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MUNICIPAL MANAGEMENT ASSESSMENT

INDONESIA

Prepared for

The Office of Housing and Urban Programs
Regional Office, Bangkok, and
USAID/Jakarta
U.S. Agency for International Development

by

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I. EXECUTIVE SUMMARY

The municipal management assessment was conducted by a team of three consultants through a series of interviews with Government of Indonesia officials in Jakarta, other consultants engaged in long-term assignments with GOI ministries, and local officials in Bandung, Semarang and Sukabumi. AID officials from US-AID/Jakarta and RHUDO/Bangkok also were involved in many of the discussions. In addition, basic financial and other information was gathered from primary sources in the GOI and the municipalities and the reports of numerous other consultancies.

The purpose of the assessment was to examine the possibilities for an AID Housing Guaranty program loan to support the GOI's urban development and decentralization agenda. Existing GOI policies and programs were reviewed, and current and planned other donor agency activities were reviewed to determine if and how HG program lending might be used effectively to support AID's policy agenda with the GOI and the GOI's policy, program and financial needs.

Based on the review of existing policies and programs, five areas were identified in which additional policy reform and/or program implementation strategies are needed.

1. Present strategies for improving the integration of local investment projects and project financing do not include a sufficient focus on local selection of infrastructure and related investments based on the economically most productive alternatives. Present strategies tend to take local priorities as given and focus on developing a program and financing plan for meeting these priorities. Local governments do not presently have the planning capacity on their own to evaluate potential investments and to select those which will contribute most to local employment generation and other economic objectives.

2. Although reform of the property tax as a major source of local revenues has already been initiated, other local resource mobilization efforts are at the study and design stage. Additional efforts are needed to assist the GOI in implementing significant local resource mobilization policy changes in the smaller to medium-sized municipalities (20,000 to 500,000).

3. Most GOI and other donor agency efforts at local resource mobilization are focused on generating additional revenues. Of equal importance are policies and programs that are aimed at ensuring efficient management of expenditures. GOI officials involved in major training and assistance programs for municipalities (Ministry of Home Affairs) agree that this concern should be weighted at least equally with revenue generation.

4. Policy changes and program implementation of mechanisms to increase capital availability to municipalities is required. An incipient effort to establish a loan fund is under way. Policies for tying this loan fund to GOI grant programs, the use of market rates of interest, and incentives to promote local fiscal effort and efficient local management need to be developed.

5. Present urban sector efforts are concentrated almost entirely in the largest cities. The growth of urban populations in cities in the 20,000 to 500,000 range requires some targeting of resources to cities in that size range, and within all urban areas, policies to assure that not only higher income groups benefit are needed.

Based on these gaps or limitations in current GOI and other donor agency programs, a HG program loan is recommended that ties loan disbursements to broad policy and specific operational policy considerations on the part of the GOI. Specific policy and program areas to be discussed (negotiated) include:

1. Design of the loan fund (RDA) to include the combination of a significant share of present central government grants with loans from the fund to assist in rationalizing the present form of central government support to local governments. This design should make it impossible for local governments to go around the loan/grant program to achieve traditional levels of central grant or soft loan support.

2. Participation in the loan/grant program to be based on incentives for local fiscal effort and local expenditure management efficiency.

3. Participation in the loan/grant program over the long-term to be increasingly focused on those municipalities with poor local resource bases, for the purpose of improving local economic resources, with incentives built in to make it less and less attractive to municipalities that have built up their resource base and developed viable local economies.

4. Interest rate policy for the loan portion of the program to be immediately tied to market rates and in the long-term to include other policy options for opening the municipal sector to other sources of capital financing outside the public sector.

In addition to these HG program considerations, other USAID/Jakarta program strategies could effectively be tied through technical assistance and training projects to these policy agendas, although these are not elements included in this report.

II. PURPOSE OF ASSESSMENT

The Indonesia Municipal Management Assessment was conducted in November-December, 1987, at the request of the USAID Regional Housing and Urban Development Office (RHUDO)/Bangkok by a team of three consultants, two from the Research Triangle Institute (RTI) and one long-term consultant assigned to the RHUDO. The main purpose of the assessment was to assist the RHUDO and USAID/Jakarta in considering the feasibility of AID involvement in support of the Government of Indonesia's (GOI) decentralization policy. In particular, the management assessment focused on the role of local governments in public sector resource management, the provision of public services, and the promotion of economic development. The assessment included a national level focus to examine the national policy context and the role of the central government in promoting local development as well as case study assessments of two local governments and a brief field visit to a third municipality.

AID concerns specifically examined were the possibilities for utilizing the resources of the Housing Guarantee loan program as a potential vehicle for financial assistance to the GOI and as a mechanism to encourage GOI policies consistent with USAID/Jakarta country strategy and RHUDO regional strategy. Of special interest to USAID was the manner in which AID involvement could complement other donor agency programs.

III. NATIONAL POLICY CONTEXT

A. COUNTRY SITUATION AND DECENTRALIZATION

Into the foreseeable future, Indonesia will experience rapid and accelerating urban growth. By the end of this century, an estimated 36 % of all Indonesians, or 77 million persons, will be living in cities, compared to 22 % or 33 million persons in 1980. The country's urban population is expanding annually at 4.3 %, or more than twice the overall growth rate.

National investment in urban development has been unable to keep pace with the increased demand for new services or the costs of operating and maintaining existing infrastructure and services. As a result, over half of urban residents do not have access to piped water, and over two-thirds lack adequate sanitation facilities. The expected increase in the urban population will only compound these problems, contributing to even greater deficits in infrastructure and services, unless additional resources are mobilized for urban investments, and unless these investments are made more efficiently.

The GOI's investment in the urban sector began in earnest during Repelita II (1974-1979), with an average annual expenditure of 263 billion Rupiah (Rp). Under Repelita III (1980-1984), substantially increased earnings from oil revenues enabled the GOI to expand its urban investments, nearly doubling its yearly expenditures to 500 billion Rp. Throughout this period, capacity at the local government level to plan and carry out urban projects remained weak; thus, the GOI played a dominant role not only in funding urban development, but in planning and approving local projects as well. Over the Repelita III period, the percentage of municipal revenues coming through GOI grants rose from 69 % to 75 %, with a top-down, central-government-controlled planning and approval process. This heavy dependence by municipalities on central government revenues served as a disincentive for improving local resource mobilization, as a disincentive for managing resources efficiently and allowed for distortions in the allocation of urban expenditures. Local governments that may have wanted to operate more independently or to undertake more ambitious development programs were hampered by GOI controls on the one hand, and the lack of alternative funding sources on the other.

Despite the substantial increase in the GOI's urban expenditures between Repelitas II and III, these investments were inadequate to meet increasing needs, in part because of the absorptive capacity of government at both the local and national levels. The problems associated with limited implementation and operation and maintenance capacity at the central and local levels were compounded by a lack of systematic planning and coordination among the key national agencies. As evidence of having reached the urban sector's absorptive capacity, commonly there were budget carry-overs of 30 to 35 % from one year to the next in the programs of Directorate General Cipta Karya (within the Ministry of Public Works), the principal agency concerned with urban infrastructure.

By the end of Repelita III, some attempts were made to begin decentralizing the planning and implementation of urban activities, but these efforts were confined to only the country's largest cities. However, as a result of this process, an Institute for Urban Policy Analysis (IUPA) was created under the Ministry of Finance's chairmanship. Ultimately, the IUPA's initiatives in decentralization and coordination became the basis for the GOI's more recent policy changes in the urban sector.

The main impetus for decentralization, however, has been the sharp decline in the country's oil revenues since the mid-1980s, exacerbated by a fall in other commodity prices as well. As a result, the GOI has experienced severe budget cuts starting in 1986, with a growing gap between resources and investment needs. During Repelita IV (1985-1989), the World Bank estimated that an annual investment of 900 billion Rp (1986 prices) was needed in the urban sector to meet reasonable growth needs, to overcome service shortages at minimum service levels. In FY 1985/86, however, the total public expenditure on infrastructure, operations and maintenance amounted to only 470 billion Rp., or just over half of the estimated need. Continued budget austerity has meant that the GOI cannot complete some on-going projects or initiate new ones.

This resource gap has caused the GOI to embark on a broad policy agenda of shifting responsibility for the planning, financing and management of urban development to local governments, with concomitant programs to build local management capacity and enhance local resource mobilization. This GOI-adopted decentralization program is supported by a World Bank urban sector loan, and comprises four principal policy and programmatic areas

- Local resource mobilization including measures to enhance tax collections and user fees, and to improve local revenue administration;
- Urban development financing mechanisms including the establishment of a loan fund for local governments and enterprises, and development of criteria and guidelines for the allocation of GOI grants;
- Planning and programming including strengthening of decentralized planning procedures, development of planning guidelines, and formulation of medium-term urban development and expenditure programs; and,
- Institutional and manpower development through technical assistance and training.

The various components of the GOI's decentralization program following the next sections detailed description of the role of local government in Indonesia and related donor agency activities are discussed in detail in section III.C.

B. LOCAL GOVERNMENT ROLE

1. STRUCTURAL CHARACTERISTICS

Subnational government in Indonesia is structured as a four-tier system. The 27 provinces form the first level (Dati I or Tingkat I), with each province further divided into second level (Dati II or Tingkat II) units consisting of 292 regencies (Kabupatens) plus 54 municipalities (Kotamadayas). The regencies' closest U.S. counterpart is the county, as each regency essentially covers the areas not incorporated in one of the 54 municipalities. Jakarta (DKI) is a special case having the status of a province. The second level units in turn are subdivided into 3500 third level districts (Kecamatan). These districts again are subdivided into 64000 fourth level villages (Desa). In the large urban areas there are further divisions into Rukun Warga (RW) and Rukun Tetargga (RT) which are community or neighborhood groups. The latter, which each consist of 150 families, are the smallest urban administrative units.

Governmental organization at province and local levels is comprised of separate legislative and executive branches. The executive arm consists of Governors for provinces, Mayors (Walikota) for municipalities and Bupatis (no translation) for the counties. They all are appointed by the Minister for Home Affairs. The legislative arms are the "people's representative councils" and consist of mainly of elected representatives.

