East Asia Urban Working Paper Series

Cities in Transition : Urban Sector Review In an Era of Decentralization in Indonesia

June 30, 2003
Dissemination Paper No. 7

Urban Sector Development Unit
Infrastructure Department
East Asia and Pacific Region
The World Bank

CURRENCY AND EQUIVALENT

(Exchange Rate Effective April, 2002)

Currency Unit: Rupiah (Rp)
Rp. 1 = US$0.00010416
US$1= Rp.9,600

FISCAL YEAR

January 1 – December 31

LIST OF ABBREVIATIONS

AAA	Analytical and Advisory Activities
AIM	Association of Indonesian Municipalities
APEKSI	Association of Indonesian Municipalities
BAKN	Board for the Analysis of National Finances
BANGDA	Directorate-General for Local Development
BAPEDAL	Local Environmental Protection Agency
BAPPEDA	Local Development Planning Agency
BAPPENAS	National Development Planning Agency
BEN	National Land Administration Agency
BKM	Community Development Committees
BKN	National Civil Service Agency
BKP4N	National Board for Policy and Supervision of Housing and Settlements Development
BKTRN	National Spatial Coordination Board
BOO	Build Operate Own
BOT	Build Operate Transfer
BPPN	Debt-restructuring program
BPS	Central Bureau of Statistics
BTN	National Savings Bank
BUMD	Public enterprise owned by an autonomous regional government
BUMN	Public enterprise owned by the central government
CBHD Project	Community-Based Housing Development Project
CBH	Community-Based Housing
CBO	Community-Based Organization
CBUIM	Capacity Building for Urban Infrastructure Management
CoBILD Project	Community-Based Initiatives for Housing and Local Development
DAK	Special Local Government Grant
DAU	Consolidated Block Grant
DGURD	Directorate General of Urban and Rural Development
Dinas Perumahan	Housing section of a local government
DPOD	Regional Autonomy Advisory Council
DPR	Parliament
DPRD	Local Council
EKUIN	Coordinating Minister for Economy, Industry and Finance
FRAP	Financial Recovery Action Plan
GDP	Gross Domestic Product
GOI	Government of Indonesia
Gotong Royong	Mutual help
GRDP	Gross Regional Domestic Product

IBRA	Indonesia Bank Restructuring Agency
IUIDP	Integrated Urban Infrastructure Development Program
JABOTABEK	Jakarta-Bogor-Tangerang-Bekasi-Region
JABODETABEK	Jakarta-Bogor-Depok-Tangerang-Bekas-Regioni
Kabupaten	Rural district
Kanwil	Deconcentrated Regional Office
KASIBA	Ready-to-build area
Kelurahan	Administrative Sub-district (lower level government administrative unit in a Kota)
Kimpraswil	Ministry for Human Settlements and Regional Infrastructure
KIP	Kampung Improvement Program
Kota	City District
Krismon	Monetary crisis (used to indicate the 1997/98 crisis)
KPR	Kredit Pemilikan Rumah/Home Ownership Loan
LAP	Land Administration Project
LIDAP	Local Institutional Development Action Program
LISIBA	Stand-alone ready to build environment
LO	Land Office
MDF	Municipal Development Fund
MSIP	Multi-Sectoral Investment Program
MSRI	Ministry of Settlements and Regional Infrastructure
NGO	Non-Government Organization
O&M	Operation and Maintenance
OTDA	Directorate General for Local Autonomy
PAD	Local Own Revenues
PBB	Property Tax (*Pajak Bumi dan Bangunan*)
PDAM	Local Water Supply Enterprise
PDK	Local Solid Waste Management Enterprise
PDPP	Basic Urban Development Program
PERDA	Regional Regulation
PERPAMSI	National Association of Water Supply Enterprises
Perum Perumnas	National Urban Housing Development Corporation
PIPP	Urban Services Investment Program
PJM	Medium-Term Investment Program
PLN	State-Owned Electricity Company
PP	Government Regulation
PPP	Public-Private Partnership
PROPEDA	New Local Development Plan
PROPENAS	New National Development Plan
PSPI	*Pusat Studi Properti Indonesia*
PUMDA	Directorate-General for Local Governance
PUOD	Directorate-General for Governance and Regional Autonomy
Rakorbang	Local development coordination meeting
RDA	Regional Development Account
RIAP	Revenue Improvement Action Program
ROW	Right of Way

