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State-Owned Enterprises and Corporate Governance Strength: Evidence from Indonesia

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ABSTRACT:
Background: This study investigates whether state-owned enterprises (SOEs) in Indonesia implement stronger corporate governance than do non-SOEs. It can be argued that as a large dedicated institutional investor, the Indonesian government has an incentive to strengthen corporate governance in SOEs and possesses the ability to bear the cost of implementing stronger governance.
Research Methods: The sample of the study consists of 76 Indonesia Stock Exchange-listed firms that are included in the Kompas 100 index, ten of which are SOEs. Two scoring systems have been employed to gauge the strength of their governance.
Results: It has been consistently found that SOEs implemented stronger governance compared to non-SOEs.
Conclusion: The findings of this study, however, may have a geographical limitation as they may only apply to Indonesia or may exhibit a methodical limitation due to the assumption that a higher score index is directly proportional to stronger governance. Regardless of the limitations, however, the results of this study can be used as a case study which underscores the active involvement of governments or large dedicated institutional investors in enforcing stronger corporate governance in public companies.

Keywords: *Corporate governance, State-Owned Enterprises (SOEs), Indonesia Stock Exchange*

INTRODUCTION

It has been more than two decades since the Asian economies fell in the financial crisis of 1997-1998, which led to corporate governance reforms in Indonesia. The country was the worst hit among all East Asian economies (Ito, 2007). The financial crisis triggered a series of economic, social and political crises that resulted in thousands of casualties due to waves of riots and violent protests all over Indonesia. Lack of transparency, control, supervision, and regulation in running businesses have been widely blamed as major causes of the chaotic events and, therefore, the demand for improvement in corporate governance practices was intensified (Johnson et al., 2000).

The International Monetary Fund (IMF) tried to abet the situation by issuing a letter of intent to the Indonesian government which stipulated that the extent to which it would offer financial assistance to Indonesia would depend on the

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government's efforts to reform its corporate governance (Fischer, 1998). The letter of intent contained, among other things, a schedule of corporate governance implementation in Indonesia. Since then, numerous regulations have been decreed and institutions have been established to monitor the implementation of good corporate governance (GCG) in publicly and privately-owned enterprises as well as financial and non-financial companies in Indonesia.

The main objective of this study is to investigate whether Indonesian state-owned enterprises (SOEs) implement stronger corporate governance than do non-SOEs. To the best of the researchers' knowledge, there have only been a few studies conducted regarding the determinants of corporate governance in developing countries. Among the few, is the one conducted by Ariff et al. (2007) for public companies in Malaysia, a neighboring country to Indonesia. They found out that the size of a company is the only factor that influences the strength of corporate governance. However, they did not investigate the role of government in their study. In Indonesia, the government has a dual role in managing the economy. The laws and regulations of the land require the government to be involved actively in managing businesses, as opposed to acting as a regulator or referee only. As Porter (1992), Connelly et al. (2010), and Chung and Zhang (2011) pointed out, the Indonesian government can be viewed as a large dedicated institutional investor of SOEs in Indonesia. With its massive investment in SOEs and fiduciary responsibilities, the government has an economic incentive to strengthen corporate governance in SOEs and has the ability to absorb the cost of implementing stronger governance in SOEs. In addition, the government can also use its achievements in SOEs as a model for enforcing stronger governance throughout Indonesian businesses.

This study has found out that SOEs implement stronger governance than do non-SOEs. Using two CG scoring systems, the analysis reveals that on average SOEs have scores of 18% and 11% higher than their non-SOEs counterparts, holding everything else constant. Of the control variables employed in the model of this study, only size is consistently statistically significant in relation to governance strength. The findings regarding the control variables used in this study are similar to the ones found in Malaysian firms as investigated by Ariff et al. (2007).

The remainder of this study consists of four sections. Section II briefly discusses the theoretical framework and the hypothesis. Section III explains the data and methodology. Section IV presents the empirical results. Section V concludes the investigation.