2. SERVICE PROVISION RESPONSIBILITIES

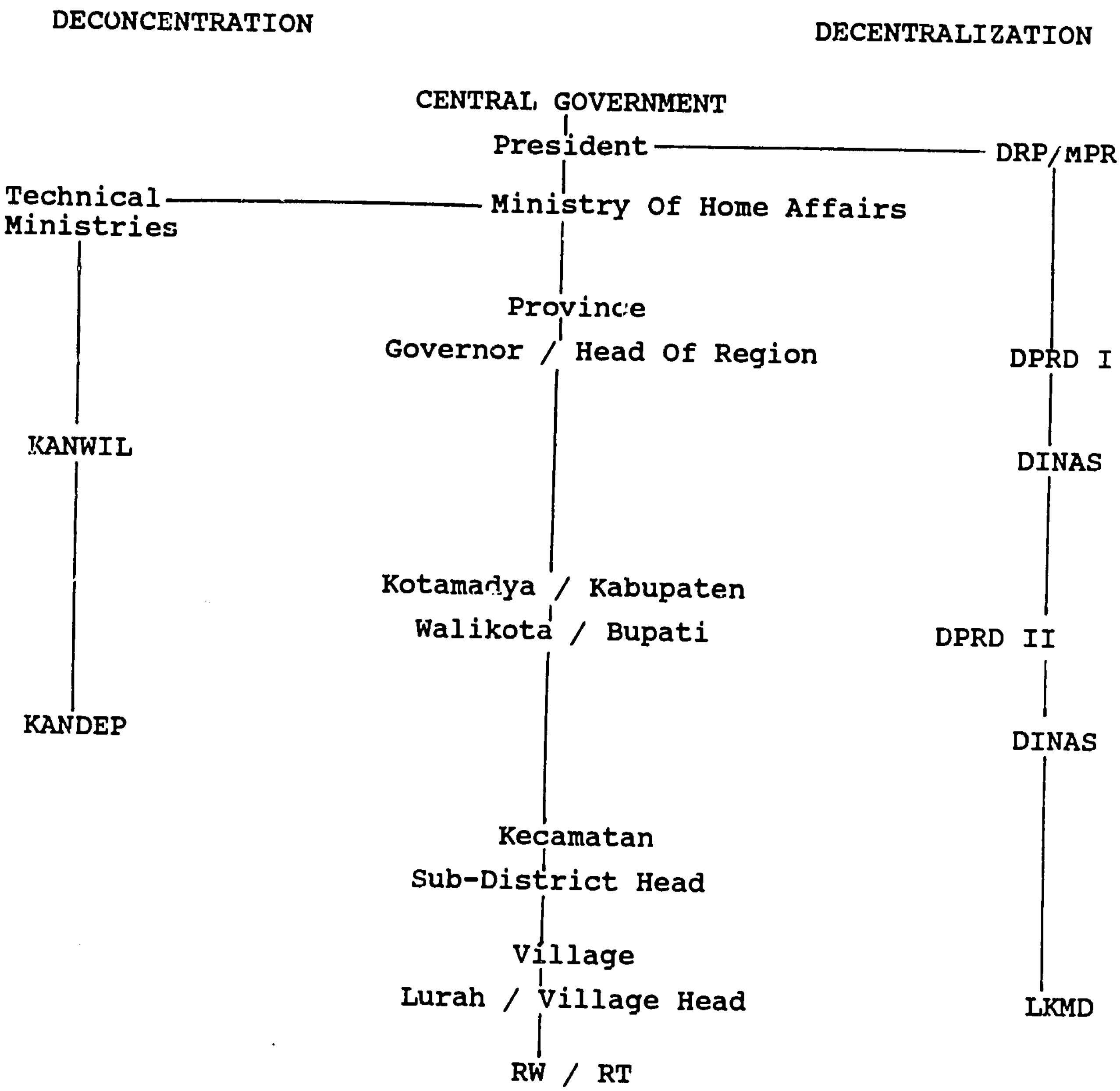
Provincial governments generally are not greatly involved in the direct provision of urban services (except for Jakarta DKI), although in certain cases they do provide some financial assistance. They are, however, responsible for overseeing all the work of the municipalities and counties. As urban services expand to numerous settlements in the province, the provincial authorities can be expectd to assume a greater role in guiding, assisting and evaluating urban plans and programs. The delivery point for most urban services is at the municipal/county level. Responsibilities are shared with a number of central government agencies. Public Works (Dina P.U.) generally is the most important, being concerned with roads, drainage, sewerage, public works and parks. In some localities, it is responsible for solid waste service (although there often is a separate, government enterprisefor this service). Where a neighborhood improvement program has been undertaken, a separate KIP (Kampung Improvement Program) unit is established. Sanitation and rural water supplies are sometimes provided through the Health Department. Markets and water supply are generally run as separate local enterprises as in Semarang, although water supply may be under the temporary control of the Directorate General of Housing, Building and Planning (Cipta Karya) or organized as a local section. Urban public transport is provided in most cities by the private sector excepting Jakarta and some four other cities.

Village governments and community groups play an important role at the very local level, particularly in the rural areas. In addition to the heads of the administrative areas, village associations (Lembaga Kemajuan Masjarakat Desa) play an important role in neighborhood life. Besides maintaining access roads and footpaths, cleaning drainage channels, house to house collection of solid waste, and managing public water standpipes, these local groups have the responsibility for planning and implementing the village development programs (Inpres Desa programs) and in some cases are actively involved in setting local priorities for KIP layouts as occurs in Semarang. In many smaller urban communities, the bulk of urban services such as drainage, waste disposal and footpaths have been provided on an informal basis through self-help (golong-royong) programs.

The allocation of responsibilities for local services between the Central Government offices at the provincial-level (Kanwils) and the local governments is not completely clear cut; both kinds of agencies may be involved in a particular geographic or functional service area. Indonesian Law (notably Law 5 of 1974) makes a distinction between those services which are provided directly by central government agencies, which are termed "deconcentrated" services, and those which are, or better said, should be provided by the local government, termed "decentralized" services. Most elements of urban infrastructure (water supply, local roads, sanitation, solid waste) fall in the latter category. The law also refers to the provision of urban services by a third means, namely, "coadministration" (tugas pembantuan), defined as "the execution of services by local government under the direction of central government". To a large extent this third approach is a fair description of the means of provision of nearly every significant service provided by local governments. Most of the urban services noted in the decentralized category are in fact implemented in the style of coadministration.

Integration between the two systems - decentralized and deconcentrated - takes place through the heads of the region at each level. As such, the Governors and Mayors are responsible for coordinating the activities of the deconcentrated agencies of the central government in their respective regions with those of their (decentralized) local government. This coordination role is carried through the heads of the various operating departments of the deconcentrated agencies: the central government sectoral departments at provincial and municipal level (Kanwil and Kandep respectively). The coordination with the decentralized local government bodies refers to the local assemblies at provincial and municipal level (DRPD I and DRPD II respectively). See Exhibit 1.

EXHIBIT 1



SOURCE: <u>Intergovernmental Financial Relationships in Indonesia,</u> N. Devas, June, 1987.

3. PLANNING AND COORDINATION AT LOCAL LEVEL

Heads of local administration (province, municipality and county) exercise a dual role. Not only are they leaders of the executive branch of the "autonomous regional governments"; they also are local representatives of the President, acting for this purpose in a "deconcentrated" capacity. This role requires administrative heads to exercise a general oversight of all government functions within the area and in particular to coordinate the work of all central and regional government agencies. Though subordinate in their executive capacity to the central sectoral departments, local administrative heads are for coordination purposes subject to the authority of the regional heads. They are, nonetheless, financially, technically and administratively responsible to the central government department.

An important role in the coordination of central and local government programs is exercised by Regional Development Planning Boards (BAPPEDA) that are established in every province and locality. As a planning service to regional heads, these boards fall under the jurisdiction of the Ministry of Home Affairs. These planning boards have both annual and long term planning functions in relation to local and regional development programs. Each year they prepare schedules of development project proposals in all service areas for approval by the regional heads and submission to the Central Government. These programs are the basis for central government financial allocation both for directly administered sectoral department development projects and for central government grants to local governments. For the purpose of the urban services program, the planning boards play a potentially important function in defining the local needs and priorities.

Longer term development planning is attempted through the medium of five-year plans coincident with the national five-year plans. These programs being undertaken in some 350 cities through the Integrated Urban Infrastructure Development Program (IUIDP), which include, inter alia, five year rolling investment plans identifying projects, financing sources and capital costs of each project. (See discussion in next section)

Responsibility for technical aspects is largely vested in the Ministry of Public works. The Directorate General for Housing, Building and Planning (CIPTA Karya) deals with water supply, sanitation and sewerage, solid waste, Kampung improvement, etc. the Directorate General for Roads (Bina Marga) is responsible for national highways including those through urban areas, and the Directorate General for Irrigation and Water Resources (Dengairan is responsible in urban areas for major drainage. The technical and financial implications of operation and maintenance is the responsibility of local government and has been given less consideration. Through an IBRD Urban Loan Program, such a study has commenced to determine ways and means on improving operation and maintenance of urban services.

Mid-term priorities for investments are established by the National Planning Agency (BAPPENAS) in the five year plans. It also reviews and approves specific projects and programs proposed each year by the sectoral departments and the plans prepared by the provincial and local agencies. The Ministry of Finance through the Directorate General for Internal Monetary Affairs monitors and has oversight of local government finances and loan schemes. The Directorate General for Budget authorizes all central government payments and a third Directorate General audits local governments. Finally the Directorate General for Taxation is responsible for the collection of certain assigned revenues and supervises the local property tax.

4. MUNICIPAL FINANCES

a. Overview

The financing sources for local governments comprise the following:

i. Central Government Grants

These grants form the bulk of all development expenditures undertaken in the municipalities and counties and also support routine expenditures covering personnel costs and a proportion of operation and maintenance.

Development expenditures financed from the National Budget (APBN) come through various channels. The DIP (Daftar Islan Projek) were the most important and linked to sectoral program. These funds financed the so called "deconcentrated services". These DIP grants have declined in recent years while the INPRES " block and categorical/specific" grants have increased. It is not entirely clear whether this change stems from the financial constraints the GOI is experiencing or whether it signals a fundamental change in government policy. Nevertheless, the shift does show an implicit recognition of the priority of local government expenditure. The most important aspects of the different grants is considered below:

- The largest grant -- the Subsidi Dareah Otonomi (SDO) covers basically wages and salaries of staff that are appointed centrally. This allocation is based on the number of officials in each region. Although the better part is destined to salary and wages, a smaller proportion (ganjaran) is assigned to operation and maintenance. The size of the latter portion is determined by the Ministry of Home Affairs.

- "Block" grants (INPRES II) are allocated on a per capita basis for the second level governments, while the village level (Desa) receives a grant on prorata basis per village. These grants, although they contain elements of local choice, are subject to national guidelines and are commonly referred to as "guided" (Diarhkan)
- The "specific" or "categorical" INPRES II grants are earmarked for roads, bridges, education, regreening and reforestation. These "directed" (Ditetapkan) grants are to ensure the equal distribution of minimum education and health services. However, the per capita criterion falls short on the regional equity issue, but the criteria for these grants are currently under revision.

ii. Assigned Revenues

These are a shared revenue base with provinces and local government. The most important of these assigned revenues is the property tax (PBB), but also included are royalties on forestry, mining and gasoline. The latter are not a significant source. Provincial governments receive 40 % of royalties collected from their regions while municipalities receive 20 %, the rest going to central government coffers.

iii. Own Source Revenues

These consist of local taxes, user charges, profits from local municipal enterprises, departmental revenues (Dinas-daerah) and other miscellaneous revenues. Although municipalities receive most of their revenues from user charges, they also impose over one hundred taxes. Most of these are regressive in nature. A draft proposal is being formulated for eliminating most of these. This is discussed in the following section on the efforts being undertaken to strengthen local government finances.

iv. Borrowing

Municipal governments have borrowed very little over the past years. This is due in part to the assistance they receive from GOI and also because of the approval required from MHA. A further reason is the debt ceiling established at 15 % of total development revenues. Currently the debt service ratio is under revision and the central government is contemplating increasing it to 30 %.

b. Analysis of Revenues And Expenditures.

For municipal governments only 11 % of their budget comes from local revenue sources. Of this, charges contribute the largest share (5.2 %), with the main sources being markets, hospital charges, building permits. Local taxes only contribute 2.2 %, of which the main sources are taxes on entertainment, hotels/restaurants, and street lighting. Assigned revenues contribute 5.2 %, most of which comes from the property tax (PBB). See Tables 1 and 2.

TABLE 1

LOCAL GOVERNMENT FINANCE

REPUBLIC OF INDONESIA

FINANCIAL SITUATION ASSESSMENT OF MUNICIPALITIES

(Rp. Millions)

	1979-1980	1983-1984
ROUTINE REVENUES 1/		
BALANCE B/F	10,700	10,800
LOCAL TAXES	21,500	45,200
CHARGES	46,100	105,800
REGIONAL ENTERPRISES	1,900	3,100
OTHER	27,000	63,900
CENTRAL GOV. (SDO)	188,500	452,500
TOTAL ROUTINE REVENUES	295,700	681,300
DEVELOPMENT REVENUES		
INPRES	274,400	1,102,900
TRANSFERS FROM PROV.	10,200	20,400
IPEDA	49,900	109,400
LOANS & DEV INCOME	40,100	126,400
CURRENT ACCOUNT SURPLUS		
TOTAL DEV. REVENUES	374,600	1,359,100
TOTAL REVENUES	670,300	2,040,400
ROUTINE EXPENDITURES		
PERSONNEL	193,447	443,998
MATERIALS	26,056	65,897
SUBSIDIES TO REGIONAL E.	813	1,394
O & M	12,014	25,764
DEBT SERVICE	1,426	4,711
OTHER	49,302	116,986
TOTAL R. EXPENDITURES	283,058	658,750
DEVELOPMENT EXPENDITURES		
INVESTMENTS	376,800	1,356,100
TOTAL EXPENDITURES	659,858	2,014,850
CURRENT ACCOUNT SURPLUS	12,642	22,550
SURPLUS / DEFICIT	10,442	25,550

1/ Figures shown are estimated total receipts and expenditures based on data available. Typical delay in published data is around 2 years.

