Chapter 25

Asia
Indonesia

After crises, decentralization and renewed efforts seek to bring local governments to the capital market.

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Lessons

In Indonesia, which has a tradition of strong unitary government and central control, meaningful political and fiscal decentralization is just beginning. The great challenge is not only to establish a new system of subnational fiscal autonomy and fiscal transfers, but to do so in a disrupted political system struggling to emerge from the financial crises of the late 1990s. For subnational credit, the legacy of national on-lending programs that have gone awry makes reformulating the debt market difficult.

In the mid-1990s the national government attempted to move local utilities into the emerging domestic bond market. However, the 1997 economic and political crises dealt the prospects for this market a severe blow. The financial markets and banking system were decimated, and the corporate market experienced heavy defaults. The rate of default by local governments on their borrowings from the central government's develop-

ment funds (which had effectively been the only long-term lenders available to them) steadily increased. The heavy arrears on these loans, coupled with the failure to deal with this situation, have eroded the perceived creditworthiness of local governments and introduced considerable moral hazard. With little appetite or capacity to finance local government debt, private credit markets are unlikely to be a source of funds in the near future. Improving that prospect requires redesigning grant and loan programs to stimulate rather than crowd out the participation of private credit markets.

As Indonesia redesigns its intergovernmental system, consulting economists are urging that officials consider integrating grants and loans in ways that promote access to private credit markets. Getting this integration process right, however, requires data and analyses that typically have not been produced in the past and that would require funding in the future. Poor financial management and reporting practices and a lack of competent human resources also impair prospects for local governments gaining access to credit markets any time soon.

On a more positive note, Indonesia is committed to political and fiscal decentralization. When local governments' spending responsibilities and revenue sources are settled and their financial management is improved, their creditworthiness, real and perceived, should improve as well. However, care will need to be taken to avoid repeating the mistakes of the past in parceling out assisted credit and insulating local governments from the costs and demands of private capital markets.

Indonesia is the world's fourth most populous country, with a population of approximately 210 million according to the 2000 census.[1] An apparent economic pacesetter during much of the 1980s and 1990s, Indonesia saw its economy swiftly and devastatingly derailed in the East Asian crisis of the late 1990s. The crisis led to the toppling of the Suharto regime and rapid political change.

A unitary state, Indonesia is divided into about 30 provinces and more than 360 local government units, including cities (*kota*) and more rural regencies or districts (*kabupaten*). Together, provinces, cities, and districts are referred to as regional authorities. In addition, some local services are provided by locally owned enterprises *(badan usaha milik daerah)*.

Until very recently Indonesia was highly centralized, with regional authorities generally lacking meaningful political or fiscal autonomy. The administration of local government was tightly controlled from the top down, with the national government having substantial presence at the local level. Regional authorities relied on central government transfers for 70 percent or more of their revenues. Almost all subnational investment projects were funded by grants or loans from the central government, a policy that has left a legacy of moral hazard following the recent regime change.

The economic and political turmoil in the years since 1997 has led to considerable loosening of restrictions on local spending and revenue raising powers. In addition, intergovernmental transfers have been increased to promote more local decisionmaking. These changes have been made in part to try to counter the separatist mentality that has spread throughout parts of the country and in reaction to the former top-down controls. Thanks to the greater intergovernmental transfers and expanded local taxing powers, some local governments now have more resources to finance their needs. Others remain impoverished. Meanwhile, the difficult economic circumstances (and the conditions imposed by the International Monetary Fund in its rescue activities) have caused the central government to reduce its own spending and subsidies.

The political restructuring and devolution in Indonesia have arrested the earlier efforts at development of the subnational credit markets. However, they also provide the potential for erecting these markets on a sounder foundation in the future.

Characteristics of Subnational Government Borrowing

Despite some early efforts by local governments to enter private credit markets, almost all the funds they have borrowed in the past 20 years or so have passed through one of two central government mechanisms:[2]

- Regional Development Account (RDA), the government's channel for lending state budget funds (some derived initially from donor funding) to regional governments and their enterprises.[3]

- Subsidiary loan agreements (SLAs), the mechanism for on-lending funds from major donors and lenders (mainly sovereign loan funds from the World Bank and the Asian Development Bank) for qualified regional infrastructure projects.