Corporate Governance and SOEs in Indonesia

It is stated in Article 33 of the Constitution of the Republic of Indonesia that all resources in the country shall be utilized for the economic advancement of all Indonesians. The constitution further prescribes that the government is responsible for ensuring that wealth is created and distributed throughout the nation. In response to the task, the Indonesian government has created, among other entities, various SOEs. According to Article 1 of the SOE Act (UU No. 19/2003/BUMN), the government must have at least 51% ownership in SOEs. The Act also states that the main objective of the SOES is to gain profits by providing superior goods and services to customers and to spur economic growth and national prosperity.

Based on the Indonesian economic tradition, SOEs play a major role in the economy. In terms of their number, there are 141 SOEs actively engaged in the production of goods and services in the economy. Based on the latest data released by the Indonesian Security Exchange Commission (BAPEPAM-LK), publicly listed SOEs in 2010 had 24.7% of the total market capitalization of the Indonesia Stock Exchange. Furthermore, five of these SOEs belonged to the top ten firms with the highest market capitalization. In terms of total assets and revenues, the asset value owned by SOEs is 40% of the 2011 Indonesian gross domestic product (GDP) and the revenue is 15% of the GDP. Given the massive stake SOEs have in the economy, the Indonesian government must monitor the performance of its 141 SOEs closely. This may not be an easy task given their number, size, complexity, and the variety of industry types and geographic locations in which they operate.

Bushee and Noe (2000) argue that monitoring costs on firms borne by investors can

be reduced if the firms have stronger governance. Chung and Zhang (2011) have noted that institutional investors focus their investments on well-governed companies to ensure the fulfillment of their fiduciary responsibilities. One of the indicators of a well-governed company stock is a stable history of dividend payments and a strong investor confidence in the company. Logically, institutional investors avoid investing in firms that do not pay dividends (Grinstein and Michaely, 2005). The official website of the Indonesian SOE ministry (www.bumn.go.id) states that the main performance indicator of SOEs is often judged by the amount of dividends distributed to the government. This suggests that in order to keep the steady flow of income from SOEs, the Indonesian government, with its power as the ruler of the land and the majority owner of the SOEs, should enforce stronger governance of SOEs. In line with the argument, the Ministry of State-Owned Enterprises (MSOEs) through its decree (Surat Keputusan Menteri BUMN no Kep-117/M-MBU/2002) obliges all of the SOEs to implement transparency, accountability, responsibility, independence, and fairness in their affairs to increase company performance.

The argument of professional managers that a lack of motivation and incentives negatively affects the operations of a business was advanced by Adam Smith two centuries ago (1776/1952). The principal-agent framework puts forward the notion that managers may engage in activities other than in the best interests of shareholders (Jensen and Meckling, 1976). This agency problem worsens when there is no majority shareholder in the ownership structure of a firm (Berle and Means, 1932). Jensen (1993) argues that to mitigate these behavior deviations, shareholders should rely on various internal and external governance mechanisms. Despite the effectiveness of these mechanisms, however, ownership structure still plays an important role in aligning managers' actions with the interests of shareholders (Connelly et al., 2010).

As mentioned earlier, the Indonesian government is a large institutional investor in SOEs because it must own at least 51% of the stake as prescribed by Article 1 of the SOE Act (UU No. 19/2003/BUMN). As a large institutional investor, the government owns resources to find better ways of managing firms and has the power to exercise control over professional managers (Shleifer and Vishny, 1986). Reddy et al. (2008) have noted that implementing good corporate governance entails high compliance costs, both directly and indirectly. Direct costs may come from establishing and maintaining various committees, procedures, documentations, and reporting, while the indirect costs include losing flexibility and speed in responding to competitions. These costs are included in the costs for controlling managers' actions and eventually borne by shareholders as the residual owners.

