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USAID/INDONESIA

A POTENTIAL ROLE FOR USAID IN THE STATE-OWNED ENTERPRISE (SOE) RESTRUCTURING PROGRAM OF THE GOVERNMENT OF INDONESIA (GOI)

FINAL REPORT

November 2, 1990

Office of Government Services
1801 K Street. N.W.
Washington. DC 20006

Telephone 202 296 0800

Price Waterhouse

November 2, 1990

Mr. Joseph M. Carroll
Deputy Chief
Office of Private Sector Development
USAID/Indonesia
Jakarta, Indonesia

Dear Mr. Carroll:

Re: APRE/EM - Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
USAID/Indonesia - Financial Markets Project (FMP)
PIO/T No. 497-0357-3-70121 (as amended)
FSDP Activity No. 20

Attached please find our Final Report on A Potential Role for USAID/Indonesia in the State-Owned Enterprise (SOE) Restructuring and Privatization Program of the Government of Indonesia (GOI) as prepared by William Hollinger and Mark Camstra of Price Waterhouse, Prime Contractor under FSDP.

It has been a pleasure working with you and Jim Watson on this important assignment. We greatly appreciate the opportunity to be of service to USAID/Indonesia, and look forward to further collaboration with you in the future.

Sincerely,

Mark Camstra for

J. Richard Breen
FSDP Director

Attachment (as stated, 12 copies)

cc: Sandra Frydman, FSDP Project Manager, APRE/EM

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I. INTRODUCTION

A. Background

The Ministry of Finance (MOF) has stressed that the Government of Indonesia (GOI) accords a very high priority to achieving improved efficiency of state-owned enterprises (SOEs). Efficiency is sought for its own sake, as well as to permit a reduction in the demand on the national budget for investment funds for the SOEs. These two goals form the mainstay of the GOI's approach to the restructuring and privatization of the public sector.

The MOF has also stressed the high priority that is accorded to the development of a vigorous, broad-based capital market to create a broader range of investment options capable of mobilizing untapped investment funds. These two objectives--restructuring and privatization of the state enterprise sector, and the strengthening of a broad-based, strong capital market--are complementary. Both objectives address the need to rationalize resource mobilization and allocation. They also provide the basis and continued sound footing for USAID/Indonesia's Financial Market Project (FMP), which is making a strong and important contribution to the vigorous growth of the private sector in Indonesia.

The GOI is in the preliminary stages of planning a pragmatic program of SOE restructuring and privatization in support of these broader economic development objectives. In carrying out this process, the GOI will require significant amounts and varied types of specialized technical assistance. USAID/Indonesia, through its Financial Markets Project, is in a unique position to be an important provider of such technical assistance to support the GOI in further planning and executing its SOE restructuring and privatization program, linked to the Government's capital market development efforts and program to rationalize resource mobilization.

B. Objective and Scope of the Report

This report, building off an analysis of the performance of BUPN, i.e., the agency of the MOF which serves as the executing agent for unpaid and overdue debts owed to SOEs (see Appendix A), presents a review and analysis of the status of the GOI's current SOE restructuring and privatization program. The objective and scope of this report is to provide USAID project design specialists with information to update and further develop the Mission's strategy and program in the area of SOE restructuring and privatization.

This report was prepared under a USAID/Indonesia buy-in to APRE/EM's Financial Sector Development Project (FSDP). The information contained herein is based on interviews carried out by the FSDP TA Team with various GOI officials; data and information gathered from various sources, including up-to-date GOI documentation; and feedback from USAID/Indonesia on the Preliminary Draft version of this report.

C. Contents of the Report

Chapter II presents a review and analysis of the GOI's current SOE restructuring and privatization program, including:

- The objectives guiding the GOI's SOE restructuring efforts
- A description of the analysis and initial decisions taken by the GOI in categorizing the SOEs
- The action program as presently proposed by the GOI
- Preliminary issues pertaining to the legal form and third party obligations of the SOEs.

The types of technical assistance which may be useful to the GOI in further formulating and implementing its SOE restructuring and privatization program are also summarized in this Chapter.

Based on the status of the GOI's SOE restructuring and privatization program as presented in Chapter II, Chapter III contains information for use by USAID strategy and program design specialists to further develop the Mission's SOE restructuring and privatization project. This chapter contains the following sections:

- Lessons Learned: A distillation of key "lessons learned" in the design and implementation of privatization programs in other USAID-assisted countries which may be helpful in designing USAID/Indonesia's program.
- Premises/Assumptions: Based on these "lessons learned," as well as the objectives and current status of the GOI's program, a number of fundamental premises and assumptions which could serve to underpin USAID's stratetgy and guide its program design efforts are presented.

- <u>Objectives</u>: A description of the possible objectives for USAID's SOE restructuring and privatization program.

- <u>Overall Project Output Areas</u>: A description of a number possible overall output areas which define the general categories of technical assistance that the GOI is likely to require, and which might therefore form part of USAID's overall program design.

- <u>Specific Outputs</u>: A listing possible specific "outputs," or discrete events or circumstances which indicate that USAID's technical assistance has been successfully applied.

II. STATE-OWNED ENTERPRISE (SOE) RESTRUCTURING AND PRIVATIZATION IN INDONESIA

A. Background

The precise scope of the GOI's involvement in commercial and industrial activities is difficult to determine. Although the Central Government has complete ownership in approximately 189 non-bank enterprises, other levels of Government and public entities own many businesses in whole or in part. The GOI is especially involved in, and in many instances dominates, a number of key economic sectors such as natural resources, utilities, banking, heavy industry, transportation and communications.

It is noteworthy that the GOI's dominant role in the economy has deep roots in Indonesia for many reasons:

- o <u>Historical</u>: The pre-independence regime in the Dutch East Indies organized and ran the economy largely through state monopolies, and that tradition was reinforced during the struggle for independence and the subsequent need for economic development.
- o <u>Political</u>: The need to hold together a heterogeneous and far-flung archipelagic country.
- o <u>Economic</u>: The need to accelerate development and to counter the power of economically strong minorities.

As such, the GOI's heavy involvement in economic activity has enjoyed widespread public support. However, pressures for economic reform have been mounting from within and without the GOI, particularly since the collapse of oil prices during the 1980s forced an end to relatively high levels of public spending and necessitated serious belt-tightening efforts.

The performance of the economy as a whole, and SOEs in particular, has since become the subject of intense deliberations at the highest executive and legislative levels of Government. The result has been a series of economic deregulation measures brought about by the need to revitalize and diversify the economy, to create the basis for growth and expansion necessary to accommodate the large number of entrants into the labor force, and to reduce the risk of political unrest and instability.

The recent upsurge in oil prices has not dampened the Government's determination to push ahead with its deregulation and restructuring efforts. It is recoginzed that today's oil price is an aberration unrelated to market forces, and therefore of uncertain duration. More important, the policy makers are now convinced by the response to their economic reform packages that the country's welfare is best served by developing as strong a non-oil sector as possible. The benefits of a diversified economy are well understood.

The issue of the level of GOI commitment to SOE restructuring and privatization can be best understood within the context of how decisions are made by the GOI. The decision-making process is one of consensus among various factions and interest groups within the Government. At this point, it is clear that a consensus has developed that the performance of SOEs represents a heavy drain on the economy and that concrete steps must taken to address the issue, as noted in the repeated calls for improvement in the efficiency of SOEs. Beyond that, however, the consensus weakens because of the inherent complexities of designing and implementing an SOE restructuring and privatization program.

Hence, while there is a certain degree of commitment to SOE restructuring and privatization across the board within Government, the depth of commitment to a comprehensive program is greater in some quarters than others. One thing is clear however: the GOI has broad powers to implement its SOE restructuring program.

B. Current Status of the Government of Indonesia's (GOI) SOE Restructuring and Privatization Efforts

1. The GOI's Objectives in Developing an SOE Deregulation and Privatization Program

While the decisions and actions recommended in the early stages of the SOE restructuring and privatization process have been largely shaped by the single criterion of reduced pressure on the national budget, it is clear from both the public announcements and internal discussions that the Government has a far broader range of objectives in mind.

To a large extent these broader objectives still need to be defined more explicitly. Nevertheless, they start from the basic premise that there is an urgent need to increase the efficiency of the economy's performance. It is recognized that achieving increased efficiency depends upon making market forces more pervasive in driving the economy. This, in turn, will require reduction or elimination of monopoly elements in the markets, and greatly increasing the participation of the private sector in areas which currently fall under the domain of the Government.

