relinquishment from government to private owners. This study argues that privatization is likely to bring about favorable impact

regardless of whether it is followed by control relinquishment or not as long as it brings about improved monitoring and better incentive mechanism.

Thirdly, the study proposes a conceptual framework to describe the determinants of the success of partial privatization at firm level which consists of three main drivers of monitoring and incentive mechanism. Those determinants are government governance, capital market governance, and product market competition. As separate variables, some of the literatures might have mentioned the role capital market and product market competition as determinants of firm performance after privatization but the role of improved government governance is understated completely. Moreover, the proposed conceptual framework considers all determinants not only as separate and independent variables but also as interdependent variables that interact and affect each other to produce aggregate impact on monitoring and incentive scheme. The framework also sheds light on potential factors for each determinant so that it can ease the policy maker in creating required conditions on the ground.

Fourthly, the study presents recent empirical proofs over the impact of privatization in Indonesian context. Privatization is a very popular issue in almost every country all over the world. Therefore, there have been numerous studies and publications produced on this topic. Among those researches, many are cross-country studies that tend to be very broad, paying less attention on country specific context in their discussions. Consequently, those studies fail in clarifying some very important issues accurately. Furthermore, among those carried out at country-level, despite the long history of privatization, comprehensive studies about privatization in Indonesia are very limited. Thus, this study is undoubtedly important because it has contributed in filling the literature gap about the implementation of privatization policy in the

context of Indonesia including the concept, the strategy, the methods, the impacts and the policy implications.

Fifthly, the study provides a guideline in the form of policy formulation that is very important for policy makers in establishing institutional setting needed for creating effective monitoring mechanism and adequate incentives scheme. This becomes more relevant because there are many developing countries facing similar constraints in pursuing privatization policies. Identifying potential key factors for each variable, this study helps the government as policy maker to formulate necessary policies for improving public governance, enhancing capital market, and creating desirable level of product market competition. By adopting similar policies that have been empirically proven in the Indonesian context, other developing countries are also likely to achieve the same success in pursuing partial privatization. In other words, this study also offers a model of privatization that may be replicated in other developing countries.

Last but not least, the study suggests a niche for future research with regard to the applicability of proposed analytical framework in other developing countries. Full privatization that requires several pre conditions such as efficient stock market, the absence political and social constraints, seems to be less applicable in many developing countries. In such context, this study has contributed in providing new insights and direction to show that developing countries still have chances to make partial privatization as an effective economic policy. Proposed analytical framework need to be tested in other developing countries, especially by emphasizing on the relations and the interactions among the determinants of performance improvement.

1.6 Scope of the Study

This thesis challenges the mainstream argument on the partial privatization. This thesis also explores a new hypothesis that could help explain why the current mode of partial privatization in Indonesia continues to work well, despite the fact that some schools have argued it is imperfect from the standpoint of the Neo-Classical principles. Nonetheless, there have been some identified limitations in regard to this study, which largely defines the scope of analysis.

First, this thesis suggests that the mode of full privatization would be less feasible for a number of reasons given the specificities of the Indonesian political and economic context. Nevertheless, the success of the partial privatization policy in Indonesia does not always mean that the mode of partial privatization brings about better outcomes for the society than full privatization. Very limited number of full privatization case in Indonesia (there has been only one case so far) make such comparison is highly unlikely to be carried out. In this thesis, the improvement or decline of some selected macro- and micro-economic indicators between the pre- and the post "partial" privatization is used as the basis for assessing the success or failure of privatization. This does not explain how the mode of full privatization would bring about further improvement or decline in any partially privatized SOE.

Second, the above mentioned indicators used as benchmarks are selected mainly (1) from the macroeconomic impact of privatization on the development of capital market, the generation of fiscal revenue, the management of budget deficit, and on the maintenance of the level of employment, and (2) from the micro-level impact of the strategy on the performance of respective privatized SOEs. Originally, the policy of privatization might be pursued to enhance the public or consumers' welfare. Better performance of privatized SOEs may have created or maintained job opportunities, leading directly or indirectly to better outcomes for society. On the

other hand, it is possible that the mode of partial privatization may have maintained a moderate-level competition among the producers and suppliers, partly hampering the potential consumers' surplus which would have been more enjoyed in a severe or excess competition (though this thesis suggests that the political cost for seeking the mode of full privatization would cancel off the potential consumers' surplus). We note that these indicators, showing the room for enhancing the consumer's welfare, are important as benchmarks for examining the success of the partial privatization policy and the potential it has for the improvement of public welfare. Nevertheless, it is very difficult to estimate the potential consumers' surplus, in other words, the economic rent being maintained in the mode of partial privatization. In this thesis, we select the above mentioned macroeconomic and micro-level indicators within the existing socio-economic and political context to examine the impact of partial privatization in Indonesia.

Third, the study is significantly based on privatization carried out through capital market in the form of Initial Public Offering (IPO) or Secondary Public Offering (SPO). Therefore, the variable of stock market is significantly emphasized in the discussion. Consequently, the findings of the study might not be fully applicable in the countries where other channels of privatization, for example direct investment or employee management buyout, are more dominantly employed. Second, this thesis demonstrates empirical evidences based on Indonesian context. To be implemented in other countries with very distinctive financial environment, consequently, there might be a necessity of adjustment in the applicability of the findings. For example, the findings may have a certain limitation of its applicability for a country where banking industry plays major role as financial intermediary in the privatization processes.

Fourth, this study does not specify a certain type of industry as an object of analysis. It is well understood that each industry usually has distinct characteristic compared to others.

However, in this study that is not the issue because comparing one industry to another industry is undone. Each SOE from various industries is measured and compared to its own self to observe the performance change pre and post privatization. Therefore, this is another reason for not incorporating operational indicators into the analysis. Each industry has very distinctive operational characteristics that are impossible to be compared. On the other hand, the variety of industries is also unlikely to be represented in the statistical regression due to the limitedness of population.

Fifth, due to data unavailability not all determinants proposed in the analytical framework are employed in the empirical investigations by using econometric approach. However, the thesis assures that variables employed in the empirical investigations are sufficient to represent the issues and to support the argument raised. To support and complement the argument, this thesis provides descriptive and qualitative analyses.

1.7 Organization of the Study

This thesis is organized into 7 chapters. Chapter 2 conducts literature review on the existing critical concepts related to the topic. It reviews the definitions, the rationales as well as the objectives of privatization policies. It also describes some main theories supporting privatization policy and some major factors affecting the successfulness of privatization. This chapter tries to emphasize that monitoring and incentive is the main driver of firms' performance. Chapter 3 describes the recent practice of privatization in Indonesia. The discussion in this chapter elucidates the government policy evolution and dynamics concerning the way of government engaging in the SOEs. The chapter also elaborates the strategy of privatization employed by the government of Indonesia given several existing constraints in the country. Then, the rationales toward the employed privatization strategy are also investigated in this chapter.

Chapter 4 presents a set of simple empirical investigations to examine the impact of privatization strategy pursued by the government of Indonesia from a macro point of view. The analyses are done by using some macroeconomic indicators such as capital market development, budget deficit, financial contribution to state budget, and employment analyzed mainly by employing descriptive statistic and qualitative approach. The chapter also investigates the key factors affecting the success or failure of pursued privatization strategy at macroeconomic level.

A conceptual framework explaining how partial privatization can successfully improve the performance of individual privatized SOEs is proposed in Chapter 5. The proposed conceptual framework explains that performance enhancement is still likely to be present if partial privatization can lead to improved monitoring and incentive. The chapter also extends the discussion by identifying some main variables of each determinant to be employed when performing empirical investigation concerning the impact of partial privatization on individual firm performance.

Chapter 6 conducts empirical investigations regarding the impact of partial privatization on the performance of individual privatized firms. The investigations are based on the proposed analytical framework developed in Chapter 5. The performance changes between pre and post privatization are examined by using predetermined methodology. Then, using econometric regression technique completed by a case study, the determining factors of the performance changes of privatized firms are investigated. Chapter 7 concludes the study, providing summary of the research and policy implication of the findings.

Chapter 2

Theoretical Background and Empirical Literature

2.1 Introduction

The involvement of the state in the economy has become one of the primary issues in economics for hundreds of years, dating as far back as human history. The state gets involved in the economy through the establishment of SOEs. The pros and cons of SOEs have drawn interests from numerous scholars in various fields such as politics, economics, public administration and law; also from business and finance. Private ownership and public ownership have changed position as mainstream views throughout the time. In the modern era, triggered by the great economic depression state ownership had widely gained support from the society. Until late 1970s, the view favoring state ownership over private ownership had continued to be a mainstream notion. At the same time, however, many countries became dissatisfied with the real performance of SOEs, which was characterized as poor, ill governed, inefficient, and less transparent in various measures. Thus, efforts toward denationalization/privatization became prominent, although in the middle of fierce opposition.

Although it is widely known that the Thatcher administration have not been the first to initiate a massive privatization program, it is no doubt that it has been the most important event in the history of privatization. Subsequently, there are many countries that have tried to adopt the same policy regardless of the economic development they have been facing. A group of countries realistically implement the policy, taking into account various realities in their localities, while another group of countries adopt the policy as it is without any adjustments. Privatization has been evolving rapidly with many innovations and variations in it. One of major

inventions is partial privatization as opposed to full privatization. Considered as not ideal mode of privatization, partial privatization has attracted little interests so that the studies about it have been limited and incomplete. However, by reviewing the concept of privatization more comprehensively, one might discover useful perspectives as to how partial privatization could be pursued to bring about substantial positive impact on society.

This chapter is aimed to shed light on some underlying concepts of privatization with a view to understanding how various privatization models may work. The argument in this chapter is to emphasize the necessity of effective monitoring and adequate incentive system as the key ingredient of successful enterprises regardless of the ownership regime prevailing. These two most important ingredients of success might stem from two different sources, namely capital-related governance mechanism and product market-related governance mechanism. Using widely-used term, capital -related governance mechanism can be divided into two which are internal governance mechanism and external governance mechanism. It is hypothesized that the success of any firms regardless of the ownership structure would heavily depend on the combination of monitoring and incentives power presented by those three different sources.

It is easy to understand that full privatization is more likely to present more effective monitoring and adequate incentive plan through its desirable ownership structure: simple principal-agent structure in internal governance mechanism as well as the presence of market discipline as external governance mechanism. Despite the mainstream theories views as well as numerous studies that neglect its possible success, partial privatization has potential to enjoin the internal governance (in the form of hierarchical control of government) and external governance (in the form of capital market control) equipped with product market competition to generate aggregate positive effect on the performance of privatized SOEs.

To this end, section 2.2 illustrates the government engagement in the economy through SOEs. In this section the rationales of SOEs' presence in the economy are elaborated. Section 2.3 presents a comparison of the main features between public and private firms while emphasizing the importance of effective monitoring and adequate incentives in affecting the performance of enterprises under two different ownership regimes. The foundation of discussion in this section is based on the concept pertaining to the principal-agent framework, property right theory, public choice theory, and soft budget constraint theory.

Section 2.4 reviews some basic concepts of privatization such as definition, objective, full and partial privatization, some theoretical issue on how privatization can improve firm performance, and also what empirical studies find regarding the impact of privatization on corporate performance. Section 2.5 focuses specifically on the issues of partial privatization such as its rationales, its impacts on firm's performance, and the determining factors of success. Privatization in developing countries is reviewed in Section 2.6.

2.2 Government Engagement in the Economy

The debate regarding the engagement of the state has attracted massive attentions from many scholars in the area of politics and economics for many decades. They have devoted abundant resources to address the fundamental question about what the ideal role of the state should be. With respect to the level of government engagement, three main economic views exist: the Neo Classical, Keynesian and Planned economic. Yet, there is convergence about the basic functions that the state should play. According to some scholars, the states play some primary roles such as making sure the establishment and enforcement of law, guaranteeing public order, and preserving property rights so that the rest of the economic activities can be undertaken properly. In other words, the fundamental roles of the state are to facilitate economic

development and to promote institutional changes. Promoting required institutional novelty is most likely to be realized since the state possesses monopoly power to legitimately use its force in particular region (Webber, 1947).

The Neo Classical economic view, following Adam Smith and his popular book “The Wealth of Nations”, lies on the basic belief that market is capable of regulating itself in attaining and maintaining equilibrium. It has to be left unfettered without any interventions from any other parties especially the government. Market is believed to have an automatic mechanism (an invisible hand) in the form of self interest of each economic player that would adjust automatically any imbalances that occur in the economy. Any types of state interventions should be avoided because it only leads to wasting of resources (deadweight lost). Since the government is not always genuinely benevolent in their interventions, the impact of state interventions may distract the economy from achieving its optimal efficiency. Following the argument of this view, ideally, the role of the state should have been limited only to very fundamental tasks, including guiding against forces or frauds, upholding contracts, and the like.

Different from what is believed by classical economists, Keynesian economics which is based on the idea of John Maynard Keynes, contends that market mechanism does not always work as expected. This is because one or more required preconditions, for example the presence of perfect information, zero transaction cost, complete contract as well as perfect competition, cannot be satisfied (Demirbas and Demirbas, 2011). Moreover, free markets may also cause some externalities such as in the form of inefficiencies and deficiencies to the economy. All of those facts indicate a situation referred to as market failure for which, according to Pigovian’s view, the government should pursue some interventions to correct the failures and abolish the unfavorable externalities. In this respect, Keynesian economists argue that some urgent

government interventions are tolerable and necessary to be practiced. Government may intervene in the economy through several forms of intervention such as monetary, fiscal policy, and direct production of public goods and services. Keynesian economists claim that a mixed economy in which private sectors are dominant but with significant government engagements in the public sector is the most suitable one. Public ownership in SOEs is obviously regarded as a form of government intervention since by doing so the government can influence the economy either directly or indirectly. The Great Depression in 1930s, blamed heavily on market failure, led to the rise of Neo-Keynesian that developed massively with the expansion of public ownership and various forms of government engagement in the 1970s (Demirbas and Demirbas, 2011).

The highest level of government engagement in the economy can be found in planned economic system. In this economic system, all decisions associated with production of goods and services needed are determined by a central government body, embedded in a comprehensive plan (Nove, 1987). The rationale behind this system is that perfect-centralized plan enables the state to grasp the benefits of perfect information in making decisions concerning production and investment in the economy. However, in order to formulate a sophisticated plan preliminary big survey needs to be conducted to acquire needed information about what people need and want. Then, the state also would use its authorities to allocate labor force, to set in motion production processes and facilities, as well as to oversee the distribution of goods and services produced. In this type of economic system, the government or state controls the entire primary segments of the economy and produces all related decisions regarding resource utilizations (Myers, 2004). In doing so, a planned economy may use numerous channels of the economy for instance SOEs, cooperative firms, private firms directed by the government, and alike.

It is not difficult to observe the evidence of the relative success of one economic system compared to the others. Countries with tendency to mixed economic system or capitalism is relatively more successful in fostering development than planned economic systems. In this respect, Shleifer (1998) argues that the relative merit of capitalism compared to socialism lies on the existence of incentive mechanism so that more innovative and efficient products or way of productions can be found. In this respect, incentive mechanism may appear in the form of, among others, the assignment of property right. In fact, merely incentive mechanism may not be enough to promote development. In fact, the role of government to control and monitor the economy is also obviously critical even in the capitalistic country. The recent American economic crisis triggered by subprime mortgage is one of evidences where the government is still needed to monitor and to intervene in the economy. Seemingly, proper mix between monitoring and incentive is the key success of economic development in any countries. Too much incentive and less monitoring may lead to economic crisis, conversely too little incentive and too much monitor may lead to economic stagnation.

2.3 Public Ownership versus Private Ownership

One way to observe the intensity of government engagement in a certain country is through the relations and interactions between the state and its SOEs. SOEs have been playing very critical role in the economic development of countries all over the world. Referring to argument by Megginson (2005), in general at least there are five reasons that encourage the government to engage in the economy through SOEs. They are: 1) as a natural development of feudal power or other old type of societies, 2) as a tool to commercialize a complicated, critical, and costly novel technologies, 3) in order to protect employment or to avail basic important goods and service through nationalizing troubled firms, 4) on ideological grounds, 5) extreme factionalism in

politics. However, as argued by Rondinelli and Iacono (1996), the developing countries have slightly different motives from the developed countries. Pursuing and promoting growth is said as the major reason for governments in developing countries to nurture SOEs. Another major motive is necessity of huge investments in infrastructure development that pushes the government in postcolonial nations in Africa, Asia, as well as Latin America regions to establish SOEs as the vehicle of executing programs. In addition, many SOEs also originated from nationalization of large firms formerly owned by foreigners, specifically colonists. This was regarded as a form of resentment toward a group of people who exploited and grasped the resources of the country. This latter circumstance is also another way of government ownership to grow in developing countries.

The discussion about the superiority of public over private ownership or vice versa has become an endless debate among the economists since the beginning of academic work. Today debate remains as passionate and relevant as it was in the era of Adam Smith. The merit of private ownership is based on welfare economic theorem that argues that equilibrium manifests in terms of Pareto efficiency. However this equilibrium may not be realized unless some rigid underlying assumptions must be satisfied. Those assumptions are zero externalities in production, low information cost, the product is private goods, and the market structure must not be monopolistic. Thus, the failure in meeting one of those assumptions, referred to as market failure, would be enough as a basis for government intervention through SOEs (Megginson, 2005). In this respect, the state plays a role as a “welfare state” in which the intervention of state is intended to rectify market failure (Briggs, 1961).

In recent decades, the government’s engagement through state ownership in the public firms has gained justifications from its proponents through the following rationales. Firstly, it is

considered as a justified way to make sure that each firm sets not only economic goal but also social agenda. According to Yarrow (1986), with the presence of efficient political market, in addition to be able to avoid problem caused by diffused shareholding, public ownership also enables the problem of goal deviation between social and commercial to be tackled immediately. Similarly, Vickers and Yarrow (1988) also argue that rivalry among politicians in a sound political structure would lead to a search of optimum social welfare.

Secondly, public ownership is also said to be the best option for a situation in which natural monopolies exist. In this case the state can increase the output to the optimal level without constraint of profit maximization. According to Sappington and Stiglitz (1987) although public and private share a similarity in terms of constituting considerable delegations, public ownership is said to be able to lessen intervention cost in the economy when market failures are significantly present. Thirdly, public ownership is considered very suitable in the situation in which there are asymmetric information and an incomplete contract between public as the principal and producer as the agent. When asymmetric information prevails, managers of private firms, as more informed agent, will be certainly in favorable position to determine the level of output and price in their favor. Thus, this situation may create regulation for private firm ineffective. In the case of incomplete contract, Shapiro and Willig (1990) argue that public ownership could be more superior than private one if some preconditions such as market failure, asymmetric information, sound political structure, exist. From different angle, public ownership is claimed of having less transaction/management cost than in private one because in the former case there is only single principal, that is the government, to be satisfied by managers in comparison with multiple masters; shareholders and regulatory bodies in the latter case (Laffont and Tirole, 1991).

Despite some differences, public and private enterprises also share commonalities. Of those similarities is what is argued by Stiglitz (1994):

Although the labels “public” and “private” may elicit images of very distinct mode of operation, many similarities exist between the everyday operations of public and private enterprises. Both models involve substantial delegation of responsibility. Neither member of Congress nor shareholder (in large companies with wide diversification of ownership) directly controls the daily activities of an enterprise that is, in principle, under their control. Instead, oversight of the firm’s operation is delegated to a commission or board of director. A chief of director is also endowed with considerable discretion to influence the firm’s operation. There generally follow many additional layers of authority under form of ownership. The hierarchy of authority terminates in both cases with manager who uses their precise knowledge of local condition to make daily decisions that directly affect the firm’s performance (p.172).

The problem begins to arise when the manager as operator (delegation receiver) deviates from what is mandated by the owner (delegation provider). As advocated by agency problem theorists, the problem basically arises from the divergence in objective between the less-informed shareholders (principal) who want to maximize the value of firm and the more well-informed but self-interested managers who are more concerned about their personal benefits such as salary, fringes, perks (Arrow, 1986).

Although the problem is likely to happen in any types of firm regardless of the owner; either private or public, the agency problem in the public enterprises is more severe and, thus, more difficult to be tackled. In comparison with private owned enterprises (POEs), the most apparent distinctions with respect to relationship between managers and their direct principal comes up from the facts that: a) the principals not only seek for profit maximization but also pursue non-economic objectives, b) there is absence of tradable/transferrable stock in the companies, c) there is absence of direct comparison to the bankruptcy threat on poor financial performance (Vickers and Yarrow, 1988). With regard to the structure of principal-agent, public ownership has more complex structure within which multi layers of agency problems are present

(Aharoni, 1982). As shown in Figure 2.1, it involves layers such as between citizen (tax payers) and the government, between the government and the members of BOC, between BOC and BOD. In fact, this is probably the root cause of why the fully state-owned public enterprises typically underperform in comparison with their private rivals.

Adversely complex principle-agent problem in public ownership as illustrated in the figure above poses two major problems causing SOEs to have poorly performed in comparison with their private counterparts. The problems are 1) the absence of effective monitoring and 2) the absence of adequate incentive. The problem of monitoring stems from the owner's (principal) side which is the state, while the problem of incentive arises from the agent's side which is the managers. Addressing these two problems precisely could lead to resolving the agency problem as whole as suggested by numerous studies (Boeker, 1992; Zahra and Pearce, 1989; Zajac and Westphal, 1994; Beatty and Zajac, 1994).

1. The absence of effective monitoring.

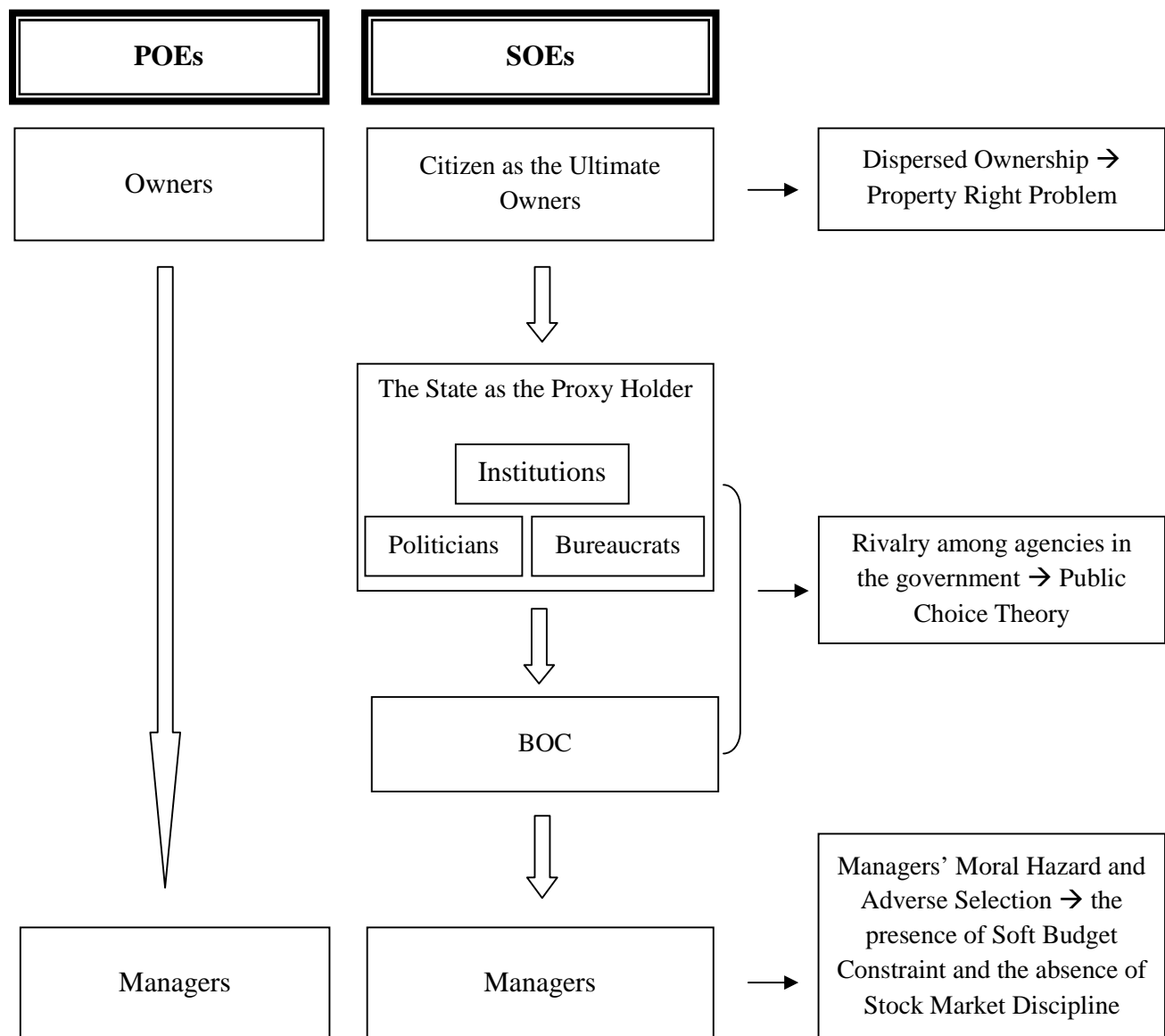
As a consequence of the delegation of responsibility from the state as the owner to the managers as the operator, proper monitoring mechanism is obviously required in order to ensure that the managers execute its responsibility accordingly as mandated. However, it seems to be difficult to be implemented in the context of fully run SOEs. It is caused at least by two issues as follows:

a. Extremely dispersed ownership

The quality of monitoring is closely related to how the right over the property is defined and distributed. With respect to this concern, a basic proposition of property right theory might have explanatory power. According to its advocates, if the right upon particular assets is more straightforward and less attenuated, the assets would be used in better way (Hodge, 2000). This is because, according to Lindblom (1977), "the property is a set of right to control assets".

Consequently, the use of a property would hinge on the power of control over the certain assets. Public ownership is characterized as highly attenuated, diffused, as well as uncertain (Alessi, 1980, Alchian, 1965) which claim to profit is also unclearly defined. In contrast, private ownership has more inducement to profitability and efficiency because the right to residual profit is clearly defined and more certain.

Figure 2. 1 The Comparison of Agency Problem Structure between POEs and SOEs



Source: Constructed by the Author based on several sources

The ownership of fully state-owned enterprises is deemed extremely dispersed because those SOEs basically belong to the people (tax payers). If everyone in the country possesses it, it means no one really owns it. Following the property right theory proposition that better defined property right will lead to better use, dispersed ownership will deprive the intention of assets usage monitor. It is because no single owner has adequate incentive to monitor how the managers behave (Alchian, 1965).

b. Multifaceted and ill-articulated objectives

Private firms are established with single and crystal goal to be achieved which is maximizing the value of the firm. Even when they have social activities such as corporate social responsibility, the program is essentially aimed at achieving the primary goal of maximizing the profit. By contrast, public enterprises have been widely known to have multifaceted and ill defined objectives to be accomplished. Besides seeking profit, SOEs are often required to pursue other non-profit activities and even non-economic activities. It has been a common practices that the government often uses SOEs as vehicle for delivering some government programs which vary from assisting the government for food and fuel security, availing public transportation, providing public health and alike. The objectives become vague and prone to change in accordance with the political climate, causing uncertainty concerning long term strategy (Martin and Parker, 1997). With several multifaceted, ill-articulated objectives set, monitoring would not be easy.

c. The presence of several monitoring bodies with conflicting goals and interests.

As the real owner of the public enterprises which is the citizen (tax payers) has no incentive to monitor the managers, the authority of monitoring then is assumed by the state. Nonetheless, this would lead to creation of another problem. In this regard, a mainstream theory called public

choice theory is fairly useful to describe the problem. According to public choice proponents, such as Buchanan and Tullock, (1962), the state is not always benevolent because the decision making process in the state involves large number of agents with conflicting goals and interests. Those agents are *homo economicus* in the sense that they tend to be self-interest, rational, as well as egoist in pursuing their own preferences and interests. As a result the decisions produced by the government or state are not always in line with general public preferences because those decisions are determined endogenously by many competing forces of diverse existing agents (Demirbas and Demirbas, 2011).

There are potential rivalries between bureaucrats and politicians with regard to what the state should do toward SOEs. Even among bureaucrats, they are divided into several departments and institutions with different objectives. For instance, there are potential contradictory objectives between ministerial bureaucrats and politicians. One of the major bureaucrats' goals is to maximize the budget allocated through the state budget as much as possible. The allocated budget may encompass capital injections, subsidies, and loans for related SOEs but they are proposed by SOEs-associated ministries. The objectives preferred by bureaucrats presumably are not in line with what politicians demand. In order to gain votes from the people, the politicians are more likely to disagree with bureaucrats' proposal. Providing either capital injections or subsidies to SOEs is more likely to reduce budget allocation to other provisions that may impact more positively on society. As an implication, the government may impose more burdens on the taxpayers. From politician's point of view, this circumstance may pose possible threat to their political carrier since people are most likely to shift their vote to other political parties.

With regard to those rivalries between bureaucrats and politicians, even worse among bureaucrats in several ministries, Vickers and Yarrow (1988) identify four potential

suboptimality in the framework of monitoring under public ownership: a) the dislodgment of social aims by political aims, b) a favor of straight political interference in operational decisions rather than arm's length relationship, c) the presence of internal bureaucracies inefficiencies, and d) the magnitude of inefficiency of bureaucratic activity.

d. Information aspect of monitoring

Due to the presence of multi-layers of principle-agent relations in public ownership, there would be more space for "noise" so that information flowing from the ultimate principle (citizens as the ultimate owner) to the last agents which are managers is likely to be distorted. As a consequence, there would be some extent of difficulty for principal to pursue proper monitoring (Smith, 1990, p.55).

In accordance with what Vickers and Yarrow (1988) argue, there is possibility that monitoring under public ownership is less effective in comparison with private ownership due to the quality and quantity of information gathered. Under public ownership the pursuit of oversight task, within which information-gathering role is performed, is typically entrusted to single government body. In contrast, under private ownership numerous individuals and institutions, which are normally specialist in the given job, by and large take part in gathering and examining the information regarding the firm. In addition to the presence of economic of scale in gaining the information, the competition and rivalry among independent monitors is likely to lead to the discovery of larger volume of related information. This would obviously improve the quality of monitoring under private ownership.

2. The absence of adequate incentive.

The ultimate goal of shareholders is to maximize the value of the firm sustainably. Through the process of delegation, the managers are assigned to realize the goal. Effective

monitoring alone is not sufficient to make sure that the delegated goal could be realized. It is also important to have a mechanism in which every achievement is rewarded and every failure is punished. The presence of adequate incentive plan is important. Unfortunately, such sound incentive mechanism is hardly found in the case of SOEs due to several causes, as follows:

a. Soft budget constraint effect

Soft budget constraint (SBC) was coined at the first time by Janos Kornai (1980) to shed analytical light on the relationship between budget provider (state) and budget receivers (in this discussion are SOEs) which is equalized as a caring father and his child, or between patron and clients, or between the insurance company and the insured party. Thus, in brief the SBC syndrome is regarded as the expression of paternalistic role of modern state. To be more specific, SBC is described by Kornai as:

The 'softening' of the budget constraint appears when the strict relationship between expenditure and earning has been relaxed, because excess expenditure and earning will be paid by some other, institution, typically by the state. A further condition of 'softening' is that the decision-maker expects such external financial built into his behavior.

SBC has become very powerful word in expressing some similar actions done by various supporting organizations of budget constraint but with the same spirit of supporting, rescuing, and pursuing bailout to SBC beneficiaries such as ailing firms, mostly SOEs, troubling financial institutions (Tornell, 1999), nonprofit organizations (Duggan, 2000), needy local governments (Wildasin, 1997) or even insolvent countries (Fischer, 1999).

With respect to SOEs, it is widely known that the government often provides various facilities and privileges to them such as in the form of subsidies, tax discounts/exemptions, soft loans, as well as discounted administrative prices. The ultimate impact of SBC syndrome in the firm level is moral hazard and adverse selection of the managers. Moral hazard may arise when

SBC syndrome will cause the managers of public firms become spoiled, dependent, as well as lack of initiatives. SBC syndrome also can cause adverse selection in the sense that managers may choose high risk projects or less profitable one just because they are convinced that loss that may occur will be compensated by the state. In another case, the managers become less sensitive toward business risk. In another word, the manager might have no incentive to enhance profitability and efficiency of the firm because they know that the state would commit to bestow the firm with limitless help in many form of SBC when the firm in financial hardship. Thus, SBC cause any monitoring efforts to have ignorable effect of fear punishment on the manager's behavior (Vickers and Yarrow, 1988).

b. Serving multiple principles with conflicting goals

Besides posing problem in monitoring, the presence of competing overseeing masters also creates problem of incentive. It is as shown by Dixit (1997) that managers of public firms usually have very weak incentive to achieve higher level of efficiency when they have to serve several principles. Compared to the managers of private firms who are required to satisfy single principal, satisfying many competing principles which is likely with multiple interests would present disincentive to the managers to pursue higher level of efficiency.

c. Poor remuneration scheme

SOEs are often considered as part of the government. In some countries, a SOEs employee is treated to have the same status as civil servant although the enterprises are autonomous in their operation. The employee is usually waged with relatively low salary that tends to be fixed and unrelated to the performance of the firms. As a consequence, it is almost impossible for SOEs to attract highly qualified and skillful human resources. The problem is even relatively more severe in the case of developing countries where the shortage of management talent is often experienced

(Coburn and Wortzel, 1986). It has been a common practice that public enterprises are very seldom to have adequate incentive plan. If an incentive arrangement exists, it is hardly based on the performance of the firm. Consequently, it is less likely to expect that the employees would have incentive to improve their performance.

On the other hand, the absence of sound evaluation mechanism might cause a manager even with poor performance less likely to be deposed from his position. It might occur because the appointment of management is often based on political preferences other than using professional considerations and justifications.

According to Hit, et.al, (2005) there are two different governance mechanisms to solve the abovementioned problems, namely internal and external governance mechanism. Internal governance mechanism comprises the creation of sound ownership structure, ideal composition of Board of Commissioners and Board of Directors, as well as structure of manager compensation. In this respect, the government as the only shareholder is the one that can take initiatives. However, common practice shows that the government has failed in delivering its job. In comparison with public ownership, listing private enterprises have another tool to deal with the aforementioned problem, which is through the presence of external governance mechanism. The presence of capital market as external governance mechanism can complement internal monitoring and incentive so that listing private firms are likely to have more proper monitoring and more adequate incentive system.

As documented by Megginson (2005), except under certain circumstances, most numerous academic works generate a convincing conclusion that private ownership is relatively more superior compared to the public one. The researches performed at both country-level (such as Boardman and Vining, 1989; Mamjudar, 1996, Karpoff, 2001; Bartel and Harisson, 2002;

Tian 2003) and industry-level (such as Ehrlich et. al, 1994; Ros, 1999; Laurin and Bosc, 2000; LaPorta et.al, 2002) have come up with the same conclusion. Although some studies, for instance Kole and Mulherin (1997) and Kwoka (2002), do not support the supremacy of private ownership, they also do not favor public ownership either. Thus, the mainstream argument is still undoubtedly strong in favor of private enterprises superiority.

From the discussion in this section, it is obvious that monitoring and incentive are key factors that make private ownership relatively more superior in performance than public firms. With simple principle-agent structure, proper monitoring and adequate incentive are more likely to present in the case of private ownership than in the case of public firms whose very complex structure of principle agent.

2.4 Privatization: Definitions, Objectives, Theoretical and Empirical Evidences

2.4.1 Definitions of Privatization

After the end of the cold war, the march of globalization has been reaching almost all countries throughout the world. Globalization provides both tremendous impacts politically and economically. Politically, many countries that previously followed communism have adopted capitalism gradually or partially. Economically, those communist countries had shifted their economic system from centralized and planned economy paradigm to becoming more decentralized and liberal, by allowing foreign investment, reducing subsidies, and getting rid of most of the trade barriers. With respect to SOEs, the state keep reducing its involvement by implementing several reforms, for instance, abolishing monopoly right which was previously occupied by SOEs through liberalization, minimizing subsidies, streamlining control and monitor procedure, and etc. The ultimate action of government disengagement in running SOEs is by pursuing privatization.

Along with the aforementioned facts, reintroduced in the United Kingdom when Margaret Thatcher was in administration, privatization has been considered a panacea for the public firms with poor performance, ill-governed, lack of efficiency, as well as being less transparent. Since then, privatization has been spreading all over the world and has become a major economic policy not only in developed countries but also in developing countries. Thousands of state-owned enterprises all over the world have been privatized with the great hope of increasing the firm's profit (Kikeri et al, 1992). Due to massive privatization in countries, the contribution of the public sector to total world GDP has notably reduced from around 10 percent in the early 1980s to 6 percent in early 2000s (Megginson and Netter, 2001).

In general, privatization is defined as any actions pursued by the state to allow private parties to take part in the production of goods and services produced previously by the state. In this respect, actions such as public assets sale, deregulation, and liberalization toward certain business sector, contracting out, public private cooperation, subsidies alleviation, etc. (Jackson and Price, 1994) could be deemed as privatization. In other words, privatization has the same way of thinking and the ultimate objective as liberalization. In more specific ways, privatization could be defined as the process of transferring partial or full ownership with or without transferring control of public enterprises to the private players of claim of remaining profit from the operation of the firm (Yarrow, 1986). Almost all of the academic works associated with privatization use the later definition instead of the former one. Unless stated specifically, this thesis also uses narrow definition of privatization to confine the discussion.

2.4.2 Objectives of Privatization

The objectives of privatization may vary from country to country specifically in terms of its priority. Even in the same country, the priority put on the objective may change from time to

time depending on the situation faced in the country. However, generally speaking, there are several common aims of privatization across the globe (Parker and Saal, 2003), summarized as follows:

- a. to improve the performance of privatized SOEs by bolstering the profitability, efficiency, and productivity ;
- b. to create strong financial structure and sound financial management of the divested firms;
- c. to craft a firm with global orientation and high competitiveness;
- d. to reduce fiscal burden on the nation due to huge subsidies given to loss-making public firms;
- e. as a means to raise national revenue in order to finance budget deficit experienced in the country so that the government is expected to have more space and flexibility in their budgetary policy;
- f. to create an industry with a strong and competitive structure;
- g. to increase the private sector ownership in the economy;
- h. to reduce government engagement in the process of making decisions in public firms;
- i. as a tool to redistribute income and wealth;

As to whom the benefits will be, the list of objectives of privatization mentioned above can be classified into two categories: internal and external. Internal objectives refer to the benefits accruing to the privatized firms themselves, while external objectives refer to the benefit of privatization enjoyed by parties outside the divested firms. From the list, internal objective includes the first three objectives discussed above, while the rest constitute external objectives. However, according to Vickers and Yarrow (1991), the poor performance of existing public firm

equipped with the expectation that private ownership will be able to considerably enhance the performance is suspected as the real motive of the government in pursuing privatization program.

2.4.3 Theoretical Arguments on Privatization and the Performance of Firms

After shedding analytical light on the reason why public enterprises usually fall into poorer performance in comparison with their private rivals, most mainstream theories end with a suggestion that privatization especially in the form of full privatization as the panacea for all poor aspects of governance symptoms.

From the perspective of public choice, it is argued that privatization can be the embarkation between politicians and the public enterprises (Shapiro and Willig, 1990). It is also said that privatization could reduce the availability of the information accessed by all involving agents in the decision making within the state (Schmidt; 1990). As a result, the firms become more independent and freer from political noises. At the same time, privatization is believed to be able to provide huge incentives for the economic players, especially in the stock/money market, to search for and examine the accessible and related information affecting the stock price. According to Vickers and Yarrow (1991), the severe implication of political engagement on the incentives of economic as well as on the behavior of economic players also could be trimmed down through privatization. Through divestiture of state ownership, political influence is expected to be replaced by the increased capital market influence though it is not as straightforward as argued.

Based on the agency theory, it is argued that privatization could resolve the agency problem of divested firms mainly through the presence of market discipline in the stock market (Shleifer and Vishny, 1997). It is possible that underperforming managers might be unable to be fired or replaced under the firm internal mechanism due to some reasons. Under the threat of

hostile takeover, the existing shareholders would have incentive to monitor more strictly the performance of the managers. With less satisfactory performance of the current managers, the existing owners might have two options; either deposing the current managers with hope that the new managers could enhance the firm's performance (Aoki, 1983; Leech, 1987) or just sell their stock to other investors with some loss burdened because of the lower price of the stock. In latter case, the new owners are more likely to change the underperforming managers with somebody else considered more capable. In order to avoid this bankruptcy threat there would be stricter monitoring over the managers by the owners. Thus, in any cases, the underperforming managers would be punished so as to they will have an incentive to perform satisfactorily.

Privatization is also considered as a means used by the state to harden the budget constraint toward its SOEs. As described by Grossman and Hart (1986), one of the implications of privatization is ownership transfer from the state to the private owners, either fully or partially. In the case of full privatization, the new owner has full control to reject or accept any assignment given by the state, depending on whether those assignments oppose profit maximization goal or not. Schmidt (1996) gives another perspective by stating that privatization could cause information inside the privatized firms become limitedly accessible to the state. As a result, ex post enforcement of punishment is more likely to be pursued. In addition, external governance in terms of takeover threat brought by privatization, especially if it is through stock market, would be able to discipline managers, and thus, would reduce the level of managers' moral hazard and adverse selection.

Nonetheless, the reality is not always as simple as what theories say. Those arguments abovementioned appear to have some limitations in their applicability. Seemingly, all arguments above are only applicable if the following conditions are met:

Firstly, most studies propose that the privatization pursued should be in full privatization mode in the sense that the privatization is not only transferring the ownership but also relinquishing control over the firm. If the state retains full control over the companies, either by holding more than 50% of remaining shares or by possessing golden share, share with special right to approve or disapprove upon particular issues, the situation might not change significantly. Public choice argument might be only true in the case of absolute privatization, which is the state letting 100% of its ownership to be sold. Political interference carried out by several agents within the government is likely to remain to exist. Even where the state maintains the ownership at very low level of percentage and without possessing a golden share, the political engagements would possibly continue to be rampant, especially if the corporate governance in the system lags behind. Under such situation, rent seeking activities are likely to be adversely pervasive.

Notions advocated by soft budget constraint theorists are also less likely to work in the case of partial privatization. Managers would not have determination to refuse government assignment imposed to avail public goods and service, even if the potential financial loss is visible. Patron-client relationship between the state and the SOEs is too big to be gotten rid of with merely decreased state ownership within the SOEs. As discovered by Lin and Li (2007), in Eastern European countries the SBC syndrome was unable to be eradicated at all; it even apparently increased after the massive privatization was done. According to them, the syndrome of SBC is not necessarily gotten rid of by the presence of private ownership in the firm; it could be aggravated as long as the divested firms are still obliged to execute the policy assignment from the state. It is because the private owner as the new owner of partial or full ownership in privatized firms is more likely to require more subsidies for the same assignment (Lin and Li,

2007). The situation can be worsened if there is increased competition in the market while policy burden remains to be realized (Röller and Zhang; 2005).

The impact of privatization with respect to incentive for monitoring is also not as big as believed by property right theorists. Incentive for the shareholders to monitor depends considerably on the characteristics of capital structure and the composition of shareholders post privatization. If ownership is dominated by individuals and dispersed shareholders, the incentive of monitoring the managers might be insignificantly improved. It could not even be that much different from pre privatization. Likewise, in the case of partial privatization where the state is still majority shareholder and the rest of shareholders are discrete individual investors, incentive to monitor would practically not exist. Hostile takeover threat is also less likely to exist if the government still retains the control and be majority shareholder. Considering the important role of a SOE for the economy, the government might not sell its shares and relinquish the control to private owner though under the threat of huge capital losses.

Secondly, the proposition might work only in a country with well-developed and efficient capital market. The advocates of mainstream theories essentially believe that market in general and capital market in particular is the best option to improve the performance of the firms. Thanks to its ability to present a transparency, capital market is believed by public choice theorist to be able to deter political interference. With its hostile takeover threat, according to the advocates of agency theory, capital market would provide an incentive to the current owner to intensify the monitoring. Similarly, it is also capable to disciplining the inefficient managers' behavior. With the same logic, hardened soft budget is possible to be done through privatization so that managers' moral hazard and adverse selection could be eliminated. However, all of those potential virtues are very less likely to be grasped unless the capital market is well developed and

highly efficient. Only in the highly efficient stock market that all information associated with the firms could be sought, examined, and utilized adequately. In this kind of stock market, stock price of a company could objectively and precisely signal the past, the current, and the future performance of the firm and its manager. The capital market is also described liquid so that the impact of disciplinary action by investor is felt timely without long time lag. Control relinquishment over SOEs by the state as proposed by public choice theorist in the absence of efficient stock market would possibly pose more harmful effect to the performance of the firms.

Thirdly, the notion raised by those mainstream theories seems to prevail specifically in the developed countries. According to public choice advocates, in order to let the market operate efficiently, there should be no government intervention in the economy. Even more, the state is considered as an evil that confines the freedom of the people, hence, it should engage in very limited activities in the society. Streamlining the size of the state (Hayek, 1944), of them is through full privatization, is not advisable in the context of developing countries or transitional economy within which the state plays very immense role in the economy. In addition, hardening budget constraint, even to fully privatized SOEs, is also not simple policy in the developing country where SOEs play enormous role in the economy. As an illustration, letting SOEs employing huge number of workers to be bankrupted would cause vast political, social, and economic costs. Moreover, from macro perspective, according to Vickers and Yarrow (1988) the magnitude impact of takeover threat may vary from country to country because it depends strongly on the precise characteristic of the related stock market, including factors such as the level of shareholder protection given by the regulatory and legal system, the restrictions imposed by competition law as well as the prevailing fiscal system in certain country. Needless to say,

realizing those necessary conditions in order for takeover threat to present in the developing countries is just another big and time consuming plan.

2.4.4 Empirical Evidences on the Impact of Privatization on the Performance of Enterprises

After being implemented, the biggest question which has been addressed by many scholars through tremendous number of studies is what impact brought about by privatization. Privatization has been pursued with overwhelming hope that it can boost the performance of privatized firms. Theoretical and empirical works have been carried out to examine the proposition. Since privatization is not something but big, massive, structured, and interconnected program it surely brings multi dimensional and multi aspects effects to the economy. Hundreds of empirical studies carried out by employing great variety of methodological approaches, covering different countries and different types of economic system, emphasizing many distinctive aspects are aimed at discovering the impact of privatization on customers, employees, shareholders, as well as stakeholders. In line with the concern of this study, the effect of privatization toward the improvement of firms' performance will be the emphasis of the discussion.

The most common way to examine whether privatization brings a positive impact on performance is by comparing pre and post performance of those divested firms. The first study addressing this issue comprehensively is done by Megginson, Nash, and van Randenborgh, MNR, (1994). Examining the impact of privatization on 61 SOEs from 18 nations and 32 sectors, the study documents that privatization significantly increases the performance of divested firms represented in the form of sales, profitability, efficiency, and so on. This study, then, is followed by numerous researches targeted to non transitional economy (including developed and

developing countries) that largely use the same methodological approach. Some subsequent researches couple the MNR approach with some additional techniques such as binominal test and panel data regression. As summarized by Megginson (2005) those studies carry out multinational and multi-industry analysis (Boubakri and Cosset; 1998, 2003, D'Souza and Megginson, 1999; Dewenter and Malatesta, 2000; and Boubakri, Cosset, and Guedhami, 2005) as well as single country or single industry analysis (Verbruge, Megginson, and Owens, 1999; Boardman, Laurin, and Vining, 2003; Omran, 2002; Feng, Sun, and Tong, 2002). Most of the studies consistently show the same findings that privatization is most likely to bring about significantly positive impact on the performance of divested firms'.

In general the finding of those researches that use MNR methodology seems to be very convincing in favoring privatization, yet some scholars suspect that there is bias problem in selecting the sample of the studies. Firstly, it is important to note that those studies confine only privatization done through share issue privatization (SIP) as samples. Consequently, privatizations carried out through other approaches such as strategic sales, Employee Management Buy Out (EMBO), and block sale are excluded from the studies. Secondly, the bias problem may also stem from the tendency of each government in selecting the best performer of SOEs as firms that are going to be privatized. Therefore, it will be unsurprising when the selected SOEs can continue their excellent performance in the post privatization.

Although the majority of the researches have come up with the result which is in favor of privatization, in fact the findings with respect to this issue are far from conclusive. Some studies have ended up with findings that go against the mainstream. As discovered by Frydman et al. (1999), using countries situated in Central Europe as the context, privatization produces no positive effect in the case of privatized SOEs controlled by insider such as manager or employee

and it provides very evident effect in the case of post privatization firms run by outsiders. Furthermore, he also found that the impact of privatization on post privatization performance may result to very different conclusion depending on the measurement of performance used. Furthermore, besides discovering that 69 Egyptian firms divested from 1994 to 1998 experience significant performance change, Omran (2001, 2002) also finds that 54 SOEs that are not privatized also exhibit positive improvement during the post privatization period.

Most seminal works consistently report that there are two key factors reported to have significant contribution to the success of privatization, i.e. (1) the relinquishment of control from the government to the private owner and (2) capital market development. D'Souza, et al (2005) found it in their study over 129 privatizations from 23 developed nations as a sample. The same conclusion is also reported by Boubakri et.al (2005) in their research toward 230 companies from 32 less developed nations as a sample. The same finding was also reported by country specific studies, such as in Malaysia (Sun and Tong, 2002).

2.5 Partial Privatization

2.5.1 Definition of Partial Privatization

With respect to the transfer of control, privatization is widely classified into two different modes; full and partial privatization. Full privatization is defined as selling (transfer) of state ownership followed by the relinquishment of control from government to private owner; while partial privatization is described as selling (transfer) of state ownership without control relinquishment from state to private hand (Gupta; 2005, Bortolotti and Facio, 2004). Control in firm is commonly indicated by the number of shares retained, a party would be considered as control holder if it holds more than 50% of shares. If after privatization state still maintains more than 50% of share, the privatization is classified as partial privatization and vice versa. More

than 50% of total ownership (it could be 50% of total shares + 1share) is widely accepted as a limit for a shareholder to be considered as control holder because by employing the right that attaches in his/her shares he/she could direct the decision of GSM in accordance of his/her interest. In some cases, although the number of remaining share retained by state is less than 50% but if the state holds a share with veto or some other special rights in several crucial issues, privatization is also considered as partial. Nevertheless, apparently there has not been a consensus about the definition of partial privatization. Using several countries characterized as transitional economy, Maw (2002) describes partial privatization in more conservative way, as a situation where state still retains less than 50% of non-controlling ownership stock in denationalized firms. If state sells 100% of its ownership, thus, it would be called as absolute privatization. From different perspective, though it may not be always true, partial privatization is occasionally termed as reluctant privatization because it reflects government hesitance in implementing the policy (Bortolotti and Facio, 2004). In this study, the firstly mentioned definition is considered more appropriate and suitable with the practice in Indonesia.

The distinction toward the mode of privatization is important in relation to the discourse of identifying and curing the root cause of the SOEs poor performance. According to Gupta (2005) there has been two different perspectives pertaining to how SOEs is plagued with poor performance. Political perspective contends that government engagement/interference often diverts the firms from their initial profit-maximizing objective (Shleifer and Vishny; 1994). It is as exactly as raised by public choice theory advocates. Hence, the relinquishment of control of state, and transferring it to private owner is argued as the only way to get rid of the problem. On the other hand, managerial view argues that conflicting objective between principle and agent, as proposed by agency theorist, is the root cause of suboptimal firm' performance. Under public

ownership, there would be no single individual or group of ownership that has both incentive and proper mechanism to watch the performance of running managers. Referring to this problem analysis, full privatization, specifically through capital market, is considered as the most effective way to cure both political and managerial problem. Meanwhile, partial privatization may be able to cure only the managerial problem as concerned by agency theorists.

2.5.2 The Rationales of Pursuing Partial Privatization

Although it might not be considered as ideal mode of privatization, in fact, the number of partial privatization transaction has outnumbered the number of full privatization transactions all over the world. Using 1999 data of share issue privatization from 59 countries, Jones, et. al, reported that around 58.5% of total privatizations were done through partial privatization (less than 50%), 30% of privatizations by selling more than 50%, and the rest were done through selling all of shares. In the same study Jones, et.al also reported some causes of why this phenomenon could occur, especially in the transitional economies. Firstly, in the same industry there are many firms which are potentially privatized so that the success or failure in preceding privatization is likely to spread after privatizations. Thus, partial privatization is considered to be good strategy due to limited available cash and more suitable to moderate the failure risk. Secondly, stock market as one of critical requirements of share issue privatization is typically less developed. Coupled with less accessibility toward foreign capital, both conditions pose considerable constraint for government to generate significant proceed if full privatization carried out. Thirdly, a great deal of uncertainty caused by various aspects may discourage prospective investors to invest. Government has to assure by sharing the risk to induce investors to invest. Lastly, there is a need of political supports from government in privatization process. The presence of the state in the ownership structure may be able to guarantee this need to be met.

Most of the developing countries have a big deal of similarities with transitional economy countries in terms of institutional economic development. Hence, partial privatization is usually adopted by government in transitional and developing countries.

2.5.3 Mainstream Argument pertaining to the Success of Partial Privatization

Theoretically, there is no other way but full privatization, especially through stock market, to be considered as the most effective way of curing the existing problem in public enterprises. It is basically a transfer of control from multi-agents with multifaceted goals to private owners with single concern of profit maximization. It is obviously capable of eliminating all potential problems triggered by political interference. On the other hand, partial privatization is perceived to have a little impact on the performance of newly divested SOEs. Based on what is argued by Boycko et al (1996), agency problem in public enterprises could be decomposed into two kinds; politician-involving agency problem and managers-involving agency problem. Of two, politicians-involving agency problem is considered more harmful in causing inefficiency in the firm. In addition, they also believe that problems caused by managerial discretions are relatively less serious than what is caused by political discretions. In partial privatization, transfer of ownership would not make significant effect if state still holds the control. In other words, partial privatization basically leaves politicians-involving agency problem intact. In fact, it generally doesn't get rid of the main problem of political engagement. Moreover, the capability of partial privatization to deal with another part of agency problem, which is with managers, is considerably subject to the level of takeover threat / market discipline provided by stock market (Gupta, 2005) as the only potential source of performance improvement (Scharfstein; 1988 and Stein; 1988). In this regard, the intensity of market discipline given by stock market considerably

depends on the capital market development (Fama, 1970). Unfortunately, the presence of well-developed capital market is not always the case, especially for most of developing countries.