TABLE 2

REVENUE AND EXPENDITURE PERCENTAGE DISTRIBUTION

	1979-1980	1983-1984
ROUTINE REVENUES		
BALANCE B/F	1.6%	0.5%
LOCAL TAXES	3.2%	2.2%
CHARGES	6.9%	5.2%
REGIONAL ENTERPRISES	0.3%	0.2%
OTHER	4.0%	3.1%
CENTRAL GOV. (SDO)	28.1%	22.2%
TOTAL ROUTINE REVENUES	44.1%	33.4%
DEVELOPMENT REVENUES		
INPRES	40.9%	54.1%
TRANSFERS FROM PROV.	1.5%	1.0%
IPEDA	7.4%	5.4%
LOANS & DEV INCOME 1/	6.0%	6.2%
TOTAL DEV. REVENUES	55.9%	66.6%
ROUTINE EXPENDITURES		
PERSONNEL	29.3%	22.0%
MATERIALS	3.9%	3.3%
SUBSIDIES TO REGIONAL E.	0.1%	0.1%
O & M	1.8%	1.3%
DEBT SERVICE	0.2%	0.2%
OTHER	7.5%	5.8%
TOTAL R. EXPENDITURES	42.9%	32.7%
DEVELOPMENT EXPENDITURES		
INVESTMENTS	57.1%	67.3%

1/ Loans amounted to Rp. 40,100 and 25,700 in 1979/80 and 1983/84. This constitutes roughly 1.3% of total revenues in 1983/84

Local authorities borrow about 6.5 % of their budget if development income (soft loans) are included. Most of the remainder -- about 77.3 % comes from central government grants which includes 1 % from provincial governments. Of this, 22 % is constituted by the SDO, while 54.3 % is channeled into development either through "block" or "specific" grants.

Development revenues rose steadily from 56 % in FY 1979/80 to 67 % in FY 1983/84. This pattern reflects the influence of the INPRES program which rose substantially over the period.

Routine expenditures account for 32.7 % in FY 1983/84. Of this, personnel expenditures account for 22 % of total expenditures, followed by materials, while O & M accounted for only 1.3 % of total development costs. This is very low by international standards. Annual average growth rates for municipalities over the same period show that expenditures grew at a faster rate than the Gross Domestic Product in both routine and development expenditures. While routine expenditures grew at 23.5% and development expenditures averaged 37.7%, the gross domestic product averaged 23.2%.

C. PRESENT POLICY AND PROGRAM EFFORTS

1. OVERVIEW

Although the recent decline in Central Government revenues has served as catalyst for change in the way urban development investments are planned and financed, the need for adopting different and innovative financing mechanisms has been recognized for some time.

A draft statement of Policies for Urban Development prepared recently stresses the need for more initiative and responsibility for implementation of local services to be devolved to lower levels. These policies encompass strengthening local government financial management, particularly with respect to local resource mobilization, budgeting, improved O & M; changes in urban infrastructure financing and improved planning and programming of multi-year urban investments.

The key elements in the strategy of local resource mobilization focus on the implementation of a new property tax (PBB, effective in January 1986); a draft law to improve the structure of local taxes; pilot efforts to improve tax administration and financial management in 6 cities that next will be extended to some 90 areas; and the development of national water tariff guidelines for water enterprises (PDAMs).

In the future financing of urban infrastructure investments, due to a limited availability of grants, the government is taking steps to set up a consolidated revolving loan fund and specific proposals for a comprehensive reform of the central-local grant system. Taken together, these policy changes should represent a significant shift from Central to Local government.

Several initiatives to improve the planning and programming process in conjunction with the fiscal reforms described above have already begun. Of particular significance, is the Integrated Urban Infrastructure Development Program (IUIDP) that was introduced in 1985 and eventually will cover some 350 cities. Its major objectives are to implement an integrated planning approach and to issue guidelines defining investment policy and criteria, as well as the functional responsibilities of central, provincial and local authorities.

It is important to note that while these intergovernmental reforms and proposals reflect a significant commitment to strengthen the role of local government in the provision, financing and delivery of urban services, it will not be in place in the immediate future. Detailed policies for implementation of broad policy goals, operational programs for carrying out implementation strategies, and securing financing and technical support for implementation are very much still in flux. In addition, as more specific policies are agreed upon and operational strategies are initiated, it still is unclear how rapidly this process can be in place, especially considering that the managerial and technical capability is presently available only in the largest cities.

2. LOCAL RESOURCE MANAGEMENT

In order to develop local government responsibility for providing urban infrastructure services, various efforts are either being undertaken or contemplated to strengthen capability to manage efficiently the use of funds and mobilize resources.

a. Property Tax Reform (Pajak Bumi dann Bangunan, PBB)

The Law on Land and Building Tax (Law 12 of 1985) was passed on December 27, 1985, and became effective on January 1, 1986. This new tax represents a significant departure from IPEDA because it simplifies the rate structure and broadens the tax base (change from annual rental value to capital market value). Its other innovative features impact the administration and enforcement of the new law where incentives for evasion are reduced and penalties for non-payment are included.

The revenue potential of the new property tax looks promising. According to World Bank estimates, receipts could be increased from 243 million R in 1986/87 to over 1000 billion R within the next five years. It is estimated that by having 95 % of the property registered, having properties valued at 90 % of their true market values, collecting 85 % of all the assessed taxes, property tax revenues could reach over 2400 billion R by 1995, more than 14 times the present value. Should this target be reached, these assigned revenues could compensate for the declining contributions from the Central Government.

The distribution criterion by which the tax revenues from PBB flow to local governments differs from the previous IPEDA allocation. The new property tax allocates about 65 % of its revenue to local governments, 16 % to provinces, 10 % to the Central Government and 9 % to cover collection costs. This allocation differs from the old IPEDA system which allocated 70 % to local governments, 10 % to provincial governments, 10 % as local equity contribution to the regional development banks and 10 % to cover collection costs.

Another fundamental difference between the old and new law refers to its use. Unlike the old IPEDA law that stipulated that the tax be used for the development budget, the new law gives local governments considerably more discretion over its use; between 10 and 50 % need be allocated to the development budget. From a financial management perspective, the use of 50 to 90 % in the routine budget may have varying consequences depending on its use. This will be examined in greater detail in the following section.

b. Increasing Local Taxes

Local governments levy nearly 100 taxes. However, few of these taxes are individually very important in local government finances and constitute less than 10 % of total revenues. A three pronged strategy is planned focusing on:

i. Improving Tax Administration

Local tax administration is deficient in three broad areas of registration of taxpayers, assessment of tax liabilities and collection of revenues. In an attempt to remedy some of these administrative deficiencies, a new tax registration, assessment and collection system is being introduced on a pilot basis in 6 cities (five Kotamadya and one urbanized Kabupaten.) and is expected to be replicated next to 93 other areas. This also includes the reorganization of the local tax offices (DINAS Pendapaten Daerah, DIPENDA). Under the pilot program, a standardized organizational system will be used in all localities. However, it is too early to assess the impact of this program.

ii. Draft Reform Of the Local Tax System

A draft proposal is pending approval. It is aimed at eliminating the less productive taxes to reduce the distortions and misallocations caused by such taxes, mitigating the administrative and cost burden and reorienting principal employee efforts to the more productive ones.

If enacted the law would eliminate all except the following taxes: taxes on motor vehicle and transfer duties that would still be retained at provincial level; local taxes on non-motorized vehicles, entertainment, restaurants and hotels, businesses, street lighting and advertisements.

In addition to the proposed elimination of many unproductive taxes, the draft law also is considering the introduction of two new taxes for the Level II governments. These are the gasoline tax and the betterment levy tax. The gasoline tax is to be levied on consumption of fuel and is progressive in nature. Some estimates on this tax consider that a one % surcharge would generate roughly 15 billion R while a three % levy would produce the equivalent of total local taxes currently being generated. On all basic criteria for a tax - efficiency, equity, ease of administration and collection, this tax measures favorably.

The betterment levy tax, which is used in many South American countries, was introduced in DKI Jakarta where it is called Payak Khusus. However, it appears to have had administrative problems in its initial implementation; no revenues were budgeted for the last fiscal year. Another variation of this tax has been introduced in Bali. This is the land development tax that has been used in countries like Taiwan and Korea. GOI is studying the possibility of introducing one of these variations under the the IBRD Urban Sector Loan Project.

c. User Charges

User charges levied either by service departments of local governments (DINAS) or local enterprises (Perusahaan Daerah) constitute an important source of local revenues (18 % in Bandund in 1983/84). The most significant user charges are those for water supply (PDAMs), as well as charges for markets, solid waste collection and disposal, parking, bus stations, taxi stands and building permits.

A number of technical assistance efforts to improve cost recovery and administration are currently being carried out. As has been mentioned earlier, efforts to improve the structure and procedure of local revenue offices are being carried out in 6 cities. Improved planning and financial programming has been introduced in Kotamadya Surubaya, while a financial management study is being undertaken in Bandung, Semarang, Surukarta, Pandgang and Ujung. An Operation and Maintenance Study on City Infrastructure also is being carried out in the cities mentioned above. The objective is to better identify and measure the cost of services provided. Additionally , under the World Bank Urban Sector Loan, similar efforts will be directed specifically at Water Enterprises. The aim is to make these entities self- sustaining financially and also to improve their management practices, particularly in accounting and tariff structure.

d. Other Financing Sources

Due to limited availability of Central Government funds, two cost sharing mechanisms are currently being contemplated: the formulation for specific proposals for reform of the Central-Local Grant System and the establishment of a consolidated revolving loan fund -the Regional Development Account.

Both these initiatives are being contemplated under the Urban Sector Loan Program. It is anticipated that the instruments for improvement of the Central-Local Grant System will be prepared by 1989. The RDA, considered a precursor to a full Regional Government Development Fund, is proposed as an account at the Ministry of Finance. Its function will be to lend to local governments for capital investments in infrastructure, equipment and to provide facilities for bridge financing needs. The lending terms and conditions would be structured to ensure consistent treatment of all local governments as well as the financial viability of the RDA.

3. INTEGRATED URBAN INFRASTRUCTURE DEVELOPMENT PROGRAM (IUIDP)

The GOI, initially through its Directorate Cipta Karya (DGCK) but with increasing support from other Central Government ministries (Finance and Home Affairs), has initiated an improved planning and programming process for urban investments. The basic approach is that the Level II governments would take the lead, with the assistance of the sectoral agencies, in preparing:

- o medium term 5 year investment rolling plans, identifying the needs spatially and by sector;
- o an operation and maintenance plan and program and a multi-year budget;
- o a financing plan with a mix of loans, grants, own source revenues and cost recovery measures.

Provincial governments would provide guidance and assistance as well as review the multi -year investment plans. This function would be headed by the planning unit with coordinated technical inputs from other departments. The Central Government's role would be limited to setting standards, providing financing mechanisms, guidance on the planning process to provincial governments and technical assistance where necessary, and training local staff in planning, implementation and O & M procedures.

A program of training and technical assistance has been launched to support implementation of the change, with the assistance from UNDP/UNCHS, IBRD and ADB as well as other bilateral donors.

Managed properly this process can offer integrated infrastructure programming based on rational technical criteria and standards. It would improve the previously fragmented coordination between the various levels of government and also focus better on the estimation and provision for the hitherto neglected operation and maintenance of urban infrastructure investments. Much of its success will undoubtedly depend on the transfer of technology from provincial level staff to local government staff and an acceptance of the process by local counterparts.

4. TRAINING AND TECHNICAL ASSISTANCE

In order to rationalize planning for the development of staff involved in urban development, GOI proposes to carry out a comprehensive review of existing conditions and future needs. Because of the primary role of the Ministry of Home Affairs in local government administration, the Secretariat General of MHA. plans to commission a study that would form the basis to amend policy and procedures in order to strengthen local authorities' capacity over the medium to long term to undertake their responsibilities. While the primary focus would be on local authorities, the capacity and structure of supporting agencies of central and provincial government would also be examined.