Therefore, in formulating even its initial program for SOE restructuring, the GOI is seeking to achieve not only economies in the claims on the budget arising from the public sector, but also greater efficiency in the economic performance of the firms that now make up the state-owned sector.

Three immediate targets have been identified to support the achievement of these dual objectives:

(1) Capacity for Self-Generation of Financing: To create the capacity for greater self-generation of the financial resources necessary for efficient operation of the enterprise, especially foreign exchange, so as to reduce the call on general GOI resources to meet these financing requirements.

(2) Quality of Management: To improve the quality of management and to create those attitudes necessary for running an efficient and profitable operation.

(3) Economies of Scale: To merge or consolidate state enterprises when doing so will create a more rational structure for the firms, permitting economies of scale.

It should be noted that this specification of objectives clearly focuses on increased efficiency in the use of resources and on increased market determination of the performance of individual SOEs, not necessarily on the formal issue of ownership. Nevertheless, ownership is an important consideration in achieving the efficiency objective. There are two principal reasons for this. First, while in principle the conditions of managerial autonomy can be created within a government-owned enterprise, and competent, market-driven managers hired, the lack of incentives associated with ownership can defeat the purpose of increasing efficiency. The fact of government ownership and the natural temptations of politicians and bureaucrats to assert themselves work against fully achieving higher levels of efficiency. Even partial ownership of equity by members of the general public creates a desirable element of transparency and accountability.

Second, the best route to increased efficiency in many cases will be the introduction of "outside" management. Again, while in principle this can be accomplished through a management contract, it is likely to be more effective if a joint venture involving an equity infusion by the joint venture partner is established. If equity is a requirement for the private partner, then there will be an incentive to operate the enterprise as efficiently as possible.

2. The Role of the Ministry of Finance (MOF) in SOE Restructuring and Privatization

As set out in Government Regulation No. 3 of 1983, the MOF is the General Shareholder in an SOE on behalf of the Government. The MOF appoints the relevant technical Minister as its proxy to promote, supervise, and control the activities of the SOE in coordination and consultation with the MOF (Article 7(1)(2)). However, as General Shareholder, the MOF is vested with the management of the State Wealth that is invested in the SOE (Article 5(1)). Under this charge, the MOF must approve the budget and accounts of the SOE. Moreover, under Article 13, the MOF must approve amendments of the total capital of an SOE; the sale or burdening of fixed assets; the capital participation or release of capital; the establishment of a daughter company/subsidiary; the partial or total release of shares; incurring medium or long-term debt; and the liquidation, merger, or reorganization of an SOE.

This allocation of responsibilities between the MOF and the Technical Ministries gives the MOF a central role in initiating, approving, and implementing a restructuring or privatization of SOEs. The MOF is therefore the agency primarily responsible for those aspects of ownership central to restructuring and privatization, and would bear the overall responsibility for carrying out the GOI's SOE program. Within the MOF, the Directorate of State Assets is likely to be the key institutional interface in Government responsible for managing the process of designing and implementing the GOI's SOE restructuring and privatization program.

3. Steps to Date: Analysis and Initial Decisions

The GOI has defined the first phase of a program to increase the efficiency and productivity of its SOEs. A very significant increase in private sector participation in areas previously the domain of the public sector is a key element of this program. Market determination and discipline, with respect to prices and allocative and production decisions, are clearly recognized as important to the success of this program.

In response to Presidential Instruction (INPRES) No. 5 of 1988, and the follow-up guidelines laid down in The Decree of the Minister of Finance Number 740/KMK.00/1989 (28 June 1989), the financial performance of all SOEs, as reflected in their accounts as audited by the State Auditor, were evaluated.

Initially, two steps have been taken. First, as a measure of performance, three financial ratios were calculated for each of the 189 non-bank SOEs, the combined activity of which are estimated to contribute to 25 percent of GDP: profitability, liquidity, and solvency. A weighted average of these measures was determined and, on the basis of the average, all enterprise firms were assigned to one of four classes: very healthy, healthy, less healthy, sick.

Second, with this performance measure in hand, the Ministry of Finance (MOF) reviewed the situation of each SOE with its respective technical Ministry. On the basis of this first round of discussions, the SOEs were divided tentatively into seven categories defined in terms of the next stage of action to be applied to the enterprise.

It is important to note two aspects of this exercise. First, there was no direct connection made between the performance criteria and assessment, on the one hand, and the action decisions taken with respect to individual enterprises on the other. The performance assessment and the decision to go public, seek a joint venture partner, etc., are independent of each other. Second, the main objective addressed so far is minimizing future burdens on the national budget.

Generally speaking, SOEs that are in relatively fair shape, and have significant investment or expansion plans, were selected to go public as a means to finance those plans. Cement is a case in point. Supplies are projected to be in tight supply with significant shortages potentially developing on or about 1993. The three state cement firms (Gresik, Padang, and Tonasa) all have substantial expansion plans under implementation.

SOEs that are in relatively fair shape yet, in the judgement of the Government analysts, require greater levels of assistance, were selected to seek joint venture partners. The assumption is that the equity injected by a joint venture partner would finance the costs of the "turnaround" efforts required for these SOEs.

The firms in the largest category, i.e., those that are to retain their present status but that will be subject to efficiency improvement efforts, are presumably those SOEs that at present do not fall within either of the above two categories: they are neither too badly off, nor are they proposing major demands on the budget for investment and expansion. In this regard, Pertamina would be an exception, as it has a major investment program on the table.

The process of placing SOEs in categories reflecting different treatment (e.g., going public versus finding a joint venture partner) raises an important issue with respect to objectives and strategy. When efficiency is an important objective in the restructuring of a particular enterprise, then establishing an appropriate joint venture relationship is a more direct and effective remedy than selling shares to individual portfolio investors on the stock market. On the other hand, if the primary objective is to allow needed investment to go forward without burdening the national budget, then floating shares is an eminently attractive device. Moreover, public floatations have the added effect of spreading ownership throughout a broader range of society.

It is useful to recognize that there are multiple goals to be sought in carrying out an SOE restructuring and privatization program, and that multiple goals require multiple strategies. However, for each strategy, specific plans for implementation must be devised. Up to now, this effort remains to be done. The questions of the attractiveness to the public of the shares of the first group of companies, or of the second group's potential interest to joint venturers, have essentially not been addressed as yet.

4. The Action Program as Presently Proposed

In addition to the three general groups described above, the SOEs have been divided into seven preliminary categories:

(1) SOEs requiring changes in their legal status as a basis for improving their efficiency (16). At present, these enterprises are either Perums (public corporations), such as Perum Tambang Batubara Ombilan (coal mining), Perum Telekomunikasi (telecommunications), and Perum Indofarma (pharmaceuticals); or Perjans (Government agencies), such as Perjan Kereta Api (state railway system).

(2) SOEs that are to seek management contracts or joint operations arrangements (5). These are all under the Ministry of Agriculture--four industrial estates and a fishing operation.

(3) SOEs that are to be merged or consolidated (15). Each of these mergers will involve a minimum of two firms, and several are expected to bring together three or more previously independent entities. More than thirty entities will therefore be involved in these consolidations. Some of the newly-merged firms resulting from this process are among the firms that will then fall under other categories. For example, Cement Padang will go to the market after Cement Baturadja has been merged into it, and Perum Tambang Batabar Ombilon will be merged with the other state coal enterprise, P.T. Bukit Asam, after it has been converted to a P.T.

(4) SOEs that will float shares on the capital markets (52). Of these:

- -- Nine are under the Ministry of Finance (insurance companies, Danareksa, industrial estates)
- -- One is under the Ministry of Transportation (Garuda)
- -- Ten are under the Ministry of Public Works (construction companies and toll road operations)
- -- Three are under the Ministry of Trade (two state trading companies and the Sarinah Ministry Store operation)

-- Four are under the Ministry of Tourism and Posts (hotels, travel agencies, and international telecommunications operations--Indosat)

(5) SOEs that will seek joint venture participation (17). Of these:

-- Twelve are industrial operations (paper, shipyards or dry docks, engirneering firms)

-- Two are agricultural firms

-- One comes under the Ministry of Public Works, Trade and Forestry.

(6) SOEs that will be sold (6) or liquidated (3). At this stage of the evolution of the program, the enterprises to be sold are in general small and those that appear to be interesting as part of the GOI's portfolio. They include PT Industri Marmer, PT Leppin, Perum Pengeringan Tembaku Bojonegoro (to be "sold" to a local cooperative), PT Milatronika, PT Indonesia Motor Company, PT Angkutan Pertambangan.