Connelly et al. (2010) note that large institutional investors have substantial wealth in a firm at stake and this large holding provides economic incentives for them to bear the costs for controlling managers' actions. They also state that large institutional shareholders can avoid tiring and costly campaigning to gather voting power from dispersed investors. The costs for controlling professional managers borne by large institutional shareholders are further reduced by their expertise in managing investment portfolios and employing dedicated units to gather information on ways and means to improve the performance of their portfolios (Gillan and Starks, 2007). Large institutional shareholders can combine their readily available voting power to hire and fire managers. Also, with their intellectual capital, large institutional shareholders can easily push proposals that may affect the direction of a firm, including the implementation of stronger governance.

Until recently, as in Dalton et al. (2007), agency scholars seemed to view large shareholders as having an agreement regarding their role in pressuring professional managers for shareholders' long-term wealth maximization. Built on the previous work by Porter (1992), Connelly et al. (2010), on the other hand, categorize large shareholders mainly into transient and dedicated investors depending on their behavior and incentives. They argue that transient large shareholders focus on capturing short-term gains by selling and buying stocks based on current financial performance and available news. In contrast, dedicated large shareholders have a long-term investment in

selected firms and are aware of the fact that the full potential of their investments are achieved through proper management. These dedicated, large shareholders tend to be lenient regarding short-term setbacks as long as they are still on the right track to realize long-term value prospects through the implementation of approved strategic actions.

As mentioned earlier, the Indonesian government's implementation of stronger corporate governance aims to avoid an economic crisis or to soften its negative impact and to improve general economic performance. Implementing stronger governance, therefore, is not only a strategic action for an individual institution in Indonesia but also for the whole nation. Connelly et al. (2010), Koh (2007) and David et al. (2001) provide several reasons why a dedicated large institutional investor, such as the Indonesian government, encourages managers to engage in long-term strategic actions with respect to SOE investments. For instance, dedicated large institutional shareholders through their superior knowledge acquisition mechanisms understand the value of such actions and have the resources to monitor managers' activities. Also as sophisticated investors, dedicated large institutional shareholders are able to provide technical advice and facilitate in implementing their plans of action. In addition, when confronted with a difficult situation, dedicated large institutional shareholders are able to wait for results patiently.

In light of the task assigned by the constitution and the size of its investment in SOEs, therefore, the Indonesian government might treat SOEs as a strategic target to implement stronger governance. By doing so, the government can ensure the fulfillment of its fiduciary responsibilities to the country and at the same time tolerate and absorb its implementation costs. With their unique role and dominance in the economy, SOEs might also be used to showcase stronger governance throughout Indonesian businesses. In line with the arguments above, the hypothesis in this study can be formally stated in the alternate form as follows:

H_A: SOEs in Indonesia implement stronger governance than do non-SOEs.

RESEARCH METHOD

The initial sample of this research includes firms in the 2008 Kompas 100. The index consists of the large and liquid companies in the IDX. From these 100 initial samples, 11 banking companies were excluded because they are closely monitored on corporate governance compliance by Bank Indonesia (the Indonesia central bank) and, therefore, should be treated as a special government case. The 2008 annual reports of the remaining 89 companies were collected from their websites and the IDX library. The sample was further reduced because 13 companies did not have their annual reports available. The final sample included 76 companies, ten of which are SOEs while the rest are non-SOEs.

The dependent variable in this study is the governance score of each sample firm in 2008. The main independent variable in this study is a dummy variable that represents SOEs. Besides the dummy, there are also some other independent variables that act as control variables in this study as in the previous studies conducted by Ariff et al. (2007) and Khanchel (2007). These control variables are Sales Growth, Firm Size, Firm Age, Asset Tangibility, External Funding, and Managerial Ownership.

