Case Study Municipal Development Funds In Indonesia: The Regional Development Account

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Financing Urban Infrastructure in Indonesia:

The Regional Development Account

by

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FINANCING URBAN INFRASTRUCTURE:
IMPLEMENTING MARKET-BASED FINANCING OPTIONS

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FINANCING URBAN INFRASTRUCTURE IN INDONESIA: THE REGIONAL DEVELOPMENT ACCOUNT

I. INTRODUCTION

The Government of Indonesia is now developing several creative, market-based mechanisms for raising the enormous sums of capital needed for long-term investments in urban infrastructure and services, such as the issuance of municipal bonds and the encouragement of private sector participation and public-private partnerships.

One such initiative, an infrastructure development fund called the Regional Development Account (RDA), offers considerable promise in helping to close the urban infrastructure investment gap, and thus, will be the focus of the remainder of this paper.

The paper's introduction is followed by:

- an overview of urban infrastructure financing needs and trends in Indonesia;
- a summary of key RDA features to date;
- a description of plans to improve RDA; and
- a conclusion.

II. URBAN INFRASTRUCTURE FINANCING NEEDS AND TRENDS

The projected infrastructure needs in Indonesia are quite staggering. For example, the World Bank estimates for the 1990s indicate that investment needs for urban environmental infrastructure alone will be approximately Rp. 21 trillion, whereas Repelita VI planned investment is only Rp. 4.1 trillion.

Even these public investment targets are quite ambitious. Meeting these targets would mean:

- o Doubling water production capacity for human settlements, from 105 cubic meters per second at the end of Repelita V to 210 cubic meters per second at the end of Repelita VI.
- o Almost tripling the number of telephone connections, from 3 million at the end of Repelita V to 8 million at the end of Repelita VI.
- o Upgrading or rehabilitating almost 500,000 kms of local roads during Repelita VI, versus roughly 300,000 kms during Repelita V.

These investment targets reflect Indonesia's extremely rapid rate of urbanization. The average annual rate of urbanization in Indonesia from 1980 to 1990 was 5.4%, as Indonesia's urban population increased from 32.8 million to 55.5 million. Moreover, according to current projections, by the year 2005, more than half of Indonesia's population will be urban, and by the year 2018, only 2 of

Indonesia's 27 provinces will be less than half urban.[1]

Absolute investment in urban infrastructure and services has indeed grown considerably over the past decade. As depicted in Figure 1, investment has more than doubled in current terms, from Rp. 428 billion in 1986/87 to Rp. 998 billion in 1993/94. However, as indicated in Figure 2, when these investment figures are adjusted for inflation and population growth, the real per capita public investment in urban infrastructure and services has actually fallen, from Rp. 8,466 in 1986/87 to Rp. 8,250 in 1993/94.[2]

At the same time, the capacity of local governments to support debt financing to make up for shortfalls in budgetary resources has increased dramatically. For example, as depicted in Figure 3, local government real per capita own source revenue rose from Rp. 5,283 in 1985/86 to Rp. 11,868 in 1993/94, equivalent to Rp. 23,428 in 1993/94 current prices and reflecting an average real per capita increase of 13 percent per year over the past five years.[3]

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[1]Internal Ministry of Finance and Bappenas analyses.

[2]Municipal Finance Project, *Monitoring Indicators of Repelita VI Urban Policy Action Plan Implementation Results* (Jakarta: Ministry of Finance in cooperation with Bappenas, Ministry of Home Affairs, Ministry of Public Works, and the U.S. Agency for International Development, 31 January 1996).

[3]Ibid.

FIGURE 1:

ANNUAL URBAN INFRASTRUCTURE AND SERVICES INVESTMENT

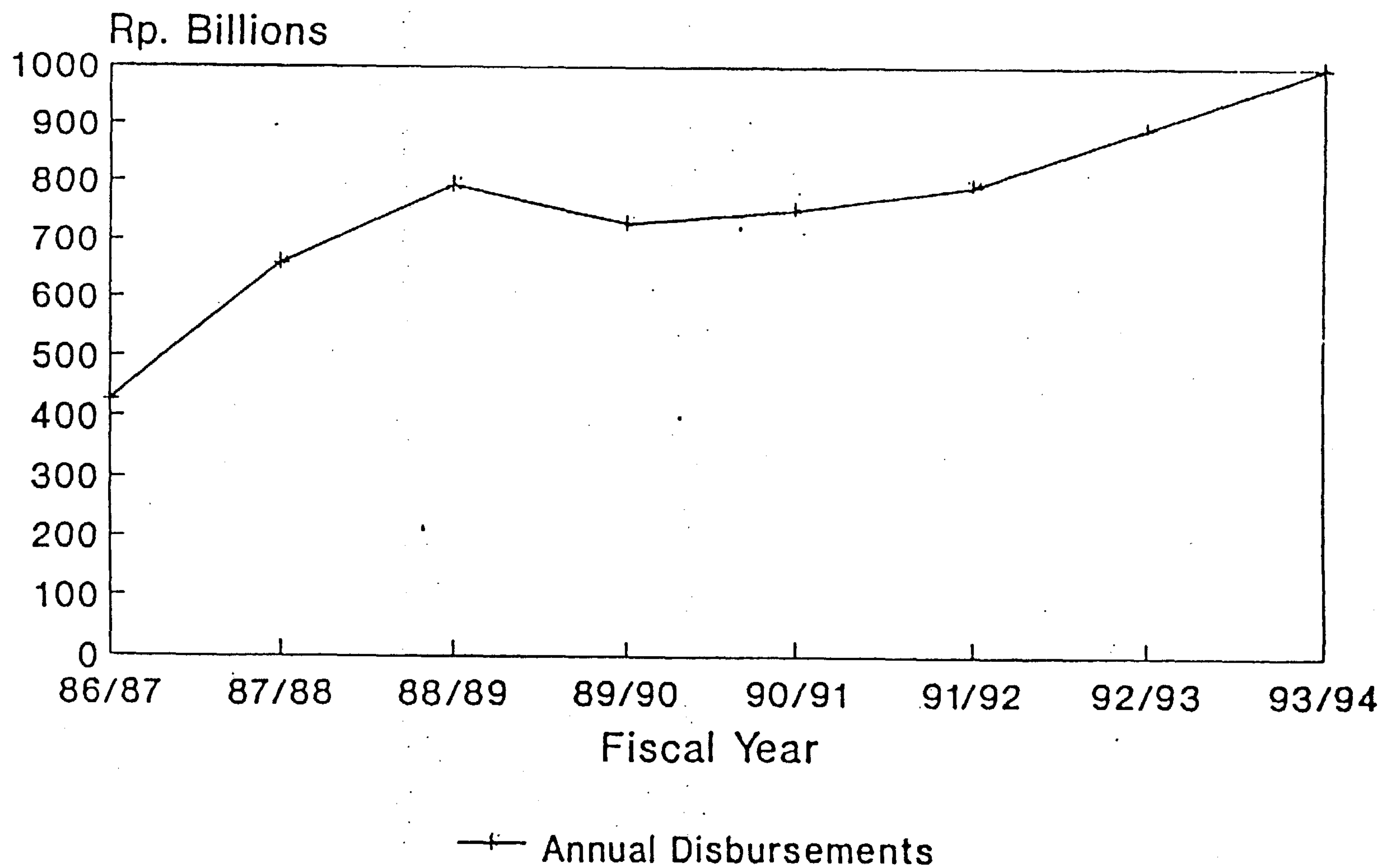


FIGURE 2:

REAL PER CAPITA ANNUAL INVESTMENT IN URBAN INFRASTRUCTURE AND SERVICES

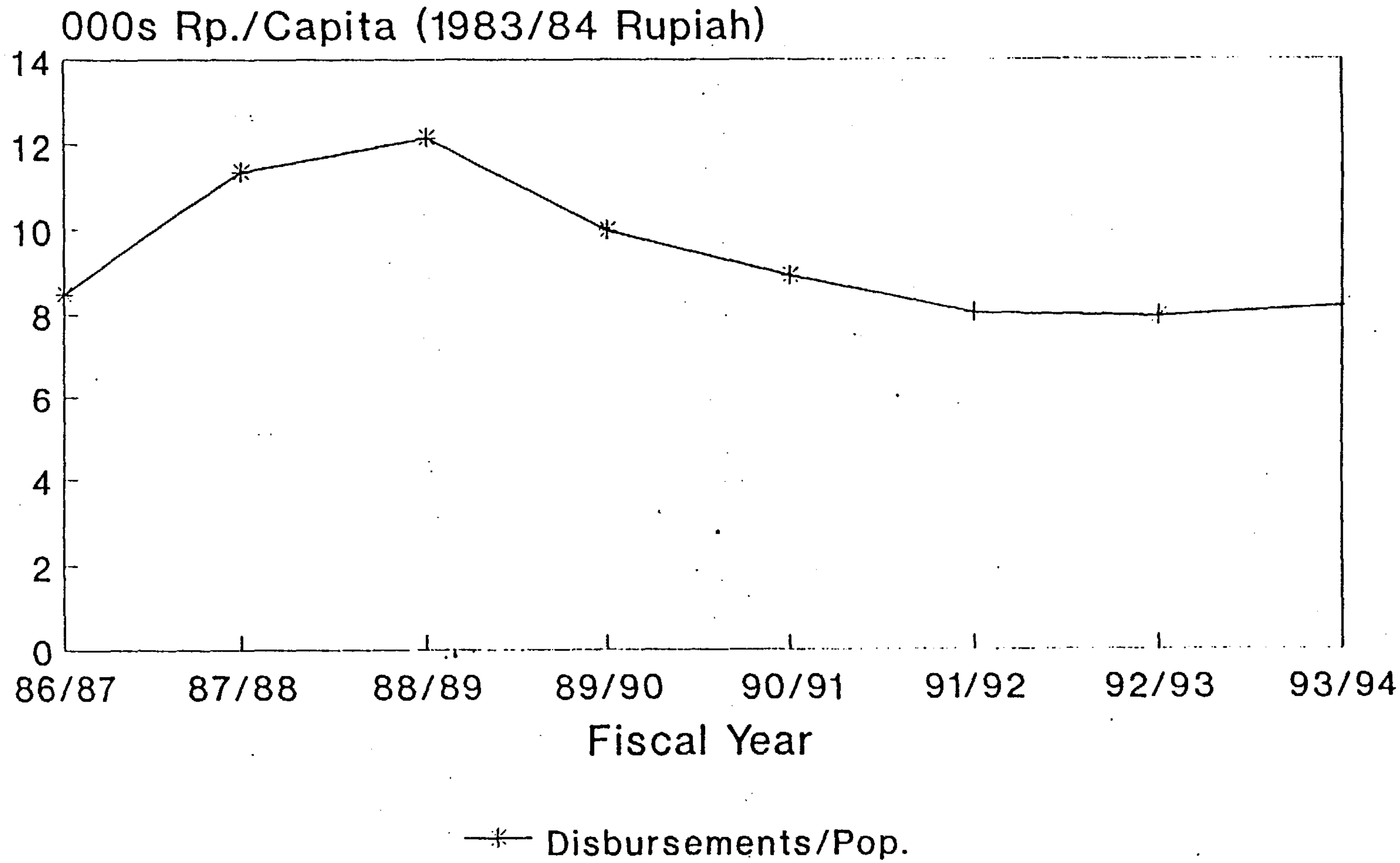
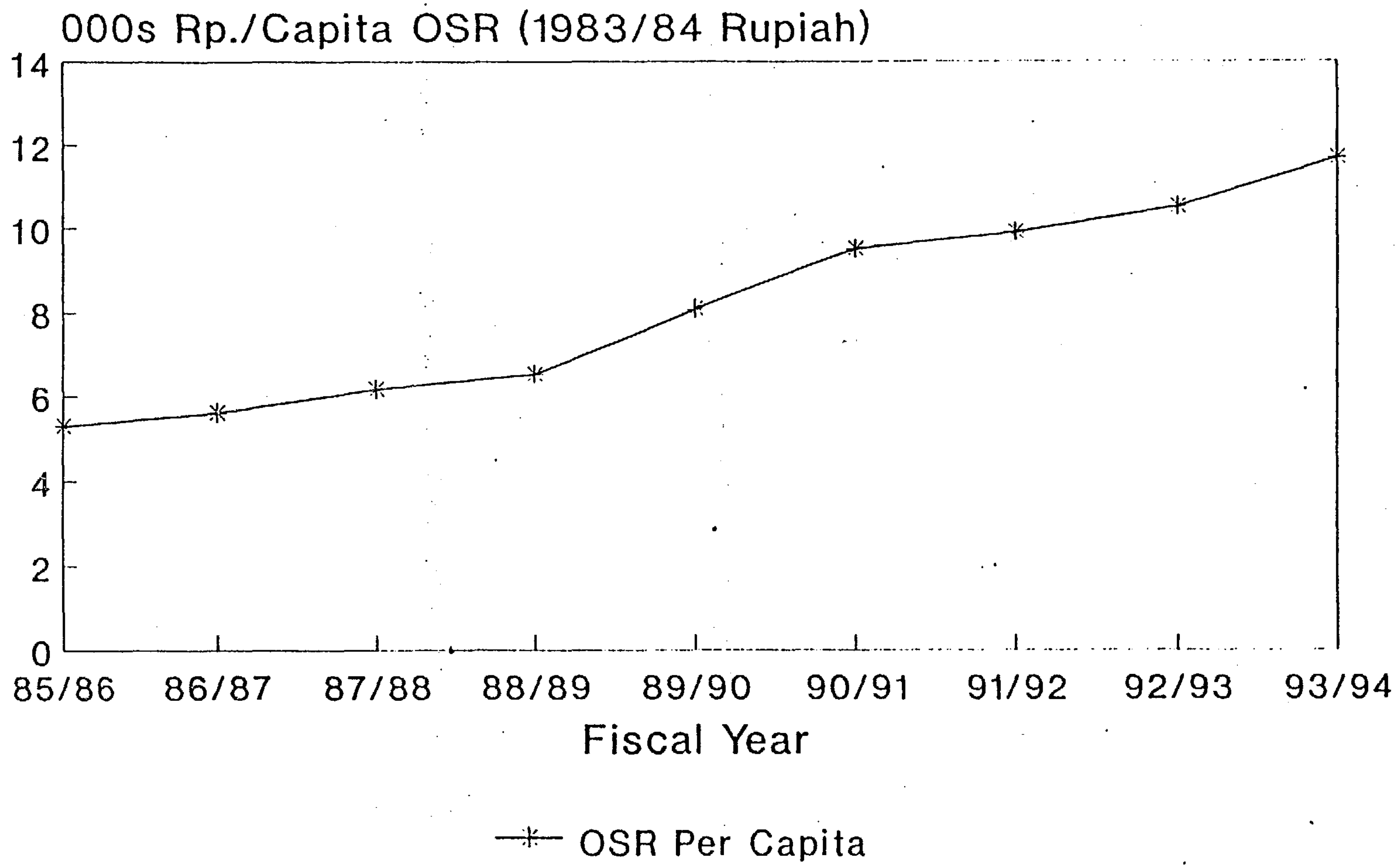