(7) SOEs that are not to be changed in status at this time, but are to be subjected to major programs to increase their efficiency (75).

5. Preliminary Issues of Legal Form and Third Party Obligations

In most countries there are a number of problems that must be addressed before SOEs can be effectively privatized. One such area relates to the issues raised by the legal form of the SOEs at the time when it is decided that they should be restructured or privatized. Another range of issues that usually must be dealt with among the preliminaries are the obligations to third parties such as creditors or employees (pension and termination rights).

In the Indonesian context, these two issues should not pose too many problems in the choice of restructuring method or the implementation of the program. Those SOEs that have been selected for public share offering at this time, or for which formation of joint ventures will be sought, are already in a legal form (Persero, or limited liability companies) which should facilitate the desired restructuring.

There may be cases in these two groups in which some revision to their Articles of Association may be necessary in respect to such issues as the election of the members of the Board of Commissioners, minority stockholder rights and protection, or to meet the desires of potential joint venture partners. There has been, however, a problem in this regard which, unless addressed, would have been a major constraint on the process of SOEs going public. The assets of the SOEs are "State Assets" as defined under the Presidential Decree on Budget Implementation (Kepres 29 of 1984), and as such have been subject to its provisions. Moreover, the operations of the SOEs are governed by a series of additional decrees, affecting in particular procurement, the disposal of assets, and borrowing. Both the Budget Decree and the other decrees and regulations set requirements, procedures and limitations on management actions that are inconsistent with the operation and management of private sector enterprise. As such, shares in companies operating under this SOE legal regime would not be comparable in value or attractiveness to the public as compared to the with shares of other companies. Importantly however, by a Government Regulation signed by President Soeharto on 24 October (PP Number 55 1990) setting out the procedures under which an SOE can go public, all SOEs that do issue shares are freed from the applicability of all of these regulations and decrees.

One additional issue that will have to be dealt with in some cases is a clarification of the implications for the enterprises' future performance and prospects of the changes in their operating environment that further deregulation of the economy might produce, i.e., abolition of monopolistic elements in an enterprise's situation. Clearly, the broader objectives of greater economic efficiency and increased employment creation will depend critically on the reduction of elements of monopoly in the economy. Unless monopoly positions are reduced or eliminated, the desired effects of market discipline will be inhibited, and the benefits of changed ownership or greater private participation will be aborted.

The major effort in the preliminary stage will need to be in getting the individual enterprises internally ready for restructuring. Records, accounts, and asset valuations will need to be put in good order. Accounts payable and receivable will need to be cleaned up as much as possible. The GOI, as owner, will in many cases need to get a clearer picture of the real market situation and prospects for many of the SOEs. That is, the owner needs a clearer picture of the value of the business as a going concern before he can effectively go public or negotiate a joint venture agreement.

With regard to settling outstanding obligations, a number of connections exist between the process of restructuring the BUPN's portfolio and facilitating the implementation of the GOI's SOE restructuring and privatization program. First, if any of the 52 state enterprises currently slated to go public figure prominently in BUPN's portfolio, this could complicate or delay any public offering of their shares. If the enterprises have particularly large and long-outstanding accounts receivable, this could certainly be a negative factor in the eyes of any potential equity buyer or issuing underwriter. Furthermore, any substantial arrears in their accounts payable could create a disincentive to generating investor interest. However, if a company is valued properly, with the valuation taking into account debt-related problems, and if any debt problems are fully disclosed to the public, the debt need not pose an outright barrier to sale.

Second, there is a more general relationship between helping the BUPN sort out its problems and making the economy more efficient. For example, the development of broad-based investor interest in acquiring equity is facilitated if a number of important procedures or transactions take place in an economy in a more or less orderly and predictable fashion. The enforceability of contracts is a frequently cited example. The collectability of debts and current accounts receivable is a strategically important class of such transactions. Any contribution to a better understanding and specification of the necessary documentation and accounting requirements for improved collection performance that is generated in the course of the work of helping BUPN clean up its portfolio will be of great value in this respect. As such, it will help strengthen the general basis for carrying out the broader SOE restructuring and privatization process, as well as developing confidence in the capital markets more broadly.

6. Limitations of the Work Done to Date

The authorities are aware of the limitations of the work done to date. It is recognized that the initial review, based solely on current and recent financial results, will need to be supplemented by commercial and technical analyses, frequently requiring the input of sector-specific expertise, before detailed action programs can be prescribed and executed for most enterprises. It is also recognized that such further reviews may lead to modification if the initial remedies assigned to particular SOEs. The present assignment of the firms to the various action categories should therefore be taken as indicative at this time. Further work may lead to selecting different solutions for a number of firms than those currently proposed. A number of next steps and issues needing resolution will need to be identified and implemented to reorganize, strengthen, and improve the structure and functioning of many enterprises before they can be fully and effectively restructured or privatized.

C. Technical Assistance Requirements

In continuing its efforts to define and implement a comprehensive SOE restructuring and privatization program, the GOI will require significant amounts and varied types of specialized technical assistance over a fairly long period of time. This assistance can be generally categorized at the policy and implementation levels, and could include the following elements:

(1) Policy Level: Assistance in designing the program and the policy framework within which it will be implemented. This includes assistance in defining the program's objectives, performance measures, restructuring criteria, and overall implementation strategy.

(2) Implementation Level: Assistance in developing the institutional capacity of the GOI to design, implement, monitor and adjust the program on an ongoing, systematic basis. This includes assistance in:

   (a) Strengthening the capacity of the MOF, from both an organizational and human resource perspective, to design, implement, monitor and adjust the program over time.

   (b) Defining and institutionalizing within Government the policies, guidelines and procedures required to carry out the program. This includes identifying the legal, regulatory and administrative changes required to implement the program; defining, testing and codifying the steps required to restructure and privatize individual SOEs; and defining guidelines and procedures to arrange and manage the private financing of public services.

   (c) Designing and carrying out a consensus-building process to create an environment that supports and motivates the program both within and without Government.

   (d) Providing case-by-case "work out" assistance of individual SOEs. For example, offering technical assistance to determine the condition of selected SOEs which the GOI decides to privatize, and providing the technical skills necessary to prepare an SOE for sale (e.g., financial, legal, asset valuation).

The process of carrying out the GOI's program, including the provision of outside technical assistance resources, will need to be phased over a considerable time period. This will be true not only because the volume of policy development and implementing activities will be so large as to stretch available staff to their limits, but also because implementation will entail major phasing considerations if the process is to be prudent and orderly. For example, generating an excess supply of new issues on the stock market may have the undesirable result of causing an undue weakening of prices or "crowding out" good new issues from the private sector, or both.

Assistance will be critically important at two managerial levels:

- Monitoring and managing the process of overall implementation of the SOE restructuring and privatization program (including close coordination with the GOI's objectives and strategy in financial market development)

- Monitoring and managing the process of defining the need for, obtaining and utilizing specialized technical assistance as effectively and efficiently as possible.

Assistance in managing both of these levels would be most effectively rendered by a resident advisor or team possessing a fundamental understanding of SOE restrucuturing and privatization combined with strong project management skills, and able to access specialized technical assistance on and as-needed basis.

These technical assistance categories, and USAID's possible role in providing technical assistance services , are described in more detail in the following Chapter.

III. USAID STRATEGY AND PROJECT DESIGN ELEMENTS

A. Introduction

This Chapter provides input to be utilized by USAID in its ongoing efforts to design a strategy and program to support the GOI's efforts in the area of SOE restructuring and privatization, and is organized as follows:

- A distillation of lessons learned from other SOE restructuring and privatization programs
- Premises and assumptions that underpin USAID's strategy development and project design efforts
- A listing of possible goals and objectives of a USAID technical assistance project
- A description of major project output areas to guide the definition of USAID's technical assistance efforts
- A listing of possible specific outputs under major project output areas.

B. Lessons Learned from other SOE Restructuring Privatization Programs

Sufficient developing country experience has been generated to begin to extract key lessons learned in the design and implementation of privatization programs which USAID might consider in developing its own strategy and project design in Indonesia. With respect to the current status of privatization efforts in AID-assisted countries, the following lessons can be distilled:

(1) Continuity of commitment and political will by the Government is essential to the success of the restructuring and privatization process.

Strong political commitment and will to carry out SOE restructuring and privatization at the highest government levels is critical to the successful implementation of such programs. In countries where this commitment is absent, programs are likely to experience delays and are often derailed. The GOI is currently committed to carrying out a comprehensive SOE restructuring and privatization program. USAID's assistance efforts should focus on ways to help the government sustain such a commitment over time.

