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Market and Corporate Governance in the New International Environment: Indonesian Experiences[1]

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Abstract

The economic crises in Indonisia was only rooted in financial sector fragilities. It was also related to poor managerial performance in both public and private institutions. The implementation of public and corporate governanceindicates several weaknesses. First, the Indonesian economy, shocked by market sentiment combined with inefficiency in the micro policy implementation, has caused the lack of coordination in conducting macroeconomic policies. Second, the culture of corruption, collusion and nepotism found in most levels of public and private institutions across regions and sectors has proliferated. This has accelerated the deterioration process of the political and economic situation, which was also worsened by the lack of discipline and poor implementation of law and order. Specifically, poor implementation of public and corporate governance has caused economic problems even more difficult to solve. Finally, lack of transparency in almost every aspect of administrative and decision-making process creates uncertainly and raises the country risk. This paper discusses the progress of efforts in establishing good corporate governance in Indonesia in the context of an international environment.

Globalization and decentralization ideologies give challenges and opportunities for Indonesia in implementing good corporate governance. However, social and political pressures still play a more important role in determining the direction of successful corporate governance. In order to reach the optimum economic and social solutions to this dilemma, diversities across regions and culture should be taken into account. The government is expected to play an important role as facilitator in establishing good corporate governance by considering technical and economic efficiency grounds. The government, in cooperation with the legislature includes law and regulatory infrastructure to resolve agency or moral hazard problems.

Control in the macro and micro levels is also important to establish and facilitate efficient mechanisms at various levels of management. However, this condition requires a clear and applicable law and regulatory framework depicting horizontal and vertical power sharing. This requirement is very important to determine the revenue sharing across regions and levels of government.

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1.Introduction

Indonesia has been suffering from continuing economic crisis for more than two years. As baht was devalued in early July 1997, the value of rupiah also collapsed and the Indonesian economy began to fall apart. The currency crisis in Indonesia is just part of a more fundamental crisis indicated by the collapse of confidence. It is a total crisis. The resignation of Suharto in May 1998 after ruling the country for 32 years showed a much more serious problem faced by political elites and Indonesia has to solve a leadership crisis.

The fall of a long period dictatorship government under Suharto cost not only material things, but also human beings as many students ended up dead in a clash with the military troops. Economic activities were paralyzed and rupiah reached the lowest value around IDR 14,900 per USD in June 1998.

The economic crisis in Indonesia was not only rooted in financial sector was fragilities, but was also related to poor managerial performance in both public and private institutions. The implementation of public and corporate governance indicates several weaknesses. First, the lack of coordination in conducting macroeconomic policies combined with inefficiency in the micro policy implementation resulted to the Indonesian economy being easily shocked by countrywide market sentiment. Second, the countrywide corruption accelerates the deterioration process of the political and economic situation. Corruption in both public and private institutions in addition to collusion and nepotism has strengthened the KKN culture found in most levels of institutions across regions and sectors.[2] Third, lack of transparency in almost every aspect of administrative and decision making process creates uncertainty and raises the country risk. Finally, lack of discipline combined with poor implementation of law and order has worsened the overall economic condition. Poor implementation of public and corporate governance has caused economic problems even more difficult to solve.

This paper will discuss the progress of efforts in establishing good corporate governance in Indonesia within new international environment. The next section of this paper will explore basic concepts of corporate governance. Section three elaborates external environment as well as global issues associated with development of good corporate governance. Section four describes the progress of achieving good corporate governance in Indonesia. Section five explains the importance of having corporate culture reform, and the last section gives summary and conclu-

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[2]KKN is an abbreviation of Korupsi, Kolusi dan Nepotisme, or we might call it CCN (Corruption, Collusion, and Nepotism).

2. Basic Concepts of Corporate Governance

The total crisis that severely hit Indonesia has forced the Indonesian government to take major economic reform under the assistance of the International Monetary Fund (IMF) and the World Bank . These two international institutions, along with others like Asian Development Bank (ADB), Islamic Development Bank (IDB), and several countries under bilateral agreement, play a major role in assisting Indonesia to recover from the economic turmoil. One of the most important step taken by the government is to reform the financial sector including banking and corporate restructuring. The restructuring programs show a slow progress. Corruption and other type of inefficiencies are still major distortions found in both public and private institution. The Bank Bali scandal is a clear example of corruption and crony capitalism in the financial sector. The success of resolving the Bank Bali scandal is very important for IMF since the problem is strongly associated with the credibility of Indonesian Banking Restructuring Agency (IBRA) designated by the IMF. Solving the scandal is one positive indicator of efforts in straightening institutions right to regain market confidence.