The previous studies cited above hypothesized that a growth firm that is in dire need of external financing and stronger governance will reduce its cost of capital. With regard to the size effect, larger firms have stronger governance because they have ample resources to cover fixed costs. The variable of age, which refers to how long a company has been established, does not only reflect the availability and sophistication of systems and procedures required for implementing stronger governance, but also indicates awareness of the extent of reputation damage that could be had if corporate misconduct occurred. The composition of the assets of a firm will also affect level monitoring. Since tangible assets are harder to steal, firms with higher proportions of intangible assets may find stronger governance mechanisms to be more desirable in their operations. The strength of governance is hypothesized to be positively related to external funding. Stronger governance provides greater investor protection and, therefore, increases investors' willingness to provide financing.

Finally, managerial ownership is hypothesized to have a negative relationship with the strength of governance. In East Asia where companies are typically family owned, wealth expropriation of minority shareholders by majority shareholders is worse when the latter participate in the management of these companies.

The complete model and the hypothesized relationships between the dependent variable and the independent variables are as follows:

$$CGS_i = \alpha_i + \beta_1 Status_i + \beta_2 Growth_i + \beta_3 Size_i + \beta_4 Age_i + \beta_5 Funding_i + \beta_6 Tangibility_i + \beta_7 Manager_i + \varepsilon_i$$

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Where:

CGS_I = Corporate governance score of firm.
$Status_I$ = Dummy variable that takes a value of 1 if firm i is an SOE and 0 otherwise.
$Growth_i$ = Sales growth of firm i in the last 3 years
$Size_I$ = Logarithm of total assets of firm i.
Age_i = Years since the establishment of firm i.
$Funding_I$ = The ratio of total liabilities to total assets of firm i.
$Tangibility_I$ = The ratio of fixed Assets to total assets of firm i.
$Manager_I$ = Managerial ownership of firm i.
ε_i= Error term.

Table 1: Governance scores (%)

Scoring System	Sample	Mean	Std Dev	Min.	Max
BPKP	Total	53.38	13.71	26.17	83.40
	SOE	72.74	7.15	60.09	83.40
	Non-SOE	50.45	11.98	26.17	82.68
FCGI	Total	29.22	9.77	8.42	54.19
	SOE	42.13	7.62	29.19	54.19
	Non-SOE	27.26	8.52	8.42	44.84

Table 2: Summary of statistics

Variable	Sample	Mean	Std Dev	Min.	Max
AGE (Years)	Total	34.97	26.27	6.00	152.00
	SOE	62.10	47.20	27.00	152.00
	Non-SOE	30.86	18.91	6.00	106.00
SIZE (IDR. 000,000)	Total	9,465,515	14,172,104	124,356	82,058,760
	SOE	15,562,122	24,068,430	1,386,739	82,058,760
	Non-SOE	8,541,786	12,039,699	124,356	63,519,598
FUNDING (%)	Total	49.96	19.55	10.64	87.41
	SOE	46.72	21.60	21.09	87.41
	Non-SOE	50.45	19.35	10.64	84.20
TANGIBILITY (%)	Total	34.76	23.07	0.07	80.82
	SOE	34.02	29.77	3.40	80.82
	Non-SOE	34.87	22.17	0.07	78.68
GROWTH (%)	Total	46.09	201.32	-14.43	1,649.24
	SOE	19.58	14.46	8.42	53.94
	Non-SOE	50.10	215.90	-14.43	1,649.24
MANAGER (%)	Total	0.78	3.03	0.00	23.33
	SOE	0.06	0.11	0.00	0.27
	Non-SOE	0.89	3.24	0.00	23.33

Table 3: Pearson's correlation coefficients

Variable	BPKP	FCGI	Age	Status	Size	Funding	Tangibility	Growth	Manager
BPKP	1								
FCGI	0.869***	1							
Age	0.349***	0.308***	1						
Status	0.518***	0.553***	0.372***	1					
Size	0.492***	0.413***	0.281**	0.179	1				
Funding	0.041	-0.003	0.038	-0.065	0.165	1			
Tangibility	0.020	018	0.180	-0.012	0.270**	0.249**	1		
Growth	-0.073	-0.100	-0.322***	-0.052	-0.118	0.139	-0.101	1	
Manager	-0.228**	-0.252**	-0.068	-0.093	-0.302***	-0.133	-0.060	030	1

