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Local Government Borrowing and Repayment in Indonesia: Does Fiscal Capacity Matter?

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Summary. — Most regional government borrowing in Indonesia has been conducted via central government mechanisms. While the terms and conditions of central lending have been highly favorable to regional borrowers, repayment of debt has been very poor. The empirical evidence suggests that local governments have borrowed well within their fiscal capacities to repay and that repayment problems are largely a function of unwillingness to repay debts and of central government acquiescence. Regional borrowing must significantly increase in the years ahead in order to meet growing demand for infrastructure services and lending to regions will have to become more market-based. Reducing systemic credit risk and improving the creditworthiness of regional borrowers are prerequisites to increased and sustained market-based lending.

Key words — Southeast Asia, Indonesia, decentralization, local government, public finance, debt

1. INTRODUCTION

Borrowing is widely seen as being both efficient and equitable for use in regional public capital investment. These conclusions largely derive from the significant amounts of money needed for development and because the purchased capital equipment or constructed facilities usually have long useful lives. That is, it is usually argued that it is more economically efficient to borrow money now in order to satisfy present needs or demand than it would be to wait until adequate funds can be accumulated over time. Borrowing for capital development is believed to be equitable since those who actually use the generated services can be made to pay for them over the course of a project's life.

Of course, one might ask: why is regional public capital development so important in the first instance? The typical answer is that it is necessary in order to provide regional public infrastructure services to residents that cannot otherwise be provided by the private sector. But another important rationale concerns the economic development of a region. That is, public capital goods also serve as inputs to the private production process and therefore contribute to regional economic development. In this regard, there are three main possible roles for public capital: (a) as an "unpaid factor of production" in private sector operations, (b) as an "augmenting factor" that improves the productivity of other (i.e. private) capital and labor inputs, and (c) in a more dynamic sense as an incentive for business creation and/or relocation. In any case, the important point here is that publicly-provided regional capital is not just useful as a means to meet the consumption needs of residents but also can serve as a stimulant to economic development. [1]

Indonesia has recently embarked upon an ambitious program of fiscal decentralization. The effort has its genesis in two laws, both promulgated in May 1999, one on administrative matters and the other concerning fiscal and finance issues. [2] Starting in fiscal year 2001, provincial and local governments have assumed major new public service responsibilities, including, but not limited to those for public works, health, education and culture, agriculture, communications, industry and trade, environment, and land. Regional governments are also now becoming much more proactive

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regarding matters related to regional economic development.

Among other things, responsibility for subnational public capital development in Indonesia now rests to a large extent with regional governments. This means that regional governments now have a greater role in setting capital development priorities and in designing and implementing projects. In addition, of course, they gain greater responsibility over financing the development of public infrastructure.

This increased responsibility comes at a time when needs for public capital are growing as a result of increasing levels of urbanization. The Indonesian population is now over 40% urban and urban population is growing at rate of nearly 6% per year. Furthermore, decentralization and urbanization are taking place at a time of increased fiscal stress at the central level. These constraints on the central budget will likely mean that even less money will be available to finance and/or subsidize regional capital developments than would otherwise be the case. All this suggests that regional governments will need to shoulder an increasing share of the burden in financing public capital development. Much of this burden will have to be carried out through borrowing of one type or another.

Although the rationale for regional borrowing is clear and strong, the debt experience of regional governments in most countries in the developing world has not been particularly auspicious. In some cases, regional governments have borrowed excessively [3] and loan repayment has, in general, been especially problematic. [4] Major difficulties notwithstanding, there has been little thorough empirical analysis of regional government borrowing or repayment in particular countries. This paper attempts to help fill that void.

The rest of the paper is organized as follows. First, a basic description of regional borrowing in Indonesia is offered. Here, some fundamental information on the main lending mechanisms is provided and the history of regional government and regional government enterprise borrowing through these mechanisms over the past 20 years is empirically described. Second, the paper examines the borrowing and repayment experience of Indonesian local governments, in particular. The focus in this section of the paper concerns the potential impact of local government fiscal capacity on borrowing and repayment. A simple model is specified and estimated; empirical results derived from the model are presented and discussed. Third, the paper discusses some major policy implications of the analysis. Finally, the paper closes with a summary of the main points and some conclusions.

2. REGIONAL BORROWING EXPERIENCE TO DATE

Since the late 1970s, the vast majority of regional government and regional government enterprise borrowing in Indonesia has been via two central government mechanisms: Subsidiary Loan Agreements (SLAs) and the Regional Development Account (RDA, and/or the latter's predecessor, the Investment Funds Account–RDI). [5] There has been only a very small amount of regional borrowing from other financial institutions, such as regional development, state, or commercial banks, and most of this has been to assist in the management of cash flow. [6] SLA is the on-lending mechanism for major donor funds and it has been closely associated over the years with the Integrated Urban Infrastructure Development Programs (IUIDP) of the World Bank and the Asian Development Bank. RDA is the government's channel for lending state budget funds (occasionally derived from donor funding in the first instance) to regional governments and their enterprises. The account has been used to finance regional infrastructure development, ostensibly based on demand, and outside the context of donor-organized projects. The SLA and RDA loan mechanisms are both managed by the Ministry of Finance. [7]

Originally, terms and conditions of SLA and RDA loans varied quite significantly. Beginning in 1989, however, the government made an attempt to standardize SLA and RDA lending. Since that time, interest rates have been set at 11.5% for both types of loans (although, most often, SLA loans carry an additional 0.25% interest charge which is remitted to the local correspondent bank responsible for administering collections). Maturities typically range from 18 to 20 years, where the latter figure predominates. Grace periods on the repayment of interest and principal are normally 3–5 years and, again, most are the latter. Interest is usually capitalized during grace periods. Loans are disbursed at regular intervals during grace and against evidence of project expenditures. The Ministry of Finance levies commitment fees on undisbursed balances; charges are 0.75% in the case of RDA loans and vary by donor institu-