Empirically, there have been numerous studies revealing the superiority of full privatization over the partial one. While most seminal works, such as Juliet D'Souza, et al, (2005) in the case of developed countries and Boubakri et.al (2005) in the case of developing countries, convincingly show the superiority of full privatization over partial privatization, in contrast, empirical studies concerning partial privatization are very limited and incomplete. Very few studies report the success story of partial privatization throughout the world. Of them, is Gupta (2005) who found that the favorable impact of the partial privatization in India is due mainly to its well established capital market.

Existing literature appears to pay less attention on the possibility of improved performance under partial privatization in developing countries. The potential of enhanced monitoring and rectified incentive as a positive effect of the presence of joint ownership, state and non state ownership, is rather neglected. They seem to overlook the possibility of change in monitoring and incentive pursued by government as a result of privatization.

2.6 Summary

After several decades of enjoying public supports, public ownership has been under fierce criticism due to their poor performance in comparison with private ownership. Complex principle-agent problem is suspected as the root cause of monitoring and incentive problem in public ownership. Using some mainstream theories such as property right theory, public choice theory, soft budget constraints theory as foundation, the problem of poor monitoring is said to arise as a consequence of extreme dispersed ownership structure, multifaceted and ill-articulated objectives, the presence of several monitoring bodies with conflicting goal and interest. On the

other hand, the absence of adequate incentive system is caused by manager moral hazard due to soft budget constraint effect, lack of focus experienced by managers due to the presence of multi masters to be satisfied, and the absence of sound incentive plan.

Unlike in the case of private ownership, the problem of monitoring and incentive plagued public enterprises tend to be more difficult to be solved. It is not only because the absence of internal governance mechanism in form of desirable ownership structure, ideal composition of BOD and BOC, but also lack of external governance mechanism in terms of market discipline that can provide effective monitoring tool for the owners and serve objective incentive for the managers. Hence, all mainstream theories end up with privatization as the main way out.

Theoretical and empirical studies also convincingly support the argument. Privatization evidently brings about positive impact on the performance of divested SOEs. To be successful, however, it is subject to several conditions that might not prevail in all situations. Firstly, privatization pursued should be done in full privatization mode in the sense that the privatization is not only transferring ownership but also relinquishing control over firm from government to private investors. Secondly, the proposition might work only in countries with well-developed and efficient capital market in order to get effective external governance. Thirdly, those mainstream theories seem to prevail specifically in developed countries in which the government is fairly benevolent with well developed economic infrastructure and less tendency of soft budget constraint practices.

In fact, privatization is often pursued in imperfection. Given some barriers in economy, partial privatization in the sense that government retains control in privatized SOEs is pervasive throughout the world. Under partial privatization, government-involving agency problem which is considered more harmful to the performance remains intact in the SOEs operation. It is also

said that the only potential driver for improved performance is capital market as source of external governance. Therefore, partial privatization is often perceived to bring little impact on the performance improvement of divested SOEs. Furthermore, given some financial and political barriers as well as lack of sound plan, partial privatization is more plausible and massive to be implemented in developing countries. Meanwhile, capital market in developing countries is generally characterized as less developed and inefficient so that its disciplinary power is relatively weak. Based on current mainstream argument, it would make the implementation of partial privatization in developing countries become far from success.

Chapter 3

Overview of Privatization in Indonesia

3.1 Introduction

The discussion in the literature review chapter shows that the success of privatization in certain regions depends considerably on certain factors in the country. Indeed, there have been observable differences in the determinants of success factors between developed and developing country (Boubakri, 2005 and D'Souza 2005). It has been emphasized that privatization in developing countries may have specific characteristics due to some existing constraints in the economy. Privatization, in this regard, is a part of grand economic reform so that it should not be separated from political, economic, and social realities prevailing in the implementing country. This chapter aims to provide a brief overview of the privatization policy and its implementation in the Indonesian context. It highlights the unique characteristics of privatization in the country.

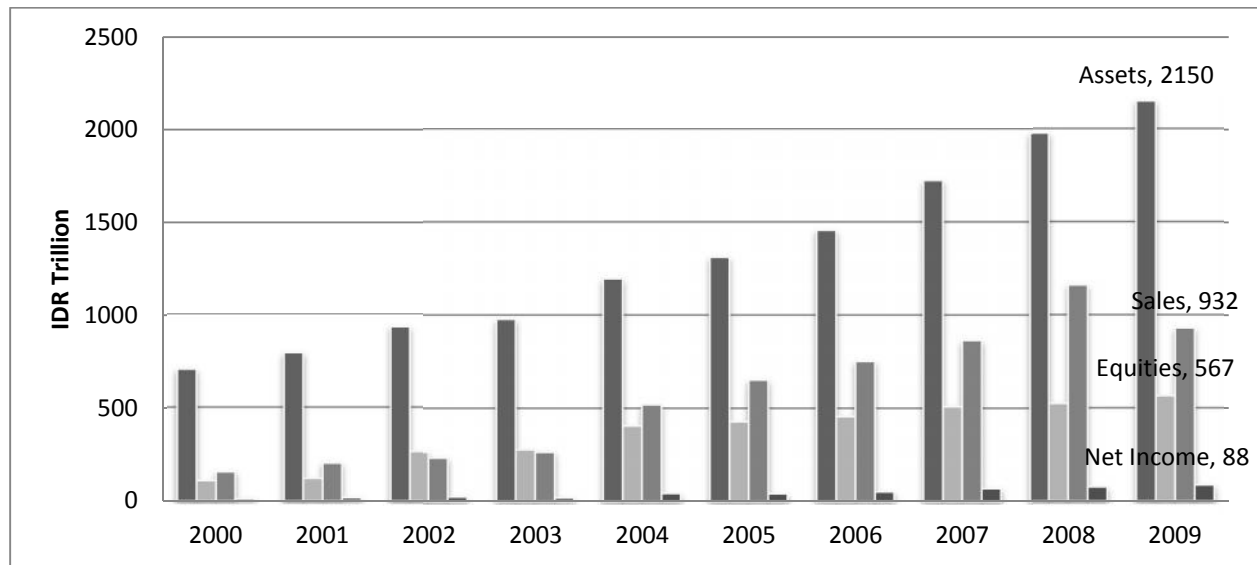
Section 3.2 discusses the Indonesian SOEs with regard to their aggregate performance, number, and types of enterprises. Then, Section 3.3 presents the grand policy of the Indonesian government concerning the operations of the SOEs overtime. Section 3.4 explores the implementation of privatization policy in Indonesia. It includes the basic concepts of privatization in the Indonesian context in terms of definition and objective. It reviews the main characteristics of privatization in the country along the broad typology of selective privatization, gradual privatization, and partial privatization. The rationale of the implementation of such types of privatization is also elaborated. This section ends with a review of the evolution of privatization in the context of the economic crises experienced in Indonesia.

3.2 Overview SOEs in Indonesia

The presence of SOEs has been undeniably important in Indonesian economy. Having existed since the early period of independence and run almost in every sector ranging from banking to insurance, from manufacturing to retail, and from plantation to fishery, and so on, SOEs have been occupying a special position in the heart of Indonesian people. However, having perceived SOEs as ill-governed, less transparent, and inefficient business entities, some people have been unsatisfied with the financial performance of SOEs.

In this respect, Figure 3.1 displays aggregate financial summary of Indonesian SOEs from 2000 to 2009. The table shows that all figures had significantly increased during this period. In 2009, SOEs generated as much as IDR 932 trillion sales or almost six times compared to 2000 sales at IDR 156 trillion. Furthermore, the total net income yielded in 2009 was IDR 88 trillion or increased nearly 700% from the net income in 2000. With regard to total assets, there was also an increase approximately by three folds from IDR 705 trillion in 2000 to more than IDR 2,100 trillion in 2009. However, further inquiry finds that about twenty of the largest SOEs dominantly accounted for more than 90% of total assets, total sales, and total net income. Meanwhile, the rest of the SOEs made up only less than 10% of the total value of the enterprises. This fact demonstrates that Indonesian SOEs have been dominated by less performing-small size SOEs.

Figure 3. 1 Financial Summary of SOEs

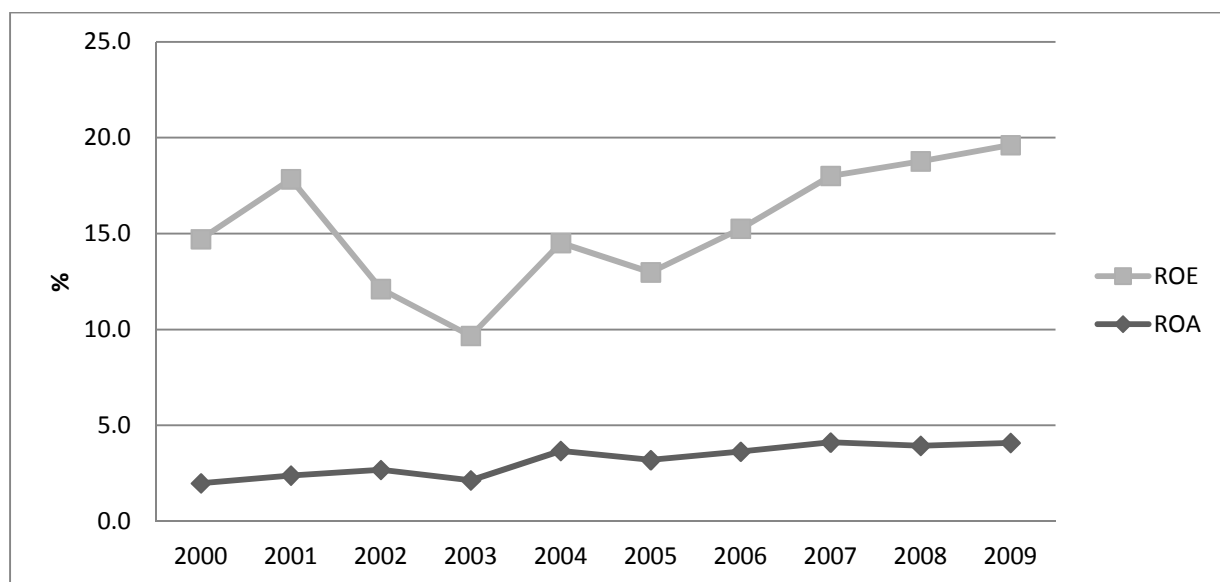


Source: Constructed by the Author based on MSOEs

Having a huge size of total assets (such as more than 40% of total Indonesian GDP in 2009), the SOEs are expected to be able to generate great financial benefit to the society. But this expectation seems not easy to be realized. Using Return on Assets (ROA) and Return on Equity (ROE) as performance measures, some people argue that Indonesian SOEs have lagged behind in excellent performance. Figure 3.2 shows that the ROA (calculated as net income divided by total asset) has never reached a level of 5% during last decade. According to some business practioners quoted by Moeljono (2004), this score is considered very low in comparison with the business benchmark of 20%. Therefore, based on Moeljono's argument, Indonesian SOEs have experienced asset value destruction as much as 15% of total assets every year. This unsatisfactory performance is also noted when examining the performance of SOEs using Return on Equity ratio (calculated as net income divided by total equity value). Although there has been promising increasing trend since 2005, the ROE score has not attained the level of 20% regarded as business average.

Another illustration of the Indonesian SOEs' performance is given by Abeng (1997). In 1993, the total assets of SOEs was IDR 267 trillion, which generated sales at IDR 82 trillion or 32% of total assets. In the same year, there was a private conglomerate firm that possessed IDR 227 trillion total assets and IDR 144 trillion sales. The sales accounted for almost 63% of total assets. Two years later, SOEs's assets increased to IDR 291 trillion and sales raised to IDR 100 trillion or 34% of total assets. On the other hand, the total assets of the private conglomerate went up to IDR 343 trillion, while the sales increased by IDR 150 trillion or approximately 44%. Thus, the performance of SOEs relatively was outperformed by their private counterparts.

Figure3. 2 Aggregate ROA and ROE of Indonesian SOEs



Source: Constructed by the Author based on MSOEs

Nonetheless, it is not always fair to compare SOEs with their private competitors. As widely known that SOEs are usually established with multifaceted aims, not only to pursue profit maximization but also to perform non profit (non economic) activities. In Indonesia, there are three categories of SOEs along the objectives around which each of the enterprises was established as stated in Law Number 19 of 1969. The first category is Company Limited

(Persero) which is established with the pursuit of profit maximization as the main purpose. Under this category there are two subcategories depending on whether they have been going public or not. The second category is Perum (Public Company) established not only to gain profit but also to serve public interest. The government usually assigns certain duties of public interest related to the core business of Perum. The last category is Perjan whose objective is solely to serve public interest with no goal of seeking any profits. However this last type of SOEs is no longer in existence since it was converted into General Service Unit (Badan Layanan Umum/BLU) under associated technical ministries in 2004. In practice, however, the government may assign certain duty of providing public goods and services which are usually less profitable to any SOEs according to their respective business sector regardless of the type of SOE. Consequently, it will affect aggregate performance of SOEs. In 2010, there were 141 SOEs categorized into two types of SOEs as shown in Table 3-3.

Table 3- 1 Type and Number of SOEs

FORM OF SOEs	2002	2004	2006	2008	2010
Company Limited (Persero)	132	131	126	127	125
Listed	8	12	12	14	16
Unlisted	124	119	114	113	109
Public Company (Perum)	11	13	13	14	14
Perjan	15	14	0	0	0
Number of SOEs (ownership > 51%)	158	158	139	141	141

Source: Constructed by the Author based on MSOEs

3.3 Grand Policy of Indonesian Government in Governing SOEs

In order to comprehend privatization as a part of a grand policy in governing SOEs, it is relevant to know the Indonesian government policy toward SOEs overtime. In this respect, the policy can be broadly categorized into three different periods: nationalization, liberalization, and disengagement period. Each period is elaborated in the following passages.

3.3.1 Nationalization Period (1945 - 1965)

This period can be divided into two sub-periods according to the economic system adopted by the government for each sub-period. Although there had been nationalization over colonially--owned firms throughout the period, the rationale of nationalization policy may differ from time to time. In fact, different economic systems may raise different motives behind the action of nationalization.

From the early period of independence in 1945 until 1956 the government had adopted a liberal economic system. During this period, Indonesia attempted to attract foreign investors through several ways. Indonesia was also recorded as a member of the IMF during the period. Concerned with a sluggish economic activity as a result of unstable security situation, and ignited by political rows between the new government and the Dutch, the former colonizer of the country, the government decided to undertake nationalization policy. The first wave of nationalization, which was undertaken in 1950, involved 12 firms including those in transportation and banking industry. Several years later, the West Papua crisis provoked President Soekarno to nationalize dozens of ex-Dutch firms operating in plantation, airline, postal services and telecommunication, insurance, steel, pharmacy, and also the banking sector. This nationalization prompted a colossal exodus of 50,000 managers and businessmen of nationalized companies with most of the valuable assets of the firms to Netherland (Basri and

Munandar, 2009). They had apparently anticipated this policy much earlier, and so they had moved out all production activities of the firms before the policy was implemented and they migrated to their home country. As a result, most of the nationalized firms did not provide economic benefit to the society anymore. This situation was heavily blamed as the primary contributor to the economic crisis experienced by the country subsequently (see details in later sections).

Since 1957, there has been critical change in the politics. The government became highly centralized in the hands of Soekarno as the president. It marked a new era called Guided-Democratic System (Sistem Demokrasi Terpimpin) on the political front, and Guided-Economic System (Sistem Ekonomi Terpimpin) on the economic front. President Soekarno was very dominant not only in the political realm but also in economic sphere. Due to a political row related to the Indonesian territory, President Soekarno was disappointed by the political views of western countries that tended to go against the interest of the Indonesian people. It sparked ill sentiments toward western countries. It was noticeably indicated by the decision taken by the government to quit from the membership of the United Nations and the IMF. At that time, the bond of alignment with socialist countries such as Soviet Union and China became stronger. In the economic sphere, following a new economic jargon called “*stand on our own two feet*” (Berdiri di Atas Kaki Sendiri-Berdikari) introduced by the president, the involvement of foreign firms and foreign investment in the country had begun to reduce, and the government continued to further nationalize existing foreign companies.

Despite disagreement among politicians, specifically between President Soekarno and Vice President Hatta, the largest nationalization policy was carried out coincidentally with the Presidential Decree of July 5, 1959. On this occasion, more or less 600 foreign companies were

nationalized. Among them were 300 plantation companies, 100 mining firms, and the rest were trading, banking, insurance, and construction (Basri and Munandar, 2009). Massive nationalization carried out over former colonially-owned firms had discouraged foreign firms and investors from running businesses in the country. As a result, the economy became closed. This policy also brought another form of harmful consequences. As mentioned earlier most of the nationalized firms were almost valueless since most of the valuable assets and its economic activities were already moved out of the country. The government became responsible to keep the nationalized firms live by subsidizing all operating expenses through the state budget. This led the country to a state of bankruptcy in the middle of 1960 (Mardjana, 1999).

The Guided-Economic System itself was apparently just another name for planned economic system as employed by other socialist countries. It can be seen from the definition given by one of its thinkers. Soerjadi (1965) described Guided-Economic System (Sistem Ekonomi Terpimpin) as the opposite of liberal economy, where all economic activity was planned, initiated, undertaken by the state to overcome all potential economic problems that may arise in the future. The economic policy was formulated centrally by a specific institution called Economy Board under the instruction of Soekarno. Planned and centralized economic policy was not only implemented in the fiscal aspect but also in the monetary policy. Soerjadi (1963) said that banking had to be centralized and had to be in line with national planning, in planning, operating, monitoring, and evaluating. All banking activities, such as pertaining to whom and in which amount the credit/loan could be extended, were under very tight supervision of central bank. During the period, foreign banks were also not allowed to operate.

The new closed and centralized economic paradigm drove the economy into worse economic problems. The level of inflation rose dramatically from 21.5% in 1960 to 660% in

1965. A huge share of national spending was dedicated to financing the government socialist projects in the form of subsidies (subsidies for keeping nationalized firms alive, fuel subsidies that accounted for 20% of state budget, overwhelming commodities subsidies). Unproductively, significant amount of expenditure was also spent to finance superfluous project such as building national sport center, building national monument, and acquiring military equipments. In 1966 total national expenditure was seven fold of national revenue (Prawiro, 1966). Those unbalanced national expenditures led to huge annual deficit. In 1960, the country still gained surplus approximately US \$ 97 million; however in 1965 the government experienced huge deficit of \$ 157 million (Budiman dan Soesatro, 2005).

To resolve severe deficit problem, the government took a shortcut policy by printing new money. Consequently, this policy sharply increased the money supply. As an illustration, in 1960, the amount of money supply was “only” IDR 47 billion which unprecedentedly reached IDR 5.3 trillion in 1966. In addition, the government also financed the deficit by using loan. The composition of outstanding loan in 1965 was US\$ 1.404 million from socialist bloc countries, US \$ 587 million from western countries, and US\$ 102 million from IMF (Siahaan, 1996).

Apparently, during this period, the presence of SOEs as a result of nationalization was intended to play two critical roles, 1) to be the motor of development in the early period of independence, 2) to be a means used by the government to realize planned economy during Guided-Economic System (Sistem Ekonomi Terpimpin). However, to some extent massive nationalization toward former Dutch-owned firms also contributed to the country’s bankruptcy. It caused a big exodus of nationalized firms’ managers followed by the movement of capital and business activities out of the nation. Eventually, it led to a situation in which the government faced the problem of lack of capital, shortage of skillful businessmen, as well as declined

business activities. It also discouraged foreign firms and foreign investors to invest in the country. Furthermore, huge subsidies that the government had to provide to support the operations of nationalized firms also led the country to severe budget deficit.

3.3.2 Liberalization Period (1966 - 1980)

When President Soekarno with his Old Order system collapsed, President Soeharto came to power with a new regime, so called the New Order (Orde Baru)¹ era. The beginning of this new economic era had been marked by the reacceptance of Indonesian's proposal to be a member of the World Bank and International Monetary Fund (IMF) in February 1967. As publicly known, both international organizations have actively promoted free market economy. As a new poor country, the decision to join those organizations was mainly driven by the need of funds to boost the economy. However, the receipt of any assistance from IMF and World Bank was not without conditions.

Shortly after joining IMF and World Bank, the government of Indonesia launched de-concentration, de-bureaucracy, and decentralization (dekonsentrasi, debirokrasi, and desentralisasi) policies. The essence of these policies was to liberalize the economy by providing the private sector more opportunities to play bigger role in the economy. To attract the private sector, procedures were improved to create the necessary conducive environment; and to speed up the decision making process some functions of the central government were delegated to local governments. Furthermore, to attract foreign investors as well as to mobilize capital from abroad,

¹ President Soeharto was the one who coined the term "New Order" in 1966 when he came to power. He used the term to distinguish his administration from the first Indonesian President Soekarno's era that he called as the "Old Order". Recently, the term "New Order" has been identical with the era of Suharto regime, 1965–1998.

the government legislation Law Number 1 of 1967 was amended to Law Number 11 of 1970 for the establishment of foreign direct investment.

Government policy toward SOEs definitely could not be segregated from the macroeconomic policy prevailing in that period of time. While giving more opportunities to private economic players to be more active, the government also attempted to administer SOEs. The government appeared to pursue rightsizing policy by reducing the number of SOEs from 634 SOEs in the early period of Soeharto regime to 233 big but crumbly companies. In 1968 the number of SOEs further shrank to 186 enterprises. Not only reducing the number of SOEs, the government also repositioned them so that they had clear objectives to be achieved. It was also presumably intended to limit the area of SOEs business so that they did not distract or discourage incoming private business players. In regard to this, the government enacted government decree (PERPU) Number 9 of 1969 that classified SOEs into 3 categories in accordance with their economic and social missions as discussed earlier. In addition to avoiding overlaps among SOEs in running the firms, this statute was also aimed at encouraging the private owned firms to take bigger role in the economy.

In order to implement Law Number 9 of 1969 abovementioned, the government enacted President Instruction (Inpres) Number 11 of 1973 that regulated in more detail the way to manage SOEs that was specifically in the form of Company Limited (Persero). According to this decree, technical ministries and MoF would share duties in supervising SOEs so that there would be no overlaps between both ministries. The technical ministries were assigned to monitor and supervise the technical aspects of SOEs whose core business was related to the ministries' responsibility. As such, the Ministry of Transportation was responsible to monitor and supervise technical aspects of SOEs relating to transportation businesses like Perum Damri, Perum PPD,

Garuda Indonesia Airways and so on. On the other hand, MoF was responsible to monitor, supervise, and regulate issues related to financial and administrative aspects. So, the chapter of dual and overlap supervision had just begun.

Because the private businesses had just involved in the economy, State-Owned Enterprises (SOEs) still held the mandate to become backbone of Indonesian economy. Moreover, for any particular business sector that required high capital investment/high entry barriers, and or less profitable, the government decided to establish new public firms to become pioneers in the associated industries. As a consequence, the government had to be responsible to provide help in the form of capital injections, loan, or subsidies to needy SOEs. To stimulate economic development through price stability and low level of inflation, the government also provided some protection and monopoly right to several SOEs. In this period SOEs were still very critical even though they were not the only player in the economy. Despite also causing some negative externalities in the economy, the role of Pertamina could not be trivialized in this period of time.

Having been formally promulgated in 1971, Pertamina had initially been given very important governmental responsibilities only in the oil business (Hertzmark, 2007). Due to a good personal connection, President Soeharto appointed Ibnu Sutowo who firstly introduced a genuine form of contract in the oil industry called the production sharing contract (PSC). In addition to allowing the government to retain ownership structure and machineries used for exploration and production, the scheme also enabled the government to earn 85%-90% of the profit once the company recovered the costs of production. The new contract appeared to be very attractive for foreign firms. Hence, the Indonesian's oil production had reached the peak in 1977 at more than 1.64 million barrel per day (Hertzmark, 2007). Thank to the high oil price during

1970s, Indonesia and Pertamina had experienced a cash flow boom. Following his pro-growth economic policy, President Soeharto seemed to give special mandate with some special discretion for Ibnu Sutowo to utilize abundant cash flow in Pertamina to bankroll national development plan. Consequently, Pertamina began to invest in the unrelated-oil businesses such as oil tankers/shipping, construction, steel, hotel, real estate, automobile, shipping, and others (Schwartz, 1994). An extravagant and aggressive entrepreneurship style of the chairman equipped with endemic collusions and nepotism to President Soeharto's cronies had led Pertamina to imprudent investment decisions. As a result, Pertamina had been in the severe debt trapped and had begun defaulting on some bank loans. The Pertamina's debt was estimated around \$10 billion or equal to 30% of GDP at the time (Mc Donald, 1980) and it was believed that some OPEC members helped to bailed out the firm. That was why probably the Indonesian's official foreign debt doubled in 1975-1976, reflecting the assumption that the government shouldered Pertamina's debts (Hertzmark, 2007).

3.3.3 Disengagement and Privatization Period (1981 – now),

After more than two decades of high government involvement, the governance of SOEs began with the new era, the so-called disengagement period. In this period, the government had provided more opportunities to private sector, at the same time had reduced the direct involvement of the state in the economy, especially through SOEs. This phenomenon appeared to be caused by two reasons: internal factor and external factor.

Internally, during that period of time Indonesia had enjoyed tremendous high economic growth, even some economists predicted that Indonesia would be one of the biggest economic players in the world. The strategy of development implementation, which put emphasis on stability and growth, seemed to be very successful. The achievement might not be isolated from

the success of economic liberalization undertaken by the regime. As a result, during that period private sector had replaced the position of SOEs as the most dominant player in the Indonesian economy. As an illustration, in 1990/1991 the contribution of SOEs was IDR 1,096 trillion or approximately 46% of total non taxes income in the state budget that accounted for IDR 2,383 trillions. The contribution was much higher in comparison with the dividend contribution in 1995/1996 which was although in terms of absolute currency it increased to IDR 1,477 trillion but in terms of percentage it accounted only for 14% of state total non tax income. In other words, the non tax contribution of SOEs had decreased by 32% in five years or 6.4% per year on average. Similarly, the tax contribution of SOEs had decreased by 9.8% in 1995/1996 relative to 41.2% 1990/1991.

Externally, the march to globalization that had been endlessly promoted by Indonesian donors also undeniably played critical role in this regard. Indonesian's dependence on foreign loan had been considerably critical. The average increase of foreign loan from 1984 to 1992 had been more than 22% of national income per year. During that period, foreign debt had been mainly utilized to cover state budget deficit; this was a fundamental aspect of the pro-growth policy strategy pursued by the government. The extent of dependence on foreign debt also can be noticed from state budget expenditures dedicated to repay loans that reached more than 25% of total annual state expenditure. In this respect, the involvement of international organization such as Inter-Governmental Group on Indonesia (IGGI)/ Consultative Group on Indonesia (CGI) could not be ruled out. IGGI is the international organization established to coordinate foreign aid to the government of Indonesia. The organization had consisted of 16 donor countries including United Kingdom, Canada, France, Germany, Italia, Japan, New Zealand, Swiss, Dutch, and USA and had been supported in its program by several international organizations such as

Asia Development Bank (ADB), International Monetary Fund (IMF), UNDP, and World Bank. The organization had actively discussed and stimulated to realize the rehabilitation, stabilization, and development policies of the country (Posthumus, 2006). The name of organization changed to CGI in 1992 after the government of Dutch quitted from the membership due to a political row between the government of Indonesia and a Dutch politician. The mounting trend of debts, however, became catastrophic for the economy following the huge debts accumulation and the attendant debt servicing burden. Some economists contend that during this period Indonesia had been experiencing bubble economy that burst severely in 1997/1998.

Both situations revealed the facts that the level of dependence of the Indonesian economy on SOEs was much less in comparison with the previous periods. This macro condition led to the new paradigm pertaining to the role of SOEs in the economy. The momentum arrived soon as the world economic was facing severe hardship triggered by the end of oil boom era in 1986. This situation compelled the government to adopt tight money policy measures in order to minimize the budget deficit. One of the consequences of this policy was that government had to phase-off or to reduce any form of subsidies, and most subsidies had been poured into the SOEs. As a result, SOEs were unable to rely anymore on the government subsidies. The presence of SOEs had not been as critical as previous era so that it was very possible for other economic players to replace its position as the most dominant economic players.

The rise of private economic players in a poor corporate governance environment somewhat led to worsening rent seeking activities and mounting moral hazard practices. Those phenomena usually occurred when the private economic players wanted to get some business privileges, such as in form of monopoly right or access to cheap credit, by giving some kickbacks or briberies to high-ranked ruling elites. With an elite recommendation, the

conglomerates could get several privileges from associated parties. In this regard, the scandal of Bank Pembangunan Indonesia (Bapindo) corruption could be used as the example. Bapindo, which was the government's development bank, issued letter of credit (LC) for Golden Key, one of top conglomerates running department store business. When Bapindo was subsequently reported for suffering huge business losses, public outcry arose after knowing that the imports never happened but approximately IDR 1.3 trillion of loans were already given. It was an unprecedented circumstance in Indonesian banking industry when many several Bapindo's top officer were finally arrested because of the case (Demmers, et. al, 2004).

At the same time, the success story of the British government under Prime Minister Margaret Thatcher in privatizing its telecommunications firm (British Telecom) in 1984 followed by the Japanese government privatization of Nippon Telephone and Telegraph had inspired other countries throughout the world, including Indonesia, to pursue the same action. These two events began the new era of government engagement toward SOEs.

Following two precedents of privatization that could be considered as a milestone of SOEs governance in Indonesia, systematic and massive effort to reduce the government involvement in SOEs still went ahead. It was Law Number 1 of 1995 (recently the law has been renewed with the Law Number 40 of 2007) regarding company limited that regulated all enterprises in the form of company limited including SOEs that were in the form of Persero. According to this law, the government had to relax its control over SOEs from "control by process" to be "control by result". Under the former mode of control, the government in its position as shareholder had involved in daily controls and supervisions. In subsequent forms of control, the government set certain targets for the managements to achieve in the interest of shareholders. Control was carried out by monitoring the achievement of predetermined targets.

The managements were however given some flexibility in daily operations in attaining the pre-determined targets. By doing so, the level of government engagement was much less than before. However, as mentioned earlier it was applicable only for SOEs that were in the form of company limited (Persero) and not relevant for other forms of SOEs; the Perjan and Perum. In addition, still in the same year, Law Number 8 of 1995 concerning stock exchange was also passed. According to this act, there was no different treatment between listed SOEs and their listed private owned peers. This act implied that the government could not provide privileges to the SOEs anymore; instead they would be treated equally as private firms.

The story of government disengagement still continued. In order to diminish the complexity of government oversight due to the involvement of several ministries, several president decrees for which the main substance was to simplify the supervision and monitoring of SOEs, were passed. Before 1998, there had been several ministries getting involved in monitoring and supervising SOEs. It was stated in Government Decree Number 12 of 1969 that the supervision and monitoring of SOEs had been carried out by MoF along with other related technical ministries. Consequently, there were many SOEs monitored and supervised by more than two related ministries simultaneously. For instance, state enterprises which ran business in transportation industry had been supervised and monitored by the Ministry of Transportation. The pharmaceutical public firms also had to be overseen by the Ministry of Health. Problems may have arisen when a public enterprise had to be under supervision of several related ministries. In many cases there would be complex political interferences because each ministry might have different, even often conflicting, objectives. Besides causing technical oversight problems, this situation was also prone to the presence of overwhelming rent seeking activities pursued by the officers from connected ministries who utilized their positions to gain

personal/group benefits at the expense of the SOEs' performance. This had been presumably one of the main causes of inefficiencies hindering SOEs operations from achieving excellent performance.

Apparently, the existing monitoring and supervision mechanism was also regarded by the IMF that came to help the government out of severe economic crisis hit the country in 1997, as one of the main structural economic problems. Therefore, the government was strongly advised to shift the oversight tasks from multiple competing line ministries to MoF. By enacting Government Regulation Number 12 of 1998, the government shifted the oversight task toward SOEs in form of Persero from multiple technical ministries to MoF alone. Meanwhile, through the enactment of Government Regulation Number 13 of 1998, the government also shifted most of the oversight task toward SOEs Perum to MOF although related ministries was still involved with minor role. At that moment, special unit so-called General Directorate of SOEs Supervision was assigned to take the charge. Those decrees nullified the previous ruling in this regard that was Government Decree Number 12 of 1969.

In addition to improving the way of supervising SOEs, IMF also made privatization over SOEs as one of structural adjustment program that the government had to follow as a return of loan poured. In this regard, IMF recommendation was to pursue fast-massive-full privatization. Having around 160 SOEs, which most of them were ill-operated, required to be privatized in the very limited time given, the government considered to fasten the process of privatization by establishing a separate ministry. Theoretically, the government needed to enhance the performance of SOEs (efficiency, profitability, and productivity) before being privatized. Therefore, through the enactment of Government Decree Number 50 of 1998 the government established a separate ministry with the main mission was to restructure (including to enhance

the firms' performance) and privatize SOEs. Through the same decree the government transferred the role, duty, and authority of MoF as the government proxy holder of general shareholder meeting to MSOEs. However, the decree excluded all matters related to the administration of state capital participation such as capital injection, merger, and acquisition over SOEs. Consequently, the decision of divestiture or privatization would remain in the hand of MoF. Referring to abovementioned explanation, with regard to the issue of privatization, after conducting preliminary analyses MSOEs may have proposed to Privatization Committee in which MOF is present, pertaining to which SOEs to be privatized, what size of ownership to be privatized, and what privatization method to be employed. Final decision, however, will be subject to the joint decision of the privatization committee

Although the change was not as dramatic as in the Persero case, there was also an improvement in the way supervision and monitoring was carried over the Perum. According to previous regulation--the Government Decree Number 3 of 1983 - associated technical ministries played more dominant role than MoF in supervising and monitoring Perum. Since the associated ministries had a regulatory function, this situation might create potential problem with respect to the independence of the associated ministries. That decree was nullified by Government Decree Number 13 of 1998. In this new regulation, MoF had been given authority to formulate the development policy for the Perum operations, then delegate supervision and monitoring to associated ministries.

The ultimate action of government disengagement with regard to public firms is privatization. This will allow firms to be more independent operationally, financially as well as legally. In addition, the presence of non-state shareholders will enable external parties to bring external governance to replace government governance in the company. More detail about

privatization in Indonesia is discussed in the next section. Table 3-2 summarizes the policy of the Indonesian government pursued toward SOEs from the period of Nationalization to the period of Disengagement and Privatization.

Table 3- 2 Milestones of Government Policy in Indonesian SOEs

No	Year	Event
1	1950	Nationalization upon 12 colonizer-owned firms
2	1957	Second nationalization toward colonizer-owned firms that operated in plantation, post, airline, etc
3	1958	The big exodus of managers together with their productive assets to colonizer country
4	1959	The biggest nationalization was carried out toward around 600 foreign-owned enterprises
5	1960	Economic crisis which was partly caused by huge expenditure on state budget to support nationalized firms
6	1967	The re-acknowledgement of Indonesia as the members of IMF and World Bank
7	1967	The enactment of Law Number 1 of 1967 concerning Foreign Investments (UU PMA)
8	1968	The enactment of Law Number 6 of 1968 concerning Domestic Investments (UU PMN)
9	1969	The launch of de-concentration, de-bureaucracy, decentralization policies
11	1969	The enactment of Law Number 9 of 1969 concerning the classification SOEs into 3 categories (Perum, Perjan, and Persero)
12	1969	The enactment of Government Decree (PP) Number 12 of 1969 regarding SOEs in form of Limited Liability (Persero)
14	1973	The enactment of President Instruction (Inpres) Number 11 of 1973 regarding the division of supervision tasks between technical ministry and MoF
15	1983	The enactment of Government Decree Number 3 of 1983 regarding Perjan and Perum
16	1991	The first privatization of PT Semen Gresik
17	1994	The first privatization of PT Indosat
18	1995	The enactment of Law Number 1 of 1995 about Liability Limited Company that also regulated listing SOEs. This statute signified the release of government supervision from “control by process” to “government by result”

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|----|------|--|
| 19 | 1995 | The enactment of Law Number 8 of 1995 regarding Stock Exchange, which also obliged listing SOEs to implement |
| 20 | 1998 | The enactment of Government Regulation (PP) Number 12, 13, 50 of 1998 concerning the transfer of oversight authority from decentralized technical ministries to MoF |
| 21 | 1998 | The enactment of Government Decree Number 50 of 1998 concerning the establishment of MSOEs and the transfer of supervision tasks from MoF to MSOEs |
| 22 | 1999 | The enactment of People Consultative Assembly Decree Number IV/MPR/1999 instructed (1) the governance of SOEs has to be efficient, transparent, and professional (2) the betterment of SOEs that serve public interest (3), the encouragement to SOEs that do not engage in serving public interest to go public |
| 23 | 2003 | The enactment of Law of SOEs Number 19 of 2003 |
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Source: Constructed by the Author based on many sources

Table 3- 3 Period of Government Policy in Governing SOEs

	Nationalization	Liberalization	Disengagement and Privatization	
	1945 - 1965	1966 - 1980	1981 - 1990	1991 - now
Macro Economic Characteristic	<ul style="list-style-type: none"> • Post independent period; • Low economic activities; • Massive Nationalization over valueless enterprises owned by colonist-linked businessmen; • The country quitted from IMF and United Nation • The government undertook planned economy; • Government fully backed up Nationalized firm; • SOEs were almost the only player in the economy; 	<ul style="list-style-type: none"> • The country rejoined IMF and UN, also joined World Bank; • Implementation of De-concentration, de-bureaucracy, and decentralization policy; • Foreign investment liberalization; • SOEs was classified into 3 types; • Most SOEs were non profit oriented; • Private firms started playing role, 	<ul style="list-style-type: none"> • High economic growth; • High dependence on foreign debt; • The end of oil boom; • Government experienced high deficit; • The Government reduced most its financial support to SOEs; • More number of profit oriented SOEs than non profit oriented one; • Private owned firms more dominant in the economy 	<ul style="list-style-type: none"> • First privatization (1991); • Shifting from “control by process” to “control by result”; • Supervision was centralized under MOF; • Oversight of SOEs has been transferred to MSOEs (1998); • Privatization become primary policy
The Extent of government Engagement in SOEs	The Government fully backed up the nationalized firms	The government was highly engaged in both financial and operational aspects	The government reduced its engagements in financial aspects but still highly engaged in operational aspects	The government engagements in both financial and operational aspects have been reduced

Source: constructed by the Author based on various sources

3.4 Privatization in Indonesia

3.4.1 Definition and Objectives

According to Law Number 19 of 2003, privatization is defined as a sale of state shares in company limited SOEs (Persero), partially or fully to other parties aimed at improving the performance and the value of the enterprises, increasing benefits for the state and society, as well as broadening share ownership by society. Meanwhile, the objectives of privatization are stated in verse 74 of the Law as follows:

- a. to enlarge the ownership over SOEs to the society;
- b. to enhance the efficiency and productivity of the public firms;
- c. to create a sound financial and managerial structure of the firms;
- d. to build a healthy and competitive industrial structure;
- e. to nurture competitive and global-oriented firms;
- f. to grow sound business climate/environment, conducive macroeconomic, and the capital market capacity.

Interestingly, this act does not explicitly mention raising national revenue to finance budget deficit as one of the privatization objectives. In fact, this objective may be one of the short term objectives that the government wants to achieve through privatization. It is discussed in more detail in the next sections below. To ensure that the objectives can be accomplished, it is also stated that privatization should be carried out by taking into account some important principles such as transparency, independence, accountability, responsibility, and fairness.

3.4.2 The Realization of Privatization in Indonesia

Since it has been carried out in 1991 along with industrial and firm restructuring, privatization has become a part of major policies of SOEs in Indonesia. SOEs from various competitive industries, for instance telecommunication, banking, construction, mining, and pharmacy, have been privatized.

According to their original ownership structure, privatized firms can be grouped into four different types, namely: SOE, subsidiaries of SOEs, temporary SOEs, and minority SOEs. As defined in Law of SOE (Law Number 19 of 2003), SOEs refer to the enterprises with most of or its entire shares owned by the state. In this regard, the state acts as majority (more than 50%) or the only shareholder in the enterprises. By contrast, minority SOEs are firms in which the state holds less than 50% of ownership. Meanwhile, temporary SOE refers to ailing private firms bailed out by the state so that it would temporarily become SOE until re-divested by the government. In this dissertation, only temporary SOEs managed and administered by MSOEs are included in the discussion. Lastly, in some cases, instead of selling its direct ownership in SOEs, the government may pursue privatization by selling shares of firms which are mostly or fully owned by SOE. Literally, all transactions of selling state ownership in one of these types of firms could be considered as privatization. However, this study focuses more on partial privatization of SOEs.

The list of all firms privatized during 1991-2011 is presented in Table 3-4 below:

Table 3- 4 List of SOEs privatized from 1991 - 2011

No	SOE	Sectors	Year of Privatization and Share Sold	Residual State Shares	Type of Firm
1	PT Semen Gresik	Cement	1991 (25%), 1998 (14%)	51.0%	SOE
2	PT Indosat	Telecommunication	1994 (35%), 2002 (8.06%), 2002 (41.94%)	15.0%	SOE
3	PT Tambang Timah	Mining	1995 (35%)	65.0%	SOE
4	PT Telekomunikasi Indonesia	Telecommunication	1995 (23%), 1999 (9.62%), 2001 (11.9%), 2002 (3.1%)	51.2%	SOE
5	PT BNI	Banking	1996 (25%), 2007 (26.3%), 2010 (3.1%)	60.0%	SOE
6	PT Aneka Tambang	Mining	1997 (35%)	65.0%	SOE
7	PT Indofood	Manufacturing	1999 (n.a)	0.0%	Temporary SOE
8	PT JICT	Seaport	1999 (49%)	51%	Subsidiary of SOE
9	PT TPS	Seaport	1999 (51%)	49%	Subsidiary of SOE
10	PT Kimia Farma	Pharmacy	2001 (9.2%)	90.8%	SOE
11	PT Indofarma	Pharmacy	2001 (19.8%)	80.2%	SOE
12	PT Socfindo	Plantation	2001 (30%)	10%	Minority SOE
13	PT TABA	Mining	2002 (16.26%), 2004 (12.5%)	65.0%	SOE
14	PT WNI	Hotel	2002 (41.9)	0	Minority SOE
15	PT Bank Mandiri	Banking	2003 (20%), 2004 (10%),	60.0%	SOE

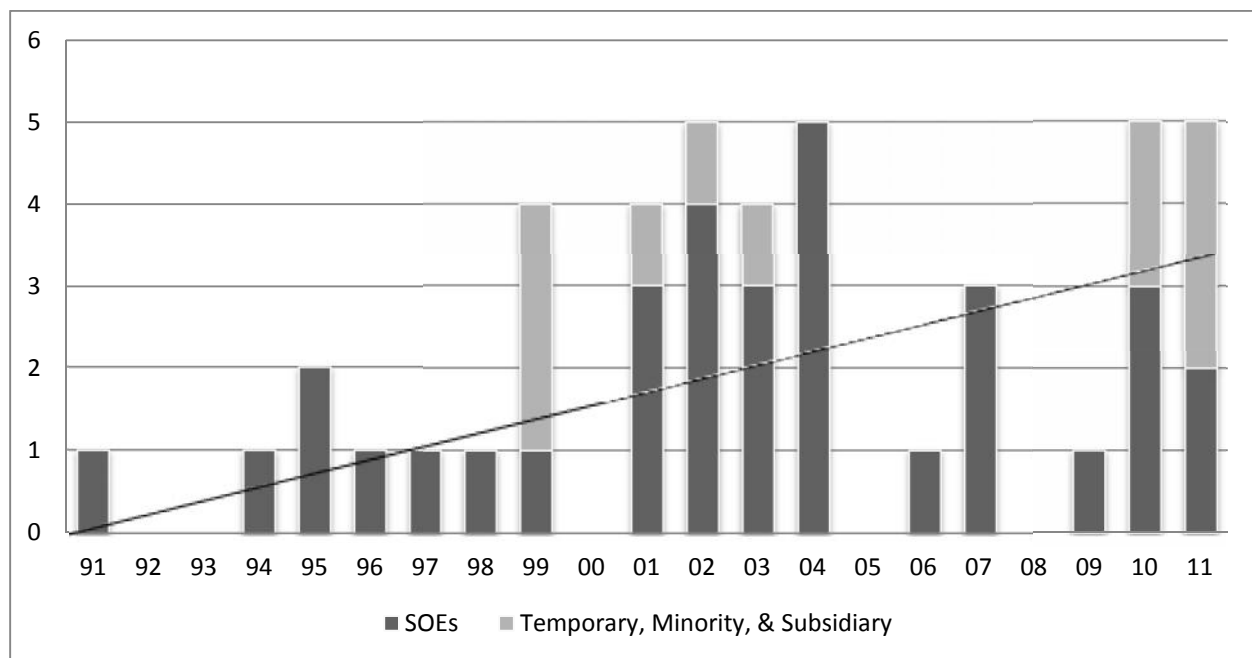
			2011(10%)		
16	PT BRI	Banking	2003 (45%)	55.0%	SOE
17	PT PGN	Mining	2003 (39%), 2006 (5.31%)	55.3%	SOE
18	PT Indocement TP	Cement	2003 (16.67)	0	Minority SOE
19	PT PP	Construction	2004 (49%), 2010 (21.46%)	51.0%	SOE
20	PT Adhi Karya	Construction	2004 (49%)	51.0%	SOE
21	PT Jasa Marga	Service	2007 (30%)	70.0%	SOE
22	PT Wijaya Karya	Construction	2007 (31.7%)	68.3%	SOE
23	PT BTN	Banking	2009 (27.08%)	72.92%	SOE
24	PT Krakatau Steel	Steel Manufacturing	2010 (20%)	80%	SOE
25	PT Kertas Blabak	Paper Manufacturing	2011 (0.84%)	0%	Minority
26	PT Intirub	Rubber Manufacturing	2011 (9.99%)	0%	Minority
27	PT Garuda Indonesia	Airline	2011 (26.67%)	73.33%	SOE
28	PT Kertas Basuki Rahmat	Paper Manufacturing	2011 (0.38%)	0%	Minority
29	PT Atmindo	Construction	2011 (36.65%)	0%	Minority
30	PT JIHD	Hotel	2011 (1.33%)	0%	Minority

Note: the sale of assets of temporary SOEs administered and managed by Indonesian Bank Restructuring Agency (IBRA) are excluded from the list as those proceeds are not recorded as privatization receipt in the state budget

Source: constructor by the Author based on MSOEs

Figure 3.3 depicts the number of firms privatized during 1991 - 2011, while Figure 3.4 shows the revenue generated from privatization during the same period of time. In general, there is increasing trends in both number of SOEs privatized and privatization proceeds produced. Nonetheless, there have been several years in which no single privatization transaction occurred. It could be because of either no plan of privatization set or there has been plan but no realization due to many hindrances stemming from prospective divested SOEs or non-conducive macroeconomic environment relating to politics, the overall economy, and social barriers.

Figure 3. 3 Numbers of Privatized Firms 1991 – 2011

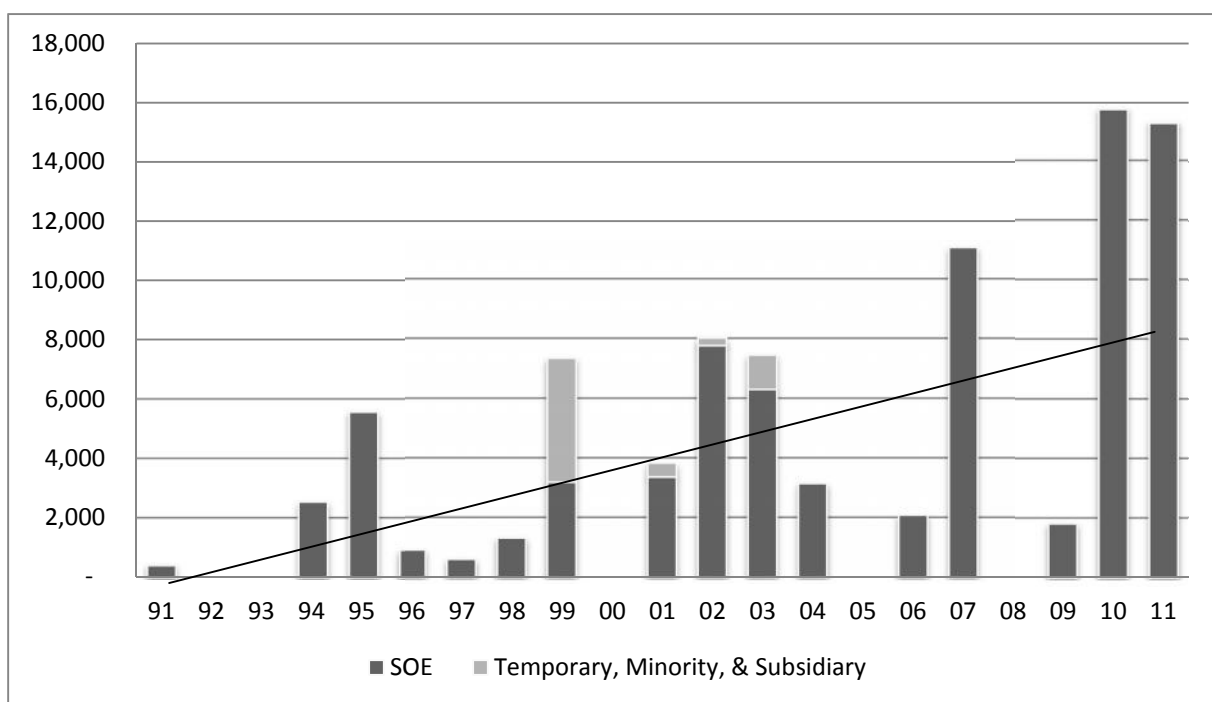


Source: constructed by the Author based on MSOEs

As demonstrated in Figure 3.3, there were significant numbers of firms divested during 1999-2003 compared to other time period. It is widely understood that during that period of time, Indonesia had been facing a severe financial, economic, and political crisis- hereafter called the

Crisis². The government not only privatized SOEs but also subsidiaries of SOEs, temporary SOEs, and minority SOEs at that moment. The figure also reveals that the government had also privatized minority SOEs recently, during 2010-2011. Seemingly, there is new government policy to privatize non-strategic minority SOEs. Besides promising economic situation, the absence of strong political and social resistance allows the government to pursue rather extensive privatization. Despite substantial number of firms privatized, the proceeds generated from privatization of Non SOE (temporary, minority, and subsidiary SOEs) have been very marginal as shown in Figure 3.4. The rest of the discussion in this study will focus on the privatization over genuine SOE.

Figure 3. 4 The Proceeds of Privatization 1991 – 2011 (IDR Billion)



Source: constructed by the Author based on MSOEs

² Otherwise it is specified, the word “the Crisis” refers to the financial, economic, and political crisis in Indonesia during the period of 1997-1998.

3.4.3 The Period of Privatization

As discussed in earlier sections, privatization in developing countries is often a part of grand economic policy reform, so-called structural adjustment program. Therefore, privatization cannot be segregated from ongoing economic situation. In fact, current economic situation faced by government becomes primary consideration in implementing the policy of privatization. In this regard, by using the Crisis as a landmark, privatization in Indonesia can be classified into three periods as follows: (1) pre the Crisis, (2) during the Crisis, and (3) post the Crisis. As will be shown in more details later, this periodization is very useful to know the general characteristics of privatization in each period

3.4.3.1 Pre the Crisis Privatization (1991-1997)

The end of the oil boom in 1980s caused economic hardships in many countries, especially oil producers. Indonesia, as one of the main oil exporters in the world faced severe state budget deficit due to decreased revenue from oil exports. To minimize the detrimental effects, the government tried to lessen or to omit completely any subsidies on budget spending. At that moment, most subsidies were allocated to SOEs which were assigned to execute government programs. Capital injections meant to rescue ailing SOEs were also sharply reduced.

Actually, it was not the first time to see the country having budget deficit problem. In most previous decades, the government used loans from foreign creditors/organizations for whatever amount needed to finance the deficit so that it became balanced. Therefore, it was called balanced budget policy. As time went on, the amount of accumulated outstanding loans became tremendously huge so that it might preclude the government from getting more loans. The debilitating impact of the economic turmoil harmed not only the ailing SOEs but also those which were needed to finance their expansion plan. During the oil boom, it was not a big issue

for the government to allocate needed funds. This became nearly impossible overtime. Concurrently, the success story of the British government under Prime Minister Margaret Thatcher in privatizing its telecommunication firm (British Telecom) in 1984 followed by Japan's privatization of the Nippon Telephone and Telegraph had inspired other countries throughout the world, including Indonesia, to pursue the same policy, either to obtain revenues for financing deficit or to obtain required additional capital.

In 1991, the first privatization was carried out toward the PT Semen Gresik, a cement manufacturer. The government released 25.00% of its share through initial public offering (IPO). That privatization was a noticeable landmark of SOEs governance in Indonesian since the independence. It should have required very much effort to pursue something unpopular that broke the perception of the people. However, under Soeharto's dictatorship and very stable economic situation, at least on the surface, there were no considerable public resistances against the decision. Such less noisy reaction gave the government a confidence to go with other privatization plans in the following years.