With the advent of the Integrated Urban Infrastructure Development Program and the need to devolve authority to local government, the need to provide a broad spectrum of high impact, relevant, management and technical level training is clear. Furthermore, due to the increased emphasis on cross sectoral integrated urban development projects, local government personnel, particularly at management levels, require a much wider range of technical and managerial expertise. As has been mentioned earlier on, some of this training and technical assistance is already in place.

IV. MUNICIPAL CASE STUDIES

A. MUNICIPALITY OF SEMARANG

1. Overview

Semarang, the fourth largest city of Indonesia with a population of about 1.2 million (1986) is located on the north coast of Java midway between Jakarta and Surabaya. The capital of Central Java, it was designated in the regional development program of Repelita III as the growth center for the "sub development" region that includes Central Java and Jogjakarta. The growth of Semarang's population during the period of 1971-80 averaged over 5 % annually. All of its major industries, trade centers and government offices are located on the coastal plain surrounding the port area. While shipping and related activities provide employment for a significant proportion of the population, almost two thirds of the work force is concentrated in three sectors: manufacturing (17%), commerce (27%) and government (20%).

Semarang's vast backlog of basic urban services is currently being addressed by the Fifth Urban Development Project of IBRD. The major areas of intervention are water supply, drainage improvement (DRIP), sewerage and solid waste improvement program (SWIP). In addition, a municipal management component has been contemplated. It is intended to foster urban institutional development with a medium- to long-term objective of promoting self-reliance in providing urban services on a sustained basis.

The present IBRD- Urban V SWIP Project includes components for improving solid waste collection and disposal methods, provision of equipment, trucks, car pool facilities and civil works. The present system serves some 60 % of the total population with a total collection of 1000 cubic meters collected a day. Of this some 60% relates to the residential/domestic sector and the remainder to market solid waste.

The DRIP component of the same project is a program to improve selected secondary and tertiary drains, drainage infrastructure, workshops and equipment provision. It estimated that some 1400 houses under permanent, semi-permanent or temporary housing will have to be relocated. One city official considered that a redefinition of boundary area of the city was a prerequisite considering the city's potential growth. Many of these issues are being addressed by the IUIDP team in the field.

2. Financial Management

The bulk of Semarang's expenditures is financed by third party sources as opposed to own revenue sources. These include the SDO grant, INPRES and loans and development income which constituted 60% of total revenues. (See Table 3 for revenue -expenditure composition). Of these, the INPRES grants constituted a negligible proportion in FY 1986/87 primarily because the funds were earmarked for the IBRD components and are included in development income (25.15%). The SDO grant for routine personnel expenditures were by far the largest portion. About 50% of routine revenues are derived from the SDO. It covers wages and salaries of the municipal staff whose appointments are centrally approved. A small proportion of the SDO (10%) finances non-staff operational expenditures such as small allowances for maintenance of primary schools and hospitals. Other operation and maintenance costs are financed from local own source revenues.

The next largest contributor is the municipality's own source base of local taxes, which provide some 20% of routine revenues. Of these, the entertainment tax, the street lighting tax and the hotel/restaurant tax are the most significant. The entertainment tax is imposed as a specific percentage of ticket prices to various performances. Collection costs appear to be relatively low compared to other taxes and evasion would appear to be difficult as numbered tickets are issued by the municipality. However, this was not easily verified.

The street lighting tax appears to be the fastest growing tax base. The municipality has substantial discretion in the selection of the tax base and rate. It is levied upon individual consumption of electricity and is collected by the power company as part of its regular customer billing, with a commission fee of 5% over gross sales.

Charges, fees or retribution (Retribusi Daerah) are the next most important source of local revenue, contributing about 18% to the routine revenues. Over 80% of this comes from the regional enterprises that include market rental fees, parking/terminal charges, business development licenses etc.

The development revenue base accounts for 34.5% of total revenues. Of this revenue base, loans and development income constitute more than 70% of development revenues primarily as this municipality is one of the six being targeted under the IBRD Urban V project. However, of this, about 23% are loans and the remainder earmarked revenues for the various projects. No separate accounts of these development projects is in place, but the municipality is the beneficiary of a municipal management component under the IBRD loan which will strengthen the budgeting, accounting and tax administration systems.

The next important revenue line item in development revenues is the assigned revenues which are comprised principally of the property tax, about 9% of total revenues and about 26% of development revenues. There is some confusion since the restructuring of the PBB as to the accounting of these revenues. Previously the property tax was considered a development revenue. However, under the new law 50-90% may be used for routine expenditures. Semarang's account continue to consider this revenue source a development income source, although its applications may vary in the future.

In terms of revenue performance, own source revenues appear to have declined in real terms. Local taxes grew at 4.5% in nominal terms, well below the 10% inflation rate for the same period. One of the issues discussed was that tax rates had to be approved by MHA. However, it should be noted that the government is in the process of working on a new local taxation and user charges law which will attempt to rationalize and improve the existing system. This law is expected to eliminate numerous "nuisance" taxes and increase local discretion in setting tax rates. In terms of per capita income, own source revenues increased slightly above the 3.46% assumed in the city master plan.(See Table 5 for per capita data)

3. Management Support systems

a. Programming and Budgeting

There is at present no general system of programming medium to long term investments. This is being addressed in part by the IUIDP in Semarang. The annual budgets are constructed on an annual basis and are generated on a departmental basis. While there is no program or activity based budgeting system, the Development and Implementation Of Financial Management and Planning Study under the IBRD loan project has targeted the municipality of Semarang among the 5 other cities. The resulting recommendations will be implemented in the next two years. Up to to now the annual budgets have tended to be prepared in an isolated manner according to the most pressing expenditure needs and financial constraints of the moment. This has been without regard to their impact on expenditure commitments for future years.

Although the five-year plans (Repelita Daerah) are prepared covering the same period as the national development plans, they are not adequate for budgeting purposes as they respond more to physical plans based on the master plan. They are more statements of intention rather than realistic assessments of what is either affordable or realistically achievable. As a result, the projects are neither specified nor do they contain detailed financing proposals for each project or group of projects. They are in a sense static rather than dynamic and are prepared once every five years with little annual revision.

The IUIDP concept has been instituted to remedy these flaws. This process has already been alluded to in Section III. However,it is too early to assess its impact. Perhaps, the most important concern relating to this initiative is technology and skill transfer. Per interviews conducted, it appeared that the officials had scarce knowledge of the objectives basically because consultant-counterpart relationships have not as of writing this report been clearly established.

The budgeting process begins with each department constructing its activity for the next fiscal year. These departmental budgets are then consolidated by the local planning board (BAPPEDA) and submitted to the Budgeting Committee composed of BAPPEDA, Finance and Development. This body is entrusted with reviewing and approving the different line items. It is then sent to the mayor who in turn presents it to the municipal parliament.

The process for approval begins at the municipal level where it has to be approved by the Municipal Council after which it is sent to the provincial governor. Although the preparation of the budget begins in May, from our interviews it appeared timely presentation of budgets was a real problem. Budgets are often finalized too late to be of full use for either policy planning or for action plans for management.

b. Accounting

Accounting in Semarang is on a cash basis, and annexes to the documents provide summary cash transactions, cash balances, creditors and debtors. The general ledger and chart of accounts are all manually operated. The municipality does not have an updated record of its commitments, nor is it clear to what level the arrears rise. While it is too early to move to an accrual based accounting system with double entry, a commitment recording and an accounts payable system would be beneficial.

On the presentation of line items, one particularly confusing aspect is that of O & M related costs. They appear both on routine and development budgets and the total effort is difficult to identify. Another relates to identification of costs of collection versus income actually collected. It is simply not possible to identify such costs. However, earlier reports allude to the fact that collection costs are often higher than income actually collected. As no cost accounting is being carried out, the use of performance measurement, accountability and responsibility cannot be stressed.

Finally, a detailed study to review some of these weaknesses already is being carried out under the development and implementation of improved system of financial management and planning. Semarang is one of the six targeted cities. Changes are being contemplated in routine and development accounting and budgeting, development planning and programming, management of income, control of expenditure, treasury control and computerization. When fully implemented, the management of the municipality's finances should be greatly strengthened.

c. Personnel Administration

The administration of personnel follows the guidelines of the central government, especially as most municipal staff are paid from the SDO grant conferred to the municipality. A formal personnel structure has been designed and maintained by the Office of Personnel and Personnel Welfare. Specifically, it lists all municipal divisions and personnel by category, title and salary. A distribution of personnel is provided in the following exhibit.

EXHIBIT 1

DEPARTMENT	GROUP I	GROUP II	GROUP III	GROUP IV
Secretariat	11	14	3	-
Local Secretariat	369	346	49	4
Regional Inspectorate	3	15	6	1
Ass. Walikota	12	5	2	1
Political Office	3	10	2	-
Mawil	2	3	-	-
DIPPENDA	69	105	3	-
BAPPEDA	2	26	7	1
Public Security	28	19	-	-
Sub-Districts	713	306	9	-
Tourism	31	18	1	-
Public Works	270	151	6	-
Cleansing	319	140	4	-
Administration	73	71	-	-
Parking	48	10	6	-
Health	124	76	-	-
Veterinary Service	21	15	18	-
Fishery Services	4	9	2	-
Market Services	255	46	1	-
T.H.R. Services	55	21	3	-
TOTAL	2412	1406	122	7

SOURCE: Municipality of Semarang.

Per interviews conducted, it appears that a formal system for review and periodic evaluations are in place. Leave with pay is given as one of the benefits, although personnel are not exempted for training and attending seminars which is normally done after work hours. Salary increases are based on the policies established by the central government although they are pegged to the cost of living index. These are granted annually.

Personnel records are kept on file and include records of salary history, category, work performance evaluations, etc. The payroll system is manually operated but is targeted for computerization in the near future. The number of municipal employees stood at 3947 in FY 1985/86 and by January 1987 it had risen to about 4300.

4. Municipal Services

a. Solid Waste

As an emerging development center, various municipal services are currently being targeted for improvements. As beneficiary of foreign donor assistance, the municipality is taking specific measures to improve solid waste disposal by strengthening its technical, management and financial aspects. A combined effort of the community and municipality is being undertaken for domestic solid waste. The municipality is responsible for removal from the transfer stations to the final disposal sites and also collection of domestic solid waste along some major routes in the city.

b. Drainage

From information obtained through the IUIDP representative in Semarang, we learned that drainage is one of the city's principal problems. Some 2515 hectares are still subject to flooding; this is approximately 20% of the built up area. Improvements in the drainage facilities are under way. These include the two flood canals - Timur and Barat, widening, deepening of Kai Semarang and Banger as well as about 461 kilometers of secondary and tertiary drains. City officials consider these efforts as a partial solution to their problems and believe that a master plan of the entire city drainage is necessary.

c. Urban Roads

Efforts are under way with assistance from the Ministry of Roads Bina Marga to rationalize traffic circulation, improve primary and secondary roads and ease traffic bottlenecks by the construction of a new Ring road (beltway). Financial assistance is being obtained from the central and provincial governments through appropriations from their respective budgets

5. Conclusions

Semarang as a growing development center is currently the beneficiary of various projects principally funded by IBRD. These efforts are directed to strengthening its institutional capabilities as well as improve its provision of service delivery. Through the Urban V Project, Semarang is targeting efforts in improving solid waste (SWIP). This project is due to end next year. A Municipal Finance Management study is aimed at implementing recommended accounting/budgeting practices and procedures as well as strengthening financial management. An Urban Transport project has been funded by IBRD to improve traffic management, improve access roads and identify and improve routine maintenance. Two studies are under way to improve the operation and maintenance of city infrastructure and to improve revenue collections and administrative procedures. Finally, an Institutional and Manpower Development study, focusing on urban institutional development, the current manpower situation and development of training polices is scheduled to start in late 1987.