FIGURE 3:

REAL PER CAPITA OWN SOURCE REVENUE (OSR)



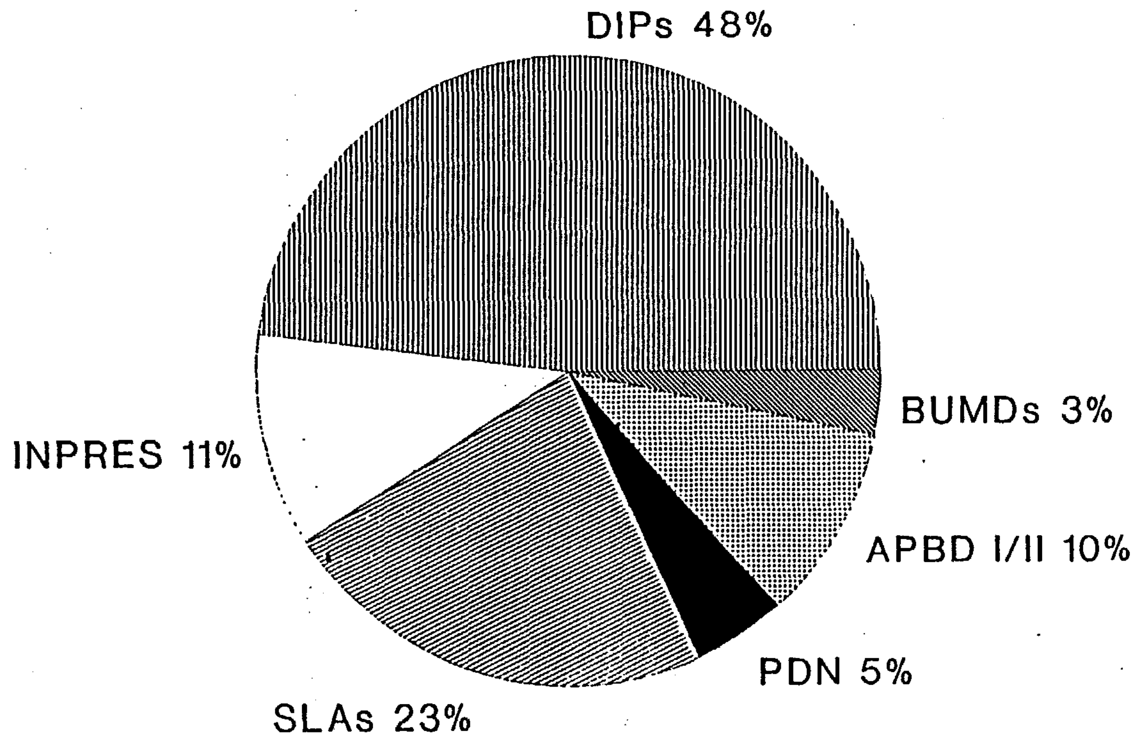
Nonetheless, the financing of urban environmental infrastructure in Indonesia has been dominated by central government grants and foreign loans. As depicted in Figure 4, of the Rp. 7.2 trillion invested in urban environmental infrastructure over the past seven years (1989/90 - 1995/96), 59 percent came from national budget sectoral and block grants (DIPs and Inpres), and 23 percent has came from foreign loans on-lent to local governments and local enterprises (SLAs). Only 13 percent came from local government budget allocations (APBD I and II), while a mere 5 percent came from domestic loans (RDA and pre-RDA).

It is clear that this pattern of financing is not sustainable in the long-run, given that central government resources are extremely limited and that central government borrowing is approaching its limit. The key is to increase local own source revenue, and to use the greater debt carrying capacity that these resources generate to leverage domestically-sourced local government borrowing.

