
PLANNING AND DEVELOPMENT COLLABORATIVE INTERNATIONAL, INC.

**Municipal Finance for Environmental Infrastructure
(MFEI)**

**Urban Policy Action Plan:
Third Annual Assessment**

Prepared for
United States Agency for International Development

Prepared by
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Contract No. PCE-1008-I-6008-00, DO #11

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Executive Summary

The Municipal Finance for Environmental Infrastructure (MFEI) Housing Guaranty Loan Program provides the Government of Indonesia (GOI) with up to \$125 million in funding for urban environmental infrastructure investment over a four-year period. Two associated technical assistance and training projects (the Municipal Finance Project [MFP] and Private Participation in Urban Services [PURSE]) provide assistance to the GOI in implementing an ambitious five-year Urban Policy Action Plan (UPAP). The UPAP charts the GOI's course in decentralizing resources, authority, and responsibility for increased infrastructure and service provision at the local government level.

An annual assessment is carried out by an independent expert to determine the degree to which UPAP targets supported by MFEI have been met and to identify areas in which the MFEI implementation plan may require adjustment. This third annual assessment summarizes the continuing excellent progress that is being made in achieving key reform targets related to the six key UPAP objectives on which MFEI assistance is focused.

Achievement of Targets for the Period

Year three progress continued to be excellent, with virtually all targets for the period met or exceeded. During year three, many targets required very significant policy reform and innovative design and implementation activities. This assessment revealed, through more than 20 interviews, that GOI officials, United States Agency for International Development (USAID)-supported consultants, and USAID management have continued to work together in an exemplary fashion both to achieve stated targets and to creatively adapt resource deployment to meet situational requirements. All participants are to be congratulated on their skillful implementation of this ambitious sectoral reform program.

The key objectives and summary achievements for the period are as follows:

- **Strengthening GOI Apparatus for Urban Management (UPAP Obj. 2).** Key year three activities focused on continuing issuance of urban management guidelines (UMGs) and establishment of an employee exchange program to promote best practices among Indonesian cities.
- **Strengthening Local Government Urban Management Capacity (UPAP Obj. 3).** Development and delivery of the Urban Management Training Program (UMTP) continued to be of high quality. Coordination with the \$75 million ADB-financed Capacity Building project, expected to be effective in early 1998, should lead to the long-term institutionalization of the UMTP.
- **Implement a Decentralized and Coordinated Process for the Provision and Management of Urban Infrastructure (UPAP Obj. 5).** During year three, all key guidelines and public-private partnership (PPP) management tools were finalized in Bahasa Indonesia providing a sound basis for the operation of the proposed PPP center being organized by Bappenas. This center, which will receive USAID design support, will carry on PURSE's work in facilitating PPPs of all sorts throughout the country.

- **Establish a Decentralized and Coordinated System for Urban Environmental Quality Management (UPAP Obj. 7).** Two pilot projects to raise community awareness about and increase participation in environmental management were carried out. In addition, important diagnostic work was started with the country's rapidly growing number of septic sludge treatment plants. A program of assistance to improve the efficiency of these critical environmental management facilities is underway.
- **Increasing the Availability and Effectiveness of Financial Resources for Urban Development (UPAP Obj. 9).** Major progress was made in beginning the process of fiscal transfers through a \$120 million initial transfer of Cipta Karya (CK) DIPs to local government Inpres. Up to Rp.3 trillion in additional DIPs that may be appropriate for transfer to Inpres have been identified. Excellent progress was also made in selecting, through a competitive process, underwriters for PDAM bonds, two of which may be issued in 1997. Issuance of the MOF Decree rationalizing RDA is expected in July 1997.
- **Mobilizing Private Sector and Community Participation in Urban Development (UPAP Obj. 12).** Progress continued to be made in facilitating a range of pilot PPPs around the country, including the signing of a contract for water supply in Medan.