RS	Low-cost housing units
RSS	Very low-cost housing units
SASKENAS	National Labor Force Surveys
SK	Surat Keputusan (Decree)
SLA	Sub-Loan Agreement
SMERU	Social Monitoring and Early Response Unit
SPAPB	Grants from central to local governments
SUSENAS	National Household Expenditure Survey
TELKOM	State-owned telecommunication company
TKPP	Coordination Team for Urban Development
UDF	Urban Development Fund
UNCHS	United Nations Center of Human Settlements
UNDP	United Nations Development Program
UPP	Urban Poverty Project
URDI	Urban and Regional Development Institute
USDRP	Urban Sector Development and Reform Project
WSS	Water and Sanitation Sector

CITIES IN TRANSITION :

"URBAN SECTOR REVIEW IN AN ERA OF DECENTRALIZATION IN INDONESIA"

Table of Contents

TABLES

FIGURES

BOXES

ANNEXES

FOREWORD

Indonesia, the world's fourth most populous country, experienced major economic and political trauma at the end of the 20th century which set it reeling: the financial crisis of 1997 (the *Krismon*) and a period of political upheaval which led to the election of three presidents.

Since then, Indonesia has undergone two significant metamorphoses: decentralization and urbanization. These two intersecting movements are transforming the country's society and economy in significant ways. The first, an expression of political will --which occurred almost overnight -- entails a devolution of authority and resources from the center to local jurisdictions; it represents a radical change from the highly centralized administrations of the past. The second, an uninterrupted migration of individuals from the countryside to the cities, reflects the intentions of many hundreds of thousands, even millions, of people in a quest for a better life.

While urbanization is stressing Indonesia's cities, it is the urban poor who are afflicted most. The cities, which have been neglected for years, are unable to satisfy the demand for urban services occasioned by a continuous influx of people. Like the Janus of Roman times, decentralization has two faces: Opportunity and Risk. Decentralization might provide city managers with the incentive to embrace important issues affecting their citizens; at the same time, hasty implementation could strain cities even further in the short run. For cities to move forward, the central government must carry out its unfinished agenda of decentralization. Only then will local governments be able to fully shoulder their new responsibilities. In the meantime, cities must work hard to improve urban services, reduce urban poverty and promote local economic development.

The Urban Sector Review analyzes the trends, achievements and difficulties of a multi-faceted transformation. Against a background of a transfer of power and the associated growth of democratic local institutions in the country's 30 provinces, 416 districts and more than 50 cities with populations of 100,000 or more, the review concentrates on urbanization. It focuses on five general topics under the urban sector umbrella: governance, urban finance, poverty alleviation, local economic development and urban services. The review ends with the specification of strategic frameworks, policy initiatives and action steps that will make Indonesia's cities engines of economic growth, effective providers of services and centers of opportunity for the poor.

It is inherent in the Bank's mission to help shrink the long list of urban challenges described in this review, to build local democracy, expand the economy and reduce urban poverty. We hope that this review will further the central and regional governments' efforts to satisfy the aspirations of the country's urban dwellers, particularly millions of urban poor people.

Andrew D. Steer	Christian Delvoie	Keshav Varma
Country Director Indonesia	Infrastructure Director	Urban Sector Director
East Asia and Pacific Region	East Asia and Pacific Region	East Asia and Pacific Region

