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ABSTRACT

Indonesia Municipal Finance and Shelter Program: Second Year Assessment

This study provides an assessment of the progress in the second year (August 1989-July 1990) of the Indonesia Municipal Finance and Shelter Program, a five-year, \$100 million Housing Guaranty Loan designed to support a major enhancement of Indonesia's urban infrastructure delivery capacity through decentralization and strengthening municipal financing capacity. The program is reviewed along two dimensions: first by examining actual accomplishments under the Indonesian government's current Policy Action Plan, and second, by analyzing the draft of the new Policy Action Plan for 1990-94.

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**INDONESIA MUNICIPAL FINANCE
AND SHELTER PROGRAM:
SECOND YEAR ASSESSMENT**

G. Thomas Kingsley

August 1990

Report to:

**Tim Koordinasi Pembangunan Perkotaan,
Government of Indonesia, and the
United States Agency for International Development**

**THE URBAN INSTITUTE
Washington, D.C.**

**INDONESIA MUNICIPAL FINANCE
AND SHELTER PROGRAM:
SECOND YEAR ASSESSMENT**

EXECUTIVE SUMMARY

PURPOSE

In mid-1988, the U.S. Agency for International Development (USAID) approved a five-year program to support a major enhancement of Indonesia's urban infrastructure delivery capacity. The program (USAID/Indonesia, 1988) is to provide \$100 million in Housing Guaranty Loan (HGL) resources for capital investment and \$5 million in Development Assistance (DA) grants for technical assistance and training. For its part, Government of Indonesia (GOI) has agreed to implement a Policy Action Plan whose goal is to "improve the shelter conditions of the urban poor by developing the means by which municipal governments can finance shelter-related urban services and infrastructure at a pace sufficient to overcome present deficits and match the pace of urban population growth".

The first tranche of HGL funds (\$25 million) was authorized soon after the program was initiated. The authorization of the second \$25 million tranche followed a review of the GOI's performance under its Policy Action Plan over the first year (Johnson, 1989). This report presents an assessment of progress during the program's second year (August 1989-July 1990) as a basis for USAID decisions concerning the third \$25 million authorization.

MAIN FINDINGS

In this mission the program was reviewed along two dimensions: first, by examining actual accomplishments under the six elements of the current Policy Action Plan; and second, by analyzing the draft of the GOI's new Policy Action Plan for 1990-1994. The main findings are:

1. **1989-90 Performance.** Over the past year, progress under a number of the elements of the Policy Action Plan has continued to be very impressive. Highlights include:

- Not only completing the basic studies called for in relation to expanding private sector role urban services, but actually beginning a number of new private-public partnership ventures (most notably, in Surabaya, Jakarta, Semarang, and Lhok Semaue).
- Progress that continues generally ahead of schedule in strengthening the property tax (PBB) including: completing valuations for a sizeable number of high value properties, extending the successfully piloted new administration and collection procedures to additional localities, and again achieving a substantial increase in the actual yield from this tax.
- Expanded implementation of efforts to rationalize and improve the administration of local taxes and service charges and to strengthen cost recovery by water enterprises.
- The completion of a number of new integrated local investment programs (PJMs) under Integrated Urban Infrastructure Development Program (UIDP), and consistent progress in planning for new areas and bringing completed PJMs through financing and into implementation.

On the other hand, while serious efforts to improve rules for allocating central grants and to strengthen local government capacity continued, progress has been slower than anticipated. A key element this year has been the program to establish a lending facility to support local government borrowing (RDA). At the end of this mission, the interministerial decree establishing the operating policies for the RDA still had not been finalized, although its issuance appeared imminent. Active interministerial policy debates over the past year have led to a clearer understanding of how a policy allowing varied and concessional interest rates could undermine the fiscal integrity of the fund. There now seems to be broader agreement that RDA financing should move toward market rates and justifiable related subsidies should be delivered through a loan/grant blending mechanism. Principles in the current draft appear consistent with those required for a self-sustaining lending facility. If the decree is in fact issued in this form, it will represent a major accomplishment, but it should be recognized that the program is behind schedule in this area.

Overall, performance in implementing the Policy Action Plan has been adequate to sustain the forward momentum of the program even though progress has been slower than hoped in some areas.

2. Influence of 1989-90 Resource Constraints. The volume of work accomplished over the past year, both in infrastructure development and policy formulation, was probably somewhat below that of prior years. This seems largely explained by temporary reduction in the availability of donor assistance - capital funds from previous agreements were running low and promised technical assistance teams were being recruited but had not yet begun work. Substantial increases in resource flows for 1990-91, however, now appear certain as technical assistance teams are now being mobilized and major new World Bank lending

programs get underway. It is noteworthy that the GOI was able to spend the last tranche of HGL funds very rapidly after disbursement.

3. **Level of Commitment.** Evidence compiled in this mission makes it clear that this program remains a high priority for Government. A high level of activity continues under all six program elements, and a sense of urgency has been retained throughout.

4. **The Proposed Policy Action Plan for 1990-1994** is generally well conceived. It calls for actions to solidify accomplishments under the current Plan and adds important new objectives: e.g., the full integration of IUIDP into the regular local government budgeting processes; the expansion of cost recovery goals to other sectors beyond water supply; the design of improved methods for pricing local services; the establishment of a loan-grant linkage mechanism; coordination of the activities of agencies concerned with land development in urban areas; and a new emphasis on strengthening local infrastructure operations and maintenance. However, the Plan could be improved by adding more definite targets in a few key areas (noted below).

CONCLUSIONS

The GOI's overall program for decentralized urban development as reviewed by this mission is one of the most innovative, forceful, and pragmatic in the developing world. While it has been temporarily delayed in some areas, its overall accomplishments have been substantial over the past year, and there is every indication that the GOI remains committed to serious pursuit of all of its Policy Action Plan objectives.

The GOI and USAID should work to further strengthen the Policy Action Plan in two key areas that will expedite the program's achievement. (1) More detailed implementation planning to firmly establish and secure the operations of the RDA as a self-sustaining lending facility is appropriate. It would be advisable to include preparation of a resource mobilization strategy for the RDA that will enable it to satisfy the potential demand for infrastructure loans currently foreseen. (2) It is also appropriate to specify the steps needed to establish a viable loan/grant blending mechanism for financing urban services, such as water and sanitation that serve the basic needs of urban residents. In this context, it would also be useful to include plans to expedite the granting of more local discretion in the use of central grant resources to at least some urban governments.

To undertake effective and lasting fiscal decentralization measures (such as the creation of a viable lending mechanism and reform of the central-local grant system) it is essential to build solid policy agreements among the key ministries involved. This is an arduous task which the GOI is pursuing with diligence and patience. 1989-90 has been a year when the GOI had to confront the most difficult aspects of its Policy Action Plan. A consensus is slowly emerging in a form that appears consistent with the objectives of the USAID Municipal Finance and Shelter Program. The consensus building process, led by TKPP, is working. It clearly warrants continued USAID support.

STRUCTURE OF THE REPORT

The first section of this report contains the overall assessment of the program as it has operated over the past year and the remaining sections provide supporting information about its components. Section 2 discusses the history of the program's development and the progress of the IUIDP program. Section 3 provides background information on Indonesia's present public finance system and data on budget trends. Section 4 reviews program activities related to enhancing local revenue generation and the involvement of the private sector in infrastructure provision. Section 5 examines progress toward the development of the RDA and the improvement of central grant mechanisms. Section 6 focuses on institutional development and program coordination. A statement by the Government (TKPP) on the progress of the program is included as Annex A.

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Section 1

PROGRAM ASSESSMENT

BACKGROUND AND CONTEXT

Before examining recent performance, it is important to review the history behind the program's development. The Policy Action Plan, against which progress will be assessed, was not developed solely as a basis for USAID support. Rather, it is a broader plan for coordinating urban development in Indonesia. It was formally established by the GOI in 1987 (TKPP, 1987b) and has been updated a number of times since then (most recently in TKPP, 1990a) to serve as the baseline for the Government's monitoring of its own performance as well as coordinating the support of all external donors in the sector. While USAID's interests focus on the municipal finance elements of the Plan, there are strong linkages between elements and adequate progress in other areas is important to achieving the municipal finance related objectives.

INDONESIA'S URBAN DEVELOPMENT PROGRAM AND ITS PROGRESS THROUGH JULY 1989

Concerns about the mounting problems of its cities and towns almost a decade ago led the GOI to initiate a National Urban Development Strategy Project (NUDS). The Strategy was completed in late 1985 and, in March 1987, the GOI formally adopted six basic policies for urban development consistent with NUDS recommendations. The GOI then also established the original version of the Policy Action Plan and an interministerial Coordination Team for Urban Development (*Tim Koordinasi Pembangunan Perkotaan*, TKPP). Work under the Plan was structured to implement each of the six policies.

Coordinated/Decentralized Implementation - The Integrated Urban Infrastructure Development Program (IUIDP). The IUIDP process has been the principle vehicle for addressing objectives related to clarifying responsibilities for urban services provision in a manner that expands the role of local government (Policy 1) and preparing local investment programs in a decentralized and coordinated manner (Policy 2). Until IUIDP, almost all urban infrastructure was

planned by central government offices in Jakarta (mostly by the Ministry of Public Works, MPW). Weaknesses in local government capacity, however, implied that complete decentralization would be infeasible in the short term. Accordingly, IUIDP is a phased decentralization process. Local staff, with technical assistance from the center, develop mutually consistent: (1) spatial development plans (at least in outline form); (2) multi-year intersectoral investment programs (PJMs); (3) plans showing how the PJMs will be financed (RIAPs, which cover all sources of funds, including enhanced local revenue generation as well as central loan and grant funds); and (4) plans for building capacity (LIDAPs) to enable the localities to assume increasing program responsibility.

IUIDP has since been implemented nation-wide. Through July 1989, initial PJMs had been prepared (or were in preparation) for key urban areas in almost all provinces, covering in total approximately 60 percent of Indonesia's 1980 urban population. There have been a variety of problems in implementation and local involvement has not been as extensive as was hoped initially. Nonetheless, IUIDP has been a remarkable accomplishment. Its basic characteristics represent a dramatic improvement over the centralized and sectorally fragmented approach of the past and pressures for the expansion of local responsibility as the program continues are inherent in the process.

Financing the Program: Revenue Generation and Involving the Private Sector. Under Policy 3, the Plan called for a series of actions to enhance revenue generation to support urban development:

The Property Tax (Pajak Bumi dan Bangunan, PBB). The most successful through July 1989, was a series of measures aimed at strengthening the administration of, and the yield from, the property tax (PBB). The approach has been pragmatic, concentrating first on high-value properties in large cities. From 1985/86 to 1988/89, PBB revenues increased by 250 percent. While the tax is administered and collected by the Central Government, provisions established in the 1980s require that 81 percent of the revenue be passed on to regional and local governments with few strings attached.

Cost Recovery by Water Enterprises. In the early 1980s, local water supply was provided by entities that were in effect subunits of the MPW. Since then, most have been reestablished as independent enterprises (PDAMS), and efforts have been made under the program to enhance their fiscal integrity. New tariff structures have been designed and substantial increases in cost recovery have been attained by a number of the PDAMS that have implemented them. But many have yet to do so.

Other Local Taxes and Service Charges. Indonesia's provincial and local governments have traditionally earned revenue from a variety of additional taxes and service charges, although their yield has been small in relation to total revenues. The program has aimed at rationalizing these sources, eliminating some where revenues were low in relation to administrative cost, and strengthening the administration and improving the yield of those that remained. Through July 1989, a system to achieve these ends had been designed (MAPATDA). Implementation

had been initiated in more than 100 local governments, although the system was far from full institutionalization in most of them.

Private Sector Participation. Considering present limitations in local government capacity, involving private firms in various aspects of urban service provision (ranging from direct investment to playing roles in operations and maintenance) is a promising option for Indonesia. A new objective was added to the Policy Action Plan in 1989 to recognize this potential - an important step in itself, although it was too early to expect progress under it by the time of the July 1989 review.

Financing the Program: Loan and Grant Mechanisms. While the steps noted above are important, they alone are incapable of generating the increases in resources needed to meet rapidly expanding urban growth requirements. Two principles for more substantial resource mobilization were recommended by NUDS and strongly amplified under Policy 4 in the Policy Action Plan.

