ROMEO GACAD/AFP

Is there hope for corporate governance in Indonesia?

Peter Verhezen
is a principal at Verhezen & Associates Ltd in Jakarta and a visiting associate professor at the University of Melbourne.

Natalia Soebagjo
is executive director of the University of Indonesia's Center for the Study of Governance and chairwoman of Transparency International Indonesia.

How serious are the Indonesian elite and top government officials about improving corporate governance in Indonesia and implementing or adhering to "best" practices? Although we see some promising improvements, Indonesia still lags behind its neighbors in terms of applying best governance practices within government and the private sector, potentially undermining its future political status and competitive advantage. If Indonesia wants to be taken seriously within the G20 and use its growing political influence more effectively, it will need to improve its overall governance practices at home. Despite Indonesia's perceived positive investment climate, serious investment pitfalls and governance risks loom behind the current rosy picture.

Obviously Indonesia, with the biggest economy in Southeast Asia, has enhanced its global status since the advent of its democratization process 15 years ago. Moreover, globalization continuously expands networks of interdependence that span intercontinental distances. Governance is defined as the processes and institutions, both formal

The cost of managerial self-interest and unethical behavior is estimated to be quite substantial in Indonesia.

and informal, that guide and restrain the collective activities of a group. Governance, therefore, can be interpreted as a set of authority relationships that have the legal power to make the ultimate effective decisions about resource allocation, which is a prerequisite for good financial and non-financial performance.

When talking about the relationship between public and corporate governance, one cannot ignore the uncomfortable fact that politically powerful groups often dislike outcomes produced by institutions aiming to implement good governance. Such outcomes may ignore long-term cozy relationships between powerful business elites and government officials. Governance, therefore, may become a contest rather than a way to secure fair treatment for all stakeholders. Generally speaking, Indonesian politico-bureaucrats in league with domestic conglomerate owners have strongly opposed drastic reform of corporate governance practices because they benefit from the status-quo. Organizations and society at large are likely better served by implementing market-driven best corporate governance practices rather than heavy-handed bureaucratic regulations. Society, however, may want to impose more rules and stricter governance-related regulations as a substitute for eroded trust in the ethical value of people. But it should be warned that public and investor trust cannot be achieved by stringent rules only.

Our hypothesis is simple and clear: corporate governance can only thrive where business can rely on fair rules of law, as proclaimed and enforced by good public and corporate governance.

Best practices

Corporate governance is concerned with the rules and mechanisms that guide the relationship among interested parties within a corporation, especially owners, boards and senior executives. These rules and mechanisms are intimately linked with national laws, regulations and corporate practices. Capital market regulations, corporate law and labor laws all affect good corporate governance practices. Corporate governance goes beyond just implementing the minimum standards and procedures of accountability and responsibility, and it also goes beyond mere compliance. Corporate governance is based on the principles of (1) transparency or openness; (2) accountability for one's actions and fiduciary duties; (3) fairness based on integrity or ethical values; (4) being responsible for the reputation of the firm, which can be affected by any relevant stakeholder; and (5) ultimately safeguarding equal rights for all shareholders.

It also means that the apex of power lies in the hands of an able, committed and independent board that oversees and steers the firm to long-term organizational value and profitability. The board should make sure all shareholders are fairly treated and that shareholder rights are protected, including minority shareholders. The legitimate concerns of relevant stakeholders and social obligations should also be taken into account in making strategic decisions. It must be noted that the legal interpretation of corporate governance applies to publicly listed companies. Nonetheless, we believe that private, unlisted firms can also benefit from implement-

ing good corporate governance practices. Although Indonesian conglomerates and state-owned enterprises have traditionally relied on banks for financing, corporate governance has become more important during the past few years because of a growing dependency on local and international capital and equity financing.