ACKNOWLEDGEMENTS

The Urban Sector Review for Indonesia was prepared by a team consisting of Hiroaki Suzuki (Task Team Leader), Balakrishna Menon (Co-task Team Leader), Soraya Goga, Suhadi Hadiwinoto and Shizuo Iwata. The background report, *Cities Speak*, was prepared by a consultant team from the Urban and Rural Development Institute (URDI), Indonesia headed by Wicaksono Sarosa. The *Cities Speak* workshops were organized in Jakarta by a team of Suhadi Hadiwinoto, Sri Endang Utami and URDI staff under the supervision of Hiroaki Suzuki. Critical support in terms of advise and comments was provided by M. Baird, A. Dasgupta, I. Dharmapatni, S. Dice, E. Dotson, L. Elvas, B. Hofman, J. Hohnen, R. Huque, V. Jagannathan, K. Kaiser, H. Kawashima, K.S. Lateef, V. Nehru, I. Sadoko, G. Soraya, R. Sukarma, D. Visveswaran and T. Zearley. S. Middaugh, A. Harrison, I. Herawati, I. Farina and S. E. Utami contributed to the logistical support in typing and editing of the report and arranging the field visits. The team also benefited from views and comments of Andrew D. Steer, Country Director of Indonesia, Christian Delvoie, Infrastructure Sector Director, Keshav Varma, Urban Sector Director, members of the Indonesian Country team, other staff from EASUR, and so forth. The peer reviewers were E. Codato and C. Kessides.

Valuable comments were also received from GOI officials, Messrs/Mmes Penny Lukita Firdaus, Director for Urban and Rural Development, National Development Planning Agency (BAPPENAS), Salusra Widya, Directorate for Settlements and Housing , BAPPENAS, Oswar, BAPPENAS, Irin, BAPPENAS, Nelson Siregar, Director for Technical Development, DGURD, Kimpraswil, Andreas Suhono, Head of Sub Directorate for General Planning, Kimpraswil, Imam Ernawi, Director for Technical Development, DGHS, Kimpraswil, Dani Sutjiono, Kimpraswil, and Haryo Sasongko, Director for Urban Development, Ministry of Home Affairs (MoH).

The team was greatly assisted by Indonesian officials in Kimpraswil, BAPPENAS, the Coordinating Ministry for Economic Affairs, the Ministry of Finance and the Ministry of Home Affairs. In particular, the team would like to extend its thanks to Dr. Ir. Bambang Bintoro Soedjito, Deputy Minister for Regional Autonomy and Regional Development, National Development Planning Agency (BAPPENAS) and Ir. Budiman Arif, Director General of Urban and Rural Development of Kimpraswil. The Bank also thanks the mayors, local government officials, the DPRD members and NGO representatives of Bandung, Palembang, Balikpapan, Kendari, Kupang and Blitar for their excellent hospitality and collaboration.

PREFACE

Why an Urban Sector Review Now

Indonesia has produced several urban strategies or similar efforts in recent years, initiated by the government and a few international development agencies. The most recent of these includes the Urban Sector Review and the Urban Sector Policy and Guidelines TA supported by the Asian Development Bank (ADB, 2001), the Urban Sector Policy Profile with ADB/UNCRD support, to name a few. These efforts have, without a doubt, brought greater attention to the urban sector at a time of enormous change within the country. The financial crisis of 1997 was a watershed in Indonesia's history, exposing the country and its people to a level of vulnerability never before experienced. The difficult political transition that immediately followed—the rapid turnover of the Suharto, Habibie and Wahid governments, culminating in the ascension of Megawati—added to the uncertainties in the country. Yet, perhaps the most striking of all changes, one that will possibly have the greatest ramifications over the long term, has been the *big bang* decentralization of 2001. Truly, Indonesia's decentralization efforts have been nothing short of spectacular. In two years, Indonesia managed to put in place the most essential legal and regulatory frameworks for devolving the government machinery, transferred responsibilities for service delivery to the local governments and shifted over two million civil servants from the center to the regions. While much more remains to be done on the regulatory side and there are problems in managing the process, it is important to accord Indonesia the recognition it rightly deserves for managing this transition at a period of uncertainty and challenge, with minimum disruption and chaos.

