Corporate Governance and State-Owned Enterprises: An Overview of the Relevant Literature
Chapter Two

Corporate Governance and State-Owned Enterprises:
An Overview of the Relevant Literature

- Introducing corporate governance
- The origins of corporate governance
- Agency relationship and State-Owned Enterprises

2.1 INTRODUCING CORPORATE GOVERNANCE

‘Corporate governance’ is a wide and somewhat nebulous term that is employed in a number of different contexts. Hence, it is useful to begin by considering some definitions of corporate governance which have been formulated by scholars and organisations. The term was first introduced by Richard Eells of the Columbia Business School in 1962 in his book entitled The Government of Corporation.\(^1\) However, the term is ancient because, as noted by Tricker, it has been employed for as long as there have been business bodies. Issues of governance come up at whenever a business entity acquires a life of its own and the corporate owners is separated from its managers.\(^2\) A discussion of the precise meaning of ‘corporate governance’ is helpful in order to disclose the precise nature and ambit of the term.

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2.1.1 Definitions of corporate governance

It is arguable that there is no one definition that can be claimed to provide definitive meaning of the term corporate governance.\(^3\) As Gillan states, ‘the definition of corporate governance differs depending on one’s view of the world’.\(^4\) As outlined in chapter 1, this thesis deals with the role of the board of commissioners from a legal perspective, it is useful to commence this discussion by providing a legal definition of corporate governance. Gilan and Starks define corporate governance ‘as the system of laws, rules, and factors that control operations at a company’.\(^5\) In comparison, the UK Cadbury Report of 1992 relates that corporate governance is a mechanism to direct and control a company, defining it as ‘the system by which companies are directed and controlled’.\(^6\)

In contrast, Steward defines corporate governance as ‘a manage a trios among the CEO, the board, and the shareholders, each of whom wonders what the other two get up to when he’s not around’.\(^7\) Stewart believes that corporate governance within the one-tier corporation model is the interrelationship mechanism of three company’s organs: CEO, the board and the shareholders. A comprehensive definition of corporate governance comes from Du Plessis, McConvill and Bagaric, as follows:

> The process of controlling management and of balancing the interests of all internal stakeholders and other parties who can be affected by the corporation’s conduct in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation.\(^8\)

\(^7\) Ibid.
\(^8\) Du Plessis, McConvill and Bagaric, above n 3.
Further, in 1999 the Organisation for Economic Cooperation and Development (OECD) provides definition of corporate governance as follows:

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those activities and monitoring performance.  

The OECD goes on to explain its point on corporate governance in 2004, stating that:

Corporate governance involves a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Furthermore, the OECD’s principles of corporate governance are: ‘(1) The right of shareholders and key ownership functions; (2) The equitable treatment of shareholders; (3) The role of stakeholders in corporate governance; (4) Disclosure and transparency and; (4) The responsibility of the Board’. These principles originated from the OECD’s 2004 definition of corporate governance.

Moreover, in the context of Multi National Enterprises, Luo defines corporate governance as ‘the relationship between the corporation and the stakeholders that determines and controls the strategic direction and performance of the corporation. It is the system by which corporations are directed and controlled’.

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9 Jim Psaros, Australian Corporate Governance: A Review and Analysis of Key Issue (Pearson Education Australia 2009), 3
10 Ibid
Similar to the OECD’s corporate governance definition, in Indonesia –as formulated by the Forum for Corporate Governance in Indonesia (FCGI), corporate governance is defined as:

A set of rules to regulate the relationship among shareholders, company management, creditors, government, employees, and internal and external stakeholders related to rights and obligations or, in order words, a system that controls the company. The purpose of corporate governance is to create added value for all stakeholders.  

The Indonesian government’s definition of corporate governance focus on SOEs, defines corporate governance as:

Corporate governance is a process and structure used by the state-owned enterprises’ organs to improve the success of the business and corporate accountability in order to increase shareholder value for the long-term while taking into account the interests of other stakeholders, based on legislation and ethical values.

The above definitions all have a highly normative meaning. That is, all these definitions fail to clearly disclose what is behind the concept of corporate governance. Corporate governance is not simply about how a company is directed and controlled. However, corporate governance is a system whereby shareholders can benefit from their investment. This is stated by Shleifer and Vishny; ‘corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment’. Similar to Shleifer and Vishny’s assertion, La Porta et al.’s definition of ‘a set of mechanisms through which outside investors protect themselves against expropriation by the insiders’ reveals what is the underlying concept of corporate governance. From this definition, it can be seen that La Porta et al. divide the types of company players into two: outsiders and insiders. They classify both controlling

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13 I Nyoman Tjager et al, Corporate Governance: Tantangan dan Kesempatan Bagi Komunitas Bisnis Indonesia (PT Prenhallindo, 2003), 26
14 The Degree of Minister for State-owned Enterprises No. KEP-117/M-MBU/2002
shareholders and managers as insiders, while investors and minority shareholders are classified as outsiders.\textsuperscript{17} In addition to coining the idea of the division of company players, La Porta et al. bluntly illustrate that the corporate governance tenet has been designed to protect the outsiders’ interests.

