

Privatisation Failures in Indonesia

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Abstract: Despite repeated commitments by successive governments in Indonesia to divestment of state-owned enterprises, little has occurred. There has been considerable experimentation with a different kind of privatisation, however, involving reforms that opened up markets previously dominated by state firms to the private sector. The spectacular failure of some of these experiments has weakened the appeal of privatisation. It is argued here that these disappointments do not reflect any conceptual shortcoming of privatisation as a means of improving efficiency, but are attributable to moral hazard resulting from the failure to ensure that business risks were shifted into the private sector along with ownership.

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Introduction

A typical, if superficial, complaint about many policy recommendations of market-oriented economists is that they may be 'fine in theory but don't work in the real world'. In years gone by the writer's usual response to such complaints was cursorily to brush them aside. But as one now surveys the wreckage of Indonesia's banking sector, for example, only a few years after having praised the government for undertaking far-reaching deregulation of it (McLeod 1999), the salutary lesson that suggests itself is that great care needs to be exercised when recommending the abandonment of policies that distort market outcomes. Many countries have experienced financial crises after deregulating their banking systems or opening their capital accounts, for example. One possible response is simply to cease advocating the virtues of dismantling government interventions, such as the maintenance of barriers to entry in banking or of controls on international capital flows. An alternative approach to analysing unsuccessful examples of deregulation, however, is to consider whether, at the same time one set of distortions was removed, another was introduced. In the discussion that follows it will be argued that privatisation that occurred in the late 1980s and early 1990s in Indonesia has been unsuccessful, but that this can be explained in just these terms. The appropriate policy response is not to turn away from privatisation, but to learn from mistakes in the way it has been pursued in the past.

Indonesia's economic policies began to become much more market oriented during the 1980s. In the 1970s the economy had benefited greatly from rises in the world price of oil, first in 1973-74 and again in 1979-80. This generated huge increases in export revenues and consequent rapid growth of the economy. But in the mid 1980s the oil price fell drastically, and policymakers were quick to realise that this had very significant implications for growth. Various policy reforms were implemented, notably in the fields of taxation and international trade. The government was able to generate new revenues to offset falling revenues from oil, mainly in the form of income tax and value-added tax (Booth 1992: 44-54). It also reduced tariffs significantly and abolished most quantitative restrictions on imports (Fane and Condon 1996) so as to stimulate the production of other exports and import substitutes.

In addition, there came to be a new emphasis on privatisation, although this turned out to be nearly all talk and no action (Hill 2000: 103-5). In 1989 the then finance minister announced that 52 state-owned enterprises (SOEs) would be listed on the Jakarta Stock Exchange between 1990 and 1992 (Habir 1990: 101); in the event, almost none were. In 1993, the then minister for research and technology (later to become

president), BJ Habibie, claimed that a similar number could be sold within a very short time frame (McLeod 1993: 7); again, almost nothing came of this.

Privatisation again came to prominence as a result of the economic crisis that commenced in Indonesia shortly after the unexpected float of the Thai baht in July 1997. It was included as one of the policies to which the government committed itself as a condition for the provision of financial assistance by the IMF in November 1997 (GOI 1997). The rationale for this was somewhat vague. Reading between the lines, the reasoning seems to have been that since private capital was fleeing the country it was necessary to persuade the markets that henceforth the government would pay greater attention to microeconomic reform as a precondition for the return of rapid growth. Among other things, this would require SOEs—previously used as instruments for the distribution of patronage by way of artificially high buying prices, artificially low selling prices, privileged access to jobs and cheap loans or even grants—to be divested.

Before any such divestments could take place the crisis worsened, however, and the banking system began to crumble. The government responded eventually by issuing a blanket guarantee of the banks' liabilities. This avoided a system-wide run on banks' deposits, but many banks failed, nevertheless. To make good its guarantee, the government chose to issue bonds, which were used to compensate banks that took over failed banks' liabilities, or to inject as new equity in banks that were kept alive, even though their capital had become negative.¹ The volume of these bonds was enormous—some Rp644 trillion, or around \$75 billion at mid 2002 exchange rates. The cost of servicing the bonds has become a major component of government spending, with interest payments accounting for some 17% of the budget total in 2002 (Deuster 2002: 20). As a consequence privatisation is now seen as important—not so much as a signal of the government's commitment to policy reform, but because of its potential to contribute revenue to offset the interest payments on these bank recapitalisation bonds. Nevertheless progress has remained extremely slow.