The Value Added by this Study

In addition to the overview sectoral information and analysis, based largely on secondary sources, during the period from November 2001 to May 2002, field studies were conducted in six cities: Bandung, Palembang, Blitar, Kupang, Balikpapan and Kendari. These studies included city-level stakeholder workshops and detailed discussions with elected representatives, bureaucrats, members of the private sector, NGOs and CBOs (especially those working with the urban poor), and other relevant constituents in the cities. Detailed data about case study cities, encompassing governance structures, municipal financing, urban services, land and housing, and urban poverty, were also collected and analyzed. This dimension of the urban sector review—*Cities Speak* — presents firsthand evidence from the cities and towns on the ramifications of the decentralization process in the immediate post-decentralization period. This was complemented by two national-level workshops held in Jakarta, attended by key representatives of Kimpraswil, BAPPENAS, the Coordinating Ministry for Economic Affairs, the Ministries of Finance and Home Affairs, and other relevant agencies of the Government of Indonesia (GOI), mayors and city officials from several urban local governments, and the members of the private sector, NGO and donor communities. *Cities Speak* is perhaps the most unique aspect and the key value added to this study.

Objectives of the Urban Sector Review

In the coming years, the World Bank sees itself as a close working partner with the GOI and its urban local governments, to help them seize opportunities and manage the challenges wrought by decentralization, for improving economic efficiency, reducing poverty and enhancing the quality of life in the cities and towns of Indonesia. To this end, the Indonesian urban sector review sets out to do the following:

- Review and analyze the urban sector from the perspective of recent events, especially decentralization and democratization, in a comparative framework with the pre-decentralization period;
- Identify key issues and challenges confronting the urban sector, especially urban local governments in the post-decentralization period;
- Identify key opportunities presented for urban sector reforms, especially at the local government level, due to the changed state of affairs; and
- Propose an approach to address complex urban issues for sustainable growth and reform.

EXECUTIVE SUMMARY

Rapid urbanization is straining Indonesia's cities; it is the urban poor who suffer most. Urban services are inadequate to absorb the continuous flow of people into the cities, which were neglected for years and which took a blow in the aftermath of the crisis. Decentralization is providing an opportunity as well as a threat for improving urban services. The policy could enable city managers to tackle issues affecting their citizens, but at the same time, its hasty implementation and incomplete framework could strain cities even further in the short run. For cities to be able to face the challenges of the present and the potential of the future, the central government must complete the unfinished agenda of decentralization that will enable local governments to fully assume their new responsibilities, while the cities must strive to meet rising local aspirations by improving urban services, reducing urban poverty and promoting local economic development.

Introduction

1. During the first half century and more of its existence as an independent republic, which coincided with the presidencies of Suharto and Sukarno, Indonesia was ruled from the center. Power was vested in the hands of a few institutions, notably the armed forces and the central bureaucracy. This centralized system of governance presided over 200 million people, representing more than 300 ethnic groups spread across more than 13,000 islands of the Indonesian archipelago.

2. In the aftermath of an unparalleled financial crisis and political turmoil, Indonesians groped for a new structure of government. They found it in decentralization; almost overnight, decision making dispersed from the capital to the country's 30 provinces and 416 local governments.

3. The "big-bang" decentralization went into effect on January 1, 2001. It still has far to go. This review examines the interplay between urbanization and the early stage of decentralization; both of these movements are changing the face of the country. In 1975, just 20 percent of Indonesians were city-dwellers, by 2025 over 60 percent of the population will live in the country's urban centers. Urban local governments face enormous challenges as a result; their success is crucial to Indonesia's revival, as well as its future economic growth and poverty reduction. In 1999, two out of five urban Indonesians were counted as poor; over the next decades, urbanization will bring more, not fewer, destitute individuals and families into urban slums.

4. On the plus side, the big-bang decentralization strategy took place with a minimum of disruption during the transition. However, many jurisdictions lack the skills and knowledge needed to exercise their new authority. Whether they can generate the revenues needed to meet their new expenditure responsibilities, is also uncertain. This review analyzes these knotty realities and suggests ways to enable the smooth transition to a more urbanized and decentralized Indonesia.

Power Shift

5. Triggered by the *Krismon* and subsequent political upheavals, Indonesia has initiated major legislation to bring about political and fiscal decentralization. In April 1999, the Parliament hastily adopted the following two laws which set January 1, 2001 as the starting date for the "big bang" change.

- **Law 22/1999 on Regional Governance** specifies the political and administrative responsibilities of the central, provincial, and local governments.

- **Law 25/1999 on Fiscal Balance** provides the legal foundation for fiscal decentralization, delineating the new division of revenue sources and intergovernmental transfers.