Themes Arising from the Assessment

Key themes arising from the third year assessment focus mainly on interrelationships critical to the emergence of a municipal finance market in Indonesia. As discussed further in Section 3, these themes include:

- **Creating an Environment for Successful PPPs:** Awareness of and interest in PPPs is growing rapidly, but the lack of experience in this market is causing a variety of difficulties in initial deals, most of which are related to a lack of transparency. While the PPP law is being fully implemented over the next several years, USAID-funded assistance to pilot project preparation could seek to maximize multilateral (e.g., ADB, IFC, etc.) investor participation.
- **RDA Rationalization:** MOF's focus on building the capacity of regional development banks (BPDs) as quickly as possible in order to effectively decentralize the retail lending function should be supported to the extent possible. The need to spin off a freestanding, capitalized RDA should be reexamined.
- **BUMDs and Equity:** The potential benefits of encouraging private equity investments in BPDs, PDAMs, and other BUMDs should be fully evaluated as a potential means to promote greater transparency and operating efficiency while mobilizing additional financial resources.
- **Demand for Bonds:** While it appears that the supply side of the emerging bond market is developing nicely, demand from bond issuers is still somewhat weak. While this demand may strengthen once the first pilot bonds are issued, it may still be prudent for the GOI to investigate means to encourage bond issuance, including the kinds of grant and DIP funds available to support subsidiary loan agreements (SLAs).
- **Inpres and Local Government Performance:** The initiation of significant new transfers from DIPs to local government Inpres needs to be accompanied by measures to monitor local government investment efficiency and performance benchmarks to create incentives.

- **Repelita VII:** The urban strategy for the next Repelita is being drafted, through Bappenas, in June 1997. Timely USAID inputs will be welcomed.

Summary

Once again, GOI and USAID staff, as well as project consultants, are to be commended for continuing their excellent management of this ambitious and complex program. The fundamental improvements being made under the program are gaining momentum on all fronts, and the commitment and dedication of all involved in this ground-breaking process is both refreshing and admirable. Continuation of this record of achievement in year four will certainly lead to Indonesia's decentralization program taking its place as one of the best-conceived and -managed efforts in the developing world.

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**Municipal Finance for Environmental Infrastructure
Housing Guaranty Loan
Third Annual Assessment
June 1997**

1 Introduction

This annual assessment of the Municipal Finance for Environmental Infrastructure (MFEI) Housing Guaranty (HG) Loan to the Government of Indonesia (GOI) was carried out over the period of May 22 to June 9, 1997. In the course of the assessment, more than 20 interviews were conducted with key GOI officials and consultants associated with the MFEI project.

This annual assessment has two main purposes. First, an external expert is requested to review progress made in achieving annual policy targets with all of the key parties. These targets are very clearly set forth in the Urban Policy Action Plan (UPAP). The second purpose of the assessment is to allow all key participants to reflect on the continuing appropriateness of established targets, to identify emerging priorities, and to consider possible realignments in both targets and deployment of resources through associated technical assistance and training activities.

The main body of the report contains two sections. First, progress in meeting annual UPAP targets is summarized. Second, themes emerging from interviews are discussed and related to overall project and UPAP goals. Possible implications and recommendations for the GOI and the United States Agency for International Development (USAID) are also discussed in Section 3. This assessment does not include a review of attributable GOI investments related to justification of HG tranche releases. That exercise has been conducted separately and the results are on file with USAID.

A sincere word of thanks is due to all of the GOI officials and project consultants interviewed during the assessment for their universal willingness to make available information and time from their busy schedules. Similar gratitude is expressed to USAID staff who were uniformly informative and highly efficient in organizing a rather hectic three weeks. Any errors of omission or misinterpretation in this report are entirely the author's.

2 Summary of Progress toward UPAP Objectives

This section of the assessment examines progress made in achieving UPAP goals and annual targets for which MFEI and USAID support is explicitly provided. Comments are provided, where necessary, on the status of individual actions as well as summary comments for each major objective.

2.1 Strengthen Governmental Administrative Apparatus for Urban Management

This objective (UPAP No. 2) focuses on strengthening intergovernmental coordination and development of clearer legal and regulatory systems and guidelines to support urban management. The key actions, third year targets, and accomplishments for the reporting period are reviewed below.

1. **Action:** Establish a full-time urban secretariat to support the interdepartmental coordinating committee (UPAP 2.1B).

Third year target: Reorganization of TKPP to provide policy input and review function for P4RPR is implemented through a ministerial directive.

Accomplishments: Bappenas has reorganized TKPP in the sense of assigning additional responsibilities for monitoring all urban development projects throughout the country. Bappenas has not yet determined that a ministerial decree is necessary to formalize these responsibilities.

Comment: As noted in the preceding two annual reviews, the need for, composition of, and appropriate institutional home for a full-time urban policy secretariat in addition to TKPP is not entirely clear. Bappenas management believes TKPP can adequately monitor urban development and the decentralization process. If this is the general consensus, then UPAP 2.1B and the annual targets should be amended accordingly.

2. **Action:** Complete and continuously update an inventory and analysis of all existing laws, regulations, and guidelines issued by central agencies of relevance to urban management at the local government level (UPAP 2.3A).