Perhaps La Porta et al.’s definition can be regarded as a working definition, as opposed to a normative meaning, because this is a result of their series of empirical works on investor protection in the United States.\textsuperscript{18} During their study, La Porta et al. witness the diversion of outsider’s money by insiders. They believe that the situation occurs due to an asymmetric information problem between outsiders and insiders. The asymmetric information problem typically takes place because insiders as the company’s majority shareholders and the controlling management do not share transparently the company’s vital information.\textsuperscript{19}

\subsection*{2.1.2 Systems of corporate governance}

The definitions of corporate governance discussed above lead to the formation of two district categories of corporate governance, and they are the Anglo-American corporate governance and the Continental Europe system also often called the German-Japanese

\textsuperscript{17} Ibid.
\textsuperscript{19} La Porta et al., above n 16, 4.
model. The former is credited as being the dominant model, while the latter is its challenger.²⁰

### 2.1.2.1 Anglo-American system

The Anglo-American model is called arm’s-length since the company’s shareholders control shares they have at a distance by putting their trust in the company’s management to run daily activities.²¹ This exists in the US and the United Kingdom (UK). This is because the majority of the US and UK’s large companies are listed in stock exchanges. As stated by Moerland 99 per cent of the top 400 US companies are listed on a stock exchange, while 67 per cent of the top 100 UK firms are listed corporations.²² This model emphasises the company’s shareholders value, shareholder-management relations, and positioning market as a supervising tool as its features; therefore, it also can be illustrated as an outsider model.²³

There are two major theories of the Anglo-American corporate governance model, and they are the principal-agent or the finance model and the myopic market model. The finance model is concerned with the maximisation of shareholders’ prosperity in which the shareholders’ prosperity is regarded as a social function of the corporations.²⁴ As

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Friedman states, making profits in a free market for the company’s shareholders is the only role of a company in the community. Consequentially, other social functions should not hinder the company from realising its goal; thus, those functions should be undertaken by the government and charitable organisations. For the Anglo-American model’s supporters, when corporations are managed properly to make the most of shareholder value, the performance of the economic structure at large can be straightforwardly improved.

As the finance model, the myopic market model also supports the maximisation of shareholders’ affluence as a key company target. However, it criticises the financial model on the basis that such a model is too focused on the short-term interests of company performance, such as short-term return on investment, short-term corporate profits, short-term management performance, short-term stock market prices, and short-term expenditure. It neglects the corporations’ long-term value and competitiveness. Thus, the myopic market model suggests that the restructuring of corporate governance reform should be conducted by encouraging shareholders and managers to share long-term performance horizons, including ‘increasing shareholders’ royalty and voice, reducing the ease of shareholders’ exit, restricting the takeover process and voting rights for short-term shareholders, encouraging relationship to lock financial institutions into

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26 Ibid.  
27 O’Sullivan, above n20, 43  
29 Letza et al., above n 50, 19
long-term positions and empowering other groups such as employees and suppliers to form long-term relationship with the firm’.  

Scholars summarise the main characteristics of the Anglo-American model, and they are:

- Corporations’ shares are owned by minority shareholders, or a fragmented ownership.
- Independent directors play an important role on the board of directors, and become a key part of corporate monitoring.
- Freedom of employment exists as employees are connected to the company through employment contracts.
- There is a fairly sound legal system in terms of mandatory information disclosure, control of inside trade, and protection of minority shareholders.
- The maximisation of shareholders’ value is its primary goal.
- A well-developed financial market is positioned as a firm’s supervising instrument.

2.1.2.2 The Continental Europe System

A close relationship between a corporation and its capital providers, including shareholders and bankers and other financial institutions, are the core elements of the insider/control-oriented model. Japan and the Continental European countries such as

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30 Letza and Sun, above n 54, 32
32 Yuan Dujuan, ‘Inefficient American Corporate Governance under the Financial Crisis and China’s Reflections’ (2009) 51 International Journal Law and Management 140–1
33 Moerland, above 22, 19
Germany are considered representative of the model.\textsuperscript{34} This is called the insider model as it gives room for stakeholders, in addition to shareholders, to be company board (supervisory board) members.\textsuperscript{35}

The major notions of the insider perspective are the abuse of executive power and the stakeholder models.\textsuperscript{36} The abuse of executive power model is a criticism of the Anglo-American arrangements, which provide greater power in the hands of the executive management that has potential to distort that authority for their own interests at the stockholders’ expense and that of society. The model’s supporters criticise that the problem of the abuse of executive power cannot be resolved even if the Anglo-American corporate governance model has introduced institutional restraints on managerial behaviour such as non-executive directors, the audit process, and the threat of takeover.\textsuperscript{37} Executive overpay, in which the executive management sets their own large salaries that are not comparable to the performance of the company, is one of the examples of the abuse of executive power.\textsuperscript{38}

The proponents of the notion doubt that the corporate governance reforms, such as non-executive directors, shareholder involvement in major decisions and fuller information about corporate affairs, are appropriate monitoring instruments.\textsuperscript{39} Therefore, the abuse of executive power proponents propose the idea of ‘managerial freedom with

\textsuperscript{34} Fanon, above n 49, 425.
\textsuperscript{35} Ibid.
\textsuperscript{36} Letza et al., above n 24, 19.
\textsuperscript{37} Ibid.
\textsuperscript{38} Ibid.
\textsuperscript{39} Ibid 20.
accountability’, which is to let the decision-making management to build up the longer-term company, while holding them strictly responsible to all stakeholders involved in the company.\(^\text{40}\) Meanwhile, the stakeholder’s proponents believe that a corporation has responsibility to individuals and groups in addition to the company’s capital providers.\(^\text{41}\) The notion recognises the existence of other company’s group i.e. employees, suppliers, customers and managers, who have a continuing connection with the company.\(^\text{42}\)

Unlike the shareholder perspective, the stakeholder model sees that corporate governance’s aim is to maximise the business’ value.\(^\text{43}\) Thus, from the perspective of stakeholder theory, two stakeholder group exists: first, the primary stakeholders, i.e. minority shareholders, lenders, costumers, employees, suppliers and management; and second, the secondary stakeholders, including local community, the media, the court, the government, special interest groups and the public.\(^\text{44}\)