The IMF and World Bank have been actively contributing to promoting good governance in member countries.[3] In general, IMF suggests to member countries to fight corruption and minimize any type of inefficiency. Bureaucratic cost can be minimized through several ways. The cost can be reduced by lessening the scope of ad hoc decision making, rent seeking activities, and undesirable preferential treatment of individuals or organizations. Achieving efficiency and implementing fairness in all economic activities are important keys in having good governance.

IMF also helps member countries through technical assistance in enhancing country capacity to design and implement economic policies.in building effective policymaking institutions, and in improving public sector accountability. In addition, IMF promotes transparency in financial transaction for the government operations. The IMF's role in promoting governance is primarily associated with macroeconomic matters, hence the technical assistance is more focused on improving the management of public resources through reforming public sector institutions, and supporting the development and maintenance of a transparent and stable economic and regulatory environment conducive to efficient private sector economic activities.

The success of reforming corporations through structural policies will be affected by macroeconomic environment, market structure, legal, regulatory, and institutional environment, as well as the existence of corporate governance. The corporate governance reflects the underlining culture of corporations. Therefore, systematic reform taken by the government requires synergy among structural and

[3]IMF. "Good Governance, The IMF's Role," 1997.

cultural reform policies as well as conducive macroeconomic environment.

Cultural reform on corporation means establishing good corporate governance to improve economic efficiency. Based on OECD principles[4], "good corporate governance should provide proper incentives for the supervisory and management boards to pursue objectives that are in the interest of the company shareholders, and should facilitate effective monitoring to establish efficiency in resource allocation. In order to attract foreign capital as well as domestic investors, and in the context of global environment, good corporate governance in a country must be credible and well understood across borders. The OECD principle of corporate governance presented in Appendix A mention five important areas, i.e.: (I) The rights of shareholders; (ii) The equitable treatment of shareholders;(iii) The role of stakeholders; (iv) Disclosure and transparency; and (v) The responsibilities of the board.

Building good corporate governance can be considered as establishing right and proper culture in the context of principal-agent relationships to achieve efficiency within a conducive environment. The agency or moral hazard problem faced by corporations is related to different objectives between shareholders and managers, between shareholders and creditors, and between controlling and minority shareholders.[5] This moral hazard problem is common when we have a market with imperfect information. To solve this agency problem, we require to have a competitive market and a conducive environment (fairness) for both shareholders and creditors. Under imperfect information market, to overcome the governance problem we need government regulations by creating proper incentive structures.

Zhuang (1999) discusses the agency problem and the need to reduce the cost of legal protection by focusing on ownership concentration, market for corporate control, and discipline by creditors. He argues that the problem with dispersed corporate ownership is in the form of free-rider problem as small shareholders could not bear the monitoring cost. However, when corporate ownership is concentrated, there could be potencial conflict between large controlling block holders and powerless minority shareholders. There could be an abuse of power by majority shareholders.

Zhuang (1999) also describes that the market for corporate control is usually related to transfer mechanism for corporate control such as mergers and takeovers. The mechanism is expected to improve corporate governance by threatening managers with takeovers to avoid abuse of power and misalocation of corporate resources. Creditors may have strong influence to the company's decision making process since they are concerned with their money borrowed by the company. The effectiveness of debt management in corporate governance is very important to

[4]OECD (Organization for Economic Co-operation and Development) Principles ofCorporate Governance.

[5]Juzhong Zhuang (1999).

minimize default. In addition, Zhuang also mentions the importance of having legal protection for investors including securities market regulations, fiduciary responsibilities of directors and managers, and laws governing shareholder rights, takeover, and corporate insolvency.