There are a number of explanations for the seemingly irremediable lack of progress with privatisation in the face of the urgent need for additional funds if the government is to maintain its spending programmes.

¹ The collapse of the banking system, and the attempts to rebuild it, are discussed in detail in Fane and McLeod (2002).

Nationalist sentiment

One obstacle is popular opposition to foreign investment. With the large-scale corporate sector so badly damaged by the crisis it seems likely that the greatest potential for new private sector owners of enterprises now in government hands is to be found in the foreign investment community. But nationalist sentiment is strong (as it is in many countries), and the government is reluctant to push too hard with privatisation if this would result in foreign ownership of what are regarded as key economic assets. Indeed, even the speaker of the Peoples' Consultative Assembly has publicly voiced his objections to the sale of firms under government control to foreign interests (*Jakarta Post*, 6 April 2002). From the point of view of foreign investors themselves there is also considerable reluctance—in part, precisely because of this anti-foreigner sentiment.

Concerns with government and legal system

In addition, there are great concerns among both foreign and domestic businesses about the condition of the economy and about the ability of the government to implement policies to get it back close to full capacity utilisation.² Perhaps more fundamentally, moreover, there is a very widespread lack of trust in the legal system. Corruption and incompetence are endemic, and there have been several prominent examples where foreign firms have been particularly badly treated by the courts (Pangestu and Goeltom 2001: 147, Athukorala 2002: 145–7).

Timing

Those who have been opposing privatisation often argue that this is simply not the right time: the economy is still operating far below its capacity; the large conglomerates that have dominated the modern sector of the economy for many years are seemingly experiencing great difficulties, such that they cannot afford to service their existing debt let alone acquire new assets; and there are the fundamental concerns (just mentioned) about the near-term future for Indonesia's economy, and a lack of confidence in the ability of the government to perform. The problem with this argument is that it implicitly assumes that enterprise valuations will eventually improve. On the contrary, it is very likely that asset values will fall even further the longer the assets stay in government hands, partly because there is no dominant shareholder with a strong incentive to undertake policies and actions

² In the first quarter of 2002, GDP was still slightly below its level five years earlier (Athukorala 2002: 149).

that will boost the value of the firms in question, and partly because of continuing political interference in the way in which they are run.

SOEs as cash cows

It is hardly open to doubt that many interests are strongly opposed to government divestment of enterprises, whether these are state enterprises of longstanding or enterprises newly acquired as a result of the crisis. Such enterprises are regarded as cash cows that can be used for the enrichment of individuals and, especially, for financing the political parties in newly democratic Indonesia,³ where the name of the game currently is to boost representation in the House of Representatives and the People's Consultative Assembly. Clearly the argument that 'the time is not right' is a convenient cover for these interests.

The rationale for privatisation

Privatisation is important in present circumstances from the point of view of providing the cash flows needed to maintain the government's spending programs.⁴ But cash generation is not the real rationale for privatisation. The only sound justification for converting earning assets to cash is if their return is lower than the opportunity cost of continuing to hold them. This will be the case if a firm is likely to be more efficiently managed in the private sector than as an SOE, which will imply that the sale value of the enterprise will be greater than the expected present value of future returns with the government as manager.

The fundamental economic argument in favour of privatisation is based partly on the empirical record, and partly on economic theory. The empirical record, especially in Indonesia, is that SOEs typically generate low or negative profits (Hill 2000: 105-7, Mardjana 1995), whereas private enterprises are profitable on average. The theoretical argument is based on the observation that firms' performance depends on the incentives faced by their managers. The managers of private firms either have their own funds at risk (the most typical case in Indonesia), or are appointed and monitored by shareholders with a significant stake in the company in question, so the incentives for good management are strong. On the other hand, neither the managers nor the politicians that control SOEs have more than a negligibly small

³ Indonesia held its first genuinely democratic elections since the 1950s in June 1999, after former president Soeharto was forced to step down in 1998 (Soesastro 1999).