Target: Update inventory/analysis of laws, regulations, and guidelines related to urban management.

Accomplishments: A database has been established; routine updating of the database continued.

Comment: This action is accomplished.

3. **Action:** Prepare detailed urban management guidelines (UMGs) for specific functional areas for use by local governments. The UMGs will instruct TK II managers in the practical application of existing laws, regulations, and guidelines for more effective urban management (UPAP 2.3B).

Target: Finish preparation and dissemination of urban environmental quality management (UEQM) technical guidelines.

Accomplishments: The UEQM guidelines were completed and a pilot application was carried out in Bandung in December. This pilot application revealed an inadequate linkage between descriptions of national laws/regulations/guidelines (LRGs) and the structure of local government LRGs. An additional study was conducted in West Java to demonstrate the linkage and provide sample, revised local government regulations.

Related activities included a study of the criteria used to designate Administrative Cities (Kotip) and a workshop on community-based approaches in environmental management. This workshop included representatives from 50 cities, 11 of which signed agreements to create employee exchange programs to promote city sharing on a continuing basis.

4. **Action:** Improve the existing systems for dissemination of central laws, regulations, and guidelines to LGU managers (UPAP 2.3C).

Target: Through cooperation between MFP and BKS-AKSI training programs, develop a system to disseminate UGMs to urban managers.

Accomplishments: The new UEQM urban management guidelines have been sent directly to 120 local government agencies and associated central institutions, and will be incorporated into the Urban Management Training Program (UMTP) UEQM course. Guidelines Dissemination Forums, developed with BKS-AKSI support, will begin functioning in the fourth year of the UPAP.

In summary, year three progress was entirely satisfactory in achieving the stated UPAP targets to improve urban management administrative apparatus.

2.2 Strengthen the Institutional Capacity of Local Governments for Urban Management
MFEI-related support for this critical objective (UPAP No. 3) focuses primarily on design and implementation of a coordinated and self-sustaining UMTP. Four key actions were involved for the period under review.

1. **Action:** Design and continuously maintain an interministerial framework for urban management training and technical assistance, providing a basis and focal point for all such training and technical assistance (UPAP 3.2A).

Target: Conceptual framework reassessed and revised as necessary based on alumni surveys and other inputs, emphasizing long-term institutionalization of the UMTF.

Accomplishments: Surveys were carried out with about two-thirds of the participants in the Urban Financial Management Course, which was piloted in May 1996. The results of these surveys, particularly concerning the relevance of case studies to local conditions, have been incorporated in the course, which has been transferred to the Universitas Gajah Mada in Yogyakarta for future delivery.

The larger issue of institutionalizing the delivery and further development of the UMTF was examined in a January 1997 paper on the National Training Program in Strategic Urban Management prepared for the National Training Coordinator. The advent of the ADB-financed Capacity Building Program may provide new opportunities as discussed below.

- 2. Action:** Implement the UMTF core course with selected local governments (UPAP 3.2B).

Target: Urban management core course conducted for strategic cities and monitored by UMTF (UPAP 3.2B.1).

Accomplishments: By the end of year three, 30 of the targeted 38 strategic cities had participated in the core course. All eight remaining cities are expected to be covered in year four.

- 3. Action:** Preparation of the Urban Financial Management Module of the UMTF (UPAP 3.2B).

Target: UMTF Financial Management Module pilot tested, revisions made, refresher TOT conducted, and university(s) selected for continuing delivery (UPAP 3.2B.2).

Accomplishment: The UMTF Financial Management module was pilot tested in May 1996, several substantive revisions were made to the course as a result of the pilot, and Universitas Gajah Mada was selected to provide continuing delivery of the course, in consultation with Badan Diklat. The University will offer the course for the first time in August 1997.

- 4. Action:** Development of UEQM management course (UPAP 3.2B.3).

Target: Curriculum developed, training materials prepared and revised, TOT conducted, pilot training conducted, and potential implementing institutions identified for UEQM.

Accomplishments: The UEQM course was developed and presented at a one-day workshop involving academic and professional experts in June 1996; comments received provided the basis for revisions of the course. The curriculum includes 12 strategic environmental management issues and five case studies, all of which are drawn from Indonesian urban experiences. The course was pilot tested with representatives from six provinces and six municipalities in December 1996. The training agency of Bappedal and several regional universities are now

being evaluated as continuing delivery agents, final arrangements for which will be made in year four.