(2) The prospects for successful restructuring and privatization implementation depend heavily on the existence of a favorable macroeconomic, regulatory and legal framework that recognizes the importance of the discipline of the market and the role of the private sector to the development process.

SOE restructuring and privatization programs are most likely to succeed where the environment is conducive to private investment, growth and development. Successful restructuring and privatization therefore normally forms part of a broader program of reform that includes macroeconomic adjustments, legal and regulatory reform and human resource development, all of which must be geared to promoting the conditions that encourage the private sector to prosper in a relatively free market environment. The GOI has made great strides through various deregulation measures to create such an enviroment in Indonesia, and is committed to continuing efforts in this area.

(3) A clear definition of objectives and measures of success of the program are essential.

Clearly defined, realistic and mutually reinforcing objectives ratified at the highest level of government are fundamental to the success of SOE restructuring and privatization programs. Each country must craft its objectives to meet its unique national circumstances, but frequently they include improving economic efficiency, promoting overall private sector growth and development, reducing the fiscal deficit and developing the capital market, depending on its stage of development. These objectives provide the foundation for restructuring and privatization policy, and govern the selection of SOEs and the methods used. In addition to defining objectives, mechanisms should be put in place to monitor the government's progress in achieving these goals. USAID's own program design should, to the extent feasible, conform to the objectives of the GOI.

(4) The breadth and depth of financial markets can determine the pace at which privatization can take place; the techniques used to privatize SOEs can be a catalyst for stimulating financial market development.

In most LDCs, the existence of strong capital markets prior to undertaking an SOE restructuring and privatization program is the exception to the rule. As the failed Chilean privatization experience in the late 1970's and early 1980's has shown, the pace of privatization cannot readily exceed the capacity of the financial markets. On the other hand, privatization can be an important tool for stimulating the development of the capital market. This was the case in Jamaica, which successfully undertook the privatization of a number SOEs through public share offers despite its underdeveloped capital market. The total value of the public offer of shares of Jamaica's National Commercial Bank in 1986 was equivalent to one year's trading of the stock market, and was 2.7 times oversubscribed. This offering drew about 30,000 new Jamaicans into the capital market. The overwhelming response on the part of the general public in Jamaica is an encouraging example of how privatization can spur capital market development.

In Indonesia, the capital market has experienced extraordinary growth since the implementation of deregulation measures in 1987 and 1988. The goal of capital market development therefore need not be a primary imperative underlying the GOI's SOE restructuring and privatization program. Nevertheless, the SOE program must take into account the impact that privatizations would have on the capital markets. For example, generating an excess supply of new issues on the stock market may have the undesirable result of causing an undue weakening of prices or "crowding out" good new issues from the private sector, or both. The phasing of major privatizations therefore needs to be carefully planned by policymakers. Furthermore, current efforts to enhance both the operational efficiency of the Jakarta Stock Exchange and the capacity of the domestic brokerage industry to profitably trade in securities must be continued so that a secondary market of sufficient liquidity, depth and continuity is developed in Indonesia. This type of secondary market is essential so that prices established by the primary market reflect the true underlying value of the enterprises.

(5) The concept of market value for going concerns should be understood and accepted by government officials.

Unless persons responsible for approving privatization transactions understand that investors, in most cases, will not be prepared to buy assets at any non-economic value (i.e., book value, replacement values, etc.), a privatization program can become paralyzed. In most cases, the value established using these methods is not sufficient to enable the investor to earn a sufficient rate of return, and therefore will not be accepted by investors. Disagreements over the final price and conditions of sale have derailed many privatization transactions after months or years of preparatory work. The valuation issue, for example, was politically divisive and led to significant delays in the Costa Rican privatization program in which USAID participated. USAID's program design in Indonesia should consider this factor, and incorporate ways in which to develop a clear-cut consensus within the GOI on the concept of market value for going business concerns, and provide training assistance to ensure that appropriate GOI staff are well-versed in the content and methodology of this subject matter.

(6) The SOE restructuring and privatization process must be transparent and devoid of any suggestion of impropriety to encourage broad public support.

The government has a fiduciary responsibility, as holder of the public assets, and consequently will be held directly accountable for any impropriety in the restructuring and privatization process. This can discredit the program and undermine public confidence in the government itself. The government should therefore establish clear-cut policies and procedural guidelines for implementation, and monitor the process to make sure that these guidelines are followed. Keeping the process as transparent as possible and in the public eye will reinforce these safeguards and promote public comfort and support.

(7) An effective and efficient public information campaign has proven to be an essential component of any SOE restructuring and privatization process.

Recognizing that SOE restructuring and privatization is a political as well as an economic process, the government should design and carefully manage a public information campaign aimed at mobilizing public support and diffusing any opposition. As part of this process, the government should ensure the fullest possible public access to information, including the positive experiences of privatization in other countries. The government must also design tailor-made strategies targeted toward potential opposition groups.

(8) The appointment of an independent commission or individual to direct the process appears to have been more successful than other alternative structures.

Experience has shown that the public sector has not always been able to act with the speed and flexibility necessary to properly implement such complex programs. In many cases it has proven desirable that the implementing entity be as independent as possible from the political structure. Even under an independent structure, the government, as owner of the assets, would logically retain its supervisory role and give final approval to all strategic decisions and transactions. The types of individuals named by government to direct the process have been of high status within the society, have had the trust of the politicians, top civil servants and the private sector, and possessed a high degree of technical competence. The individual has been supported by either a commission or ad-hoc teams, with the objective of minimizing the extent to which the decision-making structure becomes overly bureaucratized.

In Indonesia, indications are that the GOI would prefer to work within the existing government machinery to the extent possible in carrying out the program. The Ministry of Finance (MOF), as the statutory holder of the state's assets, would be the lead entity in carrying out the program, coordinating with technical and other pertinent ministries as necessary. The Directorate of State Assets (BUMN) would presumably be the entity within the MOF charged with the day-to-day responsibility of implementing the program. However, if experience proves that working within the established machinery is less effective than the Government might desire, Indonesia's high degree of pragmatism in dealing with such issues in the past suggests that they may reconsider this institutional approach. Hence, ad-hoc committees or other structures may be created from time to time participate in the implementation of the program.

C. Premises Underlying USAID's Strategy and Project Design

The "lessons learned" described above, combined with the review and analysis of the GOI's current objectives, point to a number of premises that can be used to guide USAID's strategy and project design efforts, including:

- The GOI is committed to carrying out an SOE restructuring and privatization program. The GOI is currently committed to carrying out a pragmatic program of SOE deregulation and privatization in support of its broader economic development objectives which include diversifying into non-oil sectors, enhancing the efficiency of the SOEs, and reducing the burden that SOEs place on the national budget.

- The role of market forces and the private sector are viewed as important to carry out the program. The GOI envisions a very significant increase in private sector participation in areas previously the domain of the public sector as a key element of its program. Market determination and discipline, with respect to prices and allocative and production decisions, are also clearly recognized as important to the success of this program.

- A sound financial market is viewed as important to carry out the program. The GOI recognizes the importance of properly functioning capital markets to the successful execution of its SOE deregulation and privatization program.

- The SOE restructuring and privatization process will require significant amounts of technical assistance. The GOI will require significant amounts and varied types of specialized technical assistance in carrying out its SOE restructuring and privatization program.

- USAID is strategically positioned to assist the GOI. USAID, through its Financial Markets Project, is in a strong position to become a key player in providing the assistance required by the GOI to further plan and execute its SOE restructuring and privatization program, linked to its capital market development efforts.

- The GOI's goals provide a sound basis for developing a USAID project. The MOF has stressed improved SOE efficiency and reduced demand on the national budget for investment funds for SOEs as the two most important goals of the GOI's restructuring and privatization program. The GOI also envisions that the private sector, capital markets and market forces will play key roles in carrying out the program. The GOI's goals and means for accomplishing them therefore provide a sound basis for developing a USAID project, the objectives of which should closely follow the GOI's overall goals.

- USAID's strategy should focus on building indigenous capacity. USAID's project should stress building the GOI's capability to design, implement, monitor and revise the program over time. Technical assistance should be targetted at the GOI entity or entities responsible for carrying out the program to enhance their institutional capacity, as well as develop appropriate policies and procedures (e.g., independent third party valuation, arm's length negotiations between buyers and sellers).