These two loan windows are operated out of the Ministry of Finance. There is no separate financial institution that focuses on lending to local governments. While regional governments have borrowed a small amount from other sources, such as regional development, state, or commercial banks, most of this borrowing has occurred in response to short-term needs, such as the management of cash flow, rather than long-term capital investment needs. Bank loans, which are relatively expensive and short term, more often go to locally owned enterprises.

Following the first SLA loan in 1978 and the initial RDA transaction in 1980, the first decade of SLA and RDA operations saw only modest borrowing. Since 1987 the volume of lending from these windows has increased: the 315,011 million rupiah (Rp) lent in 1999 was fairly typical (table 25.1). In 1978–99 the central government made some 814 loans worth around Rp 4.6 billion.[4] Most of the loans that have been made have gone to locally owned enterprises in the water sector. By 1999 about two-thirds (63.4 percent) of the country's 292 cities and rural districts had borrowed from these windows, while the rest had no experience in RDA and SLA borrowing.

To place matters in context: the volume of RDA and SLA loans that have been made does not reflect a large market, even in relative terms. Lewis

Table 25.1. Central Government Lending to Local Governments, Indonesia, Selected Years, 1980–99

Year	Loans per year		Annual disbursements (millions of rupiah)	Cumulative arrears	
	SLA	RDA		Millions of rupiah	Rate (percent)[a]
1980	0	1	18,930	16,181	47.5
1985	3	6	23,903	82,049	24.7
1990	12	27	546,003	428,499	32.6
1995	16	6	266,117	812,482	41.5
1999	15	12	315,011	843,269	41.9
Total (for 1978–99)	387	427	4,599,864	843,269	41.9

a. Arrears as a percentage of payments due (principal, interest, penalties, and the like).
Source: Lewis 2001, p. 5.

(2001) points out that total lending to regional governments as of 1999 represented only about 0.5 percent of Indonesia's GDP for that year. In South Africa for that year, by contrast, regional debt represented about 4.0 percent of GDP.

The RDA and SLA loans do not reflect market terms and conditions. Since 1989 the central government has set interest rates at 11.5 percent for both types of loans (SLA loans often carry an additional 0.25 percent interest charge, remitted to a local bank that administers repayment collections). Maturities typically range from 18 to 20 years. Grace periods on interest and principal payments are normally 3 to 5 years, with interest usually capitalized during grace periods. The government levies commitment fees on undisbursed balances. Contrast these conditions with those in the commercial market, where rates in 2002 stood at around 18 percent a year and loan maturities were much less than half those for the RDA and SLA loans.

A key problem with RDA and SLA lending is the unacceptably high level of arrears. Cumulative arrears on loan repayments (including principal, interest, and penalties), already high in the early years of RDA and SLA lending, grew steadily to more than 40 percent in 1999. At the end of 2000 subnational borrowers were at least 6 months late in making payments on some 640 loans—80 percent of the 802 loans being monitored by the central government. This high arrearage rate occurs despite substantial penalties on arrears. For RDA loans the penalty on overdue principal is 6.5 percent a year, and that on overdue interest 18.0 percent. For SLA loans the penalty is 2.0 percent over the annual interest charges. The high level of arrears taints the creditworthiness of the entire local government sector, discouraging the formation of a subnational government credit market.

Factors Shaping the Subnational Government Credit Market

Efforts to build a local government credit market are not new. The legacy of earlier efforts and recent political and economic events have led to a number of conditions that are shaping the nature and pace of the development of the subnational government credit market.

Early Efforts to Create a Market

Indonesia had a booming economy throughout the 1980s and early 1990s and was held up as one of the more successful development stories in Asia. In the late 1980s, as part of its national central planning initiative, the

country undertook limited devolution aimed at increasing local technical and administrative capacity and transferring greater authority to local governments, including the ability to market debt in the financial markets. Part of the motivation was to take some of the excess demand load off the SLA and RDA loan funds and to move self-supporting activities into the expanding commercial credit markets (Ardiwinata 1997).[5] The central government took the lead in establishing a regulatory framework for local bond issues, fostered market interest, and promoted the first generation of borrowers. The initial borrowers were to be local water utilities, which were to sell self-supporting revenue bonds.[6]

After a review of some 300 local water utilities, 25 were selected as financially healthy and therefore prime candidates for issuing bonds. Hopes were high: it was estimated that the potential demand for funds over the first three years would be about Rp 1 trillion ($300 million at the prevailing exchange rate). Three local water utilities were initially selected for the first batch of issues, but the number was reduced to two when one candidate was instead put up for privatization. The two remaining bond issues were to have been completed in 1997. However, the bond deals went awry during the financial crisis and the ensuing political turmoil of that year and the next.