Corporate governance is ultimately about "steering" an organization to fulfill its mission and vision, underpinned by corporate values that function as beacons for its fiduciary duties and responsible behavior within the organization. Along with regulatory compliance, which is necessary but not sufficient to instigate responsible and responsive management in the boardroom, corporate governance mechanisms are meant to function as checks and balances on the power of senior management and reduce possible agency costs that result from such power. Most executives are professionals who are assumed to exhibit some self-restraint on moral grounds that can hardly be explained by rational self-interest that would maximize economic rewards. Such moral salience often depends on the personality of the executive, religious convictions and personal and financial circumstances, as well as the organizational culture and ultimately the norms of what is acceptable in Indonesia. The cost of managerial self-interest and unethical behavior is estimated to be quite substantial in Indonesia. Governance, therefore, aims to discourage costly, self-interested behavior, and its success will depend on the size of the potential agency costs, the ability of the control mechanism to mitigate those agency costs, and the cost of implementing particular control and monitoring mechanisms.

Most jurisdictions, including Indonesia, tacitly assume that directors and management have a duty of loyalty and diligence to act in the best interests of shareholders. Boards are usually held liable for breach of the following three legal obligations: compliance with legal or regulatory provisions applicable to the firm, observance of the articles of association of the company and duty of care or diligence in management. However, in emerging markets, the crucial question is how minority rights can be protected against possible expropriation by majority shareholders. Indeed, the board of commissioners' main task is to monitor and oversee the performance of the board of directors and the continuity of the organization. In addition, the non-executive directors or commissioners provide valuable advice and mentoring to top management.

The fiduciary duties of a board usually include a duty of care that requires directors to make decisions with due deliberation, a duty of loyalty that addresses conflicts of interest whereby the interest of shareholders should prevail over the interest of a director and a duty of candor that requires management and the board to inform shareholders of all information that is important in their evaluation of the company and its management.

These fiduciary duties are often translated in the legal requirement of having at least two or three professionally run subcommittees within the board: (1) a committee of internal audit and control to contain accounting and other specific risks; (2) a nomination committee that seeks to guarantee that the best professional chief executive officer will be chosen; and (3) a remuneration committee that decides on an appropriate and fair package for the most senior managers. Sometimes a subcommittee is installed to assess risks that are allied to a suggested

ROMEO GACAD/AFP

strategy. Governance systems are influenced by the owners of the firm, its managers, creditors, labor unions, customers, suppliers, investment analysts, the media, regulators and all those who could significantly affect the value of the company.

Admittedly, Indonesian corporations have made significant progress since the 1997-1998 Asian Financial Crisis. Most publicly listed companies have adapted best corporate governance practices, especially the installment of an independent (non-executive) director or commissioner on the board, and the establishment of an audit, nomination and remuneration committee within the board structure. However, quite a number of these improvements remain mere tick-the-box exercises that formally comply with rules imposed by the Capital Markets Supervisory Agency and other regulators. In line with the interests of the main block-holding shareholders controlling the board in most listed companies in Indonesia, these adaptations may have slightly improved transparency and fairness within the firm, but they have affected the real accountability and responsibility of owners and senior management. Let us call it a good first step. We should not forget that Indonesia's corporate structure is dominated by insiders who control the board and major decisions within the firm. It is obvious that the shareholder-value creation model, as the unique purpose of the company, has been dominant in the international investment community since 1990s.

However, the Asian crisis, which exposed the abuses of crony capitalism, and the recent global financial crisis with its systemic risks as a result of unmonitored self-interest, have tainted that shareholder model. Indeed, the recent global crisis and the Asian crisis of 1997 have shown that failures in corporate governance can destabilize an entire global or regional financial and economic system. Indonesian firms should embrace corporate governance to remain competitive by ensuring the implementation of best practices,

while acknowledging the particularities of the Indonesian business and institutional context. Companies should set a target of becoming key actors in promoting excellence in corporate governance. This would benefit Indonesian companies. One cannot ignore the fact that Singapore's excellent credibility in corporate governance has attracted global recognition and allowed it to become a regional center of financial and economic reliability and success. Despite Indonesia's recent healthy economic growth, it still lags behind in governance, which has resulted in a rather feeble reputation. Indonesia could perform much better with good governance in place.

Indonesia's corporate leadership should fine tune governance practices and acknowledge that the best performing "great firms" have vision and a purpose beyond mere short-term profitability, and consciously align financial and non-financial objectives. Happy customers create loyalty and enhanced revenues, reliable suppliers guarantee the quality needed to be competitive, trustworthy and trusted employees generate the necessary innovative creativity to keep a competitive edge in the industry. Taking community and environmental concerns seriously will allow the firm to "renew" its license to operate without unnecessary social disturbances. Having satisfied stakeholders will not hurt the reputation of great firms, let alone their profitability, which is the ultimate aim of any shareholder.