Simply put, scholars summarise the main features of the Continental Europe System, as follows:

- Giving the opportunity for the company’s stakeholders like employees other than shareholders to be company board members;
- Closely held corporations;
- The existence of block holders ownership or group members;

\(^{40}\) Ibid.
\(^{42}\) Letza et al., above n 50, 20.
\(^{43}\) Ibid.
\(^{44}\) Ibid.
The involvement banks as capital provider and corporations’ controller;\textsuperscript{45}

Two boards (board of directors and supervisory board) exist, and;

Monitoring a corporation’s management by external market is rare.\textsuperscript{46}

2.2 APPLICATION OF LA PORTA ET AL.’S CORPORATE GOVERNANCE FOR INDONESIAN SOEs

The question that arises after consideration of the two district categories of corporate governance is: which corporate governance model or models are applicable to Indonesia? According to Indreswari, Indonesia adopts the Anglo-American model for its corporate governance system,\textsuperscript{47} though Indonesia employs two-tier structure model with the board of commissioners and board of directors (management board) present as two compulsory organs in every single of company. Similar to this, Worang and Holloway state that, Indonesia, including in the SOEs sector, employs the dominant system.\textsuperscript{48} This evidently can be learnt from the content of code of Indonesian corporate governance, which will be discussed further in the next section, and in depth in paper 2. Also, this can be understood from the history of corporate governance: through an examination of the role of the IMF, one of the International Financial Institutions (IFIs) that has role to spread the Washington Consensus’ mission in introducing the concept of corporate governance in Indonesia. In addition to the IMF two others IFIs, the Asian Development bank and the World Bank, also get involved in the implementation of the Anglo-American corporate

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\item \textsuperscript{45} Moerland, above n 22, 19.
\item \textsuperscript{46} Yang, above n 31, 17.
\item \textsuperscript{47} Meidyah Indreswari, \textit{Corporate Governance in the Indonesian State-Owned Enterprises} (PhD Thesis, Massey University, 2006) 15.
\item \textsuperscript{48} Frederik G. Worang and David A. Holloway, ‘Corporate Governance in Indonesian State-Owned Enterprises: Feeding With Western Ingredients’ (Winter 2006-2007) 4(2) \textit{Journal of Corporate Ownership and Control} 205, 22.
\end{itemize}
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governance regime in Indonesia by being financial providers in the promulgation of Indonesian code of corporate governance.\textsuperscript{49}

Seen from the historical perspective, corporate governance became an important issue in Indonesia when the IMF came to insist that the Indonesian government applied the idea. The IMF came to Indonesia to assist the country out of the 1997 Asian Financial Crisis. The crisis was an unforgotten economic tragedy in which Indonesia faced a dreadful financial situation. The value of the rupiah at mid-August 1997 lost 27 per cent against the US dollar.\textsuperscript{50} In addition, the Indonesian currency depreciated by nearly 80 per cent and some businesses, particularly in the banking sector had shrunk.\textsuperscript{51}

According to the IMF, Indonesia’s economic woes were caused by the poor corporate governance practices of Indonesia’s corporate sector, both private companies and SOEs. Thus, a restoration of the governance system of companies was required.\textsuperscript{52} In the SOEs sector, a scholar points out that the main factors of such poor governance practices were intervention from the government in daily SOEs activities, lack of internal control, flaws in accounting practices, deficient auditing standards and practices, and arbitrary subsidies and protection that destabilised Indonesian SOEs.\textsuperscript{53}

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\textsuperscript{49}Ibid, 9.
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\textsuperscript{53}Indreswari, above n 47, 346.
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The Government of the Republic of Indonesia followed the IMF’s plans to apply the Anglo-American corporate governance model. In 1999, the Indonesian government through the Coordinating Minister for Economy, Finance and Industry established the National Committee on Corporate Governance (NCCG). Codifying corporate governance principles and developing an institutional framework to implement the code were two main duties of the committee.\(^5^4\) Subsequently, in March 2000, the committee successfully established the Code for Good Corporate Governance.\(^5^5\) This applied to SOEs and companies listed on the Jakarta Stock Exchange. In 2004, the government changed the NCCG to the National Committee on Governance (NCG), which embraced the Public Governance Sub-committee and Corporate Governance Sub-committee.\(^5^6\) In 2006, the NCG reviewed the Code for Good Corporate Governance under the title Indonesia’s Code of Good Corporate Governance.\(^5^7\)

In the SOE sector, the implementation of the concept began through the introduction of new laws and regulations, for instance, Law No. 19 of 2003 concerning State-Owned Enterprises and Law No. 40 of 2007 regarding Limited Liability Companies. In 2002, before those laws were enacted, the government issued the Minister for State-Owned Enterprises’ regulation No. KEP-117/M-MBU/2002, which is the legal basis for the implementation of the corporate governance concept in the SOE sector. As the legal basis of implementing corporate governance in the SOEs sector, the decree prescribes that

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\(^5^5\) Daniel, above n 75, 360.


\(^5^7\) Ibid.
SOEs are obliged to consistently apply the concept of corporate governance and/or establish corporate governance as their operational basis.\(^{58}\) The concept of corporate governance applies to all Indonesian SOEs regardless of category.

As noted above, La Porta et al. divide a company’s owners into two types: insiders and outsiders. Put differently, to La Porta et al., no company is owned by a single acting owner. This, of course, contrasts sharply with the Indonesian pure SOEs: as the companies owned by public with the government as acting shareholder, the division of shareholders is not in existence. In that sense, because the SOE shares are concentrated in the hands of the acting shareholders, the government, there is no division of types of shareholders in the SOEs.

