



## Indonesia: Strengthening the Local Government Bond Market

Project Name	Strengthening the Local Government Bond Market	
Project Number	48169-001	
Country	Indonesia	
Project Status	Active	
Project Type / Modality of Assistance	Technical Assistance	
Source of Funding / Amount	<b>TA 8753-INO: Strengthening the Local Government Bond Market</b>	
	Financial Sector Development Partnership Special Fund	US\$ 420,000.00
Strategic Agendas	Inclusive economic growth	
Drivers of Change	Governance and capacity development Knowledge solutions Partnerships Private sector development	
Sector / Subsector	<b>Finance</b> - Finance sector development	
Gender Equity and Mainstreaming	No gender elements	

## Description

Lack of infrastructure. ADB has identified lack of infrastructure as a binding constraint in the development of Indonesian's economy. The government also shared the same views and estimated investment needs for infrastructure within 2010-2014 to be roughly US\$ 214 billion. Limited fiscal space, however, led the government to look for more private participation in infrastructure projects. The Economic Master Plan for Acceleration and Expansion of Indonesia Economic Development, 2011-2015 (MP3EI) identifies national infrastructure projects that can accelerate and expand Indonesia's economy. The implementation of MP3EI requires commitment from the central and also the sub-national governments (SNGs). Under Indonesia's decentralized governance structure, the provision of infrastructure has increasingly become the responsibility of SNGs bodies, which defined by Law 32 on regional governments to be provincial, district, and municipal levels. Despite this, most funding is still derived from national government transfers, with little mobilization at the sub-national levels. This TA aims to assist in building the capacity of selected SNGs to mobilize funding for infrastructure development through the issuance of bonds and also to improve local government's capacity to prioritize their investment needs.

Decentralization gives more responsibilities to SNGs. Indonesia's long-term decentralization policy objectives are to improve the delivery of basic services and infrastructure to local communities across the country. Since implementation of *big bang* decentralization reforms in 2001, about 33% of total public expenditure, up from barely 7% in 2000, have been delegated to SNGs. The reforms launched in 2001 involved a massive delegation of responsibility for the provision of public services and the reassignment of two-thirds of central government civil servants and more than 16,000 service delivery facilities to SNGs. Now, SNGs are responsible in managing their own fiscal and development affairs. The management quality of their public investment, including the infrastructure sectors, corresponds to the quality of basic service delivery given to their constituent. The result on the ground, however, has been disappointing. While many SNGs run fiscal budget surpluses, when capital investment needs are taken into account, they have insufficient financial resources to meet their investment needs, which far exceed their revenues and surpluses. In effect, public service delivery at local level has been disappointing and negatively impacts local business environment. With low quality of infrastructure, local business activities have not reached their optimal level. On this background, there is a need for more private participation in mobilizing large-scale infrastructure funding. Municipal bonds are seen as one way to encourage more private participation.

Local service delivery is mostly financed with central government grants. Currently, the largest unconditional grant available to SNGs (the General Allocation Fund [DAU]) accounts, on average, for 50% of total SNGs' revenues. The SNGs' share of revenues from extractive industries (the *dana bagi hasil* [revenue sharing]) represents 17% of their revenues; an additional 7% is accounted for by the infrastructure development grant (the Specific Allocation Fund [DAK]). Total grants to SNGs have more than doubled since 2005, from an estimated Rp150 trillion to around Rp350 trillion in 2010. Local revenue, from limited taxes and charges, represented about 16% of total SNGs' revenue. In addition to these revenues, more and more SNGs are borrowing money from the central government to finance their capital projects.

Local financing relies mostly on central government loans that are given through either Subsidiary Loan Agreements (SLAs) or the Regional Development Account (RDA). The loans made through these mechanisms, particularly the SLA, were often driven by central ministries managing donor-financed projects that were conceived and designed to respond to concerns articulated at the central, rather than the local level. The commitment of SNGs and enterprises to repay their loans was never tested *ex-ante* in these arrangements, and *ex-post* problems arose. In addition, the RDA and SLA were managed primarily as central government programs. The SNGs view the ownership of projects funded through RDA and SLA is with the central government.

Options needed to increase public capital investment. To increase capital investment over time, SNGs will need to have access to various sources of funding beyond the intergovernmental transfers and SNG's own source revenues. Therefore, it is necessary for the central government to develop an appropriate SNG borrowing and debt management framework, in particular to facilitate creation of sub-national capital market and encourage active participation of SNGs into the market.

Municipal bonds as options to increase local financing for infrastructure projects. The central government has allowed SNGs to issue local bonds since 2007. The aim is for SNG to finance their public investment which has multiplier effect and not to finance local operating budget deficit. The regulation is based on international best practices that emphasize fiscal capacity. Criteria that are based on institutional requirements and financial viability ensure no weak and debt-ridden SNGs can issue a municipal bond. The two institutional requirements are the SNG need to obtain unqualified or qualified opinion from the *Supreme Audit Board* and there needs to be a functioning *debt management unit* within their PFM organization. The two financial criteria are: the SNGs' aggregate debt-service coverage ratio (DSCR) is no more than 2.5 and the accumulated debt of the SNG is no more than 75% of last year revenue. These criteria were in place to avoid SNGs overextending themselves--overburdening themselves with debt and projects--in the environment where their financial management quality is generally weak.