The Capital Investment Programming module is being designed and will be completed in year four, during which the design of the Spatial Planning and Land Management module will begin, for completion in year five.

Action: Improved participation by regional universities and other management training institutions in developing and delivering urban management courses and programs (UPAP 3.2C).

Target: Regional university(s) selected for delivery of the UFM and evaluated for the UEQM.

Accomplishments: As discussed above, Universitas Gajah Mada was selected to deliver the UFM course and several possibilities are being evaluated for the UEQM course.

In summary, all UMTF targets continue to be met or exceeded. Year three saw an important development with the agreement between the GOI and the ADB to negotiate, in late 1997, a Capacity Building loan for urban infrastructure planning and management. This \$75 million loan facility, expected to be effective in early 1998, will allow the training institutions of MOHA and Cipta Karya (CK) to deliver a wide variety of courses to technical and managerial staff at all levels of government. Discussions are now underway to incorporate the UMTF courses into the Capacity Building project, which will, during its five-year implementation period, arrive at permanent institutional arrangements for the continuing delivery of urban management and other relevant training.

Two other observations are relevant with regard to the UMTF. MOHA personnel report that Badan Diklat has had to revise a UMTF module to improve its applicability for local government officials. UMTF has a formal plan for monitoring delivery of these modules by Badan Diklat, as well as for reviewing revisions made to the modules. It would seem advisable for UMTF to exercise special vigilance to ensure that any revisions of UMTF courses made by delivery institutions be consistent with the original aims of the program.

In addition and as raised in the two previous annual reviews, training courses for public-private partnerships need to be integrated with the overall urban management training program of the GOI. Presumably, this will now take place within the context of the Capacity Building project.

2.3 Implement a Decentralized and Coordinated Process for the Provision and Management of Urban Infrastructure and Facilities, including Adequate Levels of Investment

This objective (UPAP No. 5) has focused in MFEI mainly on improving regulations for private-public participation (PPP) (e.g., "build, own, and operate" and "build, operate, and transfer" [BOO/BOT]) joint ventures in development of sanitary landfills, wastewater treatment systems, and real property development.

1. **Action:** Improve and implement basic technical standards for design, construction, and operation of sanitary landfills (UPAP 5.3E).

Target: Promulgation of final regulations and guidelines by the Ministry of Public Works for solid waste management.

Accomplishments: The draft regulations and guidelines were prepared and submitted to Cipta Karya. The documents have been revised and are currently under review by Cipta Karya staff.

2. **Action:** Improve and implement regulations and technical standards for the design, construction, and operation of wastewater treatment systems (UPAP 5.3F).

Target: Completion and revision of draft regulations and guidelines for wastewater treatment.

Accomplishments: The development of required regulations and guidelines was initiated in 1996. The process of revising and reviewing these documents is ongoing.

3. **Action:** Improve and implement regulations requiring real estate, commercial, and industrial developers to construct and maintain environmental infrastructure (e.g., water and wastewater systems) as part of their developments (UPAP 5.3G).

Target: Preparation of draft regulations and guidelines for inclusion of environmental infrastructure in new developments.

Accomplishments: No further action was taken on this target since, as discussed in the year two review, the GOI is not proceeding with development of the larger private developmental regulatory framework, which would be necessary for these specific guidelines to be useful.

4. **Action:** Provide MFEI financing for urban environmental infrastructure (UPAP 5.4).

Target: \$25 million.

Accomplishment: The annual borrowing was completed on schedule and, according to a separate review of investments, was fully utilized for the intended purpose of financing urban environmental infrastructure.

Comment: All of the feasible actions under this objective were accomplished during year three. It is clear that the promulgation of some of the regulations and guidelines targeted in this section has been slower than expected. This appears to be the result of Cipta Karya's effort to reduce the number of centrally issued directives, and to increase its own ability to facilitate local decision-making in many of these areas. It may be prudent to discuss with the GOI over the next year how to adapt these targets to be more fully consistent with progressive changes in Cipta Karya's role and responsibilities.

2.4 Establish a Decentralized and Coordinated System for Urban Environmental Quality Management

This objective (UPAP No. 7) is, in relation to MFEI, focused on pricing strategies and improved incorporation of environmental management considerations in urban capital investment programming.

1. **Action:** Formulate and implement improved pricing strategies for water sector services (UPAP 7.3A).

Target: Inventory current systems, identify best practices, prepare draft guidelines, and partially implement a pilot project to test community-based septic tank desludging.