At the time economists acknowledged that the true costs of issuing municipal bonds compared with those of other financing alternatives were largely obscured by distortions in the lending programs and the credit markets. The subsidized RDA and SLA loans led to an uneven playing field and fostered both long waits for assistance and political manipulation to get to the head of the line. In addition, private investors were actively promoting concession and build-operate-transfer (BOT) contracts that were not based on strictly economic merits and could have political advantages. Moreover, the high domestic interest rates favored a heavy reliance on offshore financing, which entailed substantial exchange risk—as was clearly demonstrated in the aftermath of the 1997 crisis and the devaluation.

Macroeconomic Conditions: Weak Economy and Financial Markets

Indonesia's economy was hurt severely by the 1997 economic crisis. Data from the Asian Development Bank indicate that Indonesia's real per capita GDP plummeted from $1,110 in 1997 to $600 in 1999 (Asian Development Bank 2002). In two years the country lost what had been a decade's gain in living standards.

The economic crisis affected all aspects of the economy, including Indonesia's financial and capital markets. It crippled the banking system,

which, as a result of a huge bailout program, is now dominated by the central government. At the end of March 2001 government-controlled banks held about two-thirds of the system's assets (table 25.2). This reflects a sharp increase from five years earlier, when government-controlled banks held only about 45 percent of assets. This situation, a result of actions taken by the government in response to the 1997 economic crisis, reflects the underlying weakness of the banking sector.

Of the government banks, the four state banks are controlled by the Ministry of State-Owned Enterprises. The others, formerly private banks taken over in the aftermath of the 1997 crisis, are now controlled by the Indonesian Bank Restructuring Agency. The agency has a policy of divesting itself of the banks it holds, and it has begun to do so. Successful bank divestitures are a sign of the returning health of the banking sector, since divested banks had to be sufficiently healthy to attract buyers. Restructuring should pave the way for injections of private capital into the market.

The banking system remains highly vulnerable and faces liquidity problems. Bank assets are dominated by recapitalization bonds issued by the government in response to the 1997 crisis. The shares of nonperforming loans are high, with the weighted average for the government banks about 17 percent (World Bank 2001). Private banks also face problems of liquidity and nonperforming loans.

Few debt instruments of any kind are traded in the capital market, in part because the market is dominated by the recapitalization bonds. Trading in these central government debt instruments has been minimal, largely because of the combined effect of high interest rates (which mean that the recapitalization bonds with fixed rates of interest would trade at a

Table 25.2. Banking Sector Assets by Type of Bank, Indonesia, End of March 2001

Type of bank	Assets (trillions of rupiah)	Share of total (percent)
Government banks	730.5	66
State banks (4)	470.8	43
Banks controlled by the Indonesian Bank Restructuring Agency (7)	259.7	23
Other banks[a]	370.0[b]	34
Total	1,100[b]	100

a. Includes private domestic and foreign banks and public regional development banks.

b. Estimated.

Source: World Bank 2001.

heavy discount) and banks' small effective capital ratios. There has been no primary market (much less a secondary one) for bonds issued by local governments or locally owned enterprises.

The central government is restructuring its massive public debt, which has affected the prospects for developing a long-term debt market. Under this restructuring the government expects to repay a portion of the recapitalization bonds upon maturity. It plans to roll over another portion of its maturing debt into variable interest rate bonds with longer maturities. This action should increase liquidity. While it will also increase investors' familiarity with longer-term debt instruments (a strength in the long term), in the immediate future it could absorb what little demand now exists for longer-term debt (a weakness in the short term). The government also plans to issue treasury bills, which will promote the development of the capital and financial markets by setting benchmark interest rates and increasing liquidity. Treasury bills will be issued only after approval of a sovereign debt securities law, now being developed.