⁴ This said, it should be noted that the targeted proceeds from privatisation in 2002 amount to a meagre Rp4 trillion, by comparison with some Rp60 trillion of interest payments (Deuster 2002: 20-1).

ownership stake in them, and so they are likely to have relatively little concern for efficiency and profitability. Indeed, the incentives for sound management of SOEs in Indonesia are largely non-existent: the rule of law is very weak, and accountability of the government through the political processes – given an unsophisticated electorate unused to democracy – is also lacking. Thus the owners of SOEs – the general public – are in no position to ensure that these firms are well managed.

The essence of privatisation

It is important to note that the argument for privatisation depends crucially on the presumption that the *risks involved* in the business in question are transferred to the private sector, along with *ownership*, since it is the risk of diminution in the value of shareholders' equity stakes that provides the incentive for careful management. If ownership is transferred to the private sector without ensuring that the risks are also transferred, the argument in favour of privatisation disappears – indeed, it is turned on its head. In such circumstances the new owners will in fact have a strong incentive to engage in high risk gambles, since they will enjoy the fruits of success but will be affected little by failure. In other words the transfer to the private sector of ownership but not risk creates a moral hazard that is likely to result in costly failures with privatisation. This key idea provides the focus of the discussion that follows.

Approaches to privatisation

There has been so little progress with privatisation in Indonesia to date that there may seem little to gain by discussing the issue. In fact, however, there has been considerable progress with privatisation of a non-conventional kind. We begin, therefore, by drawing a distinction between different approaches to privatisation.

Sale of state enterprises

In the conventional sense, 'privatisation' refers to the sale of SOEs to the private sector. The Indonesian government owns a wide range of enterprises, including electricity, water supply, transportation, telecommunications and construction companies, mining and manufacturing firms, plantations, banks, insurers, importers, retailers, hotels and so on. There is, therefore, much scope for privatisation by way of divestment of SOEs.

It should be noted here that opposition to privatisation in Indonesia has often manifested itself in partial privatisation – that is, the sale of only a part of the government's shares in a firm. The impact of this is likely to be quite different than in the case of total divestment. If the proportion of shares divested is sufficiently

small, or if the divested shares are highly fragmented as to ownership, this will mean that no private sector owner will have a large enough interest in the company to be able to exert a significant influence on its management, or to be highly motivated to do so. Yet this is crucial to the presumed change in management behaviour from which the potential benefits of privatisation are expected to flow. Privatisation of this kind really serves no useful purpose.

Encouraging greater private sector involvement

In a broader sense, privatisation can be thought of as encouraging relatively greater private sector involvement in parts of the economy relative to the public sector. By definition, the divestment of SOEs results in a larger share of the market in question being supplied by the private sector. But this can also be achieved by encouraging the involvement of, and competition from, private enterprises in sectors where state-owned firms hitherto have played an important role. There was in fact considerable privatisation in Indonesia in this broader sense in the late 1980s and the 1990s. We shall consider examples from three different industries in this paper, each of which showed some promise but ultimately ended in failure. Of these the most spectacular example is banking, which is treated in considerable detail here. Much the same principles and pitfalls are evident in the other two cases considered, however: civil aviation and electricity.

The banking sector

Although both approaches to privatisation are apparent in the case of banking, by far the more important is privatisation by allowing private firms to take up a larger market share. Commencing in 1982 the government began to deregulate the banking sector, which was at that time heavily dominated by seven large state institutions: five commercial banks, a savings bank and a development bank (McLeod 1999). There were many more privately owned banks, but in aggregate they accounted for only 7% of total bank assets. In the early phases of deregulation the government abolished its practice of trying to impose ceilings on the growth of each bank's assets, which had held back the growth of the private banks. In the later phase commencing in 1988 the government abolished barriers to entry to banking that for many years had prevented the establishment of new banks. In addition, it removed bureaucratic obstacles to the expansion of the banks' branch networks.

The impact was dramatic (Table 1). The number of private banks increased rapidly, and the number of bank branches even more so. Other indicators, such as the number of savings bank accounts and the total amount of deposits of all kinds grew extremely rapidly as banking became much more accessible to the general

population, and as banks offered attractive interest rates and other incentives to their customers.⁵ Although the existing state banks also expanded their branch networks and became somewhat more customer oriented, the net result was that the market share of the private banks grew dramatically at the expense of the state banks. In other words, the industry as a whole moved in the general direction of privatisation, even though no state banks were sold. In a single instance, a minority share (25%) of Bank BNI, one of the state banks, was sold to the general public (in 1996). The bank was publicly listed, but still continued to be thought of, and to behave, as a state-owned bank.