Establishing a Lending Facility. The first called for a significant expansion of local borrowing to finance urban infrastructure. In the late 1980s, efforts were made to pass some central government and donor funds on to local governments in the form of loans, albeit at highly subsidized interest rates. The amounts have been small overall, but this was a step forward because it gave local governments some experience with credit financing. Still, concessional loans do not achieve the objective of broader resource mobilization. A lending facility that charges high enough rates to cover its true costs not only maintains its capital base so that it can continue to lend but, ultimately, can attract additional funding from private capital markets. To establish proper incentives, it is also important for lending rates to be uniform at any point in time. The Policy Action Plan has called for the development of a new central facility for municipal borrowing: the Regional Development Account (RDA). Through July 1989, substantial planning for the implementation of RDA had been completed, but the GOI had not finally agreed on the basic principles for its operation.

Reforming the Allocation of Central Grants. The second principle was to increase local discretion over the use of central government grant funds for urban development. Through the 1989 review, progress in this area had been disappointing. To the extent that local officials actively participated in the IUIDP process, they had much more influence than ever before over the way central government investments would be made in their areas. However, final decisions on those investments still rested with central departments. A number of proposals for reform of the grants system had been advanced and were actively under discussion, but there was no definitive timetable for resolving issues that remained outstanding.

Poverty Alleviation. The GOI added a new objective in 1989 to ensure that an appropriate share of urban grant allocations would be directly targeted to low-income groups. Again, it was too soon to expect actual progress in this area by the July review.

Institutional Development and Coordination. Consistent with Policy 5, the Policy Action Plan's objectives included carrying out a comprehensive study of

the urban institutional and manpower development needs of local governments, and then developing a program to strengthen local government capacity based on the results of the study. The study has been completed but, through July 1989, definite plans for follow-up had not been formulated. Policy 6 called for strengthening coordination and consultation in the urban development sector. The most basic step under this policy was the formal establishment of TKPP in 1987 and the subsequent decree extending its responsibility for an indefinite period. Another accomplishment under this element was the preparation of inputs to the nation's fifth five-year development plan (*Repelita V*).

1989-90 PERFORMANCE AND PLANS FOR THE FUTURE

This mission reviewed the program's progress over the past year along two dimensions: first, examining actual accomplishments in relation to stated objectives under the six elements of the current Policy Action Plan; and second, analyzing the draft of the GOI's new Policy Action Plan for 1990-1994 (this draft, prepared by TKPP, has been negotiated with, and generally accepted by the relevant ministries, but has not yet been formally approved). Overall conclusions, summarized from the remaining sections of this report, are as follows:

1989-90 Performance. Over the past year, progress under a number of elements of the Policy Action Plan has continued to be very impressive. Highlights include:

1. Basic studies called for in relation to methods of expanding the private sector role in urban services have been completed. More important, however, a number of new private-public partnership ventures have actually been initiated (most notably, in Surabaya, Jakarta, Semarang, and Lhok Semaue) in fields including, water supply, drainage, and solid waste disposal.

2. Progress continues generally ahead of schedule in strengthening the property tax (PBB). Valuations have been completed for the first 10,000 high value properties, and much progress has been made on the next 60,000. The new systems to improve PBB administration and collections, successfully tested in the Tangerang pilot project, are now being extended in additional localities. There has again been a substantial increase in the PBB yield nation-wide over the past year due to general administrative strengthening. And the impacts of the new valuations which promise additional increases will not be evident until 1991.

3. The new system to rationalize and improve the administration of local taxes and service charges (MAPATDA) has been initiated in 100 additional localities and efforts aimed at strengthening cost recovery by water enterprises continue to be actively pursued.

4. Even with reduced resources this year (see discussion below) a number of new integrated local investment programs (PJMs) have been completed under IUIDP, and consistent progress has been made in planning for additional areas and bringing completed PJMs through financing and into implementation. It is estimated that PJMs are now complete or in preparation for cities and towns

accounting for 75 percent of Indonesia's urban population. Also an Instruction of the Ministry of Home Affairs connected with implementing the Performance Oriented Operations Maintenance Management System in IUIDP took a major step toward proper budget practice for maintenance activities.

On the other hand, while serious efforts continued to improve rules for allocating central grants and to strengthen local government capacity, progress in these areas has been slower than anticipated. A key element this year has been the program to establish a lending facility to support local government borrowing (RDA). At the end of this mission, the interministerial decree establishing the operating policies for the RDA still had not been finalized, although its issuance appeared imminent. Active interministerial policy debates over the past year have led to a clearer understanding of how a policy allowing varied and concessional interest rates could undermine the fiscal integrity of the fund. There now seems to be broader agreement that RDA financing should move toward market rates and that justifiable related subsidies should be delivered through a loan/grant blending mechanism.

A major World Bank loan package for metropolitan Jakarta was recently negotiated at a 9 percent interest rate, higher than the rates typically applied in municipal lending in the late 1980s, but still below the 12 percent required for a self-sustaining fund. It seems unlikely that the RDA will be able to move substantially above this 9 percent precedent at the outset, but the decree is to contain language committing RDA to move to higher levels as soon as possible. Principles in the current draft appear consistent with those required for a self-sustaining lending facility. If the decree is in fact issued in this form, it will represent a major accomplishment, but it should be recognized that the program is remains behind schedule in this area.

In program efforts to improve rules for allocating central grants and to strengthen local government capacity, there was continued activity over the past year as the consensus building process moved forward, but there were few concrete achievements. Considering the program overall, however, performance in implementing the Policy Action Plan has been adequate to sustain forward momentum even though progress has been slower than hoped in some areas.

Influence of 1989-90 Resource Constraints. It does appear that the volume of work accomplished over the past year, both in infrastructure development and policy formulation, was probably somewhat below that of prior years. This seems largely explained by temporary reduction in the availability of donor assistance - capital funds from previous agreements were running low and, while promised technical assistance teams were being recruited, they had not yet begun work. Substantial increases in resource flows for 1990-91, however, now appear a virtual certainty. Technical assistance teams supported by USAID and UNDP will be in place during the next few months. Also, major new loan agreements with the World Bank - in particular, for Jabotabek (JUDP) and East Java/Bali - are being finalized. While these do not support the program comprehensively in the manner of the past World Bank Sector Loan, they have been designed to be consistent with it and contribute to it in important ways. An important indicator that the GOI is

able to move ahead once resources are available is the fact that it was able to spend the last \$25 million tranche of HGL funds very rapidly after disbursement.

Level of Commitment. Observations during this mission make it clear that the overall program remains a serious priority for Government. Activity continues under all six program elements and a sense of urgency has been retained. The actions, as well as the statements, of virtually all participants indicate that the GOI is committed to continuing to pursue this program vigorously on its own merits.

The New Plan. The proposed Policy Action Plan for 1990-1994 is generally well conceived. It calls for actions to solidify accomplishments under the current Plan and adds new medium-term objectives that are, by and large, useful and logical extensions. Most important: the full integration of IUIDP into the regular local government budgeting process (RAKORBANG); the expansion of cost recovery goals to other sectors beyond water supply; the design of improved methods for pricing local services; the establishment of a loan-grant linkage mechanism; the coordination of the activities of agencies concerned with land development in urban areas; and a new emphasis on strengthening local infrastructure operations and maintenance.

However, the new Plan still expresses targets primarily in terms of administrative events (e.g., the establishment of working groups, promulgation of guidelines, etc.). Progress might be improved if some objectives stated at a fairly abstract level at present could be translated into more concrete and substantive targets for achievement. Also, while the Plan addresses the most important topics that are relevant to achieving its major goals over the long term, a few additions would be useful. Among these are stronger actions to strengthen local government capacity and the coordination of information systems development and training. (See further discussion of these issues below).

Relation of the Program to the Original Project Paper for the USAID Municipal Finance Project (HGL). The original project paper for the HGL program proposed three main objectives: improving central government financial arrangements to support urban development, strengthening financial management capacities of provincial and local governments, and increasing private sector participation. In the final HGL agreement, however, the GOI's broader Policy Action Plan was accepted as the basis for program assessment. This mission was asked to determine whether the Policy Action Plan, as it has evolved, fully addresses the objectives stated in the Project Paper.

A year ago there were some gaps in this regard but, with 1989-90 activities and the new 1990-94 Plan, objectives now appear consistent throughout. The most important change here has been the GOI's addition and elaboration of the program to expand private sector participation. It is clear that USAID support to date has played an important and positive role in GOI movement in this direction.

Three more detailed actions described in the Project Paper are implicit in the new GOI Plan: (1) the development of a written strategy for urban resource mobilization (with stated targets); (2) preparation of an overall plan to monitor subsidy allocations and target them more effectively to low-income groups; and (3)

analysis and plans to create the conditions that would encourage private capital market involvement in lending for urban infrastructure. These actions are consistent with the themes of the Plan and the GOI has given thought to each of them already. However, they should be addressed more clearly in the final Policy Action Plan for 1990-94.

OPPORTUNITIES TO STRENGTHEN THE PROGRAM

While the process of building consensus has been slow in some areas of late, the GOI has not reached a state of impasse on any objective. Officials are actively seeking breakthroughs in all topics that have proven to be controversial. The following suggestions are offered with a view to expediting these efforts.

Strategic Incrementalism. The fact is that some of Indonesia's local governments are amply prepared to assume greater responsibilities (financially and administratively) for their own destinies, but others are not. Actually, capabilities and needs fall at varying points across a broad continuum. One cause for delay in the program has been the difficulty of defining comprehensive laws, regulations, systems, or guidelines that will work effectively everywhere.

There is an approach that offers a way out of this dilemma, and it has in fact been applied in almost all elements of the program that have made substantial progress to date. *Strategic incrementalism* is not a bad term for it (the phrase "learning by doing" is also applicable). It entails: conducting limited surveys; planning and implementing pilot projects and experiments; studying the results and adjusting planned solutions; applying these solutions to a broader range of localities; studying the outcomes and making further adjustments; and so on. This is exactly what is happening in the PBB program. It has also been characteristic of IUIDP, even though it may not have always appeared so on the surface. IUIDP was implemented nation-wide, but its designers never expected it would operate adequately at the outset. After learning from the first round, IUIDP guidelines are now being adapted to better address diversity.

It seems that this approach could be extended to other elements of the Plan that have slowed down in the effort to design comprehensive solutions: most important, the implementation of RDA and changes to grant allocation mechanisms and local capacity building activities. The approach does not imply regional bias. In each program element it could be designed as a consistent nation-wide policy. But it would mean that within each province, for example, some cities would be granted more authority and responsibility for their own development more rapidly than others.

Focus Within the Program for 1990-91. Over the coming year, it would seem important for the GOI to apply strategic incrementalism, giving highest priority to elements which at this point appear: (a) most critical to the further progress of the overall program; and/or (b) delayed in the search for more comprehensive solutions. This would include:

1. *Fully implementing and beginning operations of the RDA.* As presently designed, an incremental approach to RDA implementation is already contemplated. Initial loans will go to locations and types of investments where the probability of responsible debt servicing is high. The highest priority should be assigned to the finalization of: (a) a detailed RDA implementation work program (with clear assignment of responsibilities, activity schedules, and a mechanism for frequent performance monitoring); (b) a resource mobilization strategy; (c) implementation regulations; and (d) the final borrowers manual. When potential demand is compared with likely public resource availability in the resource mobilization strategy exercise, it is likely to emphasize the need to gradually phase in support for the RDA from private capital markets. It would be useful for the Policy Action Plan to call for initial analysis and planning to devise means of adapting the present RDA framework over time as might be needed to enhance the prospects of private capital market involvement.

2. *Designing and conducting pilot experiences for the loan/grant mechanism.* Initial outputs should include: (a) a concept paper and analytically-based design for the mechanism; (b) a detailed implementation work program; (c) drafts for decrees and any other legal/regulatory changes needed to allow pilots to move ahead; and (d) a monitoring plan for examining and reporting results of the pilot initiatives. While searches for more comprehensive reforms of the grant system should continue, progress in this area should benefit from trying out reforms in some local governments likely to have the administrative capacity to handle them. This could include well structured rules for granting more discretion in the use of SDO and Inpres resources and, possibly, for reallocating some funds these cities would otherwise received via DIPS into the Inpres allocations.