6. Financial Tables

TABLE 3

MUNICIPALITY OF SEMARANG

REVENUE - EXPENDITURE PERCENTAGE COMPOSITION

	ACTUAL[1]		BUDGETED[2]
ROUTINE REVENUES	1985-86	1986-87	1987-1988
BALANCE B/F	7.95%	3.79%	2.42%
LOCAL TAXES	13.18%	13.06%	15.56%
CHARGES	2.30%	1.77%	4.52%
REGIONAL ENTERPRISES	9.88%	10.19%	10.42%
OTHER	2.94%	1.80%	1.05%
CENTRAL GOV. (SDO)	30.18%	34.90%	35.33%
TOTAL ROUTINE REVENUES	66.44%	65.50%	70.30%
DEVELOPMENT REVENUES			
INPRES	5.93%	0.22%	0.22%
TRANSFERS FROM PROV.	0.85%	0.00%	0.00%
IPEDA	7.93%	9.13%	9.59%
LOANS & DEV INCOME	18.86%	25.15%	19.89%
TOTAL DEV. REVENUES	33.56%	34.50%	29.70%
TOTAL REVENUES	100.00%	100.00%	100.00%
ROUTINE EXPENDITURES			
PERSONNEL	33.91%	32.87%	33.98%
MATERIALS	6.18%	6.31%	7.13%
SUBSIDIES TO REGIONAL E.	2.21%	2.35%	2.40%
O & M	2.53%	2.69%	2.72%
DEBT SERVICE	2.44%	1.28%	2.60%
OTHER	1.97%	1.85%	1.64%
TOTAL R. EXPENDITURES	49.25%	47.35%	50.48%
DEVELOPMENT EXPENDITURES			
INVESTMENTS	50.75%	52.65%	49.52%
TOTAL EXPENDITURES	100.00%	100.00%	100.00%

1/ Information obtained from Municipality of Semarang Budgets
2/ Appropriations committed but not disbursed during fiscal year.

TABLE 4

MUNICIPALITY OF SEMARANG

(Rp. Millions)

ROUTINE REVENUES 1/	ACTUAL[1] 1985-86	1986-87	BUDGETED[2] 1987-1988
BALANCE B/F 2/	1,812.31	919.08	602.15
LOCAL TAXES	3,004.00	3,170.20	4,114.72
CHARGES	524.49	429.68	1,123.07
REGIONAL ENTERPRISES	2,251.54	2,473.11	2,588.31
OTHER	670.02	437.06	260.80
CENTRAL GOV. (SDO)	6,876.00	8,470.19	8,778.39
TOTAL ROUTINE REVENUES	15,138.36	15,899.31	17,467.44
DEVELOPMENT REVENUES			
INPRES	1,350.64	52.55	54.55
TRANSFERS FROM PROV.	193.68	0.00	0.00
IPEDA	1,805.92	2,215.95	2,382.59
LOANS & DEV INCOME	4,297.23	6,104.23	4,941.79
TOTAL DEV. REVENUES	7,647.46	8,372.74	7,378.94
TOTAL REVENUES	22,785.83	24,272.04	24,846.37
ROUTINE EXPENDITURES			
PERSONNEL	7,659.59	7,977.44	7,995.54
MATERIALS	1,395.84	1,532.01	1,677.48
SUBSIDIES TO REGIONAL E.	499.74	571.23	564.66
O & M	570.90	652.08	640.26
DEBT SERVICE	552.05	309.65	612.16
OTHER	445.85	449.40	385.57
TOTAL R. EXPENDITURES	11,123.97	11,491.80	11,875.68
DEVELOPMENT EXPENDITURES			
INVESTMENTS	11,461.84	12,780.02	11,651.49
TOTAL EXPENDITURES	22,585.81	24,271.83	23,527.16
CURRENT ACCOUNT SURPLUS	4,014.39	4,407.50	5,591.76
SURPLUS / DEFICIT	200.01	0.21	1,319.21

1/ Information obtained from Municipality of Semarang Budgets
2/ Appropriations committed but not disbursed during fiscal year.

TABLE 5

MUNICIPALITY OF SEMARANG

PER CAPITA DISTRIBUTION

ROUTINE REVENUES	1985-86	1986-87
BALANCE B/F	1,653	830
LOCAL TAXES	2,740	2,862
CHARGES	478	388
REGIONAL ENTERPRISES	2,054	2,233
OTHER	611	395
CENTRAL GOV. (SDO)	6,272	7,647
	0	0
TOTAL ROUTINE REVENUES	13,809	14,354
DEVELOPMENT REVENUES		
INPRES	1,232	47
TRANSFERS FROM PROV.	177	0
IPEDA	1,647	2,001
LOANS & DEV INCOME	3,920	5,511
TOTAL DEV. REVENUES	6,976	7,559
TOTAL REVENUES	20,785	21,913
ROUTINE EXPENDITURES		
PERSONNEL	6,987	7,202
MATERIALS	1,273	1,383
SUBSIDIES TO REGIONAL E.	456	516
O & M	521	589
DEBT SERVICE	504	280
OTHER	407	406
TOTAL R. EXPENDITURES	10,147	10,375
DEVELOPMENT EXPENDITURES		
INVESTMENTS	10,455	11,538
TOTAL EXPENDITURES	20,602	21,913
POPULATION (mill.)	1.10	1.11

TABLE 6

MUNICIPALITY OF SEMARANG

PERFORMANCE INDICATORS

	1985-86	1986-87
CURRENT REVENUES / CURRENT EXPENDITURES	1.36	1.38
PERSONNEL / CURRENT EXPENDITURES	68.86%	69.42%
DEBT SERVICE / CURRENT REVENUES	3.65%	1.95%
INVESTMENTS / TOTAL REVENUES	50.30%	52.65%
C & M / CURRENT REVENUES	3.77%	4.10%
O & M / INVESTMENTS	4.98%	5.10%

B. MUNICIPALITY OF BANDUNG

1. Overview

Bandung, the third largest city in Indonesia after Jakarta and Surabaya, is an inland city located in the province of Jawa Barat and to the south of Jakarta. According to the 1980 census, the annual growth rate of its population was 2.2%. The total population of Bandung was 2.6 million while the municipality proper registered 1.4 million. It has a high population density of 185 per hectare.

As a university town, Bandung is fast growing, and there are plans to increase its boundaries from 8000 hectares to 17,500 in the next few years. The meeting with the mayor of the city revealed that high density is a pressing issue as there exists a high demand for land development. The strategy in the medium term is to improve the urban infrastructure for the 12 slum areas by improving drainage, access feeder roads and solid waste. This is being undertaken through the Bandung Urban Development Project financed by the ADB. Simultaneously, an Urban Transport Project, financed by IBRD, is targeting improvements in traffic flow and rationalization of traffic circulation , upgrading of footpaths and access feeder roads and improvements in traffic management.

Great emphasis also is being given to regreening and reforestation. Bandung, according to the mayor, values its parks, and every effort is being made to keep these parks clean and green.

It is an important commercial and manufacturing city. The principal economic activities are agro-related industries, wood and furniture, handicrafts and other related manufacturing industries.

2. Financial Management

a. Financial analysis

The municipality of Bandung has in the last few years been spending a greater proportion on development, reversing the trends of the years prior to FY 1984/85. By FY 1986/87, development expenditures accounted for 55% of total expenditures versus 47% for FY 1984/85. However, the proportion met by central government transfers for both routine and development expenditures increased from 48% in FY 1984/85 to 53% in FY 1986/87. Of these grants, about 60% is for routine expenditures through the SDO.

Turning to non-grant revenues, Table 7 shows the relative importance of the different revenue sources. Bandung receives the bulk of its revenues from fees, service charges and licenses and taxes. The most important charges are parking and market retribution. In FY 1986/87, charges amounted to about 23.8%, local taxes to 22.6% and SDO making up the remainder of routine revenues. While there was a nominal increase over the previous year, in real terms revenues declined slightly.

The taxes that contribute most to own source revenues are the hotel/ restaurant tax, the entertainment tax, business registration and street lighting tax. Of these, the largest single tax is the entertainment tax which contributes about 40%, followed by the hotel/restaurant tax and the street lighting and business tax in descending order.

Development revenues, on the other hand were dominated by grants (60%) with assigned revenues contributing about 20% total development revenues. Although loans constitute a negligible proportion, it is worth pointing out that the municipality through central government approval has created two decentralized agencies - parking and cleaning (solid waste) that are managed as autonomous entities. As autonomous enterprises, loans undertaken do not count within the municipality's 15% legal debt ceiling, although the municipality is liable for the operating deficits of the enterprises.

These revenues finance routine operations and capital investments. Of the routine expenditures, personnel expenses account for some 54% of total routine expenditures, followed by subsidies to the decentralized agencies (parking and solid waste autonomous enterprises) with some 25%. Although the cleansing enterprise was created to be a financially self sufficient enterprise, it currently receives subsidies of about 50%. It is expected to be fully self sufficient by 1990. This is discussed in detail under municipal services. Although personnel expenditures have increased in nominal terms, they have declined in real terms.

Turning to revenue performance, in per capita terms, own source revenues have been steadily increasing. Local taxes grew by 8% in the last two years while charges averaged about 4% in nominal terms. This is less than the rate of inflation registered for the same period. The ratio of current revenues to routine expenditures have been increasing since FY 1984/85 from 1.25 to 1.6. The current account surplus generated has been used to finance additional capital outlays, and investments as a percentage of total revenues have increased from 44.8% to 50.4% over the same period. At the same time personnel expenditures have decreased from 57.9% in FY 1985/86 to 53.9% in FY 1986/97. As can be seen in Table 4, the debt service ratio is negligible even of current revenues.

b. Tax Administration

The ticket method is used for parking, bus terminals, daily market fees, non-motorized vehicle inspection, etc.. Prenumbered tickets are issued by the local revenue office (DIPPENDA) to the management units using ticket receipt notes and recorded in a ticket inventory register. Printing of these tickets is controlled by the Central Procurement Department whereby monthly usages and balances are reported. The collection is done on a daily basis when these tickets are issued on payment for parking and the revenues are deposited at the parking operational unit. Bus terminal tickets are purchased in advance, and these tickets are collected by the inspectors. They are returned to the operational unit on a daily basis.

For market fees and trash collection, the card and receipt method is used. The charges are based on the subject data collected when processing applications for market rentals. These data then serve as the basis for estimating the charges. These charges are collected on a monthly basis and paid to the head of Pasars. They are in turn responsible to the DIPPENDA.

This system is carried manually, and while the city officials acknowledged that deficiencies exist, the computerization of the tax records was not being considered. One of the sensitive issues raised was that while a computerized tax roll would be beneficial, the possible displacement of labor was not in the best interests of the community. There are some 700 inspectors in the municipality. One of the weaknesses that originate in this system are unrecorded income or income not being deposited on a timely basis. There appears to be little analysis of daily income done by the collector and hence a lack of follow up on unpaid receivables.

The business tax, although supposedly a tax on turnover, is assessed in practice on the the size of the premise, location, use and structure of the building. Although the tax base is updated every two to three years, according to city officials, tariff rate increases are subject to approval from the MHA. One of the apparent deficiencies within the system is that because the base of the tax is some physical feature of the business rather than some value, increases in revenues are not automatic, and require some discretionary changes in policies. The incidence of the tax is also not clear as it might be shifted to consumers. City officials were fast to point out that price differentials were common.

Local tax administration appears to be deficient in three broad areas of registration of taxpayers, assessment of liabilities, collection of revenues and outstanding arrears. City officials acknowledged that each local tax had its own separate tax roll, and there is little coordination between the separate units. In this way, it is possible for tax payers to register a different name in the different tax rolls, and there was no way of knowing it. Consequently, the municipality had little information on the total number of taxpayers within its jurisdiction and the total amount of arrears. However, to circumvent this, the use of "luhus paje", a tax clearance certificate, is required in all commercial transactions. Another innovative mechanism to increase collection and reduce arrears has been the introduction of commissions being given to tax collectors. Targets are established and collectors receive a percentage of collections received. Based on performance, the municipality also provides incentives for promotion and salary increases.