Table 1 Impact of deregulation on Indonesia's private banks

	Dec 1988	Jun 1997
Number	63	160
Branches	574	4,267
Savings accounts (million)	2.6	17.4
Deposits (Rp trillion)	11	183
Share of total assets (%)	24	54
(State banks' share of total assets, %) ^a	71	35

Note^a: The remaining market share was held mainly by local branches or subsidiary joint ventures of foreign banks.

The Asian crisis brought an abrupt end to the rapid growth of the private sector's market share in banking. The large depreciation of the Thai baht in July 1997 resulted in a loss of confidence in the rupiah, which lost 24% of its value over the next two months alone. This had drastic implications for the corporate sector, which had faced an exchange rate risk by virtue of having borrowed heavily in dollars rather than rupiah, often in order to invest in sectors producing non-tradables. In turn, many of these now very vulnerable dollar loans had been provided by domestic banks, which quickly came under pressure in the form of large scale withdrawals of deposits. Before long the central bank began to operate as lender of last resort, providing emergency liquidity to banks whose funds were being drained (Enoch *et al.* 2001: 32).

Last resort lending is not the appropriate policy when banks are clearly insolvent, rather than merely illiquid, of course, and all that was achieved by it was to delay the inevitable – and to make the eventual losses even greater. Liquidity support was

⁵ Previously many businesses, and most individuals, had no bank deposits at all.

not enough to stop the run on deposits, and the government eventually responded by issuing a guarantee of the banks' liabilities, as mentioned above. Eventually many banks were closed down, while several others were recapitalised. In both cases the government made good the whole or a large part of their accumulated losses. Fane and McLeod (2002) estimate the fiscal cost of the claims against the government's guarantee of bank liabilities to be of the order of 40% of 1998 GDP. More recent developments suggest that this is likely to be an underestimate (Athukorala 2002: 154).

The explanation for the unsatisfactory outcome of this experiment is closely related to the failure to ensure that the approach was consistent with the core argument in favour of privatisation. Specifically, the government failed in two ways to ensure that the owners of the private banks had significant amounts of their own wealth at risk.

First, the prudential regulations called for banks to observe a minimum capital adequacy ratio (CAR, the ratio of capital to risk weighted assets) of only 8-9%.⁶ This reflects an extremely high gearing ratio (i.e. of debt to equity) relative to the norms of the corporate sector outside banking. The only obvious explanation for creditors of banks—primarily, their depositors—being willing to accept such a small level of equity to protect themselves against potential losses incurred by the banks is that there is a perception that the government will step in to provide such protection if necessary. When the crisis struck this is precisely what it did, despite frequent denials previously that it provided any kind of guarantee of the safety of bank deposits.

As we have seen, the banks had made skilful use of this perception of an implicit government guarantee by actively marketing their deposit products, opening many new branches and offering high interest rates and other benefits such as lottery prizes. The implicit government guarantee amounted to a subsidy, and the more deposits that could be mobilised, the greater its total value. In turn, much of the subsidy found its way to borrowers, who were able to enjoy lower rates than if it had not existed. When the guarantee became explicit, at least some of the banks simply exploited it even more vigorously, increasing their lending in circumstances in which there were strong incentives to purchase foreign currency. Thus rupiah denominated bank loans increased by some 10% in nominal terms during the first

⁶ The minimum CAR was in the process of being raised in stages from 8% to 12%. It became 9% in September 1997, just as the crisis was getting under way.

quarter of 1998, at the same time the banks were supposedly experiencing liquidity difficulties due to deposit withdrawals.

Second, the government permitted banks to lend to affiliated parties—roughly speaking, to companies owned by the same people. The prudential regulations actually sought to limit this practice by imposing a ceiling on loans to affiliates as a proportion of banks' capital. The constraint was lax in itself by international standards, but in any case banks flouted these lending limits with impunity: the central bank, in its capacity as prudential regulator, seemingly did nothing to enforce its own regulation.