Additions to the Program for 1990-94. The review conducted in this mission suggests the need for some additional activities that could further strengthen the Plan for 1990-94.

1. *Review and revised plan for training across program elements.* Training for central, and more important local, government officials has been conducted under various elements of the program. The results of these efforts are not well documented individually, and there has never been a comparative evaluation of their performance. Anecdotal evidence suggests that off-site training (where trainees are sent to a separate facility for lectures and participatory work in subjects relevant to their jobs) have been less beneficial than *on-the-job, learn by doing, training experiences*. In the former, there is little guarantee that the trainee will be able to apply what has been learned directly to the job when he or she returns to it. In the latter, the training is designed to fit the job and the new techniques or principles have to be directly applicable to the tasks that are central to the trainees' performance. When the trainers depart, the trainees simply continue to do what they have recently gained experience in doing *in situ*. A comprehensive review, with these issues in mind, seems much needed at this point as a basis for future planning. The World Bank has recognized this point and a review is contemplated prior to the initiation of its new Local Government Institutional Development program with the Ministry of Home Affairs (MHF).

2. *Review and revise plan for information systems development.* Today, probably no device is more important to enhancing local government capacity than a computer-based financial management and accountancy system (covering all sources of revenue and routine as well as capital expenditures). Such a system can form the core for broader planning and control of all municipal activities in addition to providing the base for financial planning, accounting, and auditing *per se*. In the overall program, several systems which appear to be at least partly overlapping in these areas seem to be in process (MAPATDA, PAFPACK, systems developed to support PJM and RIAP formation in IUIDP, and a package developed by Redecon for the Ministry of Finance). The time has come for a comprehensive comparative review of these efforts and proposals on how to incorporate the best features of each into a series of useable packages (designed to meet the needs of local governments at differing levels of development). Similarly, there is need for clearer and more integrated planning for information systems development at the national level. The new system objective added under Policy 6 in the 1990-94 Plan seems to be on the right track in this regard, but it needs to advance with explicit recognition of other national systems already complete or underway (e.g., the NUDS database, the system developed by Videcon for the Ministry of Home Affairs, MHA).

3. *Adding objectives related to the classification of urban governments.* Virtually all participants interviewed in this mission recognize that the program's ultimate goals will not be achieved unless progress is made in this area. Unless a city has been given Kotamadya status, there is no public entity that can represent it adequately. It has no government primarily concerned with its own interests as distinct from those of its rural hinterland. In deciding whether or not to borrow from the RDA, for example, the incentives of a Bupati that happens to have a sizeable city within his Kabupaten boundaries are very different than they would be for the Walikota of the city itself. NUDS proposed a schedule for accelerating the classification of urban areas in Indonesia, but that schedule has fallen far behind. Progress here will be difficult and it should not be expected that major changes can be made immediately. Nonetheless, it would seem that this topic should be represented by an objective under the Policy Action Plan.

4. *Developing a Clearer Strategy for Broadening the Scope of IUIDP and Relating the Program to Broader Spatial Development Planning.* To avoid an overly ambitious charter at the start, IUIDP has been purposefully limited to a basic set of functions (water supply, drainage, sanitation, urban roads and a few other related activities). This is an important set (including all that together really set the spatial pattern *within an urban area*), but there are others that have to be considered in local capital budgeting. The PJM/RIAP process is an excellent approach for planning local investments and there is little doubt that local officials should expand its scope to cover, for example, school and health center development. But what about building new electric power plants, telecommunication facilities, and major roads? These are investments in which the provincial and central governments retain a stronger interest since they play a more powerful role in setting the *interurban* pattern of opportunities for economic expansion. There seems to be a general agreement at this point that IUIDP should be broadened and linked to the work of the recently appointed Committee for Spatial Planning. However, there is a need for very careful thinking about how this should be accomplished (analysis that covers the practical administrative implications as well

as the economic development aspects). Perhaps there is a need for two linked but relatively independent processes: one that covers matters fully under the discretion of the localities and another that involves more negotiation between local and higher level governments. A concept paper addressing these issues should be developed and discussed over the coming year before definite decisions are made to change IUIDP.

5. *Clarifying the Responsibilities of Technical Assistance Teams.* As noted above, substantial new technical assistance support for the program will be mobilized over the next few months. The terms of reference for different teams are stated at a somewhat general level and, as such, are potentially overlapping. That is not surprising at this point, but there is a need for more detailed agreements over the coming months about who will be assigned to what specific tasks. This is particularly important in the high priority areas noted above related to RDA development, grant revisions, and strengthening local capacity. It involves general long-term advisors supported by HIID, UNDP, and United States and British assistance as well as others coming in on shorter-term missions.

The Need for a Factually-Based Quarterly Monitoring Report and More Concrete Targets. This review has indicated the need for much better reporting on the accomplishments of the overall program than has existed to date. There are reports on individual elements of the program and some of them are excellent. However, there is nothing that provides a solid factually based description on the progress of the program as a whole. An elaborate new monitoring system is not required. The need is for a simple quarterly report that is easy for top decision makers to understand (probably no more than 25 pages, mostly tables).

Past program-wide reports have offered summary narrative statements on accomplishments without clearly documenting the basis for what has been asserted. Because of this, the reporting system does not motivate performance as effectively as it could. The new report would address this problem in varying ways depending on the item considered. For tasks involving working groups in developing work plans and new proposals, the report would include tables indicating only the dates on which meetings were held (and who attended) and explicit citations of any documents produced (with a one-paragraph abstract of their content, where possible).

For program elements that are into implementation, tables would be structured differently. For MAPATDA, there would be a table listing the cities in which the program is underway along with some indication of implementation status in each. A similar table on PBB implementation would show for each city, the total number of parcels, total valued to date, recent and expected future collection rates, and Rp. yields. The basic table for IUIDP would again list the cities involved and show, for each, the status of PJM, RIAP, and LIDAP preparation and/or updating (with milestone dates), and some indication of the extent of local government involvement. Some data on PJM characteristics for each city could also be helpful: e.g., total and percapita investment levels by subsector and some simple performance ratios. Tables on training would indicate the number of employees who have received training under each component program in each city.

There is little doubt that the achievements of managers of different program elements would be more strongly motivated if the targets set for them were stated in a clearer and more definite manner than they are in the present Plan. Setting concrete targets, however, is difficult. It is often hard to know what it is feasible to expect ahead of time. The best approach may be to first gain experience by recurrently monitoring more definite measures of performance as suggested above, and then to set clearer targets in different areas incrementally as TKPP becomes more confident about defining reasonable expectations in each area.

CONCLUSIONS FOR USAID CONSIDERATION

The GOI's overall program for urban development as reviewed by this mission is one of the most innovative, forceful, and pragmatic in the developing world. While it has been temporarily delayed in some areas, its overall accomplishments have been substantial over the past year and there is every indication that the GOI remains committed to serious pursuit of all of its Policy Action Plan objectives.

The GOI and USAID should work to further strengthen the Policy Action Plan in two key areas that will expedite the program's achievement. (1) More detailed implementation planning to firmly establish and secure the operations of the RDA as a self-sustaining lending facility is appropriate. It would be advisable to include preparation of a resource mobilization strategy for the RDA that will enable it to satisfy the potential demand for infrastructure loans currently foreseen. (2) It is also appropriate to specify the steps needed to establish a viable loan/grant blending mechanism for financing urban services such as water and sanitation which serve the basic needs of urban residents. In this context, it would also be useful to include plans to expedite the granting of more local discretion in the use of central grant resources to at least some urban governments.

It would also be helpful in this period if the other issues raised above could begin to be addressed (points related to the coordination of information systems and training development, the addition of new objectives related to the classification of urban governments, clearer planning for broadening IUIDP in the framework of national spatial planning, and efforts to create a more definite and factually based program monitoring system).

While USAID will have to focus a limited number of priorities over the next few months, it should not reduce its commitment to the overall program during the HGL period. USAID's primary interest has been to enhance Indonesia's capability in municipal finance. However, that objective is itself directly dependent on the continuation and strengthening of the IUIDP approach and on broader efforts to build local government management capacity.

To undertake effective and lasting fiscal decentralization measures (such as the creation of a viable lending mechanism and reform of the central-local grant system) it is essential to build solid policy agreements among the key ministries involved. This is an arduous task which the GOI is pursuing with diligence and patience. 1989-90 has been a year when the GOI had to confront the most difficult aspects of its Policy Action Plan. A consensus is slowly emerging in a form that

appears consistent with the objectives of the USAID Municipal Finance and Shelter Program. The consensus building process, led by TKPP, is working. It clearly warrants continued USAID support.

Section 2

PROGRAM DESIGN AND PROGRESS OF THE ACTION PROGRAM

PROGRAM FOUNDATIONS: THE NATIONAL URBAN DEVELOPMENT STRATEGY

In 1980, Indonesia had serious concerns about the recently rapid growth of its cities and towns and the mounting problems that seemed to be associated with that growth. The Government of Indonesia (GOI) secured support from the United Nations to conduct a National Urban Development Strategy Project (NUDS) to examine the trends and propose a nation-wide strategy to address the issues. Whereas past spatial planning projects had operated strictly under the purview of one ministry, NUDS reported to an interministerial steering committee with representatives of all key agencies with responsibilities for urban development: most prominently, the Ministry of Public Works (MPW), the National Development Planning Board (BAPPENAS), the Ministry of Home Affairs (MHA), and the Ministry of Finance (MOF). (NUDS, 1985, and Soegijoko, 1990).

Spatial Analysis and Strategy

One of the most important elements in the NUDS work program was the development of an accurate database on urban areas (developed by the Center for Planning Studies (LPP), at ITB, and NUDS staff (Kingsley, Gardner and Stolte, 1985). The information system used a functional definition of urban areas to provide a more reliable basis for infrastructure programming. Analysis showed that traditional tabulations of populations for municipalities (Kotamadya) often misstated the actual populations of those centers and omitted data for many large urban settlements that had not yet been classified as Kotamadya (Table 2.1). Analysis of the spatial pattern of urban growth during the 1970s showed that trends were moving away from overconcentration in the largest cities and on Java. Medium-sized cities (100,000 to one million - mostly port cities on other islands) had experienced the most rapid growth.

Table 2.1 - LARGE AND MEDIUM-SIZED CITIES RANKED BY SIZE OF 1980 URBAN POPULATION
(Population in thousands)

CODE	NAME OF CITY	KYDA POP. 1980	URBAN POP.		GROWTH RATE (%) 1971-1980
			1971	1980	
GREATER THAN 1 MILLION		11372.95	7538.43	10868.50	4.15
310000*	JAKARTA	6503.45	4084.95	6071.75	4.48
320673*	BANDUNG	1462.64	1310.91	1794.52	3.55
352578*	SURABAYA	2027.91	1308.63	1737.02	3.20
121075*	MEDAN	1378.96	892.13	1265.21	3.96
500-999,000		3240.19	2262.93	3301.21	4.29
332274	SEMARANG	1026.67	566.38	820.14	4.20
160671	PALEMBANG	787.19	504.34	757.49	4.62
730671*	UJUNG PANDANG	709.04	423.56	638.80	4.67
320371*	BOGOR	247.41	330.16	544.79	5.72
331172*	SURAKARTA	469.89	438.49	539.98	2.34
200-499,000		3457.66	2655.07	3905.40	4.38
350773*	MALANG	511.78	365.28	491.47	3.35
340271*	YOGYAKARTA	398.73	347.26	460.17	3.18
180171*	BANDAR LAMPUNG	284.28	166.01	357.69	8.90
630371	BANJARMASIN	381.29	224.06	330.13	4.40
332876*	TEGAL	131.73	229.59	326.80	4.00
130571	PADANG	480.92	188.94	296.68	5.14
610271	PONTIANAK	304.78	182.19	276.67	4.75
321174*	CIREBON	223.78	195.36	265.72	3.48
332675*	PEKALONGAN	132.56	191.59	249.17	2.96
710372	MANADO	217.16	151.49	217.09	4.08
320472*	SUKABUMI	109.99	160.84	215.29	3.29
520170*	MATARAM	.00	155.10	210.49	3.45
647071	BALIKPAPAN	280.68	97.37	208.04	8.80
100-199,000		1632.37	2077.81	3015.35	4.22
320870*	TASIKMALAYA	.00	146.62	192.27	3.06
140471	PEKAN BARU	186.26	126.09	186.20	4.43
647072	SAMARINDA	264.72	90.77	182.47	8.07
350671*	KEDIRI	221.83	130.50	176.26	3.40
120773	PEMATANG SIANTAR	150.38	143.42	172.91	2.10
350970*	JEMBER	.00	147.35	171.28	1.69
351977*	MADIUN	150.56	135.66	169.92	2.53
510370	DENPASAR	.00	72.83	159.23	9.08
150371	JAMBI	230.37	94.35	155.76	5.73
331902*	KUDUS	.00	114.84	154.48	3.35
330871*	MAGELANG	123.48	126.80	152.95	2.10
320714*	GARUT	.00	113.32	145.62	2.83
321807*	BEKASI	.00	61.32	144.29	9.97
330219*	PURWOKERTO	.00	113.16	143.79	2.70
330102	CILACAP	.00	85.47	127.02	4.50
320319*	DEPOK	.00	44.64	126.69	12.29
351475*	PASURUAN	95.86	87.02	119.09	3.55
331007*	KLATEN	.00	97.55	117.56	2.09
810271	AMBON	208.90	64.70	111.91	6.28
320510*	CIANJUR	.00	81.43	105.66	2.94

Source: NUDS Database (see Kingsley, Gariner, and Stolte, 1985)

KYDA = Kotamadya; * = Agglomeration including more than one jurisdiction.