BPKP is the BPKP corporate governance score for a firm; FCGI is the FCGI corporate governance score for a firm; Age is years since a firm's establishment; Status is a dummy variable that takes a value of 1 if a firm is a SOE and 0 otherwise. Size is a logarithm of total assets of a firm; Funding is the ratio of liabilities to total assets of a firm; Tangibility is the ratio of fixed assets to total assets of a firm; Growth is the three-year sales growth of a firm; Manager is the managerial ownership of a firm. ***, **, and * indicate the 1%, 5%, and 10% levels of the two-tailed statistical significance tests.

Corporate Governance Score

Strenger (2003) notes that assessing corporate governance in a company is a very complex process because it involves all the operational aspects of a company. For that reason, he recommends a systematic and comprehensive approach through ranking and scoring. The main corporate governance measurement used in this study is based on a scoring system developed by a team that derived its members from the Board of Finance and Development Control (BPKP), a government agency under the Indonesian Ministry of Finance, and the Indonesian Ministry of State-Owned Enterprises (MSOEs). According to the BPKP Head's decision (KEP-06.02.00-268/K/2001), this CG team is responsible for formulating principles and guidance related to the evaluation of GCG implementation for the country. One of the products of the team is a CG scoring system for evaluating the extent of corporate governance compliance of SOEs and non-SOEs in Indonesia.

The BPKP scoring system is divided into five categories, each having a different weight for the total maximum and minimum scores of 100 and 0 respectively. The categories and the weights which include Shareholders' Rights (9%), CG Policy (8%), CG Practice (66%), Disclosure and Transparency (7%), and Commitment (10%) are grouped into 50 indicators, which are further expanded into 160 statements. The results of the test using the BPKP scoring system can be found in table 4.

Based on the information on annual reports of the 76 sample firms, the authors assigned score 1 (one) if a sample firm conducted an activity that is aligned with a CG statement in the scoring system, and 0 (zero) otherwise. In constructing a CG score for each firm, the authors independently examined the annual reports and recorded information related to each component on a coding sheet. Questionable points were discussed and, if necessary, new coding rules were introduced as suggested by Striukova, Unerman, and Guthrie (2008).

For the test of robustness, the researchers also used the scoring system developed jointly by Forum Corporate Governance Indonesia (FCGI) and PricewaterhouseCooper. FCGI is a private institution that provides information and guidance on corporate governance for all Indonesian companies. The FCGI scoring system consists of five different categories and weights such as, Shareholders' Rights (20%), CG Policy (15%), CG practice (30%), Disclosure & Transparency (20%), and Auditing (15%). There are a total of 112 items and the score range for

the FCGI scoring system is from 0 to 100, where 100 indicates that a company has a positive response to all indicators in each category. The results of the test using the FCGI scoring system can be found in table 5.

Table 4: Results of the regression analysis BPKP scoring system

Independent Variable	Expected Sign	Coefficients	t-statistic
C	?	-45.13	-1.24
Status	+	18.84	6.91***
Age	+	1.05	0.56
Size	+	3.26	2.42**
Funding	+	-0.01	-0.22
Tangibility	-	-0.04	-0.86
Growth	+	-0.01	-0.77
Manager	-	-0.55	-2.03**
F-statistics (p-value)		7.29 (0.00)	
Adjusted R-squared		0.37	

$CGS_i = \alpha_i + \beta_4 Age_i + \beta_1 Status_i + \beta_3 Size_i + \beta_5 Funding_i + \beta_6 Tangibility_i + \beta_2 Growth_i + \beta_6 Manager_i + \varepsilon_i$; CGS_i = Corporate governance score of firm i; Age_i = Years since a firm's establishment; $Status_i$ = Dummy variable that takes a value of 1 if firm i is a SOE and 0 otherwise; $Size_i$ = Logarithm of total assets of firm i; $Funding_i$ = the ratio of liabilities to total assets of firm i; $Tangibility_i$ = The ratio of fixed Assets to total Assets of firm i; $Growth_i$ = Sales Growth of firm i; $Manager_i$ = Managerial ownership of firm i; ε_i = Error term. ***, **, and * indicate the 1%, 5%, and 10% levels of the two-tailed statistical significance tests respectively.