During 1991-1997 there were 6 SOEs privatized, namely PT Semen Gresik, PT Indosat, PT Tambang Timah, PT Telkom, PT BNI, and PT Aneka Tambang. Interestingly, all privatizations at this time were accomplished by employing IPO as the mode of privatization. The most plausible reason is that the stock market was in bullish at that moment, in which the investors especially from abroad were very active in finding investment opportunities. It prevailed not only in the domestic market but also in the global market. The first two privatizations toward PT Semen Gresik (1991) and PT Indosat (1994) demonstrated this fact. There were oversubscriptions from foreign investors over the offering of the SOEs' stock. Specifically, in PT Indosat case where privatization was pursued through dual listing in Jakarta

Stock Exchange and New York Stock Exchange, there were oversubscriptions for almost 500% in Asia market and approximately 175% (around 140 million shares) in the domestic market.

Another common feature of privatizations carried out in this period is that all SOEs, but PT BNI and PT Aneka Tambang that only offered new shares, sold both existing state's shares and newly issued shares on the IPO. It represented the hybrid objectives of privatization, which were to meet the need of the state for cutting budget deficit and to satisfy the need of the firms themselves for getting additional capital. There was a consensus that the receipt from selling existing state shares will be devoted to the former objective, while the receipt from selling newly-issued share will be allocated for the latter one. Figure 3.5 shows that the proportion of privatization proceeds devoted to the government part and to the companies was moderately the same or fifty-fifty. From this fact, it can be concluded that privatization undertaken in pre the Crisis period was driven by both state budget motive and SOEs' productive-efficiency motive.

3.4.3.2 Privatization during the Crisis (1998-2006)

It has been in the public's memory that a great economic crisis hit the Indonesian economy in the middle of 1997. It was initially ignited by drastic decreases in the value of Rupiah currency against the value of dollar that reached almost 200% relative to pre crisis exchange rate. Such sharp currency depreciation led to worse economic situation in all aspects including drastic decline in people's purchasing power, increased production costs, huge increased payment of foreign loans, soared inflation rates, and a huge dive in stock price index. These economic chronicles generated huge bankruptcy threats to most enterprises that ended up in high unemployment rates. On the government side, decreased national revenues caused by decreased tax revenue, export receipts, and costly import spending undermined government's ability to finance planned national development expenditures. Consequently, it compelled the government

to reconsider the spending priorities. Various government subsidies for public basic needs had to be cut down. Budget spending even became larger when the government decided to rescue banking and financial industry by pouring huge liquidity funds into the troubling banks. This compounded situation led to enormous government budget deficit.

In order to avoid economic bankruptcy, Indonesian government had no choice except to seek help from the International Monetary Fund (IMF) and the World Bank. As a consequence, Indonesia had to adopt several structural adjustment programs required by both international creditors. The program was basically a multifaceted and comprehensive economic reforms packet with predetermined target date to follow. In response to the directives given by IMF, the government presented a list of policy actions including the target dates of each action as the implementation of IMF recommendations. Those commitments and their implementation updates had been regularly reported through the several letters of intent (LOI) and Memorandum of Finance and Economic Policy throughout the term of loan agreement. Of policy actions related to SOEs were to establish a clear framework of SOE reform, to move the oversight of public enterprises to MOF and establish a privatization board, to prepare an action plan for public enterprises, to set and to realize a privatization plan in the short term.

Shortly after the agreement between the government and IMF was signed, the Master Plan of SOEs over five-year term was taken on and publicly released. In addition to mainly presenting a guideline for restructuring and privatization of all SOEs, the Master Plan also gave a brief elaboration about the regulatory framework especially in the critical privatized sectors. With the exception of a specified short list, the document calls for all of the 164 SOEs to be privatized over the medium term. Giving priority on construction and civil engineering firms, hotels, mining, trading, and fertilizer manufacturers, list of enterprises to be divested during

1999-2001 were incorporated in the plan. In the meantime, the efficiency of firms was expected to be enhanced through allowing larger management autonomy, promoting competition, hardening budget constraints, and removing favored access to bank credit gradually. Interestingly, state enterprises planned to be restructured throughout the period for later privatization included the state electricity corporation and the national airline.

Apparently, IMF required the government to pursue fast-massive-full privatization. It was considered fast privatization because it optimistically targeted more than 160 enterprises to be restructured and divested later within a medium term. Excluding highly specified SOEs, privatization was targeted to almost all of SOEs; even it would include the electricity firm which was granted with monopoly right because it was considered critically affect the life of the people according to the constitution. Hence, it was considered as massive privatization program. Moreover, IMF also required that public enterprises had to be fully privatized by transferring both ownership and control to private owner at the same time. In respond to this, as stated in Memorandum of Economic and Financial Policies dated January 15, 1998, the government committed to accelerate privatization program after the oversight task was shifted from line ministry to MOF and Privatization Board was instituted. To realize this, the government established a clear framework in which includes setting criteria which public enterprises should be 1) closed, 2) restructured, and 3) fully privatized. Full privatization was also intended to be implemented for 12 privatized in the first year of the program.

From the fiscal perspective, privatization public enterprise was considered as the most feasible way to overcome ongoing severe budget deficit problem. Several possible reasons are relevant to the discussion. First of all, as mentioned above privatization was one of the conditions required by IMF as the last resort lender, to pour a liquidity loan needed to help the

country out of crisis. Secondly, being confronted with extremely high domestic interest rate as a consequence of tight monetary policy imposed during the crisis, the government was highly unlikely to obtain loan from the domestic creditors. Thirdly, in comparison with increasing tax revenues, privatization was much more feasible both economically and politically. Economically, during the Crisis individuals and firms were facing seriously harmful economic situation such as low purchasing power (either due to high inflation or high unemployment), sharp decreased demand, increased cost of production, and unfavorable exchange rate. Consequently, it was not advisable to raise taxes from both individuals and enterprises. Politically, increasing tax was much more risky in comparison with raising revenue by selling state stocks (privatization). Although pursuing privatization also had a potential political problem, the scope of potential impact was narrower and more segmented than that of increasing tax.

The Crisis seemed to be primary driver of privatization in this period. Therefore, the main objective of privatization in this period was to raise revenue to finance budget deficits. To meet the objective, the government included not only the first time privatizations but also several subsequent privatizations. In the short run, the government of Indonesia had a target to gain as much as US\$ 1.5 billion (equal to IDR 15 trillion) at the end of March 1999. During that period of time 12 SOEs, which consisted of 5 SOEs previously privatized and the rest was 7 un-privatized firms, were expected to be privatized. Given very short time and unfavorable economic situations with so many SOEs to be privatized, it was considered as a mission impossible. However, despite the impossibility, IMF insisted the Indonesian government should undertake the program. Therefore, some people criticized that IMF was not genuinely helping the Indonesian economy to be back on track. Instead, IMF was deemed to be pursuing its own agenda of liberalization by forcing the government to do a big sale over its SOEs in unfavorable

economic environment. Due to unstable political and economic situation, however, the target eventually could not be achieved successfully. Within the timeframe advised by the IMF the government had only succeeded to privatize 4 SOEs (of 12) in addition to bailed out firm, PT Indofood, with total privatization receipt of US\$ 1.03 billion (equal to IDR 8.6 trillion). There was a shortfall of about IDR 6.4 trillion.

There was a clear pattern with regard to the method of privatization employed. The government used different methods for different types of privatization. As employed in previous period, initial public offering (IPO) was used for the first time privatizations. Meanwhile, in the case of subsequent privatizations, the government mostly employed strategic sale or private placement.

In this study, we extend the period of privatization during crisis not only covering 1998-1999 but also until 2006. We have identified that privatizations carried out during 1998-2006 had some common features. Firstly, there was the dominant involvement of IMF in pursuing this program. IMF intensively advised, supervised, and monitored privatization since the Memorandum of Finance and Economic Policy in 1998 until the settlement of Indonesian loan to IMF in 2006. Secondly, privatization during the period was driven by state budget deficit caused by the Crisis; as a result the number of SOEs planned to be privatized as well as the proceeds targeted to be earned in any year mostly depended on the size of deficit that had to be covered. Therefore, the main proportion of the privatization revenues went to the government rather than to the privatized enterprises themselves. As depicted in Figure 3.6 on average more than 96% of privatization proceeds were enjoyed by the government, while very small portion of it went to the divested firms.

Interestingly, massive-fast-and full privatization as recommended by IMF and World Bank could not be realized until the loan agreement ended in 2006. Until the government settled its entire obligation of loan payment, only 25 transactions of privatization (over 15 firms) had been successfully realized, or on average 3 privatization transactions per year. It was undoubtedly very slow and very few compared to the target. Furthermore, among privatized SOEs only one that was fully divested in the sense that the state held less than 50% of shares. It was definitely far below the target. Potential strong political opposition and social unrest from the stakeholders in the middle of unstable transition period (from New Order regime to Reform Regime³) seemed to have forced the government to reconsider its privatization strategy. This was probably already realized by the government from the very beginning. However, severe economic crisis provided the government no other choice except to accept the conditions given by IMF either sincerely or insincerely. Eventually, the government ended up with shifting its commitment of implementing fast-massive-full privatization, which was almost impossible to be realized, back to the genuine strategy of selective-gradual-partial privatization.

With regard to regulation, privatization carried out after the Crisis burst has gained very strong legal basis, especially after the house of representative legalizing Law Number 19 of 2003 concerning SOEs. In order to implement aforementioned act some regulations have also been produced as detailed guidance. Of them, the Government Decree Number 33 of 2005 (revised with the government decree Number 59 of 2009) stipulates detailed procedures of privatization that had to be followed. Furthermore, a special unit called Privatization Committee which was responsible for formulating privatization strategy, setting necessary actions to realize

³ The term Reform (Reformasi in Bahasa) refers to the period of transition after the collapse of President Soeharto regime in 1998. The period was characterized with the presence of more freedom of speech and expression and liberal socio-political environment after three decades under the authoritarian of New Order regime.

privatization, and proposing solution over potential privatization problem was also required to be formed.

3.4.3.3 Post the Crisis Privatization (2006-now)

After suffering severely because of the Crisis, the Indonesian economy did not take much time to recover. After experiencing 13% negative growth in 1997, the economy had achieved positive growth, although very small in figure, which was only 0.8% in 1998. The economy had constantly grown at more than 5% average annual growth from 2000 to 2006. This favorable situation led to substantial surplus in the balance of payment and increased national reserves. Eventually, on October 12, 2006, the Bank of Indonesia on behalf of the government of Indonesia settled all outstanding loans to IMF under Extended Fund Facility (EFF) as much as US\$ 3.1 trillion. This outstanding loan was supposed to be paid back completely at the end of 2010 or around 4 years later than the settlement date. Those facts simply indicated that the Indonesian economy had been fully recovering.

Furthermore, the loan settlement marked a new era of Indonesian economic development. It was no longer dependent on IMF after under very tight surveillance from it since 1997. As a result, commitment of the government over structural adjustment program and economic reform required by IMF by de facto also ended. There was no longer obligation for the government to stick with the previous commitment. Also, this recent circumstance enabled the government to implement policy concerning SOEs reform program more independently. However, the privatization program, in fact, still continued as one of primary reforms. In spite of lack of clear annual trend, privatization carried out after the Crisis has involved more SOEs and has yielded greater receipts in comparison with previous periods.

Nevertheless, the realization of privatization during this period was still much less than what it was planned. For example, in 2008 there was a big privatization plan of 44 SOEs, consisting of 34 SOEs new proposal and 10 SOEs carried over from 2007. In fact, there was no single SOE successfully privatized in that year due mainly to political considerations. It was apparent that 2008, a year before the general election, was considered as improper time for such massive privatization to be pursued. Since privatization was politically sensitive and unpopular, it could tarnish the image of the ruling party and its supporters. Another possible factor, from 2000 to 2001 there were three times changes related to the presence/function of MSOEs as the oversight body. Consequently, there was also a change in the structure of authority that was responsible to supervise SOEs. After being established at the end of President Soeharto administration in 1998, the MSOEs whose main duty was to supervise and monitor SOEs had ever been dismissed by the end of 2000. One year later the ministry was reestablished. These several strategic changes in the very short time simply exhibited that there was no clear and firmed policy governing SOEs.

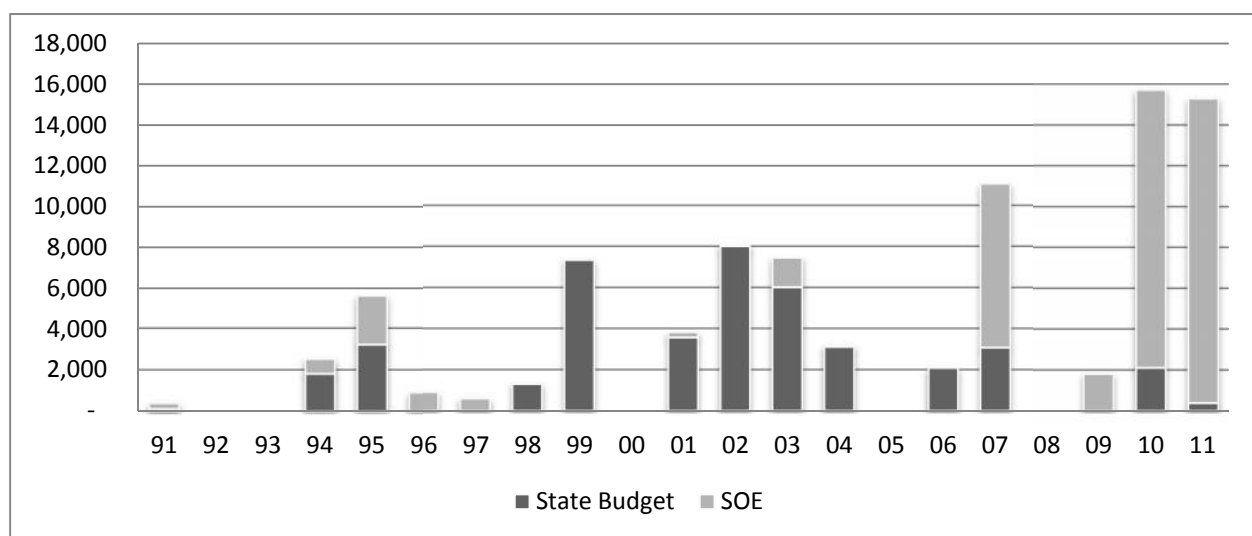
Besides SOEs, during this period, actually the government also planned to privatize dozens of minority SOEs. It differed from previous period that only focused on SOEs. Some almost bankrupt SOEs were also scheduled to be divested. One of the main reasons for doing so was to reduce state burden of bailing out the firms. Eventually, some of firms were privatized recently during 2010-2011.

In line with the completeness to debt payment to IMF, the receipt of post crisis privatization was not devoted to addressing the budget deficit problem. Therefore, the government has had more flexibility in terms of target, methods as well as time frame. With regard to the utilization of the privatization receipts, as shown by Figure 3.6 on average, almost

90% of the receipts of privatization carried out during 2007-2011 were allocated to related SOEs and the state only enjoyed very marginal quantum of it. This sharply contrasts with previous eras. This was very favorable for the companies because they would be able to utilize the fund to finance their business expansions.

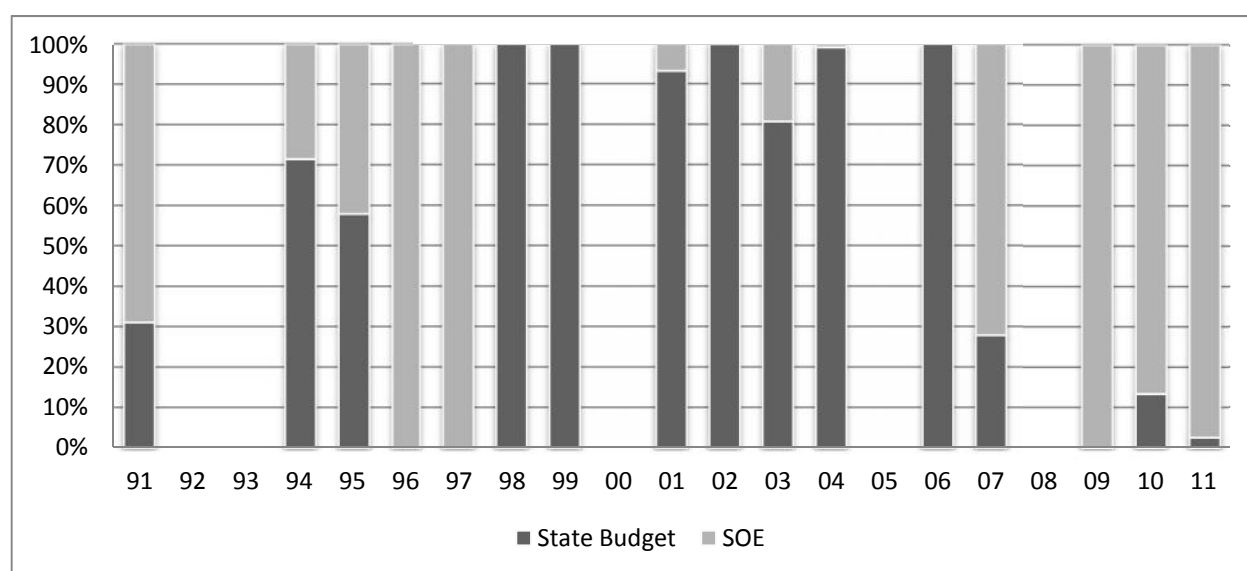
Privatization has been pursued since 1991, before the involvement of IMF in the Indonesian economy. The main difference between the various stages of privatization reforms was the motive of privatization. They have evolved and changed in accordance with emerging economic realities. Regardless of the period, the government has consistently pursued selective, gradual, and partial privatization, even during the Crisis when the government initially tried to pursue massive-fast-full privatization as a part of its commitment to IMF in return for liquidity loan. However, facing political, economic, and social hindrances, the government appeared to become realistic by shifting to selective-gradual- partial privatization. This mode of privatization can be defined as the original mode of privatization in Indonesia. It has been pursued since the beginning of the policy until the recent time.

Figure 3. 5 Privatization Proceeds and its Allocations 1991 – 2011 (In Billion IDR)



Source: constructed by the Author based on MSOEs

Figure 3. 6 The Proportion of Privatization Receipt Allocation 1991 – 2011



Source: constructed by the Author based on MSOEs

Table 3- 5 Period of Privatization

Description	Pre the Crisis (1991-1997)	During the Crisis (1998-2006)	Post the Crisis (2007-now)
Economic Background	Economic downturn as a result of the end of oil boom period	Severe economic crisis	Sound and stable economic situation
Primary Objective	Dual/hybrid aims: reducing a little budget deficit and satisfying firm need over capital	Mainly to reduce the budget deficits	Mainly to satisfy the firms' need over capital
Type of Privatization	First time privatizations over SOEs	First time and subsequent privatizations over SOE, temporary SOEs, and minority SOEs	First time and subsequent privatizations over SOE and minority SOEs
Privatization Method	Mostly IPO	IPO and strategic sales	IPO, strategic sales, and SPO
Privatization Strategy	Selective, Gradual, and Partial	Selective, Gradual, and Partial	Selective, Gradual, and Partial
Privatization Receipt Use	Partly for the government and partly for the privatized firms	Mostly for the government	Mostly for privatized firms

Source: constructed by the Author based on MSOEs

3.4.4 Privatization Strategy and the Rationale of It

3.4.4.1 The Privatization Strategy

From the list of privatization transactions shown in Table 3-4, three main features of privatization over SOEs in Indonesia are identified, regardless of the period in which privatizations have been carried out: They are as follows:

a. selective privatization

Generally, rather than pursuing fast-massive privatization, it seems that slow-selective privatization has been more preferable to the government. In total, there had been 42 privatization transactions over 21 years (1991-2011). On average there had been only two privatizations transactions every year. Furthermore, those transactions had involved very few SOEs and relatively insignificant number of existing public firms; i.e. 19 SOEs (of 142), 8 minority SOEs (of 23 firms), 2 subsidiary SOEs (of thousands firms) during the last two decades. It can also be considered relatively very small in number in comparison with other developing countries that are at similar level of development such as Turkey, Nigeria, India, and Egypt with 104, 104, 69, 68 privatization transactions during 2001-2008 respectively (World Bank).

b. Gradual privatization

Moreover, instead of holding big one-time privatization, the government of Indonesia prefers to carry out small and gradual privatization. As shown in Table 3-4, the state shareholdings of some SOEs have been disposed to public several times, such as PT Telekomunikasi Indonesia (4 times), PT BNI (3 times), PT Bank Mandiri (3 times), PT TABA (2 times), PT PGN (2 times), and PT PP (2 times). Looking at the remaining state ownership in some privatized SOEs which are much higher than 51%, minimum ownership to control firms, it is not impossible for the government to pursue other privatizations over the privatized firms in the following years.

c. partial privatization

As discussed in Chapter 2, partial privatization is defined as sale of state ownership without control relinquishment from the state to the private investors. In other words, the state still retains control in the privatized firms. The most noticeable way to identify the continued government control is by looking at the percentage of remaining state shares in the privatized firms. Following general assumption that voting right is represented by the number of share, partial privatization prevails when the state still holds more than 50% of total shares and vice versa. Among 19 SOEs that have been privatized for more than twenty years only one SOE, the PT Indosat is considered as fully privatized, while the rest of the firms are partially privatized. The government holds the highest residual shares in the case of PT Kimia Farma with 90.8% of total shares and lowest in the PT Indosat at 14.4% of total share.

In addition to retaining majority of common stock, the government can retain the control through possessing preferred stock which is typically granted with special rights, the so-called A Series Share (golden share). This share is single and nontransferable. In the Indonesian case, several special rights granted to A Series Share can be described as follows:

- a) Appointment and termination of a member of board of directors (BOD) have to be done through general shareholder meeting attended by golden shareholder and the decision about it has to be agreed by golden shareholder;
- b) Appointment and termination of a member of Board of Commissioners (BOC) have be done through general shareholder meeting attended by golden shareholder and the decision about it has to be agreed by golden shareholder;
- c) Change of Article of Association including change in the name of firm, the home base of firm, the objectives of firm, merger and liquidation before the due date, capital stock or paid

in capital has to be done through specific extraordinary GSM attended by golden shareholder and the decisions have to be agreed by golden shareholder.

At present, besides holding majority of common shares the state also possesses golden share with abovementioned special rights. Thus, in this regard the government has been very conservative. Apparently, the presence of golden shares aims to anticipate the future where the state may become minority shareholder after pursuing other subsequent privatizations.

3.4.4.2 The Rationale of Selective, Gradual, and Partial Privatization

3.4.4.2.1 Transition Cost versus Expected Economic Benefit of Privatization

As discussed above, the government of Indonesia has relentlessly carried out the same type of privatization strategy throughout the years and regardless of prevailing economic situation. The strategy is selective, gradual, and partial privatization as opposite to massive, fast, and full privatization. Seemingly, this becomes the general strategy of privatization in Indonesia. This strategy may come up as way out over the variety of constraints faced by the government of Indonesia. In other words, this strategy has been undertaken after taking into consideration several existing factors in the country. Below are several factors that may affect the decision of government to pursue the current strategy of privatization.

a. Politics and constitution

The position of SOEs has been supported constitutionally. The presence and the importance of SOEs has been implicitly mentioned in the constitution of the country (UUD 1945) Chapter XIV regarding National Economy and Social Welfare, Article 33 verse 2-3 that says:

(2) Sectors of production which are important for the country and affect the life of the people shall be under the powers of the State;

(3) The land, the waters and the natural resources within shall be under the powers of the State and shall be used to the greatest benefit of the people.

One of the effective ways to realize the abovementioned article is through SOEs. Although it is explained further in the implementation of the law that the SOEs assigned to serve public interests might not be privatized, the absence of clear definition/demarcation in the phrase “*important for the country and affect the life of the people*” has caused psychological effect on the people as if all SOEs are, as stated in the constitution, should not be denationalized. Also, it may be caused by the absence of technical regulation that explicitly indicates the list of permissible and non permissible SOEs’ sectors to be privatized.

Considering the strategic position of SOEs in the constitution, the idea of denationalization is definitely very sensitive. Some politicians from opposition party may use the issue of denationalization as political commodity to tarnish the image of the ruling party. On the other hand, the ruling government may face financial hardships, thus privatization can be the best option for tackling the situation. Extensive and massive privatization carried out by the ruling government may attract the perception from some groups of people who link the issue of privatization to sovereignty. For them, privatization is perceived as resembling to *foreignization*. It was relevant especially during the Crisis when domestic investors were facing serious financial hardship but at the same time foreign investors were having relatively stronger purchasing power. Moreover, the involvement of international organizations, namely IMF and World Bank, which vigorously pressure the government to pursue an extensive privatization, can also worsen the political impact of privatization. This exogenous pressure can be perceived as the new form of colonization.

Taking into consideration several abovementioned political issues, pursuing full privatization is likely to have higher political cost than undertaking partial privatization. In this regard, political cost includes all resources exerted to get political support from other political

parties and constituencies. The ultimate political cost may arise in the form of political resistances/oppositions from other political parties and losing political support from the voters/the public. If ruling government is found guilty of violating the constitution of the country, it is also possible that the decision to completely sell the SOEs to private ownership can lead to political rows that end up with a change of regime.

In this regard, the political structure plays very critical role in affecting the intensity of political costs. After the Reformation Era which was begun in 1997, there has been drastic change in the political structure. The numbers of political parties were 48, 24, and 16 in the general election of 1999, 2004, and 2009 respectively. During the period, no single general election brought about a party winning outright majority seats in the House of Representatives. Consequently, there has always been a coalition government to run the country. This situation completely differs from previous era when there were only three political parties with Golkar always coming up as single majority by dominantly occupying the parliament with more than 85% votes. In this period, President Soeharto and his cronies had been very powerful in the politics and economic realm. During the New Order era, the political views were forcefully imposed on the country by President Soeharto and his cronies. In contrast, highly fragmented political structure brought about high political cost to privatization in the post 1997 crisis. It prevails for the idea of privatization in general, and the political cost is even much higher for full privatization.

With such a situation, pursuing full privatization can hardly be realized in the Reformation Era. On the other hand, despite increased political costs due to changes in the political structure discussed in above, gradual and partial privatization can be more acceptable than full privatization. Selling portion of shares little by little can moderate potential reaction.

Meanwhile, retaining the control over the firms can reduce strong political opposition from the stakeholders. The government remains as the control holder whose constitutional mandate was to ensure that the life of the people will not be sacrificed. Partial privatization allows the government to maintain control over privatized firms so that their existence will not harm the interest of the public. Politically, maintaining control toward privatized firms implies the commitment of the government to constantly preserve land, water, and natural resources, and important sectors of production to be used for the benefit of the people. Partial privatization also demonstrates the independence and country sovereignty from external pressures perceived as a new form of imperialism.

b. Social concerns

Privatization in Indonesia is a very complex issue. It is not only related to the issue of politic but also associated with social issues such as unemployment, income distribution, and unknown fear over the stranger (xenophobia). Hence, public acceptance over the privatization plan proposed by the government is critical; otherwise it can trigger social resistance and social unrest. One of public concerns is associated with the issue of employment. In the country with high rate of unemployment like Indonesia, all economic policies that bring about impact to employment are obviously socially sensitive. It is widely known that privatization may lead to downsizing of the existing number of employees in the denationalized firms. It refers to a general practice where the public firms often act as the last resort of employment at the expense of the firm's efficiency. When full privatization is undertaken, the new owner, which is more profit-oriented, may rationalize the number of unproductive employees. Hence, employees in general are always against the plan of privatization proposed by the government.

Some people are also concerned that full privatization will implicate the issue of income distribution. This issue is also undoubtedly sensitive in the country like Indonesia where income inequality is pervasive. SOEs are capable of facilitating the alleviation of income inequality. First, it can be done through the execution of government assignment by SOEs dedicated to lower income people such as the distribution of subsidized food, subsidized fuel, or other activities as discussed in the next section. Second, it is through state budget mechanism. Profit-making firms usually contribute to state budget through tax and dividend. Those revenues are significantly dedicated to lower income in form of pro-poor national program.

Full privatization not only prevents the government from utilizing SOEs to deliver several pro poor programs but also eliminates the opportunity for the government to obtain budget revenue in the form of dividend for financing pro-poor program. In contrast, partial privatization grants the government with almost the same level of power in addressing the issue of employment. There will not be a dramatic change with respect to employment. The government will strive in maintaining the employment at least at the existing level. With regard to dividend, assuming there is no significance performance change in privatized firms, there may be possibility of decreased dividend due to declined percentage of state ownership. However, with control retained by the government, the state will have power to manage the payout ratio so that the total dividend needed finally can be met. Even, given the assumption that partial privatization can successfully enhance the performance of divested firms, the ability of the government to manage the amount of dividend contributed to state budget will be much easily.

Based on the abovementioned discussions, full privatization has inevitably higher potential social cost than partial privatization. Full privatization may incite stronger people's opposition and potentially cause bigger scale of social unrest. Thus, partial privatization is more

preferable because it has lower potential social costs. In this respect, social costs are somewhat affected by prevailing political climate in the nation. After 1997, when the Reformation Era was started, people have dared to express their opinion pertaining to a particular policy proposed by the government. The media and press also have had more freedom to openly criticize the government policy. It is completely different from the period when President Soeharto had been in power for more than three decades. At that period, people had tended to keep silent though they had had disagreements over the government policy. Therefore, it is sensible that social cost over privatization policy, especially partial privatization, during President Soeharto era was less costly than during Reformation period.

c. The need of fund

Proceeds from privatization will be used to satisfy the need of both parties, either the government or the firms themselves. In some cases, privatization aims to meet the need of both parties simultaneously so that they may share the privatization receipt as planned. To government, privatization receipts are generally aimed to finance estimated budget deficit. Meanwhile, from the firms' point of view, privatization receipt is usually used to finance planned business investment. Therefore, the size of privatization is usually matched to the need of fund of both parties. Both parties do not require either undersupply or oversupply of privatization receipts.

From the government perspective, the proper size of privatization is critical. Too small of privatization size is likely to lead to the shortage of fund that causes unfinanced budget deficit. On the other hand, too large of privatization size (including full privatization) may lead to some macroeconomic problems, for instance, undersupply of money and *crowding out effect* in the financial market. Of course, this will harm national economy as a whole because it may

discourage private investors to run business and investment in the country. From the firms' point of view, the determination of appropriate size of privatization is also important in relation to firm management cash flow. Too small a size of privatization may lead to unfinanced investment plan, while too large a privatization scheme may lead to idle and unproductive assets due to oversupply of cash. After taking into account the transaction cost of privatization, it might be preferable for the firm and the government to divest gradually, little by little rather than one time-big divestment.

d. Capital market capacity

As shown in Table 3-4, most of the privatizations in Indonesia have been carried out through capital market channel. Consequently, to maximize the privatization receipt, the size of privatization should be matched the ability of capital market in absorbing the offered stocks and in return to provide the capital required. In this regard, the ability of capital market to absorb shares offered is affected by current economic situation as well as the level of stock market development. During economic downturn or stock market burst the investors' ability and appetite to invest is decreasing. As a result the ability of stock market to absorb stock offered is also declining. Likewise, less developed markets which is typical in the developing countries, have limited ability to provide the required amount although the economy is in its booming trend. Selling of too much share in the failing or less developed capital market is likely to undercut the price of stock.

Reflecting on some of the indicators discussed in Chapter 4, the Indonesian capital market can be categorized as underdeveloped compared to other countries, including some neighboring countries such as Singapore, Malaysia, and the Philippines. Moreover, Indonesia also faced economic hardship in the past particularly during 1991-2011. As such, in the middle

of 1997 the country faced severe economic crisis that also severely affected the capital market. During that economic downturn, domestic investors lost badly their ability and appetite to invest. On the other hand, foreign investors gained advantages due to favorable currency exchange. However, the government put certain maximum limitation for foreign investors to buy SOEs stock offered. Those circumstances lead to gradual and partial privatization as the best option to maximize privatization revenues.

e. The economic benefit derived from SOEs

As mentioned earlier the role and the contributions of public firms in developing countries, including Indonesia, is undoubtedly significant. The roles and the contributions of SOEs are described as follows:

(1) SOEs as agents of development

The importance of the role of SOEs has begun since the early period of post Indonesian independence. At that time, the economic activity was paralyzed due to the closing down of many enterprises owned by colonist-linked businessmen. Most assets of colonialist investors had been shipped out of the country during the transition period. In order to activate the economy, the government decided to nationalize those paralyzed enterprises and to feed the firms with all fund or capital needed to restart their operation. The SOEs had been the only economic player actively promoting development for several decades until the government decided to encourage private investment again. Overtime, the SOEs had actively involved almost in every sector of the Indonesian economy, covering from transportation to telecommunication, from banking to insurance, as well as from manufacture to trading. No single business sector had been left untouched. Even, after private ownership had taken over the position of public ownership as the most dominant economic players in the economy, the participation of SOEs still could not be

neglected especially in certain sectors/industry/region where profit is too low to attract private business to enter the market or where huge capital is required to enter the market. In a number of industries/markets/regions, SOEs are typically assigned to produce goods and services with some subsidies from the government. Due to this long and central participation, SOEs have been in the heart of the people. Consequently, it is not easy for the people to accept any idea of denationalization. Full denationalization may imply the government would lose very critical agent of development more so certain critical sectors aforementioned. In this respect, operating and capital expenditure can be used as one of the parameters of SOEs role in the economy. As shown in Table 3-6, in 2008, the total operating expenditure spent by all Indonesian SOEs was roughly 21% of total GDP. Using expenditure-based approach, it implies that the economic activity contributed by all SOEs accounted for one-fifth of whole Indonesian economic activity. This figure does not even include capital expenditure that was also very significant.

Table 3- 6 The Importance of SOEs in the Economic Activity (IDR Trillion)

ITEM	2001	2002	2003	2004	2005	2006	2007	2008
SOEs' Operating Expenditure	189	215	238	453	596	672	748	1,028
GDP in Local LCU	1,646	1,822	2,014	2,296	2,774	3,339	3,951	4,949
SOEs' Opex/GDP (%)	11	12	12	20	21	20	19	21

Source: constructed by the Author based on MSOEs and World Bank

(2) The financial contribution of SOEs

The importance of SOEs can also be justified from their financial contribution to the state budget. In the context of Indonesia, the financial contribution of SOEs mainly consists of dividend and taxes. For a developing country like Indonesia, any possible sources of fund including financial contribution paid by SOEs, is undoubtedly essential to finance development. As shown by Table 3-7, combined dividend and taxes paid by SOEs altogether steadily increased year by year. As a

proportion of total income of state budget, combined dividend and tax has accounted for approximately 10%-13% of total budgeted state revenue for the last decade.

Table 3- 7 Financial Contributions of SOEs (IDR Trillion)

ITEMS	2001	2002	2003	2004	2005	2006	2007	2008
Dividend Contribution	9	10	13	10	13	22	23	29.1
Tax Contribution	16	23	27	34	41	59	66	86
Dividend + Tax	25	33	39	44	54	81	90	116
Total Revenue in State Budget	300	305	343	350	492	659	723	895
(Dividend + Tax) /Tot. Income (%)	8	11	11	12	11	12	12	13

Source: constructed by the Author based on MSOEs

Nevertheless, in general the degree of SOE contribution to the country has been shrinking proportionately from time to time. As an illustration, in 1990, dividend contribution from SOEs was IDR 1.096 trillion or 46% of total non tax revenue at IDR 2.383 trillion. In 1995, although the contribution increased to IDR 1.477 trillion in absolute figure, however in comparison with total non tax income at IDR 7.901, it accounted for only 14%, drastically decreasing by 32% relative to 1990 estimates. With regard to the income tax, SOEs contributed IDR 1.438 trillion or 41.2% of total national income tax, IDR 3.489 trillion in 1990. Nonetheless, it drastically decreased to only 9.8% of IDR 20.52 trillion, or IDR 2.020 trillion in 1995 (Moeljono, 2004).

Considering such substantial financial contribution, the government has to decide the type of privatization that can bring the optimum benefit for the government. On one hand, full privatization may be able to bring higher tax contribution from fully privatized SOEs or new entrants in the long run enough to compensate for the reduced opportunity to receive the dividend from the existing SOEs. However, this situation may take place if full privatization has been employed in the supportive and perfect economic environment indicated by several factors.

In fact, the presence of several constraints in the country such as political, social, as well as economic constraints may cause the success of full privatization less certain and more costly.

On the other hand, it seems that there is an economic significance/justification for the government to pursue partial privatization as a way to ensure the stability and the sustainability of revenue inflows from privatized SOEs. Indonesia, like other developing countries, is in need of fiscal stability to maintain the pace of development. Partial privatization allows the government to have full control over the dividend policy of the privatized firms. With its retained control, the government will be able to make sure that certain amount of targeted revenue can be earned from privatized SOEs. While it could happen that dividend revenue from one privatized SOE may decrease, but the decreases might be compensated by an increase in dividend revenue from other privatized SOEs. Moreover, assuming that there is improved performance of privatized SOEs in post privatization, partial privatization may also enable the government to obtain larger potential tax and dividend revenue.

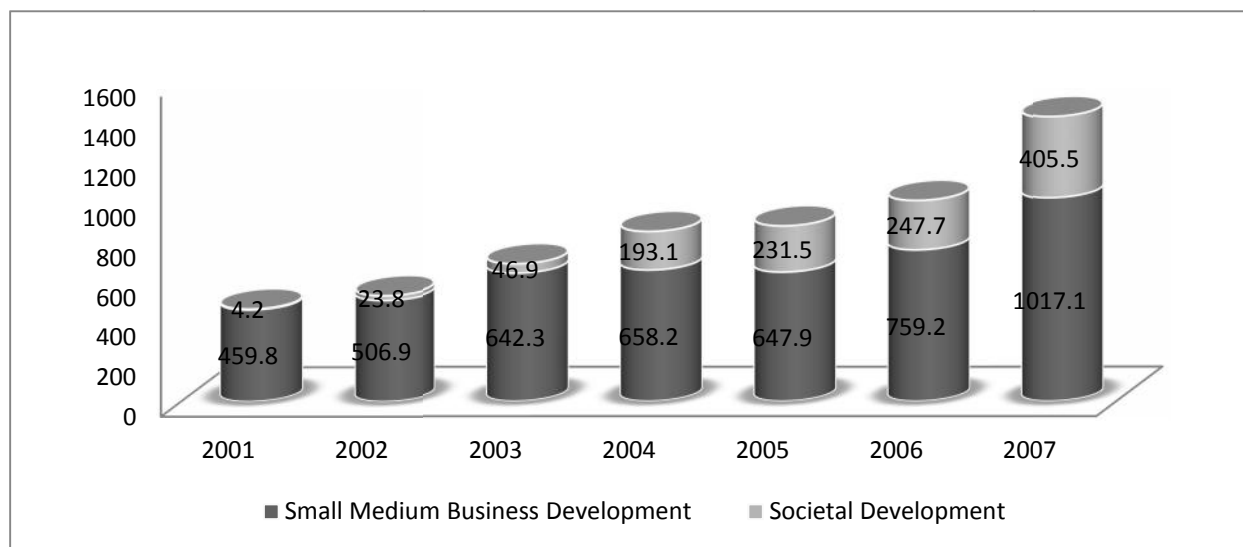
(3) Social activities and non financial contribution,

The importance of SOEs can also be seen from their participation in pursuing social activities and their non-financial contribution such as reducing unemployment, preserving social interest, spreading the prosperity, and alleviating poverty.

Among the social activities, there is a non-profit program assigned specifically to profit-making SOEs called Partnership and Societal Development Program (Program Kemitraan dan Bina Lingkungan-PKBL). It is basically a combination of two different programs, namely partnership program and societal development program. The former program aims to help cooperatives and small medium business enterprises to grow by giving them a soft loan with subsidized interest rate, while the latter program aims to help society with regard to those who

live surrounding the location of firms by providing grants for building public facilities and the like. The funds are mainly obtained from annual net income of the respective firms allocated. It ranges around 1-3% of total net income. Privatized SOEs are the main contributors of this program because they are typically huge profit-making firms. The figure below displays increased trend of both funds from year to year. It clearly depicts the increased dividend and tax contribution of SOEs for last several years.

Figure 3. 7 Partnerships and Societal Development Program (IDR billion)



Source: constructed by the Author based on MSOEs

The presence of SOEs is also critical as a vehicle used by the government to deliver some public programs. Although there has been a certain classification of SOEs according to their main objective as mentioned earlier, in reality, government assignments have not been strictly assigned only to Perum. It is mainly because the area of business in which Perum operates is very limited, whereas the government assignments that need to be done are broader than it. Consequently, there have been several Perseros, nonetheless originally established to purely pursue profit maximization, that have to deliver the assignments.

Some of the main government assignments are conducted under the program named Public Service Obligation (PSO). It is basically a subsidized government program to make available the basic needs of people such as transportation, energy, and food. In order to implement these programs, government usually appoints certain SOEs in related business to execute them. In this regard, appointed SOEs are obliged to produce goods and services to be sold at predetermined subsidized price. To provide incentive to SOEs, the government uses “cost plus margin” formula. Besides the PSO, the government also launches some other programs such as providing credits for small business enterprises and distributing society empowerment fund that are also carried out through SOEs. Table 3-8 exhibits the list of government assignments carried out by SOEs.

With regard to employment, all Indonesian SOEs employed almost one million persons in 2010. This figure is very significant for Indonesia that has unemployment rate of approximately 8% (BPS, 2009).

Table 3- 8 List of SOEs Assigned to Pursue Certain Task

NO	BUMN	GOVERNMENT ASSIGNMENT
A. Transportation		
1.	PT KAI	Train Transportation for Economic Class
2.	PT PELNI	Sea Transportation for Economic Class
3.	PT Posindo	Postal Service
4.	Perum Antara	News, Photograph, Audiovisual Service
B. Energy		
5.	PT Pertamina	Production and Distribution Subsidized Fuel
6.	PT PLN	Electricity Service
C. Food and Agriculture		
7.	PT Pusri (Holding)	Production and Distribution Subsidized Fertilizer
8.	PT SHS	Production and Distribution Seed
9.	PT Pertani	Production and Distribution Seed
10.	Perum Bulog	Purchase and Distribution Rice for Poor People

D. Finance and Banking

11.	PT BTN	Providing Housing Credit especially for low income
12.	PT BRI	Providing credit for small medium business firms &
13	PT Mandiri	distributing Society Empowerment National Program
14	PT BNI	fund

Source: constructed by the Author based on MSOEs

Considering all potential financial and non financial benefits derived from the existence of SOEs, pursuing full privatization may be less preferable compared to partial privatization. Selling the whole state's stock may yield the government huge amount of privatization revenue in the beginning. However, it can cause the government losing some potential benefits obtained from the presence of SOEs. Dividend revenue, partnership and societal development fund, and the important role of the SOEs as a vehicle of government programs will completely disappear. Moreover, transfer of control over SOEs as a consequence of full privatization will leave the government with no power to affect the firms' decision in favor of public interest. For example, the government would be no longer able to determine the amount of dividend and the dividend payout rate, as such there would be no guarantee that the national budget needs can be satisfied.

Considering the several roles and the huge contributions of SOEs, hence, the Indonesian government hesitates to undertake full privatization policy. In this regard, partial privatization can be more acceptable because it gives the government almost the same level of control over the firms. Almost all existing benefits derived from the role and the contributions of SOEs can be maintained. Thus, in general partial privatization allows the government to realize some objectives of privatization without losing some existing benefits from the presence of SOEs.

From the discussion above, apparently the decision of the Indonesian government to pursue a particular strategy of privatization has been based on cost-benefit analysis. In this

respect, cost constitutes all possible costs that may occur because of pursuing the strategy. It can be categorized into political, social, and economic cost.

Political cost refers to all resources spent to get approval from political players pertaining to privatization plans proposed by the government. It incorporates all resources for brainstorming, lobbying, negotiating, taking decision, and monitoring over taken decision by political parties. In this respect, politicians and bureaucrats will definitely strive to maintain a status quo to preserve their rents that is usually protected in prolonged patron-client relationship between them and SOEs' managers. As full privatization is highly likely to completely eliminate the existing patron-client relationship, it becomes less preferable to the benefiting politicians and bureaucrats. Thus, full privatization is more likely to cause high political cost. In contrast, they will have less resistance over partial privatization because they expect that the significant degree of rents still can be maintained. Including in this political costs are all related-costs that may arise as a result of the rejection and failure of a proposed plan of privatization, such as worsened political image toward the ruling parties.

Social cost encompasses all resources spent to convince the public, such as academicians, employees, press, and citizens in general to accept privatization proposal. In this respect, each stakeholder may have certain type of rents worried to disappear as a result of the pursuit of privatization. For instance, employee may have rents to be maintained such as in forms of long life employment or others. The rents are more likely to disappear when the firm is fully owned by private investors who are more profit-oriented. Hence, employees will resist against the proposal of full privatization proposed by the government. Citizens may also have social rents with the presence of fully state owned SOEs. In the context of Indonesia social rent may arise in form of subsidies or partnership and societal development fund allocated mostly for medium-low

income people. Full privatization is highly likely to get rid of them or to exclude them from the list of recipients. Including in this category is cost that may arise as a result of social unrest and public opposition against the privatization plan.

Economic cost includes all potential costs that may arise as the result of the loss of existing economic benefit as a consequence of privatization plan undertaken. It can be in the form of potential financial contributions declines, employment decreases, suboptimum privatized firms' performance, or undelivered government programs. Meanwhile, expected economic benefit includes all potential benefits obtained from privatization; this includes macroeconomic and microeconomic benefits. In broader sense, the expected economic benefit should include all potential benefits enjoyed by stakeholders including the government, employee, and society. Referring to the scope of the study mentioned in Chapter 1, however, in this dissertation the benefits is confined only from the government's point of view. Therefore, it encompasses government revenues (dividend, taxes, and privatization receipt), employment, capital market development, and economic development.

From another perspective, privatization can be considered as a process of change aimed to accomplish certain economic benefits. According to Khan (2000), the intensity and magnitude of resistance over a particular policy is the real cost of change faced by the government. In this respect, the costs of change can be defined as transition cost. Hence, all abovementioned costs (political, social, as well as economic cost) are categorized as transition cost of privatization. Based on our discussion, in the case of full privatization, the transition costs of privatization (from fully state-owned firm to fully private owned) seems to be greater than the expected economic benefit of privatization that is still uncertain due to some factors. As discussed in Chapter 2, in addition to control relinquishment, several existing literatures (Boubakri, 2005;

D'Souza, 2005) emphasize the role of well-established capital market as key success factor of privatization. Unfortunately, from some of the indicators shown in Chapter 4, the Indonesian capital market has been strongly shown as less efficient capital market.

$$\text{Transition Cost} \geq \text{Expected Economic Benefit}$$

$$[\text{Political cost} + \text{Social Cost} + \text{Economic Cost}] \geq \text{Expected Economic Benefit}$$

3.4.4.2.2 Transition Cost vs. Economic Benefit: the Case of Full Privatization over PT

Indosat

To support the aforementioned argument, the privatization toward PT Indosat, which is the only case of full privatization in Indonesia context so far, can be used as a case study. As shown in Table 3-4, the state ownership in PT Indosat has been disposed three times so far. In the first privatization, the government sold 35% of its stock through IPO in 1994 when President Soeharto was still in power. On that occasion, more than 70% of privatization revenue was utilized to finance budget deficit, while the rest of the receipt was utilized to finance firm's investment plan. The second privatization was undertaken in the beginning of 2002 when President Abdurrahman Wahid was in the administration. On this occasion, the government sold 8.06 % of its share through private placement in stock market. All revenues stemmed from this privatization were dedicated to finance budget deficit that arose as the impact of the severe economic crisis in 1997. The last privatization was carried out when the government of Megawati was facing huge potential budget deficit in the end of 2002. In this occasion, the privatization was targeted to generate approximately IDR 6.2 trillion. Facing critical national budget problem within very limited time for policy adjustment, the government decided to sell 41.96% of state share in the firm. This privatization marked the new era in the operation of PT Indosat. It was the first time the government undertook full privatization. Following this last

privatization, the government became minority shareholder in the SOE by holding only 14.96% of the total shares.

With regard to the public stance on privatizing the PT Indosat, only the last phase of privatization that roused strong oppositions and resistances from most of the stakeholders, including politicians, employees, and the public in general. Most parties were concerned about the issue of control relinquishment upon the SOEs from the state to private investors and its potential unfavorable impact from their own perspective. The golden share held by the government was considered less assuring because as discussed earlier it would be applicable only for limited decisions. The full privatization carried out over PT Indosat was unprecedented and considered the most controversial decision that has ever been taken by the government. This has continued to remain a concern from all relevant parties, who still refer to the divestiture of SOEs as notorious economic policy. It always comes to the mind of the people when they discuss about bad examples of privatization.

To highlight the high transition cost in this full privatization transaction, some aspects mainly covering politic, social, economic, and technical issues are discussed at below:

a. Political cost

All existing regulations at that moment: including TAP MPR No.VIII/MPR/2000, TAP MPR No. X/MPR/2001, and TAP MPR No.VI/MPR/2002 provided the guidelines by which the government has pursued privatization of state enterprises. Those decrees also obliged the government to consult with the parliament on every stage of the privatization process. In the first and special case of full privatization, the process of consultation and discussion undertaking was much longer and much cautious. It took very long process for the government to get the approval from parliament (more than a year). Consequently, some other critical agendas of parliament

were suspended and were put aside due to this government privatization proposal. For instance, the discussion over the government draft of SOEs law submitted before privatization plan was postponed until 2003. This law was considered very urgent because it would be guidance and legal basis for stakeholders in governing the SOEs. Included in this law was the guidance and legal basis for privatization itself.

Dispute among political parties and members of parliament did not end, even after parliament approved the proposal. Some members of parliament, especially from Reformation Fraction withdrew their approval and asked the government to cancel/postpone the plan after finding suspicious privatization process.

For ruling parties this privatization appeared to bring about significant political cost/loss. It was indicated by the decrease in numbers of seats in the parliament. In the general elections of 1999, Megawati with her political party, Indonesian Democratic Party-Struggle, (Partai Demokrasi Indonesia Perjuangan-PDIP) won the race by occupying more than 33% of parliament seats. However, in the next general election in 2004 (two years after full privatization) PDIP lost its position and became second in rank after Golkar (Soeharto Party) by occupying less than 20% of seats. As a ruling party, it was obviously an embarrassing loss against the party that was almost banned by the Reformation Government. Thus, full privatization negatively tarnished the political image of the Megawati administration which had ruled not more than 2 years. This devastating political row could be one of the main reasons for the Megawati failure to win the next general election held in 2004 and failed to resume her administration for the second term.

The main opposition related to the consequences of a privatization strategy where the control over firms was transferred to private investors. However, the following facts might cause political cost even higher:

(1) Fragmented political structure

President Megawati administration was formed based on the result of general election held in 1999 which was considered the first democratic election with held in the country after 1955. It was the first multi-parties general election with 48 political parties took part in the election, compared to only three parties during New Order era more than three decades. However, no party won the election with single majority (more than 50%). Consequently, the parliament was very fragmented. In order to form relatively strong government, the winning party had to form coalition with other several parties. Under the ongoing system, the President and vice president were elected by the members of parliament; in this regard, the coalition among the parties to get sustainable support toward the development programs proposed by the President. Abdurrahman Wahid and Megawati Soekarnoputri were elected as President and as vice president respectively. Unfortunately, due to a political scandal, President Abdurrahman Wahid had to step down in 2002 and then Megawati was automatically elected as the successor for the rest of term. Therefore, the President Megawati was not very strong politically compared to Abdurrahman Wahid.

Given very fragmented political structure with no single majority in the parliament, it was very hard for the government to get unanimous support from the parliament for the plan. Until, when the decision was taken some political fractions still objected and disagreed over the plan. Even, they proposed to take further action that could lead to an impeachment toward the ruling government.

(2) The absence of strong underlying law as the policy basis.

When privatization plan was proposed, there were no strong underlying regulations. The decision of privatization was only based on some decrees stipulated by parliament. Some parties

considered those decrees as not sufficient to pursue full privatization. Privatization that required relinquishment of control should be based on a strong legal and technical basis. The draft of SOEs law proposed by the government was put aside from the discussion due to the privatization plan.

b. Social cost

Social cost arising as the impact of the implementation of full privatization was fairly high. Resistances and oppositions against the plan came from various groups of people in the society through several means such as seminar, conference, public discussion on TV and Radio Program, demonstration, and even strikes. Employees of the PT Indosat demonstrated under the flag of Indosat Labor Union (Serikat Pekerja Indosat); academicians under the name of the University of Indonesia Alumni (Ikatan Alumni UI-Iluni) and professional worker under the name of Civilized Professional Society (Masyarakat Profesional Madani -MPM) along with several members of parliament (including the chairman of parliament, Mr Amin Rais). Class action lawsuits were filed in court against the government of Megawati and the Minister of SOEs, Mr Laksamana Sukardi. Arguing that privatization of Indosat had been harmful for the public interest, they had asked the court to cancel the privatization. In June 2004, the claim was rejected by the first level of court (Pengadilan Negeri Jakarta). Then, they brought the lawsuit to second level of court (Pengadilan Tinggi Jakarta) that also rejected the claim in September 2004. The last judicial level which is the Supreme Court (Mahkamah Agung) also ruled against the plaintiff in December 2006. The abovementioned resistances and oppositions were social costs that have to be borne by the stakeholders.

The following were among the several social issues raised by concerned parties with regard to full privatization toward PT Indosat.