Its final report (1985) advocated spatially neutral development policies: i.e., those that would avoid "forcing" development toward either rural or urban areas contrary to economic efficiency. This allowed for continued strong support for rural development efforts and definitely did not imply "promoting" urban growth. Nonetheless, it recognized that even with such policies rapid urbanization would be an inevitable and natural accompaniment of rapid economic development as structural change moved the economy toward sectors that find urban locations more efficient. It urged, in essence, that urbanization should be accepted as such and regarded more as an opportunity than a problem.

As to the future spatial pattern, the project analyzed three possible development scenarios, ranging from most to least concentrated, and recommended an intermediate alternative, representing a modest bending of 1970s trends rather than any marked change in direction. Within provinces, NUDS recognized that different cities should grow at different rates depending on changing market conditions. (See general classification in Figure 2.1). This conclusion was based on experience in other countries as well as Indonesia to the effect attempts to promote industrial activities in remote locations too rapidly had often failed because government infrastructure provision alone had been insufficient to overcome market realities. In process, substantial resources had been wasted that could have been used much more effectively to promote job generation and poverty alleviation elsewhere.

This did not imply a development focus on the biggest cities instead, but rather on medium-sized centers that already evidenced sufficient dynamism to indicate potential for high leveraging of strategic public investment. The solution for the largest metropolitan areas was not to try to stop their growth (since that would significantly constrain the nation's economic prospects) but, rather, to make them pay the full costs of their own development. Subsidies for them would be avoided (except for assistance targeted directly to the poor). The approach clearly did not imply forgetting about the smaller towns. The concept was that giving medium- and large-size cities more discretion and responsibility for financing their own development would free up resources to facilitate an acceleration of the development of smaller centers when they had moved up sufficiently to take advantage of it.

The Linkage to Implementation

NUDS estimates indicated that Indonesia's urban population was likely to increase from 32.8 million (22 percent of total population) in 1980 to 75.8 million (36 percent) in 2000. In the 1970s the urban population had grown by 1.1 million per year (35 percent of total population growth). From 1980 to 2000, it would grow by 2.1 million per year (67 percent of total population growth). More recent analyses (Gardiner, 1990) suggest that Indonesia's urban population could grow to a level ranging from 125 to 135 million by 2020.

NUDS recommended indicative infrastructure investment programs to accommodate 1985-2000 urbanization. Cost analyses indicated that those programs would require a substantial increase in outlays but that, with appropriate

standards and technologies, they should be affordable considering expected change in the economy. NUDS also recommended, however, that to be feasible those programs would require a drastically altered approach to implementation - one that built in a transition to more decentralized management, substantial improvements in the technical capacity of local governments, and marked increases in local revenue generation, borrowing, and cost recovery.

In 1987, the GOI formally adopted six policies for urban development that embraced these themes and established the implementation mechanism (along with the original version of the Policy Action Plan). Central responsibility was assigned to an interministerial Coordination Team for Urban Development (*Tim Koordinasi Pembangunan Perkotaan*, TKPP). It is generally accepted that these decisions represented a fundamental change in the GOI's policy stance regarding urbanization.

INTEGRATED URBAN INFRASTRUCTURE DEVELOPMENT (IUIDP)

The first two policies called for clarifying responsibilities for urban services provision in a manner that expands the role of local government (Policy 1) and preparing local investment programs in a decentralized and coordinated manner (under Policy 2). The IUIDP process was designed as the principle vehicle for addressing these policies.

The IUIDP Concept

Until the mid-1980s, almost all urban infrastructure was planned by central government offices in Jakarta (most importantly in MPW) and implemented by their field offices in the provinces. Priorities of one central office (e.g., water supply) were seldom coordinated with those of another (e.g., drainage) either across cities or within a given city.

With accelerating urbanization, it was recognized that this approach could not hold up logistically, let alone respond sensitively to the varying needs of individual cities. It was also recognized that the only satisfactory long-term solution would be for local governments to assume full responsibility for providing (and largely financing) their own urban services. The capacity of Indonesia's local governments, however, remained extremely weak. In 1988, Indonesia had only 11 provincial and local government employees per thousand population, compared to 62 per thousand in the United States and 44 on average for 16 OECD countries (BPS, 1988, Kingsley, 1989). While there were 211 Indonesian cities with populations of 20,000 or more in 1980, only 78 of them even had formal administrative status independent of their rural hinterlands (NUDS, 1985). A World Bank analysis (1988) for 18 larger developing countries, showed that Indonesia's own-source local revenue generation as a percent of total subnational government spending ranked lowest by a considerable margin. Simply "assigning" full responsibility to the local level in the near term clearly would have been infeasible.

The IUIDP response to this dilemma is a phased approach to decentralization in which the central government plays an active role in helping to build local capacity at the same time that it works with existing local staff in planning and implementing investment programs. (See TKPP, 1987b and, Hedropranoto Suselo, 1988). In its

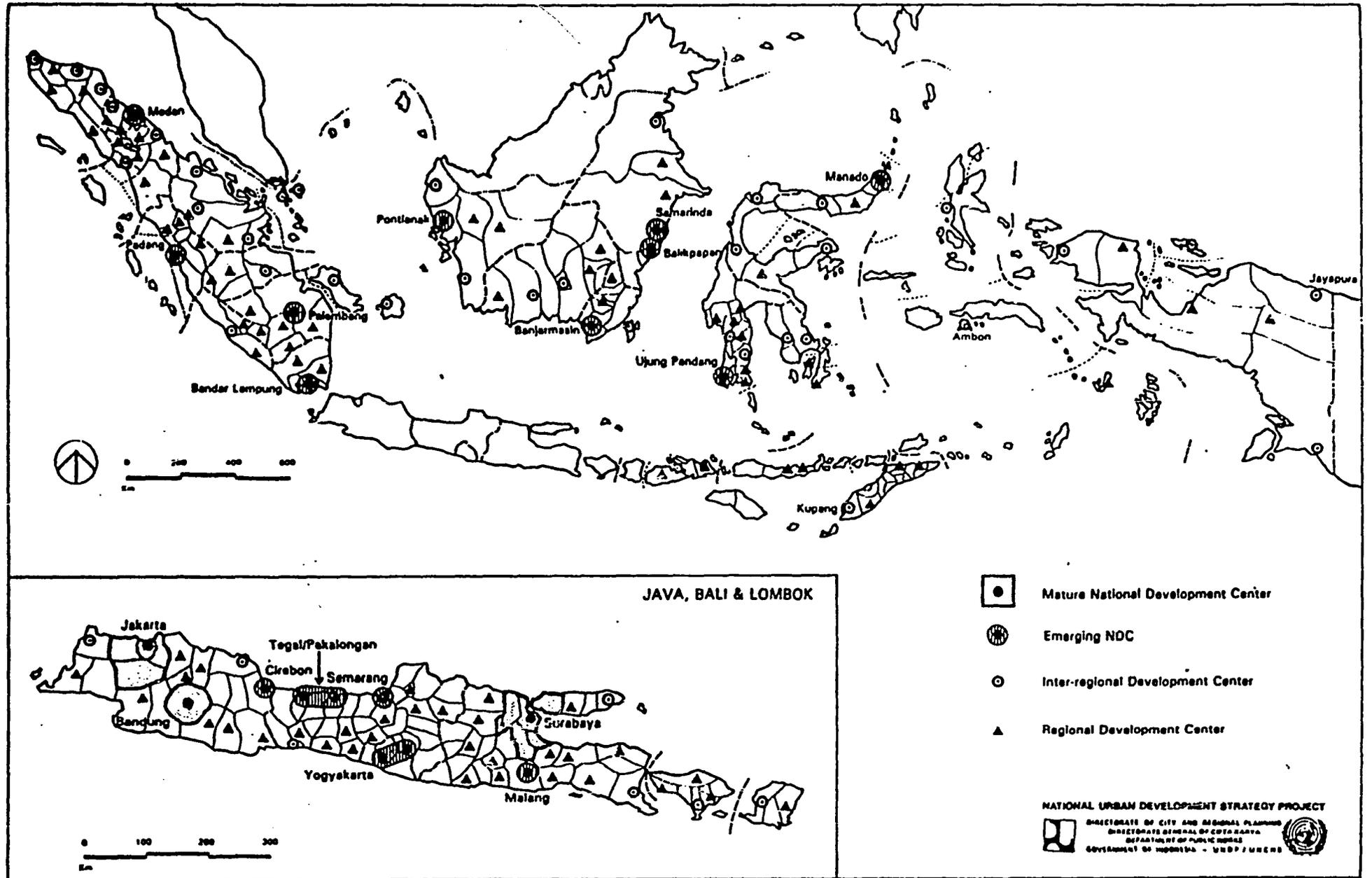


Figure 2.1 - Policy Classification of Major Urban Areas, National and Urban Development Strategy

idealized form, the process entails the following steps: (1) meetings are held with provincial governments to review NUDS analyses and prioritize cities for attention; (2) project teams in the selected cities (local staff with technical assistance provided from the center) review and update local master plans or develop a new "structure plan" where none is available; (3) teams then use those plans as a guide in developing a proposed local multi-year investment program (PJM) integrated across several sectors; (4) the teams are also required to prepare a complete financing plan (RIAP) that covers the enhancement of local revenues and borrowing as well as support from the central budget and/or external donors; (5) plans (LIDAP) are also prepared for building the capacity of local government to assume ever increasing responsibility for infrastructure development, operation, and maintenance; and (6) individual city programs so defined are then reviewed at the province and central levels and decisions are made about the allocation of central loan and grant funds.

To date, IUIDP has been limited to functions that had traditionally been the responsibility of MPW's Directorates General Cipta Karya (water supply, sanitation, drainage, kampung improvement) and Bina Marga (urban roads). It was reasoned that trying to cover more functions at the start might add complexity and threaten program viability - other functions could be added later after the IUIDP had proved itself.

Initial Implementation, 1985-89

IUIDP has since been implemented nation-wide under guidelines issued in 1987 (TKPP, 1987b). Progress is detailed in Directorate Bina Program, 1990, and summarized in Budhi Tjahjati, 1990. Through July 1989, initial PJMs had been prepared (or were in preparation) for key urban areas in almost all provinces, covering in total approximately 60 percent of Indonesia's 1980 urban population. Also, further efforts had been made to clarify responsibility for the development and operation of various categories of infrastructure. A new policy statement (PP 14 1987) set forth parameters assigning functions more clearly at the local level. Infrastructure was inventoried in 10 cities, and central and local officials reached joint agreements on more specific allocations in those cities (e.g., maps of all roads were marked to identify which level of government and which specific agency would be responsible for the development upkeep of each road link). Lessons from these exercises were then used as a basis for similar classification as a part of PJM preparation elsewhere (Directorate Bina Program, 1989 and TKPP, 1989a).