Complying with procedural rules may improve board governance, but as long as the attitude of integrity and openness that creates trustworthiness in the capital market remains only lip service and compliance-oriented, processes and procedures may continue to be perceived as weak and superficial. Those are not exactly the ingredients needed to attract long-term sustainable investment. In other words, visionary corporate leadership that understands the negative implications of mere spinning instead of genuine corporate reform will need to be supported by strong institutional reform. Businesses require trustworthy public and corporate governance to thrive.

We should not forget that Indonesia's corporate structure is dominated by insiders who control the board and major decisions within the firm.

Rule of law

One could question whether the balance of power in Indonesia should remain very relationship-based, or instead nudge towards a market-based system in which rules and regulations are on average better enforced. In the past, cozy relationships between senior government officials and powerful corporate elites may have brought enormous economic and controlled growth in spite of weak capital markets and institutions. In a more globalized economy, however, Indonesian corporations need to rely on long-term beacons and guidelines from strong and reliable institutions. Most definitions of governance agree on the importance of a well-functioning state that effectively operates under the rule of law, rather than rule by law. Where "public" governance is not strong or when the institutions in which organizations function are rather weak, one sometimes speaks of institutional voids.

Corporate decisions with long-term implications should not rely on the whim of public officials who may be too tempted to take personal advantage of their power instead of fulfilling their public duties.

Corporate governance can only thrive in an environment where the rule of law prevails over personal power and relationships. One can argue, however, that relationship-based governance plays an important role in an environment with weak institutions and where law enforcement is less than ideal. With the globalization of the Indonesian economy, companies will need to embrace rule-based governance based on certain generic and widely accepted principles and norms. We foresee that those generic principles of transparency and accountability will become the norm in international business, while relationships will continue to play an indisputable role to allow competitive firms access to scarce resources in Indonesia.

The political principles of good governance are based on the establishment of a representative and accountable government that requires good institutions, as in sets of rules governing the actions of individuals and organizations and the negotiation of differences between them. Good public governance, in its political interpretation, also requires a strong and pluralistic civil society where there is both freedom of expression and association and the primacy of law maintained through an impartial and effective legal system. Moreover, this interpretation also requires a high degree of transparency and accountability in public and corporate processes. Economic governance principles refer to policies to promote broad-based economic growth, a dynamic private sector and efficient state-owned firms, and social policies that will lead to poverty reduction. Effective institutions and good corporate governance are needed to support the development of a competitive and thriving economy, with deep respect for contracts and property rights. Governance at a macro level includes institutional reforms and the overall role of the government itself, whereas micro-level governance, or corporate governance, involves the supervision and control of both state-owned and private enterprises.

Corporate governance can only thrive where there is good public governance. The overall consensus indicates that there is indeed a direct correlation between good public governance that provides the overall appropriate structure, and best corporate governance practices that allow optimal decisions to be taken.

Since the fall of Suharto in 1998, Indonesia has indeed succeeded in moving away from authoritarian rule toward a democracy still in the making, attempting to shift from relationship-based governance to rules-based governance. Making this shift means strengthening institutions that have been established and reconstituted during the past decade, an undertaking which requires strong and committed leadership.

Corporate governance can only thrive in an environment where the rule of law prevails over personal power and relationships.

Governance in the context of public administration has become more complex because of the greater interaction between government and nongovernmental actors. This interaction between diverse actors

and different interests needs to be guided and directed towards collective decision-making that no longer can be driven just by the state's use of power and authority to command compliance. Instead, the state must give direction by using a complex set of hard and soft governing tools, as well as its network relationships, to manage power dependencies between actors. Hence, reforming Indonesia's public sector, including the government bureaucracy, strengthening anti-corruption agencies and improving law enforcement, must be done simultaneously and with greater public engagement.

