Corporate Governance, State Ownership and Firm Performance: An Empirical Study of State-Owned Enterprises in Indonesia**

Chermian Eforis*
Universitas Multimedia Nusantara, Scientia Garden-Gading Serpong, 15820, Tangerang, Indonesia

ABSTRACT

Objective – The purpose of this research is to determine the effect of good corporate governance (GCG) on Indonesia’s SOEs and the influence of state ownership on company performance.

Methodology/Technique – This study examines State Owned Enterprises in Indonesia that were listed on the Indonesia Stock Exchange between 2011 and 2015.

Findings – The empirical results show that GCG and state ownership both have a positive influence on the company’s financial performance (in this case, Return On Assets). However, the percentage of state ownership has a negative effect on the relationship between Good Corporate Governance and Return On Assets.

Novelty – One agency cost is monitoring expenditure by the principal. Privatization is one way to improve the performance of SOEs. Privatization is believed to improve the performance of SOEs, as a result of increased supervision of the performance of SOEs in Indonesia.

Type of Paper: Empirical.

Keywords: State Owned Enterprises; Good Corporate Governance; State Ownership; ROA; Indonesia.

JEL Classification: G32, H70, G34.

1. Introduction

One type of agency cost is monitoring expenditure by the principal (Jensen & Meckling, 1976). In Indonesia, privatization of state-owned enterprises (SOE) is expected to reduce these costs, due to the fact that when part of an SOE’s shares are owned by the public, the SOE has an obligation to disclose its financial reports. The state is considered to have inadequate resources and expertise in monitoring and disciplining management (Qi, Wu, & Zhang, 2000) and public scrutiny is expected to help governments address this issue. According to the Law of the Republic of Indonesia No. 19 of Year 2003 on State-Owned Enterprises, what is meant by a ‘SOE’ is a business entity which is wholly or primarily owned by the state through direct participation derived from separated state assets. There are some advantages for SOEs when compared with...
private firms. For instance, in the case of China, SOEs have access to cheaper and less restrictive loans from banks and offer their employees a higher level of employment security (Stan, Peng, & Bruton, 2014). However, this situation is not without risks, such as lower motivation among employees (Girma, Gong, & Gorg, 2009).

Law No. 19 of 2003 states that privatization of SOEs serves several objectives, including the expansion of public ownership of the SOE, to improve company efficiency and productivity and to create a competitive and globally-oriented SOE. Astami, Tower, Rusmin, and Neilson (2010) conducted a study of 157 Indonesian SOEs in 2006, to determine the effect of ownership structure on performance. The authors state that SOEs entirely owned by the government demonstrate lower performance levels when compared to SOEs that are partly owned by the public. Further, Boubakri, Cosset, and Guedhami (2005) have found significant increases in profitability, efficiency, investment, and output following privatization of SOEs. Their study examined 230 multinational companies in developing countries.

However, at the end of 2017, during a meeting between Rini Soemarno (Minister of State Enterprises) and chief executives of state-owned companies, it was identified that the airline Garuda Indonesia and steel maker Krakatau Steel were each reporting a loss of more than IDR 1 trillion (approximately USD 70 million) for the 2017 financial year. Tariff warfare and operational inefficiency are cited as the cause for the loss experienced by Garuda Indonesia, while the reported losses for Krakatau Steel are the result of competition from Chinese companies offering lower prices (Muhammad Sal, 2018). With reference to Law No. 19 of 2003, this situation is contrary to the purpose of the privatization of listed SOEs — that is, to improve efficiency and create competition among SOEs.

Corporate governance, according to Boubakri et al. (2005), is considered one of the triggering variables that can improve performance following privatization of SOEs. The effects of any given mix of corporate governance devices can be evaluated on two different grounds: static efficiency (maximizing innovation and human capital investments) and dynamic efficiency (the ability to create enough of an incentive for people to improve their skills) (Barca & Trento, 1997).

The objective of this study is to investigate the relationship between state ownership, corporate governance, and firm performance. This paper uses the corporate governance implementation rating developed by the Indonesian Institute for Corporate Governance.

2. Literature Review and Hypothesis Development

There have been several studies conducted on state ownership and performance following privatization. For example, Le and Buck (2011) have identified that state ownership is positively associated with the performance of privatized firms (Le & Buck, 2011) Further, the private benefits of state control (political, social, or personal advantages that a controlling politician may be able to extract from a state-owned enterprise) have important economic implications (D'Souza & Nash, 2017). In addition, Ben-Nasr and Cosset (2014) found that state ownership is associated with lower firm-level stock price variation, with the effects being more pronounced in countries with lower political rights.

