INDONESIAN CHALLENGES TOWARDS 2000
WITH REFERENCE TO STATE-OWNED ENTERPRISES*

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Ladies and gentlemen,

I am very pleased to have the opportunity to share my thoughts concerning *"The Challenge of Making Indonesia Competitive - Visions and Strategies for the New Asia"*. In my view, competitive advantage is at the heart of a nation's economic performance in the growing global competitive market place. One of the most important elements to a successful globalization effort is that every country, including Indonesia, should maximize competitive advantage. rather than comparative advantage (see Porter, 1985). The importance of this point is emphasized by the fact that true world trade is being marked by two apparent trends. *First*, the Uruguay Round is complete, which has strengthened the General Agreement on Tariff and Trade (GATT) and put in place the World Trade Organization (WTO), with the objective of promoting freer trade. *Second*, there is a growing popularity of regional and sub-regional trading arrangements, such as NAFTA (North American Free Trade Agreement), EU (European Union), ANZCERTA (Australia-New Zealand Closer Economic Relations Trade Arrangement), AFTA (ASEAN Free Trade Area) and APEC (Asia-Pacific Economic Cooperation). These trading arrangements also tend to focus our vision

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in line with the fundamental GATT principles of non-discrimination and the creation of a trading system based on multilateralism. In this respect, the regional free trade areas, which have sought to liberalize trade various each groups, have appeared as an impetus to smoothen, broaden and deepen international trade. In such situation, participating economies are more open to international trade and more integrated in to the global economic environment.

Indonesia's commitment to open international trade remains firm. This has been demonstrated by the ratification of the Uruguay Round agreements, the signing of the Bogor and other APEC declarations, and the implementation of our AFTA commitments. Indeed the ultimate objective of AFTA is to ensure that our domestic producers can avail themselves of improvements in productivity and efficiency which will allow us to become a more active participant in the world market (see Imada and Naya, 1992; Soesastro, 1995). Indonesia has also taken an active role in promoting free and open trade in the Asia-Pacific region economy through APEC. At the conclusion of the 1994 APEC conference under the chairmanship of President Soeharto, the economic leaders of APEC issued the ***"Bogor Declaration"*** committing member economies to free and open trade and investment in the Asia-Pacific region by 2010 for industrialized countries, and by 2020 for developing countries. We believe that this declaration, which was followed up by APEC's 1995 *OAA*-***Osaka Action Agenda*** and by *MAPA*, ***Manila Action Program for APEC***, that was adopted at the 1996 APEC conference, broadens and deepens the commitments of the APEC economies in the Uruguay Round agreements and provides concrete evidence of our continued pursuit of the principles of free and open trade.

With these guidelines firmly in place, Indonesia can face the emerging world economic trends and challenges, and can step confidently ahead in to the future. Developing new visions and strategies especially for Indonesia is extremely important if we are to succeed in global competition and to be competitive in our domestic markets. To achieve this objective, we will continuously fine-tune our economy in response to the inevitable rapid global changes. In this respect, Indonesia has adopted unilateral deregulation measures which will gradually reduce our tariff and non-tariff barriers. We are determined to implement a schedule that will reduce tariffs to a very low level. After a series of carefully defined steps, to be carried out over the next six years, almost no tariff will exceed 10 per cent by the year 2003. As well as pursuing trade reform, in the last twenty years Indonesia has also consistently demonstrated its commitment to deregulation and debureaucratization. The policy changes that we have implemented include a financial sector deregulation, industrial promotion, revisions in our investment law, and the privatization of our state-owned enterprises (see Pangestu, 1996). I would like to focus on the recent changes in Indonesian state-owned enterprise (SOE) systems and their further roles in collaborating with the private sector in infrastructure development.

In Indonesia, a reevaluation of the position of SOEs in the economy is important. Almost all SOEs in Indonesia play important roles in our economy, particularly those in upstream industries on which the performance of other industries depends. Accordingly, the performance of SOE have significant effects not only for the SOEs themselves but also on the entire economy.

In order to become ready for the year 2000, which will mark the beginning of an era characterized by free and open multilateral trade and investment systems we must use our resources more efficiently and effectively. SOEs must be part of this process. In this regard there can be no distinction between SOEs and private enterprises. It would be a mistake to ignore the level of efficiency of the SOEs. Rather, we need to improve SOE management and their competitive power to enable the SOE to compete in the international arena of free trade and investment.

Indonesian government policy seeks to deal with SOE inefficiency through two approaches. *First,* we seek to improve the relationship between government and SOEs. This is designed to force SOEs into a market orientation. It includes improvement in the government's systems of control, and the granting increased autonomy to managers, with financial self-reliance for SOEs being the main target. This approach includes rewards and sanctions linked to financial achievement, especially for the boards of directors and supervisory board. Simplification of the decision-making process between SOEs and the government is also involved. The shift from a bureaucratic management style to a system of management which enables companies to develop their own strategies provides strong behavioral and financial incentives for managers to attain better performance.