The effect of banks lending to their own affiliates is to reduce the amount of funds of the owner genuinely at risk. Suppose that an owner subscribes \$1 million as equity in the bank, but then makes a loan to himself of \$1 million. If he fails to repay the loan there is then effectively no equity cushion for the benefit of the bank's creditors if it gets into trouble. If the bank were to be wound up, and if there were no government guarantee, the depositors would need to try to recover the loan from the owner through the courts, but this may be exceedingly difficult—especially if loan documentation is inadequate and collateral of low value or non-existent. In a country in which the legal system is inefficient, lacking in competence, and highly corrupt, the chance of success would be negligible. The owner could therefore expect to escape with his million dollars intact and, given the extreme political pressure on the government to protect depositors an *ex post* guarantee of some kind would be bound to emerge; the effect then would be to shift the banks' losses to taxpayers, as the government would be even less likely than private sector creditors to meet with success in the courts. This precisely describes what has happened in numerous cases in Indonesia during the crisis; having chosen to act as guarantor of the banks' liabilities, the government has proven virtually powerless to recover funds from banks that operated in this fashion.

As already mentioned, when it became clear that many of the banks—and all of the major banks—were insolvent, the government decided, in consultation with the IMF and the World Bank: to close numerous banks; to take over, or at least take a majority shareholding in, many of the large private banks that had failed, and recapitalise them; to set up what was in effect a new state-owned holding company, IBRA (the Indonesian Bank Restructuring Agency), to which were transferred all of the assets of banks that had been closed, along with the worst of all the non-performing loans of the state banks and the private banks that had been recapitalised; and finally, to take control of a wide range of corporate assets that had

been pledged by the owners of banks that borrowed heavily from the central bank at the height of the crisis.⁷

The intention was for these arrangements to be temporary. Nationalised banks were to be privatised as soon as possible; newly acquired government stakes in banks were to be divested as soon as possible; the state banks themselves were soon to be privatised; and IBRA was to have a limited life of only five years during which it would sell off all of the assets it had acquired and then be wound up. Progress on all these fronts has been agonisingly slow, however, for much the same reasons as for the privatisation of SOEs. In addition, however, the apparently disastrous consequences of the push to privatise the banking system by encouraging much greater private sector involvement has created even stronger doubts among those who were previously still to be persuaded of the wisdom of reducing the role of the state in business activity.

Assuming that the present (or a future) government does find the will to push through the divestment of banks and other enterprises that have come under its control as a result of the banking collapse, it is important that the previous mistakes with privatisation are not repeated. In relation to banks, action is required on several fronts to avoid the kinds of outcomes described above, by ensuring that private bank owners have significant amounts of their own capital at risk.

First, much higher standards for capital adequacy need to be set. It is arguable that the CAR of 8% prescribed in the international convention known as the Basle Accord (Basle Committee On Banking Supervision [1988]) is too low, even in developed economies. An important purpose of capital, or equity, in all businesses is to provide a cushion of safety to creditors. Clearly this cushion needs to be larger when the risks are relatively large, which is certainly the case in Indonesia (and probably in developing countries in general), where political stability cannot be taken for granted, the legal system is exceedingly weak, and the economy is vulnerable to negative shocks of various kinds. On this basis, Fane (2000b: 127–30) argues in favour of a CAR of at least 16 percent for economies similar to Indonesia.

Second, much greater care needs to be taken in measuring and defining capital for the purpose of calculating the CAR. A more realistic approach is called for, in which assets are marked to market frequently, and adequate provisions for loan losses are

⁷ A detailed record of the evolution of policy during this period is contained in (Enoch *et al.* 2001: 26–40).

created in timely fashion whenever there are indications that particular loans may not be repaid in full. In addition, capital should be defined to exclude the value of loans or any other kind of exposure of the bank to affiliated companies. In the previous example of a bank with equity of \$1 million that lent \$1 million to a firm controlled by its owner, the bank's capital would be recorded as zero for regulatory purposes because the \$1 million loan to its owner would be offset against the \$1 million of equity. This would have the desirable impact of removing the incentive to set up banks for the main purpose of obtaining cheap finance for affiliated companies by exploiting the implicit government guarantee of bank safety: arguably, the fact that all the major conglomerates had their own banks, and that many of them used these banks to channel savings of the public into their own activities, was one of the important factors underlying Indonesia's banking collapse.