(1) employment

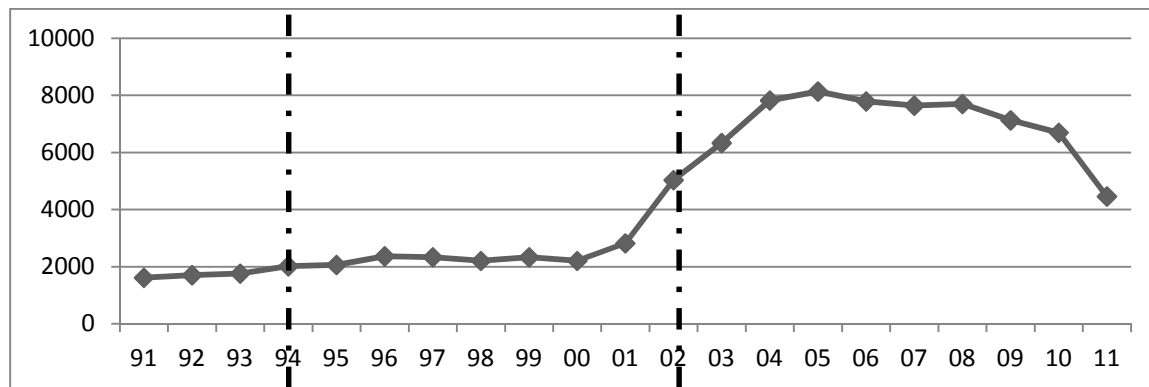
The employees of PT Indosat were the party who paid attention on this issue utmost. Most of Indosat's employees concerned to a potential massive layoff carried out by the new owner as attempt of enhancing the firm efficiency. It can be understood especially when the previous control holder over the firm, which was the government, pursued high level of employment/recruitment. Organized by Indosat Labor Union (Serikat Pekerja Indosat-SPI), employees relentlessly expressed their oppositions against the proposed plan through massive demonstrations and strikes. Even, they planned to bring the case to international arbitrary to reject the plan. After long negotiation, the government and the investors reached an agreement to minimize layoff after privatization. In case that layoff was unavoidable, it was agreed that the employee would get financial compensation approximately three times of what was stipulated by Ministry of Labor. Despite this attractive agreement, the oppositions from the employees still continued.

Figure 3.8 reveals that there were significant employment increases for the last two-three years before privatization (2000-2002). During the period, the government appeared to undertake massive recruitment. As a result, there were significant numbers of new employees that had high expectation to be employed for long period of time. It was understandable when they show strong opposition against full privatization plan that posed threat to their future employment. The trend of increased employment continued until 2005 along with enhanced performance. However, given fierce competition as the result of industry liberalization, the firm began undertaking employment layoff program in 2006. Hence, the number of employees has constantly declined in the following years. The number of employee in 2011 was lower than it was 2002, the year when

full privatization was carried out. Apparently, what was worried by employees in 2002 came to true in 2011.

As depicted in Figure 3.8, it might be true that full privatization of PT Indosat created and maintained relatively high employment level. However, it is matter of fact that there was severe resistance from the employees at the time when the government launched the privatization plan. As mentioned above, the strong opposition from the employees might arise from employees that were newly recruited in the last two years before privatization (2000-2002) when there were significant recruitments. It seems that expected/potential economic benefit in form of potential high employment level was offset by real social cost that immediately arose in form of severe opposition from newly recruited employees due to the fear of lay off. Furthermore, this fear seemed to get a justification when the firm has continuously unemployed the employees since 2005 (3 years after privatization).

Figure 3. 8 the Number of Employee PT Indosat (1991-2011)



Source: constructed by the Author based on Financial Statement PT Indosat and Priantono, B. (2012)

(2) Public interest

Some people, who opposed the privatization plan, also argued that telecommunication was very vital business sector for the life of the people. Referring to the country's constitution, such type

of businesses should be under the control of state to ensure that the interest of the people is preserved. Specifically, PT Indosat had been granted with exclusive/monopoly right for providing international call service for several years. Although some people might know that the monopoly right would soon be lifted through market liberalization policy, most people preferred to follow the existing reality.

Public objections were also prompted by the concern toward the consumer welfare loss due to potential imperfect market competition/monopoly triggered by the ownership of STT in PT Indosat. PT Indosat through its subsidiaries occupied around 35% of cellular service market share. Besides through STT as its subsidiary, Temasek Holdings through its 67% of ownership in the Singapore Telecommunication Limited/SingTel also owned around 35% of shares in PT Telkomsel, the biggest cellular service provider in the country. Combined together, Temasek would have potential market dominance in the Indonesian cellular market. Utilizing its market power, Temasek Holding could reduce consumer welfare by setting harmful service rate to the consumers. This concern was also raised by a member of Business Competition Oversight Committee (Komite Pengawas Persaingan Usaha-KPPU). In 2007, KPPU eventually proved and stipulated that Temasek Holding had violated Anti-Monopoly Law through its cross ownership in both cellular service provider, PT Telkomsel (the subsidiary of PT Telkom) and PT IM3 (the subsidiary of PT Indosat). Consequently, Temasek Holding was obliged to sell its ownership in one of two companies to other investors.

(3) the issue of *foreignization* and national security

The opposition got stronger when in the middle of the privatization process, the public came to realize that the government would sell almost 42% of its shares to Singapore Telemedia Technologies (STT), which was a foreign company under Temasek Holding, business

conglomerates owned by Singaporean government. This fact provoked some groups of people to raise the issue of *foreignization*. Full privatization itself might have caused relatively strong opposition even if the ownership was transferred to individual domestic investors. Therefore, the objections from the public were even much stronger after knowing the fact. Meanwhile, most people considered telecommunication sector, where the firm operates, was very strategic and very close related to the issue of national security. Those people worried that the new foreign owner would have unlimited access to information related to national security. Those people believed that country security and sovereignty were in danger. To make situation worse, some group of people considered Singapore as the country whose close relation/connection with Israel. Regardless of the fact, those things complicated the issue.

(4) Lack of transparency in the process

In this privatization, the government employed strategic sale as privatization method. As discussed later in Chapter 4, this method is carried out by offering shares to some selected investors in the first stage, and then the investor with the highest offering price in the closed bid will be chosen to go to the negotiation stage. Compared to IPO method, strategic sale is rather less transparent. The public might not be able to monitor the whole process of privatization. In this case of privatization, public was surprised by the fact that STT participated in bidding process by using another firm as special purpose vehicle, SPV. The name of the firm was Indonesia Communication Limited (ICL) whose home base in Mauritius. This fact inflamed public resistance. It was widely known that Mauritius was considered as tax heaven country with its tricky tax policy. Given that fact, the government of Indonesia was likely to earn less tax revenue in comparison to a situation where STT did not use SPV in the bidding. It is related to the different tax treaty between Indonesia - Mauritius and Indonesia – Singapore. This shocking

fact provoked another suspicion in the public mind and other political parties that the ruling party might get kickback from this opaque transaction.

c. Economic cost

As discussed above, economic cost may include several foregone potential economic benefits because of pursuing the policy. The control relinquishment may cause some financial benefits such as dividend, tax, and corporate social responsibility fund to reduce. Some people might oppose the full privatization plan over PT Indosat because of this concern. Some potential economic benefits that might decline due to full privatization of PT Indosat are discussed below:

(1) Dividend

PT Indosat had ranked fourth in dividend contribution to the state budget among SOEs, after PT Pertamina, PT Telkom, and PT Bank Mandiri for several years before privatization. The trend of dividend paid also significantly increased before privatization. For instance, dividend amount received by the government increased from IDR 152 billion in 1995 (one year after first privatization) to IDR 448 billion in 1999. Though it slightly decreased in 2000 and 2001, the amount was still huge for financing budget expenditure. Selling almost 42% of ownership would definitely reduce potential dividend paid to the state budget. Given its significance, the state budgets would be likely in deficit problem in the future. As shown in Figure 3.10, in 2003 (one year after full privatization) the dividend amount paid to the government sharply dropped from IDR 316 billion in 2001 (one year before privatization) to IDR 113 billion in 2003 (one year after privatization). After that, the government has never received dividend more than IDR 145 billion from the firm. As depicted in Figure 3.10 where the firm's performance in post privatization had been relatively stable, the dividend decreases were mainly caused by the decreased ownership, not by declined performance declines or decreased payout ratio.

(2) Income tax

The contribution of the firm to the government in terms of income tax had even been much larger than dividend. The firm had been among big tax payers in Indonesia. Along with the increased firm performance, the income tax contribution of the firm had steadily increased during 1991- 2001. In 2001, the contribution of the firm from income tax reached the highest level in the history of the firm by paying more than IDR 650 billion. Therefore, it was understandable when many people rejected the idea of full privatization due to the worry of the potential loss of income tax. The amount of income tax contribution was undoubtedly huge for financing people welfare such as education, health, etc.

The worry seemed to have come to a glaring reality. As displayed in Figure 3.10, the income tax contribution of the firm had tended to decrease. The decreases were noticeably seen during 2003-2006. After contributing significant amount of income tax in 2007, the trend dived again, dropping down continuously in the following years. It was true that the firm paid the tax at significantly high amount in 2007. The further analysis, however, finds out that the increase of income tax is significantly caused by external factor in form of the implementation of several new service tariffs which were effectively imposed by the firm since 1 January 2007. The implementation of several new tariffs was based on some new regulation issued by Ministry of Information and Telecommunication such as the ministry decree No.8/PER/M.KOMINFO/02/2006 (interconnection tariff), the ministry decree No. 9/PER/M.KOMINFO/02/2006 (fixed line and international communication tariff), and the ministry decree No. 12/PER/M.KOMINFO/02/2006 (cellular tariff). As the significance increase of income tax was triggered by external factor in form of higher tariff of service rather than internal genuine factor, it cannot be said as the result of full privatization pursued. This fact is

also supported by the general trend demonstrating that the income tax contribution in post full privatization has tended to be decreasing.

Given relatively stable performance in post privatization and relatively similar to the firm performance in pre privatization, the decrease in income tax mainly seemed to be fairly caused by tax heaven policy of Mauritius, where the majority shareholder bases. It is undoubtedly an economic cost of full privatization.

(3) Corporate social responsibility fund

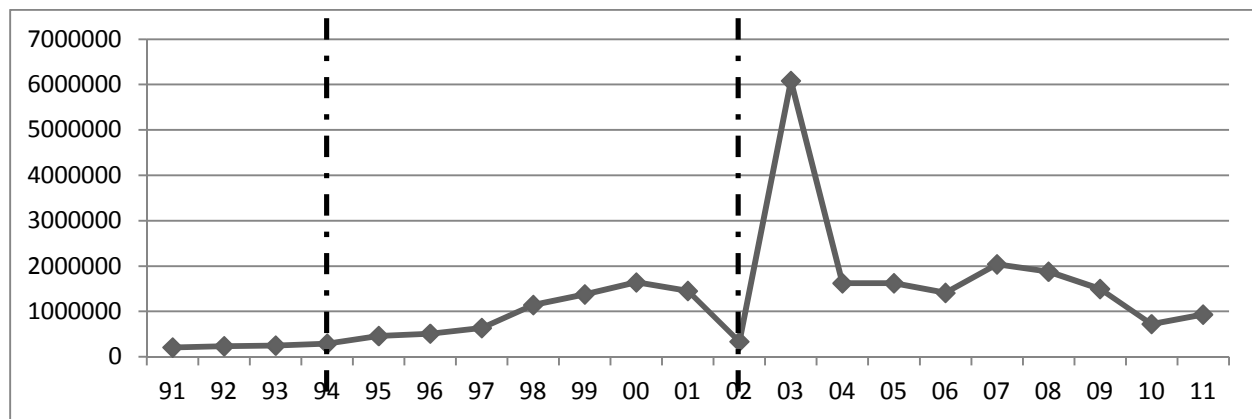
Another potential economic cost might arise following full privatization was associated with CSR fund. When the firm was still under the control of government the program was called as Partnership and Societal Development Program Fund as elaborated in Section 3.4.4.2.1 e (3) above. Along with the increased performance of the firm, the fund dedicated to small medium enterprises and society also significantly went up. During three consecutive years before privatization, the firm allocated approximately IDR 30 billion per year for the program. The amount of the fund had been unquestionably significant and also constructive for developing SMEs. The change of firm from SOEs to PSOs following full privatization was worrying to some stakeholders over the potential reduction of contributions toward the fund. The government would not have any power to compel the firm to allocate 1%-3% of its net income for the designated purposes, as regulated by Minister of SOEs decree.

This worry came to reality. As depicted by Figure 3.10 the amount of CSR had significantly declined after full privatization. Apparently, it is not related to the performance of the firm. It was mainly caused by management policy that did not have to follow any specific rule from the government. The amount of fund dedicated to CSR has been determined arbitrarily by the management.

Combining all forms of abovementioned economic/financial benefit, the total financial contribution from the firm had drastically dropped after full privatization. The total financial contribution from the firm had accounted to almost IDR 1 trillion for the last three years before full privatization undertaken. On the contrary, the maximum total contribution of the firm after privatization has never exceeded IDR 835 billion so far, even the trend has continuously decreased. The difference between total contribution pre privatization and post privatization can be regarded as economic cost of pursuing full privatization policy.

From the government perspective the only economic benefit of full privatization is one-time privatization revenue as much as IDR 5.2 trillion or equal to USD 583.4 million utilized to finance budget deficit in 2002. The realized economic benefit seems to be lower than total political, social, and economic costs that arose. It can be one of the reasons why the government has never undertaken other full privatizations up to date.

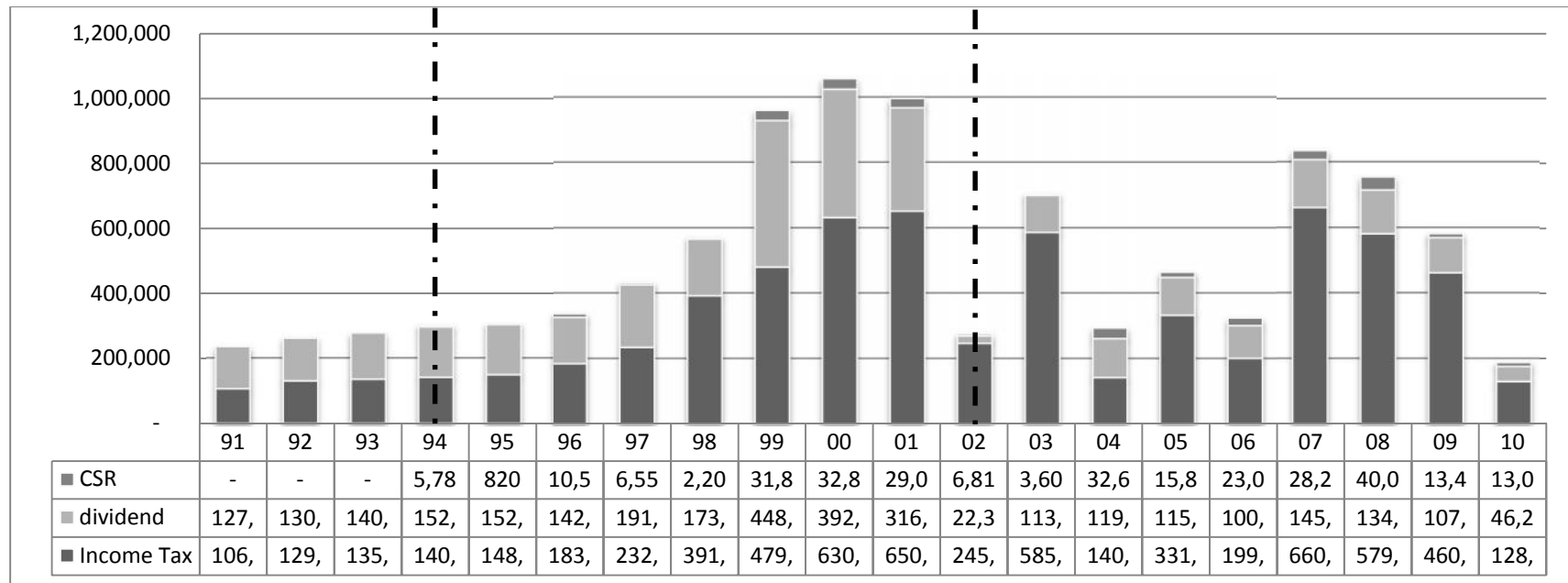
Figure 3. 9 Net Income of PT Indosat 1991-2011 (IDR Million)



Note: Net Income 2003 included realized gain on difference in value from restructuring transactions of entities under common control

Source: Author based on Financial Statement PT Indosat and Priantono, B. (2012)

Figure 3. 10 Financial Contribution of PT Indosat 1991-2011 (IDR Million)



Source: Author based on Financial Statement PT Indosat and Priantono, B. (2012)

3.5 Summary

This chapter sheds light on the overview of privatization practiced in Indonesia. Amid latent problems plaguing public enterprises, privatization arose to be considered as a panacea. With more than 140 SOEs in almost every business sector since the early period of independence, SOEs have a special place in the heart of people in Indonesia. Worth more than IDR 2,000 trillion total assets but producing quite low net income, SOEs are still considered to be outperformed by their private rivals. Inspired by the success of privatization implemented in the United Kingdom and pushed by macroeconomic situations, the government undertook privatization policy at the first time in 1991. Since then, privatization has become a major part of SOEs reform in Indonesia regardless of the change of regime.

Tracing back to the early period of Indonesian post independence, grand strategy undertaken by the government with respect to SOEs can be divided into three main periods, which are nationalization, liberalization, as well as disengagement and privatization period. Nationalization was a period in which government massively nationalize business enterprises previously owned by colonialist-linked businessman. As SOEs was almost the only economic player in the country, in this period, state had highly relied on the role of SOE to boost the economy; at the same time the government was liable to ensuring the existence of SOEs. In the liberalization period, which was signaled with the acceptance of Indonesia as a member of IMF and the World Bank, the government encouraged private players to enter the economy by enacting necessary rules and regulations pertaining to capital liberalization, de-bureaucracy, and decentralization. Simultaneously, the government clarified the position and mission of each SOE in the economy so that it might create some room for private enterprises to take a part in it. In the disengagement and privatization period, the government began to reduce its involvement in the

production of goods and services through SOE when private firms became more dominant in the economy. This disengagement have been done gradually, starting from lessening subsidies and capital participation (financial disengagement), to shifting from “control by process” to “control by result”, centralizing oversight task to single ministry, and eventually pursuing privatization (financial and operational disengagement). From this story, privatization can be seen as a part of government long term plan strategy rather than just a spontaneous policy.

With no great differences in terms of its definition and objectives compared to the general concept, privatization has been pursued for more than two decades in Indonesia.

Using economic catastrophe that occurred in the middle of 1997 as a landmark, privatization in Indonesia can be divided into three different periods, those that are pre the Crisis (1991-1997), during the Crisis (1998-2006), and post the Crisis (2007-now). Pre the Crisis privatization was held at the end of the oil boom period when the government needed some revenue for reducing budget deficit and at the same time the firms also needed an additional capital for their business expansion. As it was in the early period of privatization implementation, the first time privatization through IPO method was very dominant at that moment. Privatization during the Crisis is typified as budget deficit driven so that almost all privatization receipts in this period had been utilized to finance the deficit. Faced with huge budget deficit, the government pursued relatively massive privatization. Moreover, the government disposed its ownership not only in the un-privatized firms (first time privatization) but also in the privatized enterprises (subsequent privatizations). Besides SOEs, the government also divested temporary SOEs and some minority SOEs to reach the target. Therefore, IPO was not the only method used during this period, there was also strategic sale/private placement. Privatization in post the Crisis has completely different characteristics. It has been undertaken amid stable economic

atmosphere. It has been mostly business driven. Hence, most part of privatization receipt is used by the privatized firms themselves. Additionally, promising economic situation and growing stock market has attracted privatized firms to issue new share through SPO in hope to raise more capital for their business expansion.

Irrespective of the period, the government of Indonesia has consistently pursued the same strategy of privatization, which can be characterized into three words; selective, gradual, and partial. There are some possible reasons behind this ongoing practice. Firstly, the presence of SOEs is preserved by constitution so that it is politically strong. Even if it is selectively done, full privatization would definitely incite strong political oppositions from stakeholders, not only politicians but also others (high political cost). Secondly, full privatization can cause social unrest and people resistance due to some social issue such as unemployment, income inequality, and unknown fear over the stranger (xenophobia) (social cost). Thirdly, the size of privatization has been matched with estimated fund needed both by the government and privatized firms. Fourthly, size and method of privatization have been matched with the capacity of capital market. Fifthly, partial privatization enables the government to realize the objectives of privatization without losing existing benefits obtained from the presence of SOEs such as the role of SOEs as an agent of development, the financial contribution of SOEs in the form of tax, dividend, and alike, the role of SOEs in employment, as well as the function of SOEs as a vehicle to deliver government program (economic cost). In other word, full privatization is less preferable because its potential aggregate costs that consist of political, social, and economic cost (which are also called transition cost) are greater than its expected economic benefits.

Chapter 4

Partial Privatization and Economic Performance:

An Empirical Evidence from Macroeconomic Perspective

4.1 Introduction

As elaborated earlier in Chapter 2, privatization, especially in developing countries, constitutes a part of grand economic policy with multiple objectives. With respect to the scope, the objective of privatization can be broadly grouped into two; macroeconomic and microeconomic level. Of macroeconomic objectives are to develop stock market, to increase financial contribution from SOEs to state budget, to manage national budget deficit, and to maintain/improve the level of employment. Meanwhile, microeconomic objectives are focused on the firm level, with a view to improving the performance of privatized firms. The two objectives are different but not unrelated; they complement each other. To some extent, the realization of the objectives at macro level would highly rely on the achievement of objectives at micro level. For instance, the financial contribution of privatized firms to the government, in the form of tax and dividend, and might not increase unless the performance of firm rises accordingly.

In developing countries, which are usually plagued with multifaceted and structural economic problems, the macro objectives of privatization are occasionally more urgent to be achieved than micro objectives because it can facilitate the achievement of other developments. However, privatization would be considered to be successful if it can bring positives impact on both macro and micro aspects. Hence, it is important to judge the success of privatization by looking at the realization of those objectives comprehensively.

Using Indonesia as a case study, this chapter aims to assess the impact of partial privatization at macroeconomic level, then to find out the key factors of its success. To this end, Section 4.2 examines the impact of partial privatization in Indonesia on some macroeconomic measures. In this section, the four macroeconomic measures, namely capital market development, budget deficit management, financial contribution to the state budget, and employment are assessed. In general, the assessment is done by using descriptive analysis from the aggregate data of partially privatized SOEs. The last two measures are accessed by comparing three years before privatization and four years after privatization. Section 4.3 is to shed light on the determining factors of privatization success from macro perspective. In this section, four aspects of privatization, namely the selection of firm, the method of privatization, the strategy of privatization, as well as the political process of privatization are elaborated.

4.2 The Impact of Partial Privatization on Macroeconomic Performance

4.2.1 Promoting Capital Market Development

As mentioned in the previous chapter, the capital market efficiency is measured by its ability to generate available firm-related information and to reflect them on the price of firm's stock. The more information about a particular enterprise that can be reflected in the firm's stock price, the more efficient the stock market would be. In other words, more efficient stock market will present less information asymmetry between management and investors. As a result, it can lead to allocative efficiency in the sense that available resources in the economy will be allocated to the right firm producing the right goods or services at the right price. All of this information will be reflected on the price of the stock. Financial market with less information asymmetry/distortion can build trust among the people so that it can attract both domestic and foreign investors to invest their fund through it. From a broader perspective, well developed

capital market would help to channel fund from people with excess liquidity to the firms that are in need of funds for their business development and able to use funds obtained in the most efficient way. This is the medium through which efficient financial market can boost the economy. The literature presents plentiful evidence that a well-established financial systems leads to economic and industrial development (e.g Rajan and Zingales, 1998; Levine and Zervos, 1998).

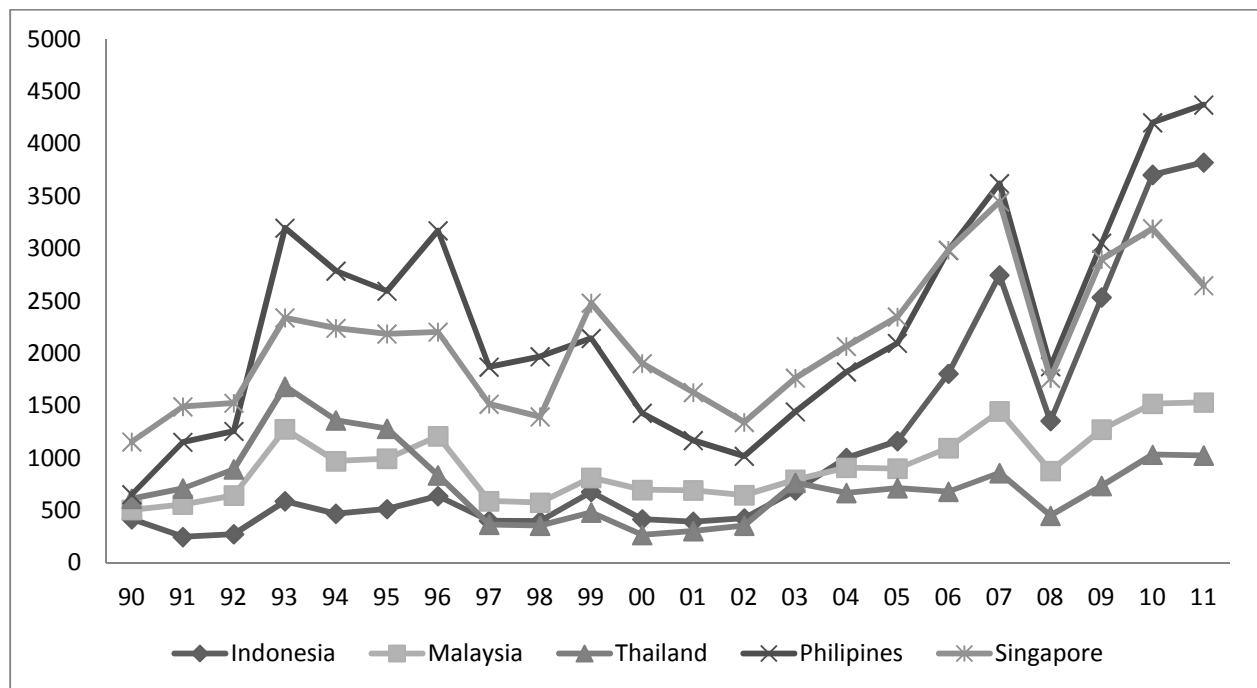
According to several studies done with respect to Indonesian Stock Exchange (Arianto, 1996 and Prihantoro; 2001), Indonesian stock exchange (in early 1990s) could be classified at least into the category of weak efficiency. Using composite stock index⁴ as an indicator, Figure 4.1 depicts the trend of composite stock index in Indonesian Stock Exchange in comparison with four neighboring countries in the same region: Malaysia, Thailand, Philippines, and Singapore from 1990 to 2011. Indonesia had always been in the bottom position during the period 1991-1997. During this period, the Indonesian index had ranged from 247.3 to 637.4. It was enormously low compared to Singapore whose index ranged from 1,150 to 2,240.

⁴ Composite Stock Index is a market capitalization-weighted grouping of whole stocks listed on the particular capital market. This index is valuable tools to measure and track changes of price level to an entire stock market. It can be used to show the performance of particular stock market in particular point of time. It is calculated by using formula at below:

$$CSI = \frac{\sum p}{d} \times 100$$

Which is p = stock price X number of shares and d denotes basis value. In Indonesian case, total market capitalization of stock listed on 10 August 1982 is considered to have value of 100 and used as basis value of composite index calculation.

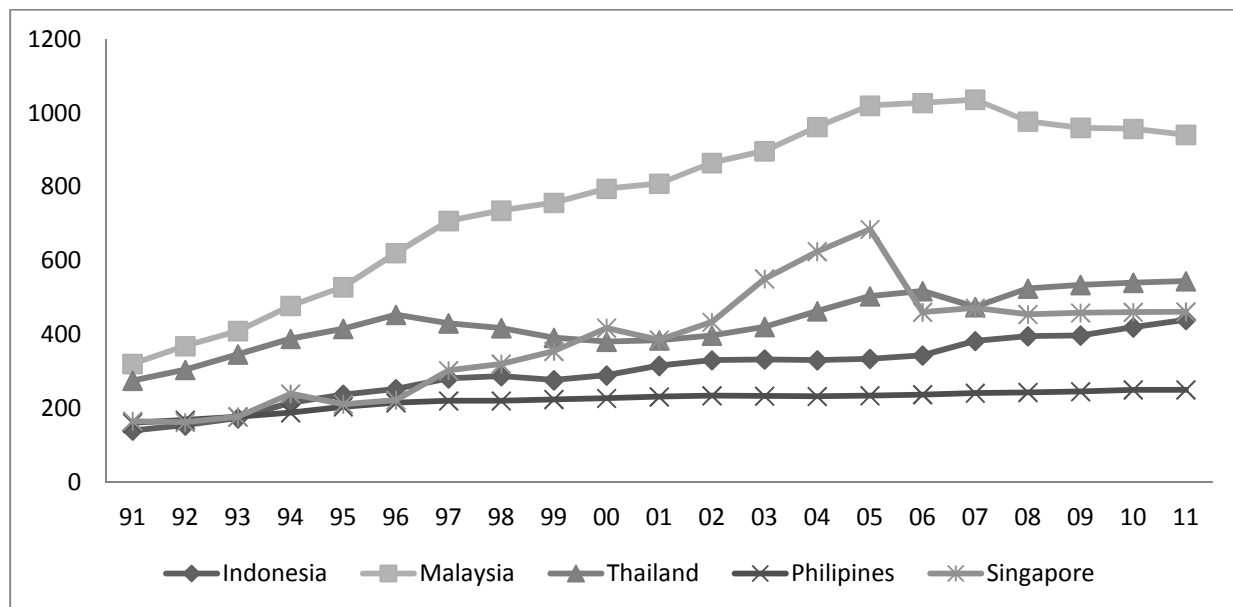
Figure 4. 1 Composite Stock Index of Selected ASEAN Countries



Source: constructed by the Author based on Indonesian Capital Market Statistic, Capital Market Supervisory Agency, MoF

Likewise, the same phenomenon had also appeared with regard to the number of listed firms as shown in Figure 4.2. Although capital market has been liberalized since 1989, the number of enterprises listed had not reached 200 until 1994, far below Malaysia whose number of firms listed more than double. It would be ironical that, as the most populous nation in the region, Indonesia was considered the fastest-growing economy during that period of time. However, Indonesia was the country with the least number of listed firms in the region at that moment.

Figure 4. 2 Number of Listed Firms of Selected ASEAN Countries



Source: constructed by the Author based on Indonesian Capital Market Statistic, Capital Market supervisory Agency, MoF

Referring to SOE Law Number 19 of 2003, it is stated that among the objectives of privatization in Indonesia is to develop capital market. In its implementation, the government also seems to go in line with this objective. After taking into account several aspects relating to politics, economics, and society, capital market has still been considered as the best channel of privatization. It can be seen from the fact that majority of privatizations in Indonesia have been carried out through this channel, in spite of relatively less developed stock market on the ground.

Along with privatization carried out since 1991, as exhibited in Figure 4.1, the Indonesian capital market has demonstrated substantial and continued improvement. After slightly declining due to the Crisis, Indonesia Stock Index resumed upward trend, though gradually. Having always been in the bottom among neighboring countries, the index began to outnumber Thai's Stock Index in the fourth position. The trend continued to increase until the index exceeded 1,000 in 2004 when it outperformed Malaysian Index. The march on development did not stop there. In

2010 when the index reached 3,703, and took over Singapore's position, Indonesian Stock Market had ranked second in the region, just below Philippine Stock Market on the top.

Similarly, there has been an increasing trend in terms of number of firms listed on the Indonesia capital market. In 1997, the number of listing firms had doubled what it was in 1991. Interestingly, unlike some neighbors that have experienced decreased number of listing firms, Indonesia stock market has steadily increased all the time. Therefore, in 2011 the number of listing firms has recorded three fold what it recorded in 1991. Assuming the trend will continue, Indonesia may have the second largest number of firm listed on the stock market after Malaysia within several incoming years.

One may say that such great development of capital market has nothing to do with privatization. However, ensuing facts can show that privatized SOEs play very critical role in this respect. Along with the increased number of privatized SOEs, total market capitalization⁵ of listed SOEs has continuously increased. More importantly, the combined market capitalizations of privatized SOEs has accounted for very significant portion of the whole market capitalization. At the initial stage, capital market development, specifically during 2000-2006 was when the stock index had been considerably low, a few divested SOEs had occupied very dominant position in the market. For instance, in 2000, six listed SOEs (out of 290 listed firms) accounted for 19.7% of total market capitalization. Along with the increased number of listed SOEs, the figure then had constantly grown until 2006 when 13 listed SOEs (out of 344 listed enterprises)

⁵ Market capitalization can be defined as the total value of the issued stocks of a publicly traded firm; it is calculated by multiplying the price of stock with the number of outstanding shares. Since outstanding stock is freely bought and sold in capital markets, giving market mechanism, market capitalization can represent the consensus of public on the value of company's net worth or firm's equity and is a determining factor in several forms of stock valuation. The calculation includes preferred shares.

reached 39.2% of total market capitalization as shown in Figure 4.3. In this regard, the stock of listed SOEs would be determining stock movements. If something bad happens to the stock of listed SOEs, the capital market as a whole would be adversely affected.

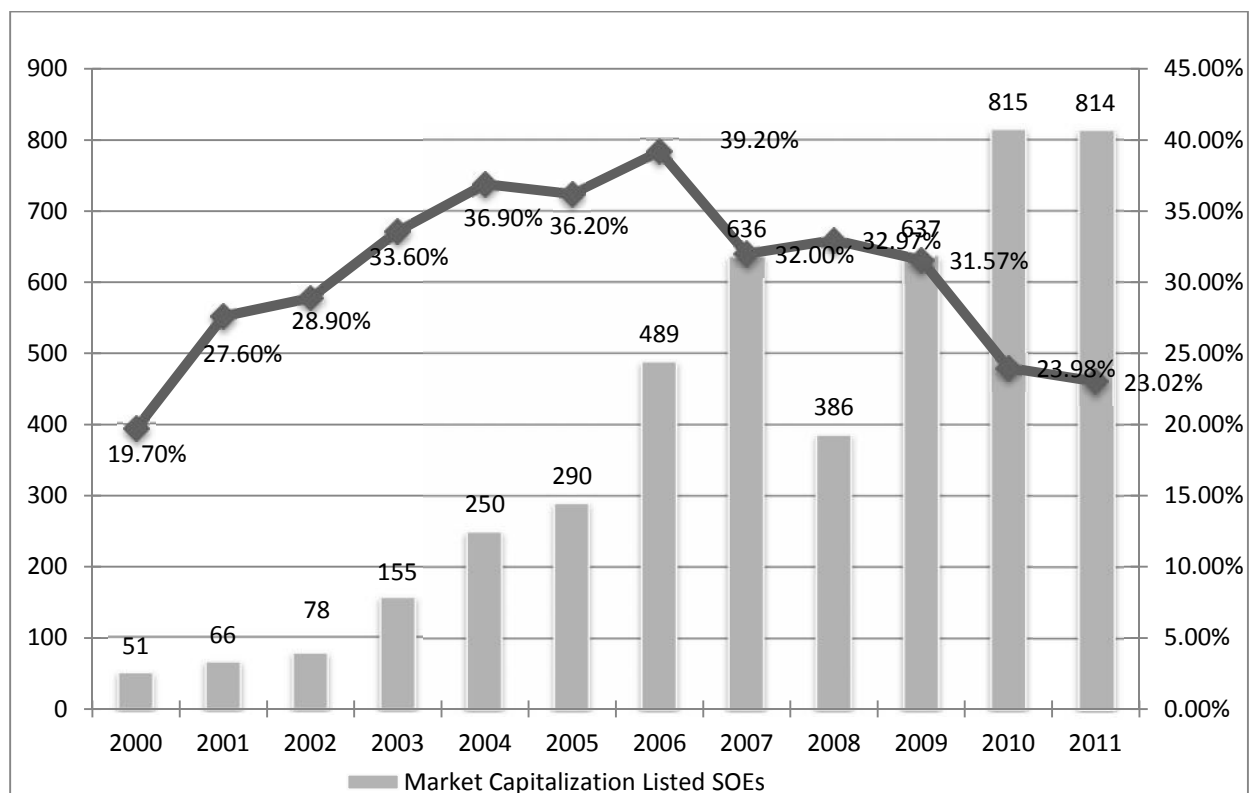
The general trend changes in 2006. Though total value of SOEs market capitalization continued to increase (as displayed in Figure 4.3), its contribution to stock market in aggregate began to decrease. It went down from 39% in 2006 to 32% in 2007. Interestingly, while there was a general downturn in the stock market operations in 2008 due to US subprime mortgage crisis, causing the Indonesian stock index to plunge sharply to 1,355 from 2,745 in the previous year, the market capitalization value of the listed SOEs slightly increased to 33%. When the market recovered from the crisis in the following years, which witnessed IPO of many new listed firms, the contribution of SOEs stock has again continued to shrink though it has still skyrocketed in terms of value (in IDR trillion, Figure 4.4). However, the contribution of SOEs' market capitalization has remained very significant until the end of 2011. It is important to note that although the number of listed SOEs is only 17 out of 440 companies, it accounts for more than 23% of total market capitalization.

Another fact is that, most of the listed SOEs' stocks have been among the top performers on the stock market. As the evidence, there had been 12 out of 17 privatized SOEs included in this study that had been among the 45 most heavily traded stock on the Indonesia Stock Exchange called LQ45 for the period August 2011 to January 2012. To be included in this group, a company has to meet following conditions: (1) it has to be one of the 60 largest firms in terms of market capitalization within the last year; (2) it has to be one of the 60 largest firms in terms of value of transaction in the market within the last year, (3) it has to be listed in the stock market minimum for last 3 months, (4) it has sound financial aspect, good prospect of performance, and

high value and frequent of transaction. So, if the level of capital market development is measured from the liquidity of market, the listed SOEs have considerably contributed in this regard. Almost all of the listed SOEs' stocks have been heavily traded throughout the years.

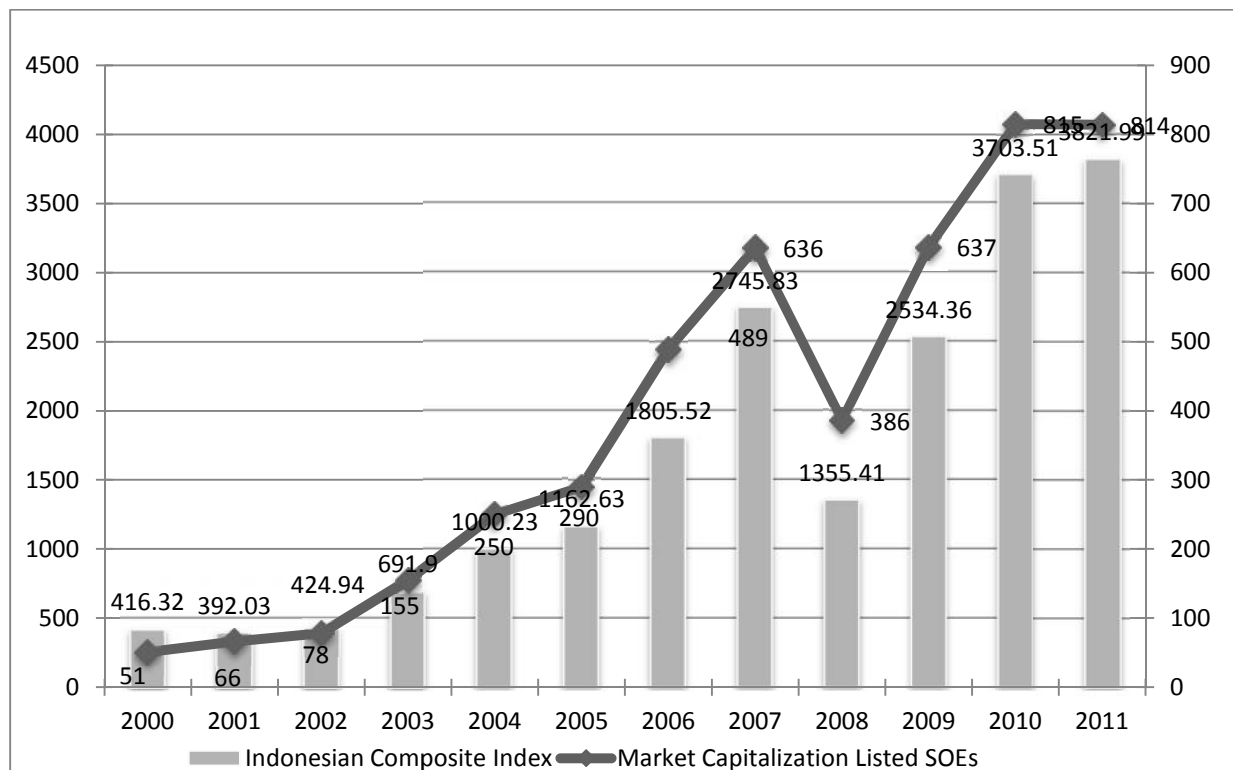
It is crystal-clear that the role of privatization is undeniably critical in promoting Indonesian capital market. This can be clearly seen especially during the early period of capital market development. It is evident that the stock performance of the listed SOEs can attract the interest of investors both domestic and foreign. As a result it can induce other enterprises to go public. It is very apparent especially after 2006.

Figure 4. 3 Market Capitalizations of Listed SOEs (Total Value and % of Total)



Source: constructed by the Author based on Indonesian Capital Market Statistic, Capital Market Supervisory Agency, MoF

Figure 4. 4 Indonesian Composite Index and Total Market Capitalization Value of SOEs



Source: constructed by the Author based on Indonesian Capital Market Statistic, Capital Market Supervisory Agency, MoF

4.2.2 Financing Government Expenditure in the State Budget

As elaborated in the previous chapter, the presence of SOEs is very important for the development of the nation. One of the reasons is their substantial financial contribution through the state budget (on-budget) or indirectly out of the state budget (off-budget). The financial contribution of partially privatized SOEs through state budget can be explained using the following equation:

$$G = T + NT + DF + PR + ONDF \quad (1)$$

where G stands for government expenditure, T for tax revenue, NT for non taxes revenue, DF for debt financing, PR for privatization receipts, ONDF for other non-debt financing.

The main financial contributions of the SOEs to the budget are in the form of tax (T), dividend (NT), and privatization receipt (PR). Tax and dividend are routine revenue so that they are usually used to finance routine government expenditure. Meanwhile, privatization receipts are one-time revenue that is generally utilized to finance incidental predicted budget deficit. In this regard, the target of privatization proceeds is proportionately matched with the size of potential budget deficit that need to be financed. Assuming other variables are held constant, the presence of financial contribution from SOEs can make decision makers able to (Schipke, 2001):

- a) raise government spending temporarily beyond what otherwise would be possible so that it can increase aggregate demand in the economy;
- b) preserve expenditure level, thus avoid a politically unfavorable fiscal retrenchment, even in the light of a shortfall in any of the other sources of financing;
- c) reduce taxes, in addition to stimulating aggregate demand; this allows government to target politically influential groups in society;
- d) decrease publicly recorded fiscal deficit by taking into account privatization receipt as revenue equivalent.

As elaborated earlier, the contribution of SOEs in the form of tax and dividend has been fairly significant. In total, the financial contribution of all SOEs combined has accounted for 11-13% of total expenditure in the state budget for the last five years. It can be considered significant for developing countries like Indonesia. In this respect, privatization is very central because it will bring about positive impact on the capacity of government to finance its expenditure.

In the Indonesian context, to critically understanding the methods of financing state budget is very important in relation to maintaining political, economic, and social stability. This can further be seen from the following facts (MoF, 2010):

- a. It is a result of political negotiation and involves political process between the Government and the Parliament;
- b. It is related to bolstering development through certain critical sectors such as infrastructure, agriculture, energy, and another kind of “pump priming” project;
- c. It is related to sustaining people’s welfare program such as society empowerment fund, education subsidies, health security programs, and so on;
- d. It is associated with supporting real sector’s activity for example through tax incentives;
- e. It has something to do with sustaining government commitment of allocating 20% of state budget to support education sectors;
- f. It has something to do with the government program of enhancing defense system.

Therefore, the failure of government to meet commitment stated in the state budget would bring about disastrous political effects for the ruling government in the next general election.

The decision of privatization has to be taken cautiously, taking into consideration its implication for the fulfillment of state budget commitment. Privatization may cause a certain potential financial contribution to disappear or diminish. However, there is also potential increased financial contribution if the performance of the firms improves. A privatization is considered to be successful if aggregate financial contribution from partially privatized SOEs in post privatization is greater than its pre privatization level. Table 4-1 shows how the financial contribution may increase or decrease as an impact of partial privatization. If C stands for contribution, T represent tax revenue, D represents dividend earned by government, t stands for tax rate, P represents performance, r represent the ratio of dividend payout, O stands for state ownership, and a symbolizes after privatization and b symbolizes before privatization, so total financial contribution of privatized firms before and after privatization can be written as follows:

$$Cb = Tb + Db = ((ta \times Pb) + (rb \times Pb \times Ob)) \quad (2)$$

$$Ca = Ta + Da = ((tb \times Pa) + (ra \times Pa \times Oa)) \quad (3)$$

Assuming there is no change in enterprises' performance ($Pb=Pa$) and related policy ($tb = ta$; $rb = ra$) total financial contribution is likely to decrease after privatization because of smaller state ownership in the divested firms ($Ob > Oa$). This smaller percentage of ownership is likely to result to less dividend in comparison with pre privatization level ($Db > Da$).

While the tax rate tends to be unchanged, the change of firms' dividend payout policy will be fairly affected by how much control retained by government. Roughly, it will be in line with the number of state shares in the divested SOEs. Remaining state's control over the firms allows the government to produce policy in favor of the government interest that is to meet the need of state budget. To compensate lowered ownership, the government may increase dividend payout ratio. On the other hand, relatively strong non-state owners may prefer to have lower pay out to finance business expansion. Similarly, the contribution of privatized SOEs in the form of tax would depend mainly on the performance of firms. The possibility of increasing tax rate is less likely because it is national policy that affects the whole business players in the country.

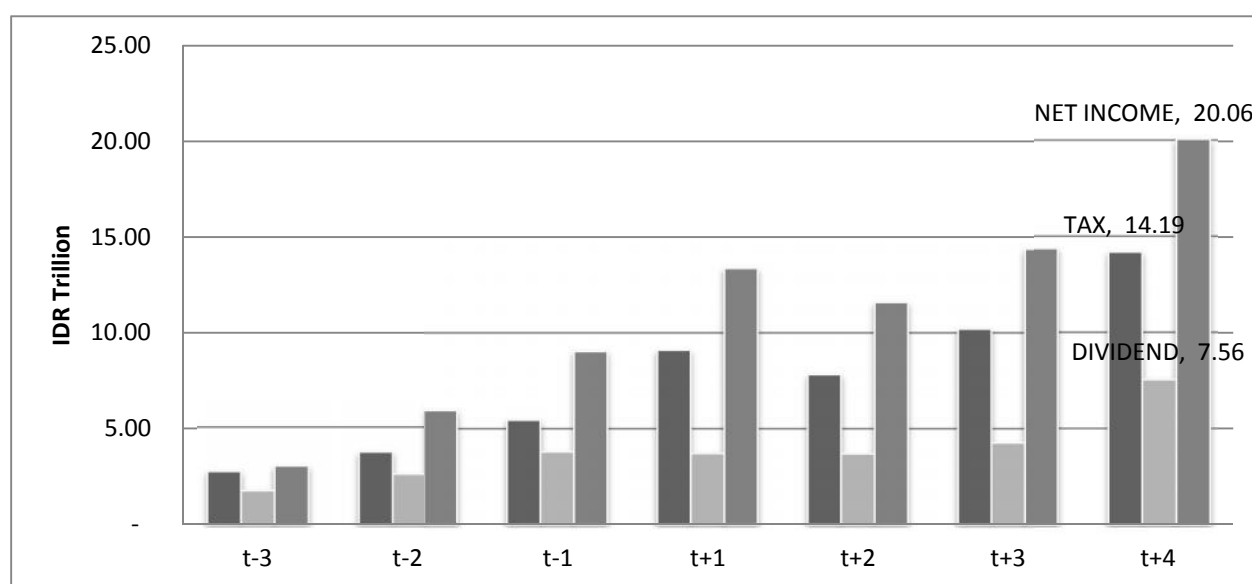
Table 4- 1 Determining Factors of Financial Contribution of Privatized SOEs

No	Contribution	Determining Factors	Possible Change due to privatization
1	Dividend	Performance of the firms, Ownership, and Pay Out	Assuming the firm' performance and payout ratio are held constant; dividend is likely to decline due to lower state's ownership
2	Tax	Performance of the firms, tax rate	Depending on the change in performance, since tax is exogenous factor it tends to remains unchanged

As depicted in Figure 4.5, the impact of partial privatization on the financial contribution in the form of tax and dividend is surprisingly positive. Using data from the immediate three years before privatization and immediate four years after privatization, it is observed that total

financial contribution that consists of tax and dividend combined generally increases from time to time. The average of total contribution prior to privatization is IDR 6.7 trillion per year; it increases by about 126% to IDR 15.2 trillion per year after privatization. In more details, each component of the contributions demonstrates its growth. Annual average tax contributed by all partially divested firms rises from IDR 3.9 trillion prior to privatization to IDR 10.3 trillion (an increase by IDR 6.4 trillion or equal to 159%). There is also an increase at IDR 2.1 trillion or equal to 76% in annual dividend average, from IDR 2.7 trillion prior to privatization to IDR 4.8 trillion.

Figure 4. 5 Financial Contribution of Privatized SOEs Pre vs. Post Privatization



Source: constructed by the Author based on MSOEs

The increase in financial contribution seems to be driven by the improvement of performance in post privatization. Figure 4.5 shows the performance of enterprises represented by total net income has increased significantly after privatization. The tendency is exactly the same as the trend of financial contribution paid to the government. In general, the financial

contribution of partially privatized firms to the state budget has substantially grown after privatization. However, there is slight decrease in the year t+2. Apparently, it is caused by the performance decline of a big privatized firm, which is PT Bank Mandiri. The performance of the company diminished from IDR 5.3 trillion in year t+1 to 0.6 trillion in year t+2. Consequently, the financial contribution from the company also sharply decreases.

The findings abovementioned is also backed up by another finding with regard to dividend payout policy. It is found that there is a tendency of lowered dividend payout rate post privatization in comparison with pre privatization. Table 4-2 confirms that among 16 partially privatized firms there are 9 firms; most of them are big companies with large financial contributors, which experience decreased payout rate after privatization. In this respect, the government control over the firm maintained through partial privatization might have worked by ensuring that the need of the government over bigger revenue from dividend has been met.

Table 4- 2 Average Dividend Payout Rate Pre vs. Post Privatization

NO	SOEs	The average of Dividend Payout Ratio		
		Pre	Post	Change
1	PT Adhi Karya	0.415	0.127	-0.288
2	PT ANTAM	0.356	0.294	-0.062
3	PT Bank Mandiri	0.619	0.430	-0.188
4	PT BNI	0.778	0.397	-0.382
5	PT BRI	0.498	0.288	-0.211
6	PT Indo Farma	0.414	0.000	-0.414
7	PT Jasa Marga	0.261	0.526	0.265
8	PT Kimia Farma	0.334	0.287	-0.047
9	PT PP	0.301	0.369	0.068
10	PT PGN	7.479	0.556	-6.923
11	PT PTBA	0.530	0.519	-0.011
12	PT TELKOM	0.163	0.389	0.226
13	PT Timah	0.139	0.377	0.238
14	PT WIKA	0.205	0.327	0.122
15	PT Semen Gresik	0.158	0.475	0.317

Source: constructed by the Author based on MSOEs

4.2.3 Financing State Budget Deficit

Governments all over the world have confronted budget constraint which calls for financing for all government expenditures in any given period of time. The inclusion of privatization receipt as one of additional financial sources especially for financing state budget deficit can soften short term budget constraint. This advocates another motive for privatization that is probably more effective to capture political enthusiasm for privatization. The presence of privatization receipt in the equation (1) provides policymakers larger spaces in pursuing their policy aims, regardless of the significance of privatization receipt in influencing the short term budget constraint.

In many cases in the developing countries, including Indonesia, privatization is more frequent to be used as a tool of covering fiscal deficit rather than of bolstering government expenditure. Having experienced slowed economic development, developing countries are often confronted with limited and uncertain revenue sources. As a result, in the middle of fiscal year they frequently find that their potential revenue might not be able to fully cover their estimated expenditures. As a result, they might end up with a potential fiscal deficit that occurs in the end of year. Uncontrolled budget deficit is harmful to the economy both in the long and short term. In the short term, huge fiscal deficit would lead to disadvantageous business atmosphere because it can affect currency exchange rate. In turn, this would affect undesirable level of export and import. In other words, unmanaged budget deficit may undermine the confidence of business players to the government. In the long term, continuous severe budget deficit would leave the government vulnerable to potential debt burden. Accumulated budget deficit can endanger the nation with liquidity problem and the risks of default. Not only the business players, large fiscal deficit and increased outstanding debt are also likely to draw attention of voters in the sense that it can shift public support away from the ruling party.

To solve deficit problem, the government might have several policy options such as fiscal adjustments and revenue generations. Besides increasing tax, privatization is an alternative of revenue generations. Compared to cutting expenditure or increasing tax, raising source of financing from privatization receipts is more preferable because it is politically less costly. Two former policy options are politically out of favor because there will be strong opposition especially from directly-affected groups.

Despite the difference in the budget policies between the New Order Government and the Reform Government, the government has consistently aimed to maintain the level of budget deficit at desirably low level. During the New Order regime, government had employed balanced budget policy in which total revenue and total expenditure had been kept equal at the end of fiscal year. Under this system, expenditures are classified into two categories, routine and project/development expenditures. Routine expenditures were financed by using domestic revenues, while project/development expenditures were funded by using foreign loans. Each pair of expenditures and revenues was maintained to be balanced all the time. During this period, privatization receipts had been treated as domestic revenue. However, in reality the budget balance had tended to result surplus rather than deficit at the end of fiscal year. Meanwhile, the government during the Reform Era has implemented controlled budget deficit policy. According to State Finance Law Number 17 of 2003 the magnitude of deficit should not exceed 3% of total GDP. This budget system particularly aims to boost economic development especially during economic downturn. To deal with estimated deficit, the government may use one or more ways classified into two categories: debt and non-debt financing. In this respect, the recent budget system is more straightforward in describing how deficit would be financed. During this era, privatization proceeds have been categorized as non-debt financing sources.