Second, the government aims to improve relationships between SOEs and the market through company restructuring or privatization. The government has followed six strategies in this effort: changes in public enterprise legal status, contracting out, consolidation or merger, splitting up, joint ventures, and partially selling SOE shares through the capital market or by direct placement. Whichever method of restructuring is adopted, there will be consequences for the management of the SOEs involved. Changes in legal status from *Perjan* to *Perum* or to *Persero,* or from *Perum* to *Persero*[1] will (formally) reduce government intervention. Managerial discretion will be widened. Furthermore, a state enterprise which has changed its legal status to *Persero* can extend and diversify its businesses, or even place its shares in the capital market with only limited political restraints. Consolidation, mergers and splitting-up of enterprises will have effects on the span of management controls. Management contracts, "going public," direct placement of shares, and joint ventures create the opportunity for third parties to be involved in controlling public enterprises. All these alternatives for enterprise restructuring will result in increased pressure on management to increase efficiency and on the government to ease its control over SOEs. Failing that, third parties would not want to be involved in managing enterprises or buying shares.

The two approaches to increasing SOE efficiency are designed to get the institutions right, that is to let the institutions work properly as the normal **function** attached, and to get the prices right, that is to let the market work with a minimal degree of price distortion. These are necessary steps for the sound management of the economy.

A collaborative work between SOE and private sector is not only beneficial to the economy in speeding up our development, but it also has an effect on management style and on the behavior of the SOE itself. The extension of privatization to not just include transfer of ownership from public sector to private

[1] *A perjan (Perusahaun Jawatan)* were departmental agencies defined as a social service corporations, which were regulated by public law, and attached to a ministerial department. They were headed and staffed by civil servants. Their cost of operation and annual profits or losses were part of the national budget. All *Perjan* have changed their legal status to *Perum. A Persero (Perusahaun Perseroan) is* a limited company whose shares, wholly or partly, are government owned. The management of *Persero* lies in the hands of a Board of Directors, and the Directors in turn are under the control of the Supervisory Board. Therefore, according to the new Act, a *Persero is* considered akin to a private enterprise. *A Perum (Perusahann Umum) of* public corporation comprises is a company that regulated by public law (Act No. 19/1960). *A Perum's* capital is wholly government owned,

sector, but to also include private financing, arrangement, (such as user charges or some version of the BOT system), participation in production (such as contracting out) and liberalization of public sector by omitting barriers to entry (see Wiltshire, 1987:15), has given way to closer relationships between SOEs and the private sector in doing business and in fostering national development. This has made public-private partnership become a more popular model in the recent years, especially in infrastructure development.

Ladies and Gentlemen.

Let me talk more in detail about privatization, especially for the experience of Indonesia. As we are aware, privatization has been portrayed in much academic literature and in the experience of some countries as an effective way of reducing government control of SOEs, substituting instead effective market controls. Just as the markets for goods and services can create pressures for managers to attain optimal efficiency, capital markets can provide SOEs with effective means of monitoring managerial performance (Zeckhauser and Horn, 1989:24). Capital markets require transparency from firms in publishing their financial results, and the consequent public scrutiny can provide explicit means of directing management towards good performance (Deane, 1991 :11; Vickers and Yarrow, 1988:27). In Indonesia, however, privatization is not defined as transferring all SOE assets or shares to private hands. The rationale originally put forward in support of a role for SOEs still prevails, although there are evident changes in the political situation, as well as the economic environment of the country. In Indonesia, we have followed one of two models of privatization: selling part of shares of a company through capital markets and fostering public-private partnership.

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and not divided into shares. Its operations are supervised by a technical minister. It is more autonomous than

Five leading Indonesian SOEs have sold part of their share, through capital markets. The firms were in the cement industry (PT Semen Geresik), the international and domestic telecommunication industries (PT Indosat and PT Telekom), the tin mining industry (PT Timah) and the banking industry (PT Bank Negara Indonesia). The government considers the partial privatization approach to be appropriate for at least two reasons. *First,* it creates less political tension, but is still very much supportive for the improvement of the management of enterprises. From a political point of view, this model gives increased opportunity for the general public as well as to small and medium sized companies to purchase enterprise shares. It is thus a good tool for spreading ownerships to citizens. This eases political opposition. From a management point of view, capital markets are useful instruments in ensuring effective monitoring of enterprise performance. If shares are not issued through capital markets, there is less incentive for managers to make information available to the general public, resulting in less public scrutiny regarding the quality of management. *Second,* selling SOE shares through the stock exchange improves the activities of the capital market, accelerating the development of our domestic capital market. The creation of a strong capital market facilitates substantial involvement by the private sector in investment and development.