The implementation of corporate governance might vary across country. However, all countries would expect to find the most proper and applicable system. The most important question is how to build the best system of corporate governance. Prowse (1998) argues that the best system for one country may not be the best for others. According to Prowse, for industrial countries, the quality of corporate governance can be evaluated by questioning whether or not there exists a well functioning competitive market with minimum government intervention, solid legal protection for outside investors, solid legal protection for outside investors, and whether there is any agency problem between outside shareholders and both directors and managers.[6] Prowse concludes that East Asian countreies need to encourage competition in financial systems, privatization of state-owned banks and financial firms. However, the existence of competitive financial system does not necessarily mean good governance and efficient corporate financial systems. He argues that corporate governance requires a legal and regulatory infrustructure to improve the enforcement of protection of outside shareholder's rights. The government may play as a facilitator in setting up conducive environment by helping to develop substantial outside shareholders to be a guardian of minority-shareholder rights and monitor directors' and managers' behavior.

3. External Environment in Corporate Governance

External government for corporate governance can be categorized into challenges and opportunities of global market and decentralized economy. Tambunan (1999) argues that there is strong parallelism between the objective of decentralization and market globalization, i.e.,: to achieve efficiency.[7] The decentralization is expected to bring regional government to be able to facilitate efficient market mechanism process and give excellent services to the local society. Once economic efficiency is achieved, the competitveness of a region, and hence a nation, will be improved. Similarly, global market forces also brings economic agents toward more competitive market, and tend to induce economic activities into an efficient level indicated by narrowing gap between world and domestic prices.

Unfortunately, under globalized economy, it is impossible for a country to isolate herself from global influences. Any negative shocks in the global market may affect domestic macroeconomic environment. Similarly, any development in best practices of corporate governance in international market will be easily trans-

[6]Prowse, Stephen (1998),

[7]Tambunan, Mangara (1999).

mitted to most countries and become important benchmark in the implementation of corporate governance in a country. However, the speed and degree of adopting best practices in corporate governance will vary across country. The heterogeneity of countries in culture, economic and political conditions, the existence of legal infrastructure, market structure, and the level of democracy in the society might affect the capacity of adopting best practices in corporate governance.

Most countries in the world may believe that liberalized economy is the best solution to convey a country to an optimum economic welfare. Free and open economy with perfect competitive market is still considered to be the savior of any problem in human economic activities. As every country in the world may easily enjoy the development of advanced technology, especially information, telecommunication and transportation technologies, the problem of imperfect information seemingly tends to disappear. It seems that the global and regional markets indicate perfect competition.

However, the integrated global market may also have challenges. It is obvious from the Asian experiences that the more integrated global market we have, the easier the crisis in a country be transmitted to another country. We have a borderless state. Even the IMF starts to believe that, considering the Malaysian case, it is impossible to implement uniform economic policies due to differences found in member countries.The conventional paradigm of liberal economy with no government intervention is now believed to be unsuccessful in helping a country to recover from economic crisis. The current economic situation faced by crisis countries gives us an opportunity to think and rethink what is the best economic system that gives the most efficient market mechanism.

In fact, we all believe that there is no perfect market due to externalities, the existence of public goods, and other market failures. In order to solve these classic problems, we may need to have government intervention. Consequently, we can only achieve the second best solution. Similarly, in establishing good corporate governance, given the existence of market failures, we may need to have government's role to facilitate the market mechanism process. At the same time, we may need to have prudent policies in adopting seemingly best practices of corporate governance by considering differences among countries.

In Indonesia, the most important issues need to be taken into account in implementing corporate governance is decentralization. The existing Law on Local Government (Law No. 22, 1999) and Law on Financial Relation between Central and Local Government (Law No. 25, 1999) have not been implemented yet while the political pressures from regions such as Aceh, Irian, and Riau have put the government into a difficult situation. Regardless of which is the ruling regime, the problem faced by Indonesia is so delicate and complicated one. Decentralization is only an economic issue, but also political and cultural. As most economists believe that in implementing decentralization, revenue and expenditure sharing would always follow the power sharing. In reality decentralization would involve process of deconcentration, delegation, and devolution The difficulty of implementing decentralization is mainly caused by the fact that the law of decentralization (Law No. 22, 1999) does not give quite clear explanation about vertical sharing of power. At the same time, regions demand bigger revenue sharing as a result from mobilizing local resources. As every region apply different policies on taxation, trade and investment, assuming free mobility of resources across regions, there will be an equilibrium condition reflecting optimum level of welfare. However, it is almost impossible if implemention of fiscal decentralization is not accompanied by having a full delegation of power across levels of government. The condition might cause difficulties in the implementation of corporate governance across regions.