However, through the IMF’s insistence, La Porta et al.’s division of company owners has been applied to Indonesian SOEs, which is a prescription for dealing with the problem with the SOEs. The existing laws and regulations that relate to the implementation of corporate governance within the SOE sector promote this prescription by way of the privatisation program. This can be clearly found in the Minister for SOEs’ decree No. KEP-117/M-MBU/2002, which states that one of the goals in implementing corporate governance in Indonesian SOEs is ‘to make a success of the privatisation program’.\(^{59}\)

Further, the desirability of privatisation is also clearly provided in article 72, paragraph 2, point d, which holds that one of the goals of restructuring SOEs is ‘to facilitate the

\(^{58}\) Article 2, paragraph 2, The Degree of Minister for State-owned Enterprises No. KEP-117/M-MBU/2002.

\(^{59}\) Article 4 point f of KEP-117/M-MBU/2002.
implementation of privatisation.\textsuperscript{60} Thus, the privatisation program can be regarded as an agenda to meet La Porta et al.’s definition of corporate governance. In the context of SOEs, the meeting of La Porta et al.’s assertion conforms to the Washington Consensus’ agenda to privatise targeted countries’ SOEs. The Washington Consensus’ agenda on privatisation is closely related to the state ownership problem in SOEs that has been criticised by scholars.

In summary, the Anglo-American corporate governance that was adopted by Indonesia aims to deal with the problem of the expropriation of shareholders’ assets by managers due to the separation of ownership and control\textsuperscript{61} that is caused by the widely fragmented company ownership. This conforms to La Porta et al.’s definition of corporate governance as a modern company consists of insiders and outsiders in which insiders are possibly illegally taking the outsiders’ money invested in the company because of the weak position of outsiders because of the asymmetry of information.

2.3 THE ORIGINS OF CORPORATE GOVERNANCE

This section looks at the origins of the dominant model of corporate governance, the Anglo-American model, rather than that of its challenger, the German-Japanese model. This is because, as above-mentioned, Indonesia employs the Anglo-American model, though Indonesia is a follower of civil law system with double boards (board of commissioners and board of directors) as its main characteristic.

\textsuperscript{60} According to Article 72, paragraph 1, Law No. 19 of 2003 Concerning State-Owned Enterprises, the restructuring carried out with the intention to improve SOEs in order to be efficient, transparent and professional companies.

2.3.1 From the saga of separation of ownership and control

The origins of corporate governance are related to Adam Smith’s legacy, the *Wealth of Nations*. Smith, who has been credited as a father of corporate governance, argues that a company manager who manages ‘other people’s money’ will not be as serious in this work as he is when managing his own money. Smith’s widely quoted words are:

> The directors … of companies … being the managers of other people’s moneys and not their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partner in a private co-partnery frequently watch over their own… Negligence and profusion therefore must always prevail more or less, in the management of affairs of such a company.

Smith’s term ‘other people’s money’ implies that because of company owners' restriction to manage their company directly, professional people are needed to operate the company. Smith’s school of thought on ‘other people’s money’ is presumed as the underlying idea of contemporary corporate governance in which company principals are not recommended by Smith to put their trust in the company’s directors without proper control.

The Smith's work has been extended by Adolph A. Berle and Gardiner C. Means through their influential book *The Modern Company and Private Property* with widely dispersed ownership of corporation was the original theoretical point. By conducting a study of larger US companies following the Wall Street crash of 1929, Berle and Means conclude that the separation of ownership and control is attributable to widely dispersed

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65 Julian Roche, *Corporate Governance in Asia* (Routledge, 2005), 1.
They observed that ‘the owner of industrial wealth is left a mere symbol of ownership as the control over companies really lies with professional managers’. Evidently, Berle and Means witness that just about half of large American companies did not have a sole owner who controlled more than 20 per cent of the shares, and argued that the dispersed owners surrendered the control of companies to senior managers and board members, which, in practice, creates the principal-agent relationship. The principal-agent relationship can create agency problems as such agents may expropriate the principals’ investments. As stated previously, this can occur when the agents have more information and knowledge than the principals do or when information asymmetry between principals and agents exists. Plainly, the underlying assumption of corporate governance concept is that a fundamental tension is prevalent among shareholders and company managers.

Berle and Means’s work was then promoted by Jensen and Meckling, who argue that the separation of ownership and control is a common problem in modern corporations. Therefore, they hold that a governance mechanism is needed to diminish the agency problem that exist as a result of the divorce of ownership and control especially in large

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67 Roche, above n 65, 2.
68 Ibid.
70 Yuwa Wei, Comparative corporate governance: a Chinese perspective (Kluwer Law International 2003), 43.
72 Roche, above n 65, 2.
public corporations. Likewise, Fama and Jensen suggest that separation of ownership and control mainly arises in large corporations, such as publicly held and listed corporations in which the owners are dispersed, and they state that corporate governance is the mechanism to deal with that issue.