Based on these statutes, a broad range of functions shifted from the center to local governments, bypassing the provinces. Cities and rural districts *(kotas* and *kabupatens*) became responsible for most public services, with the provinces acting as coordinators.

6. *Kotas* and *kabupatens* are now controlled by freely elected local councils; the councils select the mayors and hold local administrations accountable. In one year, the sub-national share of government spending almost doubled, to over 30 percent. Approximately 60 percent of the development budget will now be managed at sub-national levels.

7. More important, general allocation funds (DAU) and special purpose transfers (DAK) became the principal mechanisms for fiscal transfers to local governments. Central control over local budgets came to an end. These allocations aim to equalize the fiscal capacities of sub-national governments to meet their spending needs. The central government also shares revenue from various natural resources, personal income taxes and other sources with sub-national governments.

Unfinished Decentralization Agenda

8. Among the most pressing issues that remain outstanding in the decentralization process are:

- Law 22/1999 does not define the functions of local government directly. Regulations are critical to clarify the division of functions, sub-functions, activities and responsibilities among levels of government and the devolution of projects, personnel, assets and other resources. The Law on Regional Governance is vague in assigning spending responsibilities which affects the effective delivery of services.
- Equally unclear is what local governments are obliged to undertake. While the Law itemizes the obligatory "sectors" of local governments, it does not specify what the functions of local government are in these sectors. Furthermore, the description of "sectors" is far from the level of operational detail that local governments need to perform their function.
- Requiring local governments to provide most services may be overtaxing their capacities. Furthermore, representatives to local legislatures often lack the knowledge and experience to guide public policy and be effective overseers.
- Law 34/2001 has empowered the local governments to create their own new taxes, based on established criteria and subject to limits set by the central government. However, the central government is having a difficult time overseeing this law. New local taxes have proliferated, but many of them have not been rational or optimal.

Mismatches: Responsibilities, Resources and Expertise

9. In theory, decentralization has made Indonesia's local governments autonomous. In practice, however, most cities and rural districts remain heavily dependent on the center for their revenues and central government personnel. In the first year of decentralization, approximately 2.1 million civil servants moved from the center to local governments. The wages of these civil servants are now a serious burden on local finances.

10. According to Law 22/1999, the central government retained responsibility for the judicial system, religious affairs, national defense and security, macro-economic planning, fiscal and monetary affairs,

standardization and international relationships; all other duties were devolved to local governments by default. Thus the local governments are now responsible for public works, health, education, trade and industry, investment, environment, agriculture, cooperatives, and labor. Although the division of responsibility appears reasonable, local authorities have inadequate resources, revenues and institutional capacities to fulfill them.

11. **Transfers.** In 1990-91, central government transfers financed approximately 70 percent of local government expenditures. The new DAU grants and the much smaller DAK transfers came into being to correct vertical and horizontal fiscal imbalances, to promote national priorities and provide stability to local finances. TheDAU, by law, will amount to at least 25 percent of total central government revenue after tax sharing; 10 percent goes to the provinces and 90 percent to districts.

12. Together, the DAU transfers and DAK grants constitute a transparent and relatively stable revenue source for local governments. But even with supplements, many local governments have more expenditure responsibilities than revenue resources. To narrow, if not close, that gap, local authorities need to strengthen their own revenue base, which is currently very weak.

13. **Revenues.** In addition to inter-governmental transfers, revenue sources available to local governments consist of local taxes, local charges, profits of locally-owned enterprises and borrowings. Revenues from land and property transactions and non-tax revenues, primarily from natural resources, are transferred by the central government.

14. In 2001, city governments' own-revenues (PAD) represented approximately 9.7 percent of total revenues. Local governments have the authority to levy taxes, subject to public consultation and approval of the local legislature. Two major problems, however, have already surfaced: the lack of a major local tax base and the proliferation of nuisance taxes. At the *kota/kabupaten* level, there are around seven local taxes, but only a few contribute appreciably to total local revenue. In major urban areas, hotel, restaurant, entertainment, and advertising taxes are among the major revenue sources.