In sum, Indonesia's rapid rate of urbanization, coupled with the urban populace's rising expectations for better infrastructure and services, has led to a considerable shortfall in investment in urban infrastructure and services. However, meeting Indonesia's urban investment needs remains a high priority, and a growing capacity to pay for improved facilities has encouraged the government to develop local government debt financing via the RDA .

FIGURE 4:

FINANCING SOURCES FOR URBAN ENVIRONMENTAL INFRASTRUCTURE 1989/90 - 1995/96



RP7.2 trillion

Source: Ministry of Finance

III. OVERVIEW OF RDA

In 1991, the Minister of Finance issued a decree establishing RDA.[4] The primary purpose of RDA was to provide long-term credit to local governments and local enterprises for infrastructure investments in support of the GOI's broader urban development agenda. RDA was to serve as a transition mechanism for local authority borrowing from private capital markets, by developing local debt management experience and creditworthiness as local authorities supplemented traditional grant financing with debt financing. Also, being a bottom-up, demand driven lending facility, RDA was designed to support the GOI program of decentralization and local fiscal autonomy.

RDA is a special account at Bank Indonesia (the central bank), managed by the Ministry of Finance's Directorate General for Financial Institutions. As Figures 5 and 6 indicate, not only has overall borrowing by local governments and local enterprises increased dramatically over the past decade, from Rp. 16.5 billion in 1984/85 to a peak of Rp. 550 billion in 1993/94, but RDA disbursements have made a substantial contribution to overall local borrowing: RDA disbursements have quadrupled in the four years since the RDA decree was issued, rising from Rp. 47.9 billion in 1991/92 to Rp. 168.4 billion in 1994/95.

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[4]Decree No. 1021/KMK.013/1991.

FIGURE 5:

LOAN DISBURSEMENTS TO LOCAL GOVERNMENTS AND PUBLIC ENTERPRISES

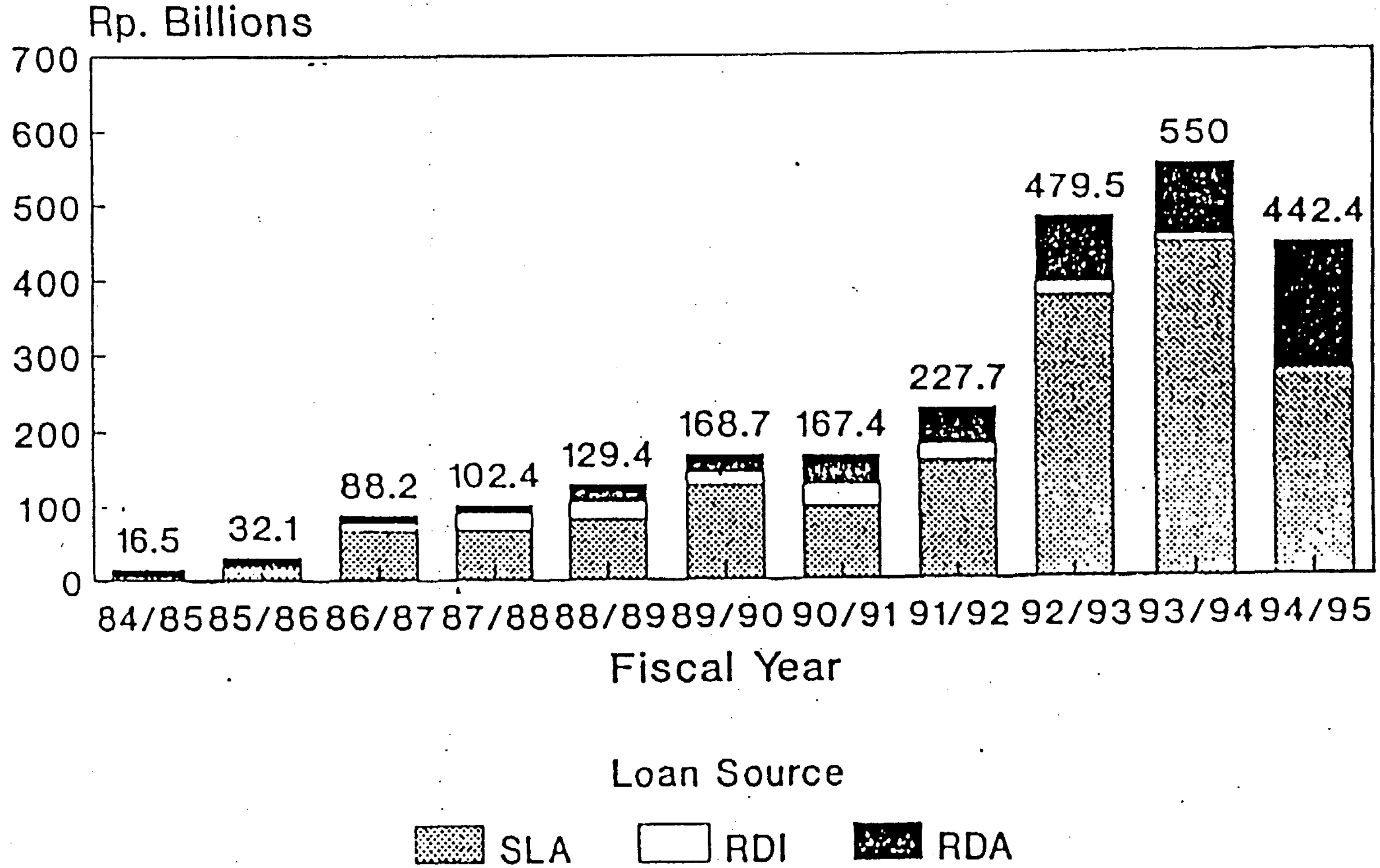
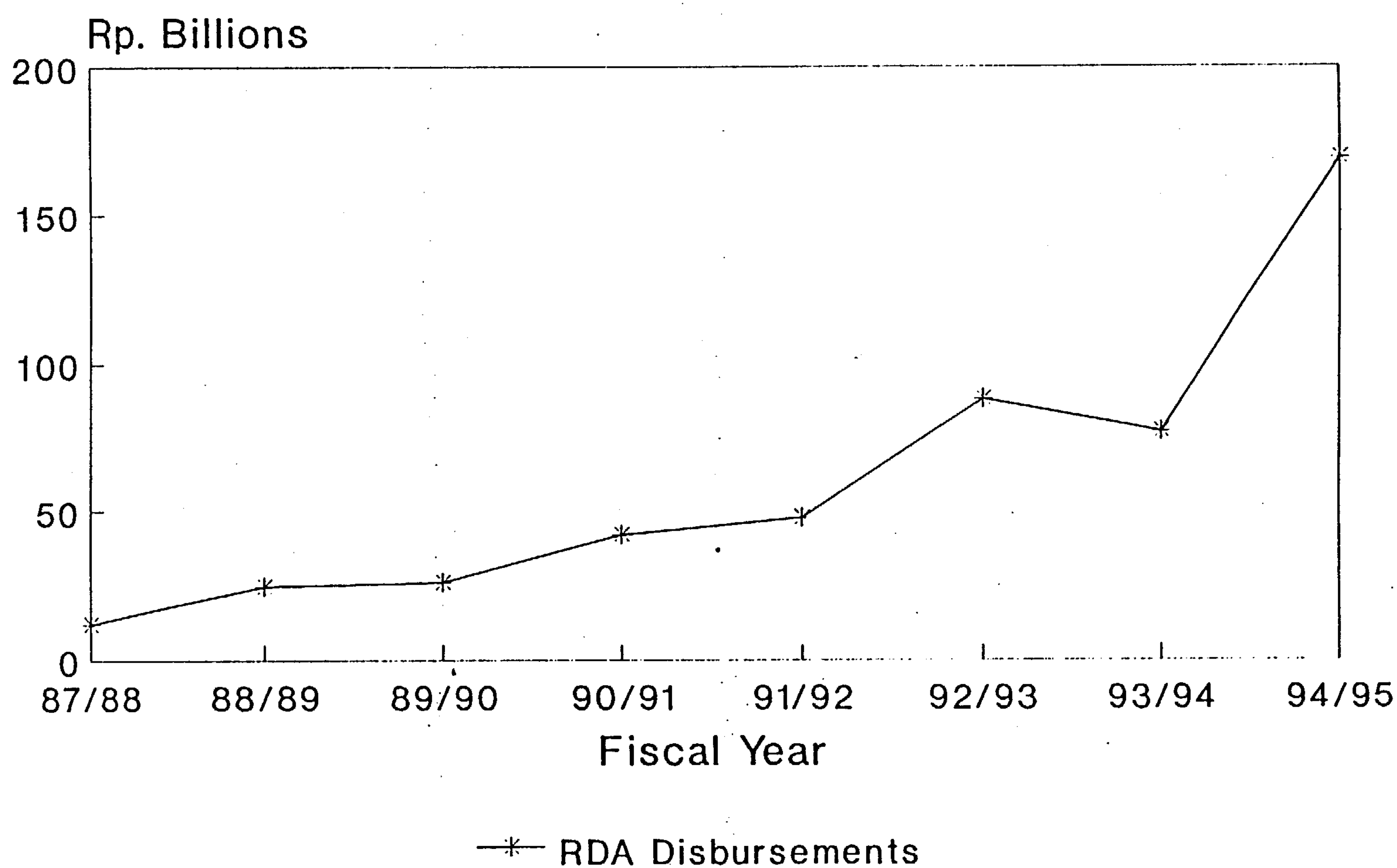