In general, the development of good corporate governance in Indonesia faces two interconnecting environment resulting from globalization and decentralization process. These two forces give challenges and opportunities in the implementation of corporate governance. In addition, since natural resources are spread in many regions and pluralism of regions still strongly exist, an investor may be confronted by different taxation and investment policies taken by different regions. In trade activities, not every region has a local or international port to facilitate regional or international trade. The condition will hinder the exports and imports activities. There should be a legal mechanism to facilitate regional and international trade conducted by regional businesses.

4. Good Corporate Governance in Indonesia

After experiencing economic turmoil triggered by the collapse of rupiah in 1997, most economists agree that strong macroeconomic fundamentals do not necessarily guarantee the country's resistance from a crisis. In fact, strong macroeconomic fundamentals, should be accompanied by healthy microeconomic condition. Efficiency, stability, and growth in the macro sense have to go along with efficiency and fairness in the micro side. The efficiency and fairness in both macro and micro are objectives of the implementation good governance. Similarly, in order to have a well functioning institution or organization we need to have capable, credible, and professional human resources to operate the institution. We need to apply good governance practices in every public and private economic activity to achieve efficiency.

The total crisis in Indonesian has disclosed the existence of more fundamental problem- the leadership crisis which is rooted from the moral and ethical crisis (See Chart 1 in Appendix B). Corruption, Collusion, and Nepotism (CCN) and other type of power abuse cannot be separated from the fact that human behavior is a reflection of the beliefs, morals, and ethics which are then practiced into a way of life. The way of life including social and economic activities will establish the human culture (See Chart 3a and 3b in Appendix B). In Indonesia CCN is mainly caused by an iron triangle or rectangle among politician, bureaucrat, businessmen, and military personnel or group. Chart 2a and 2b describe the possible models for the CCN. The corruption problem is aggravated by the gargantuan family business of almost all political elites. The challenges of implementing good corporate governance will very much depend on the success of breaking the iron triangle or rectangle through discipline in law and order.

So far, under the supervision of IMF, as described in the Letter of Intent, the Indonesian Government agreed to continue the banking and corporate restructuring programs, one of many ways to implement good governance. However, the progress seems slow due to the fact that there are many social and political problems that have not been resolved yet. The killing of students, violations of human rights, banking scandals, nation wide corruption at all natonal levels of government, national disintegration, and other problems accumulated since Suharto's New Regime took the power in 1966. All of these have become one package of problems that continue to accumulate as other problems keep appearing. It seems that economic solutions cannot be implemented alone without considering the magnitude and the multidimensional nature of the problems faced by Indonesia.

5. The Importance of Cultural Reform

Implementing good governance is a kind of cultural reform to the existing system. Combining the structural and cultural reforms, it is expected that Indonesia will find the best system to bring the economy out of the crisis. Implementing good corporate governance is also part of cultural reform in corporations. However, any policy has to be carefully implemented in the sense that one policy and another need to be applied in a sequential or in a simultaneous way. Therefore, it is a must to set up time frame of each policy in transparent way and the government need to be consistent and discipline under existing law and regulatory framework. Such conduct is expected to improve the credibility of the government to regain confidence.

Indonesia is hit the worst by the Asian crisis. This bitter experience at least will open some opportunity, even with extremely high costs, for Indonesiaand other country in the world, to learn from the crisis. Therefore, monitoring and surveilance activities combined with good corporate governance become important steps to prevent the crisis from reoccuring.

6. Summary and Conclusions

Globalization and decentralization forces give challenges and opportunities for Indonesia in implementing good corporate governance. However, social and political pressures are still dominant factors in determining the direction of successful corporate governance.Implementation of corporate governance can not ignore the diversities across regions and culture to reach the possible optimum economic and social solutions.

It is expected that the Indonesian government would play an important role as facilitator in establishing good corporate governance to achieve second best solution by considering the technical and economic efficiency grounds. The facility provided by the government in cooperation with the legislature include law and regulatory infrastructure, so that the agency or moral hazard problem can be resolved.

The functioning of control in macro and micro sense is also important to establish to facilitate efficient mechanism at various levels of executives. However, this condition requires a clear and applicable law and regulatory framework of horizontal and vertical power sharing. It is a very important factor required to determine the revenue sharing across regions and levels of government.