D. USAID Project Objectives

Conforming to the premise that the GOI's goals provide a sound basis for developing an AID project, and that USAID's objectives should therefore closely follow the GOI's goals, the following could serve as primary objectives for USAID's own program:

- Promoting job creation opportunities through enhanced efficiency of resource allocation

- Achieving greater efficiency in the economic performance of SOEs

- Reducing the claims on the budget arising from the public sector

- Creating the capacity for greater self-generation of the financial resources required for the efficient operation of SOEs

- Making market forces more pervasive in determining the allocation of resources

- Improving the quality of management and creating those attitudes necessary for running efficient and profitable operations

- Institutionalizing within the GOI the capacity to design, implement, monitor and revise the program on a systematic, ongoing basis.

A number of secondary objectives, related to the capital market-related elements of USAID's Financial Markets Project, could include:

- Generating additional supplies of securities for private sector investment

- Providing a broader range of long-term investment options to investors

- Broadening and deepening the level of activity on Indonesian capital markets.

E. Possible Overall Output Areas

In order to achieve the USAID's objectives, and in view of the anticipated technical assistance needs of the GOI, a number of program elements, or major project outputs, can be identified to provide the basic framework for USAID's technical assistance program. Major project outputs in support of the GOI's overall SOE restructuring and privatization program could be contributions to the following:

1. Improved Overall Policy Framework: Further develop the overall policy framework which provides the fundamental direction of the Government's SOE program.

2. Improved Policy and Procedural Framework: Develop, coordinate, rationalize, and continuously revise a framework of policies and procedures that clearly define the process of carrying out the SOE program.

3. Enhanced Institutional Capacity: Develop within the GOI the institutional capacity to design, implement, monitor and revise the SOE program on a systematic, ongoing basis.

These major project output areas are described in more detail below.

1. Improved Overall Policy Framework

Generally speaking, at the policy level, USAID should undertake to participate in those activities which will assist the GOI to further develop and refine its SOE restructuring and privatization program objectives and strategy, and create the necessary conditions for successful program implementation.

The objective of this project output area is to assist in further developing the overall policy framework which provides the fundamental direction of the SOE program. Clear government policies result in explicit objectives and priorities, and provide the framework which would incorporate the future policies and procedures required to support the implementation of the program. Developing a viable overall policy framework would require that the GOI develop a comprehensive strategy to implement the program. A comprehensive strategy of this nature would normally incorporates a number of elements, including the following:

- Develop an information base on SOEs
- Refine the objectives of the program
- Establish the scope of the program
- Design and implement strategies for reducing labor displacement
- Design and implement a strategy for the utilization of privatization proceeds
- Design and implement a strategy to maximize private investment in public services
- Design and implement a strategy to build consensus
- Monitor and revise the program.

These are described in more detail below.

a. Develop an Information Base on SOEs

In order to assist the GOI develop an improved policy framework for its SOE restructuring and privatization program, USAID could assist the GOI expand its information base to support the process of policy formulation within Government. This information base would include developing an SOE database and carrying out an economic impact analysis.

(1) Develop an SOE database

Detailed information on each SOE is needed to give the architects of the program a sense of the full scope of the sector and will serve as useful input for strategy design and implementation. The database should include at least the following types of basic information: name of the company, location, legal status, percentage of ownership by the state, sector, product line/services, number of employees, average salary, type of administration, net transfers to/from the government, the deficit or surplus, level of investment, sales and exports, and taxes paid over the past five years, the book value of assets, and the capital base.

(2) Conduct an economic impact analysis

Governments usually have the general sense that supporting a large SOE sector is costing them a great deal, but they often have not quantified this impact. By carrying out an economic impact analysis, the GOI should be able to estimate the full price of sustaining public enterprises (in terms of inflationary impact, impact on the public sector deficit, higher unit costs for products, and lower levels of growth due to lack of sufficient investment). This information, in addition to supporting policy decision making, is also an important element in building political support for continued reform. Typically, opponents of privatization focus on such transitional features of a reform program as layoffs or reduced subsidies, without recognizing the opportunity costs in terms of growth and employment of maintaining inefficient, uncompetitive enterprises.

b. Define the Objectives of the Program

The importance of establishing clear, broadly-defined objectives for any SOE restructuring and privatization program is paramount. In practice, however, this is a difficult process since various institutions within the Government will focus on different goals, such as equity, efficiency, competitiveness, state revenue. While the GOI has already laid out the overall objectives of the program, these will require continuous updating and refinement as the program is implemented over time.

For example, the proper balance between the budgetary and efficiency objectives in determining restructuring proposals needs to be more sharply defined in the GOI's current program.

This, in turn, is likely to be a major determinant of the scope and pace of increased private participation. Private owners or partners provide not only financing, but also efficiency-oriented management, better access to technology, and stronger marketing channels.

This elaboration of objectives can properly be done only by the responsible GOI officials. In fact, the MOF is aware of this need and is eager to seek confidential, long-term support to supplement its resources. There could be a useful role in this regard for generalized policy analysis that identifies and assesses, for the consideration of the decision maker, the economic costs and benefits of alternative objectives. However, the sensitivity of the political dimension of the costs and benefits of alternative objectives necessitates that any input at this level must be characterized by modesty and tact.

c. Establish the Scope of the Program

The GOI must decide what the general scope of its SOE restructuring and privatization program should be. Should it privatize all of the SOEs? Are there SOEs that are politically sensitive or protected by the Constitution? Should it confine privatization to the smaller and commercial SOEs? Should the country focus its program on the sale of big lossmakers?

Defining the scope of an SOE restructuring and privatization program is a difficult task. For example, if economic or infrastructure sectors are not included, the program may not have a significant impact on growth and employment. Restricting the sale of large profitable enterprises, some of which may be monopolies, might limit the opportunities for public share offers and therefore for the widening of capital ownership and the introduction of competition. While focusing exclusively on loss-makers has a potential impact of reducing the adverse effects on the national budget, this may fail to motivate the private sector and possibly limit the success of the program.

As noted in Chapter II of this report, the GOI has already gone through a first iteration analysis to categorize the SOEs. In this process, the Government has used a number of performance measures and restructuring criteria to place SOEs in various remedial categories. These performance measures and restructuring criteria will require ongoing refinements over the life of the program in order to ensure that the scope of the program remains consistent with the GOI's objectives. The objective of these efforts is to ensure that the scope of the program remains fully consistent with stated objectives.

For example, the performance measures currently applied to categorize the SOEs may need to be refined. Profitability is clearly the best overall measure of performance for an SOE; however, it may be desirable to consider a number of changes in the present definition and application of the profitability measure:

- The appropriateness of the use of the liquidity and solvency elements in the weighted average upon which the measure is now based may need to be reconsidered.

- The profitability measure may need modification to take into account non-commercial objectives that may have been assigned to some firms but not others.

- Greater enterprise and industry specific analysis needs to be developed so that the potential for improvement can be more soundly judged, recognizing that expected profitability on a "going-concern" basis, rather than historic performance, is the most relevant measure for selecting the right remedial action, particularly in the case of privatization.

Furthermore, as the objectives are clarified and the analytic measures more sharply defined, the criteria for determining the appropriate restructuring action for each firm must be refined. To achieve greatest efficiency and developmental impact, as well as to maximize the private sector's role, it is necessary to answer a number of key questions, including what are the characteristics of an enterprise that would determine whether it should go public, seek a joint venture partner, seek a management contractor, merge with another SOE, stay as is but improve efficiency, be liquidated, etc.

It may also be desirable to define additional criteria, such as: competitive position of an SOE in the market; degree of redundant labor; size of the firm; and political sensitivity of the industry. A clear link should be established between the analysis of an SOE's position with respect to established criteria, the overriding goals of the program, and the action plan for restructuring/privatizing specific SOEs.

Technical assistance provided under a USAID project can make an important contribution to improving the performance measures and their interpretation along the lines suggested above. Financial, economic, managerial, and industry-specific expertise will all be required for this purpose.

d. Design and Implement Strategies for Reducing Labor Displacement

Designing an effective labor strategy as an integral part of the program will help ease the situtation of displaced workers and minimize opposition to the program. The overall impact of labor displacement on the workforce will depend on the extent of overstaffing in SOEs, the pace of restructuring and privatization, and the availability of job opportunities in other sectors. Countries have used a variety of techniques to ease the transition for displaced workers. These include early retirement, increased pension benefits, generous severance packages, and assistance in starting a new business or acquiring new skills. The exact strategy employed by the GOI will require careful deliberation, supported by sound analyses of the alternatives.

e. Design and Implement Strategies for the Utilization of Privatization Proceeds

The true measure of success of an SOE restructuring and privatizaiton program is not the short-term benefit from any proceeds generated from a sale, but rather its long-term impact on stimulating growth and efficiency in the economy, including its ability to fundamentally reduce the demands on the national budget. Nevertheless, governments have found it useful to delineate a policy on how the proceeds from privatization would be utilized. For example, some countries have found it politically useful to earmark the proceeds from privatization for social or infrastructure programs. Governments should be careful, however, not to raise expectations regarding the amount it hopes to receive and how such proceeds can be deployed, especially as the net proceeds may be less that expected.