3. Management Support Systems

a. Budgeting and Accounting

As is apparent from the discussion of financial management, the municipal accounting and budgeting process is undergoing changes. While a departmental based budgeting system is still used in the municipality, activity based budgeting with cost accounting is being introduced in the decentralized enterprises.

The accounts are prepared on a cash basis, and as in the case of Semarang details of cash balances and summary cash transactions are provided in annexes. Major commitments are tracked separately in order to avoid overobligating the municipality. Accounting records are manually maintained and require a lot of personnel to operate.

The accounting system used by the cleaning department on the other hand is computerized, and performance is monitored and reviewed against standard costs. The double entry, accrual based accounting system is used. Among the strengths of the accounting system is that it is designed to deal with the principal expenditure components.

b. Personnel administration

As in the case of the municipality of Semarang, the guidelines from the central government form the basis of personnel administration. The personnel record system is updated on an annual basis and contains the job categories, salary ranges and benefits accrued to the employees. It also contains information on the periodic evaluations and performance of each employee.

Review of employee performance is done at the time of proposed salary increases or promotions. Its purpose as city officials pointed out was to advise and counsel employees on their progress, strengths and weaknesses of the quality and quantity of their work. In general, during the tour of the municipal offices, personnel in general appeared to be motivated and less idle than observed in Semarang.

Although salary scales are established at the national level and serve as guidelines for regional governments in general, the municipality of Bandung has initiated an incentive scheme designed to increase the collection efficiency and reduce arrears. The collectors are assigned sectors and rotate frequently among the sectors. Those that reach the targets established receive a commission. This incentive has increased the morale of employees and also has had positive effects on the collection of local revenues. However, the treasurer could not specify how much this amounted to.

The number of municipal employees has grown from 8000 in FY 1984/85 to about 10000 in FY 1986/87.

4. Municipal Services

One of the interesting strategies of municipal service in Bandung is that the concept of regional enterprises has been extended from water to include parking and solid waste. The legal justification for creating a regional enterprise is to provide a revenue earning service as efficiently as possible and generate income for the municipality. However, it seems that the cleansing enterprise was also created for other reasons, such as avoidance of financial restrictions from the debt service ratio.

The cleaning function was formerly a municipal department but was converted two years ago to an autonomous entity because of the burden it placed on municipal resources. The strategy was to create a self sufficient entity that would receive financing from the central government and other donor agencies.

The prime target is to provide city wide services on a rationalized basis that would supplant the ad hoc procedures followed heretofore. The concept covers on-site collection, transfer, transport and disposal. The project is aimed at improving the services to the 12 slum areas by cross subsidy of one district to cover the costs of three low income group areas.

One of the problems is that user charges is a new concept for a service previously financed by grants. Responsibility for house-to-house collection lies with the Lurah (leader). Charges are designed to cover labor cost of collection and transport to the transfer station. Capital investments, such as transfer stations and even the hand-carts for house to house collections have been provided as grants from the central and local government. However, despite the creation of the enterprise, the reliance on grants persists. The general manager is currently trying to get approval to handle the whole process, that is, from the origination point of the garbage and not from the transfer stations.

The enterprise has also embarked on an active public education campaign to improve civic response to the costs of providing such a service and the health benefits derived thereof. The collection and billing process is computerized and presently the enterprise has a collection efficiency of 50%. It has targeted improvements in this area to 90% by 1991.

5. Conclusions

The administration in Bandung is very progressive, and the mayor is visionary in that he is directing his efforts to improve the quality of life and services to the community. His slogan is Bandung clean and green and has promoted a sister city arrangement with West Germany. Every year municipal officials spend 3 months in Braunschweig. Also as part of the effort to improve the quality of life, Bandung is undertaking an urban development project and a water supply project, both of which are being financed by ADB and an urban transport project being financed by IBRD.

6. Financial Tables

TABLE 7

MUNICIPALITY OF BANDUNG

FINANCIAL SITUATION ASSESSMENT

(Rp. Millions)

	A C T U A L		
ROUTINE REVENUES 1	1984-1985	1985-86	1986-87
BALANCE B/F 2	716.09	945.17	292.93
LOCAL TAXES	4,597.86	4,946.94	5,381.68
CHARGES	4,151.99	5,061.34	5,787.06
REGIONAL ENTERPRISES	130.04	165.73	164.13
OTHER	484.99	595.64	691.71
CENTRAL GOV. (SDO)	7,704.91	9,511.78	11,357.36
TOTAL ROUTINE REVENUES	17,785.87	21,226.59	23,674.88
DEVELOPMENT REVENUES			
INPRES	5,797.71	8,433.56	7,845.96
TRANSFERS FROM PROV.	356.13	266.62203	176.43
IPEDA	1,795.22	2,456.24	2,449.52
LOANS	3.84	242.59	8.86
OTHER	2,512.55	2,463.55	2,404.37
TOTAL DEV. REVENUES	10,465.47	13,862.55	12,885.14
TOTAL REVENUES	28,251.34	35,089.15	36,560.02
ROUTINE EXPENDITURES			
PERSONNEL	7,321.56	7,977.44	7,995.54
MATERIALS	3,139.21	1,532.01	1,677.48
SUBSIDIES TO REGIONAL E.	1,413.42	2,788.07	3,630.46
O & M	1,659.78	1,030.89	1,153.26
DEBT SERVICE	247.78	0.00	0.00
OTHER	408.19	449.40	385.57
TOTAL R. EXPENDITURES	14,189.94	13,777.81	14,842.32
DEVELOPMENT EXPENDITURES			
INVESTMENTS	12,669.10	18,401.15	18,428.32
TOTAL EXPENDITURES	26,859.03	32,178.96	33,270.64
CURRENT ACCOUNT SURPLUS	3,595.94	7,448.78	8,832.56
SURPLUS / DEFICIT	1,392.30	2,910.19	3,289.38

1/ Information obtained from Municipality of Bandung Budgets
2/ Appropriations committed but not disbursed during fiscal year.

TABLE 8

MUNICIPALITY OF BANDUNG

REVENUE - EXPENDITURE PERCENTAGE DISTRIBUTION

	ACTUAL		
	1984-1985	1985-86	1986-87
ROUTINE REVENUES			
BALANCE B/F	2.53%	2.69%	0.80%
LOCAL TAXES	16.27%	14.10%	14.72%
CHARGES	14.70%	14.42%	15.83%
REGIONAL ENTERPRISES	0.46%	0.47%	0.45%
OTHER	1.72%	1.70%	1.89%
CENTRAL GOV. (SDO)	27.27%	27.11%	31.06%
TOTAL ROUTINE REVENUES	62.96%	60.49%	64.76%
DEVELOPMENT REVENUES			
INPRES	20.52%	24.03%	21.46%
TRANSFERS FROM PROV.	1.26%	1.01%	0.48%
IPEDA	6.35%	7.00%	6.70%
LOANS & DEV INCOME	0.01%	0.69%	0.02%
OTHER	8.89%	7.02%	6.58%
TOTAL DEV. REVENUES	37.04%	39.51%	35.24%
TOTAL REVENUES	100.00%	100.00%	100.00%
ROUTINE EXPENDITURES			
PERSONNEL	27.26%	24.79%	24.03%
MATERIALS	11.69%	4.76%	5.04%
SUBSIDIES TO REGIONAL E.	5.26%	8.66%	10.91%
O & M	6.18%	3.20%	3.47%
DEBT SERVICE	0.92%	0.00%	0.00%
OTHER	1.52%	1.40%	1.16%
TOTAL R. EXPENDITURES	52.83%	42.82%	44.61%
DEVELOPMENT EXPENDITURES			
INVESTMENTS	47.17%	57.18%	55.39%
TOTAL EXPENDITURES	100.00%	100.00%	100.00%

1/ Information obtained from Municipality of Bandung Budgets
2/ Appropriations committed but not disbursed during fiscal year.

TABLE 9

MUNICIPALITY OF BANDUNG

PER CAPITA DISTRIBUTION

ROUTINE REVENUES	1984-1985	1985-86	1986-87
BALANCE B/F	529	665	196
LOCAL TAXES	3,398	3,481	3,606
CHARGES	3,069	3,562	3,878
REGIONAL ENTERPRISES	96	117	110
OTHER	358	419	463
CENTRAL GOV. (SDO)	5,695	6,694	7,610
	0	0	0
TOTAL ROUTINE REVENUES	13,146	14,938	15,863
DEVELOPMENT REVENUES			
INPRES	4,285	5,935	5,257
TRANSFERS FROM PROV.	263	251	179
IPEDA	1,327	1,729	1,641
LOANS & DEV INCOME	3	171	6
OTHER	1,857	1,734	1,611
TOTAL DEV. REVENUES	7,735	9,755	8,634
TOTAL REVENUES	20,881	24,693	24,497
ROUTINE EXPENDITURES			
PERSONNEL	5,411	5,614	5,357
MATERIALS	2,320	1,078	1,124
SUBSIDIES TO REGIONAL E.	1,045	1,962	2,433
O & M	1,227	725	773
DEBT SERVICE	183	0	0
OTHER	302	316	258
TOTAL R. EXPENDITURES	10,488	9,696	9,945
DEVELOPMENT EXPENDITURES			
INVESTMENTS	9,364	12,949	12,348
TOTAL EXPENDITURES	19,851	22,645	22,293
POPULATION	1.35	1.42	1.49

TABLE 10

MUNICIPALITY OF BANDUNG

PERFORMANCE INDICATORS

	1984-1985	1985-86
CURRENT REVENUES / CURRENT EXPENDITURES	1.25	1.54
PERSONNEL / CURRENT EXPENDITURES	51.60%	57.90%
DEBT SERVICE / CURRENT REVENUES	1.39%	0.00%
INVESTMENTS / TOTAL REVENUES	44.84%	52.44%
O & M / CURRENT REVENUES	9.33%	4.86%
O & M / INVESTMENTS	13.10%	5.60%
DEBT SERVICE / OWN SOURCE REVENUES	1.82%	0.00%
DEBT SERVICE / TOTAL DEV REVENUES	1.75%	0.00%
DEBT SERVICE / CURRENT ACCOUNT SURPLUS	5.09%	0.00%

V. CONCLUSIONS AND RECOMMENDATIONS

What should be clear from the preceding report is that the GOI has embarked on an ambitious reform of its policies and programs in the urban sector. Through the adoption of broad decentralization policies, the fundamental relationships between various levels of government may be altered. The catalysts to these changes have been the need to improve resource mobilization and to more efficiently utilize those resources in order to meet the existing and rapidly growing demand for urban services.

Implementation of these policies and related programs will take many years, and it will not be until after the end of this century that the full impact of these changes will be realized. In such a far-reaching program, obviously some limitations can be expected to emerge, either due to resource constraints to carry out the full program or due to policy aspects which need to be further developed. These limitations, in turn, signal opportunities for additional assistance to be provided in support of the GOI's broader objectives and in coordination with other donors.

The following sections of this report identify those areas in which resources under USAID's Housing Guaranty (HG) program can be brought to bear on issues critical to the successful achievement of the GOI's objectives in the urban (municipal) sector. In some instances, HG assistance can be used to bring forward policy and programmatic considerations which would otherwise occur much later in the GOI's urban development process; in other cases, HG resources can fill gaps in policy and programmatic aspects. Following a review in section A. of the limitations in current policies and their implementation, the policy dimensions to a HG program are discussed in section B., followed by recommendations for HG project assistance in section C..

A. CURRENT POLICY AND PROGRAM LIMITATIONS

Although the decentralization policy and program efforts currently under way encompass a broad agenda, there are significant areas recognized by the GOI and the donor community in which additional, major effort is required. For the most part, these areas represent implementation issues rather than matters of broad policy goals, but further policy issues have to be considered if there is to be successful implementation of some decentralization strategies. In this section we discuss the major areas in which either additional policy attention must be focused, or additional attention to implementation must be paid, or both. Five major concerns are addressed:

- o Planning strategy for focusing local investments on the economically most productive alternatives;

- o Policy and programmatic efforts to insure the most efficient use of local resources;
- o Policy and legislative reforms to improve local, own-source revenue generation;
- o Capital resource availability to support additional local investments; and
- o Targeting development assistance to lower income households.