Although it is not openly stated in the Law of SOEs, it is apparent that one of the main motives of privatization in Indonesia is to finance budget deficit. The role of privatization receipts as budget deficit financier can be clearly seen from the allocation of privatization receipt use as shown in Figure 3.6. During the period 1998 – 2006, there had been a substantial portion of government spending allocated to repay loan provided by IMF to help the country out of crisis. At the same time, the source of finance from tax and non tax had not been back to pre the crisis level because the economy had not been fully recovered. Consequently, total government expenditures had tended to exceed total revenues. Hence, the government had experienced huge budget deficit during that period. Privatization pursued during the period had been mainly aimed to be the source of revenue for financing estimated deficit. Therefore, most of privatization revenues during the Crisis had been allocated for the state budget (on average more than 96% of total privatization proceeds). By contrast, after 2006 when the government settled its obligation to IMF, privatization receipt which has been allocated to state budget has been very little (on average almost 10% of the receipts of privatization). It is because the government no longer has serious deficit problem.

From Table 4-3 it can be seen that the government has been successful in controlling the level of budget balance within the desirable range. Privatization has appeared to have significant role in it. Budget balance has ranged from deficit IDR 44 trillion (equal to 3.7% of GDP) to surplus IDR 3.7 trillion (or equal to 2.8% of GDP) during 1991 – 2010. The lowest budget balance occurred in 1999. It was very likely that the Crisis that hit the nation in the middle of 1997 seemed to have taken effects on the state budget 1.5 years later. In that year, privatization receipt was IDR 7.5 trillion or equal to 35% of total deficit. On the other hand, the largest surplus was recorded during 1994 in which privatization receipt contributed to IDR 1.81 trillion

or equal to more than 50% of total surplus. Nonetheless, it is important to note here that there has also been the role of debt financing sources in this regard. As elaborated in the previous chapter, allocation of privatization receipt for state budget has been very marginal during post crisis period. Linking to data shown in Table 4-3, the fact is very understandable because the state budget tends to be very stable in that period of time. After 2002, the budget deficits can be kept under 1.7% of total GDP. Seemingly, this very marginal budget deficit can be solved mainly by using debt financing (government bond).

Table 4- 3 the State Budget Deficits and the Contribution of Privatization Receipts

	91	92	93	94	95	96	97	98
Budget Deficit (surplus)*	0.50	(3.20)	1.70	(3.60)	(1.60)	(10.00)	(15.00)	16.00
Privatization Receipt for Budget*	0.13	0.00	0.00	1.81	3.22	0.00	0.00	1.32
Privatization (% of Deficit)	25.25%	0.00%	0.00%	-50.33%	-201.49%	0.00%	0.00%	20.58%
Deficit (surplus) (% of GDP)	0.20%	-1.13%	0.52%	-0.94%	-0.35%	-1.88%	-2.39%	1.67%

*in IDR Trillion

99	00	01	02	03	04	05	06	07	08	09	10	11
44.00	16.13	40.50	17.11	35.11	23.81	14.41	29.14	49.84	4.12	88.62	46.85	84.40
7.35	0.00	3.57	8.01	6.01	3.12	0.00	2.09	3.09	0.00	0.00	2.11	0.39
38.00%	0.00%	8.82%	46.83%	17.12%	13.09%	0.00%	7.17%	6.19%	0.00%	0.00%	4.49%	0.46%
4.00%	1.20%	2.40%	1.30%	1.70%	1.10%	0.50%	0.90%	1.30%	0.10%	1.60%	2.10%	

Source: constructed by the Author based on MSOEs and MoF

4.2.4 Maintaining Employment

In addition to pursuing profit maximization goal, public firms are often charged by government with non-business activities. One of them is to act as last resort employer. Due to this assignment, it is very hard for public enterprises to lay off unnecessary numbers of employees regardless of the reasons. This is a key reason why public enterprises are often plagued with the problems of overstaffing. Therefore, given the over-employment witnessed in SOEs, governments that come to a decision to undertake privatization are frequently faced with the unemployment problem.

Despite the fact that the level of overstaffing in public firms may vary from country to country, industries to industries as well as firms to firms, it is commonly believed that there is large potential enhancement in labor productivity as an expected effect of privatization.

Several case studies reveal that public firms suffer from the problem of overstaffing. Watanabe (1994) estimates that there was around 22% potential employment redundancy in Japanese Railway Company arising after privatization. Meanwhile, an indication of 35% over-employment is also found in the case of public firms in India and Turkey (Banerji and Sabot, 1994). Even World Bank study indicates that Argentine railway company would experience 50% overstaffing. According to Kikeri (1998) overstaffing is most severe in the case of public enterprises operating in protected market and that relies greatly on government privileges.

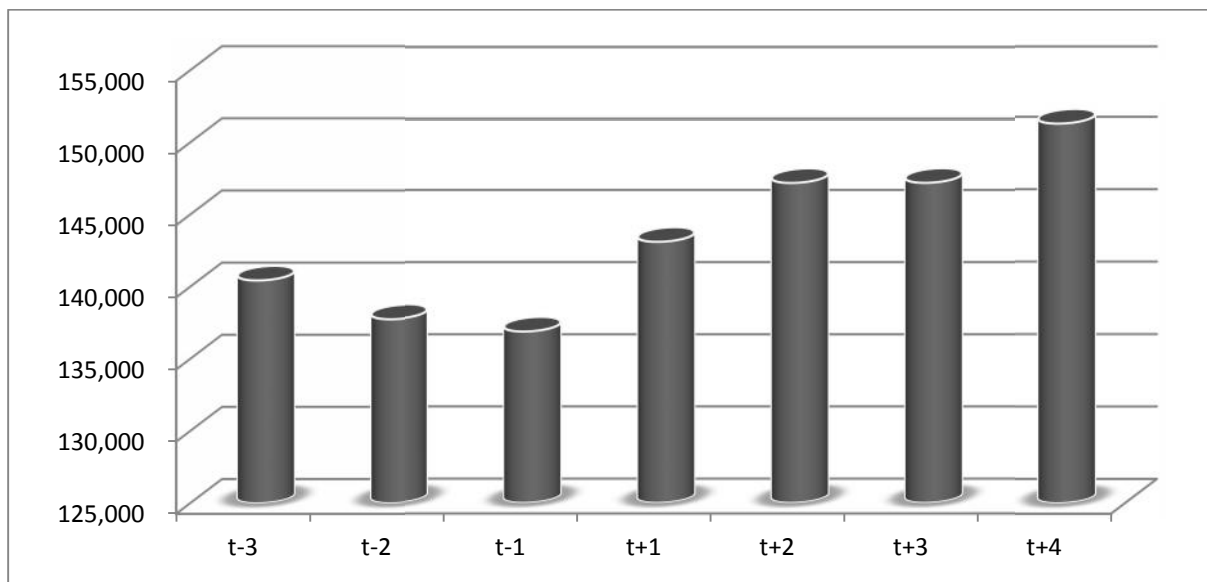
When there is ownership transfer from the state to private owners, irrespective of the percentage, profit-seeking private owners unrestricted by the level of employment tend to reduce the number of workers in order to enhance the efficiency and productivity of the firms. At first, the new owners may offer real wage cuts as a way out to avoid employees lay off. The extent to which the new owners may reduce surplus workers will hinge heavily on the readiness of the employees to accept real wage cuts. Given severe threat of unemployment, several studies find that workers are ready to accept significant pay cuts. However, given the adverse magnitude of over-employment in most public firms, downward adjustment in wage seems to be insufficient to ensure sustained employment.

In Indonesia, employment is one of the important issues raised by the opponents of privatization, specifically the employees of prospective privatized SOEs. Given very high unemployment rate and strong indication of overstaffing in the firms, it is understandable for employees to have such feelings of threat. Surprisingly, privatization in Indonesia demonstrates a

gladly unexpected trend with respect to employment concern. Unlike general trend, the level of employment shows continued increased trend in post privatization. In year t-1 (one year prior to privatization), total number of employees of all prospective privatized SOEs (16 firms) is 136,872 workers. The figure increases by 6,211 (or equal to 4.5%) to become approximately 143,083 in year t+1. Then, it keeps growing to 147,161 (increase 2.9%) in year t+2, 147,169 in year t+3, and 151,207 (increase 2.7%) in year t+4. All figures are presented in Figure 4.6. One may think that this increased number of employees in post privatization would undermine labor productivity. The finding of firm analysis presented in Chapter 5 is not in line with this way of thinking. It is found that labor productivity (inflation-adjusted operating income/number of employees) has steadily increased in post privatization. It is evident that increase in number of employees is pushed by the business needs, not because of the political interference.

Figure 4.6 also reveals another interesting finding that there was continued decreased number of employees during pre privatization. Total employees of 16 partially privatized SOEs are 140,441 workers in year t-3 (three years before privatization). It decreases by 2,690 people in year t-2, or equal to 1.9% from previous year, to become 137,751. The trend continues when the number of employees further declines by 879 (or 0.6%) to 136,872. It means for the last three years prior to privatization there was 2.5% decrease in employment. Seemingly, during this period most of the firms were undergoing restructuring program for their preparation of privatization. Of aspects of the program is to enhance productivity and efficiency by cutting off certain number of unproductive employees. This program is apparently aimed at making the firms better-looking to investors so that it can boost the price of stock. As a result, privatization proceeds can be maximized.

Figure 4. 6 Employee Hired in Privatized SOEs: Pre vs. Post Privatization



Source: constructed by the Author based on MSOEs

4.3 The Success Factors of Partial Privatization at Macroeconomic Perspective

The analyses above demonstrate the success of partial privatization to bring about evidently positive impact on macroeconomic indicators. Partial privatization play very critical role in the following four different aspects; promoting capital market development, being a source of financing for state budget, addressing budget deficit, and maintaining or even enhancing the employment level. In this section, the key factors of success are discussed. To do so, four different aspects, namely the selection of divested firms, the employment of privatization methods, and the characteristics of the process, as well as the political process of privatization, are analyzed.

4.3.1 The Selection of Firms

The government of Indonesia has pursued prudential privatization. One of the reasons can be seen from the way of selecting firms to be privatized. According to Law of SOEs, SOEs that can be privatized have to be in the form of liability limited (Persero). It means that only SOEs

established with profit-seeking objectives can be privatized, while SOEs assigned to serve public interest were impermissible to be privatized. It implies that the government wants to make sure that privatization would only be targeted to the firms which are culturally and mentally ready to confront the competition. Furthermore, a company can only be privatized if it operates in a competitive industry and in an industry with fast-changing technology. Meanwhile, SOEs which fall under one or more of the following conditions are not allowed to be privatized: (1) SOEs which run business in the industries required by law to be operated and owned only by the State, (2) SOEs which run business that are directly or indirectly related to state defense and national security, (3) SOEs which run business in resource-based industries that are specifically prohibited by law to be privatized, (4) SOEs which are assigned by the government to provide certain goods or services for public needs. In the case that there is an SOE which a part of its assets or its activities is dedicated to serve public interest and or in the industry required by law to be done specifically by SOEs, it has to be separated at first before being privatized.

The selection of firms to be privatized is not enough only by fulfilling conditions aforementioned. In the next stage of the processes, SOEs are categorized into two groups: a group of firms that have to undergo restructuring program, and another group of firms projected to undergo privatization program. The former group includes SOEs which are not yet ready and feasible to be privatized at present because of the problems resting on industry and or in internal firm. SOEs which are running business in uncompetitive industry due to either natural or regulated reasons are included in this group. SOEs assigned to serve public interest in the unprofitable industry so that very few private firms are willing to involve in it are also part of this group. In the past, some SOEs also enjoyed a monopoly right from the government. For this state of industries, the government will pursue industrial restructuring aimed at creating

conducive business climate so that efficiency and optimum service can be realized. Some SOEs are required to undertake internal restructuring program because they are unfeasible to be privatized due to the problems associated with organization, management, and finance within the firms. For these ailing SOEs the government will pursue firm restructuring intended for revitalizing SOEs from various related aspects.

To be more specific, as stipulated in Law Number 19 of 2003, privatization is targeted for well-performer SOEs in the industry characterized as competitive and fast-moving technology. Moreover, privatization is also prioritized for an industry in which huge capital investment can be effective entry barrier while technology changes quickly. Apparently, the rationale is that in such industry the firms need more autonomy and independence in dealing with very dynamic circumstances. Of course, to be able to survive and compete in such industry, well-performed enterprises are critical prerequisite of success. How SOEs are categorized with regard to the industry characteristics and the firm competitiveness is illustrated in Figure 4.7. SOEs are considered feasible to be privatized if they are in quadrant where the industry is competitive and equipped with fast-moving technology and the firms themselves are competitive. Other three quadrants imply that the government will have to undertake industrial restructuring and or firm restructuring simultaneously to improve the efficiency and productivity of public firms.

Figure 4. 7 Indonesian Government Policy Toward SOEs

		Structure of Industry	
		Uncompetitive	Competitive
Firm Performance	Low	I Both Industrial and Firm Restructuring	II Firm Restructuring
	High	IV Industrial Restructuring	III Privatization

In order to determine what kind of privatization the government should carry out, Government Regulation Number 33 of 2005 regulates in more detail. It is stated that the government has to take into consideration two aspects, namely the firm performance and positive externality. As depicted in Figure 4.8 there are 4 possible circumstances which are for each state there will be different privatization mode deemed suitable. In quadrant 1 where the performance of firm is poor at the same time the role of the firm is less critical to society, liquidation or full divesture will be the best option. Government ownership in this type of SOEs potentially burdens the citizens because it is highly likely for government to extend its help in a variety of forms such as subsidy, soft-loan, and capital injection. Consequently, some portion of the budget allocation has to be shifted from promoting society's welfare to supporting these ailing SOEs. Hence, with its little benefit for people those actions of bail out are definitely harmful to the society. A similar policy may be imposed by government to those firms which are in the

quadrant IV. In this quadrant, even though the firms may perform remarkably, since their importance for the society is less critical, the government may also divest them. Alternately, it is also possible for the government to invite private investors to run the companies, with the government retains certain extent of ownership for the sake of revenue seeking to finance budget expenditures.

Second quadrant shows a situation where an SOE with huge positive impacts on the society but experiencing low level of performance. In this circumstance, the government of Indonesia would undertake a revitalization program at the first step. In this respect, the revitalization may have many similarities to firm restructuring elaborated earlier. Some aspects related to organization, management, as well as finance needs to be reformed. In the short term, government may have to pour in subsidies, capitals or other forms of privileges. However, in the long term the firms are expected to be more profitable and more efficient. Considering its large benefit for society, tax payers may not mind with this policy. If the revitalization/empowerment program is successful, the SOEs will move to quadrant III so that they will be eligible to be partially privatized.

Privatization is suitable for those SOEs which are in quadrant III. In this quadrant, SOEs are described with excellent performance and bring about huge positive benefits to the society. Given its large favorable impacts, the government is liable to ensure the availability of their goods or services in the middle of the society. Letting private and market alone determine what should be produced at what quantity and what price is considered to violate the constitution. At the same time, since they operate in competitive market it is important for government to make sure that they have ability to compete against their rivals. To achieve both business and social objectives, partial privatization is regarded as the most suitable policy.

Among more than 140 existing SOEs, there are many SOEs which are feasible to be privatized according to abovementioned regulation. However, it does not mean that those firms would be automatically privatized. In fact, the government appears to be very selective in choosing the firms. For the firms planned to be privatized through IPO, they have to demonstrate sound performance for the last two years as an additional requirement. Actually, this requirement is not very difficult to be satisfied so many SOEs should be feasible to be privatized. Still, the government appears to be reluctant to privatize the firms. Besides macroeconomic situations, especially capital market condition, the government also considerably takes into account ongoing socio-political factors. Seemingly, high socio-political costs that present in forms of strong resistances and oppositions from the stakeholders as discussed in the previous chapter is the critical consideration to the government.

What is depicted in Figure 4.8 is what is officially stated in government regulations. In practice, Quadrant I and IV are hardly carried out by the government except for the minority SOEs privatized when the government had been facing severe deficit during the Crisis and in the most recent years when there is less public resistance for this type of privatization. Considering the ongoing political atmosphere, full divestiture towards genuine SOEs is unfeasible due to strong oppositions from stakeholders. A myriad of objections, such as unemployment and sovereignty, arises. Therefore, even for SOEs which have been in Quadrant I for long time, the government has not liquidated them due to several aforementioned reasons. Among those quadrants, only quadrant III in which partial privatization is recommended has been feasibly pursued. However, public response in general over the idea of privatization has been more than enough to give a reason why only very selected enterprises in the quadrant III have been partially privatized. As will be discussed in the following session, very long and uncertain political

process in parliament also contributes to the selectiveness of firms to be privatized. To deal with this situation, the government only proposes the best of the best firms to be consulted with and to get approval from the parliament.

Figure 4. 8 The Privatization Strategy of the Indonesian Government

		Positive Externalities	
		Low	High
Firm Performance	Low	I Full Divesture	II Empowerment/ Revitalization
	High	IV Divesture/ Strategic Sales	III Partial Privatization

Given various economic and socio-political factors early mentioned, only very few firms among the SOEs that actually meet all conditions and requirements stipulated by the government are finally selected. As a result, SOEs privatized are tightly selected among the best performers of firms. This will bring several advantages related to its impact on macroeconomic and microeconomic aspects. Firstly, the government can reap large amount of privatization proceeds to cut budget deficit. Considering their performance, the government can set high price for the stocks offered. Moreover, the firms would definitely attract the interest of the investors to buy their stocks. In addition to ongoing performance, the firms also promise high future gain both in terms of capital gain or dividend yield. Secondly, once the firms are privatized through IPO, the

stocks of firms which reflect an excellent ongoing performance and an outstanding future performance are likely to be heavily traded in the stock market. Thus, the stock is liquid because the investors are willing to sell and buy the stocks enthusiastically. As a result, it can stimulate capital market activity. In turn, this active capital market will encourage other firms and investors to also go public. Thirdly, since the firms selected are the best among the very best SOEs, it is highly likely for those firms to have skillful managers, productive workers, well established organizational culture, and other positive things that help the firms to reach better performance after privatization. Then, with enhanced performance after privatization, the privatized firms will be able to contribute to the state budget with higher dividend, larger taxes, and other financial contribution as discussed earlier.

4.3.2 The Method of Privatization

According to Law of SOEs, the method of privatization can be classified into 3 types in accordance with the channels which share offerings should go through. These are stock market, direct investor, as well as management-employee channels. Privatization through stock market channels basically consist of sale of shares through initial public offerings, secondary offering and block sale. In addition to the simplicity of the process, this channel is believed to have some other benefits such as allowing widened public ownership and promoting capital market development. Nonetheless, this channel also has some disadvantage, for instance potential dispersed ownership, lack of new access toward product market and technology, and discounted sale prices. This method is considered suitable for prospective privatized firms with the following characteristics: 1) operating business in competitive industries, 2) having high growth in last few years and high potential growth in the following years, 3) possessing excellent

goods/services, 4) the need of huge capital for business expansion, 5) having high competency in terms of technical, managerial, financial capabilities.

The second channel of privatization is through direct investor. Privatization through this channel is mostly undertaken through strategic sale (also called private placement), which is done by offering shares to some selected investors in the first stage, then the investor with the highest offering price will be chosen to go to the negotiation stage. In this stage some important issues such as first right to buy shares when one party wants to sell, the privilege rights of two parties, the composition of board directors and so on are discussed further. This method is claimed to have some advantages such as premium sales price, the access of abundant capital from the private sector and abroad, the transfer of technology and managerial expertise. Nevertheless, rather than suspicious and less transparent process in comparison with other channels is considered as the main shortcoming of this method. Firm which is suitable to be privatized through this channel has following characteristic 1) in need of expertise and know-how such as technology and product innovation, marketing network, as well as financial sources from strategic partners 2) while in need of huge fund but having difficulty in attracting fund from capital market, 3) running business in industry which is not strategic to government so that there is possibility for the government to become minority shareholder.

The last channel is through management and employees. This channel is basically to sell state shares to the management or the employees of the divested firm itself, it is usually referred as Employee Management Buy Out (EMBO). This method is generally chosen with some considerations such as to prevent foreign investors from buying the stock, to resolve agency problems by offering managers an incentive linked to the firm performance. Nonetheless, this method also has several drawbacks such as no access to new technology or managerial expertise,

SOE dependence on government help remains, and the problem of financing this privatization may be present. This channel of privatization seems to be appropriate for a firm with the following characteristics: 1) doing business in certain industry that requires “brainware” or specific expertise as core competency, 2) estimated privatization proceeds are relatively small, 3) the company has to maintain the continuation of the scheduled program, privatization is expected not to change existing management and its operation, 4) the nature of firm business can be managed by employees and management 5) the capital of firm is relatively small so that employees and management can participate in the ownership.

Almost all of first time privatizations in Indonesia (17 of 18) have been carried out through IPO so far. It can be as a response toward some objections and pressure that arise from stakeholders with regard to the privatization plan proposed by the government. Given Indonesian context, some people suspect that some officers or some politicians, especially those whose links to ruling parties, use privatization as one way of obtaining kickbacks or bribery for their personal or group benefit. It somewhat makes sense because Indonesian political system is costly and badly inefficient. Some groups of people also link the issue of privatization to the matter of sovereignty. For them, privatization is considered to be similar to *foreignization*. It was relevant especially during the the Crisis when domestic investors were in serious financial hardship and at the same time foreign investors had relatively stronger purchasing power.

IPO is considered as the most transparent method of privatization because it involves several independent and professional parties such as financial consultants, underwriters, stock market authority, and public. Among the important issues arising are at what price the firm stock shall be offered. In the case of IPO, there is certain mechanism which can ensure that the offered price of stock is estimated and set objectively and transparently based on the response of

prospective investors over the prospectus launched. Once it is publicly announced, it would be very hard for someone who wants to grasp rent from a hidden transaction of price, like in the case of strategic sale. To prevent acquisition by foreign investors as worried by a group of people, it is a common practice that the government restricts the certain proportion of shares allowed to be sold to foreign investors during IPO. Even in the case where foreign investors eventually hold more ownership by buying the stock from domestic investors in the secondary market, the concern of sovereignty is irrelevant. The characteristics of ownership resulting from privatization carried out through stock market tends to be highly dispersed among individuals and less likely for institution to possess a significant number of shares.

Despite the fact of massive privatization through stock market, it is clearly shown in the analysis that Indonesian stock market has been relatively less developed, especially until the beginning of the 2000s in which during that period many SOEs had been privatized. It can be seen from the stock index and the number of firms listed as shown in the analysis above. Apparently, the government tries to optimize the proceeds by taking into consideration economic, politic, and social variables. Although it might not be economically optimal, the choice is politically and socially more acceptable. In this respect, it seems that the government was more concerned about public acceptance than maximizing proceeds. Amid public resistance toward government's plans to privatize firms, the only SOE privatized at the first time by using method other than IPO was PT Pembangunan Perumahan divested through EMBO.

Meanwhile, the majority of subsequent privatizations (7 of 12) were done through strategic sales/direct investment. This kind of privatization method was mostly employed during 1999-2006, when the stock market seemed to experience poor performance as an impact of the Crisis. As a result it was very hard to get good price for shares offered. On the other hand, the

main objective of privatization, particularly during that period of time, was to raise national revenue to finance huge budget deficit. Strategic sales or private placements were considered as the best method to generate larger proceeds from privatization than other methods. Furthermore, the issue of transparency was not a big deal in these subsequent privatizations because the public could use existing stock price as a reference to estimate proceeds yielded. The public would expect that the minimum estimated proceeds would be equal to existing stock price times the number of stock sold.

The Secondary Public offering (SPO) has been chosen to be the method of privatization for the rest of the subsequent privatizations (5 of 12). Interestingly, this method has been used recently since 2006. Apparently, the government has shifted the method from strategic sales to secondary public offering after considering the development of capital market. As it is shown in the earlier section, Indonesian stock market has steadily grown throughout the time. As one of the indicators, the Indonesian stock index had ranked second among countries in the region in 2004 after staying at the bottom for a long time. Seemingly, the government has optimized the proceeds of privatization by selling the stock of SOEs through the upturn stock market.

From the explanation above, it is observed that the privatization methods employed by the government have played very critical role in achieving the objectives of privatization. The methods have been chosen carefully by taking into account all related aspects such as economy, politic, and social concerns. The privatization methods employed have been evidently effective not only to maximize the receipt but also minimize the resistances and oppositions. The methods have varied from one circumstance to another. It differs between first time and subsequent privatizations. The government has employed IPO for most of first time privatization for the sake of accountability and public acceptance. Subsequently, privatization has been carried out either

through strategic sale or secondary market offering according to macroeconomic condition especially capital market situation.

4.3.3 The Pace of Privatization

As elaborated in the previous chapter, in addition to being very selective, privatization in Indonesia is characterized as gradual and partial. Apparently, these characteristics also play significant role in bringing about the positive impact of privatization on the macro front. Politically, partial privatization is an effective way to respond to the concerns of several parties of stakeholders who raise the issue of national sovereignty. Partial privatization guarantees that the state would not lose its control over the firms. Almost the same level of control as pre privatization would be retained. This allows government to powerfully determine the amount of dividend paid, the level of employment hired, and other important decisions. Despite the fact of decreased dividend payout rate, the presence of state control can ensure that the total amount of dividend paid in post privatization is as much as targeted to finance a fraction of government spending in the state budget. As discussed earlier, it has been greater than having been paid in pre privatization. Similarly, though it is unclear whether it is pushed by business need or political interference, the higher level of employment after privatization somehow is affected by the presence of state control in the firms. It is impossible to segregate the objective of government to reduce unemployment in the country from the increased trend of employment in the partially privatized enterprises. As it will be shown in the next chapter, this government objective can be realized without harming the objective of firm in boosting labor productivity.

The decision of government to pursue gradual privatization also cannot be ignored as one of privatization success factors from macro point of view. This can be viewed as a part of strategy of government to soften the process of privatization and also to maximize the receipt of

privatizations. As mentioned earlier, privatization has never been as fully-agreed program in Indonesia, especially when it is in the early period of policy implementation. There is always strong resistances/oppositions from the stakeholders. To moderate the resistances and oppositions from stakeholders, the government appears to start by divesting a small number of shares, and then follow it with other subsequent privatizations. Moreover, given limited market capacity and ability to respond the offered stock during privatization, gradual privatization is also very effective to maximize the proceeds. In some circumstances stock market might not be able to absorb a big number of shares offered to public. For instance, during economic downturn or sluggish stock market, when investor's ability and appetite to invest is decreasing, it might be improper for government to release big portion of shares. Otherwise, the receipts of privatization might not be optimum. As indicated by some facts aforementioned, Indonesian capital market had not been trully developed, particularly until the beginning of 2000s. Matching with the market demand by selling relatively small number of shares seems to be very effective to optimize the offering price of stock. Therefore, pursuing gradual privatization is very appropriate policy choice in attempt to maximize the privatization receipts.

4.3.4 The Political Process of Privatization

Privatization, especially in Indonesia, is not merely an economic decision but also a political and social decision. Since privatization is politically and socially sensitive, therefore, it has been cautiously pursued. Economic impact of privatization might not be reaped unless it is politically feasible and socially acceptable. To see how these balanced-objectives can be realized in Indonesian context, it is relevant to see how decision regarding privatization has been taken by involving-political agents in the government.

Recently, how a decision concerning the privatization of SOE is taken has been stipulated in Government Regulation Number 33 of 2005. The process begins when the parliament approves state budget proposed by government. Including in the proposed state budget is estimated revenue targeted to be obtained from privatization. Actually, during discussion about the state budget the government is usually asked to present rough plan of privatization before coming up with certain figures of target of privatization revenue. After state budget is approved, MSOEs as the oversight ministry proposes draft of annual privatization program (APP), which includes list of SOEs to be privatized, the percentage of share to be sold, the proposed method, and the estimated receipt, to the privatization committee. The committee's existence, functions and some other aspects are regulated in President Decree Number 18 of 2006, consisting of several members as representatives from related ministries such as the MoF, MSOEs, technical ministries and Coordinating Ministry. After examining, studying, providing some suggestion of changes, the committee will approve the proposal to become official APP.

Afterward, according to the regulation, the ball of privatization implementation is on the government side. Basically, the government can execute the privatization plan manifested in the form of APP without further approval from the parliament. If it is necessary, the government can consult with parliament for very strategic issues. In fact, there is very long and intensive consultation session between the government and the parliament. Almost every detail with respect to privatization of a particular firm such as the percentage of share to be sold, the privatization method to be employed, the price of stock to be offered, some other technical issues have to be approved by parliament. It is not surprising that for every single SOE to be privatized there will be dozens of meetings and discussions that takes unpredictably a couple of months. Unluckily, there is no certain and fixed time schedule for this. In some circumstances,

privatization often loses the market momentum because of this long and uncertain process. To make situation worse, this stage is done firm by firm. Apparently, it could be another reason why privatization has been carried out very slowly in Indonesia. Once every aspect is clearly confirmed and approved by parliament, the government will issue a legal basis in the form of Government Act for further realization by MSOEs.

Afterward, MSOEs along with the management of related firms are required to do some preparations in order for privatization to be finally executed. Before that, management is obliged to socialize the plan of privatization to stakeholders. It aims to reduce the extent of resistances and oppositions from them. Actually, many ways of pre-socialization activities are usually already done long time before. However, at that moment the plan is not fixed yet. Simultaneously, some necessary preparations such as the appointment of underwriter, law consultant, public accountant, financial adviser and so on will be the next important thing to do before final execution. Sometimes, after everything has been done privatization is not automatically executed due to market condition.

The process of consultation between MSOE and parliament is the core of decision making process. It is the most time consuming process compared to the other stages. The dramatic change brought by the Reform era gives parliament equal power after more than three decades under the control of presidency. An euphoric reformation has seduced members of parliament to overwhelmingly exercise their power. Consequently, in some circumstances parliament forcefully politicize some processes that are actually beyond its authority. For instance, with respect to privatization parliament is only required to give approval the big plan of privatization. In fact, they also involve in taking decision for most of the technical issues. It has been worsened by a fact that there is no single majority in the parliament during the Reform Era.

Reaching agreement among various political views and interests of involved parties seem to be a major cause of it. As a consequence, most decisions have to be taken through a long process of negotiations among several political parties. On the other hand, the government is forced to follow the process in order to minimize political resistances and oppositions.

Despite long processes that sometime may cause the loss of momentum, this process also brings about positive impact from a political perspective. This process places government in the advantageous position. It would result to a decision with strong political back up because it is approved by people through their representatives. The government is not the only part to be responsible for the success or failure of privatization. The parliament as the representative of the people also has to be responsible if privatization fails. Moreover, considering very long processes to be undertaken, it is comprehensible if the government would prioritize the best and the readiest SOEs to be privatized at first. It is possible for government to have another selection among SOEs included in APP. As a result, it would increase the possibility of privatization to be successful. The description of the flow on how privatization decision is taken by involving related parties in Indonesia is as described in Figure 4.9 below.

For the illustration pertaining to the length of the political process that needs to be undertaken, the most recent privatization plan of PT Semen Baturaja that runs business in cement industry is used as the case study. In the very beginning the privatization of the firm had been included in APP of 2008 which the government planned to sale 35% of share through IPO. However, the privatization could not be realized due to some reasons including the firm's performance and economic as well as capital market situation. Afterward, the government through MSOEs proposed the privatization of the firm as part of the government's proposal of 2012 state budget in which there was the privatization receipt estimate as part of targeted

revenue. This budget proposal usually has to be submitted to the parliament six months before the fiscal year starts, meaning around mid 2011. Therefore, MoF has given the endorsement/recommendation about the privatization of the firm several months before the submission, which was on 23 March 2011 through MoF Decree No: S-142/MK.06/2011. When the House of Representative endorsed the state budget proposed the government (around the end of 2011), it meant the green light of the privatization PT Semen Baturaja was obtained.

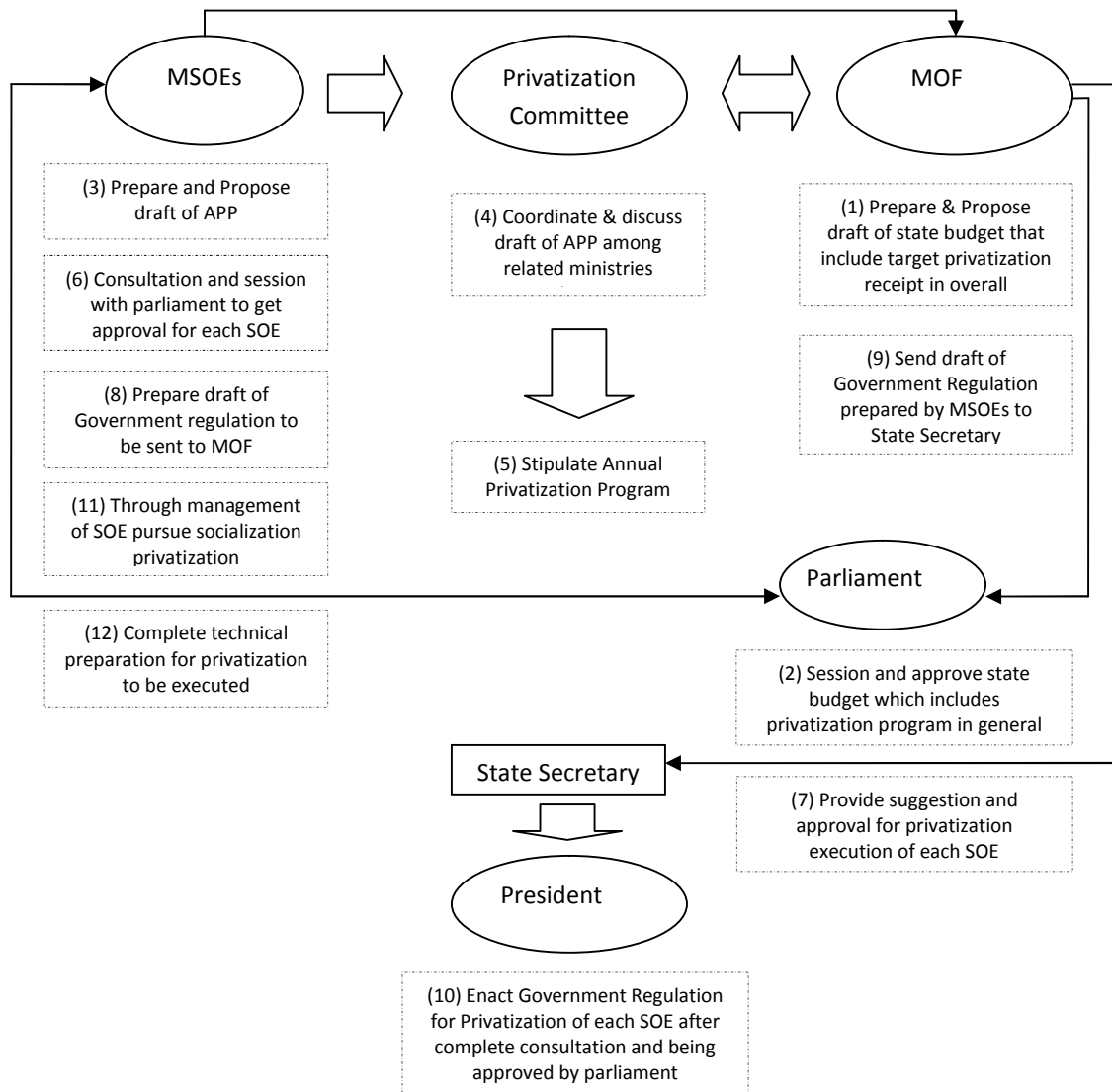
The next process was to stipulate APP by the Privatization Committee. Along with the discussion in the internal Privatization Committee, MSOEs has had a consultative meeting with Commission VI (responsible for Economy) of House of Representative simultaneously. Of the meetings was the one held on 15 March 2012 discussing concerning APP proposal. On the other hand, after several meeting with other members of committee, Minister Coordinator for Economic Affairs as the chairman of Privatization Committee' has issued decree No KEP-06/M.EKON/01/2012 dated 31 January 2012 about APP in which PT Semen Baturaja was the one of firms in the list. The next stage was the detail discussion with the House of Representative about the privatization of the firm specifically. At the same time, MSOEs has prepared other technical matters, including endorsing supporting institutions/professions on 1 June 2012 through MSOEs decree No: S-277/ MBU/2012. Technical preparations have also been carried out in the firm, including conducting extraordinary general shareholder meeting to discuss the increase of the firm's capital structure. With regard to legal aspect, that was to harmonize the draft of the government decree, a meeting under the coordination of Ministry of Law and Human right was held on 21 September 2012.

After almost seven months with numerous discussions and meetings, finally the House of Representative approved the privatization of PT Semen Baturaja. Yet, the process has not over yet. Subsequent several meetings had been undertaken with another Commission of House of Representative. It was Commission XI that was responsible for finance and planning affairs. Several meetings were held on 4, 11, 13 December 2012 to discuss about the privatization method. Related parties such as BOD of PT Semen Baturaja, MoF, and MSOEs attended the meetings. Again, after several meeting Commission XI finally agreed IPO as the method of privatization as stated in the Letter of the chairman of House of Representative no. PW-01916/DPR RI/II/2013 dated 19 February 2013. This letter was used by the government to issue the government decree Number 39 of 2013 on privatization of PT Semen Baturaja through IPO on Indonesia Stock Exchange on 28 June 2013. In total the process took two years process.

Although public choice theorists argue that conflicting interest of multiple involving agents may cause the economic decisions become less optimum, coordination which has existed in the political process of privatization in the context of Indonesia has seemed to successfully manage the agency cost at relatively tolerable magnitude compared to expected economic benefit. In my opinion it may be because of several factors such as 1) less number of involving parties compared to previous regime, 2) dramatic change in the political realm, 3) the strong benevolent commitment of the government in pursuing privatization policy. In this respect, the mainstream view of public choice theory appears to understate the possibility of positive impact stemming from such competing interest of multiple agents in the decision making process. Under certain way of effective coordination, rivalry among related institutions in decision making process is also likely to produce better decision through checks and balances mechanism. In the case of privatization in Indonesian, check and balance mechanism still exist among related institutions,

particularly between MSOEs and MoF because both ministries share authorities in some aspects of privatization.

Figure 4. 9 Privatization Decision Making Process



Source: constructed by the Author based on MSOEs

4.4 Summary and Conclusion

To be considered as a successful privatization, the microeconomic and macroeconomic impacts of the privatization have to be included in the assessment. In this chapter the impacts of privatization from macroeconomic perspective are investigated. It is in line with the objectives of privatization that include the benefit of internal and external stakeholders. The four aspects of macroeconomic considerations are promoting capital market development, financing state budget, managing budget deficit, maintaining employment. These are incorporated in the analysis.

Based on the descriptive analysis of data, spanning from three years before and four years after privatization, the following findings are revealed. Firstly, privatization plays very significant role in pushing the development of capital market. In the early 1990s Indonesian capital market was far from developed. Along with the presence of listed SOEs, the capital market has shown rapid development as indicated by increased market capitalization and number of firms listed. Total market capitalization of all privatized SOEs combined has accounted for very significant proportion in comparison with total market. Moreover, almost all of listed SOEs stocks have been rated as top performers (LQ45). Excellent SOEs stock performance derived from excellent operational performance of firms has attracted not only the interest of investors to invest in the capital market but also the interest of other firms to go public through stock market. It is also supported by the fact that the number of listed firms continues to grow from time to time.

Secondly, partial privatization has obviously improved the financial contribution of the partially privatized SOEs to the government in the form of taxes and dividend used to finance budget expenditure. As indicated by increased net income, increased financial contribution is mainly caused by improved firms' performance rather than by the change of payout policy.

However, the role of retained state control in making sure the fulfillment of budget need over the needed revenue could not be ignored in this respect. Thirdly, privatization receipt has been evident as one of effective sources of deficit financing. It is shown that the privatization receipt realized to be allocated to state budget during the Crisis tends to be higher in terms of both the amount and the proportion. Along with other sources of financing such as loans, the government has succeeded to maintain budget balance (either surplus or deficit) at desirable levels. As a result, macroeconomic performance indicators such as exchange rate, inflation rate, and interest rate can be maintained at desirable magnitude. Fourthly, unlike concerns by most stakeholders, privatization has promoted higher level of employment. An improved firms' performance in post privatization has appeared to promote employment as shown with greater number of total employees hired in privatized SOEs. Surprisingly, continued lay off occurred during the three years preceding privatization. Seemingly, employee rationalization is pursued by government as part of restructuring program in preparing certain firms to be privatized.

The analysis finds some success factors of partial privatization in Indonesia from macro perspective. Firstly, there has been very tight selection process of firms to be privatized. To be eligible for partial privatization, the firms have to: a) run business in the industry characterized as competitive or fast-changing technology, b) demonstrate very good performance, c) have large positive externalities. Moreover, very long process of consultation with parliament urges the government to prioritize the best of the best among firms approved to be privatized in the particular year. As a result, only firms with the best current and future performance would be privatized so that it can yield maximum privatization receipt, generate high market capitalization, produce more financial contribution, encourage more investors, and firms to participate in the capital market.

Secondly, privatizations have been employed using proper method in accordance with capital market situation and economic condition. It has been also selected by balancing between economic, political, and social benefits. Therefore, the method employed has varied from one circumstance to another. As a result, not only economic benefit in terms of maximized receipt but also political benefit in the form of reduced political and social resistance and opposition. Thirdly, the characteristics of privatization which are partial and gradual also play significant role as success factor. Partial privatization allows government to retain the control over the firm. Therefore, the presence of state control allows the government to make sure some critical policies such as policy of dividend and employment are in line with the interest of government, and do not harm the interest of other stakeholders. Furthermore, gradual privatization enables government to maximize privatization receipt by matching the size of stock that is going to be sold with the capital market situation. Lastly, the success of privatization is also closely related to the political support received especially from parliament through political processes. Despite a long process of consultation and sessions for the approval of almost every aspect, the government can minimize political resistance and opposition from stakeholders.

Chapter 5

Partial Privatization and the Performance of Privatized Firms: An Analytical Framework

5.1 Introduction

As presented in the chapter on the literature review, the mainstream arguments claim theoretically and empirically that full privatization is the best mode for improving the performance of public firms. Full privatization brings about two key factors of performance improvement in state firms: internal and external governance mechanisms. Transfer of control from government with multiple but ill-defined objectives to private owners whose single objective of firm value maximization enables internal governance mechanism to be present. On the other hand, external governance mechanism in the form of disciplinary impact of hostile takeover threat is expected to be present due to the involvement of capital market. However, the mainstream arguments seem to overstate the essence of finding. Consequently, they tend to understate the possibility of success for other circumstances of privatization if those two critical conditions are absent.

Due to the presence of ideological, political, economic, as well as social constraints, developing countries tend to choose partial privatization as a strategy to bolster the performance of public firms. According to the mainstream argument, the only chance of partial privatization to succeed is if an efficient capital market exists in the economy which is not the case for most of the developing countries. In fact, most of the developing countries lack well-developed stock market as a prerequisite for successful privatization. The mainstream arguments may argue that privatization in such circumstance is highly unlikely to be successful. Therefore, they fail to give

adequate explanation pertaining to the success story of partial privatization that may appear in certain countries.

This thesis suggests that the reason behind an improved performance is the presence of enhanced monitoring and incentive. Needless to say, there is no “apriori” causality between the type of ownership structure and economic efficiency. A firm under either public or private ownership is possible to reach higher level of economic efficiency as long as the required conditions, which are the presence of proper monitoring and adequate incentive, are met. However, it is impossible to deny the fact that most of empirical studies show that private ownership tends to be more relatively efficient in comparison to public firm. It is because more proper monitoring and more adequate incentive is more likely to present in the private ownership mode than in the public ownership regime due to less complex principle-agent structure, more attenuated property right, harder budget constraint, and the presence of takeover threat from capital market.

Likewise, to explain the findings that most theoretical and empirical studies are more in favor of full privatization over partial privatization to successfully bring positive impact, especially on the performance of individual divested firms, this thesis argues that because full privatization is more likely to present improved monitoring and incentive than partial privatization. Nonetheless, it does not imply that the possibility of partial privatization to successfully bring about favorable impact should be understated. As long as it can present improved monitoring and incentive through several sources of potential corporate governance, the enhanced performance of partially privatized firms is not impossible to be realized. This chapter aims to shed light on the possible mechanism through which improved monitoring and incentive may be present following partial privatization, even in the absence of well-developed

capital market as commonly prevails in developing countries. The possible mechanism is presented in a simple analytical framework proposed to emphasize the involvement and the interaction of several potential sources of governance that is present in the case of partial privatization. The analytical framework helps to understand factors affecting the success of partial privatization in developing countries in which some imperfections in the economic system may often exist.

Up to this point, Section 5.2 introduces an analytical framework composed of three potential sources of improved monitoring and incentive (corporate governance) as a key of performance improvement. Those potential sources of corporate governance are government governance, capital market governance, and product market competition. After overall model is presented, each component of the model is defined and discussed. This section also discusses potential variables underlying the potential sources of governance that may bring about positive or negative impact on the firm's performance. Section 5.3 illustrates the relations and interactions among the variables. Finally, a brief summary of the discussion is presented in the Section 5.4

5.2 The Determinants of Performance Improvement in Partial Privatization

This thesis firstly emphasizes the point that the performance of a particular firm is basically a result of the function of monitoring and incentive prevailing in the firm. The performance is affected significantly by the way monitoring is to be pursued and the way incentives are to be given to the employees and managements. The firm in which proper monitoring and adequate incentive exist would be likely to have better performance in comparison with the firm in which poor monitoring and insufficient incentive scheme prevails. With regard to this, it is important to

identify all related parties with the interest of pursuing proper monitoring and granting adequate incentive in the case of partial privatization.

According to Alchian and Demsetz (1972), the efficiency of a particular individual firm can be maximized if the firm is operated and monitored by the parties who deserve to get the residual earnings referred to as *residual claimants*. The residual earning can be defined as a part of the total earnings of firm that remains after fulfilling all obligations to the owners of production factors. There would be direct relationship between the size of the residual earning that is going to be obtained by certain parties and the level of intensity which the related parties would commit to pursuing proper monitoring and granting adequate incentive. The party with bigger proportion of residual earning would pursue higher intensity of monitoring and granting incentive. This thesis finds that at least there are three main groups of *residual claimants* in the partially privatized firms. Those are the government as majority shareholders, the non-state minority shareholders, as well as the workers and managers of the firm itself.

The government is the main residual claimant because as majority shareholder the government will enjoy the biggest part of remaining earnings in the form of dividend. The amount of dividend going to the government is proportional to the number of shares owned by the state. As discussed in Chapter 3 and Chapter 4, in addition to dividend, the government also benefits from a variety of contributions in the form of both financial and non financial aspects. Financial contribution includes tax and partnership and societal development fund, while non-financial contribution can be in the form of the critical role of SOEs as agent of development, a vehicle of public service program, as well as its role in reducing unemployment. Most of those contributions are related to the performance of individual firms. Moreover, the government, specifically politicians from the ruling parties, is also the party that benefits utmost from the

excellence of the firm's performance. More taxes and larger amount of dividends used to finance government expenditures, higher employment rate, as well as other non financial benefits are fuel for nurturing the ruling government's reputation used to win the next general election. Even simply, better performance of partially privatized firms can be considered as an achievement or credit point to the government. Therefore, the government should have huge incentives to make the partially privatized firms perform well.

In order to ensure that partially privatized firms can have better performance, the government may take several actions. In this regard, the government can act either as majority shareholder or as regulator. In fact, there are no significant contradictions in objectives between its role as shareholders or as regulator.

The second residual claimant in partially divested SOEs is non state stockholders who usually comprise individual and/or institutional investors. They altogether are usually minority in number in comparison with the government's ownership. In most cases, their main motive of investment is to get either capital gains or dividends. Capital gain/loss refers to the difference between the purchasing price and the selling price of stocks, while dividend refers to residual earning profit usually distributed in the end of operating year. In the efficient capital market both capital gain and dividend have direct relationship with the performance of the firm reflected in the price of stocks. The firm with ability to provide higher potential dividend is likely to have higher stock price. However, an efficient capital market does not always present in the economy.

In the less efficient capital market asymmetric information is pervasive; the stock price is highly affected by gossips, rumors, and pseudo-trends that may distort the information pertaining to the genuine performance of the firms. In this situation, stock price may not reflect the real

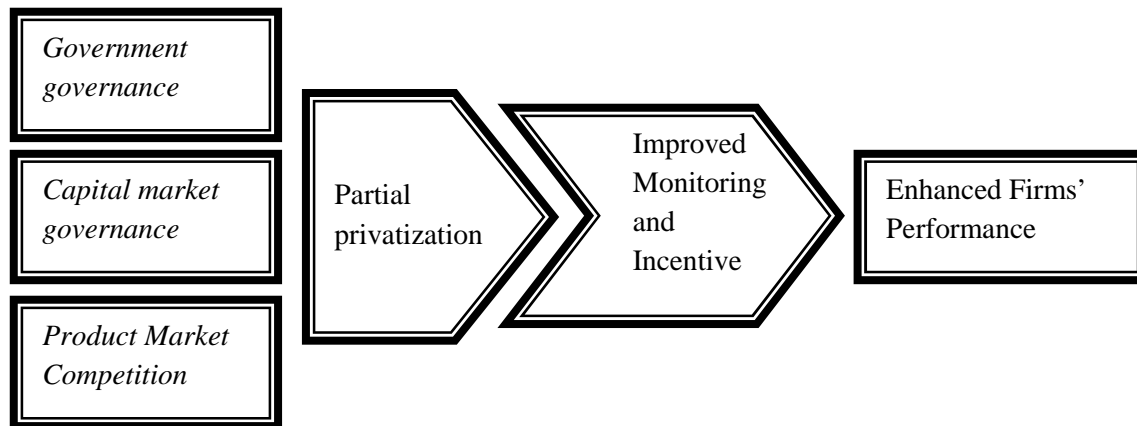
performance of firm. Consequently, most of individual investors with insignificant number of shares tend to maximize capital gain other than gaining dividend. They tend to base their investment decisions on the trend of stock price in the capital market. Realizing capital gain directly linked to the movement of stock price is considered more certain than waiting for potential dividend realization. Another consequence is that, they are likely to have less incentive to monitor the real performance of managers in operating the firms. Similarly, the behavior of institutional investors will follow the same pattern. However, they may have more incentive to monitor firms relatively to their power in influencing the decision. Furthermore, the extent to which minority shareholders can exercise its right is also found to have positive relationship with the development of capital market. In short, the level of monitoring and incentive imposed by non-state shareholder highly depends on the capital market development/efficiency.

It has been almost a consensus that employee/managerial ownership is believed to be able to lessen agency costs as a consequence of the separation of ownership and control. A higher ownership stake by insiders may assist to bring into line the interests of management and shareholders. In this respect, employee and managers become one of residual claimants who have incentive to monitor the performance to maximize their remaining earning at the end of the day. Monitoring by insiders stockholders can be done through two different ways: direct or indirect way. Direct monitoring can be done through self monitoring over themselves or reciprocal monitoring among workmates during their work time. This self and reciprocal monitoring would be effective if the incentive given by shareholders, specifically state ownership as majority shareholder, is stimulating. Thus, it goes back to the soundness of government governance mechanism. Indirect way of monitoring can be pursued through the function of capital market as it is done by non state shareholders discussed above. It is likely for

them to sell their stock when realizing capital gain is considered to be more advantageous than retaining the stock for the longer period of time. Even more, as insiders, employees and managers who own stocks, might have information publicly unavailable/unpublished. As a result, they might take preemptive actions before other investors take any decisions with respect to their future investments. Thus, the capital market efficiency also plays very important role in this matter.

Beyond those residual claimants abovementioned, there is another important factor that also plays critical role in establishing proper monitoring and adequate incentive, i.e. product market competition. Independently, the product market competition affects the performance of firm regardless of their ownership structure. Intensified competition enables large information about the firm and its competitors to be revealed so that it can help the principle/owner in pursuing better quality of monitoring. On the other hand, the incentive effect of competition stems from its threat of bankruptcy that forces managers to utilize the enterprises' resources efficiently. Product market competition is more relevant to be discussed in the issue of partial privatization especially related to its relation and interaction with two other sources of governance. For instance, the magnitude of product market competition should be considered as one of important factors for government to establish proper monitoring and adequate incentive. Too much incentive for too little competition is likely to make employees and managers become spoiled. Vice versa, too little incentive for too fierce competition would not be enough to stimulate employees and managers to achieve the goal set. Thus, matching between the level of competition and the type and the extent of incentive would be the key success to enhancing the performance of firms.

Figure 5. 1 Analytical Framework: Partial Privatization and Firm's Performance



As further illustrated in the Figure 5.1, factors affecting the quality of monitoring and incentive, which in turn will affect the performance of partially privatized firms, can be categorized into three components. They are (1) *government governance*, (2) *capital market governance*, and (3) *product market competition*. This comprehensive construct eases the identification of the role of each component toward performance improvement after privatization. It also allows identifying various conditions under each component that can bring either positive or negative effect with regard to the effectiveness of monitoring and incentive of each particular residual claimant. It also enables exploration of how each component might interact with each other to determine the overall impact on the performance of partially privatized firms. The diagram can help in explaining (1) *how partial privatization, in which the government remains retaining the control over the firms, can still succeed in the country in which capital market is yet to develop*; (2) *why some of the partial privatization over firms in the same country but across the industries might bring different outcome*; (3) *what variables may affect each potential source of improved monitoring and incentive*.