FIGURE 6:

RDA DISBURSEMENTS TO LOCAL GOVERNMENTS AND PUBLIC ENTERPRISES



Figures 7 and 8 show the distribution of RDA loans by sector and location as of 31 January 1996, with the following key features:

- o while RDA loans are distributed among 8 sectors, 83 percent of the value of RDA loan commitments went to the clean water sector, in keeping with the high priority of this sector; and
- o while RDA loans are concentrated on the island of Java, reflecting the distribution of economic activity and borrowing capacity in Indonesia, 42 percent of the value of RDA loan commitments nonetheless went to local governments and local enterprises located off Java, in efforts to support economic decentralization and regional diversification.[5]

As indicated in Figure 9 approximately half of RDA capitalization has been from national budget (APBN) allocations, with remaining sources of capital as follows:

- o 13 percent from loan repayments;
- o 12 percent from the USAID Housing Guaranty Loan (HGL) program;
- o 11 percent from the Ministry of Finance's Investment Fund Account (RDI); and

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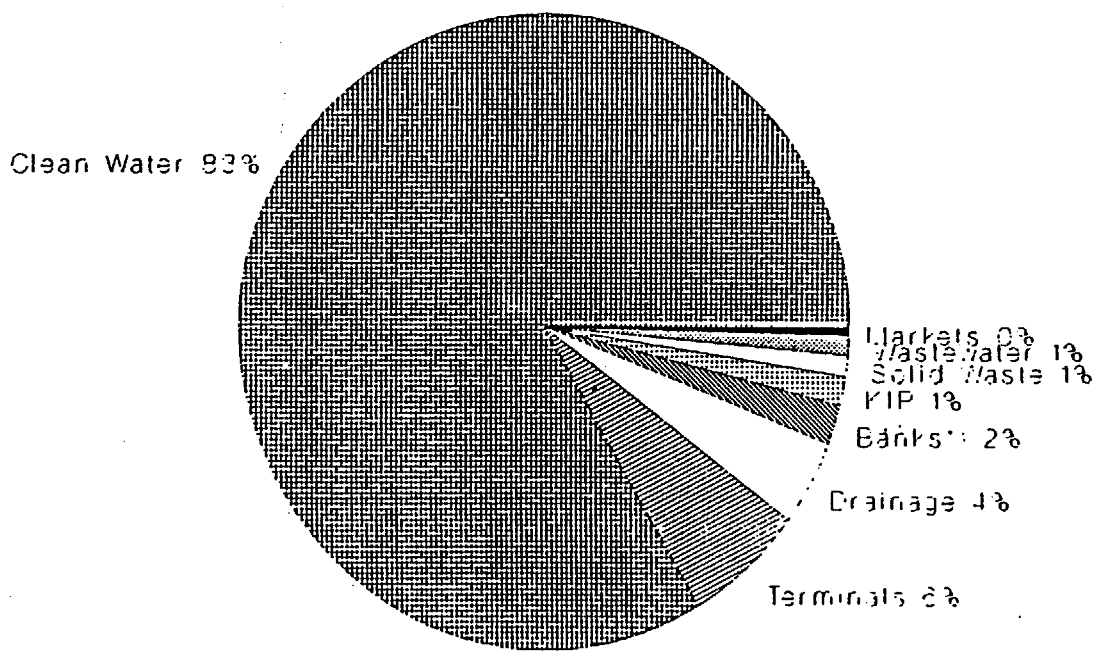
[5]Ministry of Finance.