The framework and infrastructure for a capital market—dating from before the 1997 crisis—is still in place. The government has developed a regulation and procedure for corporate bonds that would also apply to bonds issued by locally owned enterprises, though not those issued by local governments. Before the 1997 crisis corporate bonds were floated on the market; Darche (2002) reports corporate bond issues of Rp 15,887 billion in 1997. Indonesia has both equity and fixed income securities markets. It also has experienced underwriters that could serve as financial advisers to local governments and two local credit rating agencies operating in its securities markets, one of which (Perfindo) is trying to develop rating criteria for local governments.

The Indonesian institutional investment sector is relatively small and conservative, with combined assets of only about 6.9 percent of GDP in December 1999. In a sign of the sector's conservative practices, in 2001 the two largest public pension programs kept some 97 percent of their assets in bank deposits (which are insured by the central government). While perhaps prudent given the present uncertainties, this posture is not conducive to the formation of a long-term debt market.

The weakness of the banking sector and capital markets helps explain why banks and investors have lent only small amounts to local governments and locally owned enterprises, particularly after the 1997 crisis. Financiers also mention other reasons for the limited lending to subnational entities:

- A perception that local entities are generally not creditworthy.
- Inadequate financial reporting and disclosure.
- The disparity between public and private sector accounting and auditing practices and the resulting lack of familiarity with local governments as potential borrowers.[7]

Decentralization Policy

In contrast to the largely cosmetic efforts of the early 1990s, the government of Indonesia initiated a "big bang" approach to decentralization in 2001, aimed at transferring spending responsibilities, resources, assets, and some 2 million of its employees to the local level. While this process has not yet translated into a subnational government debt market, it may do so eventually. Undergirding the decentralization process are Laws 22 and 25 of 1999, which deal with administrative and fiscal decentralization.

Law 22 of 1999 begins to define local responsibilities—crucial for enabling local governments to define their capital investment needs and thus to borrow effectively. The law defines several broad "sectors" (such as education and public works) that local governments must implement. Regulations and decrees have begun to define functional responsibilities within these broad sectors, though more work is required.

Law 25 of 1999 is designed to strengthen local government revenues in support of decentralization. The law articulates a key goal of decentralization: "to make even the fiscal capacities of regional governments to finance their expenditure needs." While the fact that local responsibilities have not yet been fully defined makes it difficult to assess the sufficiency of the resources provided, the sources so far assigned to local governments have provided substantial resources. In addition, some local governments are reportedly taking matters into their own hands and have substantially raised local taxes and charges, arguing that they are free to do so under the new decentralization regime. Aside from creating greater horizontal imbalances, this is seen as harmful to local economies and internal commerce (Firdausy 2002).

A major tool for meeting the goals of vertical and horizontal fiscal balance is the general allocation grant. Law 25 of 1999 requires the central government to direct at least 25 percent of its revenues to the general allocation grant—a substantial amount. The law allows local governments to decide how best to use these resources. In principle, operating surpluses could be used to secure debt or for pay-as-you-go financing of capital investment. In practice, however, the prohibition on dismissing employees

transferred from the central government to the local level has meant that, on average, local governments use more than half the resources from the general allocation grant to pay for employee salaries and benefits.

New revenue sources under decentralization include some that the central government is to share with subnational governments, such as property-related taxes, natural resource revenues, and a tax on personal income. The revenue sharing is aimed in part at responding to regional aspirations for greater access to and control over revenues derived locally (such as through petroleum extraction). Because the bases of these shared revenues (property value, natural resources, personal income) are unevenly distributed in Indonesia, the chosen approach to revenue sharing will tend to exacerbate differences in per capita income among governments. As a result, when a subnational credit market eventually develops, that market may be segmented, with richer local governments better able to access private sources of capital than poorer ones. A strategy for rationally allocating credit and grant resources among local governments will need to take into account these differences in their access to resources.

The government of Indonesia has thus taken big strides toward providing local governments with additional resources. However, it has not yet devolved the portion of the development budget corresponding to local areas of responsibility. Lewis (2001, p. 40) estimates that some Rp 15–25 trillion of the Rp 52.3 trillion budgeted by the central government in 2001 for development expenditures corresponds to areas of responsibility that are now being decentralized. Closely related to this circumstance, a specific-purpose grant, contemplated by Law 25 and earmarked for financing specific types of capital investment, has not yet been made fully operational. Thus, responsibility for capital investment in areas of local responsibility (along with the corresponding resources) has not yet been fully defined and consolidated at the local level.