The operational significance of this consideration may be less applicable in the Indonesian context than in other countries for a number of reasons. The potential sums of money involved may be of less significance than fluctuations in the price of oil or primary commodities. Furthermore, the GOI has a well-defined development program to which any additional resources would be devoted. Basically, the GOI is not currently in search of new spending ideas to finance. The GOI may nevertheless find it useful to delineate how it plans to use the proceeds from any privatizations as part of its stated policy.

f. Design and Implement a Strategy to Secure an Optimum Level of Private Investment in the Provision of Public Services

In line with its stated objectives of enhancing efficiency in resource allocation and reducing the financing requirements for investments under the national budget, the GOI should consider developing a strategy to maximize private investment in the provision of public services. There is currently within the GOI a general recognition that there may be economic benefits of various types that could emerge from a more active participation of the private sector in the provision of services that traditionally have been the sole province of public sector agencies (e.g., infrastructure and services including electric power, telecommunications, ports and transport, water, and waste disposal). As this departure in policy could have institutional or financial consequences that are not clearly understood at this time, the GOI needs to develop a more precise and detailed specification of what the economic benefits and consequences would be within the Indonesian context. These include:

- Increased capacity for growth through enhanced infrastructure capacity and reducing bottlenecks
- Increased efficiency in the operations of the economy's infrastructure through managerial and procedural advantages that a private investor can bring to implementation and operations
- Increased efficiency in the economy resulting from a greater scope for competition in the provision of public services
- The implications for the economy's ability to sustain foreign exchange debt exposure
- The institutional, administrative, and legal consequences of private investment in infrastructure facilities.

The objective is to assist the GOI to specify these issues. This would equip the GOI with a framework to evaluate proposals for private investment in the provision of public services and to negotiate the terms under which approved projects would be implemented.

g. Develop a Consensus-Building Program

Recognizing that SOE restructuring and privatization is a political as well as an economic process, the GOI should consider designing and carefully managing a public information campaign aimed at mobilizing public support and diffusing the opposition as part of its overall strategy.

(1) Build high-level political consensus around overall program strategy and objectives

It is important that GOI officials continue to bring focus to the program by issuing policy pronouncements which outline the objectives and basic strategy of the program. Policy pronouncements which contain clear, broadly understood objectives should help to coalesce top-level support, provide legitimacy to the program, and promote consistency on the part of the Government. As part of this process, the GOI needs to identify the potential supporters and opponents of the program and how their interests may be either protected or harmed. This information will provide the basis for a focused public relations strategy to address the concerns of potential opponents and to mobilize support for the program.

(2) Design a public relations strategy

The published objectives would also serve as the cornerstone of the public relations program, which forms an integral part of the consensus building process. The ultimate objective of this activity is to assist in creating an environment that supports and motivates the program, including increasing public confidence in SOE restructuring and privatization, mobilizing support of various interest groups, and promoting adoption of reforms.

Successful public relations programs are normally organized around two components: targeted communications activities to further educate GOI officials and reassure them of the soundness of the program (closed-door meetings, briefings, seminars, etc.); and public awareness activities to keep the general public informed (conferences, seminars, widespread dissemination of information).

h. Monitor and Adjust the Program

The GOI should establish indicators to periodically measure its progress toward achieving its objectives in the area of SOE restructuring and privatization. As part of this process, it may want to monitor the program's impact on growth, the fiscal budget, and investment flows. The GOI may also want to periodically assess the program's impact on employment, prices, and economic efficiency. In addition, the effectiveness of institutional structures, guidelines, policies and procedures should be examined. The GOI should also consider how effective it has been in building political support for the program and in keeping the public adequately informed.

In tracking the program's progess, the GOI may decide to revise its policies and procedures, reorganize the implementing agency, improve regulatory and evaluations systems, or otherwise adjust other elements of its overall strategy, such as its public relations strategy. Such mid-course corrections may be necessary to keep the program on track in the case of new political or economic developments.

2. Improved Policy and Procedural Framework

The objective of this project output area is to develop, coordinate, rationalize, and continuously revise a framework of policies and procedures that clearly define the process of carrying out the SOE program. This involves identifying existing policies and procedures which are a constraint to implementing the program, as well as defining and testing new policies and procedures that facilitate carrying out the process of restructuring and privatizing SOEs.

a. Identify Current Legal, Regulatory and other Procedural Constraints to Implementing the SOE Program

As noted in an earlier section, there are a number of issues of legal form and third party obligations that must be resolved before SOEs can be restructured or privatized. As the GOI's SOE program evolves, many of these types of issues can be expected to surface.

Research and analyses must be carried out to identify current policies and procedures of this nature that may affect the implementation of the SOE program. One way of identifying such constraints involves tracing the critical path of restructuring/privatizing SOEs under various methods, and determining at each step what legal or other types of impediments or constraints exist that may hamper the process. Once possible impediments are identified, these should be analyzed and options developed to overcome them. This analytical process will also help to identify some of the deficiencies or missing elements in the current policy and procedural framework, indicating where new policies and procedures may be required to accommodate the implementation of the SOE program.

The objective of this effort is to compile and rationalize the GOI's policies and procedures as they affect the implementation of the program as an initial effort in establishing an integrated policy base from which further procedures and policies may be developed to successfully execute the program.

b. Define and Institutionalize Procedures to Restructure and Privatize SOEs

On another level, the entire range of procedures for carrying out the actual process of restructuring and privatizing SOEs must be defined and integrated within the GOI's institutional machinery. This would include developing guidelines and procedures to carry out the following types of activities:

- Target and prepare SOEs for restructuring/privatization

  -- Classify candidates on the basis of selected criteria
  -- Diagnose specific companies
  -- Select restructuring/privatization method
  -- Prepare SOEs for restructuring/privatization

- Transfer ownership

  -- Conduct valuations
  -- Meet with organized groups/stakeholders
  -- Structure the transaction
  -- Develop strategies for market candidate SOEs
  -- Close the deal

- Monitoring and adjustment

  -- Monitor company performance
  -- Examine the effect of the competitive environment on enterprise management, labor, product pricing
  -- Review criticism levelled at the process to avoid future pitfalls and improve procedures
  -- Codify procedures that are to be applied
  -- Monitor restructuring/privatization impacts
  -- Adjust the program.

c. Define and Institutionalize Guidelines and Procedures for Arranging and Managing Private Investment in the Provision of Public Services

In order to implement efforts that maximize private investment in the provision of public services, the GOI will have to be equipped with the guidelines and procedures to evaluate proposals and to negotiate the terms under which approved proposals would be implemented. The criteria for the evaluation of the financial, commercial and institutional aspects of such projects would need to be defined and institutionalized within the GOI, and could include the following types of elements:

- Financial Criteria: Balance of payment limits; financial market limits; differences in the financial and cost implications of alternative investment formats; choice between public and private investment; distribution of financial risk in the individual projects; Indonesian tax implications; etc.

- Commerical Terms Criteria: Basis for establishing the price of the service; the basis for adjusting price; the term of sales contracts; the currency of sales; valuation of past Government investment; etc.

- o **Institutional Criteria**: Conformity with existing law; need for modification of existing law or regulation; technology choice and compatibility; etc.

3. Enhanced Institutional Capacity

The objective of this project output area is to develop within the GOI the institutional capacity to design, implement, monitor and revise the program on a systematic, ongoing basis. In order to attain the objective of developing the institutional capacity within the GOI, two steps might be considered:

- o Conduct an organization and management (O&M) review of the Directorate of State Assets
- o Design and implement a training program for the Directorate of State Assets.

a. Conduct an Organizational & Management (O&M) Assessment of Directorate for State Assets

An O&M assessment would involve assisting the Directorate carry out an analysis of its current objectives, organizational structure and resources, including steps such as the following:

- o Defining in the clearest possible terms Directorate's role and objective within the program
- o Analyzing its organizational and human resource capacity to fulfill its role
- o Formulating a strategy to accomplish its objectives within the program
- o Defining the optimal organizational structure to carry out the strategy
- o Defining policies, job descriptions, administrative procedures, computerization requirements.