15. Contrary to the experience of many countries, in Indonesia, revenues from land and property taxes flow to the central government, then get redistributed to the provinces and local governments. While the central government will continue to administer property taxes, one recommendation is that the authority for setting tax rates should devolve to local governments within limits set by the center.

16. The proliferation of nuisance taxes was a problem in the first year of fiscal decentralization. Local governments, intent on raising their own revenues, resorted widely to arbitrary taxes and fees. These taxes and levies often exceed their taxation powers and have distortionary effects on the local trade and economy.

17. **Borrowing.** Taxes alone are an inefficient source of funds for major capital investments that require long-term financing, such as urban infrastructure. There is no systematic and sustainable financing mechanism for local governments to borrow for such purposes. Two central lending mechanisms—Regional Development Account (RDA) and Subsidiary Loan Agreement (SLA)—exist, but arrears have sidelined RDA; the SLA, which decides on an ad hoc basis, is requires more systematic approach. Long-term borrowing, moreover, is restricted to financing infrastructure that "generates revenues," a condition that prohibits, for instance, borrowing for slum upgrading or environmental protection. While Regulation 107/2000 (PP107) broadened the definition of "revenue generation," the Ministerial Decree 35/KMK07/2003 still maintains a rather narrow definition of "revenues generation", thus significantly limiting the access of the local governments to loan financing.

18. PP 107/2000) also sets limits on local borrowing, stipulating that local governments cannot finance more than one-sixth of a year's expenditures with short term borrowing funds, that total debt can never exceed 75 percent of the previous year's revenue, and that the ratio of revenues to debt service payments in a given year must be at least 2.5:1. Furthermore, local governments are allowed to borrow from foreign sources only through the central government, and on condition that they bear all the costs, including GOI's foreign exchange risk management fee.

19. It is critical that local governments have sustainable financing mechanisms with linkages to capital markets over time. However, many problems exist between that ideal and the present. Among them are: (a) insufficient remedies under the existing government financing schemes for borrowers who default; (b) lack of interest among private banks and investors in lending to local governments because of their perceived financial and political risks; (c) absence of a long-term debt market in the capital market; and (d) the possibility that financial markets may serve only a few of the credit-worthy local governments, leaving the poorer local governments without adequate resources. Because of these constraints, the central government must be involved in local government financing in the short-medium term. Accordingly, for most local governments, the critical issue will be to have an efficient channel for intermediation between the central and local government, and policies that would, over time, enhance local governments' creditworthiness—financial management and reporting policies and work out procedures. In parallel, it is also important that the central government introduce policies promoting the development of capital markets.

20. **Capacity Gaps.** Decentralization is fostering democratic and participatory decision-making and transparency in different ways at the local level. Citizens are enjoying greater freedom than ever before in making the legislature and the executive accountable. Nevertheless, barriers still exist which prevent community organizations from participating in public policy. Access to governmental information is uneven and impeded, more often than not, by a bureaucratic preference for secrecy. Civil society groups, moreover, are often long on enthusiasm and indignation, but short on political savvy.

21. In general, local council representatives often lack proper education and political experience. The level of policy awareness and the quality of political debate is poor. Although they are expected to hold mayors and district heads accountable for their performance, these legislators are often ill-prepared to do so. Because of weak fiduciary oversight, opportunities for corruption and nepotism are on the rise.

22. Yet, democratic participation is slowly taking root with structures and processes still under development, such as the emerging Urban Forums. Some cities have been innovative in cultivating dialogue among citizens, legislators and administrators and their example may be replicated. However, the cities need democratically elected ward heads and ward councils, much like the village heads and village councils in the rural districts.

23. Another profound challenge facing urban local governments is the need to develop the capacities of their local-level technical and professional staff in planning, engineering, budgeting, accounting, financial management and project management. The gaps will not be filled overnight, but capacity building should be a major goal for the regions.

24. Although many local governments need to streamline their workforce, few of them have actually done so. The central government agencies determine civil service wages, job classifications and standards for all government personnel, and want to see them applied locally. Although minimum national-level standards make sense during the transition period, they can also slow down efforts to develop a local administration responsive to local needs.