Accomplishments: The inventory of all existing and planned IPLTs (municipal septic sludge treatment plants), of which there will be about 100 in operation or under construction by 1998, was carried out. An in-depth study of eight IPLTs around the country concluded that construction standards were generally adequate, but that most were operating well under capacity due to, among other factors, a lack of homeowner awareness of the benefits of desludging, an associated lack of willingness to pay for this service, and cases of operating inefficiencies.

A four-part program has been designed to improve IPLT operating efficiency to be implemented in 10 East Java cities by PUOD. Cipta Karya plans to carry out a national conference on pricing and financing of wastewater services, with input from MFP, in the third or fourth quarter of 1997. CK has also been examining the potential for "piggybacking" IPLT service charges on other utility bills as a way to provide a steady revenue stream through which IPLT operating efficiency could be improved.

2. **Action:** Develop and implement guidelines for more proactive consideration of urban environmental quality management in capital investment programming, including explicit analysis of consumer demand and willingness to pay (UPAP 7.6A).

Target: Conduct demonstration projects in Kotip Ternate and the Lake Toba development area to demonstrate the use of the new PJM guidelines to strengthen environmental infrastructure planning at the local and regional levels.

Accomplishments: The Kotip Ternate pilot project was successfully completed through a local public education campaign on solid waste management and environmental sanitation. The project also included collaboration with local PJM consultants as well as a stakeholder's workshop that identified important lessons, including the need for community leaders and local officials to work more closely on local environmental management issues and the efficiency of small grants in mobilizing community-based efforts to promote environmental sanitation.

The Toba Lake Foundation led the second pilot project under this target, which included a public awareness campaign against dumping in the lake, weed eradication in the lake, water quality monitoring, and distribution of educational materials. The Foundation also established

a sister city relationship with the Lake Champlain Basin program to share environmental management strategies.

To summarize, all of the key actions under this objective were fully accomplished.

2.5 Enhance the Regional Finance System to Increase the Availability and Effectiveness of Financial Resources for Urban Development

Increasing the availability of finance for local governments and authorities is, of course, one of the cornerstones of decentralization. In the year under review, solid progress was made in achieving two of the three crucial medium-term goals under this objective, namely:

- improvements in the system for allocating intergovernmental capital investment grants known as Inpres (UPAP 9.1); and
- reducing local government reliance on central grants through increases in own source revenues (OSR) (e.g., locally generated and collected revenue) and through improved cost recovery and pricing mechanisms for urban services (UPAP 9.2).

Less progress was made in the third critical area of:

- establishing a more viable credit system to finance local government urban infrastructure and services investments (UPAP 9.3).

The key actions required to achieve this ambitious agenda are numerous.

- 1. Action:** Improve the overall intergovernmental allocation system incorporating: a) better targeting to low-income citizens; b) increased LGU allocative discretion; c) incentives for increased OSR generation; and d) increased revenue sharing with LGUs (UPAP 9.1A).

Target: Based on the action plan established in year two, policy and allocation reform recommendations to be prepared for Inpres for FY 97/98, with particular attention to meeting equity, local discretion, resource mobilization, and urban development priorities.

Accomplishments: A short-term consultancy carried out in May 1996 suggested a strategy to shift sectoral DIPs to Inpres, consolidate specific use Inpres grants into general use grants, and identify other opportunities for decentralization of Inpres while still achieving national development objectives.

The results of the consultancy were presented at a restricted policy review workshop in Jakarta at the end of May. Discussion focused on DIP reallocation to Inpres, increasing local discretion over Inpres while continuing to focus on specific priorities and redressing regional imbalances, and incentives for local governments to mobilize greater resources from own sources, debt, and private investment.

Another consultancy in September assisted in identifying almost Rp.3 trillion in DIPs suitable for transfer to Inpres over a three-year period, including Rp.310 billion in the first year. On

this basis, the GOI transferred Rp.290 billion (US\$120 million) from the Cipta Karya budget to Inpres for FY 97/98, firmly establishing the GOI commitment to decentralize Inpres and, simultaneously, radically redefining CK's institutional mission to that of a technical assistance and training provider.

Comment: The FY 97/98 shift of CK DIPs to Inpres will improve the GOI's overall performance in terms of increasing local discretion over central transfers. However, and as discussed in both of the preceding annual assessments, monitoring local government's capacity to efficiently manage these decentralized resources will now be key to the success of the Inpres decentralization effort.

2. Action: Improve local government revenues from local taxes and user fees (UPAP 9.2A).

Target: Continue increases in real per capita local government tax and user charge revenues as measured through select monitoring indicators.