Partly because initial targets were so ambitious, there have been many problems in IUIDP implementation (see UNDP, 1989, and Budhy Tjahjati, 1990). Many local governments have not yet internalized the process or developed the capacity to operate it effectively in the future. It also became clear that the initial guidelines were too cumbersome and did not permit enough flexibility to adapt to varying local needs and priorities.

Nonetheless, IUIDP has generally been regarded as a major accomplishment. Its basic characteristics (integrated planning across sectors based on city-specific conditions, the linkage to financial discipline through the RIAPs and to capacity building through the LIDAPs) in and of themselves represent a dramatic improvement over the approach of the past. And, given the institutionalization that has taken place to date, it seems highly improbable that Indonesia could ever slip back to the more fragmented and centralized approach that was typical before 1985.

It cannot be said that localities throughout Indonesia today are capable of continuing the process on their own, but tensions that press strongly in that direction are inherent in IUIDP. That there have been implementation problems has not come as a surprise to the program's designers. Their choices were limited. They could have waited until more thorough process designs had been prepared and much more local capacity building had been achieved before they began, but this would have meant either: (a) seriously postponing badly needed urban infrastructure investment, or (b) continuing to provide infrastructure by the prior ineffective centralist approach in the interim. The option they selected was to move ahead and "learn by doing".

1989-90 Performance and Future Plans

Even with temporary financial constraints (see discussion in Section 1) substantial progress continued to be made by IUIDP in 1989-90. Many PJMs moved into the final stages of financing and some into full implementation. PJMs are now completed or in process for cities and towns covering about 75 percent of Indonesia's 1980 urban population. A notable achievement was Directorate General Bina Marga's effort in shifting virtually all urban road planning into the IUIDP framework. Also, new IUIDP guidelines have been prepared (TKPP, 1989b) that attempt to address some earlier implementation problems (although further improvements could be beneficial). Planning and analysis related to increasing the emphasis on effective Operations and Maintenance (O&M) under IUIDP was a promising initiative, actually not yet required under the Plan.

A systematic approach for improving O&M has been designed and implemented on a test basis in 8 cities - the Performance Oriented Operations and Maintenance Management Systems (POMMS, see P.T. Perencana Aneka Sarana and DeLeuw Cather, Inc., 1990). Also a February 1990 Instruction of the Ministry of Home Affairs connected with implementing POMMS took a major step toward proper budget practice for maintenance activities.

One objective, however, the clarification of responsibilities for urban traffic management, appears to be behind schedule.

The 1990-94 plan for this element appears sound. Key new (or rephrased) objectives include: (1) continuing IUIDP with more emphasis given to increasing local government capacity and responsibility (although the methods by which this is to be achieved remain vague); (2) increasing capacity and the priority for O&M (through broader implementation of the POMMS system); and (3) integrating IUIDP into the regular process of local government budget preparation and approval (RAKORBANG) - an extremely important step at this point in time.

Section 3

INDONESIA'S PUBLIC FINANCE SYSTEM

Major components of the Policy Action Plan (and the focus of USAID's interest in the program) deal with issues of local government finance. This section offers a brief description of Indonesia's present system of public finance as a basis for the discussion in subsequent sections on program elements designed to reform it.

GOI BUDGET TRENDS

Table 3.1 shows the changes that have taken place in the GOI budget over the past decade. The budget total represented 24 percent of GDP as the 1980s began, dropped to about 21 percent during the middle of the decade and returned to the 24 percent level by fiscal year 1988/89. Internal shifts, however, were much more dramatic.

The corporate tax on oil accounted for 60 percent of total revenues in 1980/81 but then plummeted, reaching 25 percent 10 years later. External assistance (development funds) played the most important role in filling the gap so that variations in the total were less severe. However, the domestic tax effort also much improved, particularly with respect to income taxes, consumption taxes, and the property tax (*Pajak Bumi dan Bangunan* or PBB).

Routine (recurrent) expenditures accounted for just half of total GOI outlays through the first half of the 1980s, but jumped to and remained at about 62 percent through the last half. This shift was largely accounted for by the increase in debt service payments which jumped from 14 percent of the routine budget in 1980/81 to 49 percent in 1990/91. The routine budget subsidy to the regions is dominantly the *Subsidi Daerah Otonom* (SDO) which supports of operating expenses (mostly personnel costs) of *Data I* (provincial) governments, and *Data II* (Kabupaten and Kotamadya) and lower level governments. The SDO share of routine expenditures increased somewhat through the mid-1980s, but then dropped back close to its 1980 level by the end of the decade.

Table 3.1
GOVERNMENT OF INDONESIA BUDGET, 1980/80 - 1990/91

	1980/81	1982/83	1984/85	1986/87	1988/89	1990/91
TOTAL EXPENDITURES (Rp. Billions)						
Routine	5800	6996	9430	13559	20739	26648
Development	5916	7360	9952	8332	12251	16225
Total	11716	14356	19382	2189	132990	42873
As percent of GDP	24.0	23.0	21.6	21.3	23.7	NA
PERCENT OF TOTAL						
REVENUES						
Domestic Revenues						
Corp. Tax on Oil	59.9	56.9	53.8	28.9	28.9	25.2
Income Tax	1.4	2.0	2.3	10.4	12.0	15.2
Property Tax	0.7	0.7	0.8	0.9	1.3	1.4
Consump. Tax	6.3	7.9	7.8	23.6	18.8	21.1
Int'l Trade Tax	8.1	5.8	4.4	4.7	4.1	4.9
Other	10.9	13.1	12.9	5.2	4.8	6.0
Subtotal	87.3	86.5	82.1	73.7	69.7	73.7
Development Funds	12.7	13.5	17.9	26.3	30.3	26.3
Total Revenues	100.0	100.0	100.0	100.0	100.0	100.0
EXPENDITURES						
Routine Expend.						
Personnel	34.9	34.6	32.3	31.8	24.1	25.9
Material	11.6	14.9	12.5	10.1	7.2	6.5
Subs. to Regions	16.8	18.8	20.0	19.5	14.6	15.9
Debt Service	13.5	17.5	29.4	37.3	52.8	48.7
Other	23.2	14.3	5.7	1.3	1.3	3.0
Subtotal	100.0	100.0	100.0	100.0	100.0	100.0
Develop. Expend.						
Central						
Departments	42.8	44.3	34.9	24.1	15.2	26.6
Other	19.5	14.8	15.6	12.9	7.8	4.1
Subtotal	62.3	59.1	0.5	6.9	23.0	30.7
Trans. to Reg.						
Inpres	12.1	13.3	13.7	15.5	9.3	14.4
Share Prop. Tax	1.5	1.4	1.6	2.1	2.8	3.1
Subtotal	13.5	14.7	15.3	17.5	12.1	17.5
Project Aid	24.2	26.2	34.3	45.5	64.9	51.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: Compiled from data in World Bank, 1990.

As routine expenditures went up during the decade, the share for development (capital) outlays, by implication, declined. The major change within the development category was a substantial drop in the share the central government spent out of its own revenues, largely compensated for by the growth in its expenditure of project aid (external assistance). Project aid increased from 24 percent of all development outlays in 1980/81 to a peak of 65 percent in 1988/89 and then declined to 52 percent in 1990/91.

The remaining categories are transfers to province and local governments for development purposes. Transfers of property tax receipts doubled as a share of the total over the decade, but still represented only 3 percent of all development outlays in 1990/91. The share for Inpres (*Instruksi Presiden*) grants varied during the 1980s but showed no clear upward or downward trend.

LOCAL GOVERNMENT FINANCES

Annual tabulations of local finances are not available, but data have been compiled for 1986/87 by HIID and the MOF (Quigley, 1990). These data indicate that over 70 percent of all outlays by subnational governments are still funded by grants from the central government (as noted in Section 2, this represents one of the highest ratios in the developing world). The remainder is derived from a variety of provincial and local government taxes and service charges and the share of property tax revenues passed on to those governments. Local taxes are typically levied, for example, on vehicle registration, vehicle transfer, entertainment, hotel and restaurant receipts, and business registration. Important local user charges are those for water supply, health service, refuse collection, markets, parking, bus stations, taxi stands and supplying official documents.

The SDO accounted for about two-thirds of subnational government routine expenditures (90 percent of their outlays for salaries). Property tax transfers made up another 10 percent, and local taxes user charges accounted for another 20 percent. Inpres grants represented 84 percent of the development revenues of these governments, the rest coming from property tax transfers and local sources.

RESTRICTIONS ON THE USE OF CENTRAL TRANSFERS

Most transfers from the central government to the provinces and local governments come with strings attached. These restrictions are discussed in some depth by Lamb and Binder (1987) and Booth (1989). In summary:

The Property Tax (PBB). Traditionally, Indonesia's property tax was based on property rent levels, but the base has been changed to full market value of land and improvements. The tax rate is set by law (now 0.5 percent of assessments). The assessment ratio (now 20 percent) is determined by the Minister of Finance. Central government offices are responsible for valuation and assessments and collection for

certain types of properties (e.g., high value Jakarta properties, plantations). All other collections are handled by local governments. The distribution of receipts is fixed by formula: 9 percent is allocated to cover collection costs, 10 percent is retained by the central government, 16.2 percent is passed on to provincial governments, and the remaining 64.8 percent to local governments. These PBB transfers are virtually the only ones subnational governments can spend with complete discretion.

Subsidi Daerah Otonom (SDO). The bulk of the SDO covers salaries of "approved staff on permanent establishment account" of subnational governments, and such funds once transferred cannot be used for other purposes. SDO funds for non-personnel costs come through a separate allocation. These restrictions encourage staff expansion regardless of the real mix of needs for personnel and non-personnel expenditures. Substantial variations in per capita SDO allocations between regions have emerged as the system has evolved (Lamb and Binder, 1987).

Inpres Grants. There are several different types of Inpres grants. One group, labeled "sectoral", is transferred under tight restrictions as to the type of expenditures permitted and the standards that must be applied in individual investment decisions. The most important are the *Inpres Jalan* (for roads), *Inpres Sekolah Dasar* (for schools) and the *Inpres Kesehatan* (for health centers).

There are restrictions as well, however, on most grants in the "general" Inpres category. Regulations are such that Inpres transfers to Kabupaten and Kotamadya governments (*Inpres Dati II*) are used almost solely for roads and road-related drainage, maintenance, and upgrading. Substantial discretion is allowed only in the use of the *diarahkan* component of *Inpres Dati I* and the use of *Inpres Desa* (for villages).

CENTRAL AND LOCAL EXPENDITURES FOR URBAN SERVICES

Expenditures on urban infrastructure are made by local governments, as indicated above, largely out of funds provided through central government transfers. But it is estimated (Quigley, 1990) that these accounted for only 30 percent of total expenditures on urban infrastructure during the Repelita IV. The remainder was spent directly by the central government (*Daftar Isian Proyek*, or DIP, expenditures), mostly by the MPW.

Table 3.2 looks more closely at development expenditures over the last half of the 1980s. Regional MPW DIPs accounted for 1.5-2.0 percent of all development outlays through most of this period, but jumped up dramatically in 1990/91 (to 7 percent). This last increase was granted largely for road and irrigation investments. DIPS of the MPW's Directorate General Cipta Karya (responsible for most IUIDP functions) remained in the 0.6-1.1 percent range through 1988/89, dropped sharply to 0.3 percent in 1989/90, and then came back up again to near the mid-point of the earlier range in 1990/91; no clear trend is evident.