Third, the prudential regulator should be far more active in requiring corrective action from banks whose capital adequacy falls below the specified minimum. There should be very little regulatory forbearance: owners should be required to repair any capital deficiency without delay. If they fail to do so the bank should be taken out of their control and sold to another party, who would be required either to build up the bank's capital immediately or to liquidate it. If the bank continued to operate, the original owners should receive the purchase price paid by the new owner. If it were liquidated, they should receive nothing (Fane and McLeod 2002).

Conventional privatisation of the state banks

It was mentioned briefly above that, of the seven state banks existing prior to the crisis, the government had only divested a small minority shareholding in one of them, Bank BNI. Little, if anything, was achieved by this. The government was not seriously in need of additional cash at that time, and no single private shareholder acquired a large enough stake to be able to exert any significant influence on the policies and strategies of the bank. Presumably the government obtained a price per share from the divestment lower than its potential, since buyers would have realised that the introduction of new management capable of extracting greater value from the bank's assets was not in prospect. Bank BNI gained some notoriety during the crisis by virtue of having provided well over \$US1 billion of loans to a single conglomerate, Texmaco, which is now by far the single largest debtor to IBRA by virtue of defaulting on these loans (Fane 2000a: 29–30). It was revealed in 2000 by the then minister for state enterprises that these loans had been provided by instruction of the former president, Soeharto. In other words, having a significant but fragmented minority private sector shareholding in the bank did nothing to offset the debilitating influence of the politically powerful.

It is clear what went wrong in this example of 'privatisation'. Partial divestment of the government's shares did not result in any private owner having a sufficiently large stake in the bank to provide the incentive and the ability to exercise strong influence on its management. The managers of the bank continued to have weak incentives to strive for high profits relative to their incentives to act in the interests of other parties such as political patrons, favoured borrowers, friends and relatives.

Civil aviation

The case of the civil aviation industry is closely analogous to that of the banking sector. For decades civil aviation was dominated by the state airline, Garuda. A number of small airlines competed on a few domestic routes, but Garuda enjoyed a near monopoly position by virtue of being the only airline permitted to operate jet aircraft. This policy was dropped in the early 1990s, at the same time that a controlling private sector interest was established in Sempati Air, a small airline previously owned by the military. The new policy allowed Sempati to compete effectively with the poorly managed Garuda, just as banking deregulation allowed private banks to compete effectively with the state banks. The new airline quickly established a high profile, and injected a hitherto unknown emphasis on concern for the travelling public. It introduced lottery prizes for passengers, compensated them if departures were late, simplified and speeded up the process of making reservations, and so on. The private sector market share increased rapidly as new domestic routes were added, eventually to be followed by the introduction of a few international routes. The further benefit was to put pressure on Garuda to improve the quality of its own service, just as the state banks had been forced to become more customer oriented when the private banks began to expand rapidly.

Sempati Air also became bankrupt during the crisis, however, with debts vastly in excess of its assets. An important explanation for this is that, since most of its sales were in the domestic market, whereas three of its major cost items—aircraft lease payments, debt service and aviation fuel—were dollar-denominated, it suffered greatly as a result of depreciation of the rupiah, just like many other firms producing non-tradables. Unable to increase its airfares sufficiently—not least because government pressure on its major competitor, Garuda, prevented the latter from raising its fares as well—Sempati quickly found itself facing large negative cash flows that soon caused it to collapse.⁸ Among its very large debts were unpaid bills for the supply of aviation fuel by Pertamina, the government owned petroleum

⁸ Government backing of Garuda allowed it to avoid a similar fate.

monopoly, and for the rental of airport facilities of the state-owned company, Angkasa Pura. Moreover, the group comprising the now defunct Sempati Air plus two of its principal owners, the Humpuss and Nusamba conglomerates, emerged as one of the largest defaulters on loans from the state banks.