Accomplishments: Updated data show that, on average, OSR for all local governments increased from Rp.9,465 per capita in 1990/91 to Rp.14,186 in 1994/95, an increase of more than 50 percent over the five-year period.

Comment: It would be useful to disaggregate this data in the future to show differences, if any, in OSR growth among LGUs categorized by size, capacity, or other useful criteria.

3. Action: Improve financial management of local water companies (PDAMs) (UPAP 9.2D).

Target: Focus technical support to PDAMs to conduct and use the financial assessment process based on year two evaluation of the performance monitoring indicators.

Accomplishments: Twenty PDAM president directors attended a GOI-financed strategic management course at RTI in September 1996. In addition, the PDAM financial performance monitoring system is now fully functional at PUOD, providing valuable data for assessment of PDAM performance, planning, and identification of likely candidates for private participation deals and bond issues.

4. Action: Improve cost recovery of other (e.g., non-water) local government services, including analysis of organizational options, operational efficiency, and tariffs (UPAP 9.2E).

Target: Prepare a case study of the impact of BUMDs on local government finance; conduct national seminar on "Local Government Performance Assessment regarding Expenditure Efficiency."

Accomplishments: The national seminar, held in September 1996, was refocused to the topic of rationalization of local government tax collections in line with GOI's finalization of the law on Local Government Taxes and User Fees (expenditure efficiency will be covered in year

four). The new law will simplify local government tax and fee structures and should lead to more efficient own source revenue generation.

A second national seminar, held in October 1996, focused on transforming local government services into enterprises. A number of approaches to increasing efficiency and effectiveness of public service delivery through corporatization were examined and pilot projects involving solid waste, terminals, and markets are now being prepared in two cities. These pilots will feed into the design of a larger ADB-assisted project in 98/99.

Comment: As discussed in Section 3, the potential for private equity investments in BPDs, PDAMs, and other BUMDs merits further investigation.

5. **Action:** Carry out an external evaluation of the RDA's operations capacity, its working relations with local governments, capitalization policy, and collections record. Prepare a five-year institutional development plan for the RDA (UPAP 9.3A).

Target: Promulgate revised RDA/MOF decree and initiate new wholesale financing institution.

Accomplishments: The revised decree was completed and submitted for MOF action in October 1996. Due to the unusually heavy work load of senior MOF officials, a change in RDA management, and substantive questions about the most effective way to rationalize RDA, the decree was not promulgated. The ADB did approve an RDA loan, but with a stipulation that BPDs not be included in project implementation until a second phase of the loan was approved. This loan does include TA to strengthen BPDs.

Comment: The annual target with regard to RDA reform was, for the reasons cited above, not met. As part of this annual review, a meeting was held with senior MOF officials to discuss their substantive reservations regarding RDA reforms. These reservations clearly merit further consideration and MOF committed to reaching a final consensus to be embodied in a final decree for issuance in July. The substance of these reservations is discussed in Section 3 of this assessment.

6. **Action:** Improve mechanisms to evaluate the creditworthiness of potential municipal RDA borrowers, including routine internal MOF disclosure of RDA borrowers' performance and implementation of procedures for imposing sanctions in cases of RDA loan repayment arrears (UPAP 9.3B).

Target: Preparation of implementation guidelines for the new RDA.

Accomplishments: The necessary guidelines were prepared.

7. **Action:** Support procedures for domestic — public and private — capitalization of the RDA, including reflows of outstanding loans under RDA management, GOI resources, and private market borrowing (UPAP 9.3C).

Target: Implementation of capitalization plan for RDA as part of overall reform process following the new MOF Decree, including utilization of national budget allocations and repayment of RDA loans.

Accomplishment: The capitalization plan was not fully implemented since the Decree was not finalized. While additional capital for RDA was secured by way of the ADB-supported project, the longer-term capitalization plan for RDA can only be determined once the substantive issues to be addressed in the decree are finalized.

8. **Action:** Explore alternative short- and long-term mechanisms to mobilize domestic credit for local government financing of urban infrastructure investments (UPAP 9.3D).

Target: Municipal bond issuance.