FIGURE 7:

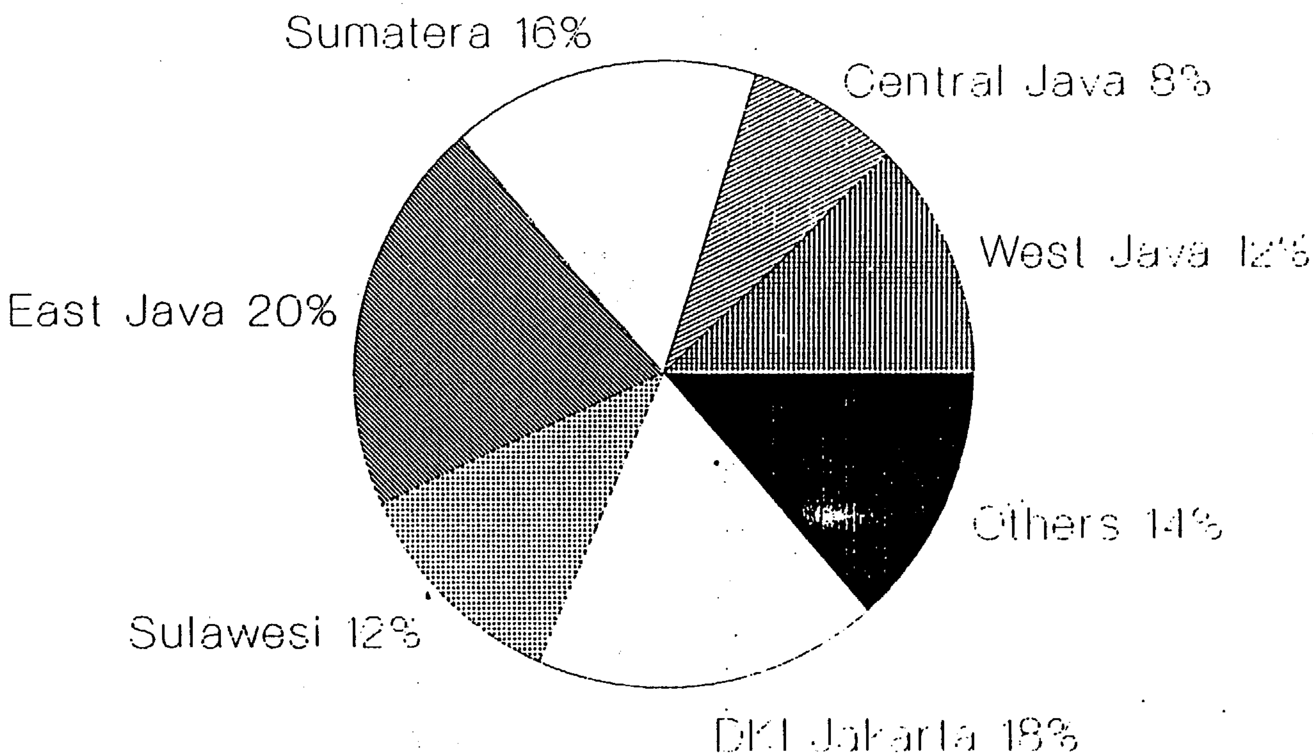
RDA LOAN COMMITMENTS BY SECTOR
As of 31 January 1996



TOTAL: RP869.2 billion

**) Pre RDA, soft loans to banks*
Source: Ministry of Finance

RDA LOAN COMMITMENTS BY PROVINCE
As of 31 January 1996



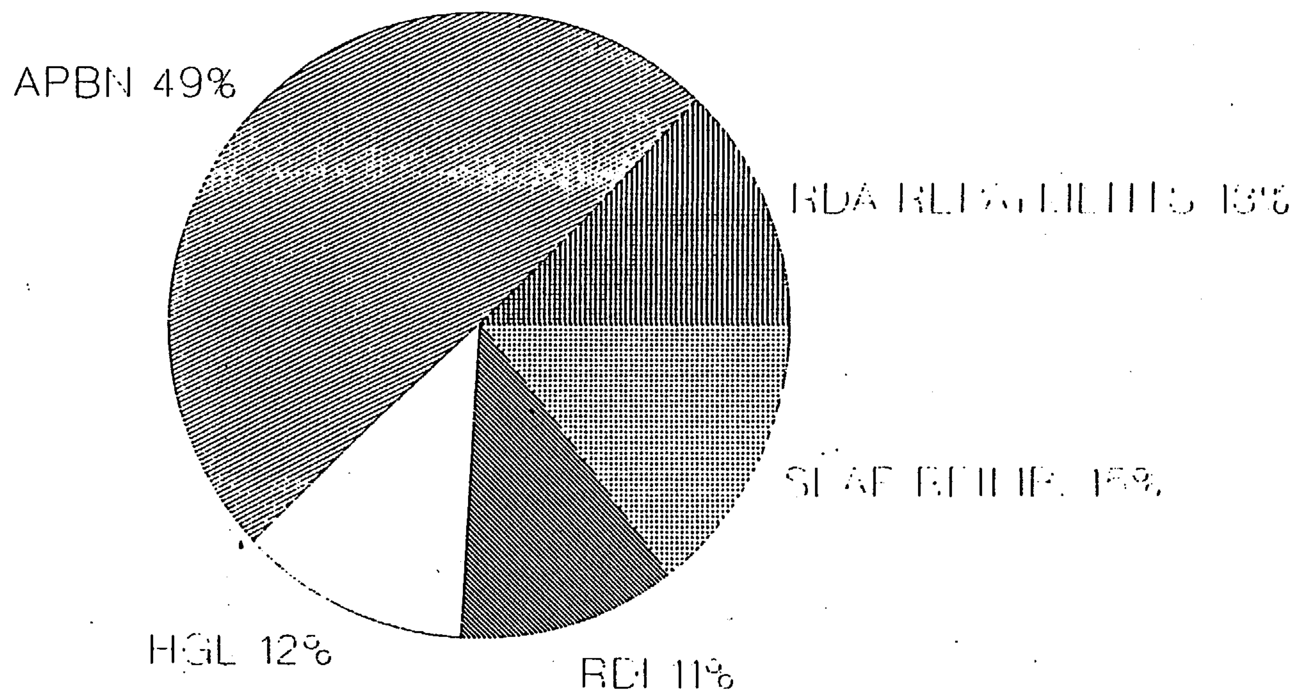
TOTAL: RP869.2 billion

Source: Ministry of Finance

FIGURE 8:

SUMMARY OF RDA CAPITALIZATION SINCE ITS INCEPTION (1991-1996)

FIGURE 9:



TOTAL: RP705.3 billion

Source: Ministry of Finance

- 15 percent from reimbursements for Subsidiary Loan Agreements Pre-financed with RDA funds (SLAPs).[6]

As indicated in Figure 10, RDA is managed by the Directorate of Subsidiary Loan Management (DitP3) in the Ministry of Finance's Directorate General for Financial Institutions (DJLK), in the Subdirectorate of Public Works and Communication Investment for RDA loan appraisal and disbursement, and the Subdirectorate of Agreements and Implementation for RDA loan administration and repayment. RDA loans have a maturity of up to 20 years, with a grace period of up to 5 years. The current RDA lending rate is 11.5 percent per annum. Any local government or local enterprise meeting RDA lending criteria is eligible to borrow from RDA.

IV. PLANS TO IMPROVE RDA

While RDA has made significant progress over the past five years, further development of RDA is constrained unless the following three challenges are addressed:

- capitalization;
- loan operations; and
- sustainability.

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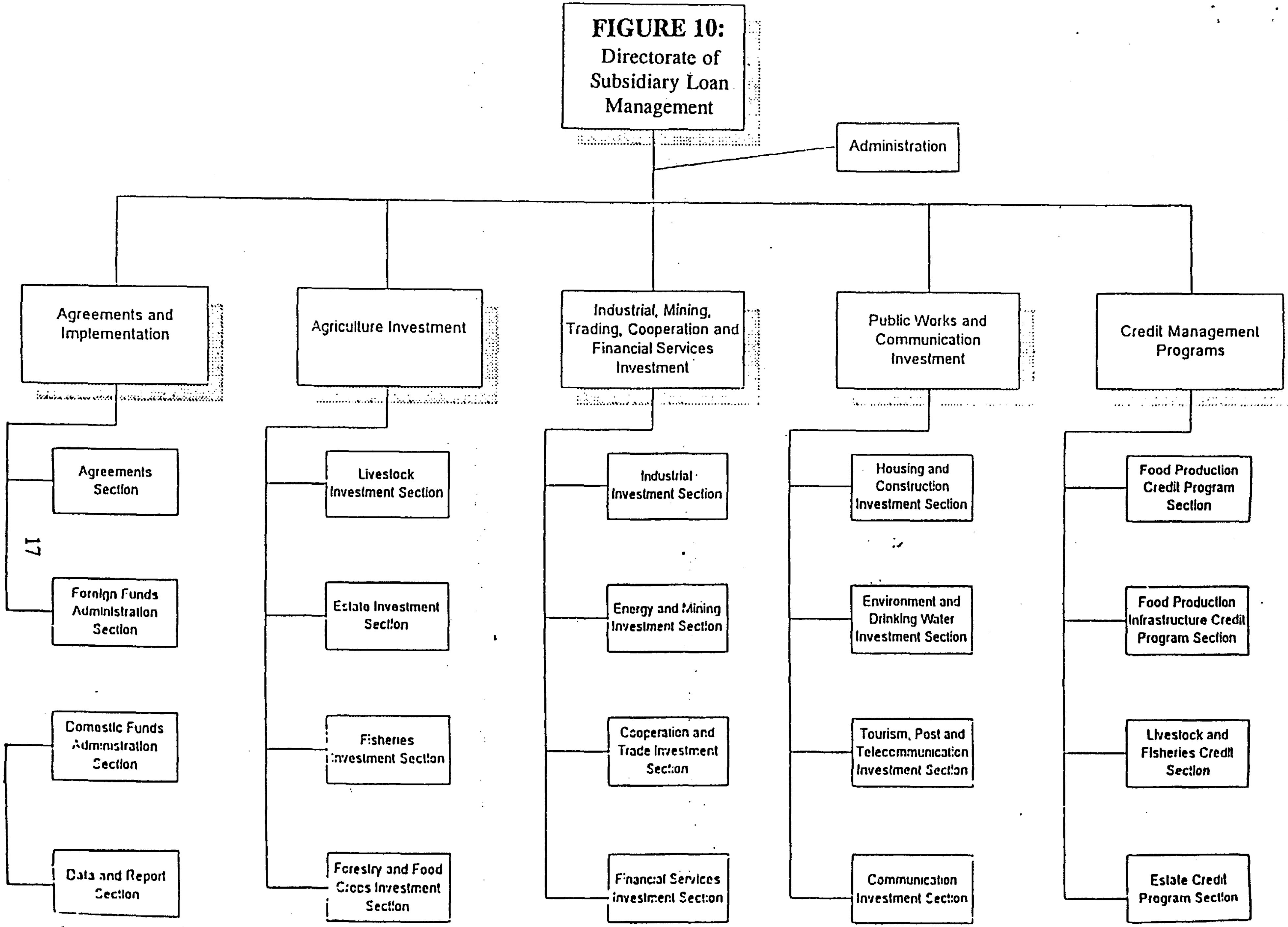
[6]Ministry of Finance.



Source: Ronald W. Johnson and Robert C.G. Varley <u>Final Report to the ADB and GOI: Technical Assistance Study for a Bank Loan and Grant Technical Assistance to the RDA</u> (Research Triangle Institute: Jakarta, 8 April 1996)

The key constraints regarding capitalization are insufficient funds to meet the demand for loans from local governments and local enterprises, resulting in a long queue for RDA credit, as well as considerable uncertainty regarding the availability of commited funds, causing expensive delays in the completion of local investment projects.

Loan operations are relatively inefficient, as they are tied to the central government bureaucratic rules and regulations, as well as to the national budget cycle. Another shortcoming of loan operations is that RDA loans at present are not secured, which makes enforcement of repayment obligations more difficult.

The long-term sustainability of RDA is weakened by its relatively low interest rates, now between soft loan and purely commercial loan rates, as well as the dependence of RDA on central government resources and facilities.

Thus, the Ministry of Finance has embarked on a-two-stage program to improve RDA. The first stage is to revise the current decree, but keep RDA under the administration of the Ministry of Finance; the second stage is to transform RDA into a self-standing municipal development fund.