Inpres grants, in total, averaged 12.1 percent over this period, and the General Inpres category accounted on average for half of that total. Here too, the data show no

Table 3.2
GOI DEVELOPMENT EXPENDITURES AND INCOME, 1985/86 TO 1990/91

	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
TOTAL DEVEL. EXPEND. (Rp. Billion)	10873.9	8333.5	9479.8	12256.0	13129.9	16225.0
	PERCENT OF TOTAL					
USE OF FUNDS						
INPRES GRANTS						
General						
Inpres Dati I	2.6	3.5	3.1	2.7	2.5	3.0
Inpres Dati II	1.7	2.3	2.8	2.2	2.1	2.4
Inpres Desa	0.9	1.0	1.1	0.9	0.9	1.1
Subtotal	5.3	6.8	6.9	5.8	5.4	6.5
Sectoral						
Inpres Jalan	0.6	0.9	1.7	1.5	2.2	4.2
Inpres SD	4.8	6.0	2.0	1.1	0.8	2.3
Inpres Kesehat	1.0	1.3	0.8	0.8	0.9	1.2
Other Inpres	0.5	0.6	0.3	0.2	0.1	0.2
Subtotal	7.0	8.7	4.8	3.5	4.1	7.8
Total	12.3	15.5	11.7	9.3	9.5	14.4
CENTRAL EXPEND. (DIPS)						
Regional Pub. Works						
Cipta Karya	0.9	0.6	1.1	0.9	0.3	0.8
Other	0.6	0.4	0.8	0.7	1.7	6.2
Subtotal	1.5	1.0	1.9	1.6	2.0	7.0
Other	29.9	22.3	10.8	29.9	60.8	46.3
Total	31.4	23.3	12.7	31.5	62.8	53.3
OTHER	56.3	61.1	75.6	59.2	27.7	32.4
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
SOURCE OF FUNDS						
GOI SAVINGS	67.1	31.0	35.0	18.5	13.7	30.4
EXT. DEV. ASSIST	32.9	69.0	65.0	81.5	86.3	69.6
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: HIID/Ministry of Finance Grants Data Base as presented in Bastin, 1990.

strong trend, up or down, either for total Inpres or its major subcomponents. In sum, the record of the past five years does not indicate any basic change in the structure of these expenditures.

Nonetheless, in absolute terms, the 1990/91 changes are important, implying an 84 percent increase for Inpres over the level of the preceding year. Careful monitoring is warranted to see how well provincial and local governments are able to expend these funds.

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Section 4

**FINANCING THE PROGRAM: ENHANCING
REVENUE GENERATION AND INVOLVING
THE PRIVATE SECTOR**

Under Policy 3, the Policy Action Plan calls for a series of actions to enhance revenue generation to support urban development: (1) improving the revenue performance of the property tax (PBB); (2) improving the cost recovery by local enterprises; (3) improving the revenue performance of local government taxes and service charges; and (4) increasing the involvement of the private sector in local infrastructure and service provision.

STRENGTHENING THE PROPERTY TAX (PBB)

Measures aimed at strengthening the administration and the yield from the PBB have been among the most successful in the overall program to date. From 1985/86 to 1988/89, PBB revenues nationally increased by 250 percent, and improvements just now underway promise much greater increases in the next few years.

Basic Reforms Through July 1989

The most important initiative here was probably the change in the basis of taxation from a rental (actual or imputed) value approach to a system based on the market value of the property (land plus improvements). Beyond this, virtually every aspect of the administrative system is being reformed. Administrative changes have been tested in the Tangerang Pilot Project, which was largely implemented by mid-1989. (Information on these developments is provided in HIID, 1989 and 1990.)

1. *Property Information.* A new, streamlined Property Information Declaration Sheet (*Surat Pemberitahuan Obyek Pajak, SPOP*), piloted in Tangerang, is now being implemented nationwide as a part of the US\$ 6 million Property Information (*Pendataan*) project. The project is targeting to collect 1 million new or updated SPOPs from throughout Indonesia.

2. *Property Valuation.* A more efficient valuation process has been designed calling for individual valuations of high value properties (replacement cost method

supplemented by checks on sales of comparable properties) and an index-based mass assessment system for other properties. A computer system to implement and document this work has been developed and satisfactorily tested in Tangerang. By July 1989, work was proceeding well on the valuation of the first 10,000 high value parcels (8,000 in Jakarta, 1,000 in Surabaya, and 1,000 in Medan).

3. *Collection and Enforcement.* In the past, property taxes were generally paid to local officials (*Lurah*). Payments could be made at a number of locations and payment schedules varied. The new approach tested in Tangerang, is involving banks as the primary collection agents. Letters inform taxpayers that they must make their payments at only one location (Payment Point) in their Kecamatan or Kelurahan. A common due date is established for all taxpayers. Copies of all payment notices are sent to the bank by the tax office. After the due date, the banks return the receipts collected plus the notices for any cases where payment was not made. This provides a clear record of delinquency. Dunning letters are then sent to delinquent taxpayers. Given the increased credibility of the new system, returns after the first letter have been much higher than originally expected. The system was fully operational in Tangerang in July 1989.

4. *Training.* Training had begun for 100 PBB staff working on valuation in Jakarta.

Progress in 1989-90

By the time of this mission, substantial further progress had been made. The evaluation of the first 10,000 high value properties has been completed and work is well underway on the next 50,000 (expected to be complete in October). Plans have been made to move on immediately thereafter to value an additional 60,000 (all those remaining in Jakarta plus 30,000 in Surabaya and Bali. In 1988/89, Tangerang PBB collections totaled Rp. 4.2 billion (much above the Rp. 3.5 billion target). In 1989/90, receipts jumped to Rp. 8.2 billion. Implementation of the Payment Point collection system was initiated in 12 additional Kotamadya and Kabupaten throughout Indonesia in April 1990. A successful experiment has been completed in Tangerang in which data from the national electricity agency (PLN) has been used to update the tax rolls (and has led to the discovery of a number of high-value properties not previously on the rolls).

The 1990-94 Plan

The new plan for the PBB component seems to be a logical extension of progress made to date and gives fresh emphasis to reducing administrative overhead and information system development. The inclusion of a new goal related to coordinating the activities of all land-related agencies is also a positive step.

COST RECOVERY

In the early 1980s, local water supply was provided by entities that were in effect subunits of the MPW. Since then, most such entities have been reestablished as independent enterprises (PDAMS), and efforts have been made under the program to enhance their fiscal integrity. Studies were completed to design realistic new tariff

structures. These were endorsed by a Ministry of Home Affairs decree (Permendagri 690-536 of June 1988), and guidelines were promulgated on improved accounting systems. Substantial increases in cost recovery have been attained in some cities that have implemented the new tariffs, although many have yet to do so.

The program to improve cost recovery by PDAMs has continued over 1989-90 but with mixed results. An analysis of performance in 30 PDAMs has been completed and, in these cases, problems have been identified and action plans for corrective actions have been prepared. Data needed for a comprehensive assessment have not been compiled but it is clear that: (1) some PDAMs have substantially increased revenue; but (2) many others have still not implemented new tariff structures (often being held back because they have not received formal approval from local officials as is now required); and (3) capacity problems have been evidenced in implementing recommended management systems. New studies have been undertaken to promote further strengthening (for example, by applying the financial management guidelines developed by the USAID-sponsored Water and Sanitation for Health (WASH) Project -see McCullough and Walker, 1990).

Goals for 1990-94 call for steps to overcome these problems, but also significantly broaden the agenda. New objectives include: (1) improving cost recovery of other types of local enterprises (*Badan Usaha Milik Daerah*, BUMD), in addition to PDAMs; and (2) more serious analysis and design efforts to develop workable policies and methodologies for pricing local services more effectively. Both are important and positive additions.

OTHER LOCAL TAXES AND SERVICE CHARGES

As noted above, Indonesia's provincial and local governments have traditionally earned revenue from a variety of additional taxes and service charges, although their yield has been small - 24 percent of total routine revenue for provinces and only 6 percent for lower level governments (Quigley, 1990). The program in this area is aimed at rationalizing these sources (including eliminating some where administrative costs were not warranted by the revenues received), and strengthening the administration and improving the yield of those that remained. Through July 1989, a system to achieve these ends had been designed (*Manual Administrasi Pendapatan Daerah*, MAPATDA), manuals had been prepared, and implementation had been initiated in about 100 local governments (P.T. Sumber Sarana Sempurna, 1988 and 1989). It cannot be said that these systems were fully institutionalized, but considerable progress was being made.

The implementation of the MAPATDA system was significantly expanded over the year with work being initiated in approximately 100 additional localities and some steps being taken by MHA to reinforce performance monitoring. Some localities have reported significant increases in revenue as a result. Estimates include: a tenfold increase in the radio tax in Surabaya, sixfold in Pasuruan; a doubling of business license revenue; and an 850 percent increase in receipts for solid waste collection in Kabupaten Jember. However, sufficient information is not yet available to permit a reliable overall assessment of the success (and sustainability) of the program.

Goals in the 1990-94 program seem appropriate, calling for further management and monitoring capacity improvements, as well as direct integration with the RIAP process under IUIDP.

PRIVATE SECTOR PARTICIPATION

Considering present limitations in local government capacity, involving private firms in various aspects of urban service provision (ranging from direct investment to playing roles in operations and maintenance) is an important opportunity for Indonesia. A new objective was added to the Policy Action Plan in 1989 to recognize this potential - an important step in itself, although it was too early to expect progress under it by the time of the July 1989 review.

Accomplishment under this new goal are one of the highlights of the 1989-90 program. Workshops to stimulate interest in the approach had been held as early as 1988 (see, for example, Hendropranoto Suselo, et al, 1988) and the government has been very active in promoting it over the past year. The Chairman of BAPPENAS, for example, devoted a major address to this approach stating: "... we are looking increasingly to the private sector to finance and operate physical infrastructure and to upgrade skills" (Affif, 1990). He noted public-private partnerships that have recently been initiated in interurban (toll) roads, industrial estates, electric power, and telecommunications facilities; reviews what he sees as solid opportunities for the expansion of this approach in the urban sector; and extols the important role already being played by the (private) informal sector in many aspects of urban services (e.g., water vendors, informal transport operators, and *pemulung* in solid waste collection).

Directly under the program, initial studies were completed to identify constraints and opportunities for an expanded private sector role. The study by P.T. Deserco and M. Macdonald and Partners (1989) study outlined how several approaches could be applied in Indonesia, including the Build, Operate, Transfer method (BOT), and reviewed potential for private sector water supply schemes in 16 cities.

More important, new private involvements in urban services have actually been initiated (or at least begun negotiations) in several localities. These include: (1) the Umbulan bulk water supply project (4 cubic meters per second) for Surabaya; (2) a BOT water supply scheme for Lhok Semaue offered by the government to a private consortium; (3) a major drainage project for northern Jakarta; and (4) and a bulk water supply program for Semarang. In Surabaya, private firms are already used extensively by the PDAM for bill collection and this approach is being promoted in other areas. Also, USAID is sponsoring a \$235,00 technical assistance project with Cipta Karya (through the WASH project) to further privatization efforts in water supply.

Also relevant here is a more intensive effort to ensure local community involvement in the planning and implementation of Kampung Improvement Programs (KIP) and sanitation projects. This has been initiated in Jakarta (a Governor's decree has been issued) as well as Surabaya and Palembang.

1990-94 objectives in this element emphasize additional study to identify legal and regulatory impediments to expanded private involvement and the design of a strategy to overcome them (clearly a priority for the coming year). An additional theme

introduced this year is the expansion of community involvement in planning local improvement and O&M projects. This has been on the agenda of some ministries before but now appears to be receiving higher priority.

Section 5

FINANCING THE PROGRAM: LOAN AND GRANT MECHANISMS

INTRODUCTION

While the steps noted above are important, they alone are incapable of generating the increases in resources needed to meet rapidly expanding urban growth requirements. Two principles for more substantial resource mobilization were recommended by NUDS and strongly endorsed and amplified under Policy 4 in the original Policy Action Plan.

The first called for a significant expansion of local borrowing to finance urban infrastructure. Through the mid-1980s local borrowing experience in Indonesia was negligible. Yet in developed countries, reliance on credit for local capital development is dominant. Loans have an important leveraging effect, permitting localities to make much larger investments in any given year than that year's budget could support because they can defer payments over a multi-year period (since major capital investments yield benefits over many years, financing them out of today's revenues in fact puts an unreasonable burden on today's taxpayers).

The second principle, was to increase local discretion over the use of central government grant funds for urban development. As noted earlier, only a small portion of all central grants have been transferred in the form of block-grants that could be programmed by local officials based on their own assessments of priorities. It was reasoned that local governments have much stronger incentives than the center to apply funds efficiently in response to real local priorities, thus higher cost-benefit ratios would be achieved if they could control a larger share of grant investment. Also, experience in other countries suggests that residents are more likely to be willing to pay more for services if they have more choice about what services to buy and how they should be delivered.

Some progress has been made by the program in accord with these principles, but to most observers, that progress had seemed frustratingly slow in relation to expectations.