Disparate though the two sectors may be, the failure of privatisation in civil aviation occurred for much the same reason as that in banking – namely, the failure to ensure that the private sector owners of Sempati had a significant amount of their own wealth at risk. There appears to have been what amounted to an implicit government guarantee that allowed the company to build up large and practically unsecured debts to its major suppliers and financiers, regardless of its own lack of equity capital. Alternatively stated, it could be said that the losses to the state in this case derived from the poor business practices of various state-owned enterprises: the state banks that lent to Sempati and its owners; the state petroleum company that supplied it with fuel on credit; and the state-owned airports that failed to collect rent payments from it. In this sense, the failure of civil aviation privatisation stems not from the new private sector competitor, but from grossly deficient management (no doubt the result of political interference) of state enterprises with which it had significant business relationships.

The first best policy here would be for the government to fully divest itself of Garuda and to open up the industry to new competitors, including foreign airlines; there is no sound economic justification for having a government-owned airline or for reserving the industry to local firms. If the government thinks it necessary to have aircraft serving particular routes that would not be commercially viable it can easily provide an explicit subsidy to a private airline to do so – and justify this policy to the electorate. In addition, it would be essential to ensure that other government entities provide no hidden subsidies, and avoid significant financial exposures, to private airlines. For example, Pertamina should insist on some arrangement such as regular weekly payments for fuel not more than, say, one month in arrears; likewise the airport management company should insist on payment of rent in advance for premises and other facilities on, say, a monthly basis.⁹ If the government's stated intention to fully privatise the banking system comes to pass, then of course there will be no possibility of loan defaults by airlines at government banks.

⁹ Better still, of course, Pertamina and Angkasa Pura should also be divested.

The electricity sector

The sale of electricity has always been monopolised by the state electricity company, PLN (*Perusahaan Listrik Negara*), or its predecessors. It should be noted, however, that many of the larger consumers of electricity have their own generation capacity because PLN has not always had a good reputation for reliability, and it has often been thought more economic to be self-reliant than to run the risk of incurring the cost of power blackouts (McCawley 1970). In 1990, however, the government announced its intention to encourage private sector involvement in the power generation component of this sector. It contracted with a number of private consortia on a build, own and operate basis to construct some 26 new plants to supply electricity to the national grid. As a result of this, perhaps a third of national power generating capacity (excluding generation for own use) is now in the hands of the private sector. Thus, although consumers of electricity still can deal only with PLN as supplier, to a significant extent the ultimate source is now the private sector.

As with banking and civil aviation, the experiment with privatisation in the electricity industry has been disastrous, resulting in huge losses to the government. In this case the losses are a direct consequence of the nature of the contracts that govern the supply of power by private generators to PLN. These contracts had two crucially important features. First, the supply price for electricity was denominated in US dollars. This meant that by 1998, after the rupiah price of US dollars had risen by a factor of four or five, the rupiah price of power supplied to PLN had risen in direct proportion. But the political realities were such that the government felt unable to allow PLN to increase its prices to consumers (denominated in rupiah) commensurately. Thus PLN immediately began to lose on every unit of electricity it purchased from the private power companies.

Second, the contracts required PLN to 'take or pay'. That is, once the private companies had installed a certain amount of productive capacity, PLN was obliged to purchase all of their output, or to pay an equivalent amount if it purchased smaller quantities. In the context of the unfolding economic crisis, many large factories and other users of electricity were cutting back their own output, and so their demand for electricity fell accordingly. This further reduced PLN's revenues relative to the amounts it was obliged to pay to the private producers. The overall result has been an enormous drain on the budget, to which PLN's profits had been a significant contributor in better times.

Although the task of power generation was partly turned over to the private sector, again this was not done in a manner consistent with the core argument in favour of

privatisation. The private sector members of the various consortia that constructed power generation plants did have large amounts of their own funds at risk, but two of the major risks themselves were shifted to the government—consistent with the notion of ‘privatisation of profits and socialisation of losses’. First, there was the risk that the demand for power from each new plant would be significantly less than its supply capacity, either because aggregate demand for electricity had been overestimated, or because of the large number of new generators being constructed simultaneously. By accepting ‘take or pay’ terms in its contracts with the new private operators, the government allowed this risk to be shifted to itself. Second, there was the exchange rate risk, reflecting the possibility that the government might not always persevere with its policy of slowly but steadily depreciating the rupiah against the US dollar (McLeod 1997: 33). By virtue of PLN’s acceptance of dollar-denominated prices for electricity this risk was also shifted to the government.¹⁰ In short, the requirement that the risks of the business in question would be carried by its private sector owners was violated in these two very important respects.