The result of this effort would be an action program designed to correct the major weaknesses and reinforce the basic strengths of the Directorate in implementing the SOE restructuring and privatization program. Each element of the action program would have specific information in terms of the priority, human resource requirements, identification of the manager responsible for its execution, etc. The Directorate's computerization requirements would also be more clearly understood upon completion of the O&M assessment, and technical assistance provided to design and install the needed systems.

b. Design and Implement a Training Program for the Directorate for State Assets

It is anticipated that significant amounts of training will be required to strengthen the Directorate's capacity to carry out the program. The O&M assessment will result in a clear definition of areas where training is necessary. Directorate staff would, for example, in all likelihood have to sharpen their managerial and technical skills to carry out the overall process of targeting and preparing candidates for restructuring or privatization and, in the case of a privatization, transferring ownership. This entails the technical ability on the part of the Directorate's staff to classify SOEs, diagnose specific enterprises, select the most appropriate method of restructuring, prepare candidates for privatization, conduct valuations, structure transactions, etc. Importantly, the staff may also require training to strengthen its ability to manage the process of carrying out the Directorate's responsibilities under the program.

F. Specific Outputs

A number of specfic outputs, or discrete events or circumstances which indicate that USAID's technical assistance has been successfully applied, are listed below by major project output area:

1. Improved Overall Policy Framework

Develop an Information Base

- Profiles on candidate companies
- Databank of SOEs, potential investors, sources of finance and technical assistance
- Methodology to conduct an economic impact analysis

Define the Objectives of the Program

- Revised program objectives (with supporting analyses/ recommendations)

Establish the Scope of the Program

- Revised performance measures (with supporting analyses/recommendations)
- Revised restructuring criteria (with supporting analyses/recommendations)
- Revised list of restructuring candidates
- Revised list of privatization candidates

Design and Implement Strategies for Reducing Labor Displacement

- Proposals for ameliorating the labor-displacement effects of the program:
  - early retirement
  - increased pension benefits
  - generous severance packages
  - starting new businesses/acquiring new skills

Design and Implement Strategies for the Utilization of Privatization Proceeds

- Proposals for the utilization of privatization proceeds:
  - Small business expansion schemes
  - Delivery mechanisms to direct subsidies to affected labor
  - Labor compensation packages for redundancies and early retirements
  - Funding retraining programs for displaced skilled labor
  - Infrastructure development programs

Design and Implement a Strategy to Maximize Private Investment in Public Services

- Analyses of benefits and consequences of private investment

- Proposed strategy

Develop a Consensus-Building Program

- Proposed strategy
- Media items (print, audio, video)
- Workshops/seminars
- Promotion campaigns

Monitor and Adjust the Program

- Indicators to measure success (growth, fiscal budget, investment flows, employment, efficiency)
- Computerized monitoring system

2. Improved Policy and Procedural Framework

Identify Current Legal, Regulatory and other Procedural Constraints to Implementing the SOE Program

- Methodology to identify constraints leading to policy/procedural changes
- List of current constraints and recommended changes
- List of new policies/procedures

Define and Institutionalize Procedures to Restructure and Privatize SOEs

- Offering memoranda
- Methods and procedures for restructuring
- Methods and procedures for privatization
- Number of SOE privatization action programs developed
- Decisions to privatize selected candidate companies

- o Public announcements of tender offers in publications
- o Recommendations for procedures for specialized techniques (e.g, ESOPs)

Define and Institutionalize Guidelines and Procedures for Arranging and Managing Private Investment in the Provision of Public Services

- o Guidelines/procedures for reviewing proposals
- o List of negotiating criteria
- o Guidelines/procedures for monitoring contract compliance

3. Enhanced Institutional Capacity

Conduct an Organizational & Management (O&M) Assessment of the Directorate for State Assets

- o Proposed action programs to strengthen the Directorate

Design and Implement a Training Program for the Directorate of State Assets

- o Proposed training programs
- o Number of Directorate staff trained

APPENDIX A

Improved BUPN Performance Plan

FINAL REPORT

I. INTRODUCTION

The BUPN has an important mission as the implementing arm of PUPN. First, the need to mobilize resources that can be used in the development effort is supported by the honoring of obligations to state entities by those who are the debtors in those obligations. Second, the effectiveness of efforts to increase the efficiency of the performance of the market depends to an important degree on increased understanding and observance by all participants in the domestic economy of certain norms of commercial practice.

Important among these are the honoring of contracts, the enforceability of obligations, and the accessibility of collateral. Effective collection of debts owed to the State can play a useful supportive role in improving understanding and practice in these respects. Furthermore, BUPN, as it seeks to settle overdue claims for the Government, naturally deals with a number of businesses in financial difficulty. It may well have more involvement with troubled firms than any other agency in the country. Thus, as it works out the recovery of claims from such companies, it is in a good position to contribute to a positive solution to the problems of those firms, rather than simply a punitive one. If equipped with the necessary mandate and staff, BUPN could help troubled firms to work out a turnaround through reorganization and restructuring while at the same time securing collection of the claims entrusted to it for processing.

To play this role would require that the present, primarily judicial nature of BUPN's operations would need to be changed. Its methods would have to be broadened from a focus on negotiations over claims, and its remedies would need to be more diverse and flexible than seizure and auction of collateral. If this can be done, the BUPN could be helping debtors become financially more viable and productive while increasing the collections of claims owned by those debtors. An important collorary if BUPN were to be given this role is tha BUPN could become a major source of strength to the evolutio of stronger and more broadly based capital markets.

If BUPN is to play this developmental role, then its present mandate and structure as set out in the Law of 1960 as supplemented by The Presidential Decree of 1976 and the Ministerial Decrees of 1976 and 1977 would have to be revised. In addition, there a number of factors that have an adverse impact on the performance of the BUPN and a number of remedies and improvements that can be identified. A review of those are set out below.

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II. KEY FINDINGS

A. Regarding The Claims Referral Process

There are a number of inhibiting factors associated with the process of referring claims to the BUPN for subsequent processing:

1. The definition of a what constitutes a claim in arrears is ambiguous.

There are directives of the Bank Indonesia (Surat Edaran of 18 September 1978 as modified by Surat Edaran of 20 June 1978) and the Ministry of Finance determination contained in the Decrees of 26 April 1971 and 30 August 1977, which set out different and inconsistent definitions of when a claim is due to a state bank which is in arrears and reportable to the BUPN. This inconsistency of definition obviously creates unnecessary operating problems for the debt collector. It would be desirable to resolve this inconsistency in a joint determination of the Ministry of Finance and the Bank Indonesia.

2. The BUPN plays a passive role in the referral process under the current system.

Even when a claim is overdue by one or both of the existing two criteria, it is the claimant agency (state bank or enterprise) which decides whether or not, or when, to refer a claim to BUPN. The BUPN is not in a position to know to what extent each state bank or enterprise has referred to it the claimant's full portfolio of loans in arrears or overdue accounts receivable. This, in turn, makes it difficult for the BUPN to discharge its responsibility to advise the Government on the full and current status of debts owed to the State. There may be merit in setting different time periods for a requirement to report a claim to BUPN for statistical purposes and a somewhat longer deadline for passing a claim to BUPN for processing procedures.

In this regard, it should be noted that there is a problem of attitude and motivation, affecting mainly claims that arise in the banking system. The banker who has made a loan that is proving difficult to collect frequently has a desire to pursue the collection of that debt himself rather than turning it over to another agency for collection. There are questions of reputation and self-esteem. More than this, however, there may be perceived to be considerations of customer relationships and competition within the banking system that make it preferable to a bank to delay referral of a claim to BUPN. If the change in BUPN's role suggested herein, then BUPN may become viewed as a partner in working out problems, not just a judicial body adjudicating a banker's mistakes.

B. Regarding the Claims Processing Stage

There are several contraints on efficient and cost-effective operations of the BUPN at the processing stage:

1. The operations of the BUPN are almost entirely manual, significantly hindering its efficiency.

The number of cases is large (almost 22,000 claims were being processed in the first half of FY 1989/90), and many of these must be dealt with locally in the Provinces throughout Indonesia. Give a workload of this magnitude and the wide geographical spread, the lack of computerization and the inadequate internal communications infrastructure available to the organization makes speedy and efficient operations very difficult.

2. The standard operating procedures within BUPN that have been developed in the past are overly elaborate and too mechanically time driven.