TABLE 5: Results of the regression analysis FCGI scoring system

Independent Variable	Expected Sign	Coefficients	t-statistic
C	?	-66.92	-2.97***
Status	+	11.48	5.10***
Age	+	1.72	0.98
Size	+	3.10	3.85***
Funding	+	0.01	0.15
Tangibility	-	-0.045	-1.26
Growth	+	0.01	0.47
Manager	-	-0.22	-0.94
F-statistics (p-value)		8.06 (0.00)	
Adjusted R-squared		0.40	

$CGS_i = \alpha_i + \beta_4 Age_i + \beta_1 Status_i + \beta_3 Size_i + \beta_5 Funding_i + \beta_6 Tangibility_i + \beta_2 Growth_i + \beta_6 Manager_i + \varepsilon_i$; CGS_i = Corporate governance score of firm i; Age_i = Years since a firm's establishment; $Status_i$ = Dummy variable that takes a value of 1 if firm i is a SOE and 0 otherwise; $Size_i$ = Logarithm of total assets of firm i; $Funding_i$ = the ratio of liabilities to total assets of firm i; $Tangibility_i$ = The ratio of fixed Assets to total Assets of firm i; $Growth_i$ = Sales Growth of firm i; $Manager_i$ = Managerial ownership of firm i; ε_i = Error term. ***, **, and * indicate the 1%, 5%, and 10% levels of the two-tailed statistical significance tests respectively.

RESULTS AND DISCUSSION

Table 1 exhibits the CG scores of the total sample and the sub-samples (SOE and non-SOE firms) using the two scoring systems (BPKP and FCGI) mentioned earlier. The average BPKP and FCGI scores for the total sample are around 53% and 29% respectively. When the sample firms were grouped into SOEs and non-SOEs, both CG-scoring systems produced the same results. On average, the SOEs generated higher governance scores than the non-SOEs. The BPKP scoring system yielded around 73% for SOEs and 50% for non-SOEs, while the FCGI scoring system generated around 42% and 27% for SOEs and non-SOEs respectively. It was also found out that the standard deviations of CG scores for SOEs were lower than those of non-SOEs, using both the BPKP and FCGI scoring systems. Therefore, SOEs had higher average governance scores and the individual scores were less dispersed than the ones found in non-SOEs.

With regard to the extreme values in governance scores, the maximum governance scores of the total sample using the BPKP and FCGI systems are 83.40% and 54.19%. It turned out these maximum scores belonged to SOEs, Aneka Tambang and Telekomunikasi Indonesia respectively. On the other hand, the minimum governance scores of the total sample were 26.17% for the BPKP scoring system and 8.42% for the FCGI scoring system. These minimum scores belonged to Ricky Putra Globalindo and Tempo Scan Pacific, which are non-SOEs. All the descriptive measures contained in Table I conform to the notion that SOEs have higher governance scores and this notion is consistent across all measurements.

Table 2 provides the descriptive statistics of the other research variables for the total sample and its sub-samples. On average, SOE sample firms are older than non-SOEs. The mean, minimum, and maximum ages of SOEs are 62, 27 and 152 years respectively, while non-SOEs are 31, 6, and 106 years respectively. On average, the SOEs are also bigger than the non-SOEs. The average total assets of the SOEs amount to IDR 15.5 trillion, with a minimum of IDR 1.4 trillion and a maximum of IDR 82 trillion worth of assets. On the other hand, the average size of non-SOEs and their maximum and minimum assets amount to IDR 8.5 trillion, IDR 124 billion, and IDR 63.5 trillion respectively. In contrast to age and size, the average external financing and asset tangibility for SOEs and non-SOEs are relatively comparable. The mean, minimum, and maximum external funding of SOEs are 47%, 21% and 87% respectively, while non-SOEs have 50%, 11% and 84% respectively.