THE LENDING FACILITY (RDA)

In the late 1980s, efforts were made to pass more central government and donor funds on to local governments in the form of loans, albeit at highly subsidized interest rates. Bastin (1990) estimates that total subnational government borrowing from central government sources (volume of contracted loan sums, not disbursements) since 1974 has amounted to about Rp. 1.8 trillion. He notes that these funds have been borrowed for a variety of functions, including: water supply, markets (*Inpres Pasar*), urban roads, KIP, and bus terminals, as well as liquidity credits for government-owned regional development banks (*Bank Pembangunan Daerah*, BPD).

Recent Lending Experience

Over Repelita IV (1984/85-1988/89), local borrowing represented less than 5 percent of total regional development expenditures (including the DIP regional development component) but roughly 15 to 20 percent of urban sector expenditures. In 1986/87, total disbursements on provincial and local government loans reached Rp. 61.8 billion. The volume of lending to subnational governments and enterprises has more than doubled since then, mostly because it was decided to pass on much of the surge in foreign assistance loans to them through subsidiary lending agreements. Even though the magnitudes have still not been high, this should be regarded as a step forward because it gave local governments some experience with credit financing.

Planning for the RDA

Still, concessional loans do not achieve the objective of broader resource mobilization. A lending facility that charges rates high enough to cover its true costs not only maintains its capital base so that it continue to lend but, ultimately, can attract additional funding from private capital markets. To establish proper incentives, it is also important for lending rates to be uniform at any point in time. The Plan has called for the development of such a facility, the Regional Development Account (RDA). The need for the facility has been much reinforced by the acceptance of Repelita V targets which call for massive increases in credit financing for the urban sector (the most conservative assumes the channeling Rp. 2.5 trillion in government funds alone in the form of loans).

Through July 1989, substantial implementation planning had been completed for the RDA, and it had been formally established as an account with Bank Indonesia to be administered by MOF. To that point, however, the GOI had not finally agreed on the basic principles for its operation.

Activities in 1989-90

In April-May 1990, HIID conducted a survey of subnational government borrowing which by June had yielded responses from 40 percent of all regional and local governments and 60 percent of all local enterprises. While analysis is not yet complete, Bastin (1990) has summarized principal findings to date. Most important, results indicate that there is substantial regional and local government loan demand. Many local governments already do borrow for a number of functions, in many cases on commercial terms. This is true even though the grant system competes directly with the lending option (no functional differentiation) and, since grants are available to

all regardless of ability to pay, grants are naturally preferred. Nonetheless, grants are not always available and local officials are under pressure to expedite infrastructure development. Commercial credit is used in part because the process of borrowing from central government is lengthy and cumbersome (borrowers may have to wait for more than a year before a commitment is made). The survey found that 40 percent of the local governments, 75 percent of the PDAMs and 65 percent of the BUMDs responding consider loans as source for Repelita V development projects.

Under its present design, the RDA should be able to respond effectively to this demand. Principle features are as follows: (1) RDA will become the sole central government loan facility, consolidating the varying forms of loans previously offered; (2) it will offer loans on uniform terms (including a uniform interest rate at any point in time) for all types of projects through a standard mechanism (thereby eliminating previous inequities across functions and regions); (3) it will lend only for public projects, avoiding public investment where there are few positive externalities and commercial credit is a viable option; (4) it is expected that, at the outset, RDA lending will focus on projects that will earn sufficient revenue for the local government or enterprise (either through user charges or increment taxes) to provide strong support for reliable debt service payments (promoting expanded cost recovery throughout the urban development sector is an implicit RDA objective); (5) it will apply standardized, and much more rigorous, appraisal techniques than have been used in government lending in the past.

Most important, RDA will establish financial policies to assure its self-sustaining operation as a revolving fund (ultimately essential to broader resource mobilization). It has been calculated that an interest rate of around 12 percent would be appropriate for this purpose at present. However, a major World Bank loan package for metropolitan Jakarta (JABOTABEK) was recently negotiated at a 9 percent interest rate, higher than the rates typically applied in municipal lending in the late 1980s, but still well below the 12 percent level. It seems unlikely that the RDA will be able to move substantially above this 9 percent precedent at the outset, but the decree is to contain language committing RDA to moving to higher levels as soon as possible. Also, a commitment is being made to ultimately move to market rates.

At the end of this mission, it appeared that the issuance of a joint BAPPENAS/Ministry of Finance decree establishing the operating policies for the RDA was imminent, and that those policies would be consistent with the above principles. If the decree is in fact issued in this form, it will represent a major accomplishment.

Other steps to support RDA implementation were taken over 1989-90: e.g., the preparation of a borrower's manual, additional detailing of administrative procedures (Price Waterhouse Siddik, 1990), and additional staff training. However, the delay in the basic decree means the process is now substantially behind schedule.

The Plan for 1990-94

The currently proposed 1990-94 agenda for this element lays out appropriate next steps to bring the RDA fully into operation, and these warrant the overall program's highest priority. Expediting this process will be important to get back on track with regard to program resource mobilization objectives and doing so will require more detailed implementation planning in the next few months.

This should include the finalization of: (a) a detailed RDA implementation work - program (with clear assignment of responsibilities, activity schedules, and a mechanism for frequent performance monitoring); (b) the development of a longer term strategy for RDA resource mobilization; (c) implementing regulations; and (d) the final borrowers manual.

A Grant Loan Mechanism

One key objective added to this element in the new agenda was the development of a new mechanism to link loan and grant financing. Indeed, one of the reasons for delay in the RDA's acceptance has been the concern that many local governments do not have the resource base to afford proposed RDA rates, particularly for investments like water systems where important equity objectives are involved. Subsidizing interest rates for such cases, however, would undermine the fiscal integrity of the fund. The appropriate way to address the issue is to offer such localities a mix of loan financing (at RDA established rates) and grants to bring down the total costs. A loan/grant mechanism of this type is likely to be critical to RDA operations, thus its design and implementation over the coming year should also be among the program's highest priorities.

Initial outputs should include: (a) a concept paper and analytically-based design for the mechanism; (b) a detailed implementation work program; (c) drafts for decrees and any other legal/regulatory changes needed to allow pilots to move ahead; and (d) a monitoring plan for examining and reporting results of the pilot initiatives.

Longer Term Evolution of Borrowing Options for Local Governments

The RDA as initially defined will not be an ideal facility for municipal borrowing over the long term. But implementing it now, and then experimenting and adjusting as lessons are learned, is likely to be the fastest and surest path to better mechanisms

and then held in portfolios until maturity. Potential buyers still see considerable risk in resale potential in relation to other forms of investment. In a Rp. 50 million issue by the BTN (*Bank Tambungan Negara*) in 1989, Rp. 11 million went unsold and had to be held by the underwriter, at least initially, in its own portfolio. At the same time, the equities market is extremely active and the interests of brokers/underwriters seem to be focused there for the time being. It is also important to remember that no facility now exists to rate the quality of municipal issues - an important requirement for an effective market.

But there are intermediate steps that could be taken. One might be to plan for some decentralizing of RDA operations. As a central government entity, the RDA could quickly become congested if demand expands rapidly. Ultimately there could be great disadvantages in having all appraisal and servicing capabilities housed in its offices in Jakarta. One step could be to decentralize functions to MOF offices in the provinces, but more flexibility might be gained if the RDA had the option of acting as a central rediscounting facility, with other institutions, perhaps the Regional Development Banks (BPD), lending to local governments and enterprises (and thus handling loan origination, appraisal, and servicing functions closer to the locations of the borrowers). Experience with an approach like this should much facilitate the eventual involvement of private intermediaries. Not enough is known at present to evaluate such options, but it would seem appropriate to devote some analysis to longer-term institutional planning over the coming year.

REFORMING THE ALLOCATION OF CENTRAL GRANTS

As noted in the introduction to this section, this program's central interest in grant reform has been to extend more discretion to provincial and local governments over the investment of central budget resources in their areas. This could include giving them more discretion in the use of SDO and Inpres resources and, possibly, reallocating some funds these cities would otherwise have received via DIPS into the Inpres allocations. An additional interest in this area has been to address problems in the criteria by which grants are allocated to different areas. There are reasonable arguments for: (1) using the grant allocation process to redress inequities in economic circumstances (i.e., give more to poorer regions and localities; and (2) using grant making to provide incentives more greater local resource mobilization (i.e., give larger amounts to localities that raise more funds on their own, an approach that could well imply giving less to poorer areas). (See discussion of various options in Booth, 1989, and Lamb and Binder, 1987). The issues are complex and the design of reforms must be thought through carefully.

Activities Through 1989

Through the 1989 review, the program had not made much progress in these areas. GOI program working groups had prepared draft proposals in these areas. It is true that to the extent local officials actively participated in the IUIDP process, they had much more influence than ever before over the way central investments (DIPs) would be made in their areas. But final decisions on those investments still rested with the central departments. A number of proposals for reform of the grants system had been advanced and were actively under discussion, but there was no definitive timetable for resolving issues that remained outstanding.

As noted earlier, in GOI's budgets did not reflect much change in position on these issues. From 1985/85 through 1990/91, central grants that are passed on to be spent by local governments (Inpres) averaged 12 percent of total development expenditures and General Inpres grants (as opposed to Sectoral Inpres where tight conditions are placed on permissible expenditures) averaged 6.1 percent. There appeared no clear trend either to increase or decrease these proportions during that period.

1989-90 Activities and 1990-94 Objectives

Over the past year, draft legislation to modify the grant system was under discussion at the Ministries of Finance and Home Affairs. There is no indication, however, that any major reform of the present system is likely in the short term. In the most recent national budget, Inpres grants were dramatically increased, but so were MPW DIPs. Thus the budget process similarly indicates no change in the comparative position of the past several years.

The 1990-94 Plan for this element basically carries over the goals from the past. There is one helpful addition, however. For the first time, the new draft explicitly mentions introducing incentives to encourage local revenue generation and borrowing.

Directions for Change

Given the complexities and the risks involved with sweeping changes in the present system, it is not surprising that it is taking a considerable amount of time to resolve issues in this area. While searches for more comprehensive reforms should continue, it might make sense to also take a more incremental approach, experimenting with and carefully documenting selected reforms before broader changes are implemented. Because of its importance as discussed earlier, the highest priority is to make modifications that will allow the development of an effective loan grant linkage mechanism. As another step, it might be possible to try out the granting of broader authority to some local governments that have the administrative capacity to handle it, and then build in the lessons learned into the design of more comprehensive solutions.

Poverty Alleviation

The desire to assure that lower-income groups be the beneficiaries of an appropriate share of urban development grant allocations led GOI to add a new objective to this effect in 1989. "Targeting subsidy resources to low-income groups" would be a more accurate label for it (since poverty alleviation depends primarily on the structuring of employment opportunities rather than the allocation of urban services).

Actually, Indonesia - given its substantial accomplishments in the KIP program and urban water supply - already has a much better record in this regard than most developing countries. But with increasing emphasis on cost-recovery, the purpose of this objective has been to ensure that a focus on low-income groups is not forgotten. The current Policy Action Plan (TKPP, 1990a) does not call for a formal start to activities under this objective (e.g., assigning a working group, arranging for consultancies, planning an initial workshop) until September 1990. Interviews conducted during this mission indicate that there have been serious discussions on the

topic within Ministries in preparation for this agenda. The 1990-94 Plan for this element continues the commitment to the previous objectives but does not set forth any more concrete targets for their achievement.

Section 6

INSTITUTIONAL DEVELOPMENT AND PROGRAM COORDINATION

STRENGTHENING LOCAL GOVERNMENT CAPACITY

Consistent with Policy 5, the Plan's objectives have included: (1) carrying out a comprehensive study of the institutional and manpower development needs of local governments; and then (2) developing a program to strengthen local government capacity based on the results of the study.

The Urban Institutional and Manpower Development Study (UIMDS)

The study (UIMDS) was completed at the end of 1988 (P.T. Hasfarm Dian Konsultan and DHV Consulting Engineers, 1988). One of its major contributions was a new Human Resource Data Base (HRDB) containing the results of a 30,000 respondent manpower survey. This should be extremely useful in analyzing policy options on an ongoing basis and warrants being updated periodically. Also, the study seems to offer solid analysis of the problems to be addressed and a number of reasonable directions for systems improvements.