1. Local Investment Planning

As described in section III.C., the GOI already has initiated a major effort to reorient the local development investment programming and financing process (IUIDP). The present focus of IUIDP is on integrating the programming and financing for all local public works investments covered by the umbrella of Ministry of Public Works responsibilities (roads, water, sanitation, drainage, and related other infrastructure). This effort, supported by IBRD urban sector loan financing and UNCHS-financed technical assistance, is operational in several larger cities and is in process of being extended to a much larger number of cities. Although the program already has an ambitious agenda, there are several areas in which it could be enhanced to increase its impact on local development.

First, the focus of the present effort is more on programming and financing local investments than on the planning process. This is not to say that consultants presently working with provincial and local government officials are not addressing the issue of priority determination, but rather to say that developing a process for identifying which investments would be the most productive is not their main focus. Rather, there may be a tendency to take local investment priorities as given and to focus on evaluating those priorities from the point of view of integrating all possible funding sources in order to determine a financially feasible set of investments. This observation is not so much a criticism of the program as it is an observation that the present focus does not encompass the entire spectrum of investment planning issues.

For example, it does not appear that sufficient attention is being paid presently, at the initial planning stage, of determining what types of investments should be considered by a local government from the point of view of contributing the most to local development. Virtually all local governments in Indonesia can catalogue a long list of public works infrastructure needs, but the planning mechanisms for evaluating which of these needs are more likely to generate additional local employment and other economic activity and meet basic population requirements for basic services such as shelter, water, and sanitation are not likely to be in place in most local and provincial governments. For example, in one municipality (Sukabumi), local officials identified the need for transportation investments to improve the linkages between rural, agricultural production centers and the urban center in order to increase the value of the urban center as a market and processing center. However, an overall planning process is lacking for identifying other investments to stimulate the local economy and for establishing priorities among these alternatives as an input into the integrated programming and financing process being established by the IUIDP program.

This issue is not unknown to the GOI and its advisors. For example, Ministry of Home Affairs officials reflect the concern that investment priorities in the near term for local governments should be focused mainly on economically attractive alternatives -- those that will have the greatest direct impact on employment generation and stimulation of local economic activity. In addition, participants in the IUIDP program also stress that it is not a complete planning tool, but rather is most valuable at the investment programming and financing stage of analysis.

A second concern, recognized by all, is that the IUIDP process does not include all development investments but is focused on the subset that is within the Ministry of Public Works responsibilities. Shelter-related, health and more social investments as well as some types of direct economic production investments such as market facilities or agroprocessing facilities and warehouses are presently not included (although basic infrastructure support such as water and sewer connections to these facilities is included). This limitation is a technical one based on the program being housed principally within Public Works rather than a conceptual one. There already is agreement that the process eventually should be extended to include all local capital investments.

A final concern is a practical implementation concern. The resources presently available to the IUIDP process simply do not permit rapid expansion to the full range of local governments in Indonesia. In particular, the present implementation approach is to focus attention on larger cities (typically above 500,000 in population) and to institutionalize the process at the provincial level with the intent that provincial staff, once trained, will extend the training to municipal level staff. At present, in some of the cities where the program is being implemented, there is confusion on the part of municipal planning staff over their role versus that of external consultants who seem to be doing the municipal job in place of local staff.

2. Local Resource Management

Although a natural focus in a program to increase local responsibilities is to enhance the ability to generate additional revenues, at least an equal focus on managing the efficiency of expenditures is also necessary. Not only have local governments in Indonesia historically been dependent in general on the central government for investment funds, but routine or current budget expenditures also have been principally funded by the central government. Municipal employees, for example, are primarily funded by central and provincial resources. Under these conditions, there have been few financial or administrative incentives for municipalities to focus attention on limiting expenditures or operating efficiently. Such controls as exist are mainly those exercised by the central government in its review of municipal budgets. This is not to say that municipal governments are inherently inefficient, but only that there is little incentive to be concerned with the cost of routine or current expenditures and no particular program at the central level for assisting municipalities in developing performance improvement programs. This concern may be even more important in the future as local revenues from the PBB increase. The previous land tax (IPEDA) revenue share for municipalities was restricted to use for investment purposes, whereas now up to ninety % of the PBB revenue share may be used for routine expenditures. This loosening of restrictions on use is motivated by the objective of encouraging increased municipal attention to operation and maintenance. However, it also could have the negative effect of further decreasing incentives to efficient management.

3. Local Resource Mobilization

Coupled with an emphasis on improving the management of existing resources, it also is clear that local governments will have to replace declining central government transfers with locally-generated revenues. The local revenue generation programs presently under way are at a very early stage of development. The one major policy reform already adopted, conversion of the traditional land tax (IPEDA) into a property tax (PBB) based on the capital value of land and buildings, is only this year showing significant increased collections. As noted in section III.B., it has the potential for increasing total property tax collections by as much as fourteen times and the municipal share by as much as twelve times. For the large cities that already have the capacity to develop relatively sophisticated tax maps and assessment processes, the reform can have major effects. For the smaller municipalities, it will take some years before the full effects can be felt.

Smaller municipalities are coping with the changes with intermediate approaches to establishing the capital value of land and buildings. For example, municipalities may establish a simple classification system with as few as five categories ranging from expensive, commercial property to unserviced residential, and place an estimated (as opposed to assessed) average value on each of these five categories. This allows the municipality to begin collecting the potentially higher taxes before they develop a more sophisticated tax mapping and valuation process.

Aside from the resources required to develop a registration and valuation process to take full advantage of the law, the major policy concern for the property tax is its continued status as a central government tax, albeit with a major return to the local level rather than as a local tax. Opinion is divided in the government over whether it should be 100% local versus the present 65% municipal, 25% provincial and 10% national. However, there is support for converting it to a strictly local tax, based on the argument that even with the return of a major share of the tax, local governments now have less incentive to collect the full possibilities than if it were perceived as their own local revenue.

In addition to the property tax reform, local governments will have to have additional revenue sources beyond those presently allowed if they are to meet long term goals for assumption of additional development responsibilities. As noted in Section III.B., use of betterment levies and a local fuels tax are among those being given primary consideration. Of the two, the fuel tax has the best prospects for additional revenue generation in the short-run because it is more easily administered. Betterment levies typically take a much more sophisticated administrative capacity.

Finally, as with initiatives to improve investment programming and financing, local resource mobilization efforts are in the early implementation stage with extensive effort required to reach all local governments. Ministry of Home Affairs, which has the major technical assistance and training responsibility for developing local administrative capacity, only now is in the process for contracting for consultants to extend the pilot program to train in local resource mobilization from six cities to ninety-three additional.

4. Capital Resource Availability to Local Governments

Even under optimistic scenarios, measures to improve local resource mobilization through taxes, user charges and other levies are not expected to enable municipalities to generate sufficient surpluses to meet investment needs on a direct payment (pay as you go) basis. Without funds available for borrowing, a significant investment deficit will remain at the local level.

Presently, municipalities are not permitted to access credit through the private market either by borrowing directly from private financial institutions or by issuing some form of revenue bonds. Nor in the short term are financial institutions or other sources of private capital likely to perceive municipalities as good credit risks or good targets for investment capital. In the medium-term, some form of government-sponsored loan facility seems essential. Present proposals focus on the creation of a development loan fund or account, with some discussion about whether it should use existing institutions such as the Regional Development Banks or should create a new entity, such as the proposed Regional Development Account (RDA).

If the RDA is established, or a functional equivalent, present capitalization plans include two sources. First are the repayments of existing central government loans to municipalities. Second are funds presently committed under IBRD urban sector loans and central government budget commitments. The first source involves 100 billion R outstanding municipal loans and another 100 billion R in local enterprise loans. The second source adds approximately 84 billion R, about two-thirds of which is already committed to projects in Jakarta and other large cities. Based on the present repayment schedule for outstanding loans, the best estimate of committed present capitalization for a loan fund for a first year of operation is about 100 billion R or approximately 60 million $US. At least $40 million of that is already committed to projects and the remainder could easily be absorbed by a few large cities.

5. Benefiting Lower Income Households

The GOI has had a general policy to direct development benefits to lower income neighborhoods, and its principal program for doing so has been the Kampung Improvement Program (KIP) program. Under KIP, neighborhoods or areas are designated for assistance based on physical criteria; specifically, high density and level of urban services.

As municipalities begin to rely increasingly on repayable funds for urban investment, such as loans through the RDA, it is probable that there will be a tendency to target new services or infrastructure to higher income neighborhoods which are deemed more likely to repay their costs. Discussions with local officials have confirmed this, and two separate reasons are given as to why this shift may occur.

First, there is the tendency to link loans cost recovery directly to projects for which fees can be charged and for which individual users can be identified. As an example, they see a water project as suitable for loan financing because fees can be levied based on use, but a non-toll road is considered inappropriate for loan financing. Obviously, this perspective underscores the need for a better understanding of how revenues from other sources, such as property taxes, will be enhanced through infrastructure improvements, with the pursuant revenue flows used to cover project costs. Presumably this understanding will develop over time through various training efforts, but in the meantime, municipalities are likely to link loan financing directly to projects for which individual users can be identified and charged.

The notion of 'individual user' is important in understanding the problem here. Again, using the example of a water project, commonly lower income neighborhoods are served by standpipes and not house connections. Thus, there is the obvious problem of attributing the amount of water used to individuals, as well as the problem of identifying all users. While a flat household fee is an alternative mechanism for cost recovery for discrete services, such as water, neither local officials nor residents easily make the connection between neighborhood improvements (e.g., drainage) and 'indirect' cost recovery mechanisms, such as higher property values resulting in additional tax revenue taxes. In short, the preference to directly attributing and recovering costs is likely to shift benefits away from poorer neighborhoods.

The second reason for potentially more resources being targeted to higher income areas is simply the issue of affordability. Higher income families can more easily pay for urban services, and certainly lower income families cannot pay as much for services, in absolute terms or in some cases even as a percentage of income. For many of the urban poor, even modest increases in user fees or taxes could be difficult to afford.

In the past, tailoring infrastructure or services to affordable levels was less important when central government grants provided deep subsidies, but the introduction of cost recovery will require new infrastructure designs and innovative approaches to addressing lower income needs. It is uncertain whether local capacity exists to design services suitable to the urban poor, or even if the will exists to do so; in turn, the possible mismatch between design and affordability may cause municipalities to concentrate their efforts in higher income areas.

B. AID POLICY OPTIONS

The four policy areas recommended for attention under the HG program include both resource management concerns and implementation aspects of the GOI's broader decentralization policies. Briefly summarized, the four areas for consideration are:

- o Ensuring that new financing mechanisms introduced under the GOI's urban sector initiatives are consistent with the longer-term development of other sources for investment capital;
- o Combining incentives for local resource mobilization with incentives for better control and management of local expenditures;
- o Ensuring that training, technical assistance and capital resources will be equitably targeted to municipalities of all sizes; and,
- o Ensuring that lower income households will equitably benefit from the GOI's urban sector initiatives and development programs.

1. Longer-term Capital Development Mobilization

In order to narrow the gap between resources and investment needs, the GOI plans to capitalize and make operational a revolving loan fund (RDA) through which municipalities will be able to borrow for development purposes. The size of this fund, however, will be constrained by the GOI's own ability and willingness to mobilize resources for on-lending through the RDA. Once municipalities understand the role that loan financing can play in speeding development efforts and improve their management capabilities to utilize the RDA, undoubtedly this source of financing will be insufficient to meet all needs. Thus, municipalities will need to look for alternative sources for financing.

In the past, most local development has been funded with central government grants, and the limited loan funds made available to municipalities were at heavily subsidized rates or even at a zero rate of interest. Legally, municipalities were not allowed to incur private debt, had they wanted to. Two results occurred. First, municipalities that might have been willing to adopt a more enterprising, market-oriented perspective for development were prevented from doing so. Second, municipalities limited their development activities to what could be paid for with GOI funds, and more ambitious development programs were shelved.