The *second* model of privatization is that of public-private partnership. Alliances among private enterprises have been common, but public-private partnership is relatively new. This concept has become an increasingly popular model in fostering private sector participation in national development. Therefore,

were the *Perjan. Perums'* activities are mixed businesses, which generate income while providing public services.

it is interesting to analyze the advantages and disadvantages involved, both for the company as well as for the economy.

The concept of public-private partnership must be examined from two view points: the narrow perspective of the firm and the broader perspective of national economic development. From the viewpoint of the firm, alliances have increasingly become a strategic business model especially in regard with the effort to succeed in global competition. They also play important roles in getting institutions right, which affects market structure in getting prices right. This has been demonstrated by the entrance of private actors in to markets that were previously only served by the public sector, such as private telecommunication, electricity, and toll road development and management.

Traditionally, partnerships or alliances have involved agreements among individuals or companies cooperate in a variety of activities from production, marketing, research and development, to the provision of technology and capital. But today alliances have entered a new phase. This new phase has three characteristics, which make partnership become more interesting and important for managerial concern. *First,* interfirm business linkages between companies are increasingly giving way to relationships that often cross national boundaries. For example, General Motors' partners include Isuzu, Suzuki and Toyota; Ford has allied itself with Mazda; and Nissan with Kia. The *second* characteristic of the new alliances is that they are often between rival firms. These alliances would have been unthinkable just a few years back, but have happened in recent years, for example, a working relationship between Toyota and General Motor or Ford and Nissan. *Third,* alliances are now occurring between unrelated industries, for example, General Motors and Hitachi (Yoshino and Rangan, 1995:9-16). Such alliances have until recently still been dominated by *multi national corporations*, but, in the future, they can also be applied to public-private partnership. Accordingly, business alliances —which are now the concern of private and public companies—are a method of consolidating strength belonging to partners in the face of competition. This is because partnership can improve the structure of capital, increase market access, strengthen the human resource base, and increase the firm's ability to diversify production.

From the wider context, public-private partnership can be part of a national economic strategy to maintain sustainable development in the face of global competition. It can be an important policy for filling saving-investment, or resource, gaps that are often exacerbated by the increasing demand for infrastructure development. Therefore, private sector participation is an increasingly significant source of funds for infrastructure. In particular it can be the vehicle by which overseas capital, such as foreign direct investment, international portfolio capital inflows, and resources from international financial institution such the World Bank, ADB, IDB or, IFC, can enter an economy (Asian Development Bank, 1996:8).

Private sector participation in Indonesian investment is particularly important for two reasons. *First,* to achieve annual economic growth of 7.1% during the *Sixth Five Year Development Plan,* the Indonesia economy requires investment of are about Rp815.3 trillion[2] within the period. Most of this investment must come from the private sector. For example, in 1995, the government provided 22.7 per cent of investment funds, while the private sector

[2] See Indonesian Budget, fiscal year 1996/1997, p. 22.

provided 77.3 per cent[3]. The increasing role of the private sector in national investment remains a crucial issue for the future. *Second,* private sector participation in national investment will enhance our access to advanced technologies and improved management practices.

What can be done to increase private sector participation in the financing of infrastructure investments? First, there must be an active and credible capital market that can attract long-term capital. If we fail to develop such a market, financing investment through inefficient capital markets will burden our economy with high cost infrastructure as surely as if these investments had been badly managed or used outmoded technologies. Second, the public sector must be credibly committed to greater private sector involvement.

However, the private sector will not be interested to ally itself with the public sector if there is no benefit from the partnership. Generally, factors that have constrained private investors from investing in infrastructure can be grouped under two broad areas: investment constraints and financing constraints. *First,* investment constraints can be attributed to the low risk-adjusted rate of return for infrastructure project owing to: (i) high transaction costs, (ii) high risks, and (iii) uneconomic pricing. Normally, high transaction costs and risks raise the rate of return that investors demand. However, high transaction costs increase project costs and affect the timing of the project's stream of revenue, both of which impact on the project's profitability. This is often added to by a political economy of tariff setting that may lead to uneconomic user charges which do not reflect the costs, thereby reducing the attractiveness of such projects. *Second,* on the financing side, private sector involvement in infrastructure is constrained by lack of

[3] 1ndonesian Budget, fiscal year 1997/1998, p.7.

available domestic debt with long-term maturity and favorable interest rates. There is a need to channel domestic resources into longer-term commitments that appropriate for the financing of infrastructure project through the domestic debt markets, which remain underdeveloped. Other constraints arise from impediments on the flow of foreign funds (ADB, 1997:2-3). These constraints need to be solved.