Chinese SOEs have very low levels of productivity due to low incentives and their role in contributing to wider social welfare (Driffield & Du, 2007). Driffield and Du (2007) found that privatization in China is important for generating productivity growth. Further, Ye and Liu (2012) state there is no significant difference in market value between SOEs and non-SOEs. State control has resulted in declining and even negative corporate performance (Kocenda & Hanousek, 2012). In China, firms in provinces with higher developed institutions (non-state-controlled firms) hold more (fewer) cash reserves than those in provinces with less developed institutions (state-controlled firms) (Kusnafl, Yang, & Zhou, 2015). In order to become and stay competitive, SOEs need to better understand and use their various forms of slack in an efficient way, particularly when the markets in which SOEs operate become increasingly competitive (Stan, Peng, & Bruton, 2014).
Brown and Caylor (2006) measure corporate governance using Gov-Score, which is a modification of the governance factors created by the Institutional Shareholder Service, to ascertain the effect of good corporate governance on firm valuation. The result is that, the more democratic a company is, the more valuable it will be. As a developing country, the election of the SOE board remains primarily based on political interests. Even minimal guidance on how to ensure good governance practices are implemented may provide the opportunity for unnecessary political interference in appointing boards without the relevant ‘soft’ and ‘hard’ attributes, to ensure improved performance of SOEs (Simpson, 2014). The threat of political extraction may cause firms to adopt corporate policies that are not necessarily the most optimal and efficient (Kusnadi et al., 2015).

GCG, according to the Regulation of the Minister of State Owned Enterprises Number PER-01/MBU/2011, refers to the principles underlying a company’s management policies, based on legislation and business ethics. SOEs in Indonesia are required to apply GCG consistently and continuously in accordance with applicable regulations. The principles of GCG referred to in this regulation include transparency, accountability, independence, and fairness. The implementation of these principles, among others, aims to optimize the value of SOEs and encourage professional, efficient, and effective management. Lu and Shi (2012) use Tobin’s Q as a firm value to examine the effect of corporate governance reform in China, which has identified that the positive effect of corporate governance reform is weaker for firms with a greater portion of state-owned shares. Based on this analysis, this study examines the following hypotheses:

1. **H1:** State ownership has a negative effect on firm performance.
2. **H2:** Corporate governance has a positive effect on firm performance.
3. **H3:** State ownership has a moderating effect on the relationship between corporate governance and firm performance.

### 3. Method

The study uses observations from SOEs listed on the Indonesian Stock Exchange between 2011 and 2015. To test the hypotheses, this study uses the following model:

\[
ROA = \beta_0 + \beta_1 GCG + \beta_1 STATEOWN + \beta_3 GCG \times STATEOWN + \epsilon
\]  

(1)

To measure the dependent variable (firm performance) this research uses return on assets (ROA) as the independent variable. Weygandt, Kimmel, and Kieso (2015) defined the ROA formula as net income divided by average total assets. The Corporate Governance Perception Index (CGPI) developed by the Indonesian Institute for Corporate Governance was used in this study to measure good corporate governance. There are four stages of assessment. The first stage — namely, self-assessment — consists of 13 aspects of assessment ascertained through a questionnaire given to management. In the second stage — the documentation system — the company must submit no fewer than 47 documents. In the third stage — the compilation of papers — the company prepares a description of a series of processes and the implementation of GCG. The fourth or last stage will be observed by the assessment team to clarify the quality of GCG implementation. To determine state ownership, the percentage of ownership by the state is used.

### Table 1. Variables and Operational Measurement

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The research design used to test the hypotheses is described in Figure 1 below.

![Figure 1. Research Design](image)

### 4. Results

Table 2 presents the descriptive statistics of all of the variables used in this study. The variable ROA has a mean value of approximately 6.3%. The mean of the variable STATEOWN is 0.629, indicating there is approximately 62.9% of state ownership in the sample firms. The variable GCG is an aggregate of the Corporate Governance Perception Index (CGPI) used by the Indonesian Institute for Corporate Governance and has a mean value of 86.254.

Table 3 presents the results based on multi-regression analysis. The dependent variable is ROA and the tested variables are GCG, STATEOWN, and GCGxSTATEOWN. The whole regression model is significant (F=5.756, p=0.002) and the explanatory power is 0.233 (adjusted R2).