Transfers and shared revenues dominate local revenues in Indonesia, with own-source revenues contributing only around 5 percent of the total on average. Analysts generally expect local taxes and user charges to produce more flexible and reliable income streams than transfers or shared revenues from the central government. Thus, until the shared taxes and transfers become fully institutionalized, this situation hurts the creditworthiness of local governments. The Ministry of Finance is evaluating alternatives for new or devolved taxes that could serve as a cornerstone for a system of local government finance.

Legal and Regulatory Framework Governing Debt Transactions

Law 25 of 1999 generally confers on local governments the right to borrow without excessive central government interference; Regulation 107 of 2000 further clarifies this right. This right, however, has been temporarily countermanded by a partial moratorium on borrowing by local governments. Responding in large part to post-1997 concerns about excessive public debt, a Ministry of Finance decree prohibits new borrowing by local governments from domestic or foreign sources until the end of 2002. Exempted from this prohibition are borrowing through an on-lending vehicle (such as the SLA) and short-term borrowing for cash flow management. Borrowing by locally owned enterprises is also exempted.

With this moratorium scheduled to be lifted, a review of the legal and regulatory framework is warranted to see whether it provides for well-constructed, enforceable, and transparent credit transactions with local governments—a precondition for the emergence of a local government debt market. This review points to several areas in which laws and regulations should be revised or clarified to allow better credit transactions and the development of a market for local government credit.

Regulation 107 in effect requires that the terms and conditions of a foreign loan that is to be on-lent to local governments be passed on to the local borrowers, including foreign exchange risk. This is a heavy burden to impose, and it has complicated recent efforts to reactivate RDA and SLA lending, which have been constrained by the moratorium. Moreover, it runs contrary to typical practices for on-lending international public resources to local governments.

A lender to a local government will seek as much security for the loan as possible. If loans cannot be sufficiently secured, a local government debt market probably will not take root. Local governments face excessive restrictions on the assets they can pledge to secure debt. Existing regulations do not clearly establish their right to pledge expected future revenues.

Nor does the law provide sufficiently for the use of a trust mechanism in local government debt transactions. Such a mechanism can help to ensure that borrowers use funds for the purposes intended and comply with loan terms and conditions, including debt service payment schedules. Trust mechanisms are particularly important in countries where rule of law is poorly developed, such as Indonesia. While the Capital Markets Law in-

cludes trust provisions, their applicability to local government debt transactions is not clearly established.[8]

Another potential route to help secure debt is a revenue intercept provision, allowing creditors to intercept revenue transfers to local governments to pay debt service. Law 25 of 1999 and Regulation 107 provide for intercept of general allocation grant funds. While encouraging, this provision appears to give the central government (as a lender through, for example, its RDA window) a senior position relative to other creditors of a local government. This situation does not encourage private entry into the local government credit market. Moreover, the intercept provision has not yet been made fully operational or tested.

Also needing further clarification is the applicability of financial reporting and disclosure provisions in the Capital Markets Law to local governments. Adequate disclosure is essential for the economic decisionmaking that allows a sustainable debt market to flourish. Weak coordination among central government oversight units adds to the difficulties. At present, oversight responsibilities for local financial reporting are shared by the Ministry of Home Affairs and the Ministry if Finance, and the two have not agreed on what accounting and reporting standards to follow. Adding to the difficulties is the low level of managerial and financial competency in many local governments, a problem that needs to be resolved by training and instilling a greater sense of professionalism.[9]

Reforming Public Lending Programs

The heavy arrears on the RDA and SLA loans have been attributed to a number of factors. One of the most important is organizational: the fact that the RDA and SLA loan windows operate out of a multipurpose government agency, the Ministry of Finance, may impede effective loan administration. Unlike a specialized entity, the Ministry of Finance must try to satisfy multiple—and sometimes conflicting—objectives. For example, the ministry is responsible for allocating the general allocation grant, a mandate that could complicate the exercise of authority to intercept funds from this source to enforce loan repayment. Other factors also play a part:

- Local officials argue that they should not be held responsible for the outstanding loans that predate decentralization, because the loans were made with little meaningful local participation or agreement.