The magnitude of the role of each component in affecting the performance may vary from one circumstance to the other. In general, the role of government governance is always the most central, considering the position of the government as a control holder that dominates the decisions. Moreover, capital market has often not developed in most of developing countries so that its role is not very significant. However, along with its stage of development, the role of capital market gradually becomes more critical. If the trend continues, it is not impossible for capital market to become as important as government governance. During this process, product market competition may act dynamically as a booster/stimulant of the process either through its relation with financial market or through government governance, as elaborated in later sections.

5.2.1 Government Governance

In this thesis, government governance can be defined as the way a government acts both as a majority stockholder and as the main stakeholder in governing SOEs. In other words, it also refers to the way the government as a major residual claimants maximizes its remaining earning and other forms of benefits by pursuing proper monitoring and establishing adequate incentive scheme. In this respect, existing mainstream views have at least two limitations.

Firstly, It seems to be very naive and unrealistic to argue that government always act as an evil so that there is no other way but minimizing its role especially in economic sense. As argued by public choice theorists, due to conflicting interest of multiple involving agents, this may cause the economic decisions become less optimum. However, it is merely impossible to single out the role of government from the economy because the government's engagement is indispensable, particularly in the developing countries where economic structures and infrastructure are far from well-developed. Even in the developed countries, certain level of government interference is necessary. It would be safe to argue that the involvement of the

government is necessitated in certain circumstances and certain level of economic development. Moreover, the mainstream view appears to understate the possibility of positive impact stemming from such competing interest of multiple agents in the decision making process. Certain magnitude of rivalry among related institutions in decision making process is likely to produce better decisions through checks and balances mechanism.

In addition to possible reasons abovementioned, it is argued that certain extent of political ownership and control might be indispensable to alleviate the cost of managerial agency. Some politicians might not want the resources which are under their influence to reduce. According to the theory of the “helping hand” (Amess, et al, 2009), some level of state ownership is also needed to provide positive effects on stakeholders’ welfare. Given the context of developing country, advocates of this theory also contend that the presence of government ownership can be a resolving tool of market failures problem; such as the absence of property rights protection, the discrimination of private investors, unsound corporate governance mechanisms and inadequate managerial incentive problems. In short, this “helping hand” view of political control is simply positive, in contrasts with the view of political control as a source of inefficiency.

Secondly, the existing mainstream arguments also tend to carelessly assume that the government’s benevolence in governing the enterprises is fixed / unchanged. In contrast, this thesis argues that the government benevolence especially in its commitment to improving the performance of public firms is likely to change (shift up or shift down) or to be reinforced in response to political, social, and economic dynamics. Developing countries are typically characterized as unstable and immature in almost all aspects of life. Unstable political systems may lead to frequent change in regime or even change in political system such as from authoritarianism to democracy. It is also understandable if the new administration (the new

regime) tries to bring new hope to the people in many aspects of life, especially with respect to the way public firms are to be managed. Under more democratic political system, people would have more freedom to express their aspirations, thereby exerting certain pressure for a change. It is also a fact that nationalism and sovereignty issue is more sensitive in developing countries. Not to be forgotten are social problems such as income inequality, employment, and etc. All of those issues abovementioned are relevant to be considered in the context of privatization. It is not unlikely that all of those concerns accumulatively form strong political opposition and social unrest and resistance against government plan on privatization. As a result, the government might respond by reinforcing its commitment in assuring stakeholders that partial privatization would bring favorable impacts not only for the firms but also for society as a whole.

The involvement of a government with firmed commitment to improving the performance of public firms is highly critical to the success of a partial privatization. The presence of sincere majority government ownership is highly likely to govern partially privatized firms more soundly and effectively in comparison to dispersed ownership structure in fully privatized firms. Ownership distributed dispersedly among large number of stockholders would lead to ineffective and inefficient decision making process. Stockholders are likely to have no incentives to control managers. Even this kind of government control, which also can be categorized as hierarchical control, is considered more effective than stock market in monitoring the managers.

The soundness of government governance would be reflected in the quality of monitoring and incentive. This thesis, then, suggest that the quality of monitoring pursued and the adequacy of incentive given by the government are mainly affected by two variables, i.e. (1) the extent of political interference, and (2) the intensity of incentive.

Political interference, which is also called as political embeddedness, is described by Michelson (2007) as “technical, bureaucratic, official, unofficial, personal, organizational or emotional ties between public firms and the state and its actors”. By default, it is almost impossible to sterilize privatized firms from political interference as long as the state still maintains the control. The presence of rivalry among multi agents such as bureaucrats, politicians, and professionals might cause public enterprises to have multifaceted and ill defined objectives to be accomplished. Besides seeking profit, SOEs are often required to pursue other non-profit activities and even non-economic activities. It has been a common practice that the government often uses SOEs as a vehicle for delivering some government programs which vary from assisting the government for food and fuel security, availing public transportation, providing public health and alike. The objectives become vague and prone to change in accordance with the political climate, causing uncertainty concerning long term strategy (Martin and Parker, 1997). With several multifaceted, ill-articulated objectives set, monitoring would not be easy. Those overwhelming political interventions may harm severely SOEs since it can distract the SOEs from their business goal.

It is not easy to assess the level of political interference toward partially privatized firms. In this respect, this thesis classifies political interference into two different categories, i.e. hard and soft political interferences. The former includes direct, formal, and noticeable government actions that explicitly affect the decisions taken by managers. Including in this category is the placement of government commissioners in the BOC, the intensity of government assignments, and the involvement of related institutions as oversight bodies. On the other hand, the latter category refers to unofficial, informal, indirect government actions such as in the form of lobbying, rent-seeking activities, collusions and etc that can influence the decisions taken by

management. Since soft political interference is hard to be identified, this thesis focuses more on the former category.

Another aspect of government governance that is important to boost the performance of firms is intensity of incentive through remuneration system. It is believed that adequate incentive/remuneration scheme is an effective tool for alleviating agency problem. Nevertheless, it is widely known that public firms often have inadequate incentive scheme. It does not mean that there is no incentive scheme. It might exist but it is insufficient to give the employees and managers appetite to achieve better performance. With multilayer agency problem that exist in public firms, the incentive scheme should be designed properly so that it will be able to deal with the problem properly. There are several variables that can affect the intensity of incentive in the context of public firms, i.e. budget constraint, the number of involving institutions, and remuneration scheme.

As discussed in the literature, soft budget constraint policy is more likely to lead to the problem of moral hazard and adverse selection. Due to their confidence that the government will surely bail out the companies whenever they are in hardship, the managers become spoiled, highly dependent, and lacking of initiative and creativity in running their business. This is the problem of moral hazard. Meanwhile, the problem of adverse selection arises when the managers ignore the business risk (less sensitive toward business risk) due to the same false confidence. They may think that public firms are "too important to collapse". Hence, SBC would make any monitoring efforts have ignorable effect of fear of punishment on the manager's behavior (Vickers and Yarrow, 1988). In other words, the intensity of incentive will have negative relationship on the magnitude of soft budget constraint.

The intensity of incentive under government governance also depends on the number of institutions involved in governing privatized firms. The involvement of several institutions in the oversight of privatized enterprises not only possesses potential problem in monitoring, in which there are several oversight bodies with multiple and conflicting interests, but also diminishes the intensity of incentive. It is as argued by Dixit (1997) that managers of public firms usually have very weak incentive to achieve higher level of efficiency when they have to serve several principles. Compared to the managers of private firms required to satisfy single principle, pleasing many competing principles with multiple interests would present disincentives to managers to pursue higher level of efficiency.

Remuneration scheme is another classical problem in governing public firms. SOEs are often falsely perceived as part of the government bodies. In many cases, an employee of SOE is treated similarly to a civil servant with long-life employment. The employee is usually waged with relatively low salary that tends to be fixed and unrelated to the performance of the firms in general and performance of individual employees in particular. Furthermore, additional remuneration in the form of bonus or alike is also absent. If such remuneration arrangement exists, it is hardly based on the performance of the firms. The immediate consequence is there will be no reason for employees and managers to improve their performance. As another consequence, it is almost impossible for SOEs to attract highly qualified and skillful human resources to be managers/employees of the firms. The problem is even severe in the case of developing countries where the shortage of management talent is more serious (Coburn and Wortzel, 1986).

On the other hand, the absence of sound evaluation mechanisms might cause a manager with poor performance probably not to be deposed from his position. It might occur because the

appointment of management is often based on political preference and barely using professional considerations and objective justifications.

Term of government governance in this study is more moral commitment rather than legal obligation of the government. If the government does not fulfill its commitment there will be no legal consequences charged. Therefore, the benevolence of government governance depends mostly on the willingness of the government to exercise its commitment to realize well-governed SOEs. However, the commitment of the government to realize well-governed SOEs can also be affected by the pressure and moral persuasion imposed by other stakeholders, including employees, academicians, politicians, and citizens. For instance, the government commitment may initially be driven by reluctance/resistance/opposition from the stakeholders toward the government plan of privatization. To get endorsement from opposing stakeholders the government may promise to govern divested SOEs in better way so that their performances are superior after privatization. If in the reality, the government does not fulfill its promise and commitment the stakeholders can raise their voice and concerns through several channels. Politicians may use parliament, while employee may use demonstration or strikes. On the other hand, academicians may voice their concerns through media/press. Investors may express their concerns by selling the privatized SOEs' stock as disciplinary sanctions/actions. Finally, citizens may express their concerns by withdrawing their supports from ruling party and shifting their votes to other political parties.

With enabling-political environment/system, it is not impossible to bind government commitments as part of legal obligations. Consequently, if the government fails to meet the commitment, the administration can be sued or be impeached that leads to a political sanction. It can obviously give the government more pressure to be more benevolent in governing SOEs.

5.2.2 Capital Market Governance

In comparison with pure public ownership, listed enterprises have another tool to deal with the principle agent problem, which is through the presence of external governance mechanism. It is principally related to the ability of the capital market to discipline managers in running the business by posing hostile takeover threat to the firm. In this regard, an efficient capital market is widely believed to have ability to represent all information associated with the firm, including current and future performance of the firm through the price of stock. Consequently, the firm is under the threat of hostile takeover when the price of the stocks sharply drops due to the poor performance of the firm. In this situation, the price of stocks is usually very low so that prospective investors will have more ability to buy it, while the current shareholders may want to sell their stock due to pessimistic expected future profit. In order to avoid losing control because of hostile takeover from other investors in the capital market, the current owners would intensify their monitoring over the managers.

One may say that capital market may not present hostile takeover threat as long as majority stocks are still owned by the government. Even if the stock price of the firms badly decreases, there will be no investors that can take over the firm unless there is an intention from the government to sell its remaining stock until below 50% of total ownership. It is true that absolute takeover is unlikely to occur, however, the role of capital market in affecting the performance of listed partially privatized firms through bolstering monitoring and enhancing incentive cannot be understated.

The first way the capital market affects the performance is through monitoring. As previously mentioned, as most information about a company could be considerably echoed in the stock price, the movement of stock price will allow the principal to have a good tool of

monitoring (Fama; 1980, Tirole; 2001). When the firm is experiencing poor performance, the price of stock would immediately drop. Likewise, the excellent performance of the manager will also be reflected in the increased stock price. The movement of stock price is not only useful for non state stockholders but also for the state as majority shareholder. For the former who has limited access to the information, the movement of stock price can be the main source of information as a basis of their investment decisions. Even for the government who already has more access to the information, information given by stock market is still critical. In a complex-multilayered principle-agent problem, it is more likely that more acute asymmetric information problem would arise between the government as the principle and the managers as the agent. As a result, the government often does not get sufficient and accurate information needed. In this regard, information which is available in the stock market can act as complement, confirmation, or clarification toward information gained from another channel. Moreover, the stock price also incorporates the expectation factor of investors over the prospect of the firm. This kind of information may not be obtained except from the stock price.

Partial privatization may also have potential effective monitoring through the improvement of the quality and quantity of information gathered. Partial privatization enables information gathering to be carried out not only by government agencies but also by numerous individuals and institutions, that are normally specialist in the given job; they by and large take part in gathering and examining the information regarding the firm. In addition to the presence of economies of scale in gaining the information, the competition and rivalry among independent monitors/fund managers is likely to lead to the discovery of larger volume of related information. This would obviously improve the quality of monitoring under private ownership (Vickers and Yarrow, 1988).

In the context of public firms where rent seeking activities, corruptions, collusions, and nepotism are rampant, the presence of capital market even can bring greater impacts. Capital market allows people in public (either investors or non investors), who previously have no access to source of information, to have an opportunity in monitoring the enterprises. Along with its development, capital market would be able to expose what goes on inside the firms to the public in a better way. Obviously, this situation can alleviate most of the bad practices that have existed for a long time in the firms. Thus, under partial privatization there would be potentially more transparency than under other ownership regimes.

Another way that capital market affects the performance of firms is through its function as incentive enhancement. For listed firms, stock price can provide incentive effect to managers and state shareholders. In the efficient capital market, the poor performance of a firm is reflected in the lower price of the stock, thereby representing the poor managerial skills of management. In this case, the existing owners might have two options to failing managers; either deposing them with a hope that the new managers could enhance the firm's performance (Aoki, 1983; Leech, 1987) or just sell their stock to other investors with some loss burdened because of lower price of the stock. For the state shareholder, the former action seems to be more viable because the government may not sell the remaining shares for several reasons as discussed in Chapter 3. On the other hand for non-state stockholders with limited right to replace failing managers, they are likely to take second action of selling their investment. It is considered much more feasible to minimize investment loss and to anticipate further decreased stock price.

In another scenario, when the price of stock goes up following enhanced firms' performance, it can grant incentive to the managers in two different ways. First, if the managers are granted with performance-linked incentive scheme such as in the form stock bonus or stock

option, the increased stock price will obviously give financial incentive through realizing capital gain. Second, the stock market can also create an incentive to the managers in the form of image capitalization. Stock market is believed to have the ability to signal the ability of the managers in running the company. Subsequently, the “price” of successful managers from successful firms would increase in the labor market (Fama, 1980). Needless to say, the presence of efficient stock market well-linked with developed labor market is unquestionably required in this case. It is found by Gupta (2005) in the case of partial privatization in India. Whichever way that prevails, this circumstance would push the managers to have more incentive to perform excellently.

Based on the argument above, it is sensible that the presence of capital market will affect the success/failure of partial privatization. The next question is which level of stock market may have an effect on the privatized firms’ performance? In other words, what are the factors affecting the ability of capital market in imposing market discipline to the manager. According to some scholars (Dow & Gorton, 1997; Vickers & Yarrow, 1991) the intensity of stock market in facilitating monitoring function and giving incentive/pressure would considerably depend on how informationally efficient the market is. It is said by many scholars that a stock market is considered completely efficient in its function if all available information concerning a certain firm could be perfectly reflected in its stock price. The magnitude of its efficiency would depend proportionally on the information reflected in the share price.

With respect to the magnitude of stock market efficiency, Eugene Fama (1970) classifies capital market into three different magnitude of efficiency; (1) weak form, (2) semi-strong form, and (3) strong form. Stock market is considered in weak form efficiency if stock price traded at certain point in time represents merely historical data of stock price. On the other hand, if information in the form of all historical data plus other generally published information are

mirrored in the stock price, the capital market where the stock is traded would be categorized as semi strong efficiency market. Lastly, if all information which is available both publicly and secretly is reflected in the stock price at certain point in time, the market would be classified as strong form efficient. Financially, a well established and dynamic stock market would enable newly divested firm to get better access to additional capital needed for further firm expansion (D'Souza et.al, 2005).

In broader sense, there is very close relationship between the magnitude of capital market efficiency and the level of capital market development. An efficient capital market may not be present except in a well-developed stock market. Therefore, in this study both terms, efficient capital market and well-developed capital market, are used interchangeably.

There are some primary indicators of capital market development. For example, Kunt and Levine (1995) in their study use the following dimensions as the indicators: (1) size of market, (2) liquidity of market (3) volatility of market, and (4) concentration of market. The economic significance of stock market size is that it reflects the capability of market in mobilizing capital and diversifying existing risks (Kunt and Levine, 1995). Firms listed in the bigger market would have more access to larger capital and more diversified investment risk in comparison with firms listed in the small capital market. Lower and more diversified investment risk lead to smaller cost of capital. It can commonly be represented in the form of the number of firms listed, stock index, and market capitalization. Meanwhile, market liquidity refers to the ability of a particular market in selling and buying securities easily. This aspect can represent all transaction costs related to trading, including the costs of time, the cost of uncertainty in finding a prospective counterpart and settling the transaction/trading (Kunt and Levine, 1995). Lower transaction cost is necessary to encourage sellers and buyers actively engage in the investment transactions. This

aspect is important because in some cases large market size may not be enough if only little trading transactions occur. Some measures are commonly used to indicate market liquidity, i.e. market turnover and ratio of total value to GDP.

Another indicator of well established capital market is related to the issue of market volatility. Though stock market with greater volatility does not always imply that the market is less developed, for simplicity reason less volatile capital market is occasionally referred to as greater development (Kunt and Levine, 1995). In this respect, less volatile market is considered to be able to reduce unpredictability and uncertainty in the market. As a result, it can enhance the confidence level of investors to undertake any decision needed. Lastly, with regard to market concentration, capital market with less concentration is regarded to be more developed because it indicates that the market as whole does not heavily rely on the activity of limited number of firms' stock. In practice, this aspect can be seen from the dominance of certain number of stock for certain market activity measures.

In this study, due to data limitation, only the first two indicators of capital market development (market size and market liquidity) are empirically tested in Chapter 6.

5.2.3 Product Market Competition

There are numerous studies that point out the role of product market competition as one of determining factors of firm performance in general and privatization success/failure in particular. Despite there are disagreements on the mechanism, it has been a general consensus that the magnitude of competition in particular industry has an effect on managerial decision. In turn, it would affect the performance of the related firms (Nickell, 1996; Porter, 1990). It is argued that competitive product market can be a tool to solve agency problem by aligning managers' goal with the aim of shareholders even in the absence of strong corporate governance (Allen and Gale,

1998). According to Hermalin (1992), there are at least four different ways for the product market competition to affect the performance of management. Those are through declined profits in intensified business environment (income effect), a volatile profit risks along with varied competition magnitude (risk-adjustment effect), a change effect to the effort of manager (change effect), and improved information effect due to the presence of larger number of competitors (informational effect).

Specifically, with regard to informational effect, Nalebuff & Stiglitz (1983) show that perfect competition is able to reveal large information to the owners about the operation of the firms. In this respect, competition helps the owner in pursuing better quality of monitoring so that it can induce higher management performance. The magnitude of product market competition is also found as one of the main considerations for stockholders in establishing an adequate incentive scheme. Some studies claim competition act as a substitute for managerial incentive that can discipline managers. As a result, competition is able to reduce managerial slack (e.g., Hart, 1983; Schmidt, 1997). By contrast, other studies, such as Scharfstein, (1988), argue that competition can increase managerial slack so that stronger incentive is necessary to explicitly motivate the managers to work harder. In this respect, competition acts as complement to managerial incentives. Thus, for any argument abovementioned there is no doubt that there should be a relation and interaction between the extent of competition and managerial incentive. It is supported by the studies carried out by Ely (1991) and Murphy (1999) that there are considerable inter-industry differences in compensation practices. This can be deemed as indirect proof that there is a relationship between competition and managerial incentives.

Moreover, according to Schmidt (1997) the incentive effect of competition stems from its threat of bankruptcy that leads to strengthened managerial effort. Competition is said to be able

to raise the possibility of bankruptcy, particularly for inefficient enterprises. In turn, it would obviously bolster the managers' effort in enhancing the performance of firms. Competition poses the incentive for managers to utilize the enterprises' resources efficiently. Under certain level of competition, the firm's profits are able to echo variation in the skill of management and a linkage between capital and product market (Martin and Parker, 1997). Competing with other firms provide SOEs no choice except making efforts aimed at enhancing their own efficiency and increasing the profitability. There is almost unanimity among scholars that competition is an important determinant of performance enhancement of divested SOEs (Vickers and Yarrow, 1991; World Bank, 1995; Ramamurti, 1997).

However, there has been less agreement on what is the ultimate impact of product market competition on the firms' performance and also how exactly competition could influence the performance of enterprises.

Empirically, there have been many researches carried out with respect to the role of product market competition in affecting the performance of firm. However, the result has been unclear and inconclusive. A number of studies reveal that competition in certain industry and the performance of firms operating in the related industry is inversely related in the sense that higher level of competition would be highly likely to lead to lower performance. It is a main conclusion of studies done by some researchers such as Slade, 2004; Hill and Hassen, 1991; Ghosal, 2002. Lower level of competition appears to allow the firms to extract monopoly rent. By contrast, some other studies done such as by Nickell, 1996; Hou and Robinson, 2006 observe that competition actually enhances the performance of firms. Reconciling two conflicting findings, the impact of competition on performance might vary from circumstance to circumstance subject to the intensity of competition and situation faced by the firms.

What described above is the direct role of product market competition to the firm's performance in general. Put the issue of partial privatization in the context of the discussion, the role of product market competition in affecting the performance of privatized firms is not only straightforward as described. The impact of it also comes from its relations/interactions with other two possible determinants, namely government governance and capital market governance. Those relations/interactions are discussed in the next section.

Referring to existing literatures, there are several variables considered as dimensions of competition that can affect the intensity of monitoring and the magnitude of incentives, for example, market power/concentration, market size/share, the cost of entry, and product substitutability (Raith, 2003). Market power/concentration generally depends on the number of companies in the industry and their relative sizes. Several measures are commonly used to reflect market power such as concentration ratio and Herfindahl-Hirshman Index (HHI) (Bikker & Haaf, 2002). Product substitutability refers to the availability of direct or indirect substitute over specified product produced by particular firm. The more the product substitutes available in the market, the fiercer the product market competition is. Market size/share can be defined as the number of firm's products demanded/purchased by customers relative to total demand of the same type of product in the industry. The larger the proportion of firm's product demanded relative to total demand in the industry, the lesser the magnitude of the competition exists. Meanwhile, the cost of entry refers to total economic cost (financial and non financial) that a particular firm has to spend on to enter the market. The industry that requires high entry cost has lower level of competition.

5.2.4 The Relations and Interactions among the Determinants

This thesis raises very critical proposition that the three potential determinants of the partially privatized is not mutually exclusive, even they complement each other in affecting the performance of firms. Furthermore, those variables are also not static and independent from each other. In fact, they are dynamic and interdependent on each other. Hence, any particular initiatives to alter one determinant may affect other determinants as well. As a result, the final impact of a particular initiative may not be linear. In this section, some possible relations and interactions among the variables are discussed.

First, this study argues that there is reciprocal positive relationship between the government governance and the capital market governance. A particular initiative taken by government to enhance its governance in the partially privatized firm may affect the development of capital market, which in turn it can boost the function of capital market as external governance mechanism. The success of government governance initiative, for example by pursuing better monitoring or establishing adequate remuneration scheme, will raise the firm's performance and in turn also the price of firms' stock later. This will fertilize investors' trust so that it will attract their interest to invest their fund in the capital market. For the firms, it will allow them to have better access to large financial sources for their next business expansion. In turn, increased interest of investors in the capital market will attract other unlisted firms to go public. Gradually, this will develop the capital market and finally enhance the capital market governance. This thesis argues that in order to have massive impact on capital market, this strategy should be implemented successfully in most of the partially privatized firms. This is less likely to happen unless the government has certain policies when selecting the firms to be

privatized. The firms have to be either good performers even before being privatized or prospective good performers.

On the other hand, it is believed that the improvement of capital market governance will likely to drive up the level of government governance. As elaborated Section 2.3, due to the presence of complex principle-agent structure (Aharoni, 1982), SOEs are plagued with more severe agency problem than private owned enterprises. As a result, there would be large spaces for “the noise of information” to exist so that information flowing from the ultimate principle (citizens as the ultimate owner) to the last agent which are managers is likely to be distorted. As a consequence, there would be some extent of difficulty for principal to pursue proper monitoring (Smith, 1990, p.55). In another word, there is adverse information asymmetric problem between well-informed management and less-informed multiple government bodies as shareholder in the public firms. As mentioned earlier, the presence of well-developed capital market with numerous individuals and institutions taking part in gathering and examining the information regarding the firms can lead to the achievement of economic of scale in gaining the information. Moreover, the competitions and rivalries among independent monitors are likely to lead to the discovery of larger volume of related information. Those would obviously reduce information asymmetric between shareholders, specifically the government, and the managers of privatized SOEs. As a result, it can improve the quality of monitoring over privatized SOEs.

On the other hand, improved capital market allows non government shareholders and other stakeholders including employees, academicians, politicians, and citizens to know what the government (including the actors) does toward SOEs. In this regard, well-developed capital market can be effective tool of those stakeholders for monitoring over the firms and its governance. In the case that the government practices poor governance over privatized SOEs (or

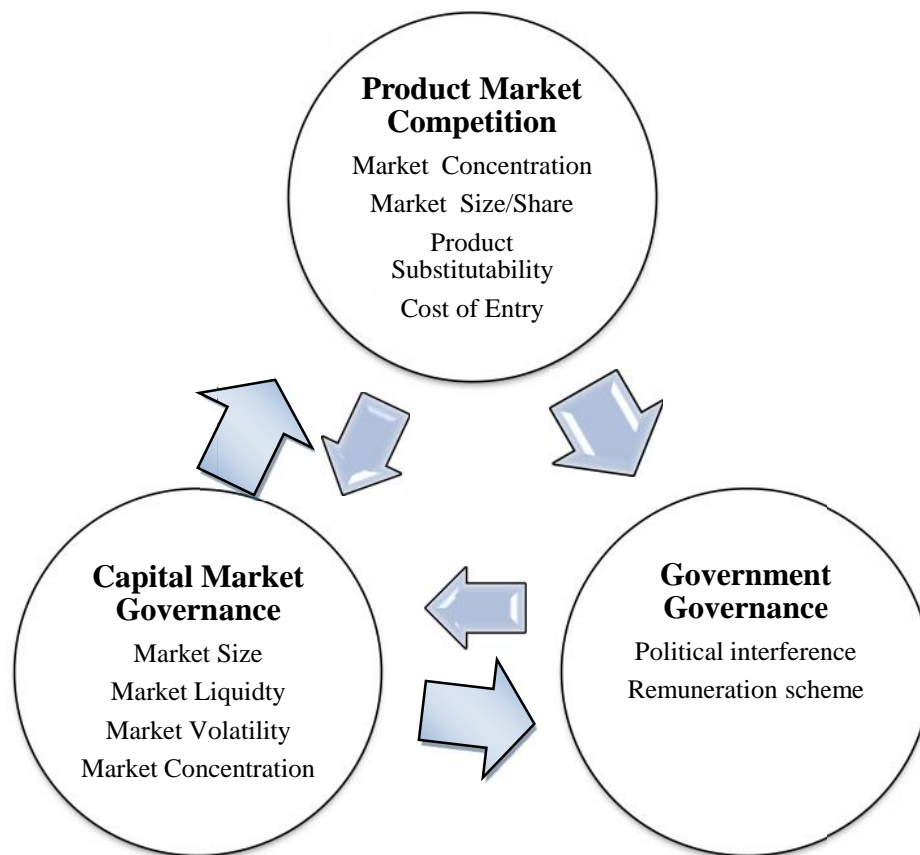
it fails to realize its commitment to govern SOEs well), for instance due to overwhelming rent-seeking activities or others, effective capital market allows other stakeholders to know the situation soon. As a result, they can raise their concern and force the government to elevate their quality of governance. Otherwise, they can take social and political sanctions against the government. In turn, this can discourage related parties, including rent seekers, corruptors, from doing evil in the firms. Thus, the improvement of capital market is essential for forcing the government to improve its way of governing partially privatized firms.

Second, there is relationship between the intensity of product market competition and the government governance. This is ideal but may not always exist, depending on the response of government. Following arguments that product market competition is complement to managerial incentive, the government should consider the level of competition within related industry when establishing remuneration scheme for the employees and managers. Granting too much compensation to the managers of firms in the industry where the level of competition is low will be inappropriate decision. This only will give an incentive for the managers for being lazy and spoiled. By contrast, giving too little compensation to managers in very competitive industry will be ineffective in promoting firm's performance. On the other hand, after providing appropriate incentive relative to the level of product market competition, the government can discipline lazy managers through some forms of sanctions. While the incentive may be given in form of promotions and remunerations (cash bonus, stock bonus, stock option, and etc), the sanctions for non performing managers may be imposed in form of termination and deposition. The severely poor managers are likely to be fired from their position, while less performed managers might be downgraded to less reputable firms with less attractive remuneration/incentive scheme.

Third, the existing literature argues that there is reciprocal relationship between capital market governance and product market competition. Some studies on finance give sufficient evidence that a strong financial systems development is likely to drive economic and industry growth (e.g. Rajan & Zingales, 1998; Levine & Zervos, 1998; Demirgüç-Kunt & Maksimovic, 1998). As what banking industry does, stock market can act as financial intermediaries by connecting firms that are in need of financial resources on one side, with investors with excess financial resources on the other side. Well developed capital market is able to offer larger finances at lower transaction cost. This will obviously attract needy firms to go to public in order to get abundant financial resources. If another firm from the same industry does the same thing, eventually it will promote competition within the related industry. From a different perspective, highly competitive industry pressure firms in the same industry to seek less costly financial sources to finance their business plan. In this respect, capital market can be an alternative besides bank to keep them in the competition. Eventually, it can promote the development of capital market. It is not so critical to know which direction is more appropriate. In the context of partial privatization, it is important to note that firms which are partially privatized should be in a competitive industry, otherwise it will not bring about significant effect on the development of capital market.

The relation and interaction between the determinants of partial privatization success is described schematically in Figure 5.2.

Figure 5. 2 Potential Determinants of the Performance of Partially Privatized Firm



5.2.5 Aggregate Impact of Determinants on Performance of Privatized Firms

As elaborated in the previous section, there are three potential sources of improved monitoring and incentive as key factors of performance improvement in partially privatized firms. Each determinant may have different level of contribution to the performance change. The contribution of each determinant is not necessarily positive. Likewise, the aggregate impact of all determinants combined may be either harmful or constructive, depending on the direct impact of each determinant and the indirect impact stemming from interaction among the determinants. For example, intensified competition with poor remuneration (as variable of government governance) may result to negative aggregate performance change to the firm. In another

example, the aggregate impact of improved capital market governance combined with worsened government governance will greatly depend on the dominance of each determinant and the interaction with another determinant such as product market competition. Mathematically, the aggregate impact of determinants can be expressed in the following equation:

$$Performance = [monitoring, incentive] \quad \text{Equation (1)}$$

$$Performance = [g, m, p] \quad \text{Equation (2)}$$

From the equation above g denotes monitoring and incentive/sanction stemming from government governance, m denotes monitoring and incentive/sanction stemming from capital market governance, and p denotes monitoring and incentive/sanction stemming from product market competition.

It is widely known that there are multiple layers of monitoring in the governance of firms in general, not only public firms but also private enterprises. However, it is also widely understood that the layers of monitoring in public/partially privatized firms is more complicated than it is in private firms. Having complex layer of monitoring, the equation tries to simplify the logic by grouping related aspects into three abovementioned categories. In this regard, government governance (g) incorporates monitoring and incentive/sanction in all layer of monitoring.

5.3 Summary

This chapter is begun with explaining the key issues of improved monitoring and incentive as the fundamental reason of improved performance in any ownership regime. This is something understated in the existing literatures. This is the rationale why most empirical studies show that private firm is more likely to be better in performance than public enterprises or full privatization

has higher probability to bring about positive impact than partial privatization. Nevertheless, it implies that there is no “apriori” causality between ownership structures, or between privatization modes with the performance of the firm. Partial privatization remains possible to successfully to bring about favorable impact on the firm performance if it can present improved monitoring and incentive.

Mainly using the concept of residual claimant plus the concept of competition, this chapter identifies three potential sources of improved monitoring and incentive in the case of partial privatization. These are: (1) *government governance*, (2) *capital market governance*, and (3) *product market competition*, which are not mutually exclusive, dynamic, and interdependent on each other. Government governance refers to the way of governments pursue monitoring and establishing incentive in order to maximize its residual earning and other forms of financial and non financial benefit. In this respect, this thesis raises two main limitations of existing arguments pertaining to (1) the understatement of the benevolence of government involvement in the operation of SOEs, including potential benefit from rivalry among related parties in the government, and (2) the false assumption that the government benevolence tends to be fixed and unchanged. The role of government governance in improving monitoring and incentive following partial privatization is mainly determined by the intensity of political interference and the adequacy of remuneration scheme.

Capital market governance mechanism refers to the abilities of capital market in facilitating stockholders in pursuing monitoring through availing sufficient, credible, and qualified information at very low cost and in providing incentive through imposing disciplinary function to the managers. These abilities are in line with the development of capital market indicated by several measures such as the size of market, the liquidity of market, the volatility of

market, and the concentration of market. Product market competition also plays critical role in affecting the quality of monitoring and the intensity of incentives. It is explained that intensified competition enables large information to be revealed so that it can help the principal in pursuing better quality of monitoring. On the other hand, the incentive effect of competition stems from its threat of bankruptcy that forces managers to utilize the enterprises' resources efficiently. Some indicators such as market concentration, market size, and the cost of entry may be relevant to represent the intensity of competition in certain industry. Besides direct effect of each potential source of governance, improved monitoring and incentive may be produced from the relations and dynamic interactions among the variables.

The aggregate impact of three potential sources of governance can be positive or negative depending on the direct impact of each determinants and the direct impact as a result of the relations and interactions among the variables. Positive aggregate impact can be interpreted that partial privatization successfully creates improvement in the monitoring and incentive system. This situation is highly likely to bring about the enhancement of partially privatized firms. Conversely, negative aggregate indicates that deteriorated monitoring and incentive rises following partial privatization. Hence, there will be potential declined performance brought about by partial privatization.

In the next chapter, the analytical framework discussed here is used to carry out an empirical examination of the impact of partial privatization on the performance of divested firms, using the Indonesian context. With its characteristics that represent a developing country, policy implication of the empirical investigation are expected to be very relevant to other developing countries.

Chapter 6

Partial Privatization and the Performance of Privatized Firm:

An Empirical Evidence from Microeconomic Perspective⁶

6.1 Introduction

It is broadly known that privatization is an economic program with multiple objectives. However, of various objectives, the main and most fundamental objective of privatization is to enhance the performance of the divested firms (Vickers and Yarrow 1991). Given partial privatization in the context, this objective becomes more relevant for the government. In the case of full privatization in which the government transfers both ownership and control to private owners, the government is no longer responsible for the performance of privatized enterprises. In return, the government also is no longer has access to the resources of the firm to be empowered for the interest of the people. The government has nothing to do with what the firms are going to be after privatization. The government does not have direct interest in it either. In contrast, under partial privatization, there is no big change with respect to the relation between the government and the enterprises. Even, the government appears to have greater incentive to improve the performance of enterprises as a response of resistances and oppositions upon the decision of partial privatization taken. Also, intensified public monitoring through the performance of stock in the capital market may provide the government more pressure in improving the performance of partially divested firms.

⁶ Most part of this chapter is derived from the author's paper: Nahadi, B., & Suzuki, Y. (2012) Partial Privatization and Performance of Privatized SOEs: The Evidence from Indonesia. *Journal of Economics and Sustainable Development*, 3(14), ISSN: 2222-1700 (Paper), 2222-2855 (Online).

In addition, the indicator of partial privatization success in macro level such as well-developed capital market, greater financial contribution to state budget, effective tool of financing budget deficit, as well as higher level employment would definitely depend on the improvement of the firms' performance at individual level. The government might fail to promote stock market if the stock performance of privatized SOEs is also unsatisfactory as a result of poor firms' performance. Larger amount of taxes and dividend contributed by privatized SOEs is impossible to be realized if the firms are not more efficient. There would be large unemployment if the privatized SOEs are less competitive in comparison with their competitor. Thus, sustainable benefit of partial privatization at macro level would not be grasped by stakeholders unless privatization could benefit by improving the individual performance of the firms at the micro level.

Theoretically, there is no other way but full privatization, which is selling state stock with control relinquishment from the state to private owners, through stock market, to be considered as the most effective way of curing the existing problem in the public enterprises. It is essentially a transfer of control from multi-agents with multifaceted goals to private owners with single concern of profit maximization. It is obviously able to eliminate all problems potentially triggered by political interference. On the other hand, partial privatization which is defined as selling of state ownership without control relinquishment from the state to private owner has been perceived to bring about a little impact on the performance of newly divested SOEs. To get rid of the problem of political engagement, the success of partial privatizations relies considerably on the level of market discipline provided by the stock market (Gupta, 2005).

Given the special context of Indonesia in which institutional development, specifically capital market, has been less developed in comparison with developed countries, is it possible for

partial privatization to work satisfactorily? If it is possible, what is the secret of the success which other developing countries with similar situation may be able to make partial privatization work favorably? Since there are very few studies, if any, that show how partial privatization may still work successfully in this kind of country, this study would contribute significantly to the body of knowledge.

This chapter is aimed to assess the impact of partial privatization on the performance of privatized SOEs, and then to investigate the determining factors of the success or failure of the partial privatization in Indonesia. This chapter is basically an empirical investigation based on proposed analytical framework discussed in Chapter 5. As discussed in previously, the determinants of the performance of partially privatized SOEs are expressed in the following equation:

$$Performance = [monitoring, incentive] \quad \text{Equation (1)}$$

$$Performance = [g, m, p] \quad \text{Equation (2)}$$

The impact of the first two variables, namely government governance (g) and capital market governance (m) is assessed by using econometric regression. Due to the problem of data characteristic and availability, product market competition (p) cannot be included in the regression. In this respect, the role of product market competition is pointed out separately in the next section by using case study.

The remainder of the chapter is organized as follow: Section 6.2 explains Data and methodology. Econometric finding is presented in section 6.3, then, our analysis and discussion is described in section 6.4. Section 6.5 concludes.

6.2 Data and Methodology

In order to be crystal clear, partial privatization in this analysis is confined to the case of privatization in which the state still holds more than 50% of remaining shares after privatization. Data is collected on the selected SOEs at least three years before and four years after privatization. On the whole, only SOEs privatized at latest in 2007 are selected for the analysis. There have been 16 SOEs privatized during 1991-2007, and only one of them (PT Indosat) divested more than 50% during this period. In this study we include all of those 15 partially divested SOEs. Furthermore, to get a clear-cut privatization impact, this analysis includes only genuine SOEs in the sense that the firms are originally SOEs, excluding temporary SOEs, minority SOEs, and SOEs' subsidiaries as described in the Chapter 3. The list of privatized SOEs is as shown in Table 6-1.

These analyses borrow from similar studies undertaken by Megginson, et al (1994), Boubakri et al (2005), D'Souza et al (2005). To assess whether partial privatization brings about significant impact on the performance of divested SOEs, most of those studies use univariate test called Wilcoxon Signed-rank test. Unlike similar test called t statistic which is parametric so that normality condition is required, Wilcoxon Signed-rank test is non parametric test. In order to run the test, the mean of each predetermined measurement of performance variable for pre and post privatization are calculated. Then, those computed means for each cross section are compared to get the conclusion whether post privatization differs statistically from pre privatization for some key pre determined measurements of performance.

Table 6- 1 List of Partially Privatized SOEs Included in the Analyses

No	SOE	Sectors	Year of Privatization and Share Sold	Residual State Shares	First Privatization Method
1	PT Semen Gresik	Cement	1991 (25%), 1998 (14%)	51.0%	IPO
2	PT Tambang Timah	Mining	1995 (35%)	65.0%	IPO
3	PT Telkom	Telecommunication	1995 (23%), 1999 (9.62%), 2001 (11.9%), 2002 (3.1%)	51.2%	IPO
4	PT BNI	Banking	1996 (25%), 2007 (26.3%), 2010 (3.1%)	60.0%	IPO
5	PT Aneka Tambang	Mining	1997 (35%)	65.0%	IPO
6	PT Kimia Farma	Pharmacy	2001 (9.2%)	90.8%	IPO
7	PT Indofarma Tbk	Pharmacy	2001 (19.8%)	80.2%	IPO
8	PT TABA	Mining	2002 (16.26%), 2004 (12.5%)	65.0%	IPO
9	PT Bank Mandiri	Banking	2003 (20%), 2004 (10%), 2011(10%)	60.0%	IPO
10	PT BRI	Banking	2003 (45%)	55.0%	IPO
11	PT PGN	Mining	2003 (39%), 2006 (5.31%)	55.3%	IPO
12	PT PP	Construction	2004 (49%), 2010 (21.46%)	51.0%	EMBO
13	PT Adhi Karya	Construction	2004 (49%)	51.0%	EMBO & IPO
14	PT Jasa Marga	Service	2007 (30%)	70.0%	IPO
15	PT Wijaya Karya	Construction	2007 (31.7%)	68.3%	IPO

Note: IPO stands for Initial Public Offering, EMBO stands for Employee Management Buy Out

Source: constructed by the Author based on MSOEs

One may argue that if significant performance change from pre to post privatization may be found using the method abovementioned, the change may not necessarily stem from privatization factor. It would probably be a result of other factors, such as economic growth. To clarify this argument, simple equation panel estimation is carried out, consisting of performance

measures dependent variables, privatization dummy as independent variable and economic/GDP growth as control variable. The equation of panel regression is expressed as follows:

$$Performance = \alpha + \beta_1 (privatization\ dummy) + \beta_2 (Size\ of\ economy\ growth) + \mu_{it} \quad (1)$$

To comprehensively measure the performance of the firms, 3 different dimensions of performance, namely, profitability, efficiency and labor productivity, are used in the analyses. Return on Sales (ROS) is considered as the best measure of profitability because of its data characteristic. ROS is calculated based on two “true flow” account of financial statement namely operating income and sales which are less sensitive to accounting convention and inflationary bias. Hence, it is considered to be better than Return on Assets (ROA) or Return on Equity (ROE) that consists of the combination of flow measure (operating income) and some degree of stock measure (assets and equity) that is vulnerable to inflationary bias. ROS signifies the ability of firm in converting sales into operating income. It incorporates all operating expenses including cost of goods sold, administration and selling expenses. Nonetheless, profitability is not enough to judge the performance of the firm. In many cases, the firms with higher profitability are not necessarily the best performers. Besides its vulnerability toward some degree of accounting engineering, profitability tends to demonstrate one time performance which is less sustainable.

Efficiency can be more genuine and more sustainable indicator of performance because it can show how much output yielded for every one unit of input used. In this analysis output is represented by value added which is calculated by adding up operating income and some non-cash expenses such as amortization and depreciation. In the mean time, input is defined as all resources utilized to produce that value added. In this respect, capital employed which

encompasses productive fixed assets and working capital, is considered as the best proxy. Specific for banking industry, efficiency is calculated by using income-based approach (Leightner and Lovell, 1998) which is total interest + non-interest income divided by total interest + non-interest expenses. To include labor factor, which is also one of the production factor, labor productivity is also used as performance indicator. It is calculated by dividing operating income by the number of employees. To eliminate inflationary bias, operating income is adjusted with prevailing consumer price index for each related year.

After assessing the impact of partial privatization on the performance of divested SOEs, the analysis is continued to investigate the determining factors of performance changes found in the first test. In other words, the key factor of success or failure of partial privatization is investigated. In this stage multivariate panel regression is used. It is argued by many scholars that this technique of regressions is the most appropriate tool to grasp the disparity of unit sample across time since it is able to control individual heterogeneity. It is also deemed more suitable to test a dynamic case. In terms of data characteristics, it provides more plentiful information of data with less problem of collinearity and higher level of freedom among the variables. In comparison to either pure cross section or pure time-series test, this panel technique is more superior in detecting effects and in constructing and testing more complex behavioral model (Klevmarken, 1989 and Hsiao, 2003).

In each regression, performance proxies mentioned above would be treated as the dependent variables. The predictors or independent variables are factors identified theoretically and empirically in the existing literature as key factors affecting the performance improvement/deterioration in post-privatization. Following Megginson and Netter (2001) and also referring to proposed analytical framework in the previous chapter, the remaining state

ownership (OWNERSHIP), number of government commissioners (GOVCMSNR), and number of independent commissioners (INDPCOMSNR) are selected to represent government governance factors. The proxy to represent remuneration scheme is excluded from the equation due to the problem of data characteristics. On the other hand, composite stock index (STOCKINDX) and stock turnover (STOCKTURNV) are chosen to represent capital market governance. Furthermore, natural logarithm of GDP (LogGDP) is employed as control variable of macroeconomic situation. The list of the variables used is presented in Table 6-2. In more details the panel estimation is expressed as follows:

$$\begin{aligned} \text{Performance} = & + 1 (\text{residual state share}) + 2 (\text{the number of government commissioners}) + \\ & 3 (\text{the number of independent commissioners}) + 4 (\text{the size of capital stock}) + 5 (\text{the intensity} \\ & \text{of capital stock transaction}) + 6 (\text{the size of economy}) + \mu it \end{aligned}$$

Table 6- 2 Description of Variables Employed in the Equations

Variable		Proxy for		Empirical Definition
Return on Sales (ROS)		Performance of SOE--	Profitability	Operating Income divided by Total Sales
Efficiency (EFFICIENCY)		Performance of SOE--	Efficiency	Value Added/Capital Employed Value Added = Operating Income + non Cash Expensed; Capital Employed = Working Capital + Fixed Assets; Working Capital = Current Assets – Current Assets
Employee (EMPROD)	Productivity	Performance of SOE--	Productivity	Inflation-Adjusted Operating Income divided by Number Employee
Privatization (PRIVAT)	dummy	Pre and post privatization		Score 0 is assigned to signify pre privatization period, while score 1 is given to indicate post privatization period

Residual State Share (OWNERSHIP)	Government factor to represent shareholder's monitoring	Governance factor to represent shareholder's monitoring	The percentage of residual state share (0-100%)
Government Commissioner (GOVCMSNR)	Government factor to represent shareholder's monitoring	Governance factor to represent shareholder's monitoring	Number of government commissioners in BOC
Independent Commissioner (INDPCMSNR)	Government factor to represent shareholder's monitoring	Governance factor to represent shareholder's monitoring	Number of independent commissioners in BOC
Stock Index (STOCKINDEX)	Capital Market Governance factor to represent size of capital market as one indicator of the capital market efficiency/development level	Market factor to represent size of capital market as one indicator of the capital market efficiency/development level	Index is taken from Indonesia Stock Exchange, representing an indicator of price stock movement of all stock listed in Indonesia Stock Exchange.
Stock Turnover (STOCKTURNV)	Capital Market Governance factor to represent the liquidity of capital market as one indicator of the capital market	Market factor to represent the liquidity of capital market as one indicator of the capital market	Stock turnover is the total value of shares traded during the period divided by the average market capitalization for the period.
Gross Domestic Product (logGDP)	Control variable; and level activity of economy	Size variable; activity of economy	Natural logarithm of total GDP data taken from world data site measured in constant local currency (trillion IDR)

Considering data characteristics, this thesis assumes that there is no unobserved-time invariant characteristic of each individual firm that may significantly bias the predictors or outcome of the regression. In other words, it is assumed that the variation across firms is random and uncorrelated with the independent variables incorporated in the equation. Hence, there is no need to control those time invariant variables. Furthermore, it is also observed that data taken in the analysis tend to vary insignificantly and also tend to change slightly and slowly over time. In this regard, random effect model is argued to be more suitable in exploring the relationship of the variables employed (Torres-Reyna, 2013).

Some diagnostic tests related to panel estimation are also carried out to check the robustness of the result. To check for the problem of heterocedasticity, Modified Wald test is employed. Furthermore, as the number of firms (cross section) and years (time series) are less than 20, the data set can be considered as micro panel. In this regard, the problem of autocorrelation and cross-sectional dependence, if any, is ignorable (Baltagi, 2008).

The models described above whether on the basis of the Wilcoxon Signed rank or panel regression are employed on two different time frame of data set: short term and extended term frame. Short term analysis which include data from three year before and four years after privatization, is aimed at assessing the immediate impact of privatization, while extended period of analysis which is to examine the impact of privatization in the long term period is done on all possible data available in pre and post privatization. Many studies, such as Boubakri et al (2005), D'Souza et al (2005), address only short term scenario. This may lead to a misleading conclusion since it is likely for privatization to take some time before showing some favorable or unfavorable impact on the performance of privatized SOEs. In the latter analysis, we use 214 data observations in the unbalanced panel regression.

The result of quantitative analysis by using abovementioned techniques will be supported and enriched by using qualitative methodology through “institutional” approach in the discussion section, especially pertaining to the determinants of partial privatization success in Indonesian context. In this regard, the chapter aims to shed light on the structure of rules and regulation to understand the effectiveness of the monitoring and incentive system undertaken by the government toward privatized firms in the mode of partial privatization.

6.3 Empirical Results

6.3.1 The Impact of Privatization on Performance of Divested SOEs

Table 6-3 shows the result of short term analysis. Generally speaking, the table reveals that there are statistically significant positive changes in the performance of partially privatized SOEs in the post privatization in comparison with the performance in the pre privatization. In the short term the divested SOEs experience improved efficiency as well as productivity at significant levels of 5% and 1% respectively. The mean efficiency goes up significantly from 0.4608 in pre privatization to 0.5234 in post privatization. An increase in efficiency is experienced by 10 of 14 firms or around 71% of privatized SOEs. Additionally, the average of productivity also improves from IDR 86.9 million before privatization to IDR 220.9 million after privatization or IDR 133 million per employee on average. Out of 14, there are 13 divested SOEs (approximately 93% of total) that demonstrate increase in labor productivity. With regard to profitability, out of 14 there are 9 divested SOEs (more than 64% of firms) that experience increased profitability. There is also improvement in the mean profitability by 0.0248, which is from 0.2139 in pre privatization to 0.2387 in post privatization. However, it is considered insignificant statistically. There is one SOE excluded from this short term analysis due to outlier problem. In this respect, data of that particular firm deviates significantly from general trend that can considerably affect the aggregate result.

The impact of privatization is even more noticeable in the long term. Even after incorporating the outliers dropped in the short term analysis, all of three performance indicators, including profitability, increase at statistically significant level. As it is shown in Table 6-4, the result of extended period reveals that most divested SOEs experience higher performance in all dimensions of performance. In comparison with the performance improvement in the short term,

the increase in performance in the long term is even bigger. The mean change of profitability goes up from 0.0248 in the short term to 0.04722 in the extended period, or there is 0.02242 difference. Likewise, the number of firms experiencing increased profitability also rises from 9 SOEs out of the 14, or 64% in the short term, to 13 SOEs out of 15, or 87% in the long term analysis. With regard to efficiency, the average improvement is 0.0836 in the long term or increases by 0.021 compared to the improvement mean in the short period at 0.0626. In this respect, the number of privatized SOEs with improved efficiency is also bigger in the long term (12 of 15 firms, or 80%) in comparison with those that improve in the short term (10 of 14 firms, 71%). Lastly, the change in the mean productivity also grows almost 250%, from IDR 134 million in the short period to IDR 332 million in the long term. There is no change in terms of number of divested firms experiencing increased productivity. All in all, the results evidently demonstrate that partial privatization brings about favorable impact on the performance of privatized SOEs, and the magnitude of the positive impact tends to be larger in the long term.

Table 6- 3 The Impact of Partial Privatization in the Short Term; Wilcoxon Signed-rank test

Independent Variable	N	Mean Pre	Mean Post	Mean Change	Z statistic for difference in medians (post – pre)	Ratio of firms with positive change over the firm with negative change
Profitability <i>Return on Sales</i>	14	0.2139	0.2387	0.0248	1.099	9 : 5
Efficiency <i>Value added/Capital Employed</i>	14	0.4608	0.5234	0.0626	1.601**	10 : 4
Productivity <i>Real Operating Income/Employee</i>	14	86.9222	220.8816	133.9593	3.233*	13 : 1

Note: Significant at the 1% (*), 5% (**) and 10% (***) levels

Table 6- 4 The Impact of Partial Privatization in the Long Term; Wilcoxon Signed-rank test

Independent Variable	N	Mean Pre	Mean Post	Mean Change	Z statistic for difference in medians (post – pre)	Ratio of firms with positive change over the firm with negative change
Profitability <i>Return on Sales</i>	15	0.1562	0.2035	0.04722	2.158**	13 : 2
Efficiency <i>Value added/Capital Employed</i>	15	0.4620	0.5456	0.0836	1.931**	12 : 3
Productivity <i>Real Operating Income/Employee</i>	15	81.6575	413.7529	332.0954	3.233*	13 : 2

Note: Significant at the 1% (*), 5% (**) and 10% (***) levels

In the mean time, the analyses using panel regressions reveal that partial privatization contribute positively to the change of performance in post privatization period at significance level. This is shown in Table 6-5 for the short term analysis and Table 6-6 for the extended term analysis.

Table 6- 5 The Impact of Partial Privatization in the Short Term; Panel Regression

Independent Variable	Dependent Variable		
	Efficiency	Profitability	Productivity
PRIVAT	0.0559 (2.05)**	0.0218 (0.58)	135.8723 (4.74)*
GDP	0.0097 (-2.70)*	-0.0042 (-0.85)	2.7561 (0.73)
CONS	0.5102 (4.37)	0.2353 (4.35)	72.8919 (1.06)
R-sq	0.0067	0.0030	0.0663
No. Obs	98	98	98
No. of Group	14	14	14
F (Prob > F)	12.63 / 0.018	1.16/0.5605	22.60/0.000

Note: Significant at the 1% (*), 5% (**) and 10% (***) levels

Table 6- 6 The Impact of Partial Privatization in the Long Term; Panel Regression

Independent Variable	Dependent Variable		
	Efficiency	Profitability	Productivity
PRIVAT	0.0890 (3.22)*	0.0537 (3.96)*	-4.8443 (-0.60)
GDP	-0.0048 (-1.46)	-0.0066 (-4.06)*	-0.2231 (-0.23)
CONS	0.4793 (4.52)	0.1824 (5.50)	93.1277 (10.68)
R-sq	0.0139	0.0521	0.0013
No. Obs	214	214	214
No. of Group	15	15	15
F (Prob > F)	11.89 / 0.0026	30.04/0.0000	0.44/0.8029

Note: Significant at the 1% (*), 5% (**) and 10% (***) levels

The fitness of the model is shown by F (prob>F) score. It is said that the model is considered fit if F (Prob>F) is less than 0.05 (95% confidence level). In this regard, the short term equation where efficiency and productivity are employed as dependent variable are considered fit because F scores (Prob>F) are 0.018 and 0.0000 respectively. Meanwhile, long term models where efficiency and profitability are employed as dependent variable are also considered fit because F scores (Prob>F) are 0.00026 and 0.0000 respectively. On the other hand, r-square represents the degree where variance in the dependent variable can be explained by independent variables. For instance, r-square scores for long term equations are 0.05 and 0.01 for the equations where efficiency and profitability are employed as independent variable respectively. Unlike linear regression that usually requires relatively high r-square score, it is very common and still acceptable that r-square in the panel regression is relatively low due to data and model characteristic (Baltagi, 2005).