<table>
<thead>
<tr>
<th>Variables</th>
<th>Operational Measurements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm performance (dependent variable)</td>
<td>Return on assets</td>
</tr>
<tr>
<td>State ownership (independent/moderating variable)</td>
<td>Percentage of ownership by the state</td>
</tr>
<tr>
<td>Corporate governance (independent variable)</td>
<td>Corporate Governance Perception Index by the Indonesian Institute for Corporate Governance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variables</th>
<th>N</th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>48</td>
<td>-0.072</td>
<td>0.305</td>
<td>0.063</td>
<td>0.072</td>
</tr>
<tr>
<td>STATEOWN</td>
<td>48</td>
<td>0.53</td>
<td>0.72</td>
<td>0.629</td>
<td>0.053</td>
</tr>
<tr>
<td>GCG</td>
<td>48</td>
<td>75.68</td>
<td>93.3</td>
<td>86.254</td>
<td>3.708</td>
</tr>
</tbody>
</table>

Table3 Regression Analysis of State Ownership and GCG

<table>
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<tr>
<th>Coef.</th>
<th>t</th>
</tr>
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</table>

The percentage of state ownership (STATEOWN) is positively related to ROA, demonstrating that companies with higher state ownership generally achieve better performance. Therefore, the first hypothesis is rejected; this is inconsistent with prior research by Astami et al. (2010) and Boubakri et al. (2005). There are several explanations for this. One of the main explanations is BUMN Bersinergi (synergy between state-owned enterprises). ‘Synergy to Build the State’ is a commitment between Indonesia’s SOEs (BUMN) with the aim of optimizing the resources and skills in each SOE within the framework of synergy among SOEs; thus, the development of SOEs is a priority for the Indonesian government. Another explanation is that, compared to the private sector, the cost of capital is lower for SOEs.

GCG is positively associated with ROA (coef.=0.176, t=3.65), indicating that SOEs with higher quality corporate governance typically achieve better financial performance. This evidence supports the second hypothesis. These findings are consistent with those of Brown and Caylor (2006), who found that good corporate governance enhances firm value.

Lastly, the third hypothesis is accepted, meaning that state ownership has a moderating effect on the relationship between GCG and ROA, in a negative way. This means that SOEs with a higher percentage of state ownership show a weaker relationship between GCG and ROA. This finding is consistent with prior research by Lu and Shi (2012).

5. Discussion

The results show that GCG and percentage of state ownership have a positive relationship with ROA. However, when ownership of the state increases, the power of GCG to influence ROA decreases. The state and its representatives have inadequate resources and expertise in monitoring and disciplining management of SOEs (Qi et al., 2000). Agency problems can be resolved by increasing the supervision of management, to prevent them from conducting value-reducing activities (Lu & Shi, 2012). Although the government has already outlined the conduct of corporate governance for Indonesian SOEs, it cannot reduce the issues associated with the supervision of SOE performance. As long as political interference remains in Indonesian SOEs, the governance mechanisms will be ineffective.

This research contributes to a deeper understanding of GCG and its impact on firm performance. For investors, the index developed by the Indonesian Institute for Corporate Governance could be one measurement tool to determine whether the company implements adequate GCG to enhance firm performance.

6. Conclusion

This study examines the impact of corporate governance and state ownership on firm performance, ROA, and whether state ownership alters the relationship between corporate governance with ROA. Using the corporate governance implementation rating developed by the Indonesian Institute of Corporate Governance (IICG), the following conclusions were made. The first is that state ownership is positively associated with firm performance, indicating that firms with higher state ownership will achieve higher firm performance due to government support. Secondly, firms with a higher IICG rating will achieve better firm performance, indicating that the implementation of corporate governance can improve return on assets. Lastly, state

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>-15.139</td>
<td>-3.603</td>
<td></td>
</tr>
<tr>
<td>STATEOWN</td>
<td>24.894</td>
<td>3.728***</td>
<td></td>
</tr>
<tr>
<td>GCG</td>
<td>0.176</td>
<td>3.65***</td>
<td></td>
</tr>
<tr>
<td>GCGxSTATEOWN</td>
<td>-0.288</td>
<td>-3.758***</td>
<td></td>
</tr>
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***Statistical significance at the 0.01 level
ownership has a moderating effect on the relationship between GCG and ROA with a negative sign, meaning that the improvement of corporate governance to improve return on assets is less effective in state-owned firms.

7. References