2.3.2 From an ideological perspective

Further, the origins of the concept of corporate governance can be learnt, too, from the perspective of ideology. Corporate governance is a product of neo-liberalism. Classical and modern liberalism are two types of liberalism. The idea that a government should not be involved in commerce and industry activities is one of the key concepts of classical liberalism. In addition to Sir William Petty, John Locke, Alexis de Tocqueville and Friederich van Hayek, the prominent scholar of corporate governance, Adam Smith, is credited as one of the leading scholars of classical liberalism. Through his influential book the Wealth of Nations, Smith systematically examines the function of free trade or \textit{laissez-faire}. According to Smith, the invisible hands along with competition have

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74 Carol Padgett and Amama Shaukat, 'The UK Code of Corporate Governance: Link between Companies and Firm Performance' (2005) \textit{ICMA Centre Discussion Papers in Finance DP2005-17}
76 Jochen Zimmermann, Igor Goncharov and Joerg R. Werner, 'Does Compliance with the German Corporate Governance Code Have an Impact on Stock Valuation? An empirical analysis' (2006) 14 \textit{Corporate Governance International} 434
78 Dag Einar Thorsen and Amund Lie, 'What is Neoliberalism?' (2008) \textit{Department of Political Science University of Oslo} \texttt{<http://folk.uio.no/daget/What%20is%20Neoliberalism%20FINAL.pdf>}
79 Ibid
81 Thorsen and Lie, above n 78
paved the basis of the market mechanism.\textsuperscript{82} Classical liberalism achieved its peak success in the period from 1800 to 1930 when it failed to deal with the Great Depression that took place in 1930s.\textsuperscript{83}

Learning from the experience of the 1930s Great Depression, John Maynard Keynes made a division between classical and modern liberalism.\textsuperscript{84} Keynes argues that state intervention is needed to administer a country’s economic activities. He extends his argument that ‘the economic cycle was largely driven by swings in the strength of demand. If demand in the private sector begins to flag, businesses lose confidence and stop investing—and providing incomes for workers—then the government should step in to fill the void’.\textsuperscript{85} To Keynes, essentially, the state has an obligation to ensure community welfare by being a provider of goods and services.\textsuperscript{86} The modern liberalism theory reached its triumphant in the period between 1945 and 1970.\textsuperscript{87}

Following the glory of the modern liberalism, Milton Friedman developed the notion of neo-liberalism, which is considered the renaissance of classical liberalism. As in classical liberalism theory, neo-liberalism also views the market as an omnipotent factor in the economy. According to Friedman, practical agendas such as cutting tax, reducing public spending, conducting deregulation and the privatisation of SOEs should be done to revive

\begin{itemize}
\item \textsuperscript{82} Torbat, above n 80.
\item \textsuperscript{84} Kamal and Rahim, above n 77, 5.
\item \textsuperscript{87} Thorsen and Lie, above n 78, 8.
\end{itemize}
the concept of *laissez-faire* capitalism. In other words, in addition to cutting tax, reducing public spending and deregulation, privatisation of SOEs are Friedman’s agenda to revive the neo-liberalism theory.

In practical matter in the modern world, two IFIs, the World Bank and the International Monetary Fund (IMF), are identified as the Bretton Woods institutions that, in addition to the World Trade Organization (WTO), have the task of spreading Friedman’s program through the so-called Washington Consensus. Put differently, two such IFIs are the Washington Consensus’ agents that have the responsibility to implement the good economic policy of the Washington Consensus. Peev notes that the Washington Consensus formulates three basics corporate governance, and they are ‘(1) Separation of ownership and control between small shareholders and top manager; (2) The inefficient role of the state both as owner of public enterprises and as regulator of economics activities; (3) Inefficient socialist state ownership and ‘totalitarian’ state’.

Further, the IFIs run their tasks under a political mantra of the ‘Ten Commandments’, which are: fiscal discipline; the redirection of public expenditure to basic education, primary health care and infrastructure; tax reform; interest rate liberalisation; competitive exchange rates; trade liberalisation; the liberalisation of FDI flows; privatisation;

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88 Torbat, above n 80.
deregulation; and secure property rights.\textsuperscript{92} Another form of guidance for the agents is the so-called ‘Ten Commandments Plus’, consisting of central bank independence and inflation targeting; reform of both the public sector and private sector governance; a flexible labour market; WTO agreement and harmonisation of national standards with international standards in business and finance, but with exceptions (most notably environment and labour); strengthening the national financial system to facilitate the eventual capital account liberalisation; sustainable development; protecting the vulnerable through safety nets; poverty reduction strategy; country ownership of policy agenda; and democratic participation.\textsuperscript{93}

Corporate governance is part of the reform of public and private sectors governance agenda as stated in the ‘Ten Commandment Plus’. The term ‘public governance’ is used for the public sector and the term ‘corporate governance’ is used for the private sector.\textsuperscript{94} The corporate governance program in fact complements the main agenda, privatisation, which is one of the ‘Ten Commandments’. A scholar bluntly states that ‘the underlying idea of Washington Consensus is a shift from state-led policies to market oriented’.\textsuperscript{95}

\textbf{2.4 AGENCY RELATIONSHIP AND STATE-OWNED ENTERPRISES}

As has been mentioned the Anglo-American model is the corporate governance mechanism adopted by Indonesia. Given that agency theory—a dominant theory of corporate governance in all business sectors including state-owned enterprises (SOEs),

\textsuperscript{92} Beeson and Islam, above n 90, 202.
\textsuperscript{93} Ibid.
\textsuperscript{94} Kamal and Rahim, above n 77, 8.
\textsuperscript{95} Peev, above n 91, 5.
should be examined. Agency problems and the principal-agent (PA) relationship are two inherent themes of discussion in the agency theory. It is generally assumed that the agency problem is a common issue for modern corporations, since it stems from PA relationships. The PA relationship is attributable to the absence of a principal within a company, that is, the individual who manages the company directly. In essence, the agency theory departs from the literature on PA relationship, which possibly gives rise to agency problems.