The main steps in the process entail: (1) negotitating the Joint Statement with the debtor (Pernyataan Bersama/PB), (2) the issuance and forwaring of the Letter Authorizing the Use of Force (Surat Paksa/SP), (3) the issuance and forwarding of the Authorization Letter to Confiscate (Surat Keputusan Penyitaan/SKP, (4) the issuance and forwarding of the Authorization Letter for the Sale of Confiscated Goods (Surat Keputusan Penjualan Barang Sitaan/SKPBS), and (5) the implementation of the Auction of Confiscated goods.

There are a number of aspects of these procedures that have a questionable impact on the effectiveness of BUPN performance. First, they divide what desirably should be a continuous flow of processing into overly discreet steps. A claim moves from one step in this process to the next mainly as a function of time. Second, these discreet steps are carried out by organizational units within BUPN which may be too self contained. This makes internal monitoring of both particular cases and the overall status of operations difficult to accomplish. Third, these procedures convert what should be in large part commercial negotiations into a process that is too formal. And fourth, the procedures also carry judicial and punitive connotations too strongly too early in the process. Clearly judicial sanctions, including confiscation, must be in the picture, but as a last resort.

III. RECOMMENDATIONS

1. A single criterion, or consistent set of criterion, should be established to to define when claims are overdue.

As noted above, if possible, it would be desirable if the definitions to be applied could be promulgated in a single joint decree of the Minister of Finance and the Governor of the Bank Indonesia. In formulating the definition of these criteria, it should be noted that there are essentially two different types of claims involved: bank loans and commercial enterprise accounts receivable. At present, only about 5 percent of the claims (in value terms) are non-bank claims. This may be due to a lower propensity for the non-bank state enterprises to refer claims to BUPN, or the problem of overdue commercial accounts receivable may be less serious, perhaps due to the fact that credit checks of customers is easier to do than credit checks of bank customers. It could also be due to the fact that the enterprises are able to collect their accounts recievable more effectively.

2. The BUPN, in conjunction with the Directorate of State Assets (Pembinaan Baden Usaha Milik Negara), should undertake a quick but thorough assessment of the status of accounts receivable.

The objective would be to determine the nature and magnitude of the overdue claims problem in commercial-type accounts receivable. If the problem is more significant than the level of present referrals would suggest, then the BUPN should continue to deal with these cases as an important part of its assignment. However, it may be appropriate to define "overdue," "non-performing," or "in default" differently for the two classes of claims. On further study, it might also be appropriate to divide the commercial (non-bank) claims into two subclasses: industrial or commercial firm accounts receivable, and overdue services bills such as electricity and phone bills. It would be desirable, however, that one criterion apply to all cases within the same class or subclass.

3. All debts to the state that are in arrears by the newly-established criteria should be referred to BUPN for statistical purposes.

For the Government to know where it stands so that it can both protect its interests and more effectively improve the performance of state credit and commercial enterprise in analyzing credit risk, the documentation of obligations and the

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definition of and accessibility of collateral, it is desirable that a comprehensive, up-to-date picture at a single data point be developed. Full referral to BUPN of overdue claims is the simplest way to achieve this.

Whether or not the BUPN is to initiate collection actions on all claims as soon as they are reported to it is a separate question. It may well be that there are types of claims for which the original claimant should continue to have a role in resolving the claim even after the point at which the BUPN is notified of the claim being overdue. If so, then a separate period after which BUPN is to initiate processing claims should be defined and specified.

4. <u>The specified claim referral time period should be considerably shortened and the minimum size of claims raised.</u>

The specified time period after which any class of claim is referred to the BUPN for processing should be considerably shortened as compared to present practice, but the minimum size of claim to be processed should be raised. As note above, all claims of the same class should have the same criteria applied. But more than this, it is important that efforts be made to resolve all cases of overdue claims over much shorter time periods than is presently the case.

The more time that elapses, the more difficult it is to settle claims. If there are weaknesses in the documentation to start with, which frequently seems to be the case, it will be increasingly difficult to track debtors or locate collateral the older the documentation. Perhaps more important, the more time that elapses the less effective is the entire process in inculcating and developing an understanding of the right attitudes and practices concerning credit obligations. The closer in time is action and accountability, the more effective is accountability in changing behavior patterns.

At present, BUPN processes claims that are for Rp. 100,000 or more. This floor amount is far too low. It involve's BUPN's considerable machinery in trying to collect claims that are too small to be important. While it is important to inculcate the proper attitude towards obligations on the part of small borrowers, BUPN is not the right vehicle for accomplishing this attitudinal objective. It is a very cost ineffective process for BUPN to deal with these loans. These are best dealt with directly with the agencies or programs making small loans. In fact, it is understood that many of these programs, such as KUPEDES, have very good collection records. The minimum size of a claim should probably be at least Rp. 2,000,000 on the basis of cost effectiveness.

5. <u>The BUPN should undertake a comprehensive organization and management study of its organization and operating structure and procedures with technical assistance</u>.

This study, when completed, could form the basis for a restructuring of BUPN with a view to achieveing a more integrated, less compartmentalized internal structure. This should permit a smoother and more efficient flow of processing, and make the efforts of BUPN more timely and cost effective. Working under the present structure, among other drawbacks, makes it very difficult to retrieve a complete picture of the status of any case that is being processed. This study should also assess the personnel and skill needs of BUPN. In specifying its structural, operational, and personnel recomendations, the study should take into account the tasks that may be assigned to BUPN in the future along the lines suggested above.

6. <u>BUPN should commission a study to identify and design an appropriate computerization system of its operations</u>.

It is understood that BUPN is currently reviewing its mechanization needs jointly with BAPEKSTA. It is suggested that this review specifically be aimed at coming up with a plan to comprehensively computerize the BUPN operations, again taking into consideration any new tasks BUPN may be given. In view of the number of cases that BUPN will need to process even if the minimum size claim is raised as proposed, as well as the number of aspects of each case that must be taken into account, this is the only way to make the efforts of BUPN efficient and cost effective.

In view of the heavy workload of BAPEKSTA, and the urgency in moving ahead with BUPN improvements, it would be desirable to consider associating some technical assistance inputs with this study. For maximum effectiveness, it would be important that this computerization study be closely coordinated with the organizational and personnel study proposed above. It is understood that grant funds may be available for such studies from USAID or trade sources.

7. <u>BUPN's mandate should be modified so as to give it a broader developmental role</u>.

These modifications could include:

a. Assisting in the process of improving the documentation of credit transactions and collateral

b. The development of improved credit analysis and the establishment of credit rating system and data bank to be available as "financial infrastructure" to the private sector as well as public entities

c. Placing increased emphasis on the workout of bad debt and insolvency situations in ways other than the confiscation and auction of collateral.

As noted above, BUPN must deal with what is probably the largest number of debt collection casis handled by any entity in the country. This places BUPN in a unique position to assess the inadequacies in the present documentation practices, at least of state banks and enterprises (although one might expect that a good part of the problems identified in this report would also be found in the practices prevailing in much of the private sector). If properly equipped with staff resources, BUPN, working with other concerned parties could make an important contribution to identifying the deficiencies and designing solutions in this area.

As the volume of financial transactions continues to grow rapidly and become more diverse and sophisticated in nature, ti will become increasingly important that the capacity to carry out sound credit analysis be strengthened. It will also become more important that credit information be better saved, retrieved and distributed than has been the case up to now. Again BUPN is well placed to play a major role in both the improvement of credit analysis practices and the development of a credit rating system and associated data bank.

Under the present rules, the only ultimate recourse open to BUPN in dealing with an overdue claim is confiscation of physical assets and their subsequent auction. This may be the appropriate or only action open in some cases. It is, however, a very negative and punitive action. It may allow collection of some part of the funds owed, but does not explicitly deal with the question of what would be the most economically productive disposition of a case.

It would be more constructive if, at least in sizable cases, there was a stronger emphasis on helping the debtor when the debtor requires a business "workout" of his financial problems. If that is not possible, then in many cases it might be possible to find a more productive use for the assets involved through restructuring the operation or finding a merger or takeover party. This would often involve recourse to the various institutions in the capital markets and would serve to strengthen the financial performance of the private sector.

It must again be emphasized that if BUPN is assigned a developmental role along these lines, then BUPN will require careful staff development and strengthening in quite specific skills. In particular, to discharge the functions outlined in the above recommendations, BUPN will require significant staff upgrading in such areas as credit analysis, appraisals, information systems, and the analysis of "sick" companies.

It should be understood that the task is so vast and important that BUPN should not be expected to be solely responsible for these development concerns. It would, however, be a major player and catalyst.