Revision of the RDA Decree

Under the revised RDA decree, the primary goal of RDA remains the same: assist in the establishment of a sustainable local government credit system which can serve as a transition mechanism for local authority borrowing from the private capital market.

RDA objectives also remain the same:

- o help to meet urban investment targets by providing loan funds to local governments and local enterprises for investments in public infrastructure and services; and
- o support decentralization, by increasing the role of local governments and local enterprises in the identification and selection of high quality projects in accordance with local development priorities, while at the same time decreasing local dependence on central government transfers.

However, under the revised RDA decree, two key constraints to RDA capitalization are addressed:

- o total amount of funds in increased by diversifying funding sources; and
- o certainty of funding is increased by decreasing dependence on national budget allocations.

Under the revised RDA decree, loan operations will be improved by the gradual conversion of RDA from retail to wholesale lending, using sound regional development banks (BPDs) as financial intermediaries. Efficiency will be improved via greater speed and lower cost of loan processing, and effectiveness will be improved via higher quality and closer supervision of projects financed with RDA funds. This initiative will also help to achieve several complementary objectives regarding decentralization and regional autonomy, by enhancing the role and quality of the BPDs.

Sustainability will be improved under the revised RDA decree by:

- o increasing the financial viability of RDA via the incremental rise in interest rates to cover the full cost of lending; and
- o enhancing the credibility of RDA via the pledging of property tax revenues by local governments and receivables by local enterprises, and thus, ensuring the higher quality of the RDA loan portfolio.

A schematic depicting RDA operations under the revised RDA decree is presented in Annex 1.

RDA as a Self-Standing Municipal Development Fund

The above-summarized improvements in RDA via a revised RDA decree will lay the foundation for the eventual transformation of RDA into a self-standing municipal development fund that can serve as a full financial intermediary, by:

- raising its own funds from domestic and foreign capital markets; and
- exercising operational autonomy in the management of these funds as a sound commercial enterprise.

A schematic depicting RDA operations as a self-standing municipal development fund is presented in Annex 2.

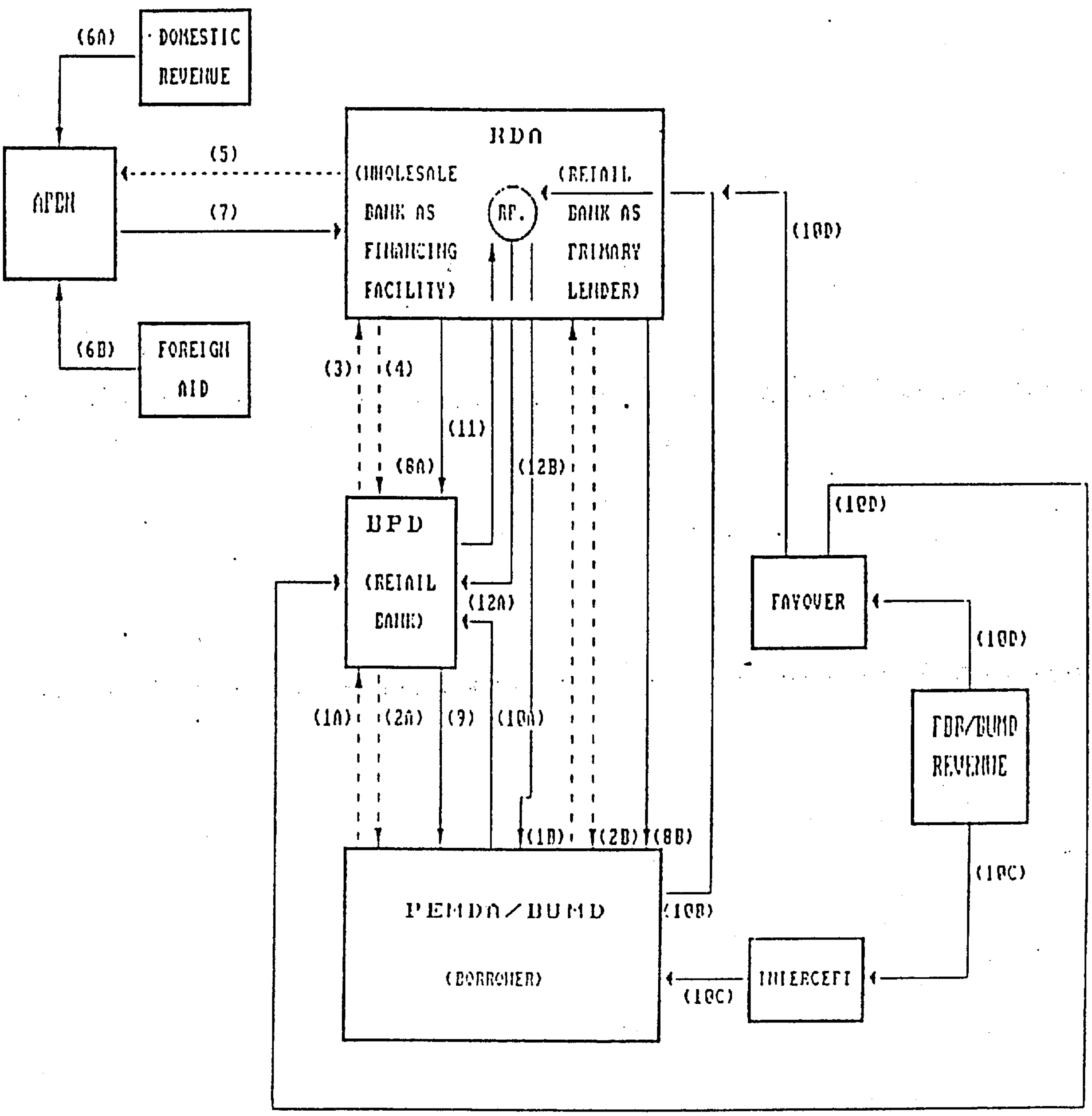
V. CONCLUSION

The Regional Development Account has contributed significantly to financing investments in urban infrastructure and services, while at the same time supporting decentralization and regional fiscal autonomy. Nonetheless, the Government of Indonesia has undertaken both short-term and long-term initiatives to develop RDA into a more efficient and effective, market-driven financial intermediary via the gradual transformation of RDA into a self-standing municipal development fund.

ANNEX 1

REVISED MOF DECREE FOR RDA

BPDS + DIRGEN FINANCIAL INSTITUTIONS



Source: Ministry of Finance

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