Problems in municipal bonds' issuance. A single municipal bond has not been issued to date, due to two main issues: credit worthiness of the SNGs and the widespread lack of capacity of SNGs financial officers.

The proposed TA aims to assist potential SNG to issue municipal bond by assisting them in building up their credit worthiness. First, the TA will assess the capacity of the SNG in managing their finance. There is already available diagnostic tool that can assess. For example, Standard and Poor uses their Financial Management Assessment tool to assess the financial viability's of SNGs. In the case of Indonesia, Pefindo, a local credit rating company, has used S&P FMA to assess the financial management of three municipalities, i.e. Jakarta, Balikpapan, and Makassar. The findings show that a general lack of capacity of local PFM officers is the biggest impediment. Of course, the specific PFM related competency for each city can vary. Second, the TA will build the capacity of SNG in PFM and debt management skills. Lack of PFM and debt management skills at the local level has contributed to private lenders' reluctance to make unsecured lending to the SNGs. This weakens the credit culture among SNGs. Defaults on loans by SNGs appear to be due to more an unwillingness to repay rather than the inability to repay. This is evident from the large number of local water supply utility companies (PDAM) in arrears yet SNGs continue to accumulate cash reserves. It appears that SNGs tend to view debts owed to the central government as *grants* rather than loans. Third, the TA will build the capacity of project selection in SNGs. Given that municipal bonds in Indonesia needs to be linked to a project, it is thus pertinent for SNGs be able to select good and viable projects to be funded by the bond. Good projects will also provide strong signal on the bond itself, and thu

Project Rationale and Linkage to Country/Regional Strategy

The proposed Technical Assistance (TA) is in line with ADB decentralization program in Indonesia, and complements the ongoing ADB programs in the public finance management (PFM) such as the State Accountability Revitalization (STAR) Project, and also ADB's capital market development program, such as Financial Market Development and Integration (FMDIP) Program. The project aims to build the capacity of the regional level authority to tap into financial resources beyond central government transfers particularly for local government infrastructure financing through bond issuance, hence addressing the weak link in Indonesia's capital market program

ADB views strengthening debt management capacity and creditworthiness of sub-national government at local and regional levels with an emphasis on municipal bonds is an important conduit to improve governance aspects at local level and also opens access to capital market. The program will support one province in its effort to access capital markets for infrastructure finance, and improve the regulations that regulate the municipal bond issuance as well as capacity building for the central government.

In designing the proposed TA, the Mission took into account:

1. Address the issue of supply and demand side of the subnational bond market in Indonesia.

On the supply side, the proposed TA will focus on working with the provincial government of West Java in improving their capacity in planning for capital investments, project selection, and improved financial management capacity. Increasing the capacity of SNGs in project selection will be a key to a successful local government bond market because the government regulation on municipal bond states that each municipal bond must be linked to a viable project that can provide a regular revenue stream to the SNG (i.e. modified revenue bond, not a general obligation bond). Another crucial assistance is on the support for improving financial management.

On the demand side, the proposed TA will focus on fine tuning the existing regulation on subnational bond. As such, some of the activities will work directly with OJK and possibly Bank of Indonesia. For example, the activities that will be undertaken are promoting subnational bond as one of the public securities so that they become admissible for statutory liquidity ratio (SLR) investment by commercial banks, improving the existing regulation on subnational bond on public disclosure and public investment guidelines, and conducting a shadow subnational bond issuance.

2. The synergy with the Economic Master Plan for 2025 or MP3EI master plan.

The master plan identifies the need for more infrastructure investment by the government to accelerate and expand the economy by 2025. The master plan's approach is to expose the competitive advantage of each region in Indonesia. Thus, it divides the country into 6 economic corridors. Within the corridors, the master plan identifies the infrastructure needs. The proposed TA takes into view for infrastructure needs in the selection of sub-national government that it will work.

3. Experiences from other development partners in advocating municipal bond in Indonesia.

In the implementation of the proposed TA, the experience of the World Bank team in assisting the Government of Jakarta will be taken into account. The Government of Jakarta has already initiated plans to finance \$120 million of their capital expenditure through a municipal bond. The funds raised will be used to finance projects in water and sanitation, transport, and housing. It was initially planned for the bond to be issued at the end of 2012. However, the new Governor stopped the process on the basis of high budget surplus from 2011.

Understanding the local political economy context in proposed SNGs under the proposed TA will assist the smooth implementation of the TA.

4. Work with a local government that plans to issue a subnational bond before the end of 2015.

The main local governments that will be assisted under the proposed TA is West Java. The focus on West Java is based on:

1. Earlier ADB's assistance has provided shadow rating for West Java. The rating result was AA or three notches below the rating of the central Government's treasury. According to the rating report, West Java's strong cash reserve position and robust economic growth have made the province's rating to be good. However, issues related to high poverty needs to be addressed to improve the rating.