The significance contribution of partial privatization variable in the model can be seen from $p > [t]$ or t value score. In order to be considered statistically significant, the $p > [t]$ of particular independent variable have to be lower than 0.05 (95% confidence level) or 0.10 (90% confidence level), or t value has to be higher than 1.96 (95% confidence level). The short term models show that variable of partial privatization (PRIVAT) is positively related to efficiency and productivity at 5% and 1% significance level respectively, while in the long term variable of partial privatization (PRIVAT) is positively related to efficiency and profitability at 1% significance level. It is also shown by t value for both equations which are 2.05 and 4.74 in the short term and 3.22 and 3.96 in the long term (higher than 1.96). The findings support the previous finding when the impact of partial privatization toward the firms' performance is analyzed by employing Wilcoxon Signed-rank test as shown Table 6-3 & Table 6-4. Thus, it is

relatively convincing to argue that partial privatization brings about favorable impact to the performance of divested firms, especially in the long term. As a result, it is also understandable to say that partial privatization has indirect-positive relationship with some forms of financial contributions.

In the long term, the significant positive impact of partial privatization can be seen in the efficiency and profitability, while the impact on productivity measures becomes statistically insignificant. However, in general, the positive impact of privatization in the long term is much bigger than the impact of it in the short term. Statistically, it can be seen from two figures on the table of results, showing coefficient estimates and confidence level. For example, in the case of efficiency as dependent variable the coefficient of PRIVAT variable is 0.0559 in the short term and 0.0890 in the long term. It means the positive impact of partial privatization on the efficiency is bigger in the long term than in the short term. Also, there is an increase with regard to the significance level of the PRIVAT variable. Again, in the case of efficiency as dependent variable, the confidence level of PRIVAT variable in the short term is 0.05 (5%) while in the long term it becomes 0.01 (1%). Similar case also prevails for the case of profitability as performance measures. With regard to productivity, the impact of partial privatization becomes less noticeable in the long term because most privatized firm demonstrate significant increases despite there are some differences among the firms.

6.3.2 The Determining Factors of the Privatization Success

Table 6-7 reports the result of regression using three different performance indicators in the short term. It reveals that there are several potential determinants of post privatization performance enhancement. Of the government governance factors, the remaining state share negatively affects all three performance measures. However, the impact is only significant in the case of

profitability, while for the rest of the two models the variable is insignificant. For every 1% increase of state share it would decrease the efficiency ratio by 0.2679. This finding obviously differs from what is reported by D'Souza et al (2005), which find this variable affecting insignificantly the profitability. In addition, the number of government commissioners on the BOC has favorable impact on profitability and labor productivity at 1% and 10% significant level accordingly. Yet, this variable has no significance on efficiency. Similarly, the number of independent commissioners on the BOC also brings about constructive influence on the efficiency and profitability at 10% and 15% significant level respectively. One additional independent commissioner is expected to bring about improvement in efficiency and profitability by 0.0558 and 0.0456 accordingly. However, the impact of the variable is not significant on labor productivity. Out of the two capital market factors, the impact of the variable is not so definite. Stock index only has positive relationship to productivity at 1% but insignificant for the rest of the two. On the other hand, the stock market turnover favorably affects profitability and not significant for two other variables.

Table 6- 7 Determining Factor of Privatization Success in Short Term

Independent Variable	Dependent Variable		
	Efficiency	Profitability	Productivity
OWNERSHIP	-0.2679 (-1.78)**	-0.0693 (-0.46)	-152.7677 (-1.22)
GOVCMSNR	0.0139 (0.43)	0.0660 (2.39)*	44.6243 (1.67)***
INDPCOMSNR	0.0558 (2.22)**	0.0456 (1.72)***	0.6950 (0.03)
STOCKINDX	0.0001 (0.16)	0.0001 (1.45)	0.1118 (3.81)*
STOCKTURNV	-0.0207 (-0.26)	0.2746 (2.81)*	-12.7326 (-0.19)
LOGGDP	-0.0987 (-2.01)**	-0.5788 (-3.12)*	156.0913 (0.84)
CONS	0.8082 (3.45)	0.0447 (0.20)	-58.0169 (-0.25)
R-sq	0.095	0.312	0.272
No. Obs	98	98	98
No. of Group	14	14	14
F (Prob > F)	24.82 / 0.004	23.74/0.000	68.57/0.000

Note: Significant at the 1% (*), 5% (**) and 10% (***) levels

Table 6-8 reveals the result of panel estimation, investigating determining factors of partial privatization success in the long term period. Residual state ownership appears to be negatively associated with efficiency and profitability at 5% and 1% significant level correspondingly. Holding other variables constant, every 1% increase in the state ownership would shrink the efficiency and profitability ratio by 0.2255 and 0.2239 respectively. Conversely, the number of government commissioners positively affects only the profitability at 1% significance level. It insignificantly influences the other measures. Additionally, efficiency and profitability are also favorably affected by the number of independent commissioners at 1% and 5% confidential level. For every one additional independent commissioner, the efficiency ratio would go up by 0.0445 and profitability ratio by 0.0155; other variables are assumed to be constant. Similarly, stock index also provides positive contribution; for every 1 point increase in the index, efficiency and profitability would improve by approximately 0.0001 for both measures. Meanwhile, capital stock liquidity/activity also seems to be positively related to profitability at 10% significance level.

Table 6- 8 Determining Factor of Privatization Success in The Long Term

Independent Variable	Dependent Variable		
	Efficiency	Profitability	Productivity
OWNERSHIP	-0.2255 (-2.02)**	-0.2239 (-4.06)*	-7.8910 (-0.30)
GOVCMSNR	0.0183 (1.10)	0.0272 (3.28)*	2.1616 (0.50)
INDPCOMSNR	0.0445 (2.68)*	0.0155 (1.89)**	-6.5037 (-1.58)
STOCKINDX	0.0001 (2.14)**	0.0001 (1.79)***	0.0045 (0.74)
STOCKTURNV	-0.0632 (1.07)	0.0588 (2.81)**	3.9985 (0.22)
LOGGDP	-0.1926 (-1.42)	-0.1318 (-1.95)**	28.9851 (0.80)
CONS	1.9024 (1.86)	1.1680 (2.30)	-128.5371 (-0.48)
R-sq	0.095	0.241	0.029
No. Obs	98	214	214
No. of Group	14	15	15
F (Prob > F)	24.82 / 0.004	47.42/0.000	7.34/0.2904

Note: Significant at the 1% (*), 5% (**) and 10% (***) levels

From both tables, it is revealed that most of the government governance predictors play significant and similar role in affecting the performance of the firms in both the short term and long term. The difference tends to be more on the magnitude and the trend of the importance. The percentage of residual state shares in the divested firms seems to bring about negative impact on the performance of divested firms. The effect tends to be increasing in the long term. While in the short term it significantly affects only the efficiency level at 5%, but not significant for the profitability and productivity, in the long term it affects efficiency and profitability at 5% and 1% respectively. The favorable influence of the number of government commissioners appears to diminish in the long term. It favorably affects only the profitability at 1% in the long term compared to the impact in the short term which affects on the profitability and productivity simultaneously. In contrast, the positive contribution of independent commissioners becomes stronger in the long term period. Although it affects the same indicators of performance in both period of analysis, which are efficiency and profitability, the significance level is stronger in the long period. It rises from 5% to 1% for efficiency and from 10% to 5% for profitability.

With respect to the capital market governance factor, our result demonstrates that the size of capital market, which is represented by stock index, also presents positive contribution to the performance improvement after privatization particularly in the long term. While in the short term it affects significantly only the productivity at 1% significance level, the important role of capital stock is even more visible in the long term when profitability as well as efficiency are favorably affected by it at 5% and 10% respectively. Nevertheless, compared to other variables the magnitude of stock market importance is very marginal. It is shown by a very small coefficient size at 0.0001 for both efficiency and profitability. Lastly, it seems to us that no single variable affects significantly the productivity of the firm in the long term period.

6.4 Discussion

Considering the mainstream theoretical argument supported by the findings from numerous empirical studies which understates the possible success of partial privatization, the finding of this study is very interesting and surprising. It is not in line with what is argued by Boycko, et al. (1996) that partial privatization is less likely to bring about positive impact because the enterprises is still under control of politicians who show less interest in seeking profit and efficiency. It also deviates from what is reported by Gupta (2002) that the only potential determinant for partial privatization to be successful is well-developed capital market that can bring about incentive to the manager in the form of disciplinary actions. In fact, as shown in Chapter 4, Indonesia can be categorized as country with less developed capital market. It is also rather contrasted with what is reported by several empirical studies such as cross country studies by Boubakri et. al (2005) on 32 developing countries and D'Souza et.al., (2005) on 23 developed countries. According to their findings, privatization without government control relinquishment and carried out in the country in which well-established stock market is absent is highly likely to fail in bringing about favorable impact to the performance of individual firm. Partial privatization is considered to be unable to eradicate the main problem of political interference.

For most of the firms, partial privatization provides positive impact on their performance shortly after privatization is carried out. It is shown by the number of privatized SOEs that experience increased performance in the short term. Among 15 firms, there are 60% (9 firms) with immediate increased profitability, 67% (10 firms) with immediate improved efficiency, and 86% (13 firms) with improved productivity. However, some firms seem to need some time for privatization to take effect. Included in this group are 26% of the firms that need some time to

improve the profitability and 13% of the firms that need some time to improve their efficiency. In terms of labor productivity, 86% of the firms (13 of 15 firms) are successful in benefitting from partial privatization. On the other hand, in the long term most of the privatized firms demonstrate increased performance for all performance measures. They are 13 out of 15 firms for profitability and productivity and 12 out of 15 firms for efficiency. The possible reason of this phenomenon is that privatization is a dynamic process which is to be successful depending on some dynamic factors inside and outside the firms such as organizational culture and behavior, incentive, leadership, and learning skills that also play critical role in the process. Nevertheless, this study would not discuss the issue of time lag in more details. Rather, it would emphasize on the factors contributing to the improved performance as discussed in the next section. The result of non parametric test are confirmed with the result of panel regression in which privatization dummy variable positively affects efficiency and productivity at certain significant level but the impact is insignificant for profitability measure. It implies that the increased productivity in post privatization may be caused by other factors than privatization.

It is revealed that partial privatization is successful in forcing the firms to enhance their efficiency shortly after privatization. It is widely understood that improving efficiency is the most sustainable way to increase the performance of the firm in general. On the other hand, privatization compels some firms to cut some portion of their abnormal profit which they may have enjoyed in pre privatization period. Hence, some divested SOEs would certainly experience declined profitability in the short term but regain in the long term. In the long term, most divested SOEs demonstrate their superiority in all aspects of performance indicators.

Despite there is strong evidence that partial privatization brings about positive impact on the performance on aggregate, there are 2 out of 15 privatized firms (13%) that consistently show

the reverse effect of partial privatization. Those two firms experience worse performance in all three dimensions of performance measures. To be more specific those companies are PT Indo Farma and PT Kimia Farma which belong to the same industry, which is the pharmaceutical industry. This variation will be discussed in more detail in different section of this chapter.

6.4.1 The Role of Government Governance

Under partial privatization, the government as both a majority shareholders and a regulator is the key player in making the program successful. In the case of Indonesia, the government seems to pursue privatization as a show its enforced commitment in improving the performance of divested SOEs. How this commitment is formed, the story goes back to when the decisions to privatize any particular SOEs have to be taken by the government. Privatization has not been a national consensus in Indonesia. Privatization is not a popular policy either. The government always gets strong resistances and oppositions not only from the stakeholders outside the government such as public/citizen, politicians, employee, as well as managers but also from the inside the government itself.

From inside the government itself, there had been a rivalry between two groups whose sharp different perspectives on how the economy should be managed and directed since the establishment of the New Order government in 1966 (Hertzmark, 2007). Those two groups were the technocrats and nationalists (development-oriented groups). The former, which is also known as the Berkeley Mafia⁷, argued that the government should give more roles and rooms for the private players in the economy by implementing several free market policies such as

⁷ It referred to a group of U.S-educated/trained Indonesian economists who supported the New Order to bring Indonesian' economy back from terrible economic conditions in the mid-1960s. Most of them were appointed to be the ministers and senior advisors in Soeharto's cabinet. The group included Widjojo Nitisastro, Soemitro Djojohadikusumo, Muhammad Sadli, Radius Prawiro, Emil Salim, Subroto, Ali Wardhana, J.B. Sumarlin.

liberalization, deregulation, as well as privatization. In contrast, the latter group consisted of group of people who preferred to reduce the role of private firms and advocated for the implementation of economic nationalism (such as self-sufficiency in basic industries) and technology-centered economic development (Hertzmark, 2007 & Elson, 2001).

Throughout New Order regime, President Soeharto appeared to successfully manage the situation by adopting the argument of one group in certain period of time and implementing another group's opinion in another point of time according to surrounding circumstance. For instance, in the early period of his regime, President Soeharto had appeared to implement more prudent economic policies advised by the Berkeley Mafia such as pursuing deregulation, controlling inflation, balancing the budget, and holding rehabilitation of infrastructure. As a result, the economy had been successfully managed and Indonesia had experienced an unprecedented economic growth (Elson, 2001). However, when the oil boom poured the economy with huge cash inflows in the mid 1970s, he looked more prefer to nationalistic economic policy by injecting significant amount of capital to some basic industries such as steel, oil refinery, and mining (Hertzmark, 2007). When the price of oil started to decline in the middle of 1980s, President Soeharto turned to accept the Berkeley Mafia's view by implementing liberalization and deregulation until the economy backed to grow (Pesek, 2010).

It is clear that by pursuing privatization policy, President Soeharto favored the perspective of Berkeley Mafia and ignored another group's opinion. With its great influence on the direction of New Order economic policy, it was understandable when people considered the Berkeley Mafia as a part of Soeharto's regime. Therefore, people also blamed on them when Indonesian's economy collapsed due to severe financial crisis hit the nation in 1997. As widely known, this economic crisis eventually led to political crisis that caused the New Order regime to end.

Ironically, the new regime (so-called the Reform Regime) seemed to have very limited options to drive economy back to normal. Despite the rise of anti the Berkeley Mafia was noticeable, the decision to pursue fast-massive-full privatization as recommended by IMF eventually had to be taken by the new government. It was not surprising if the decision provoked strong opposition from the stakeholders, especially from the supporters of development-oriented group.

Meanwhile, from outside the government, people from different affiliations such as politicians, academicians, employees, domestic investors, social activists, and general people also opposes the privatization policy with many different reasons. A part of them suspects privatization as a form of “foreignization” or “colonization” of the economy. Foreignization/westernization is accused of the government because on many occasions, especially during the Crisis when domestic investors have no purchasing power to buy the shares offered, foreign investors occupy significant portion of the shares offered in the capital market. Even, after the government limits the maximum number of shares that can be sold to foreign investors by setting certain allotment during IPO (primary market), the government cannot control what happens in the secondary market when individual domestic investors sell their shares. Some people also perceive privatization, especially the one carried out during the Crisis, as a new form of colonization or a new way of liberalization promoted by developed countries. It was mainly due to the deep involvement of IMF and World Bank in the process of privatization during the Crisis in 1997. In fact, privatization was one of the conditions that had to be met by the government for loan poured by IMF to bail the country out of the crisis.

The issue of liberalization is even more serious. A group of people regards privatization as a form of liberalization towards the Indonesian economy that violates the country’s constitution (UUD 1945) Chapter XIV regarding National Economy and Social Welfare, Article

33 as discussed in Chapter 3.4.3. This is related to economic system as a national consensus. To some people, privatization is regarded as a violation against the state constitution because it would undermine the state control toward the economy. Strong resistances over privatization plan proposed by the government are also raised by employees and managers. Most employees concerns regarding their future after privatization. It would be more likely for the privatized firms to rationalize some of their employee as an effort to improve their efficiency. The public in general also show their oppositions due to many reasons; one of them was lack of knowledge regarding the policy.

Confronted with very difficult situation, the government seems to have very limited choices to resolve these problems. For example, during the Crisis in 1997, the government had to deal with severe budget deficit. Privatization seemed to be the fastest with least consequences to solve current problem. Some other alternative policies might be available but it might take very long time to take effect. On another occasion, some prospective SOEs need huge capital for their business expansion. With that huge amount of money required and considering other urgent projects to be funded, the government might not be able to meet SOEs need. Occasionally, the government might have enough funds available, but pouring the funds needed might bring about moral hazard not only to receiving SOEs but also other SOEs in the similar situation.

Having confronted by intense oppositions and resistances from various stakeholders abovementioned as well as very complex economic situation, the government has had to take bitter and unpopular decisions to privatize the firms with one promise that privatization would bring about benefit for the stakeholders in general as well as would enhance the performance of the enterprises in particular. Thus, once the decision of privatization has been taken, the government has serious moral obligation and promise to be met to the stakeholders. In order to

realize its commitment and promise, apparently the government would have to pursue and implement a comprehensive monitoring and incentive plan.

a. Better Monitoring Mechanism

As discussed in Chapter 2, it is very true what is argued by Megginson (2005) that a major factor limiting the effectiveness of SOEs is lack of sound monitoring. Therefore, establishing fairly sound monitoring mechanism would be critical for the success of privatization, no matter whether it is full or partial privatization. It is widely understood that SOEs monitoring is characterized by complex and massive political interventions. The government of Indonesia appears to move in the right direction in addressing this issue. The effort of the government to set forth a well-established monitoring mechanism can be divided into two different monitoring mechanisms, namely external and internal firm.

External firm monitoring refers to a mechanisms of monitoring carried out by an oversight institution outside the firms. It is mainly related to the relation between the oversight body and the SOEs. In this respect, the government establishes better monitoring mechanism by centralizing the oversight task under MSOEs. Before 1998, supervision and monitoring of SOEs were done dispersedly under several Technical Ministries according to SOEs' respective sector. Each monitoring ministry had its own way of supervision and monitoring. Moreover, in many cases, there were many SOEs that had to deal with several related ministries due to their business characteristics. Consequently, the political interventions were complex and massive.

Of the conditions over financial support given by IMF to help Indonesia out of the 1997 financial crisis, the government committed to restructure and privatize all SOEs in the medium term. As recommended by the IMF and World Bank, the government had to pursue fast-track, massive and full privatization. To fasten and ease the process, oversight of public enterprises was

transferred firstly from Technical Ministries to MoF as stipulated in Government Regulation (PP) No 12 and 13. In this situation, monitoring became centralized with less political interventions. Monitoring from other related ministries still existed but it manifested more in terms of regulation and their representation on the BOC. Giving the crisis situation which required fast decision making process, however, the current mechanism was still regarded not ideal. Every decision had to go through relatively long hierarchical structure. Hence, the government decided to establish a new ministry called MSOEs which was responsible for restructuring, privatizing as well as monitoring public enterprises after privatization. Through Government Regulation (PP) No 50 and 64 all oversight tasks toward SOEs was reassigned to the MSOEs. Under the new overseeing Ministry, the government expects to be able to monitor SOEs, especially the divested ones, in better ways. Centralized monitoring and oversight is better in minimizing political interference from bureaucrats of numerous Technical Ministries. In addition, under a separate new ministry, it enabled the ministry to have more power and flexibility in executing the oversight task.

On the other hand, internal monitoring refers to the monitoring/supervision toward management undertaken by the government as shareholder through an organ of organization inside the firm. In this regard, as widely known, there are two major models of governance system in the world, i.e. single-tier board and two tier boards system. In single-tier board system all members are considered as the member of the same board, i.e. BOD. In the Anglo Saxon single tier system, the members of BOD can be divided into two, namely executive board member and non executive board member. Executive board member usually encompasses Chief Executive Officer (CEO) that also acts as the chairman, Chief Financial Officer (CFO), Chief Operating Officer (COO), and others. Meanwhile, non executive board members are appointed

from outside the firm. If they come from non-affiliated parties they are called independent board member. Meanwhile, in two-tier board system there is clear separation among the members, i.e. the members of BOC and the member of BOD. The members of BOC are appointed to represent the interest of shareholder in general. Theoretically, two-tier board system has some merits over single-tier system such as in terms of independence, practicality, and simplicity. It is important to note that Indonesia adopts two-tier boards system in this regard.

In general, the function of BOC as stated in Limited Liability Law Number 40 of 2007 and SOEs law Number 19 of 2003 are (1) to supervise management policies, the running of management in general, with respect to both the firm and the firm's business, and (2) to give advice to the BOD. In more detail, the functions of BOC in the Indonesian corporate governance system, especially in SOEs, are described in the guideline for the implementation of good corporate governance (GCG) developed by Development and Financial Supervisory Board (Badan Pengawasan Keuangan dan Pembangunan-BPKP), as follows:

- a) To supervise the implementation of management strategies, management policies, the annual work plan of firm and then to report the result of the supervision including the evaluation on them to General Shareholder Meeting (GSM);
- b) To give advice to the GSM concerning the expansion plan of the firm and the compilation of annual work plan. To give suggestion for solving the important problem faced by the firm;
- c) To monitor the firm's performance and activities, if any indications of declining performance are found, the BOC shall report to GSM along with their advices and suggestions to resolve the situation;
- d) To evaluate the performance of BOD, in some case they shall relate the performance of the BOD with remuneration system;

- e) To give advice BOD in developing human capital of the firm;
- f) To monitor the firm on the issue of law and ethic compliance and to take any necessary precautions/ actions to prevent/to solve the problem;
- g) To help BOD mitigate and manage the crisis;
- h) To help BOD seek and get the resources needed by the firm;
- i) To monitor the effectiveness of the implementation of good corporate governance;

In comparison with the real practice in Indonesian private companies where BOCs is often to be honorary posts or in another case it is often filled by family members of BODs who share common mutual interests, BOC in SOEs is better and the function becomes much more critical after privatization as it will be explained later in this section. With regard to BOC-BOD relation, it is stated in the Law of SOEs that BOC member is forbidden to be the member of BOD or other positions not only in the same company but also in other firms (either public or private) that have potential conflict of interest. Therefore, the tendency of BOC to be always supportive on BOD decision becomes less possible. Furthermore, it is also stated in the Law of Limited Liability that “In the event of bankruptcy occurring because of the fault or negligence of the BOC in performing its supervision of the management carried out by the BOD and the assets of the Company being insufficient to pay the whole of the Company’s obligations as a result of the bankruptcy, then each member of the BOC shall be jointly and severally liable together with the members of the BOD for obligations which have not been paid off”. With this responsibility, each member of BOC is supposed to strive to be “watchdog” on every strategic decision taken by BOD, otherwise they will be responsible for shouldering uncovered loss.

As mentioned earlier that the government pursue better internal monitoring in post privatization as one of ways to demonstrate its commitment. With regard to this, some of the betterments as explained below:

Firstly, the government delegates more authorities and power to BOC after privatization. The methodology of monitoring employed is critical to the success of any monitoring mechanism. Where the SOEs are fully owned by the state, the real function of supervision and monitoring is actually carried out within the framework of the General Shareholder Meeting (GSM). Although the BOC also exists, their role is not more than just as an extended hand of the GSM to monitor the BOD over operational decisions made. Almost all strategic policies in relation to the companies are taken by the GSM, and then it would be the BOC's responsibilities to ensure those decisions are implemented properly by management.

Shortly after privatization, the privatized SOEs are obliged by Liability Limited Law to make some adjustments in their article of association in accordance with changes in their status. A new proposal of the article of association has to be approved by the GSM, which is usually represented by the assigned ministers as the proxy holders. Of the main changes which are usually made in the new article of association is about the new role of the BOC. Through the new article of association, the state usually delegates more authorities to the BOC, related to planning and budgeting, assets transfer and disposal, capital participation and long term cooperation with other business partners (the detail is as shown in Table 6-9). The government usually takes several aspects into consideration in determining the level of authorities delegated. In turn, the GSM will only deal with very strategic decisions which typically deal with the decisions that might bring about a consequence to state finances such as decisions associated with change of capital structure (merger, acquisition etc). In addition to providing more

autonomy and flexibility that is definitely necessitated by SOEs as business entity, this would minimize potential rent seeking activities from bad politicians or bureaucrats by lessening their access to privatized firms.

Table 6- 9 Role of BOC: Pre vs. Post Privatization

Activity	Role of BOC
Planning and Budgeting	During pre privatization, BOC is required only to discuss with BOD, then to sign the draft prepared by BOD which then is submitted to GSM to get the approval. In post privatization, BOC get authority from GSM to approve the proposal submitted by BOD
Assets transfer or Utilizing assets as a mortgage of loan	In comparison with pre privatization, in post privatization BOC has bigger power in approving transfer of assets or assets mortgage utilization. It is typically represented either in larger range of assets value or bigger percentage range of assets value compared to total assets value
Assets Write Off or Disposal	In comparison with pre privatization, in post privatization BOC has bigger authority in approving assets write off/disposal. It is represented either in terms of bigger range of estimated value of disposed assets, more various of disposed assets characteristic, and soon
Capital Participation or Investment on other firms or Capital participation to establish on subsidiary/joint firm	In comparison with pre privatization, in post privatization BOC has bigger authority in approving capital participation/investment. It is typically represented either in terms of bigger range of investment value or bigger percentage range of investment value compared to total assets value.
Approval for long term business agreement/cooperation with other parties	In comparison with pre privatization, in post privatization BOC has bigger authority in approving business agreement/cooperation. It is commonly represented in longer period of business agreement.

Source: constructed by the Author based on MSOEs

Secondly, government enhances the intensity and quality of monitoring. While assigning BOC with more power and authorities in order to diminish rent seeking activities from bad bureaucrats and politicians, the government also improves the quality of monitoring by making some adjustment in the composition of BOC. Before privatization when SOEs are fully owned

by the state, BOC comprises of only government commissioners who are usually appointed from top-ranked bureaucrats or retired officers from related Ministries. It is also a common practice that some members of the BOC are appointed from politicians who belongs to ruling political parties. It could lead to high political embeddedness between SOEs and political parties. This highlights the facts that political interference is adversely rampant in the context of Indonesian SOEs. Bestowing the BOC with more power and authorities without making some adjustments in the composition of BOC plagued with political interest, means putting SOEs in more danger and predicaments.

As regulated in Limited Liability Law Number 40 of 2007, listed firms (including listed SOEs) are enabled to have two categories of commissioners in their BOC. They are delegated commissioners and independent commissioners. A delegated commissioner is usually appointed from parties affiliating to the shareholders, either majority or minority. Their presence is to represent the shareholders' interest. Included in this category are government commissioners who represent the state as majority shareholders. Meanwhile, an independent commissioner shall be neither appointed from parties associating with the main shareholders nor the members of the BOC. In order to know the changes in the quality of monitoring, we can see from the composition of BOC in post privatization. As depicted in panel (c) of Table 6-10, the average of total number of BOC members is higher in post privatization than it is in pre privatization. It seems to intensify the level of monitoring toward privatized firms by the government. Nonetheless, the increased number of BOC members might lead to worsening political interventions if the new composition of BOC is dominated by politicians. The government has realized and anticipated this problem. In this respect, the government trims down the number of government commissioners in listed SOEs in an effort to phase out political interferences as

shown in panel (a) of Table 6-10. The declined number of government commissioners is likely to lessen the information available to politicians and bureaucrats (Schmidt, 1990), which in turn would lead to less political interventions in the SOEs. As a result, privatized SOEs would become relatively more independent from rent-seeking activities so that it could lead to better performance as advocated by public choice theorist. It is in line with what is revealed by the results of the regression, suggesting that the number of government commissioners contribute positively to the performance of the privatized SOEs in the short term. However, the impact tends to be diminishing in the long term.

While there is decrease in the number of government commissioners, on the other hand as reported by panel (b) of Table 6-10, the presence of independent commissioners seems to be the reason for having increased number of BOC members. The commitment of government obviously plays role in this matter. Although it is not obligatory, rather just optional, for the sake of credibility and objectivity in the monitoring of privatized SOEs, the government through GSM agrees to have independent commissioners in the BOC. Independent commissioners are typically persons with expertise in the field of operations of the SOEs in question. Most of them are economic observers, practitioners, academicians, and so on. With their skill, experience, as well as professionalism but with no vested interest from any political groups, their presence is considered important to maintain public trust on the governance of SOEs. The number of independent commissioners in the BOC is not determined strictly; rather the government matches it with the need in the industry. Another factor taken into consideration is the number of shares owned by non-state shareholders; the larger the number of shares owned by the private sector the more independent commissioners will likely be in the BOD. To some extent, it can be considered as dispersed minority interest representatives.

In brief, the discussion above reveals that increased government commitment in monitoring reflected in the form of reducing political interference is conducted through (1) centralizing oversight task of public firms to the MSOEs, (2) increasing the number of the BOC members, (3) reducing the number of government commissioners on the BOC, (4) allowing independent commissioners in the BOC, (5) delegating more decision making from GSM to the BOC.

Table 6- 10 Average Number of Commissioner: Pre vs. Post Privatization

No	SOEs	(a) Government Commissioner			(b) Independent Commissioner			(c) Total Commissioner		
		Pre	Post	Chg	Pre	Post	Chg	Pre	Post	Chg
1	PT Adhi Karya	4.00	3.14	-0.86	0.00	1.71	1.71	4.00	4.86	0.86
2	PT ANTAM	4.00	3.57	-0.43	0.00	1.21	1.21	4.00	4.79	0.79
3	PT Bank Mandiri	4.00	2.75	-1.25	0.00	4.00	4.00	4.00	6.75	2.75
4	PT BNI	3.00	3.08	0.08	0.00	3.00	3.00	3.00	6.08	3.08
5	PT BRI	4.00	2.75	-1.25	0.00	3.75	3.75	4.00	6.50	2.50
6	PT Indo Farma	5.00	3.10	-1.90	0.00	0.50	0.50	5.00	3.60	-1.40
7	PT Jasa Marga	5.00	4.00	-1.00	0.00	2.50	2.50	5.00	6.50	1.50
8	PT Kimia Farma	4.00	2.10	-1.90	0.00	1.90	1.90	4.00	4.00	0.00
9	PT PP	4.00	3.14	-0.86	0.00	0.43	0.43	4.00	3.57	-0.43
10	PT PGN	5.00	3.63	-1.38	0.00	2.00	2.00	5.00	5.63	0.63
11	PT PTBA	5.00	3.78	-1.22	0.00	1.78	1.78	5.00	5.56	0.56
12	PT TELKOM	5.00	3.50	-1.50	0.00	1.50	1.50	5.00	5.00	0.00
13	PT Timah	3.00	2.25	-0.75	0.00	1.38	1.38	3.00	3.63	0.63
14	PT WIKA	4.00	3.00	-1.00	0.00	2.00	2.00	4.00	5.00	1.00
15	PT Semen Gresik	5.00	3.50	-1.50	0.00	1.75	1.75	5.00	5.25	0.25
TOTAL		4.27	3.15	-1.11	0.00	1.96	1.96	4.27	5.11	0.85

Source: constructed by the Author based on MSOEs

Is there any relationship between new capital structure in the partially privatized enterprises with the magnitude of government incentive to pursue abovementioned reformation by way of monitoring and providing incentive? The new capital structure *post* privatization is

characterized with dispersed ownership among individual shareholders. The presence of institutional shareholders in the new shareholder composition of divested SOEs is also extremely rare. Except the government that still holds a majority, the shares sold is owned dominantly by individual investors with each of them owning far below 5% of total share. Furthermore, apparently the main objective of individual private investor in purchasing stocks is to earn capital gain in the short term rather than to get dividend yield realized in the long term. In this respect, it is more likely for the individual shareholders to buy and sell their stock at any time considered more advantageous. To make situation worse, the Indonesian capital market, especially in the early stage of privatization was characterized as less developed in which minority interest right might not be well-protected. As a consequence, all these situations are more likely to create silent individual shareholders in the sense that each individual shareholder might not pay enough attention to what the management does in directing the firm. Consequently, external governance expected to arise from privatization might have never been realized under these situations as reported in several studies in other regions (Omran, 2002). This status quo situation would remain in place unless the government as the one that retains the control takes initiative to make some positive change.

It is observed that the percentage of residual ownership held by government negatively affects the performance of newly privatized SOEs at significant level. One may say that no matter how large the size of the share sold through privatization as long as it is not followed by transfer of control from the government to private owner it would not cause a major change in the way the firm is managed. Apparently, this is not the case of Indonesia. As explained above, the commitment of the government to improve the performance of privatized SOEs through delegating more power of GSM to BOC and allowing public monitoring appears to be the

rationale of this funding. It seems that the government delegates most authority to the BOC when the residual state ownership is lower, and vice versa.

At the same time, to represent larger private ownership in the enterprises, the government allows more independent commissioners to be on the BOC. Those policies show positive impact because political interference is likely to be much lower. In addition, conducting sustained public monitoring also plays role in preventing rent seeking activities from bad politicians as well as abuse of power by bureaucrats. As a result, the privatized enterprises become more sterilized from any political engagements so that they can operate to be more as business entity rather than as political vehicles. This finding is rather different from what is reported by Boubakri, Cosset, and Guedhami-BCG (2004) that documents that privatization without control relinquishment by the government may have little impact on the SOEs' performance after privatization in developing countries. In another case as reported by D'Souza, Megginson, and Nash-DMN (2004), residual government ownership is also considered as insignificant factor in determining ROS in the study which use privatized firms in developed countries as a sample.

b. Performance-Aligned Remuneration Scheme

Besides monitoring, incentive is also mentioned by Megginson (2005) as another determining factor which is absent from public enterprises. In this respect, incentive can be defined as a situation that can induce the managers to maximize the value of the firms. As discussed in Chapter 5 there are several potential causes of undersupply of incentives in the fully operated SOEs. Firstly, the presence of rivalry among some associated ministries/departments in defining the objective of the firm may give a disincentive to the managers. The objective which the managers have to achieve is likely to be ill-defined, complex and multifaceted. Moreover, with several agents that have to be satisfied, compared to single agent in the case of private enterprise,

the manager may lose focus (Dixit, 1997). Secondly, the implementation of soft budget policy may cause managers' moral hazard in utilizing the firm resources. Since the managers know that the government would always come to help the ailing enterprises, the managers would tend to act recklessly. Thirdly, as advocated by agency problem theorists, management and employees may have conflicting objectives deviating from the objective set by the state as majority shareholders as also occurs in the private enterprises. Unfortunately, the government often set inadequate remuneration system to solve this problem.

The first two of mentioned causes might not have existed any longer in the context of Indonesian SOEs. Since the establishment of the MSOEs as the only authorized monitoring and supervision institution toward SOEs in 1998, the rivalry among related ministries has become very little. The goal that the managers are required to achieve has been relatively well-defined. There is also only a single agent who is to be satisfied. With regard to soft budget effect, as discussed in Chapter 4, one of the criteria of prospective privatized SOEs is that the enterprises should not be carrying out government program of availing subsidized public goods and services. The firms have not been dependent on government help at all, even from pre privatization period. And also there has not been any precedent in which the government bestows any form of soft budget constraint policy to privatized SOEs. Hence, disincentive effect of soft budget constraint policy on partially privatized firms does not exist so that it is ignorable.

However, the last cause of incentive problem, which is poor remuneration scheme, seems to remain there. Just like in private-owned enterprises, the managers usually have their own goal in maximizing the residual profit of the enterprises. Given the context of Indonesia, where the political preference also plays considerable role in selecting the managers, especially the top level one, the managers could be terminated at any point in time without any reasonable reason.

Consequently, since there is no guarantee for the managers to be hired in the long term tenure, they tend to think for their own short term benefits. This would go against the shareholder's objective to maximize sustainable long term value of the firm. Of solutions suggested by some scholars (Boeker, 1992; Zahra and Pearce, 1989), is to address and tackle this problem by setting proper incentive linked to the performance of the firm. As a result, the owner as a principal and manager as an agent are likely to be aligned to have the same goal and interest.

Apparently, the government of Indonesia has realized the problem, even long time before privatization has been carried out. It has been common practice that the government usually grants a bonus to the management and employees as a form of appreciation for their performance. The amount of bonus has been usually aligned to the performance of the firm in related year. By doing so, it is expected that the employee would have an incentive to perform excellently in order to obtain bigger annual bonus. Unfortunately, the bonus has not been always granted every year. It is usually arbitrarily decided by the government itself. In practice, it is subject to many factors such as need over investment fund in the next year and the amount of dividend that government wants to withdraw for satisfying state budget need. Accordingly, this would diminish the incentive power of annual bonus. Furthermore, the effect of cash bonus tends to be short lived because it will not affect the performance of firm in the following years. In addition, the government through MSOEs occasionally also adjusts the salary of BOD and BOC by considering several factors including the performance of firms. However, with no fixed timeline for this adjustment to be made this incentive also becomes less stimulating. Therefore, more sustainable and encouraging incentive system is required.

In order to overcome the problem, the government always includes new remuneration scheme along with the proposal of privatization. The scheme is basically stock-based incentive

system. After going public, stock price is considered as the most representative and the most objective performance indicator. Stock price represents all information related to the firm, including current and prospective performance, future investment plan, dividend policy, also some other issue related to ethic and corporate governance. By relating the incentive to the performance of the stocks it can align the objective of both the state as the owner, and employees and managers as the operator. In general, stock-based incentive plan offered by the government of Indonesia to managers and employees of privatized SOEs can be classified into two categories, namely Employee Stock Allocation (ESA) and Management Stock Option Plan (MSOP).

Under ESA plan, the government allocates certain portion of shares issued in IPO as grant to or to be purchased by employees and managers under certain conditions and certain terms of payment. Included in this category are Bonus Share Grants and Share Purchase at Discount plan. Under Bonus Grants, the government provides annual bonus to the employees and managers as appreciation of their performance not in the form of money as usual, but in the form of shares. In this case, the employees and managers get shares for free according to their take home pay because all cost would be taken from retained earnings or be expended in the firm's financial report. To prevent the employee from realizing capital gain shortly after obtaining the stock, the government sets a lock-up period, varying from 6 month to 3 years. Meanwhile under Share Purchase at Discount plan the employees and managers are allowed to purchase certain number of shares at discounted price or subsidized price. In most cases, the main part of stock price is paid by using the bonus of the employees, while the rest is either shouldered by the firm or paid for by the employees in cash. To help and encourage the employees, in some cases the firms also give a loan at subsidized interest rate to be used for

purchase of the stock offered. Similar to Bonus Shares Grant, the government also sets certain lock-up period for this plan.

Another stock-based incentive plan is MSOP which is usually for the top managers with certain conditions and requirements. Under this scheme of incentive, eligible managers would be allowed to have option to purchase stock in the future at predetermined or discounted price. Stock-based incentive scheme for each privatized firm is as shown in the following Table 6-11.

Table 6- 11 Stock-Based Incentive Scheme for Each Privatized SOEs

No	SOEs	Incentive Scheme
1	PT Adhi Karya	Under ESA, employees and management were allowed to purchase shares at special price or special way of payment up to 10% of total shares offered through IPO or equal to 44,132,000 (fixed allotment). Detail information regarding how this program is carried out is not available. It is likely that the main portion of the purchase price was paid with employees' bonus, while the rest was subsidized by the firm.
2	PT ANTAM	Under ESA, employees and management were allowed to purchase shares at maximum 10% of total shares offered through IPO (fixed allotment) at market price which was 90% of share price paid by using bonus of the employee and 10% would be subsidized by the firm. The lock-up period was 6 months.
3	PT Bank Mandiri	GSM agreed to provide two kind of incentive programs; ESA and MSOP. ESA consisted of two different programs, namely Bonus Share Grant and Share Purchase at Discount plan. All prices/expenses and discounts would be the firm's expenses. MSOP was dedicated to BOD and senior managers at certain level and with particular conditions. It would be carried out gradually throughout five stages with total value <5% of total paid capital. Specifically for 4 th and 5 th stage, these would be issued 1% of total paid capital respectively. The first stage was done along with IPO, while the rest of stages would be carried out annually. Exercised price of 1 st stage was 110% of IPO offering price, while exercised price for the rest of the stages would be determined by basing on average of closing price for the last 25 days before exercise date. The term of the program was 5 years with 2 years vesting period. Maximum number of options that could be exercised in the first

year was 50% of total option obtained, while the rest of the option could be exercised in the rest of the program term. On the day of IPO, the firm issued 378.583.785 options with exercise price as IDR 742,5 per share (110% of IPO offering price)

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|---|----------------|---|
| 4 | PT BNI | Under ESA plan, employees and management were allowed to purchase shares up to 10% of total shares offered in IPO which was 90% of share price paid by using bonus of the employees and 10% would be subsidized by the firm. The lock-up period was 12 month. |
| 5 | PT BRI | <p>Under ESA plan: maximum 10% of total share would be dedicated for two programs; Bonus Share plan and Share Purchase at Discount plan. Bonus share was for eligible employees and managers with 1 year lock-up period. Share Purchase at Discount plan enable employees and managers to Purchase stock at a 20% discount of offering price, with lock-up period of 6 months, while for additional stock purchase plan at a 3.0% discount to the offering price, there is no lock-up period.</p> <p>MSOP was dedicated to BOD and senior managers at certain level and with particular conditions, total option was <0.72% of Market Capitalization for 1st year and <5% of Paid In Capital for next two years</p> |
| 6 | PT Indo Farma | Under ESA Plan, employees and management were allowed to purchase shares until maximum 5.5% of total share issued (fixed allotment) at market price which was 90% of purchase price paid with loan provided by Employee Foundation with 8.5% interest rate, while 10% of the rest was subsidized by the firm. Employees were required to pay loan with bonus and dividend. The lock-up period was 12 months. For additional allotment, 10% of the price would be the firm's expense, while the rest would be paid by the employees in cash, the lock up was 6 month |
| 7 | PT Jasa Marga | <p>Under ESA Plan, 10% of total shares issued were dedicated to two plans: 1) Bonus Share Grant, 2) Shares Purchase at Discount Plan.</p> <p>1) Under Bonus share Grant, around 11.8 million shares were granted to eligible employees. It was equal to one month salary of the month of June 2007, with lock-up period for 3 years.</p> <p>2) Under Sales Purchase at Discount Plan (fixed allotment), in proportion to employee's monthly salary and was subject to certain limits, management and employees were allowed to purchase approximately 192 million shares.</p> |
| 8 | PT Kimia Farma | <p>There were two incentive plans:</p> <p>1) Under Shares Purchase at Discount Plan, employees were allowed to purchase share <180,000; shares at price IDR 180</p> |

		(Offering price was IDR 200), maximum 10% minus bonus share, no lock-up period. Of the price, 50% was paid with annual bonus, while the rest was paid by using maximum 2 years loan 8%-14% interest rate, lock-up period 8 months and already fully paid;
		2) Under Stock option, certain management and employees were allowed to purchase shares at a price 115% of IPO price (equal to IDR 230) with 6 months lock up period.
9	PT PP	Employees and Management Buy Out 49%
10	PT PGN	Under ESA plan, Of maximum 4% of total capital was dedicated to employees in the forms of: <ol style="list-style-type: none"> 1) Under bonus share grant, eligible employees were granted shares which was equal to 2 times take home pay and 12 months lock up; 2) Under Share purchase at discount, employees were allowed to purchase share at 18% discount price, with 3 times take home pay bonus year 2003 paid in advance, 12 month lock up period; 3) Under cash share purchase at discount, employees were allowed to purchase shares (fixed allotment) at 18% discount price and , 16 months lock up period
11	PT PTBA	Under ESA plan, employees were allowed to purchase at maximum 10% of total share offered with warrant bonus (2 shares:1 warrant) for which 10% of market price was subsidized by the firm, 90% of price was paid with 3 year loan given by the firm with 1-6 % interest subsidy from the firm. Loan payment was installed from quarterly bonus or maximum 10% salary, 6 month lock up period.
12	PT TELKOM	Under ESA Plan, employees were allowed to purchase maximum 10% of total shares issued which was 90% of price paid with accumulated bonus while the rest was subsidized by the firm, with 12 month lock-up period.
13	PT Timah	n.a
14	PT WIKA	Under ESA plan, employees were allowed to purchase maximum 10% of total shares issued (184,6 million) which was 20% of price subsidized by the firm, with 8 month lock-up period, <10% of total number of shares. ESOP/MSOP: employee would be allowed to purchase share at discounted price until maximum 5% total capital stock for 5 years.
15	PT Semen Gresik	n.a

Source: constructed by the Author based on SOEs' Annual Report

Performance-Aligned remuneration scheme has been applied not only for BOD and employees but also for other persons in charges who monitor SOEs on behalf of the government as shareholder. Included in this are bureaucrats in the related ministries (MSOEs and MoF) and the members of BOC. With bigger responsibility after privatization, they also deserve to get decent incentives. In this respect, the incentives can be divided into two categories:

a) In-office incentive

In-office incentive refers to the incentive given to the monitors as their position as active officers. It can be in the form of financial and non-financial incentive. For the time being, official financial incentive may be only applicable specifically for monitors that belong to MoF. For instance, there is specific unit under MoF that is responsible for collecting financial contribution (such as tax or dividend) from SOEs. The ministry periodically conducts an evaluation toward the existing remuneration system by considering the achievement of targeted financial contribution assigned to the related unit in the beginning of period. Persons in charge who successfully achieve the target will get higher performance allowance. Meanwhile, non financial incentive may be given to monitors in terms of career promotion. It is common practice in the MSOEs and MoF that persons in charges on respective units and respective level may get a promotion to higher echelon or better unit with better grade of remuneration system. In the case of MSOEs, it is also a common practice that successful persons in charge may be assigned to become member of BOD or BOC in particular SOE because of their achievement.

b) Out-office incentive

Several active high ranked officers in MSOEs and MoF are often assigned as members of BOC in reputable SOEs, which most of them are partially privatized SOEs. In this regard, they act as the members of BOC in certain privatized SOEs without abandoning their official job as active

high-ranked officers in the ministries. As a result, besides getting abovementioned incentives as an active officer, those officers may also get other forms of incentives as member BOC of divested firm. As members of BOC, incentive may be given in form of annual bonus allocated in certain percentage of net income. As most of privatized SOEs in Indonesia are firms with excellent performance, the annual bonus received by the member of BOC is huge in terms of amount. Hence, it is very attractive incentive for those officers to monitor the firm well to get higher bonus. It is also very common practice in Indonesia that successful members of BOC is likely to be promoted as BOD or BOC in other firms with higher reputation and better remuneration.

6.4.2 The Role of Capital Market Governance

How capital market plays a role in bolstering the performance of privatized firms is already discussed in Chapter 5. Capital market is said to have capability in disciplining the manager to perform excellently by allowing better quality of monitoring and adequate incentive to prevail. Price stock in the efficient capital market can reflect adequately the performance of the manager. The finding in this issue supports the theory of privatization, specifically in the case of share issue privatization (SIP) that argues that the capital market as external governance can trigger the performance of listed firms. In this regard, it is arguable that capital market development is one of critical issues in the context of partial privatization in Indonesia as most privatizations in Indonesia have been carried out through capital market (only one of 15 cases in this study use method other than SIP). This finding also supports the conclusion of several recent studies (Subrahmanyam & Titman, 1998; Levine & Zervos, 1998; La Porta et al., 1997) that document that the intensity of share market, which also means the level of market efficiency, could be judged from size and or the liquidity of capital market.

As revealed by the result of the regression models above, the role of stock market in affecting the performance of privatized SOEs is more observable in the long term. It might show the stage of development of Indonesian capital market. Since it was liberalized in 1989 (Boubakri et. al. 2005), Indonesian stock market has greatly developed from time to time. According to several studies (Arianto, 1996 and Prihantoro; 2001), Indonesian stock exchange (before 2000) could be classified at least into the category of weak form of efficiency since there was strong indication that the price of the stock at a particular point in time was mainly influenced by the information of the price and its movement in the preceding periods. During that period the size of stock market was also very small, which are indicated by very few number of firms listed and very small composite index. Along with the increased number of listed SOEs, the Indonesian's stock market has continuously developed throughout the time horizon. The promising trend of Indonesian capital market development is already elaborated in Chapter 4. In turn, more developed stock market will allow the principal to pursue better quality of monitoring and to grant more adequate incentive. As a result, the listed SOEs become more profitable and more efficient in the long term along with the increased efficiency of the capital market. More detail about the relationship between privatized SOEs and the development of Indonesian capital market is discussed in Section 4.2.1.

Despite its significance in affecting the performance of SOEs, especially in the long term, the size of capital market impact is considerably marginal in comparison with other variables. As an illustration, for every 1 point increase in composite index it would contribute to the increase of profitability and productivity only at 0.0001 respectively. This finding seems to confirm the fact that Indonesian capital market has not reached efficient and well-developed stage. Another possibility is the complementary conditions for capital market to work well such as efficient

labor market, the effective implementation of bankruptcy law, and protection toward minority ownership are still underdeveloped in the current economic infrastructure. However, if the existing trend of capital market development remains to continue, in the long term it would be very possible for capital market to have greater contribution in affecting the performance of the firm.

In addition, the indirect impact of the presence of capital market on the performance of listed SOEs through its relation with two other sources of governance, i.e. government governance and product market competition, should also not be underrated. With regard to government governance, the existence of developing capital market can act as both monitoring function and incentive function simultaneously to related government officers. In this regard, minister and bureaucrats in MSOEs and MoF would be the most affected parties. Through its informational mechanism, capital market will be able to watch out the policy and behavior of bureaucrats that may affect the performance of listed SOEs. In turn, the information obtained will be reflected on the stock price of associated listed SOEs. As mentioned in Chapter 4, the government has assigned MSOEs as the only authority to oversight the operation of SOEs since 1997. In this regard, monitoring effect posed by capital market will be more effective and more efficient. Furthermore, the ability of stock market to spread and expose available information can also reinforce the incentive to the minister and bureaucrats in the MSOEs. Although the role may be decreasing as a result of the government decision to delegate more authority to BOC, MSOEs and bureaucrats in it are still considered to contribute on the success or failure of listed SOEs. In this regard, capital market is able to reinforce promotional or deposing effect of the success/failure of listed SOEs. Given Indonesian context where privatized firms are typically big firms with sound performance, the success or failure may provide more powerful effect to the

future carrier of the bureaucrats than the success or failure of unlisted firms. Carrier promotion can be given either in internal or external ministry. It has been a common practice that the middle-up level officials in MSOEs and MoF are promoted to be member of BOD or BOC in the SOEs. As a result, minister and bureaucrats in MSOEs may have more incentive to undertake better monitoring and incentive to the management.

With respect to product market competition, the indirect impact of the presence of stock market is through its ability in providing needed capital to finance investment.

6.4.3 The Role of Product Market Competition

Since partially privatized firms operate in various industries, the level of competition for each industry is very hard to be measured unless data of all firms running business on those industries are in hand. Due to such problem of data availability, the determinants of product market competition are not included in the panel regression. As an alternative, the empirical investigation pertaining to the role of product market competition toward performance improvement of privatized firm is mainly done through case studies. In this regard, analysis is mainly performed by using descriptive analysis.

First of all, it is important to note that since the enactment of SOEs Law Number 19 of 2003 all prospective firms proposed to be privatized have to run business in the competitive sector. Except for telecommunication firms, which were privatized in 1995, all divested firms have been in the competitive industry when they were privatized. Specifically for telecommunication firm, it was privatized when the firms still held monopoly right. After several years, the government decided to liberalize the industry so that the industry has become competitive with many players in it.

The analysis has begun by finding out the relationship between the level of product market competition and the performance change of partially privatized firm before and after privatization. Table 6-12 presents the market structure of the industry in which each privatized firm operates. Most market conditions presented in the table are taken from year t-1 (one year before privatization). However, some data are taken at different point in time due to the problem of data availability. Nevertheless, since the market structure usually does not drastically change all the time unless a huge industry consolidation occurs, the data is still considered valid and sufficient to describe the intensity of competition regardless of the year data are obtained.