The corporate sector needs to participate as part of a collective push for reforms. Promoting better corporate governance, improving procurement systems, resisting graft and focusing on shareholder and customer satisfaction, for example, should not be limited to business sense. It should also be considered as a means to improve the performance of the public sector, whose role is to create a business environment that is open and fair. A case in point is the need for the private sector to be involved in monitoring the implementation of Presidential Instruction Number 9/2011, which aims to improve the performance of state agencies dealing in licensing, taxation, customs and law enforcement. It is in their interest to ensure that stated policies are effectively implemented.

According to the 2013 Edelman Trust Barometer, an annual global online survey that measures the level of trust in key institutions globally, 16 out of 26 countries have greater trust in business than in government. In Indonesia, the level of trust in business is high, at 74 percent, compared to the global average of 58 percent. However, trust in government is only 47 percent, less than non-governmental organizations (51 percent) and the media (77 percent).

Indonesia's corporate sector should capitalize on this trust to act collectively and urge changes to improve the business and investment climate. While we did not specify all the contextual details, examining the reforms, cultural norms, rule of law, regulations and role of history are all significant in understanding the institutional context in which governance in Indonesia will thrive or be stifled. Non-state actors including the corporate sector must critically engage with the government to demand improvements in institutional governance, as they are in a better position to do so.

Greater collective action by the corporate sector is all the more pressing because, despite the strategies implemented by the Indonesian government, corruptors remain undeterred and the results of anti-corruption efforts are few. Indonesia's score in Transparency International's 2012 Corruption Perception Index showed no significant change, leaving it in the same company as the Dominican Republic, Ecuador, Egypt and Madagascar, to name a few, although still better than neighbors Vietnam, Cambodia, Laos and Myanmar. Indonesia's rank in the World Bank's 2013 Doing Business report was 128th globally, a drop of 13 places from 2010. The World Economic Forum's Global Competitiveness Report 2012-2013 underlined the fact that inefficient government bureaucracy and corruption are the two most problematic factors for doing business in Indonesia.

This weak institutional governance has an immediate and rather negative effect on the pursuit of best corporate governance practices in Indonesia. The unfortunate example of rampant collusion between government offi-

The World Economic Forum's Global Competitiveness Report 2012-2013 underlined the fact that inefficient government bureaucracy and corruption are the two most problematic factors for doing business in Indonesia.

cials and businessmen is not exactly the best way to convince the world that the country has changed. On the other hand, it can also be argued that businesses implementing internationally recognized corporate governance standards positively influence the way the public and government will stimulate reform through good public governance.

Conclusions

The purpose of good governance principles and contextualized practices is not to stifle innovation and value creation by excessive control that might retard the decision-making of visionary and creative executives, but to have a monitoring system in place that prevents executives from causing economic losses through agency costs and managerial or even ownership rent extraction. It should also provide guidance and access to valuable resources that will benefit the company.

Indonesia will need to acknowledge the need to promote good public governance to ensure the inflow of capital and outflow of products on the corporate level, and to position it as a creditworthy and trustworthy country in international politics and global economics. Obviously, one will need to take into account the political and economic context and social institutions that either facilitate or constrain good governance mechanisms.

Indonesia, as a typical Asian country that it is more relationship-based than transaction-oriented, will need to respect some internationally recognized governance standards of transparency and accountability to position itself within the global context. Indonesia cannot afford to do otherwise, but to do so requires the engagement and participation of a broader citizen base. The corporate sector has to look beyond the perspective of improving shareholder value, and realize the critical role it can play in improving governance in the public sector. Future leadership needs to govern by using its formal and informal authority to provide institutions with guidelines and rules that create and sustain a virtuous domino effect. The danger of the opposite always looms around the corner.

Companies with the appropriate moral values and vision to promote good corporate governance practices have gained a worthy reputation that is trusted by the market and investors. This attracts investments that often result in slightly superior long-term returns. One can only hope that Indonesian business owners (either conglomerates, family-owned or state-run enterprises), bureaucrats and senior officials understand the benefits of pursuing good corporate governance, while acknowledging the high costs when they do not. If civil society, government, creditors, investors and businesses emphasize interdependence rather than possible trade-offs and tensions, Indonesia might become a better place for business. Everyone would benefit, except those few free riding corruptors who undermine Indonesia's reputation.