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Appendix A8 : OECD Principles of Corporate Governance

OECD Principles of Corporate Governance

I **The rights of shareholders.** The corporate governance framework should protect shareholders' rights.

A. Basic shareholder rights include the right to : 1.) secure methods of ownership registration; 2.) convey or transfer shares; 3.)obtain relevant information on the corporation on a timely and regular basis; 4.) participate and vote in general shareholders meetings; 5.)elect members of the board; and 6.) share in the profits of the corporation.

B. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as : 1.) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2.) the authorization of additional shares; and 3.) extraordinary transactions that in effect result in the sale of the company.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholders meetings and should be informed of the rules, including voting procedures, that govern general shareholders meetings. (1) Shareholder should be furnished with sufficient and timely information concerning the data, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting. (2) Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations. (3) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

E. Markets for corporate control should be allowed to function in an efficient and transparent manner. (1) The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understands their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class. (2) Anti-take-over devices should not be used to shield management from accountability.

F. Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

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[8]Source: Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance, http://www.oecd.org/daf/governance/principles.htm

Appendix A (continued)

II. The equitable treatment of shareholders. The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same class should be treated equally. (1) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote. (2) Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.(3) Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes. B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

III. The role of Stakeholders in corporate governance. The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity of effective redress for violation of their rights.

C. The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant information.

IV. Disclosure and transparency. The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on: (1) The financial and operating results of the company; (2) Company objectives; (3) Major share ownership and voting rights; (4) Members of the board and key executives, and their remuneration; (5) Material foreseeable risk factors;

Appendix A (continued)

(6) Material issues regarding employees and other stakeholders; and (7) Governance structures and policies.

B. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

C. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

D. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

V. **The responsibilities of the board.** The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the boards' accountability to the company and the shareholders.

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

B. Where the board decisions may affect different shareholders groups differently, the board should treat all shareholders fairly.

C. The board should ensure compliance with applicable law and take into account the interests of stakeholders.

D. The board should fulfill certain key functions, including: (1) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures. (2) Selecting, compensating , monitoring and, when necessary, replacing key executives and overseeing succession planning.(3) Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process. (4) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions. (5) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law. (6) Monitoring the effectiveness of the governance practices under which it operates and making changesas needed. (7) Overseeing the process of disclosure and communication.

Appendix A (continued)

E. The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management. (1) Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest.Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration. (2) Board members should devote sufficient time to their responsibilities.