Urbanization: Rising Pressures, Uncertain Responses

25. Decentralization, on the scale and at the speed that it is being attempted in Indonesia, is a daring venture into new administrative, political and economic territory. Compounding the situation are extraordinary demographic changes as villages become towns, towns become cities and cities become sprawling metropolises.

26. During the 1990s, Indonesia's average annual population growth was about 1.7 percent, its urban population grew almost three times as fast, at about 4.4 percent. That trend will make city dwellers of some 167 million people in 2025, out of a projected total population of 275.6 million. Throughout Indonesia, 8 major cities—5 of them on the island of Java—hold more than a million people each and, collectively, about 12 percent of the country's total population. Jakarta, the capital, is the center of a megalopolis (Jabotabek) of 9.2 million people.

27. Between 1990 and 1995, six out of 10 internal migrants—in all, 7.2 percent of the total population—moved to urban centers, about one third of the total moving from one city to another; over one-quarter abandoned the countryside for urban living. Net rural-urban migration accounts for about 25-30 percent of urban population growth. An additional 30-35 percent share of urban growth came from the transformation of rural settlements to urban centers. Although some reverse migration occurred during the depths of the 1997 crisis, the pressure of urbanization is not abating or likely.

28. **Urban Poverty.** Between the 1960s and 1990s, up to the economic crisis, Indonesia made significant progress in reducing material poverty. The *Krismon* of 1997 changed that dramatically. The poverty headcount ratio went from 11.4 percent in 1995 to 27.1 percent in 1999, at the peak of the crisis. Many households, urban and rural alike, live so close to the poverty line that any blow to their well-being makes them destitute. As such, nearly half of Indonesia's people are considered poor or vulnerable to poverty. When such shocks occur, cities offer fewer supports than villages.

29. The effects *Krismon* fell heavily on the urban poor. Layoffs pushed thousands of urban low-income workers out of the formal sector into the informal sector. Many poor residents unable to make a living in urban areas returned to their villages. High unemployment, exacerbated by a high inflation in 1998, reduced the purchasing power of the poor to record lows. Between 1997-98, urban households reduced real spending on food by 28 percent (compared to 8 percent for rural households). The incidence of poverty increased nationwide between February 1996 and February 1999; it was much higher in urban areas, almost double the increase in rural areas. Similarly, urban poverty indices such as headcount, poverty gap and poverty severity swelled dramatically between 1996-99, well over twice the comparable increase in rural areas. The government responded in four key ways: (a) ensuring food security, (b) creating jobs, (c) preserving access to critical social services, and (d) sustaining local economic activity through regional block grants and credit extension.

30. While poverty rates have dropped in recent years, they remain above pre-crisis levels. More to the point, the urban poor still suffer tremendous odds in their daily lives. The rights of the urban poor to land, housing, basic urban services, income opportunities and credit, social capital formation, empowerment and participation in civil society institutions, and basic security and justice, are highly compromised, leaving them highly vulnerable, and often in conditions more extreme than the rural poor.

31. With decentralization, local administrations that draw poor communities into city planning and policy making may gain valuable guidance on development. A proactive agenda for poverty reduction, in an era of decentralization and local empowerment, would include: (a) a resumption of growth to create an environment for poverty reduction; (b) making use of decentralization for more *pro-poor* governance; (c)

improving the poverty focus of public expenditures; (d) developing safety nets for the poorest; (e) expanding access to secure land and affordable housing for the poor; (f) reducing current anti-poor bias in urban infrastructure policies and supporting community-based local infrastructure, where appropriate; (g) providing greater opportunities for economic empowerment through access to credit and capital; (h) strengthening human capital of the poor with better education and health; (i) strengthening the rule of law and improving access to judicial systems by the poor; and (j) addressing the special concerns and needs of poor women in policies, programs and projects.

32. **Local Economic Development (LED).** Several laws and regulations give explicit direction on economic development, and a planning process—the PROPEDA (local development plan)—creates opportunities for economic strategies at the local level. On their tables of organization, local governments have agencies and institutions with specific economic development functions with line items that can support economic projects. However, local governments have been slow to react to these legal, institutional and financial opportunities.