- Most loan agreements have been uncollateralized and therefore virtually unenforceable. (Recent loan agreements provide for an intercept of general allocation grant transfers, though this mechanism has not yet been used.)
- The system and criteria used to evaluate the creditworthiness of potential borrowers and project proposals were inadequate. In the past many SLA and RDA loans were awarded to local governments and locally owned enterprises that had significant arrears on existing loans or whose creditworthiness was otherwise not adequately assessed. More recently the government established a policy of making no additional loans to borrowers in arrears on previous loans. However, some local entities have received new loans despite being in arrears.
- Inability to pay does not help explain nonpayment by local governments. Lewis (2001) finds that the average amount borrowed by local governments in the 1990s was only Rp 1,580 million, while the average operating surplus was Rp 3,444 million, suggesting that local governments borrowed well within their capacity to repay. He concludes that "poor repayment of debts is more a function of unwillingness to repay than it is fiscal inability to make good on repayments . . ." (Lewis 2001, p. 21). Local governments in Indonesia have learned over time that they do not need to repay.
- While the government has approved a small number of debt restructuring plans for local water utilities, it has not yet put in place a comprehensive policy and program to deal with the loan arrears. This policy of indecision in effect penalizes local governments that continue to pay off their loans.

Integration of Loans and Grants

Among the many unfinished pieces of the Indonesian subnational loan agenda is how to better integrate loans with grants, to avoid having the availability of grants impede rather than support the development of capital markets. One proposed approach is to transform interest rate subsidies into a "buy-down" of the capital that a local government must borrow for a project. (The amount of that buy-down and thus the size of the subsidy could be based on various indicators of the project's affordability to the local population.) The local government would then borrow the remaining amount at prevailing commercial rates from private entities. This tech-

nique has the virtue of providing the subsidy in one lump at the outset and exposing local governments to market conditions on the margin of their financing needs.[10]

The integration of grants and loans is not an original idea. Others looking at Indonesia have argued that a significant disadvantage in developing a credit market culture is the real or potential availability of grants that scuttle the demand for loans at prevailing market rates.[11] The indiscriminate use of grants, it is argued, builds a culture of dependence on subsidies and hinders the development of notions of cost recovery. It also can stymie efforts to induce local governments to enter the capital markets. By the same token, a conscious regimen of exposing local governments to private market demands and credit expectations will benefit the development of both private lenders and government borrowers.

Integrating grants and loans for projects would require a combination of technical and affordability analyses. First, technical parameters, based on best practices in engineering, are needed to determine what operation is most efficient at different scales and with different processes and what costs are reasonable for constructing the project facilities. The analysis, the stuff of standard feasibility and engineering studies, would determine standardized annual cost functions, the capital investment needed, and its cost.

Second, in the more critical step for determining the size of the grant needed, the capital investment required would be translated into a standardized annual debt service cost. This is done by applying a factor that reflects a commercial cost of capital on the assumption that the debt could be borrowed for a period corresponding to the useful life of the project. Thus in addition to the operating and capital cost figures, a study is needed of the likely use of the facility and the applicable rate structure to determine the likely operating revenues.

The underlying idea is that for certain classes of users (say, residential users in the lowest income brackets) the potential for revenue generation may be severely limited. Facilities with a large share of low-income users would be the most likely candidates for grants (that is, some form of capital subsidies).[12] Thus the subsidies to facilities would be “means tested” and the subsidy would come from lowering (or in some cases eliminating) future debt service payments by providing a one-time capital grant that reduces the amount to be borrowed. This up-front grant is suggested rather than subsidized interest rates or operating subsidies because both of these must be extended into the future, require ongoing administration and monitoring, and tend to conceal the amount of subsidy.[13]