Table 6- 12 Market Structure of Industry Where Each Privatized SOEs Operates

No	SOEs	Market Structure
1	PT Adhi Karya	The firm has occupied around 9% of domestic market share. Despite the fact that market has been populated by thousands of firms, to take a certain project there have been many classifications of firms in accordance with specialization and size of business. The firm is classified as large size contractor along with very few firms.
2	PT ANTAM	The company is a leading Indonesian mining and minerals processing company. It occupies 5% of total world production.
3	PT Bank Mandiri	The company has been market leader in domestic banking industry. It occupies 16.6% of total domestic market according to loan given.
4	PT BNI	The company has been ranked the third largest in domestic banking industry by loan provided. It holds approximately 10.2% of total domestic market according to loan given.
5	PT BRI	The company has been ranked the second biggest in domestic banking industry by loan provided. It has held 11.2 % of total domestic market according to loan given.
6	PT Indo Farma	The firm occupied approximately 0.97% of domestic market. The industry has been very fragmented in which more than 200 companies operate, mostly produce very similar/standard product, no single firm occupies more than 10%. The comparison of market share between domestic and foreign firms is 50 : 50

7	PT Jasa Marga	The firm has operated approximately 79% of total operating highway in Indonesia
8	PT Kimia Farma	The firm occupied approximately 3% of domestic market. The industry has been very fragmented in which more than 200 companies operate, mostly produce very similar/standard products with no single firm occupies more than 10%. The comparison of market share between domestic and foreign firms is 50: 50.
9	PT PP	The firm has occupied around 5% of domestic market share./ Despite the fact that market has been populated by thousands firms, to take a certain project there have been many classification of firms in accordance with specialization and size of business. The firm is classified as large size contractor along with very few firms.
10	PT PGN	The firm has occupied around 94% of total gas distribution in Indonesia.
11	PT PTBA	The firm has the biggest coal reserves in Indonesia, an average of 71% of coal output have been sold domestically while the remaining 29% have been exported.
12	PT TELKOM	The firm enjoyed monopoly right specifically in local call through fixed line until several years after privatization. After the industry liberalization in 2002, the company has remained market leader by occupying more than 90% in fixed line service and occupies more than 55% of market share for mobile/cellular service
13	PT Timah	The firm is the biggest producer in Indonesia The firm holds approximately 19% of global market share.
14	PT WIKA	The firm has occupied 6.3%of domestic market share. Despite the fact that market has been populated by thousands of firms, to take a certain project there have been many classification of firms in accordance with specialization and size of business. The firm is classified as large size contractor along with very few firms.
15	PT Semen Gresik	The firm has occupied 50% of domestic market share.

Source: constructed by the Author based on SOEs' Annual Report

As depicted in Table 6-12 above, the market structure varies from monopoly to free competition. The case of monopoly can be seen in the telecommunication industry, specifically in the early period of privatization. PT Telekomunikasi Indonesia had enjoyed monopoly right for almost seven years (1995 to 2002). On the other hand, pharmaceutical industry where PT Indofarma and PT Kimia Farma operate is the industry with the most fragmented market coupled with the most severe competition level. These two extreme cases of competition intensity are investigated in more detail shortly.

On the other hand, the result of the analysis using Wilcoxon Signed-Rank test finds that although the overall impact of partial privatization on the performance of privatized enterprises is significantly positive, there are some firms that have experienced declined performance in post privatization. To be more specific, there are two firms that experience lowered profitability, efficiency and productivity even when the analysis is extended to longer period of time. Those firms are PT Indofarma and PT Kimia Farma that operate in the same industry, namely pharmaceutical industry. With regard to the performance of individual privatized firms, Table 6-13 depicts the comparison of average performance measures for each firm in pre and post privatization period.

Table 6- 13 The Firm Performance In The Long Term: Pre vs. Post Privatization

No	SOEs	Profitability			Efficiency			Productivity		
		Pre	Post	Change	Pre	Post	Change	Pre	Post	Change
1	PT Adhi Karya	0.047	0.065	0.018	0.174	0.534	0.360	38.364	333.590	295.226
2	PT ANTAM	0.193	0.296	0.104	0.277	0.328	0.051	9.068	461.639	452.570
3	PT Bank Mandiri	0.069	0.227	0.158	1.113	1.419	0.306	135.446	329.087	193.642
4	PT BNI	0.099	0.129	0.030	1.110	1.262	0.152	30.392	136.954	106.562
5	PT BRI	0.076	0.283	0.206	1.150	1.617	0.467	28.320	224.108	195.788
6	PT Indo Farma	0.335	0.026	-0.309	0.536	0.150	-0.386	104.362	24.273	-80.090
7	PT Jasa Marga	0.332	0.433	0.101	0.156	0.197	0.041	60.552	318.223	257.671
8	PT Kimia Farma	0.126	0.045	-0.080	0.454	0.168	-0.286	24.069	18.538	-5.532
9	PT PP	0.044	0.075	0.032	0.307	0.357	0.051	34.616	206.779	172.163
10	PT PGN	0.264	0.358	0.094	0.276	0.364	0.089	561.692	2601.539	2039.847
11	PT PTBA	0.165	0.225	0.060	0.336	0.336	0.000	60.986	437.404	376.418
12	PT TELKOM	0.295	0.404	0.109	0.277	0.433	0.155	21.673	396.064	374.391
13	PT Timah	0.150	0.191	0.041	0.412	0.452	0.040	5.731	153.806	148.074
14	PT WIKA	0.043	0.070	0.027	0.195	0.254	0.059	102.724	351.803	249.079
15	PT Semen Gresik	0.106	0.223	0.116	0.156	0.312	0.156	6.867	212.489	205.622

Source: constructed by the Author based on SOEs' Annual Report

6.4.3.1 Partial Privatization in the Highly/Excessively Competitive Industry

In this part, the impact of highly competitive product market on the performance of partially privatized firms is investigated. In this regard, pharmaceutical industry is taken as the case.

It is widely known that Indonesia is open and big market for pharmaceutical products. Potential market of medicine in Indonesia is undeniably enormous because it has a huge population which is more than 250 million people living in the country in 2010. On the other hand, consumption expenditure rate per capita for medicine is considerably low, which is only around US\$12 per capita per year or just equal to one-third of one-half of the level in Malaysia and Thailand and two-thirds of the level in the Philippines. Furthermore, the government has set no entry barriers and restrictions in the market, especially after the implementation of some trade treaties ratified by the government such as AFTA agreement in 2002. As a result, Indonesian market has attracted pharmaceutical producers and distributors to enter into it. As an illustration, in the beginning of 2000, there were 213 pharmaceutical firms operating in Indonesia, comprising of 4 SOEs, 39 multinational companies, and 170 national private firms (IMS Data). The fierce competition has also been signaled by market fragmentation that exists. According to IMS data in 2001, there was no single company that held market share more than 10%. Domestic producers altogether occupied on average around 50% of all product categories. To make situation more disadvantageous, the market power of two pharmaceutical privatized SOEs, namely PT Kimia Farma and PT Indofarma, has been very weak. It is shown by market share held, that was only 3% and 0.97% for PT Kimia Farma and PT Indofarma respectively.

Given very low concentration in the market with no particular regulation of restriction from the government, the segmentation and specializations among the producers is unclear. This situation would lead high prices, promotion, as well as distribution competition. As an

illustration, in 2000, PT Kimia Farma spent more than 12% of net sales for selling and marketing expense, while PT Indofarma had to spend around 10% of sales for the same purpose. As a result it would lower profit margin of the firms.

The competition was intensified following the implementation of regional autonomy/decentralization policy in 2002 (one year after privatization, t+1). As a consequence of this policy, procurement of drugs under Basic Health Service Program (Program Pelayanan Kesehatan Dasar, abbreviated as PKD) which was initially organized by the central government, from that moment onward was delegated to local government (provincial and district level) to procure. For the firms, it posed more difficulties to be overcome. Under centralized government system most of the procurement had been won by both public firms due to long term relationship between the central government and the firms. With the autonomy system, it was impossible for the firms to win all procurement biddings in more than 300 provinces, municipalities and districts. It would be financially costly for the firms.

The level of competition has appeared to even be more deadly when we look at sub-product market competition⁸. It was in 1985 when the government of Indonesia obliged Government Health facilities (such as public hospital and public health service centre – Puskesmas) to use generic drugs in their receipts. Afterwards, the government introduced the use of generic drugs for society in general in 1991. It was mainly aimed at satisfying the need of drugs for middle-low income people. Compared to some neighboring countries, the use of

⁸ In general drugs can be divided into two categories, patented and generic drugs. Patent drugs is newly invented drugs which is under Indonesia jurisdiction (law Number 14 of 2001) it can be produced exclusively by patent holder for 20 years. When the patent expires, the drugs category turn to generic drugs which can be produced freely without obligation to pay royalty. Therefore, the price of generic drugs is much lower than patented one because it does not include several major costs such as research and development cost and promotion costs.

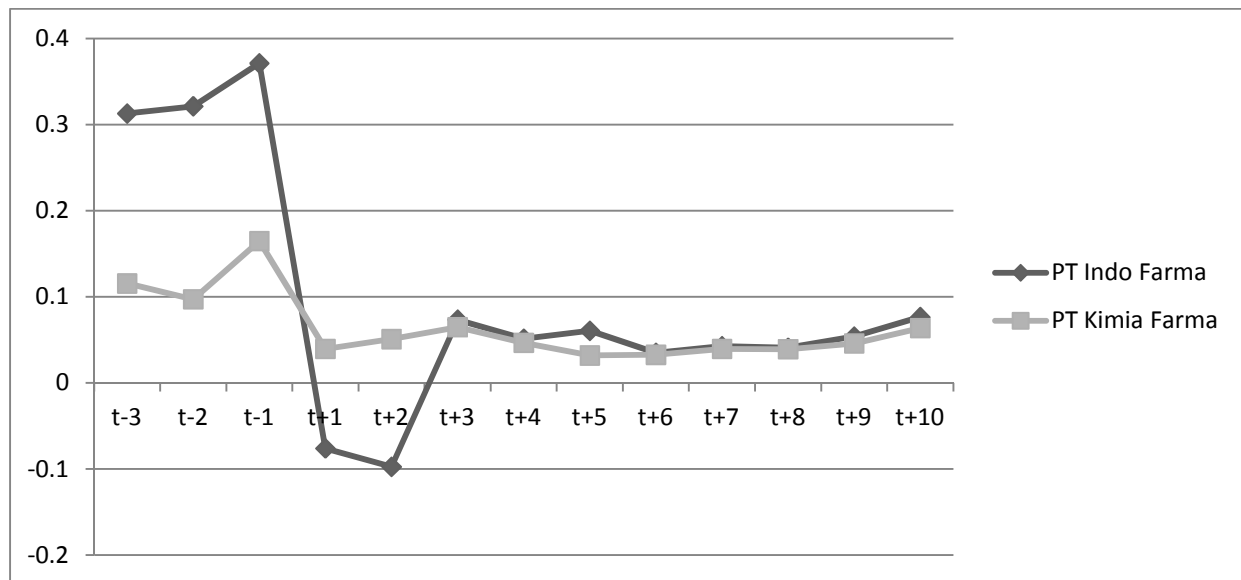
generic drugs in Indonesia has been relatively low. In 2007 the generic drugs consumption in Thailand and Malaysia reached 25% and 20% of total sales accordingly, while in Indonesia it was only 8.7% of total sales (Provincial Health Office, Jawa Barat, 2009). This huge potential market has shifted the level of competition to becoming much higher due to new entry by several ethical producers to generic drugs market. Despite the fact that the firm has attempted to diversify the product line, the dominance of generic product in the firms' product mix has still been relatively high particularly for PT Indofarma. Referring to the financial report 2002, generic drug dominated by 82% and 15% of total revenue of firm for PT Indofarma dan PT Kimia Farma accordingly. As a result, these firms ranked as the largest and the second largest generic producers in the nation in that year. Given the characteristics of the product which is very similar and standardized, the competition has been even more heavily on price. Unluckily, production of generic product has been exposed to exchange rate risk because around 90% of raw material of the generic drugs had to be imported from overseas.

Looking at the performance of both pharmaceutical firms as depicted in Table 6-13 above, it is convincingly revealed that there is relationship between the intensity of competition in the particular industry and the performance of partially privatized firms. The table displays that PT Indofarma is the firm with the biggest performance decline among all privatized firms. By comparing data taken from three years before privatization and ten years after privatization, it is shown that the enterprise has experienced significant decrease in average profitability, i.e. from 0.335 in pre privatization to 0.026 in post privatization, or 0.309 lower. In terms of average efficiency, it has also decreased by 0.386 from 0.536 to 0.150. Likewise, firm' labor productivity has shrunk approximately by IDR 80 million per worker per year. Similarly, with the same length of data and observations, it is also observed that PT Kimia Farma's performance has

diminished in all measures. The firm's average profitability has shrunk from 0.126 to 0.045, or 0.080 lesser. With regard to efficiency, it has decreased by 0.286 from 0.454 to 0.168. The firm's worker productivity has diminished by more or less IDR 5.5 million per worker per year.

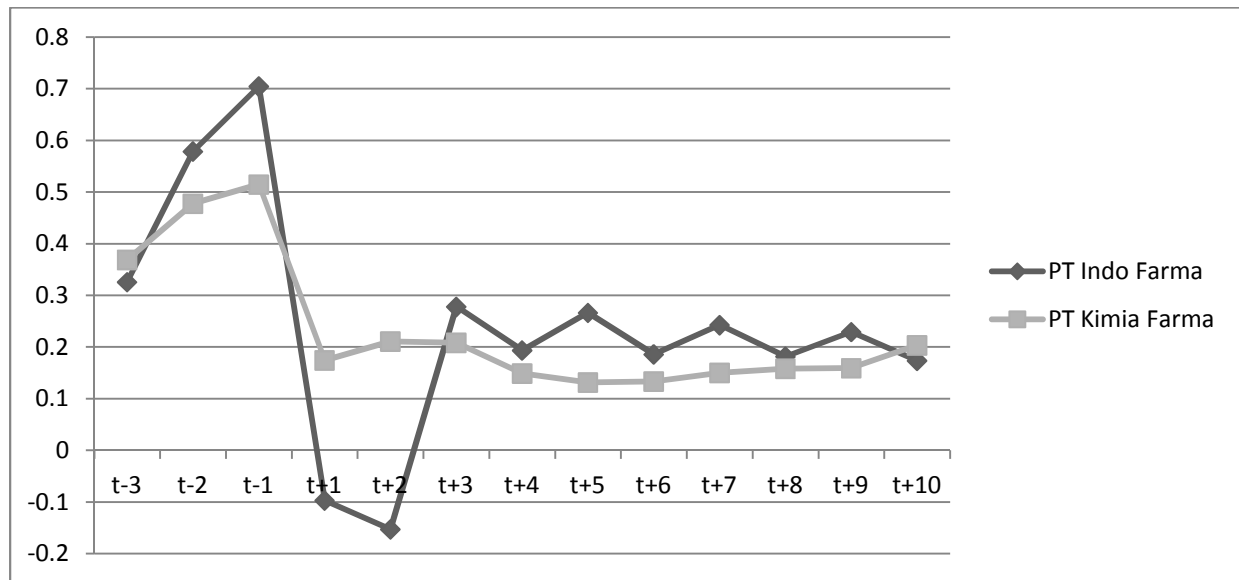
Graphically, year to year performances of both failing firms are shown in Figure 6.1- Figure 6.3. The graphs clearly show the similar trend of performance of both enterprises that have significantly gone down in post privatization. In general, the performance of firms had increased before privatization. Surprisingly, the performance of both firms drastically had dropped in two immediate years after privatization (year $t+1$ and $t+2$). The PT Indofarma had even suffered significant lost in those years. Afterward, the performance has gone up but still far from enough to reach initial level of performance achieved before privatization.

Figure 6. 1 Profitability of PT Indofarma and PT Kimia Farma



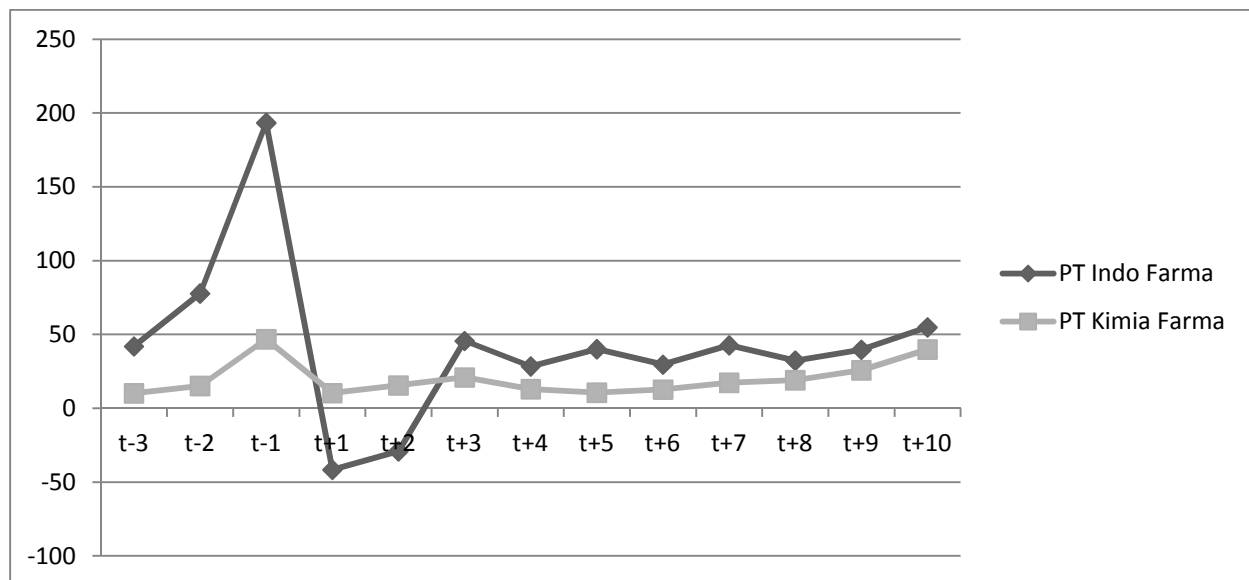
Source: constructed by the Author based on SOEs' Annual Report

Figure 6. 2 Efficiency of PT Indofarma and PT Kimia Farma



Source: constructed by the Author based on SOEs' Annual Report

Figure 6. 3 Productivity of PT Indofarma and PT Kimia Farma



Source: constructed by the Author based on SOEs' Annual Report

Seemingly, it is not a coincidence to find that the firms to which privatization has failed to bring about positive impact are in the same industry, namely pharmacy. Therefore, it is relevant to find out the reason behind this partial privatization failure through analysis carried out

by emphasizing more on the industry characteristic especially product market competition/structure.

From our analysis above it seems to be that there has been overwhelming competition in the pharmaceutical industry that might bring about disadvantageous effect to the firms. There are at least two ways for product market competition to affect the performance of partially privatized firms. These are through financial and behavioral channel.

Let us consider the financial channel, first. According to Schoubben and Hulle (2000), financial constraint being faced by the firm is believed to play critical role to determine the impact of increased competition. An intensified competition is likely to cause lower performance for the firm suffering from financing constraint. Aggressive and fierce competition does not allow the firms to postpone their investment plan. This situation can aggravate financing problem faced by the firms with limited access to external source of financing, compelling them to forgo more profitable investment opportunity unexecuted. In their study they consider listed firms as the firm that suffer less from financing constraint than unlisted firms because they have access to external financing through stock market. This argument could be extended to among listed companies from capital markets with different level of development/efficiency. Even, it is also relevant for the firms listed in the same stock market but due to some reasons those firms have different ability to raise capital needed.

As mentioned earlier, both partially privatized SOEs have faced direct competition from hundreds of firms including dozens multinational companies which are likely to have more abundant sources of financing either from internal or external sources. Internally, it is highly likely for rival companies especially foreign/multinational ones to have better financial capacity,

otherwise they would not be able to expand their business abroad. Externally, it is also very possible for competitors to have larger access of financing since they are listed in more efficient stock market in comparison with Indonesian stock market. As explained in Chapter 4, Indonesian capital market appears to be less developed in comparison with neighboring countries especially until late 2006. Moreover, both partially privatized SOEs are also likely to face more severe financing constraint compared to domestic rivals listed in the Indonesian stock market. First of all, privatization proceeds obtained from IPO is probably far from enough to finance the investment. As described earlier, the numbers of shares sold are 19.8% and 9.2% for PT Indofarma and PT Kimia Farma respectively. These are considered the least among other SOEs privatized in terms of both value and number of shares sold. However, it seemed to be not good option for government to pursue subsequent privatization in attempt to raise capital needed to finance further investment option. Disadvantageous stock price as an impact of poor performance in the previous year can be the main consideration. The investor would be likely to be reluctant to purchase the stock in that circumstance.

The other way of product market competition to affect the firms' performance is through behavioral channel. This could be realized through better managerial incentives and the quality of monitoring as argued by Karuna, 2007 and Bozec, 2005. In order to be able to survive, the managers of firms operating in more intense competition need to be stimulated with stronger incentive to unequivocally encourage them to work harder (Karuna, 2005). Likewise, the manager's behavior also can be altered through better quality of monitoring, such as through better composition of BOC. In the case of partially privatized firms, the presence of public monitoring represented by independence commissioners can also be an alternative.

Too little incentive would not be enough to push the managers to realize the firms' goal. It is observed at Table 6-11 that the incentive scheme given to employees and managers in both pharmaceutical firms can be considered as the least motivating scheme among other schemes offered to other employees and managers in other divested firms. For instance, under Shares Purchase at Discount Plan the employees in both pharmaceutical firms had to purchase the stock mainly by using their own money or loan with interest given by the firms, while in most of other firms, employees got the stock as a bonus. Thus, the incentive scheme would be more effective in the latter case because all employees would automatically take part in the plan. In this respect, the least encouraging scheme seemed to be offered in the case of PT Indofarma in which employees buy stock at market price. Of total price 90% of purchase price was paid with loan provided by Employee Foundation with 8.5% interest rate, while the remaining 10% was subsidized by the firm. Employees were required to pay loan later with future unpredictable bonus and dividend. On the other hand, in the case of PT Kimia Farma, employees were allowed to purchase shares at discount price of IDR 180 (offering price was IDR 200), in which of the price, 50% was paid with annual bonus, while the rest was paid by using maximum 2 years loan 8%-14% interest rate.

Furthermore, despite the fact that the government also offered stock option, the scheme appeared to be fully ineffective. Firstly, with such aforementioned incentive plan employees simply would not be interested in purchasing the stock and would not join the program so that it would be even less of them to exercise the option. Secondly, stock option was offered at predetermined fixed price above the IPO price. In fact, the real price of stock significantly decreased shortly after IPO due to the poor performance of both firms in immediate years of post privatization. Definitely no one exercised their option due to this circumstance.

Seemingly, the government did not take the level of product market competition into consideration when setting the incentive scheme for each privatized SOEs. The government appeared to pay more attention on the size of assets and prospective profit rather than the level of existing competition. As a result, the employees and managers in firms like banks were offered with more attractive and stimulating incentive scheme than they were in pharmaceutical firms.

6.4.3.2 Partial Privatization in the less Competitive Industry

Privatization in Indonesian telecommunication industry has special feature that is relevant to highlight in the discussion of partial privatization in the less competitive market. Partial privatization in this industry has passed two different periods with two different market structures, i.e. limited competition and unlimited competition. Before 2002 Indonesian telecommunication industry can be categorized as a closed industry because the government restricted the competition by granting exclusive right to very limited firms to do business in this industry.

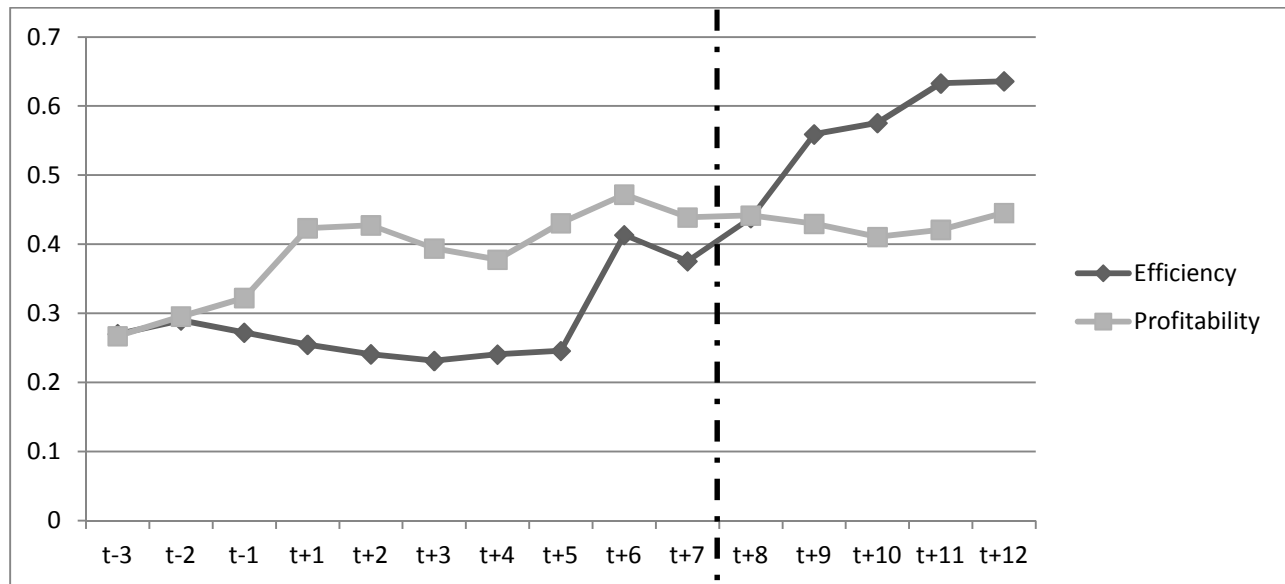
According to Telecommunication Law enacted in 1989, telecommunication services were classified into two main categories, namely basic and non basic service. Basic service included all services of sending information without further process or modification toward the content, such as short and long distance call, telex, telegraph, fixed wireless, etc. Meanwhile, non basic services encompassed all telecommunication services using computer or other equipment to further process and modify the content such as email, abbreviated dialing, multi-call address, etc. For this type of service, the government granted exclusive right to two SOEs, namely PT Telekomunikasi Indonesia and PT Indosat. The former was granted monopoly right to provide basic service in domestic area, while the latter for running basic service in overseas related transactions. Private firms were not allowed to run business in this segment unless they had to

cooperate with those two SOEs. Meanwhile, for running business in non basic segment they could do business alone without forming any business cooperation with two public firms. However, for running non basic telecommunication services those private firms depend significantly on basic services provided by two SOEs as exclusive right holders.

Globalization, followed by rapid development in information communication and technology, has created fundamental changes in the operations of telecommunication worldwide, including Indonesia. With this pace of development, the government of Indonesia has pursued restructuring program in the telecommunication sector that incorporates law and regulation, market, and business climate. The restructuring programs that manifest in the form of industry liberalization consists of three critical aspects: (1) abolishing monopoly/exclusive right by promoting competition and preventing the market players from having very big market power that can ruin competitive environment, (2) getting rid of any forms of discriminations and hindrances to private players to participate in the business, (3) repositioning the role of government from operator to regulator (Priantoro, 2012). With this restructuring program telecommunication industry has become open and competitive industry since 2002.

PT Telekomunikasi Indonesia was privatized at the first time in 1995 and liberalization telecommunication industry was begun in 2002. It means during period 1995-2002 the firm had run business in the less competitive industry (restricted market).

Figure 6. 4 The Performance of PT Telekomunikasi Indonesia



Source: constructed by the Author based on SOEs' Annual Report

Figure 6.4 depicts the profitability and the efficiency of PT Telekomunikasi Indonesia from three years before privatization to twelve years after privatization or from 1992 to 2007 (the year when privatization was carried out is excluded). Despite there had been a slightly increasing trend of profitability, there had been a decreasing trend of efficiency for period of restricted competition. Meanwhile, after industry liberalization in year 2002 (t+7), the efficiency level has been tremendously improved. On the other hand, the profitability has been stagnant during the same period of time.

From the discussion above, it can be observed that in the restricted/monopoly market, the firm tended to be less efficient due to a lack of pressure from competitors. In addition, remuneration scheme offered by the government as shown in Table 6-11 had also not succeeded in promoting efficiency. During this period, the firm could earn higher profit by raising volume of sales or even by simply increasing tariff. Therefore, increased profitability is not necessarily improved efficiency. Desirable level of competition that present after industry liberalization had

succeeded to force the firm to operate more efficiently. Remuneration scheme may also work effectively in this level of competition. However, the intensified competition appears to force the firm to cut its profit margin. Therefore, the profitability of firm tends to be stagnant after industry liberalization.

From two different cases studied above, it can be inferred that certain desirable level of competition is crucial in bolstering the performance of partially privatized firms. Highly competitive market may lead to more problematic situation if a firm faces financial constraints. The constraint may originate from its own firm due to limited ability in raising fund as an impact of poor performance or come from the presence of less developed capital market so that it is unable to provide needed fund at affordable cost. Furthermore, too much competition may also cause remuneration scheme set by government become ineffective. In the industry in which severe competition exists, managers may not be indulged with any form of remuneration scheme. Conversely, too little competition is also undesirable because it can give disincentive effect to the managers. The managers may not have intention to improve their performance due to lack of pressure from rivals. It is hard to press the manager if there is no benchmark within the industry as a reference. Similar to this is the case of severe competition; performance aligned incentive scheme also becomes less effective in this circumstance.

However, if the intensity of competition is still within desirable magnitude, government governance has to be able to find out the best formula of remuneration scheme to match with the extent of competition. Of course, it is not easy to determine whether the existing competition level is still within or beyond the desirable range.

Relating this to the previous discussion, the role of product market competition in affecting the performance of privatized SOEs cannot be separated from the two different governance mechanisms aforementioned, namely government governance as internal mechanism and capital market as external mechanism. When intensified competition compels the firm to invest in bigger investment, the presence of well developed capital market is central to provide capital needed for investment at low capital cost. Meanwhile, when intensified competition requires the appropriate behavior of managers, the presence of adequate incentive scheme offered by government governance is critical. Therefore, the proper formula in relating those three variables would lead to the success of partial privatization and vice versa.

6.5 Summary

This chapter aims to provide empirical evidence pertaining to the implementation of partial privatization in Indonesia. It is interesting to investigate the impact of partial privatization on individual firm performance as it does not meet two key factors of privatization success as suggested by mainstream argument, i.e. transfer of control from government to private owner as source of internal governance mechanism and the presence of well developed stock market as source of external governance mechanism.

Using 214 data from all Indonesian SOEs (15 firms) that have been partially privatized from 1991 to 2007, the research employs both non parametric test called Wilcoxon signed-rank test and parametric test of panel regression to assess the impact of partial privatization on the performance and uses panel regression to investigate the factors affecting the success or failure of the privatization. To support the results, qualitative approach in form of “institutional” analysis is also employed. It is carried out by shedding light on the structure of rules and regulation in surrounding SOEs.

The major findings of the empirical investigation using proposed analytical framework discussed in Chapter 5 are fourfold. First, interestingly, partial privatization seems to work at an acceptable and satisfactorily level. The results of Wilcoxon Signed-rank test confirmed by the result of panel regression reveal that partial privatization brings significantly positive impact on all performance measures both in the short term and long term. The favorable impact is even more noticeable and more satisfactory in the long term. Partial privatization appears to compel the firms to cut their normal profit. Hence, some divested SOEs experience declined profitability shortly after privatization. However, in the long term most of them are able to regain their economic profit. Second, the uneasy process of privatizations, in which there are strong resistances and oppositions from the stakeholders both inside and outside the government, have driven up the government's commitment to improve the performance of privatized SOEs. For the government, it is important to prove that the policy and the strategy of privatization undertaken are not wrong and can bring about positive impact to the stakeholders. To improve the performance of privatized SOEs, the government takes two main actions; pursuing proper monitoring and setting adequate incentive plan. Proper monitoring is carried out through establishing centralized (external monitoring) and independent monitoring ministry, reducing the number of government commissioners, delegating more authorities to BOC, and allowing public monitoring to take place (internal monitoring). Meanwhile, adequate performance-aligned incentive system is mainly pursued through Employee Stock Option and Management Stock Option Plan. Stimulating performance-aligned remuneration system is also given to the officers as the monitor. This improved government governance seems to play the most critical role in bolstering the performance of partially privatized firms.

Third, despite its relative marginal contribution compared to the contribution of other factors, the role of capital market governance shows increasing trend in the long term. Linked to the finding in Chapter 4 showing positive trend of Indonesian capital market, the magnitude of the positive impact of capital market governance seems to be in line with the stage of capital market development. If the trend continues, it is likely for capital market to have bigger role in bolstering the performance of partially privatized firms in the future.

Fourth, certain magnitude of product market competition is desirable for partial privatization to bring about favorable impact at an acceptable and satisfactory level on the performance of the divested firms. It is not only related to the direct impact but also its indirect impact through its relations and interactions with other sources of governance. Financially, it is associated with the ability of firm to raise capital needed for investment and the ability of capital market to provide capital needed at low capital cost. Moreover, it is also associated with the effectiveness of incentive scheme set by the government governance. Highly competitive product market will harm badly privatized firms facing financial constraints due to poor performance of the firm or underdeveloped capital market. Meanwhile, remuneration scheme set through the governance mechanism is likely to be ineffective at the extreme level of competition, either highly competitive or faintly competitive. Moreover, within the range of the desirable level of competition, adequate remuneration scheme is necessary to make it effective in stimulating managers to achieve better performance.

Chapter 7

Conclusion

7.1 Summary of Key Findings

This thesis has examined the Indonesian privatization strategy and its impact on the macro-economy as well as the divested firms' performance at the micro level, aiming at exploring a new hypothesis that could help explain the current mode of partial privatization in Indonesia. . Through “institutional” approach, the present study aims to shed analytical light on the structure of the rules and regulations to evaluate the effectiveness of the monitoring and incentive system undertaken by the government toward partially privatized firms. In this sense, this thesis challenged the mainstream argument on the partial privatization.

This thesis attempted to answer the following questions:

1) What is the main strategy pursued by the Indonesian government to make privatization work successfully amid ideological, political, economic, and social constraints? What are the rationale/justifications for the selected strategy?

We argued that privatization has been central in the economic policies pursued in Indonesian. It constitutes a key component of the structural adjustment programs undertaken in the country, with multifaceted purposes and objectives. According to laws governing SOEs with special reference to Law Number 19 of 2003, the objectives of privatization in Indonesia can be broadly classified into two: macroeconomic level objectives, and microeconomic level objectives. Those at the macro level include strategies to deepen capital market, increase state budget revenue, finance budget deficit, and increase the rate of employment. From the microeconomic

front, the focus has been on improving the performance of divested state firms. While they have distinct foci, the two set of objectives have not been mutually exclusive; they have been pursued with the hope of reinforcing themselves in moving the economy forward.

The criticality of privatization within the broader policy context of the Indonesian economy means the success of privatization has been highly dependent on the participation of a range of stakeholders across the social and economic spectrum. Like other developing countries, Indonesia has faced mammoth challenges in pursuit of its privatization policies. The main challenges it has encountered are (i) Economic and Financial Barriers; (ii) Political Barriers, (iii) Social Barriers, and (iv) Technical Barriers. The Indonesian government has adopted a unique approach to responding to these barriers in the reform process of the operations of state enterprises.

Rather than pursuing massive, fast, and full privatization, the government of Indonesia has preferably undertaken more conservative privatization strategy to ensure sustainability and success of the reform process given the socio-economic and political context of the country. Yet, there have been growing reservations over the effectiveness of the privatization strategy pursued in Indonesia. At the macro level, a key bottleneck faced by the government in the process is a complex institutional setting, which is commonplace across the developing world. To rationalize the rigid institutional setting has been a daunting task. From the micro perspective, the non-relinquishment of control by the government in the process and the lack of a well developed capital market has been the most debilitating bottleneck by many commentaries.

This thesis finds that the government of Indonesia has consistently pursued the same strategy of privatization on the principles of selectivity, gradualism, and partial treatment. These

principles are founded on the following. Firstly, the existence of SOEs is a preserve of the Indonesian Constitution. SOEs has been considered as a critical means for implementing the constitution, which stipulates that vital sectors of production, land, water, and the natural resources shall be under the powers of the state and accordingly, used for the greatest benefit to the people. In this regard, denationalization/privatization is a highly politically sensitive issue because it can be considered as a potential violation of the national constitution. Even if privatization is selectively done, full privatization would definitely incite strong political oppositions from stakeholders, not only politicians but also others. The issue of *foreignization*, *colonization*, and *westernization* has also worsened the situation. In this respect, full privatization has high political cost in the sense that the government may need huge efforts and resources to get political supports in pursuing such privatization mode, especially from the politicians and house of representative. Moreover, the failure of full privatization may harm ruling party in the form of losing votes in the next general election.

Secondly, full privatization can cause social unrest and people resistance relating to likely threats of unemployment, income inequality, and the unknown fear over the stranger (*xenophobia*). Social cost, which refers to all resources and effort required to obtain support from the society, is definitely high in the case of full privatization. Thirdly, the size of privatization has been matched with the estimated fund needed both by the government and privatized firms. For the government, the undersupply of privatization receipt may lead to unfinanced budget deficit, whereas oversupply of privatization revenues (such as due to large privatization/full privatization) may create the problem of crowding out effect in the financial market. On the other hand, for the firms, a financial shortage due to undersize of privatization can lead to unfinanced investment plan, while oversize of privatization may create an idle cash problem. Fourthly, the

size and the method of privatization have been matched with the capacity of capital market in order to optimize the privatization proceeds. Fifthly, the government is wary of full privatization in regard to perceived high likelihood of losing substantial source of revenue to finance development programs such as through tax and dividend, along with the likelihood of increased rates of unemployment (economic cost). Meanwhile, the expected economic benefit of full privatization is still uncertain due to the absence of success factors of it in the economy. In other words, full privatization is less preferable because its aggregate socio-economic and political costs would be greater than its expected economic benefits.

2) Employing selected privatization strategy, can macroeconomic objectives of privatization be successfully accomplished? What are the determining factors in this regard?

With regard to this research question this research has assessed the impact of privatization in Indonesia in the light of achieving four macroeconomic goals of promoting capital market development, enhancing budgetary revenues, ensuring sustainable management of the budget deficit, and increasing employment. This study reveals the following findings:

Firstly, privatization plays very significant role in promoting the development of capital market. In the early 1990s Indonesian capital market was far from developed. Following the divestitures of state enterprises and their listing on the stock market the country's capital market has shown rapid development as indicated by increased market capitalization and the number of firms listed. The contribution of the listed SOEs in the economy can be seen from the significant size of the SOEs' total market capitalization and the fact that most of listed their stocks have been categorized blue chip stocks.

Secondly, privatization has obviously improved the financial contribution of the partially privatized SOEs to the government in the form of taxes and dividend. Moreover, the increased financial contributions has not been triggered by the increased tariff of tax and dividend payout policy, rather it has been caused by the sustainably increased performance of divested firms. Thirdly, privatization receipt has been evident as one of the effective sources of deficit financing. Although it is not openly stated in the Law on SOEs, it is apparent that a major motive of privatization in Indonesia is to finance budget deficit. Therefore, privatization receipts have been planned against needed government revenues to finance budget deficit and other development expenditures. Fourthly, privatization has increased employment. Due to increased business performance, the level of employment in the partially privatized firms has increased in the post privatization phase. This increased employment is also followed by the increase in labor productivity.

The main success factors of partial privatization deduced from this research at the macro level are summarized as follows.

Firstly, there has been very tight selection process of firms to be privatized. To be eligible for partial privatization, the firms have to: a) run business in the industry characterized as competitive or fast-changing technology, b) demonstrate very good performance, and c) have large positive externalities. Moreover, very long process of consultation with the parliament to ensure the effective accountability of the process has compelled the government to prioritize the best among existing firms slated for privatization in each policy year. As a result, only firms with the best current and future performance would be privatized to maximize the likelihood of yielding planned returns from the process. Only such types of firms that can generate high privatization receipts for satisfying need of fund for financing budget deficits (from government

side) and for financing investment plan (from firm's side). In addition, selected firms will have more probability to perform better in post privatization. As a result, some other macroeconomic objectives of privatization such as increasing financial contributions to state budget, promoting stock market development, and maintaining the level of employment can be realized.

Secondly, privatization methods have been employed in accordance with the capital market situation and economic condition, consistent with the need to ensure balance among the economic, political, and social requirements of the state. Therefore, the methods employed have varied from one circumstance to another. As a result, not only economic benefits have been reflected upon, in terms of maximized receipt, but also political and social benefits and expectations to reduce political opposition and social resistance of policies.

Thirdly, the pace of privatization employed by the government has been decisive, following a gradual and partial approach in the process. Gradual privatization enables government to maximize privatization receipt by matching the size of stock that is going to be sold (supply side) in accordance with the ability of capital market to absorb the investment opportunity. Furthermore, partial privatization allows government to retain control over divested firms to ensure economic and social stability through minimizing potential political and social costs.

Lastly, the success of privatization has been recorded with high participation from the parliament. This demonstrates an effective delivery of the needed governance restraints in pursuit of national development policy which is critical to the long term socio-economic stability of the country. Also, it is observed that political support from the parliament is critical to make partial privatization successful.

3) *Employing selected privatization strategy, what is the impact of privatization in Indonesia at microeconomic level? Can partial privatization still bring about positive impact on the performance of privatized firms despite the nonexistence of control relinquishment from government to the private sector (less possibility for the presence of improved internal governance mechanism) and the absence of well-established capital market (less possibility for the presence of satisfactory external governance mechanism)?*

Using three different indicators of firms' performance--efficiency, profitability, and productivity--this thesis finds that generally speaking partial privatization brings about positive impact on the performance of firms satisfactorily. Despite the absence of two success factors believed by mainstream views, i.e. transfer of control and the presence of well-established capital market, the study suggests that, partially divested SOEs have been efficient and productive in the short term at a very high significant level. With regard to profitability, though most of the firms experience increased profitability, this has not been statistically significant. It is widely understood that improving efficiency is the most sustainable way to increase the performance of the firms in general. A suggestive explanation of this is that privatization would cause some firms to lose significant portion of their abnormal profit relative to pre privatization level, thereby reducing profitability at least in the short term. In this regard, lower level of profit experienced by some divested SOEs can be regarded as the lost of monopolistic rent, which may have positively contributed to the consumer's welfare in the form of lower product price. The study, however, shows that the long run likelihood of increased performance by all divested SOEs is high; most of those studies demonstrate positive performance indicators in the long run model.

4) *How do mainstream arguments appear to inadequately explain the phenomenon in question 3 above, including understate its determinant of success? How is the impact of partial*

privatization and its determinants explained by using an alternative analytical framework as complementary to existing argument?

This study argues that mainstream argument seems to inadequately explain the fact that partial privatization can satisfactorily bring about positive impact on the performance of divested firms. The advocates of mainstream argument believe that privatization may not bring about significant favorable impact on the performance of divested firms unless it is followed by transfer of control from the government to private owners and unless it is done in a country with well-established capital market. In this regard, the study argues that control relinquishment from the state to private owners appears to be overstated as the only source of improved internal governance, while the importance of well-developed stock market seems also to be overemphasized as source of external governance. If the mainstream argument is followed, privatization carried out in the Indonesian context is less likely to be successful because there would be very little potential improvement in both internal and external governance. Internally, the state remains as control holder with its majority ownership, meanwhile the presence of less-developed Indonesian capital market would bring a little impact on improved external governance. In fact, as presented in research finding 3 above, partial privatization pursued by the government of Indonesia satisfactorily brings about positive impact on the performance of divested firms.

To explain the impact of partial privatization on the firms' performance and also to investigate the potential determinants of performance improvement, the thesis proposes an analytical framework as complementary to the existing arguments. The analytical framework is founded on the assumption that the reason behind an improved performance is the presence of enhanced monitoring and incentive. Needless to say, there is no "apriori" causality between the type of ownership structure and economic efficiency. A firm under either public or private

ownership is possible to reach higher level of economic efficiency as long as the required conditions, which are the presence of proper monitoring and adequate incentive, are met. Also there is no “a priori” causality between mode of privatization (full versus partial) and firm performance. This thesis argues that full privatization carried out in the well-established capital market is more likely to successfully bring out positive impact on the performance of individual divested firms because this circumstance is more likely to present improved monitoring and incentive than partial privatization carried out in the less-developed capital market. Nonetheless, it does not imply that the possibility of partial privatization to successfully bring about favorable impact should be understated. As long as it can present improved monitoring and incentive through several sources of potential corporate governance, the enhanced performance of partially privatized firms is not impossible to be realized.

In the proposed analytical framework, the study argues that the sources of improved monitoring and incentive in the case of partial privatization mainly come through (1) *government governance*, (2) *capital market governance*, and (3) *product market competition*. These governance mechanisms reinforce each other in inducing performance among divested firms. The aggregate impact of the three potential sources of governance may lead to either improved or diminished monitoring as well as incentive relatively to pre privatization period. An improved monitoring and incentive is highly likely to lead to the improvement of firms’ performance in post privatization and vice versa.

The first potential source of governance is government governance. It refers to the methods undertaken by the government in pursuing monitoring and establishing incentive in order to maximize its residual earning and other forms of financial and non financial benefits. In this respect, this thesis raises two main limitations of existing arguments pertaining to (1) the

understatement of the benevolence of government involvement in the operations of SOEs and (2) the false assumption that the government benevolence tends to be fixed and unchanged. The role of government governance to improve the quality of existing monitoring and incentive following partial privatization is mainly determined by the intensity of political interference and the adequacy of remuneration scheme.

The second potential source of governance is capital market governance. It might be true that absolute takeover is unlikely to occur in the case of partial privatization, but the role of the capital market in affecting the performance of listed partially privatized firms through bolstering monitoring and enhancing incentive cannot be understated. With regard to monitoring, the movement of stock price is not only useful for non state stockholders/public, who previously had no access to information, but also for the state as majority shareholder who also suffered from the problem of information asymmetry in pre-privatization due to complex agency structure. In this regard, the information given by stock market can act as checks to firms' behavior towards improved operations. Moreover, the involvement of numerous individual and institutions, who are normally specialist in the given job, can also enhance the quality of monitoring through the improvement of the quality and quantity of information gathered. The competition and rivalry among independent monitors/fund managers is likely to lead to the discovery of larger volume of related information. Capital market enables the public to participate in financial monitoring through the stake on the market thereby restraining bad practices such as rent-seeking activities, corruptions, collusions, and nepotism in the operations of the divested SOEs.

The capital market also induces positive performance of firms through its function as an incentive provider. For listed firms, stock price can bolster incentives through imposing disciplinary action in respect of the behavior of managers. It can give "deposing threat

effect“ when the price of the stock is falling. The capital market incentives perform through better and faster marketability of their image due to information intensity with possibility of employment in more prestigious firm with better payment system (“promotional effect”). At the same time, there are benefits relating to the movement of stock prices for managers (“financial effect”) delivered through performance-based remuneration scheme such as stock option and stock bonus operated in divested firms. The presence of capital market may also affect the performance of divested firm through its ability to affect the behavior of bureaucrats whose task to oversee the firms. The disciplinary function of stock market is in line with the development of capital market indicated by several measures such as market size, market liquidity, market volatility, and market concentration.

Product market competition also plays critical role in influencing the performance of divested firms through the change of quality of monitoring and the intensity of incentive. It is noted that intensified competition enables large information to be revealed so that it can help the principal in pursuing better quality of monitoring. On the other hand, the incentive effect of competition stems from its threat of bankruptcy that forces managers to utilize the enterprises’ resources efficiently. Some indicators such as market concentration, market size, and cost of entry may be relevant to represent the intensity of competition in certain industry. The economic significance of product market competition toward the performance of privatized firms may also stem from its relation and interaction with the other two abovementioned determinants.

5) Using proposed analytical framework in question 4, what are the determinants of partial privatization success in Indonesia in enhancing the performance of privatized firms?

Using proposed analytical framework, the determinants of partial privatization success in Indonesia in enhancing the performance of privatized firms are summarized as follows:

a. The Role of Government Governance

The study suggests that, the privatization pursued by the government has been largely successful in boosting productivity through a critical reflection on the myriad of ideological, political, economic, and social barriers characterizing the country. The national backdrops help sustain government commitment to the privatization process and to ensuring the efficiency of the divested firms. The government has put in place an effective monitoring and incentive system and plans. External monitoring has been carried out mainly through establishing centralized and independent monitoring ministry; while internal monitoring carried out through raising membership on the BOC with a reduction of government representatives; delegating more authorities to BOC, and allowing public monitoring to take place through independent commissioners. It can be seen obviously that those actions are aimed at reducing the political embeddedness between divested SOEs and the governments (including many agents in it). Incentives have been raised through establishment of performance-aligned remuneration scheme not only for the employees and the managers but also for the officers as the monitors. For the employees and the managers are mainly pursued through Employee Stock Option and Management Stock Option Plan. This improved government governance seems to play the most critical role in bolstering the performance of partially privatized firms.

b. The role of Capital Market Governance

Due to the problem of data availability only two indicators of capital market development, i.e. market size (represented by stock index) and market liquidity (represented by stock turnover) are included in the empirical investigations. The results reveal that market size positively affects the performance of divested firms. The impact of market turnover is not statistically significant. Although the positive contribution of market size is relatively marginal compared to the contribution of other factors, the trend is increasing in the long term. Linked to the finding pertaining to the continuous development of capital market at macro level, the magnitude of the positive impact seems to have positive relationship with the level of capital stock development. If the trend continues, it is likely for capital market to have bigger role in bolstering the performance of partially privatized firms.

c. The role of product market competition

Empirical investigations concerning the role of product market competition are carried out by using case study. The pharmaceutical sector is selected to investigate the impact of excessive competition on the performance of partially privatized firms, while telecommunications industry (during 1995-2002) is chosen to examine the impact of less competitive product market on the performance of divested firms. In both circumstances, partial privatization negatively affects the level of firms' efficiency. However, in the case of less competition, partial privatization still brings about positive impact on the firm's profitability. Apparently, certain magnitude of product market competition is desirable for partially privatized firms to achieve better performance. It is not only related to the ability of firms to raise capital needed for investment in response to intensified competition but also the ability of capital markets to provide capital needed at low capital cost. Moreover, it is also associated with the

effectiveness of the incentive scheme set through the government governance. Seemingly, remuneration schemes will be less effective in seducing managers to perform better if the firms operate in the industry with extreme level of competition.

7.2 Policy Implication

The findings of this study have several implications for both theory and practice of privatization in Indonesia in particular, and the developing countries in general. First, the existence of several barriers in the economic environment and multiple objectives of privatization pose serious strains in the formulation of effective privatization strategy. Nonetheless, privatization can still be successful if the government can formulate appropriate strategy to balance the competing socio-economic and political realities of the country. The selective, gradual and partial privatization strategy followed by the government of Indonesia has, therefore, been appropriate and could be replicated in other developing countries.

Second, the thesis is of the position that some state control in the divested SOEs is critical for the success of privation in Indonesia against schools of thought that agitate for control relinquishment or full privatization as long as there is a well-developed capital market. The findings emphasize the need for improved monitoring and incentive as critical drivers of performance improvement in privatized firms. This is generally critical irrespective of the privatization policy regime followed by an economy—partial or full privatization.

Third, in order to be successful at microeconomic level, the policy maker has to be able to orchestrate three sources of governance to generate aggregate positive changes in monitoring and incentive. Since those factors, i.e. government governance, capital market governance, and product market competition are not mutually exclusive and static, rather interdependent and

dynamically interact to each other, the policy maker should be able to estimate the ultimate impact of each policy undertaken.

Fourth, the sustained commitment from government becomes more critical for the success of partial privatization where capital market is absent. The government has to eliminate excessive political engagement and ensure an optimal rationalization of firms to reduce the problems of any existing complexity of the agency structure in management. The efforts of the government of Indonesia at rationalizing membership of the BOC through establishing separate oversight ministry, reducing the number of government commissioners on the Board and allowing independent commissioners among other things have been laudable. This direction should be sustained for continued effectiveness and efficiency of firms.

Fifth, considering both its direct and indirect effect in improving monitoring and incentive, the government has to continue to develop capital market more seriously. Direct effect refers to the role of capital market in facilitating monitoring through its ability in providing abundant information to investors and in providing incentive through its disciplinary function to the managers. Indirect effect of capital market stems from its ability to speed up product market growth through providing capital needed for business expansion. In addition, through its informational function, capital market can restrict malpractices and moral hazards in firms' operation including corruption, collusions, and nepotism. More high performing SOEs can be privatized based on current policy strategy to attract more investors to participate in the stock market. Tax incentives can be accorded for the enhancement of capital market-related operations towards deepening the development of the stock market in the country.

Sixth, certain (moderate) level of competition is necessary to enhance the performance of divested firms and for the continued development of the capital market. Therefore, it is important for the government to undertake some policies to promote competition as part of a broad strategy for the effectuation of the privatization policy. Setting appropriate remuneration schemes is critical as an accompanying strategy, mindful of competition coming from other industries. The government should continue its industrial restructuring program for non-vital industries to enhance the competitive capacity. Meanwhile, for those SOEs that operate in the highly competitive market, it may be more beneficial for the society if the government undertakes full privatization policy.

7.3 Possible Directions for Future Research

Referring to some limitations of the study as described in Chapter 1, there are some possible directions for future research. It is recognized that privatization policy contexts may differ across countries in respect of politics, the economy, society, and culture. Thus, future studies can be conducted in other countries using the same analytical framework as the one utilized in this study given the likelihood of arriving at different or reinforcing conclusions. This would add value to the privatization policy debate across the globe. Overtime, this framework could also be used in future studies in Indonesia to determine the effect of time on these conclusions and to inform policy better on emerging and changing socio-economic and political context of the country.

Second, the study is undertaken in a country where privatization is mainly carried out through capital market channel in the form of IPO or SPO. Therefore, the role of stock market is extensively emphasized in the discussion. Even if the countries share the same characteristics, the result may differ if the government dominantly employs other method of privatization such as through direct investors or employee/management channel. In order to have more

comprehensive understanding pertaining to the impact of partial privatization, more researches may be necessary to clarify the findings and also to check the applicability of the framework. Moreover, future research is also relevant to be conducted in the country where there is dominant involvement of banking in the privatization process.

Third, as previously mentioned this study does not specify a certain type of industry as an object of analysis. In fact, this is a cross industry study. Although the industry characteristic is already accommodated in terms of product market competition, there may be some cross industry features unincorporated in the discussion. These observations can be captured in related future research focused on singly sector analysis—potential sectors include telecommunications, banking, and construction.

Fourth, due to the problem of data unavailability not all determinants proposed in the analytical framework are employed in the empirical investigation by using econometric approach. Furthermore, the research cannot pinpoint the main source of governance effects on firms performance given the theoretical interdependency of the three sources investigated: government governance; capital market governance; and product market competition. It is important that future research works delineate these effects directly and indirectly to inform policy better, where data permit.

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