F. In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

Appendix B

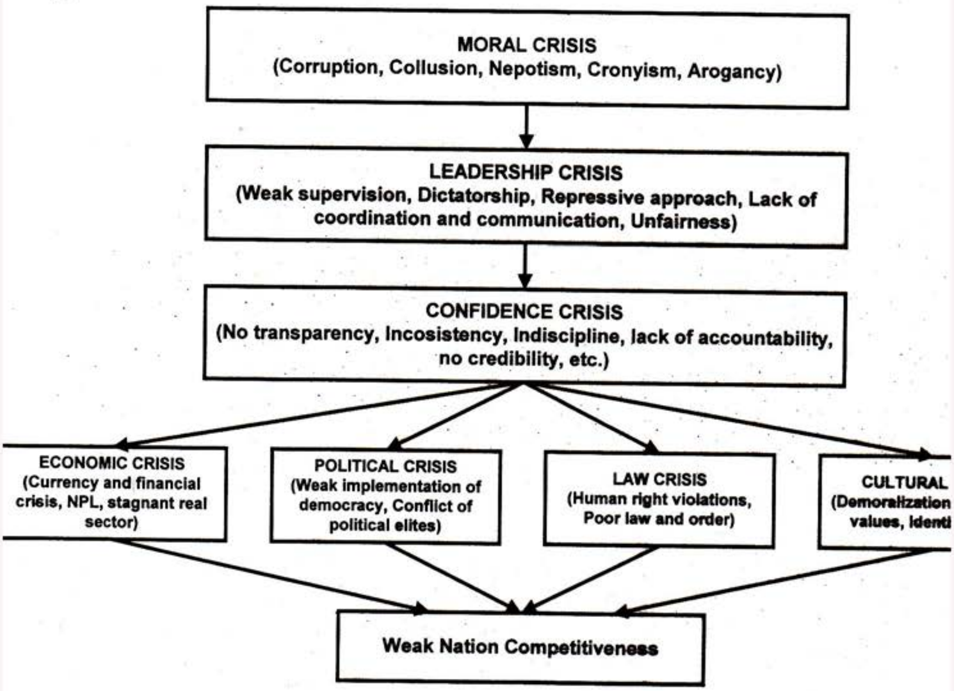

CHART 1. THE HIERARCHY OF CRISIS

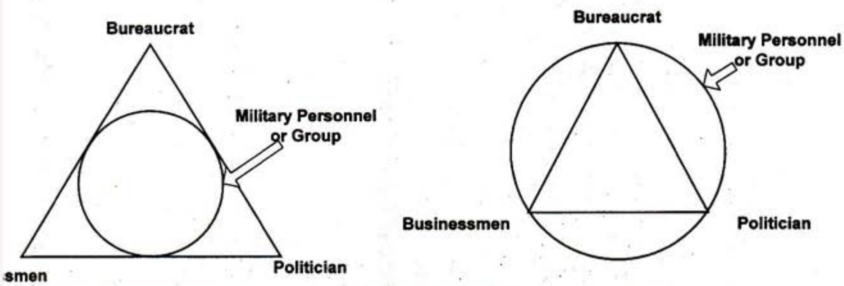

Chart 2a. The Iron Triangle

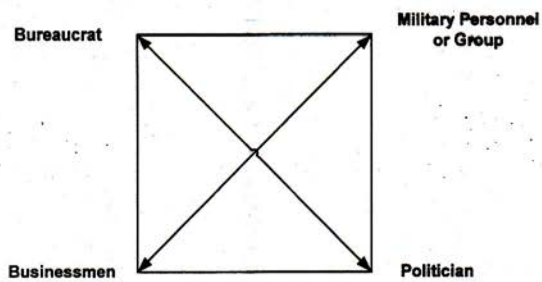

Chart 2b. The Iron Rectangle

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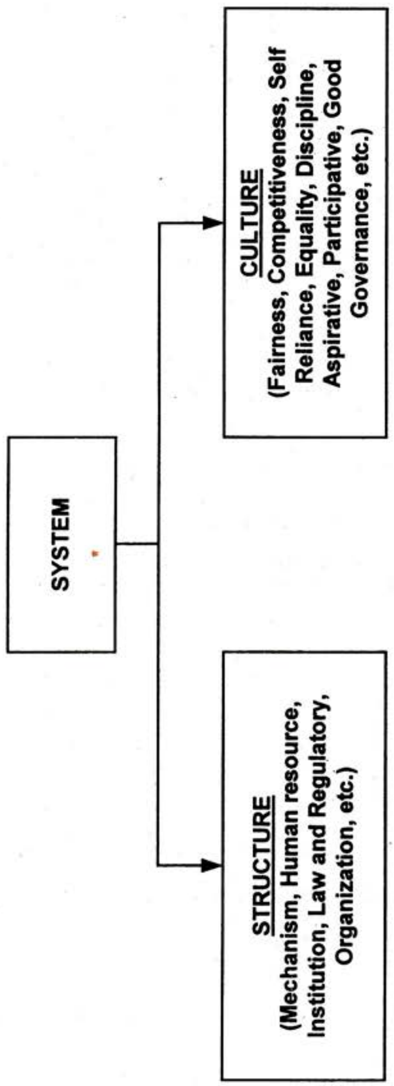

Chart 3a. System Components

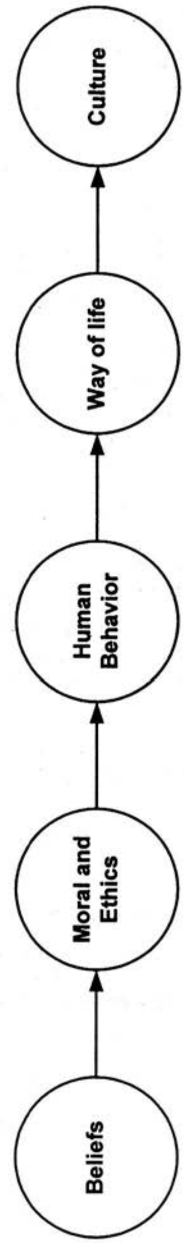

Chart 3b. Process of Cultural Formation

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