The critical question is, how large should the capital grant be? To decide this, an objective measure needs to be developed for an acceptable burden of water charges paid annually by the poorest users (residential and commercial). These affordable charges then can be "backed through" the revenue system to form a constraint on the annual revenues available to pay the operating and debt service costs. This constrained sum would be compared with the sum of annual operating costs (assuming efficient technical and economic operation) and the prototype "market proxy" annual debt service—or the required annual revenue. The extent by which the required annual revenue exceeds the needs-constrained revenue represents the proportion by which annual debt service must be reduced to make the facility feasible for debt financing (at least in part). Where the acceptable level of annual charges is equal to or less than the expected operating costs of the facility (without including debt service), it is unlikely that any of the project should be considered for debt financing.[14]

In the present era of reform in Indonesia, it is hoped that new approaches to integrating grants and loans will be used and that the mistakes of the past will not be perpetuated in the future. Twin reforms in intergovernmental finance and the financial system have the potential to be mutually reinforcing and beneficial.

Prospects for a Local Government Debt Market

The prospects for developing a local government debt market in Indonesia are undoubtedly mixed. These prospects were dealt a severe blow by the 1997 economic crisis, the after-effects of which will linger for some time. In addition, the heavy arrears on RDA and SLA loans, coupled with the lack of a comprehensive program to deal with this issue, have eroded the perceived creditworthiness of local governments. The legacy of unpaid concessional loans, rampant moral hazard, unsettled intergovernmental relations, and a weakened financial sector conspires to make achieving a market-based credit system for local governments a difficult feat, at least in the near to intermediate term.

Still, there are reasons for hope. Indonesia has embarked on true decentralization. When the implications of this process are fully realized—that is, when local governments have a clearer list of local responsibilities, a stronger set of own-source revenues, and a more effective approach to financial management—these governments will have a chance to improve their creditworthiness. When these strengthened local governments en-

counter a revived private sector and a rationalized public sector, Indonesia should see the emergence of a market for local government credit.

Notes

1. This section draws heavily on Lewis (2001).

2. This section draws from Kehew and others (2002).

3. The predecessor of the Regional Development Account was the Investment Funds Account. In this chapter loans made through the earlier account are grouped with RDA loans.

4. RDA and SLA loans also mobilized additional resources, typically requiring a 10 to 25 percent match from the central government, the local borrower, or both.

5. Indonesia had a small but growing corporate debt market and some institutional buyers at the time and was trying to develop its securities markets.

6. Local general governments (that is, regional authorities other than certain self-supporting utilities such as the local water utilities) were seen as having revenue systems too weak and inflexible to support bond issues. Moreover, it was thought that investors would better understand the accounting systems of the local water utilities.

7. Other factors, such as the lack of a well-established intercept mechanism for intergovernmental revenue transfers, are discussed below.

8. The early plans for using revenue bonds did include contracts that acted like trusts. Because there was no established trust law in Indonesia, each contract was unique. The mechanism and the enforcement of the trusts were never tested.

9. See Firdusay (2002, p. 82). Financial management at the local level is portrayed as often not only incompetent, but also corrupt. The head of the capital markets supervisory agency (BAPEPAM) cites the inability of local finance offices to do proper accounting and financial reporting as an impediment to their entering the financial markets.

10. See Johnson and Petersen (2002). The following section draws heavily from that report.

11. On the case of Indonesia, see Smoke (1999). On grants undercutting loans as a problem in credit market development, see Weitz (2001, p. 5). A recent World Bank document (2002, annex 2-3, pp. 40–41) states approvingly that it appears that the specific-purpose capital grants would depend on the income of governments and the nature of the project and that

wealthier governments would qualify for only limited grants because they qualify for commercial borrowing on most investments.

12. There may be a good deal of cross-subsidy at the local level, with richer users subsidizing poorer ones. But there are limits on how much cross-subsidy can occur in a locality without driving out the richer ratepayers, and in some localities there may be too few rich users to offset the costs of serving the poor.

13. See Varley (2001, p. 5), who argues that subsidized rates and other soft terms lead to the buildup of hidden liabilities and crowd out private suppliers of credit.

14. It is conceivable that a project could generate insufficient revenue to pay the everyday operation and maintenance costs, let alone debt service costs. In that case operating costs as well as capital costs may need to be subsidized. It is best to identify these two components separately and to try to make the project self-supporting at least to the level of operation. In Indonesia general allocation grants could be used to subsidize operations, while specific-purpose grants should be project specific, means tested, and used only for one-time capital grants.