Through the RDA, the GOI can begin to break this cycle of dependency and stimulate development efforts. In formulating the RDA's operating and loan policies, the need to position municipalities to be able to access other revenue sources needs to be kept in mind. Municipalities need to learn that capital has a real cost, even for publicly-sponsored activities, and continued interest rate subsidies will not foster this understanding. In addition, only by demonstrating their ability to finance and recover costs on a more market-oriented basis will municipalities begin to be perceived as viable investments for banks and other sources of private capital.

Accordingly, as an area for policy input, the HG program should be used to ensure that the RDA and any other similar finance mechanisms created by the GOI for municipal development should be structured in such a way as to be consistent with longer-term development of other sources of capital. More specifically, in terms of the RDA, on-lending interest rates should be set so as to cover the costs of capital and loan fund administration as well as such risks as default and inflation.

2. Incentives for Expenditures Control and Management

Under the present system where most of the municipalities routine expenses have been covered by centrally-funded grant programs, there have been few if any incentives to limit local administrative costs. Annual budget reviews have tended to limit the growth in municipal expenses to some national norm or within an acceptable range, but this process has been inadequate for improving the efficient use of resources.

The GOI's decentralization policies include revenue generation components, and there are plans to develop criteria for grant allocation based on improvements in local resource mobilization. Lacking in this policy agenda, however, is any focus on the expenditure of local resources which is, in itself, a form of resource mobilization through cost savings and greater efficiency.

Accordingly, the GOI's present policies need to be modified to agree to develop expenditure management incentives in combination with the proposed resource mobilization incentives. In turn, these would serve as the basis for allocating future grants and loan resources, and would encourage improvements in local fiscal performance from both sides of the equation. On the expenditure side, implementation of this policy would entail development of cost accounting systems and service performance measurements.

3. Assistance to Small and Medium Municipalities

The GOI's broad decentralization policies and programs ultimately will impact cities of all sizes. However, the concentration of training, technical assistance and even capital is presently in the larger metropolitan areas. IBRD-supported studies and technical assistance have primarily focused on the needs of Indonesia's largest cities, and IUIDP resources do not permit its rapid implementation in smaller towns, especially those under 500,000 population.

Indonesia's cities represent a broad spectrum of local management capabilities, and greater ability tends to correspond to community size. Without an explicit GOI policy to ensure that training, technical assistance and resources equitably benefit communities of all sizes, there is little doubt that small towns and even many medium-sized cities will not be able to assume the responsibilities associated with decentralization. In turn, increasingly the gap will widen between smaller and larger municipalities in terms of the provision of urban services and income levels. Implementation of a policy to ensure that urban areas of all sizes will benefit would require some classification of cities based on size, and a targeting of resources by classification.

4. Benefiting Lower Income Households

The tendency for urban development resources to be increasingly focused on higher income neighborhoods was discussed in section III.C. By raising this concern, we are not suggesting that the GOI has failed to give sufficient priority to lower income households in the past, nor are we suggesting that a rigorous targeting and monitoring system is needed in the future. Rather, it needs to be recognized that the increased emphasis on cost recovery has the potential for skewing programs toward those with the greatest ability to pay direct user charges. Programmatic, policy and training agendas need to be cognizant of this concern.

As a policy issue, the GOI needs to review its current policies vis-a-vis lower income beneficiaries to determine if they are adequate in the context of the changing nature of urban sector financing. A HG program should require such a policy review, and the development of a national policy and guidelines on this issue. Implementation of such a policy could occur in a number of ways. A level of targeted resources could be defined. Training in municipal finance and management could include a component on how to provide services to the urban poor, even under loan programs. Technical guidelines could be issued for how to provide services on an affordable, cost recoverable basis. In the IUIDP planning process, a municipality's lower income neighborhoods could be identified, and a strategy statement prepared as to how the needs of those neighborhoods are being addressed.

C. AID PROJECT OPTIONS

This section focuses on the option to utilize the Housing Guaranty program to provide a major initial capitalization of the Regional Development Account, or its functional equivalent. Although relevant to the GOI's policy goals in the urban sector and decentralization options, other AID programs of technical assistance and training support are not considered here. The HG option is discussed in terms of a programmatic focus on municipal lending and the design of the incentive structure for municipal participation. This discussion is not meant to imply that the HG-supported portion of municipal lending would be a separate account or separate program, but rather to discuss the policy and program design issues which AID should tie to the HG loan for GOI adoption for all municipal lending through the account. In this respect, the design will have to work with two on-going efforts in the Ministry of Finance, through external consultants, to study the eligibility criteria and operational aspects of the proposed RDA.

1. Programmatic Focus

Following from the limitations in present efforts, discussed in section A., we recommend that the HG-supported effort promote lending to small to medium-sized municipalities (20,000 to 500,000 population) and that it contain twin emphases on: (1) projects that are not presently covered by CIPTA KARYA efforts, particularly shelter and shelter-related services and projects that promote employment generation and other economic development projects over social or broad public works investments. The rationale behind these two program recommendations is based on:

- the already greater availability of a wide range of economic and technical support to larger cities; and
- the importance of strengthening the economic development planning aspects of present decentralization policies.

The first recommendation is based mainly on the recognition that a gap in coverage is likely under present programs. This is not due to overt policy decisions as much as it is to resource scarcity. The second recommendation is based more on potential policy and/or implementation weaknesses in current programs. As discussed in A., present local investment programming and financing improvements lack a sufficient focus on developing local capacity to evaluate, order priorities and select investments based on their contribution meeting specific service needs and to stimulating local economic development. Consequently, we recommend that the HG-supported effort provide a focus on the shelter-related service deficits and the stimulation of employment and local economic production.

2. Structural Design

Recognizing that consultant supported efforts already are beginning in GOI to design the characteristics of the Regional Development Account, we recommend a number of characteristics that AID should support as part of this design process. These fall under the headings:

- Combining loans and grants to rationalize the current grant process;

- Developing an incentive system for municipalities' participation in the loan/grant program based on local fiscal effort and local effort to manage costs per unit of service;
- Fixing interest rates that have a long run positive influence on additional resource mobilization for local economic development; and
- Design of incentives for municipalities to move out of the program in the long-run, to turn to other sources for financing.

a. Loan/Grant Combination

It is accepted that municipalities in Indonesia will continue to require some form of budget support from the central government in the foreseeable future. However, other forms of central government support, principally grants and technical assistance/training should be tied to the loan fund in order to develop a consistent and coherent approach. In the near term, few municipalities will develop local (own) resources sufficient to finance all investments with loan funds only. In order to make the best use of both central government loan and grant funds, it is recommended that a portion of present central grant funds be tied to the loan program in such a way as to contribute to the same development objectives.

Specifically, the likely scenario for most municipalities is that they will approach the loan fund with a package of investments integrated an IUIDP-type process, to be funded through a combination of loans and grants from central government as well local direct expenditures. The tie to the loan program is that the criteria for receiving a partial grant in addition to a loan for a particular project or package of investments is based not just on a municipality's need for funds but is based also on its meeting policy and programmatic criteria. These include basic eligibility criteria focused on the size of the local resource base and on local fiscal and management effort.

For example, the proportion of funding provided by grants should be tied to the lack of a resource base rather than the lack of an effort to utilize the resource base. Municipalities with the least amount of potential resources based on natural resources, present level of economic development, per capita income, and similar criteria would receive the highest proportion of grant relative to loan financing. Municipalities with greater resource bases would receive a mix richer on the loan side. The basic principle is that the grant portion would be utilized to develop a resource base, which in the long-run yields additional local resources, and the loan portion would be used to exploit (in the economic development sense, not in the tax sense) an existing resource base. Over the long-run, as the resource base of municipalities expand, they move to more and more of a loan versus grant basis.

To make the incentive system work in this fashion, the central government will have to tie a meaningful proportion of its present grant and other municipal budget support to the RDA program. Otherwise, municipalities would have no incentive to approach the RDA program, but rather would seek traditional channels of 100% grant financing. This is not necessarily to suggest that all central government grants should be tied to the program as there are social purposes and other objectives that the central government will wish to continue to support regardless of municipal ability to repay or ability to generate economic effects. However, the RDA fund will not meet economic development objectives if basic physical infrastructure and economic development facilities support can be funded by municipalities approaching a variety of different Ministries or central grant programs without regard to meeting the economic development objectives of the RDA program.

b. Local Fiscal Effort and Financial Management Incentives

In addition to joining existing central government grant support to the loan fund in order to create incentives for municipalities to participate in the program, participation by municipalities should be conditioned on their meeting criteria for local fiscal effort and local effort to manage the efficiency of expenditures. As discussed in the preceding section, municipalities with poor resource bases would be eligible for the richest mixture of grants relative to loans, but in order to qualify, even the poorest municipality would have to expend efforts proportionately equivalent to wealthier municipalities to generate the local resources that are possible. This will require identification of the local resource base and the development of norms for the proportion of local resources generated relative to the resources possible.

In addition to local fiscal effort, however, is the equally important criterion of local expenditure management. Programs should be developed to assist municipalities to implement cost accounting systems that enable the identification of the costs of services and the contributing cost elements to those costs. In addition, programs should be developed to assist municipalities in measuring the quantity and quality of local services delivered. With adequate cost accounting systems and service performance measurement programs, municipalities then would be able to develop cost per unit of service measures and to identify potential causes of high cost per unit. By including evaluation of the cost per unit of service for basic physical and infrastructure related services as a component of participation in the loan/grant program, incentives would be created not only to generate local resources but also to use them efficiently.

c. Interest Rate Structure

As already discussed in the preceding policy section, the program design should utilize market rates of interest to the municipal borrower that allow the central government to recover fully the cost of capital, the cost of administration and risk. The temptation to incorporate a partial soft loan element for poorer municipalities by subsidizing the interest rate should be avoided. Instead, the combination of grant with loan can be utilized to deal with poor resource base. By charging a realistic market rate, the program would tend to encourage those investment programs that will expand local resource bases and stimulate economic use of existing resource bases and discourage those programs that are viable only if provided at a subsidized rate. Again, social considerations can be met by separate grant or other assistance programs as long as they are not so large that the local budget support they provide allow municipalities to avoid the RDA program for physical and economic infrastructure provision.

d. Long-term Development of Other Sources of Financing

Regardless of the level of donor agency involvement, it is difficult to imagine meeting all the capital needs of municipalities through the RDA program. In the long-run, it is desirable that other capital resources become available to municipalities. While the form of these other capital resources may not be determined at this time, in the long-run, if municipal support through infrastructure for economic development is viable, it also is viable as a potential locus of investment for financial institutions and individuals in the private sector. While this has to be viewed over the long-run, the RDA program should be designed in such a way as to be consistent with the development of other, non-governmental capital resources.

Primary in that objective is the use of realistic interest rates. That alone, however, is not sufficient. In addition, the use of incentives to insure local fiscal effort and local expenditure efficiency also play a role in generating eventual private sector interest in municipal capital mobilization. As municipalities participate in the program, meet program criteria, and demonstrate repayment of loans, they become potential targets for private capital. The best of the municipalities, which from the capital market point of view are those with the least risk and the most viable economies, would be attractive to private capital for better rates of interest than the government would have to charge if the government interest rate realistically considers the risk pool and the variability in economic viability among municipal participants. In a sense, in the long-run the private sector may have an incentive to skim off the "best" clients from the RDA program by offering better terms. The government's role then continues to support the less financially viable, but socially important prospects, while still providing incentives for them to improve to the point that they too are attractive to private sources.

D. Conclusion

The GOI has embarked on an ambitious program of shifting some of the locus of service provision and investment in economic development from the central to local levels. Broad agreement at the central level exists on the major policy goals, but there are significant, serious policy and program decisions yet to be taken. There is ample opportunity for AID involvement at the policy level, at the program design level, and at the implementation level. In particular, the Housing Guaranty program could be a major source of capitalization for a municipal lending program, especially for local governments below 500,000 in population. In addition, other AID programs which might be developed could play roles in:

- supporting decentralization through improving local resource management;
- stimulating the development of a more geographically deconcentrated private economic enterprise such as agro-processing industries through municipal provision of the necessary, basic infrastructure; and
- stimulating the growth of capital markets.

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