2. The need to have more private sector participation in West Java to meet their capital development plan. As the third largest regional economy in Indonesia, the West Java Planning Agency estimated that the provincial government needs at least USD31 billion to finance their capital development expenditure in the next 30 years. Attracting more private investment requires commitment from the provincial government to continue to address PFM. In this context, the provincial government has already implemented measures that have improved its governance rating. Measures, such as installing a regional finance management system (with the help of ADB), have improved the ranking of their Performance Evaluation of Regional Government (EKPPD) from the rank of 15 out of 33 in 2009 to rank 8 in 2012. The improvement is also recognized by the Supreme Audit Board (BPK) by awarding the provincial government's financial statement an unqualified opinion. These advancements in governance are aimed to attract more private investment.

3. The provincial government's commitment to issue bond. As such, a governor's decree on establishing a formal team that consists of the regional planning agency, finance division, economic division, and also the governor's office was issued in October 2011. The team has actively met other relevant stakeholders at sub-national and national levels. A feasibility study and a time schedule on the issuance have also been produced. Following the timeline, West Java's municipal bond is expected to be issued by September 2015. The team budget is also indicative of the province's commitment. From the stand-point of the Ministry of Finance, the province's achievement on getting an unqualified opinion provides a clear path for them to issue a municipal bond.

4. A local infrastructure project needs that links to national interest. The Kertajati international airport which will be the underlying project to be financed by the bond proceeds is also listed in the MP3EI, thus it links to national interest. As such, the aero part of the airport will be the responsibility of the central government, and the State Budget has been allocated to support the development of the aero part.

Impact	A more conducive environment for the development of a subnational bond market in Indonesia
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**Project Outcome**

Description of Outcome	Debt management unit in West Java is operational
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Progress Toward Outcome	
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## Implementation Progress

Description of Project Outputs	<ol style="list-style-type: none"><li>1. Debt and financial management capacity of the participating SNG assessed and improved.</li><li>2. Draft local regulations on the establishment of debt management unit and municipal bond in West Java are introduced.</li><li>3. Capacity of the SNG in project selection increased.</li><li>4. Policy notes on capital market regulation supporting subnational bond issuance produced.</li></ol>
Status of Implementation Progress (Outputs, Activities, and Issues)	Ministry of Finance, Supreme Audit Board, OJK, and Provincial Government of West Java have agreed on the step to move forward to solve pertaining issues to the municipal bond issuance. A series of Focus Group Discussion and resource person, financed by ADB, were commenced in Q4 2015 with Provincial Government of West Java to map out the issues. The Provincial Government is expected to issue the bond by Q3 2017.
Geographical Location	

## Summary of Environmental and Social Aspects

Environmental Aspects

Involuntary Resettlement

Indigenous Peoples

### Stakeholder Communication, Participation, and Consultation

During Project Design

During Project Implementation

## Business Opportunities

Consulting Services	The TA will require 23 person-months of consulting services over an implementation period of 18 months (1 August 2014 to 1 February 2016). The consultants will be a mix of individuals and firms selected through fixed-budget selection (FBS) using a bio data technical proposal. The FBS will be used as the term of reference will be precisely defined with no changes expected during implementation, the time and personal inputs will be assessed accurately, and the budget is fixed and cannot be exceeded. The consultants will be engaged by ADB in accordance with the Guidelines on the Use of Consultants (2013, as amended from time to time). All procurement will be done in accordance with ADB's Procurement Guidelines (2013, as amended from time to time). Disbursement will confirm to ADB's Technical Assistance Disbursement Handbook (2010, as amended from time to time).
Procurement	All procurement will be done in accordance with ADB's Procurement Guidelines (2013, as amended from time to time).

## Responsible Staff

Responsible ADB Officer	Hattari, Rabin I.
Responsible ADB Department	Southeast Asia Department
Responsible ADB Division	Indonesia Resident Mission
Executing Agencies	<i>Directorate General Fiscal Balance Jalan Lapangan Banteng Timur 2-4 Jakarta Pusat 10710 Indonesia</i>

## Timetable

Concept Clearance	28 Apr 2014
Fact Finding	07 Apr 2014 to 11 Apr 2014
MRM	-
Approval	30 Oct 2014
Last Review Mission	-
Last PDS Update	29 Sep 2016

## TA 8753-INO

Milestones					
Approval	Signing Date	Effectivity Date	Closing		
			Original	Revised	Actual
30 Oct 2014	18 Feb 2015	18 Feb 2015	30 Apr 2016	30 Apr 2017	-

Financing Plan/TA Utilization						Cumulative Disbursements		
ADB	Cofinancing	Counterpart				Total	Date	Amount
		Gov	Beneficiaries	Project Sponsor	Others			
420,000.00	0.00	0.00	0.00	0.00	0.00	420,000.00	30 Oct 2014	49,322.90

Project Page <https://www.adb.org/projects/48169-001/main>

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