The report's findings and recommendations cover most relevant topics (urban planning, local financial management, urban service delivery, personnel management, training, the administrative status of urban areas, and internal organizational structures) and examine appropriate roles for central, provincial, and local authorities in each. Some issues are complicated and controversial. Considerable time will no doubt be required to address them adequately. But there are many other areas in which progress could be made incrementally without waiting for major legal changes. Across all topics, short-term actions could entail organizational tightening to eliminate functional redundancy, streamlining presently cumbersome procedures, and introducing computer-based management systems.

The study also states that improvements in local government training also warrant high priority. Observations during this mission confirm that, while training has been provided under several elements of the Policy Action Plan, the results of these efforts are not well documented individually and there has never been a comparative evaluation of their performance. Anecdotal evidence indicates that off-site training (where trainees are sent to a separate facility for lectures and participatory work in

subjects relevant to their jobs) have been less beneficial than *on-the-job, learn by doing, training experiences*. In the former, there is little guaranty that the trainee will be able to apply what has been learned directly to the job when he or she returns to it. In the latter, the training is designed to fit the job and the new techniques or principles have to be directly applicable to the tasks that are central to the trainees performance. When the trainers depart, the trainees simply continue to do what they have recently gained experience in doing in situ. A comprehensive review with these issues in mind seems very much needed at this point as a basis for future planning. The World Bank has recognized this point and a review is contemplated prior to the initiation of its new Local Government Institutional Development program with the Ministry of Home Affairs (MHF).

This mission also indicates a need for stronger coordination of system development efforts. Today, probably no device is more important to enhancing local government capacity than a computer-based financial management and accountancy system (covering all sources of revenue and capital as well as routine expenditures). Such systems can form the core for broader planning and control of all municipal activities in addition to providing the base for financial planning, accounting, and auditing per se. In the overall program, several systems which appear to be at least partly overlapping in these areas seem to be in process (MAPATDA, PAFFACK, systems developed to support PJM and RIAP formation in IUIDP, and a package developed by Redecon for the Ministry of Finance). It would seem reasonable to conduct comprehensive comparative review of these efforts and develop proposals on how to incorporate the best features of each into a series a useable packages (designed to meet the needs of local governments at differing levels of development).

Observations on this mission also underscore the need to at least begin to address two longer term issues. The first is more rapid action on granting appropriate administrative status to urban areas. Unless a city has been given Kotamadya status, there is no public entity that can represent it adequately. It has no government primarily concerned with its own interests as distinct from those of its rural hinterland. In deciding whether or not to borrow from the RDA, for example, the incentives of a Bupati that happens to have a sizeable city within his Kabupaten boundaries are very different than they would be for the Walikota of the city itself. NUDS proposed a schedule for accelerating the classification of urban areas in Indonesia, but that schedule has fallen far behind.

Secondly, UIMDS recognized that present civil service regulations provide strong incentives for would-be public servants to seek employment at the central, rather than the local level, and disincentives for talented young managers to seek careers in the public service in general (see also King, 1988). Progress in both of these areas will be difficult, and it should not be expected that major changes can be made immediately. Nonetheless, it would seem that initial steps to address these ends should be given greater prominence in short-term work planning.

Progress Under the Policy Action Plan

The next step in following up on UIMDS recommendations under the current Policy Action Plan is not scheduled until September 1990. Discussions of the issues have been taking place within the Ministries but, given delays in the mobilization of technical assistance for this work, it seems likely that some rescheduling will be

necessary. This topic should be a high priority for TKPP attention. It should be noted, however, that improvements in local government capacity are nonetheless continuing through other elements of the overall program (e.g., the continuation of IUIDP, further implementation of MAPATDA, and cost recovery systems in PDAMs).

Objectives for this element in the current Policy Action Plan are stated at a very general level. The new 1990-94 Plan offers more detail and helpful clarification on sub-components: regulations, organizational structure, personnel systems, training. One new objective has been added: the creation of regional technical assistance centers for environmental management and town planning.

SECTOR COORDINATION

The program's last policy (Policy 6) addresses the need to strengthen coordination and consultation in the urban development sector. The most basic step under this policy was the formal establishment of TKPP in 1987 and the subsequent decree extending its responsibility for an indefinite period. Another accomplishment under this element of the Plan was the preparation of inputs to the nation's fifth five year development plan (*Repelita V*) to assure consistency with the themes of the overall program as defined above.

The 1990-94 Plan adds two new topics: (1) the development of an information system on urban development to serve all relevant agencies; and (2) coordination with the recently formed national Spatial Planning Committee in developing medium-term plans for the urban sector.

Central Information System Development. With regard to the first, the overall comparative review of systems developments under the Plan as suggested above would be very beneficial *before* planning for new central systems moves too far ahead. The new system objective added under Policy 6 in the 1990-94 Plan seems to be on the right track, but it needs to advance with explicit recognition of other national systems already complete or underway (e.g., the NUDS database, the system developed by Videcon for MHA). Efforts to plan integrated central systems have often failed by setting overly ambitious, all-embracing, objectives. Incremental approaches (that allow different users to build components for their own use, but retain the capacity to interface them) have a much better track record. One element that is already clearly specified probably warrants the highest priority: assembling data from the new decennial census on population and other characteristics that is *exactly* comparable to the definitions used in the NUDS data base (see discussion in Section 2). Reliable data of this kind is a baseline from which the need for other systems components could be assessed much more effectively.

Developing a Clearer Strategy for Broader Spatial Development Planning. It would seem that very careful analysis and planning is needed before moving ahead too fast under the second new objective added for 1990-94. To avoid an overly ambitious charter at the start, IUIDP was purposefully limited to a basic set of functions (water supply, drainage, sanitation, urban roads, and a few other related activities). This is an important set (including all that together really set the spatial pattern *within an urban area*) but there are others that have to be considered in local capital budgeting. The PJM/RIAP process is an excellent approach for planning local

investments and there is little doubt that local officials should expand its scope to cover, for example, budgeting for school and health center development. But what about building new electric power plants, telecommunication facilities, and major roads? These are investments in which the provincial and central governments retain a stronger interest since they play a more powerful role in setting the *interurban* pattern of opportunities for economic expansion. There seems to be a general agreement at this point that IUIDP should be broadened and linked to the work of the recently appointed Committee for Spatial Planning. However, there is a need for very careful analysis as to how this should be accomplished (analysis that covers the practical administrative implications as well as the economic development aspects). Perhaps there should be two linked but relatively independent processes: one that covers matters fully under the discretion of the localities and another that involves more negotiation between local and higher level governments. A concept paper addressing these issues should be developed and discussed over the coming year before definite decisions are made to change IUIDP.

Annex A

**REVIEW OF HGL POLICY ACTION
PLAN IMPLEMENTATION**

(Statement submitted by Tim Koordinasi Pembangunan Perkotaan, Government of Indonesia, to USAID, July 17, 1990)

The implementation of *physical projects* according to an agreed timetable is relatively easy - the implementation of *policy objectives*, involving administrative, financial, and institutional reforms, is much more difficult. It is easier to have a rigid timetable for road building than for consensus building. Nonetheless, in practically all areas of the GOI's six urban policies we have moved forward during the past year along the path of the agreed policy action plan, though perhaps not with equal speed in all areas.

POLICY 1 calls for the strengthening of local government responsibility for urban infrastructure planning, development, operation, and maintenance. In this area, work on the classification of urban infrastructure and specification of responsibility for their implementation has gone ahead. A pilot project for survey and classification in 10 cities has been carried out and completed and the conclusion of these classifications is currently undergoing trial application in Surabaya and Yogyakarta. The responsibilities of central, provincial, and local governments have been defined in terms of PP. 14/87. Related guidelines and directives are under preparation.

POLICY 2 calls for decentralized and integrated infrastructure planning and programming (IUIDP). A series of guidelines has been issued and updates are issued annually, to assist in PJM preparation. PJM preparation is underway in all regions of Indonesia, and ADB- and IBRD-funded programme implementation packages have recently been appraised (West Java/Sumatra and East Java/Bali) or are moving forward to appraisal (Sulawesi, Irian Jaya). Implementation has started in Medan, West Java/Sumatra, JUDP II and JUDP III projects, and PJM preparation is underway in other Metro/Large Cities in various stages of completion. Some 75 percent of the urban population live in cities in which PJM preparation is at least underway or completed. Regarding the introduction and development of a more effective O&M system for urban infrastructure within IUIDP framework, POMMS implementation has been completed in 8 cities. Guidelines and SK have been issued. IUIDP Training has

been widely and systematically introduced in seminars, workshops, and in formal training courses.

POLICY 3 concerns strengthening of local government capability to mobilize resources and optimize the use of funds.

Regarding **PBB**, the greatest impact has been made in the area of general policy and administrative reform and the complete reorganization of the property tax administration system. The Stage 1 programme (1987-1990) for individual and semi-individual and semi - individual valuation and the upgrading of index valuation system and training of valuers is expected to be completed by December 1990. With about one year delay due to late mobilization of advisory and consultant services.

Regarding **cost recovery**, the proposed law on local taxes and charges has reached the final draft stage. Once enacted, it will reinforce the implementation of policies for pricing of public goods and services by regional governments and public enterprises. 30 PDAMs have implemented the national tariff structure to date according to MHA decree of 30 June 1989, concerning water tariffs. However, not all the tariffs recommended by PDAM managements have yet been approved by the Board of Supervisors and the Bupati/Walikota concerned. But there are many examples of successful tariff increases, such as the 25 percent increase in water tariff at Tangerang since May 1990. Improvement in tariff structure in Jakarta as part of JUDP II, including substantial revenue increases from solid waste collection. Surabaya PDAM introduced a tariff structure which has led to surplus revenue already.

Regarding the **strengthening of local government revenue administration, accounting and financial management**. Manuals have been prepared and applied (MAPATDA) in about 200 local governments. To reinforce performance monitoring an information system core has been established in PUOD, MHA.

Concerning **private sector participation**. Preparation of guidelines and appointment of consultants are somewhat delayed due to the late start of the USAID/TA programme, but channelling private sector resources into the provision of urban infrastructure facilities is going ahead both in water supply and solid waste management (Surabaya, Semarang, Jakarta etc).

Regarding **local participation** in KIP and sanitation programmes, an intensification campaign in community development started in cities, especially in connection with second round KIP programmes in Jakarta (Governor's SK already issued), and in Surabaya and Palembang.

POLICY 4 concerns the improvement of the financing system for the development of urban infrastructure services.

Regarding the provision of a **viable source of loan finance for local government**, substantial progress has been made towards the operationalization of RDA. Basic policies, guidelines and appraisal procedures have been developed. MOF conducted a survey of loan demand requirement among regional governments and enterprises, and preliminary assessment of the survey indicated substantial real demand for loan facilities (though Repelita V expenditure programme may have somewhat over estimated the demand). A final agreement between MOF and

BAPPENAS concerning RDA is imminent, and is expected to lead to early issuance of a legal instrument concerning RDA operationalization.

Regarding *grant finance*, Inpres programmes have been substantially increased (88 percent increase in the current year alone), allocation criteria has been improved, and local governments are more closely involved in the planning, programming and implementation of projects financed out of DIP funds. Their discretion regarding the utilization of Inpres funds has also increased.

POLICY 5 concerns the strengthening of local government institutions. A National Manpower Development study has been completed and its proposals have been reviewed and accepted by MHA in early 1990, for further deliberation among concerned government agencies. The study includes a comprehensive inventory of institutional and manpower issues at TK II level of government, and makes a range of important recommendations for administrative reform. The proposals are expected to be discussed in TKPP prior to being considered by DPOD later in 1990.

A wide range of training activities have been carried out to improve Public Works personnel both at central and local (dinas) levels. Targeting decision makers (60 percent of TK II); introducing programming concepts and methodology (50 percent of TK II); improving programming skills (25 percent of TK II active in detailed programming); and improving appraisal capability (in 13 provincial governments).

POLICY 6 calls for improved coordination and consultation between various agencies and levels of government. The Ministerial Decree (SK) establishing TKPP has been modified and reissued for an indefinite period. Ongoing attempts to define institutional responsibilities should facilitate inter-agency cooperation, particularly in the formulation of medium-term planning for the urban sector, with particular emphasis on Repelita VI preparation. Institutional responsibilities and procedures for data acquisition, processing and channelling, are still at a conceptual stage, but expected to be developed during the remainder of Repelita V.

TKPP is expected to coordinate urban infrastructure development with the recently established spatial development committee.

Annex B

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