Table 2 also provides the statistics of asset tangibility of SOEs and non-SOEs, which are roughly around 34% and 80% respectively. Similarly, the minimum tangibility of SOEs is 3.4% while that of non-SOEs is close to 0%. The annual growth and managerial ownership of the SOEs, on average, is less than that of non-SOEs. The mean, minimum, and maximum annual growths of SOEs are 20%, 8.5% and 54% respectively, while those of non-SOEs are 50%, -14.4% and 1,649% respectively. Finally, managerial ownership exhibits a weak presence in SOEs. None of the SOEs has managerial ownership of more than 1%. The maximum managerial ownership of SOEs is only 0.27% with mean and minimum managerial ownership close to 0%. On the other hand, the maximum managerial ownership of non-SOEs is more than 23%. The mean and minimum managerial ownership percentages for non-SOEs, however, are not much different from those of SOEs. They are 0.89 and 0% respectively.

Table 3 provides pair-wise correlation matrix for all variables used in this study. The dependent variable in this study is CG scores as measured either by the BPKP or FCGI scoring systems. Although the scoring systems were developed by two different entities, the strength of the co-movement between the two measures is quite high. Both measures are highly positively correlated with a correlation coefficient of around 87%. The close relationship between these two measures can also be seen via the independent variables that affect them. Of the seven independent variables, there are four independent variables that have the correct signs and are significantly related at least at the 5% level with the variability of both government strengths in the sample firms. The independent variables are Age, Status, Size, and Manager (Managerial Ownership).

Table 4 presents the results of the regression analysis in which the dependent variable is the BPKP corporate governance score. It can be

seen that the adjusted R-squared is 37% and the F-statistic is 7.29, which is significant at less than the 1% level. Given the cross-sectional data, the model performs reasonably well in explaining the variability of CG scores in the sample firms.

The main independent variable in the model is status, a dummy variable that takes a value of 1 if a firm is an SOE and 0 otherwise. It is hypothesized that the sign of the dummy variable is positive, which indicates that SOEs implement stronger corporate governance than non-SOEs. Table 4 shows that the sign of the dummy is indeed positive and significant at less than the 1% level, which means that SOEs in Indonesia, on average, implement better corporate governance than non-SOEs. Also, the coefficient of status is 18.84 while the coefficients of the rest of the independent variables are no bigger than 3.26. Judging from the magnitude of the coefficients, the status of whether or not a firm is an SOE has the greatest impact on the variability of the CG scores.

Table 4 also shows the effects of the other determinants of governance strength of the sample firms as control variables. Of the six control variables, only size and manager are statistically significant in explaining the strength of governance in the sample firms. Size has a positive sign as expected and significant at less than the 1% level, while managerial ownership (Manager) has a negative sign, as predicted, and is significant at the 5% level. The rest of the control variables such as age, tangibility, growth, and funding are not significant at the conventional levels as found out by Ariff et al. (2007) in their study.

Robustness Test

To explore the robustness of the findings of this study, the FCGI score was replaced with the BPKP score as the dependent variable in the regression model. Note that the BPKP scoring system was developed by the Indonesian government and SOEs are government owned. It is possible that the measurement reflects the conditions faced solely by SOEs and, therefore, is biased or less accurate in evaluating the strength of governance of non-SOEs.