One of the principal reasons why government-owned businesses make losses is that they are always under political pressure to hold their selling prices down, even though their costs may be rising.¹¹ In the private sector, firms are generally free to put up their prices and, although this may meet with opposition from their customers, there is little to fear except if the price increases are intended to offset inefficiency or to earn excessive profits. In these cases the firms can expect to lose market share to more efficient and less avaricious competitors, but private sector firms are far less vulnerable than SOEs to interference from politicians worried about being voted out of office if prices increase. The disastrous outcome of the privatisation of power generation in Indonesia can be said to have failed in large part because the approach followed did nothing to deal with this intrusion of politics into commercial decision-making, resulting in the transfer of financial risks from the private producers to the government through PLN.

A range of issues relating to future private sector involvement in the electricity sector need to be addressed if this is to be successful. The most immediate question is whether there is really an actual or incipient shortage of power generation

¹⁰ The outcome of negotiations over contract details no doubt had much to do with the identity of the domestic partners in each of the consortia, all of whom were either relatives or cronies of the president (Thirwell 2001).

¹¹ There are also pressures to hold buying prices (such as wages) up, and to extend excessive amounts of credit for lengthy terms and without adequate security.

capacity, as has been suggested often in recent times (McBeth 2001). This is such a marked reversal from the story early in the crisis – when the major concern was with excess generating capacity after dramatic expansion of private facilities – that it seems more likely a reflection of artificially boosted demand resulting from a significant reduction in the real price of power to consumers (because of the government’s unwillingness to raise prices in line with cost increases). If this is the case, the appropriate policy change is to adjust prices upward immediately in order to reflect the real cost of power production.

A second desirable change in relation to electricity generation would be for PLN’s own existing production capacity to be sold to the private sector. Just as with banking and civil aviation, there is no sound reason to have a state-owned firm competing with private firms in power generation. In the course of divesting existing generators the government would need to come to grips with the appropriate form of contracts for the purchase of electricity by PLN.¹² It is beyond the scope of this paper to canvass the wide range of possibilities here (which also encompass divestment of the national grid and handing over the retailing function to the private sector);¹³ suffice it to say that a major objective should be to ensure that the commercial risks of producing power are borne by the suppliers.

One benefit of divesting existing plants (through an open tendering process) is that this would indirectly reveal a realistic supply price, or set of prices, for electricity. This could provide a basis for renegotiation of the contracts with existing private producers. These contracts not only shifted major commercial risks to the government, but also specified prices well in excess of those that can be observed in other markets internationally, reflecting the failure of the then government to ensure competitive tendering for the right to become a supplier to PLN and, related to this, the presence of Soeharto cronies and family members in all the joint venture consortia involved (Bosshard 2000). The present government has already found that attempting to renegotiate these essentially corrupt contracts is fraught with difficulty, as the foreign partners are sufficiently influential to be able to rely on the support of their own, very powerful, governments in the US, Japan, Germany and the UK (Murphy 1999). Nevertheless, its political position will be considerably

¹² The issue is discussed in the US context by Borenstein (2002).

¹³ PLN has already talked of moving in these directions (Motoyama and Widagdo 1999: 10–11).

strengthened if it can present strong evidence that the existing contracts are grossly overpriced.

Conclusions

The divestment of state enterprises is not the only way to privatise industries. In Indonesia, privatisation has involved processes by which private sector involvement increases significantly without very much state enterprise divestment, despite the wide scope for it and despite the stated intention of successive governments to undertake such divestment. Considerable gains can be achieved by encouraging private sector involvement in this manner, whereas achieving similar gains simply by transferring ownership of existing state enterprises to private owners might encounter significant political obstacles.

Nevertheless, the experience of the last few years has shown that the devil is in the detail so far as privatisation is concerned: there are very significant dangers from privatisation, of whatever kind, if the core rationale for it is not kept clearly in mind. Specifically, the private sector is not necessarily more likely than the public sector to ensure that the enterprise is managed well unless the owners have a significant amount of their own funds invested in the enterprise, and unless the major risks remain with its owners rather than being transferred back to the government in some manner. The correct conclusion to be drawn from recent experience, however, is not that privatisation of either kind should be abandoned, but that implementation in a manner consistent with its fundamental rationale is essential.

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