2.4.1 Agency Theory

Jensen and Meckling are credited with the development of the agency theory with the help of contributions from Smith, Berle and Means, Ross and Alchian and Demsetz. They essentially indicate that the theory is concerned with the unfolding of the contracts and relationships between individuals (principals and agents), often rendered by the parties who do not have equal information. It covers all interactions involving cooperative effort and the delegation of tasks and decision making by one party (principal) to another (agent). Shankman argues that the agency theory focuses on the agency relationship in which agents (individuals or groups) have definite duties towards their principals (another individual or group) that are based on their economic

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96Jensen and Meckling, above n 73.
97Smith above n 63.
98Berle and Means, above n 64.
connection.\textsuperscript{103} Lutbakin et al. explain that ‘...agency theory is concerned with problems that can arise in any cooperative exchange when one party (the principals) contract with another (the agents) to make decisions on behalf of the principals’.\textsuperscript{104}

The agency theory assumes that a human being is self-serving, individualistic and opportunistic and tends to maximise his or her own interests at the expense of owners. Therefore, in a company, a difference in aims between the agents and principals is almost always present.\textsuperscript{105} The agency theory has been designed to cure an agency problem. It ensures the harmonisation of the interests of the principals and agents, attempting to lessen agency problems or PA problems that result from friction in PA relationships.\textsuperscript{106} In other words, as Arnold and Lange explain, agency theory clarifies how best to organise the PA relationships,\textsuperscript{107} with the intention of ensuring that the relationship is smooth.

Eisenhardt shares a theoretical overview of the agency theory. She states that the theory attempts to ensure smooth functioning PA relationships and efficient structuring of information and risk-bearing costs. She views a contract between the principal and the agent as a unit of analysis of the theory. Self-interest, bounded rationality and risk-aversion are three human assumptions of the theory. In terms of the organisational aspects, the theory assumes partial goal-conflict among participants, efficiency as the criterion for effectiveness and information-asymmetry between the principal and the

\textsuperscript{103}Neil A. Shankman, ‘Reframing the Debate Between Agency and Stakeholder Theories of the Firm’ (1999) 19 Journal of Business Ethics 319, 321
\textsuperscript{104}Michael H. Lutbakin et al, ‘Origins of Corporate Governance in the USA, Sweden and France ’ (2005) 26(26) Organization Studies 23, 868
\textsuperscript{105}Adelopo, above n 11, 141
\textsuperscript{106}Shankman, above n103, 321
\textsuperscript{107}Beth Arnold and Paul de Lange, ‘Enron: An Examination of Agency Problems’ (2004) 15 Critical Perspectives on Accounting 15, 753
agent. Eisenhardt views information as a purchasable commodity and a contract as an item that potentially creates agency as well as risk-sharing problems. Having said this, agency relationships are the domain of the agency theory, and within it, the principal and the agent have partly differing goals and risk-preferences. Table 1 depicts the overview of Eisenhardt’s agency theory. 108

Table 1: Overview of the agency theory

<table>
<thead>
<tr>
<th>Key idea</th>
<th>Principal-agent relationships should reflect efficient organisation of information and risk-bearing costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit of analysis</td>
<td>Contract between principal and agent</td>
</tr>
<tr>
<td>Human assumptions</td>
<td>Self-interest, Bounded rationality, Risk-aversion</td>
</tr>
<tr>
<td>Organisational assumptions</td>
<td>Partial goal-conflict among participants, Efficiency as the effectiveness criterion, Information-asymmetry between principal and agent</td>
</tr>
<tr>
<td>Information assumptions</td>
<td>Information as a purchasable commodity</td>
</tr>
<tr>
<td>Contracting problems</td>
<td>Agency (moral hazards and adverse selection), Risk-sharing</td>
</tr>
<tr>
<td>Problem domain</td>
<td>Relationships in which the principal and the agent have partly differing goals and risk-preferences (e.g. compensation, regulation, leadership, impression management, whistleblowing, vertical integration, transfer pricing)</td>
</tr>
</tbody>
</table>

Source: Eisenhardt (1989)

Positivist and PA research are the two streams of the agency theory. The positivist agency theory is mainly concerned with describing the methods of governance that are aimed at solving the agency problem. PA research is concerned with the theoretical aspects of the PA relationship, which includes relationships such as employer–employee,

lawyer–client and buyer–supplier. Both these streams contribute to a general unit of analysis, which is the contract between the principal and the agent. In addition, such streams share a broad hypothesis on people, organisations and information.\(^\text{109}\)

2.4.2 PA Relationship

As mentioned earlier, the agency theory revolves around PA relationships. The PA relationship is forged when one party hires another to perform certain tasks and act on behalf of the hirer.\(^\text{111}\) Examples of PA relationships can be found in everyday activities. All types of agreements, not necessarily in writing,\(^\text{112}\) conducted by the employer and the worker, for example, can be categorised as an agency relationship.\(^\text{113}\) A mason who is hired by someone to build a house is a simple example of an agency relationship or a PA relationship.

In corporations, the PA relationship develops when a company’s principal enters into an agreement with professional managers to run the company on his behalf. Ross argues that ‘an agency relationship [PA relationship] has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems’.\(^\text{114}\) In the same vein, Jensen and Meckling define the PA relationship as a ‘contract under which one or more person (the principal(s)) engage to another person (the agent) to perform some

\(^{109}\) Ibid.

\(^{110}\) Ibid, 59.


\(^{113}\) Ross, above n 99, 134.