Accomplishments: A municipal bond issue is targeted for sale, if feasible, in the MFP work plan by the end of 1997 and in the UPAP by the end of Repelita VI. While bonds have not yet been issued, much progress has been made despite some disappointments inherent in such an innovative pilot effort. Of the initial four potential bond issuers identified, Pam Jaya decided to pursue a financing option involving private concession agreements, and PDAM Kodya Malang accepted a subsidized SLA. The two remaining potential issues, to be sold by PDAM Kab. Badung and PDAM Kab. Semarang, are still being processed. The competitive selection of underwriters has been completed. The underwriter selection process has produced some innovative financing packages and provided valuable experience with a transparent selection process, which will be useful in packaging future deals. Despite some delays in the PDAM Kab. Badung issuance, due to a split of assets and operations now required due to the elevation of Denpasar to Kotamadya status, both PDAM Kab. Badung and PDAM Kab. Semarang are expected to issue bonds by year end.

Additional assistance was provided to Bapepam and Pefindo to strengthen the reporting and rating procedures for bonds to support broader market development and reduce interest rates charged by investors. Issuance of the bonds for Badung and Semarang is now expected within CY 97. Additional PDAMs are being analyzed for assistance in bond issuances, and a broader outreach program is being designed to stimulate both PDAM demand and market responsiveness.

In a related opportunity, assistance was supplied to design a secondary mortgage facility (SMF) to stimulate the availability of housing finance. Visits were arranged for senior officials to Malaysia and the United States to study the operation of secondary markets, and rapid progress was made in designing an SMF that will be capitalized by private banks and the

ADB. During the course of this assessment, the requisite SMF decree was transmitted to the Minister of Finance for final approval.

Another related initiative saw continued technical assistance in assessing the potential for a low-income home purchase subsidy scheme. Mortgage buy-down and down payment subsidy options were examined, as were broader low-income housing market constraints. The consultant's report in this regard was expected shortly after this assessment.

In summary, the GOI and the USAID-supported consultants are to be applauded for the substantial progress made during the period under review in pursuit of this very critical objective. The combination of Inpres and RDA reform together with progress in the issuance of municipal bonds constitutes a very well designed and coordinated approach to the key objective of increasing finance available to LGUs for responsible infrastructure investments. However, it is critical that the RDA decree be finalized by July as committed to by senior MOF officials.

2.6 Mobilize Private Sector and Community Participation in Urban Development

USAID support for this objective (UPAP No. 12) is focused, primarily through PURSE, on expanding private sector participation in provision of urban environmental infrastructure and services. Four key actions and associated targets are assessed below for the period under review.

- 1. Action:** Develop risk management systems for BOO/BOT project development and financing (UPAP 12.1A).

Target: Complete and disseminate risk management handbooks to TK II governments.

Accomplishments: Translation of the handbook into Bahasa Indonesia was completed. Bappenas now proposes to disseminate the handbook along with the Project Life Cycle, PPP contract examples, and related documents as a package to local governments as soon as printing of these documents, underway during this assessment, is complete.

- 2. Action:** Institute a financial guarantee mechanism to support local government initiatives in BOO/BOT projects (UPAP 12.1 B).

Target: Implement seminar for senior GOI officials on credit enhancement and financial guarantees.

Accomplishments: The GOI and USAID agreed to revise this target, opting to use a case-by-case approach with PPP projects being prepared.

- 3. Action:** Select and implement appropriate PPP projects as PURSE demonstration projects (UPAP 12.1C).

Target: Continue assistance to three demonstration projects. Conduct screening to select 4-8 additional candidate projects.

Accomplishments: Contracts for two projects have been signed and seven additional projects are in the design phase. A number of additional projects are being evaluated.

Comments: As discussed in Section 3, encouragement of multilateral investment in pilot PPPs, as is the case in Medan, may be of benefit in developing this market.

- 4. Action:** Establish a legal and regulatory framework to enable private firms and local governments to implement joint ventures in priority urban services with an appropriate balance of autonomy from and oversight by central government (UPAP 12.1D).

Target: Completion of draft PPP law in conjunction with TP4I.

Accomplishments: The draft law was completed incorporating several rounds of comments from PURSE.

Comment: While the law has yet to be adopted and it will take additional time for implementing guidelines and regulations to be circulated, a solid framework for the execution of PPPs is now emerging.

- 5. Action:** Develop technical guidelines and operational procedures for planning, implementing, and operating PPPs.

Target: Finalize Project Life Cycle.

Accomplishments: As noted above, the PLC has been translated into Bahasa Indonesia and is ready for dissemination. MOHA has issued the requisite decree for local governments and PDAMs to use the PLC in PPP negotiations.

In summary, all of the annual targets under this objective have been fully met. Section 3 of this assessment includes a discussion of additional considerations relevant to the further development of a PPP framework in Indonesia.