Therefore, it is important that the government plan strategically for private sector participation by recognizing the constraints. To solve these problems, four issues should be addressed. *First,* the government must increase it effort to maintain a sound macro economic condition. The macro economic condition is crucial to attracting and sustaining private sector participation—both foreign and domestic—in long-term investment. Investors need to have confidence in a country's macro economic policies, particularly when it comes to making long-term infrastructure investments. *Secondly,* the government needs to develop a stable and transparent legal framework and regulatory system. A transparent, stable, and credible legal and regulatory framework is critical to attracting private investment, by protecting private sector investors against unexpected changes in government policies. The ability of the government to develop these measures would increase private sector participation. *Thirdly,* the government needs to develop sectoral policies that promote competition. In this regard, government needs to prioritize and identify infrastructure projects with due consideration for the potential role of the private sector in infrastructure provision. In order to secure the maximum benefits from private participation in infrastructure development, sectoral policies need to be designed to identify market segments where there is greater potential and scope for private sector entry and competition. Moreover, user charges must be designed to reflect actual costs of delivering the service while providing incentives for efficiency and meeting the government social service objectives vis-à-vis the private sector's sector commercial objectives. User charges and the manner in which they are adjusted need to be made as transparent and as objective as possible. Also relating to transparency, there should be greater use of competitive tendering procedures rather than direct negotiation with pre-identified private entities because competitive tendering promote transparency, fairness and efficiency. *Fourthly*, the government needs to promote the availability of long-term capital. Privately financed infrastructure projects need well developed domestic capital markets. In turn, the increased use of private financing in long-term investment projects also provides opportunities to develop domestic capital markets. In many countries, infrastructure projects raise the required long-term debt financing from institutional investors by using financial instruments such as bonds and convertible securities, beside equity financing that could come from international financial institutions or big companies (see ADB, 1997:9-27).

In the case of Indonesia, the government has continually moved to improve investment policies and capital market development. Deregulatory activities first began in May 1986 with the objective of promoting export oriented investments, investments in East Indonesia, and the development of a capital market. For example, the 20 per cent minimum requirement for Indonesian share holding in the pre-1986 regulations was lowered to five per cent for foreign investment projects that a) were located in remote areas on high risk ventures (i.e., mainly East Indonesia); b) involved high technology; c) were export oriented (i.e., exports 85 per cent of their production); or d) require large capital (i.e., project costs above $ 10 million). Further relaxation of restrictions was undertaken in December 1987. This package, for example, relaxed to 51 per cent (down from 75 per cent) or 45 per cent (down from 51 per cent) Indonesian ownership, provided that 20 per cent of its shares are sold in the capital market which qualified it for national treatment.

The most dramatic investment policy change came in June 1994. That year the government opened up nine sectors previously deemed closed for foreign investment: ports, production and generation of electricity, telecommunication, shipping, air transport, drinking water, rail ways, automatic generation plant, and mass media[4]. There was substantial relaxation of the phase down requirement. For joint venture set up with at least 5 per cent Indonesian share holding, divestment of foreign shares is no longer mandatory and left up to decision of the share holders. As for companies set up with 100 per cent foreign ownership, divestment of some of the foreign shares is required after 15 years from commercial production, but the amount of divestment is not mandated at all and left to the investor (Pangestu, 1986:150-163).

The above policy reform, accordingly, has opened up both direct investment and portfolio investment. Supporting the policy, the government also launched Presidential Instruction No.5/1988 in regard to the privatization and liberalization of SOEs and the: Parliament has approved a new capital market law, Law No. 8/1985. The last two government policies have given more opportunities to private sector participation in national development process, especially in infrastructure projects, and in the improvement of domestic capital markets.

[4] There has been reinterpretation for foreign investment in the media because of its inconsistency with the press law.

In addition, with the above supporting regulations, efforts have been made to bridge the saving-investment gap by the creating a financial system that encourages private participation through public-private partnership, such as joint operations between consortiums of foreign and domestic investors, as for example between PT Telekom (state telecommunication company), PT Jasa Marga (state road company) and Perum Kereta Api (state rail ways company) with private companies joint venture; and direct placement of SOE shares or public offering (such PT Intirub, PT Telekom, PT Indosat, PT Timah, PT Semen Gresik, PT Bank Negara Indonesia).

Ladies and Gentlemen,

Let me conclude my remarks on Indonesian challenges towards 2000. Indonesia has moved forward in anticipating the challenges ahead, especially those coming from global competition. With continuing deregulation and debureaucratization measures which will foster greater private sector participation especially in infrastructure development, I believe Indonesia is well poised to sustain its economic growth.

Please accept my appreciation to the seminar committee, who gave me the opportunity to share my opinions in this distinguished forum.

Thank you.

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