\(^{114}\) Ibid.
services on their behalf that involves delegating some decision-making authority to the agent’.\textsuperscript{115} In other words, a PA relationship emerges when a company’s shareholders, deemed as principals, and managers, acting as the agents, are bound in a contract that involves delegation of certain tasks to the agents on behalf of the principals.\textsuperscript{116}

A PA relationship will not prevail in a company that is run by the principal alone. However, it can exist even if the company’s principals are involved in the company operations\textsuperscript{117} or if the ownership and the operations of a company are separated.\textsuperscript{118} The separation of ownership and control is typically attributable to dispersal of the company’s shares. In essence, the principals of a company whose shares are distributed lose their power to control or monitor the company’s activities because their role transforms from an active doer to a passive viewer. This also means that the control rests in the hands of the agents, who are hired by the shareholders to drive day-to-day business actions.\textsuperscript{119} In essence, the principals of a firm hardly ever get involved in the firm’s daily activities.\textsuperscript{120}

\textsuperscript{115}Jensen and Meckling, above n 96, 307.
\textsuperscript{116}Al-Najjar, above n 111, 177.
\textsuperscript{119}Indreswari, above n 47, 25.
\textsuperscript{120}Tarmizi Achmad, Corporate Governance of Family Firms and Voluntary Disclosure: The Case of Indonesian Manufacturing Firms (PhD Thesis, The University of Western Australia 2007).
2.4.3 PA Problem

PA relationships result in agency problems mainly because of a conflict of interests between the principals and the agents.¹²¹ Further, an agency problem can occur when the principal and the agent have dissimilar objectives and disagree over the division of work while executing their functions.¹²² A primary reason for the conflict is usually an imperfect contract. In fact, imperfections in the contract are not uncommon given the high costs of contracting. Hart explains the three costs of contracting that lead to less-than-perfect contracts:

First, there is the cost of thinking about all the different eventualities that can occur during the course of the contractual relationship, and planning how to deal with them. Second, there is the cost of negotiating with others about these plans. Third, there is the cost of writing down the plans in such a way that they can be enforced by a third party - such as a judge - in the event of a dispute.¹²³

The incomplete nature of the contract is then exacerbated by the nature of people who are opportunistic and self-interested (alert to take full advantage of their own interests), organisations (with goal-conflicts among its members)¹²⁴ and the fact that information in organisations is typically distributed asymmetrically, making it hard for principals to ascertain what the agents have actually done.¹²⁵ Information-asymmetry occurs when the agents have more information about the company than its owners, and this is possible by the agents getting involved in the day-to-day activities of the company.¹²⁶

¹²²Ibid.
¹²⁵Lutbakin et al, above n 104, 868.
¹²⁶Adelopo, above n 105, 142.
In terms of the nature of the people, Ronald Coase warns us that people are selfish, unreliable and tend to act to satisfy themselves as opposed to the interests of the principals.\textsuperscript{127} Put differently, agents are naturally constantly tempted to maximise their own gains at the expense of the principals.\textsuperscript{128} With regard to information-asymmetry, the agency problem expands because agents are free to hide information crucial to the company and/or they may undertake manoeuvres that benefit them alone.\textsuperscript{129} The information-asymmetry prevails because principals do not have the ability to control the activities of the agents in running the company, as a commentator put it.\textsuperscript{130}

Further, the PA framework has focused on two aspects of the agency problem: moral hazards and adverse selection, both outcomes of incomplete information and uncertainty. Agents who do not do their jobs seriously are referred to as moral hazards. The argument here is that the agents do not implement the agreements that have been approved. Adverse selection refers to misrepresentation of capabilities possessed by the agent. This refers to the practice of an agent falsely claiming to possess skills and abilities that he actually lacks.\textsuperscript{131}

A company hiring a scientist to work on its research project is an example used by Eisenhardt for explaining the two aspects of the agency problem—moral hazard and adverse selection. She states that moral hazards occur when the company management cannot understand the nature of scientist’s work because the research project is far too

\textsuperscript{127}Ronald Coase, 'The Nature of the Firm' (1937) 4 Economica 19.
\textsuperscript{128}Fontrodona and Sison, above n 112, 34.
\textsuperscript{129}Lutbakin et al, above n104, 868.
\textsuperscript{130}Arnold and de Lange, above n 107, 753.
\textsuperscript{131}Eisenhardt, above n 108, 61.
complex to be easily understood. Adverse selection, in such a case, deals with the inability of the company management to verify the scientist’s claim about his or her abilities. That is, when the research scientist claims to have skills in a scientific specialty, the hiring company is unable to judge whether or not the claim is true.\(^{132}\)

According to Eisenhardt, there may be two forms of PA problems in existence—the agency problem and the problem of risk-sharing. The first problem arises when ‘(a) the desires or goals of principal and agent conflict; and (b) that it is difficult or expensive for the principal to verify what the agent is doing’. The inability of principals to ensure that the agents are acting appropriately is a key aspect of the agency problem.\(^{133}\) With regard to the second problem (risk-sharing), Eisenhardt argues that it exists when the principal and the agent have dissimilar approaches to risks. The diverse set of actions taken by the principal and the agent in resolving risks motivated by the different risk-preferences constitute the key factors of the risk-sharing problem.\(^{134}\)

In summary, the selection of an appropriate mechanism of governance between the principal and the agent that results from a contractual relationship—irrespective of whether the contract is in writing or not, is the central focus of the agency theory. The theory guarantees an efficient alignment of PA interests, which is to ensure the agents serve the principals’ interests, and thereby minimise agency costs.\(^{135}\)

\(^{132}\)Ibid.
\(^{133}\) Ibid.
\(^{134}\) Ibid.
\(^{135}\) Shankman, above n103, 321.
2.4.4 PA Problem in SOEs