3 Themes and Implications Arising from the Year Three Assessment

Following two years of excellent preparatory work, the MFEI in year three began to meet the challenges necessarily associated with bringing individual deals to fruition and assisting new, sustainable markets to emerge. With much of the preparatory work complete or nearly so, the key themes arising in this year's assessment are not so numerous as in previous years, but tend to be of greater importance to the MFEI's overall success in creating a municipal finance market.

Creating an Environment for Successful PPPs

The program's emphasis on delivery of PPP pilot projects within a rapidly evolving deal-making environment is, as discussed last year, a complicated objective. In year three, some of the complexities of this objective began to surface as deals were sometimes distorted by the domination of powerful private interests, undercut by offers of concessionary donor loans, or slowed by the simple lack of experience in the local market.

None of these impediments is unique to Indonesia. Indeed, in many emerging markets around the world, the rush to PPPs in recent years as an apparent panacea for overburdened central and local government service providers has been characterized by steeper than expected learning curves.

MFEI is designed to simultaneously address all of the key elements of the PPP learning curve, including general education about the potential benefits of PPPs, structuring of a basic regulatory environment, and promotion of action pilot deals. This extremely ambitious agenda is, as discussed in the year two assessment, made all the more difficult if any of these key elements do not progress in synch with the others.

It would be fair to say that a number of PPP deals in the past year have suffered as a result of the lack of transparency in which, due to inexperience and regulatory gaps, this emerging market must operate. While implementation of the draft PPP law will eventually increase transparency, no immediate effects are likely during the next year or so that MFEI is actively supporting PPP deal-making. Thus, it would appear prudent for MFEI to support several interim approaches to improving transparency.

First, assistance could focus on deals that are likely to attract multi- and bilateral development investors, such as the IFC, the ADB, the CDC, etc. Involvement of these institutions will tend to increase deal transparency and bring in a degree of discipline.

Second, support should be given to Bappenas's efforts to establish a prequalification system for potential private partners. This function will eventually be subsumed in the PPP center now being designed. It will be very important to ensure that this center assumes a facilitative, rather than direct regulatory, approach to PPP deals.

RDA

Current thinking within the MOF directorate responsible for oversight of financial institutions is that RDA should become a bulk financing window within MOF and that spinning off the RDA as a freestanding, capitalized development finance institution may not be desirable or necessary. This view would be reasonable if the retail functions and capacities of BPDs can be significantly strengthened in the near term. Some funding from other donors is available to assist BPDs in this regard, and consideration should be given to making these regional banks into limited liability companies, thereby allowing for the possibility of private equity investment as has already taken place with the West Sumatra BPD.

BUMDs and Equity

Another approach to increasing transparency while simultaneously mobilizing financial resources and improving management capacity of local enterprises is through infusion of private equity. This should be given serious consideration for both the healthier BPDs (as West Sumatra has already done) and PDAMs, and in both cases mandates to take in private partners could be linked to other objectives, such as BPD regional expansion and PDAM bond issuance.

In addition, the potential for higher capacity BPDs to acquire equity stakes in formative BPDs in other regions should also be examined. This approach could be a very efficient way of building capacity in spreading municipal investment management capacity to disadvantaged regions of the country.

Demand for Bonds

MFEI has demonstrated, through the competitive underwriter selection process, that the supply side of the bond market exists and is formidable, in the sense that investors and financial intermediaries are willing and able to absorb these kinds of investment instruments. What is somewhat weak so far is demand on the part of bond issuers. This limited demand may improve once the first bonds are issued, and by the project's ongoing education efforts.

However, it would also be prudent for the GOI to investigate creation of incentives for local governments and PDAMs to issue bonds, including linkage of matching Inpres grants and RDA/MDB soft financing to bond issuances. A further alternative that merits consideration is to encourage BPDs to use their experience in bond issuance to tailor new issues for use as pooled financing devices for smaller local governments and BUMDs that otherwise would not attract private investment.

Inpres and Performance

As discussed in previous annual assessments, decentralization of resources in the absence of any reasonable monitoring system is not ideal. Therefore, it may be worth giving special priority to the activities of the MFP consultancy (schedule for July) that will determine at least a simple performance benchmark system that could be used to condition future Inpres allocations. In addition, Cipta Karya has established an Internet system that may be useful in achieving timely monitoring of Inpres investments.

Repelita VII

Bappenas has indicated that inputs from USAID are welcome in drafting the urban development strategy section of Repelita VII. This work is ongoing and strategic inputs need to be made in June 1997.