Table 5 reveals the results of the regression analysis given the FCGI score as the dependent variable. It can be seen that the SOE dummy (Status) still has the hypothesized sign and is statistically significant at less than the 1% level. Judging from the magnitude of its coefficient, which is 11.48, status is still the dominant factor in determining the strength of governance in the sample firms. Finally, of the six control variables, only size is statistically significant in explaining the strength of governance in the sample firms. Size has a positive sign as expected and is significant at less than the 1% level. Although the other control variables have signs as expected, none of their coefficients is statistically significant at the conventional levels. Again, the results from testing the independent variables are just like the ones found by Ariff et al. (2007) in their study of corporate governance determinants in Malaysian public firms.

CONCLUSION

This study has investigated the determinants of corporate governance strength in Indonesia and the role of the government in inducing stronger governance in firms. The researchers assert that strong corporate governance can reduce the probability of an economic crisis or soften the negative impact of a crisis if it occurs. Taking the Indonesian experience during the 1997-1998 crisis as a case in point, the government had to induce corporate governance reforms because of pressures from an external party like the IMF. The researchers have found out that corporate governance regulations have been enacted and the evidence of their implementation has been recorded in this study of SOEs and non-SOEs in Indonesia.

In particular, this study has revealed that SOEs implement stronger governance than do non-SOEs. Judging from the magnitude of the effect, SOEs, on average, have scores more than 18% or 11% above the ones achieved by non-SOEs, holding everything else constant. The necessity to implement stronger governance stems from the fact that the government of Indonesia is a large dedicated institutional investor that must monitor hundreds of its SOEs to ensure the fulfillment of its fiduciary responsibilities prescribed by the constitution. Monitoring SOEs entails costs and these costs can be reduced with stronger governance.

Implementing stronger governance in SOEs also involves higher compliance costs, whether

directly or indirectly. However, implementing stronger corporate governance is not only a strategic action for any SOE in Indonesia but also for the whole nation. As a dedicated large institutional shareholder, the government can influence SOEs to adopt stronger governance as their long-term strategic action. This study supports a case where a government's active involvement in corporate governance is needed to spur economic growth.

Of the control variables employed in the model of this study, only size is consistently significant while managerial ownership is only significant in the BPKP scoring system, but not in the FCGI scoring system. Ariff et al. (2007) also found that only size matters in corporate governance strength in Malaysia, a neighboring country to Indonesia. The argument of high implementation costs has been advanced by researchers in the past regarding the effect of size on corporate governance. Jensen (1986) argues implicitly that the size of the company is in inverse ratio to the ability of external parties to monitor the company. Hence, a big company needs stronger corporate governance while, at the same time, having the ability to absorb implementation costs. (Ariff et al., 2007; Khanchel, 2007).

This study has derived mixed results regarding the negative influence of managerial ownership on corporate governance in Indonesia. Although the BPKP and FCGI scoring systems showed a negative relationship between managerial ownership on corporate governance strength, only the use of the BPKP scoring system produced a statistically significant result. Ariff et al. (2007) find that managerial ownership is positive but insignificant in explaining the strength of corporate governance in Malaysian firms while Khencel (2007) finds that it is positive and significant for US companies. Dunerv and Kim (2002) state that the impact of shares ownership to corporate governance quality is mostly adopted from Jensen and Meckling (1976) on agency issue that managers and shareholders' interests will be in line if the managers also have substantial amount of shares. On the other hand, studies on agency issues in Asian countries find that when managers are also shareholders their authority tends to be abused to the detriment of minority shareholders' interests (Claessens et al., 2000; Johnson et al., 2000). A deeper study regarding the influence of insider ownership of corporate governance in Asian countries should be conducted in the future to shed light on this issue.

Finally, this study has used indices in classifying strong and weak governance. Brickley and Zimmerman (2010) note that the use of indices for the purpose may not be effective because it is not clear whether the combinations of governance items and their particular weights are meaningful in judging the quality of governance. Granting that their argument is valid, it can be said that SOEs have higher compliance towards the prescribed practices by their shareholders in governing businesses, which moves in the direction of a better alignment of interests among managers and majority and minority shareholders.

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