Departing from the perspective of the agency theory, this thesis considers shareholders as the owners or the principals of a company, given that there are differing views on who owns a corporation from the legal and economic standpoints. According to lawyers, a company’s shareholders cannot be regarded as its principals because a corporation is a ‘legal person’ that has its own assets and name. Thus, as a ‘legal person’, a company has the capacity act like a human being in a legal relationship.\(^\text{136}\) Economists, in contrast, state that a corporation is owned by its shareholders because they hold its residual rights.\(^\text{137}\) Hence, the company’s principals have the right to monitor and control its affairs.\(^\text{138}\)

Researchers explain that within a private company, principals and agents are reasonably easy to identify.\(^\text{139}\) This is because ownership in a private company is indicated by number of shares within the company.\(^\text{140}\) The shares of a private company are transferable, and the transferability implies that shareholders can sell their shares any time if they are not happy with the decisions of the company’s managers.\(^\text{141}\) This means that individuals who legally hold a company’s shares are considered the owners of the company.


\(^{137}\) Ibid, 409.

\(^{138}\) Ibid, 410.


\(^{140}\) Zeckhauser, above n 117, 10.

However, the ownership of SOEs is slightly different from that of privately owned corporations. Scholars reveal that it is difficult to identify the principals of an SOE. The principals of SOEs are neither a few people nor an organisation, albeit scholars claim that a country’s citizens are owners or principals of an SOE. For instance, Zhou and Wang, in their study on China’s SOEs, argue that the Chinese citizens are the principals of the SOEs.

However, from the economic point of view, considering ordinary public as the principals of SOEs presents a complex ownership challenge for SOEs. This is because the country’s citizens do not have direct possession of the SOE and the citizens’ ownership in the SOE cannot be transferred. Hence, the complexity of identifying the principals seems to be a determinant factor governing SOEs. One of decisions it affects is identifying the entity that is expected to act on behalf of the principals in monitoring the SOEs’ managers.

The complexity of SOEs’ ownership has been discussed by several scholars. In their study of Singapore’s SOEs, Anwar and Sam discuss the uniqueness of the ownership of SOEs. They divide the ownership structure into two layers. In the first layer, the ordinary

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142 Aharoni, above n 139, 1342.
143 Ibid, 1729.
146 Sokol, above n 141, 1713.
147 Wicaksono, above n 145, 9.
public is assumed to be the principal of the SOEs. Anwar and Sam argue that if the public is viewed as the principal of the SOEs, then the state or the government, including cabinet ministers and/or members of parliament, can be considered the public’s agents. From Anwar and Sam’s first layer, a PA relationship can be defined as the relationship between the ordinary public and the government. In other words, Sokol holds that the PA relationship in the SOE context is one that exists between the taxpayers and the government instead of between the government and the SOEs’ managers. Accordingly, the government acts as the agent on behalf of the citizens in maintaining the SOEs and has a responsibility to run the SOEs in accordance with public interest.

In the first layer, a PA problem arises when the interests of the public and the government differ because of the latter’s inability to ascertain the needs of the public. This, according to Anwar and Sam, is because the word ‘public’ represents a vast majority of people, and in real life the individual interests of the members are unlikely to be uniform, and this is hard to recognise and define accurately.

In the second layer, the government is deemed as the principal of all SOEs, and the civil servants are seen as the agents. The government, in fact, is not only the citizens’ agent but also an SOE’s principal, since it is acting on behalf of the country’s citizens when running SOEs. The government enters into an agreement with the civil servants that

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149 Ibid.
150 Sokol, above n 141, 1729.
151 Sajid and Anwar, above n 148, 68.
152 Ibid.
153 Ibid.
spells out the latter’s rights and obligations, including their salaries, responsibilities and other benefits.\footnote{154} A PA problem in such cases stems from an imperfect agreement, for instance, when the contract fails to detail the working hours of the civil servants.\footnote{155}

In brief, as an agent, the government is responsible for running the day-to-day activities of the SOE, while as a principal stakeholder; the government is also under obligation to act in the best interests of the ultimate owners. Given that the government has dual roles to play in SOEs, namely, two types of owners can be seen to exist in the SOEs: actual owners (government) and ultimate owners (the public at large).

The debates surrounding the first layer of PA problems are rare and limited. Unlike the second layer situation, there have been no discussions and recommendations for PA problems in SOEs. While the two aspects of PA problems (moral hazards and adverse selection) are likely to occur in SOEs, no study, except for a single proposal of privatisation, has attempted to address the following problems: the country’s citizens do not have direct possession over the SOEs and the citizens’ ownership in the SOEs cannot be transferred.

This situation is probably significantly influenced by the general perception that SOEs are owned by the government and not by the public. This fact can be gathered, for instance, from laws governing SOEs in Indonesia (Law No. 19 of 2003). In Indonesia, members of the board of commissioners and directors are elected and dismissed by the

\footnote{154 Ibid.} \footnote{155 Ibid.}
government. In other words, the right to elect and dismiss the board of commissioners and directors is a manifestation of the government’s rights as the SOEs’ principal.

The scarce discussion on the first layer of ownership is evident in the singular suggestion proposed by scholars studying ownership structures of SOEs: privatisation.156 In other words, public ownership of SOEs has been presumed to be a major problem and one that can only be resolved by privatising the SOEs, a view that has been rejected by deeper discussions on both PA relationships and PA problems in SOEs. However, this view evidently prevails in Indonesia where the government officially states that one of the objectives of corporate governance is to promote the privatisation agenda.157

157Art. 72, Para 2, Point d of Law No. 19 of 2003 Concerning State-Owned Enterprises.