33. Few cities, even the largest ones, have thought strategically about their roles within the region or to the country as a whole. Consequently, regional cooperation among cites or between cities and their rural hinterlands, linkages with national organizations and associated investment promotion are absent from whatever LED strategies and programs the cities claim to advance. Institutional structures, expenditures and programs for economic development exist. But they have done little either to change businesses' opinions of local government or to improve the local business environment. Those governments that have tried to reach out to community groups have not made similar moves to collaborate with the business community.

34. The business community in most of these cities appears to regard the local government as irrelevant, except as a source of problems. Businesses tend to concentrate their complaints on corruption, additional tax burdens and lack of infrastructure instead of the economic development strategies of cities. Instead of ambitious strategies, economic development at the local level needs to address a range of tangible shortcomings—roads, telecommunications, power, and water supply—and on the pervasive corruption that poisons most land dealings. Sales, purchases, planning, development licensing, zoning, taxation and building regulations are all occasions for bribery. Until cities acknowledge corruption as an obstacle to healthy economic growth, they will lag behind their potential as engines of Indonesia's prosperity.

35. **Land and Housing.** Urban land, a finite commodity under mounting pressure from urbanization, is a foundation of local development. Its administration, already inefficient, is still controlled by the central government. The Regional Governance Law formally devolved the primary responsibility for routine land administration to the *kotas* and *kabupatens*. Despite the Law, no changes have occurred; in the interim, the previous system remains in place. The relative responsibilities of the National Land Administration Agency (BPN) and local governments are yet to be defined; the role of the community, on which the law is silent, remains marginal.

36. Constraints to the functioning of urban land markets include an outdated and incomplete regulatory framework that is poorly reconciled between formal and *adat* (customary) laws, a poorly-developed and inefficient land registration system, weak land administration, cumbersome formal land development process and corruption. These deficiencies are distorting land markets, impeding the supply of affordable urban land and causing delays and increases in land development, with proportionately greater time and costs incurred by poor households. They also encourage sellers and buyers to evade the formalities and discourage much needed private investments in land and housing development.

37. With less than 10 percent of the country covered by cadastral maps and only about 20 percent of the land parcels officially registered, land administration by the Ministry of Forests and BPN has been deficient. District administrations have a mixed record. In the absence of clear policies, regulations, transparency requirements and enforcement mechanisms, they may not perform any better. Many central government agencies retain power that can influence land administration and/or override regional decisions. The regions will need protection against regressive attempts to reinstate centralized land administration. Decentralization provides the opportunity to initiate wide-ranging stakeholder consultations, to build consensus for sustainable land reforms and to spur urban growth in an orderly and transparent setting. That opportunity, though, remains largely unexplored.

38. Sustainable urban development requires an efficient land market. Briefly, the priority areas for reforming urban land administration and management include: (a) policy and regulatory reforms that lay down the foundations for an efficient, equitable and growth-oriented urban land market; (b) improving land titling and registration for upgrading efficiency and equity in land administration; and (c) strengthening decentralization in land administration and management through a clear program for transferring responsibilities from central agencies to local ones, and strengthening local capacities in this area.

39. Urban housing has been a stepchild of national policy. In general, investment in housing has run at about 1.5 percent of GDP versus 2 to 8 percent in comparable countries. Mortgage financing in Indonesia equaled 3.1 percent of GDP, a figure far less than some of its neighbors. Growth in housing is critical to economic development. What impedes that is constraints in the land market, a fragmented policy and institutional framework for housing, low levels of affordability, supply side weaknesses and limited reach of housing finance. The informal markets have been meeting the bulk of the demand. GOI's efforts to enhance the supply of low-income housing through measures such as the 1-3-6 rule have failed.

40. With devolution, local governments have a mandate to support housing development, but they do not have the resources to handle their new responsibilities. There are concerns that housing, and in particular housing for low-income households, will not be a priority for local governments. They often lack housing-related planning, financing and implementation as well as a clear understanding of market operations, particularly in dealing with the private sector. It is also possible that their new power will lead them to take a highly interventionist role in the housing market, rather than an enabling one.

41. Creating efficient housing markets will require: (a) a stable and transparent regulatory and political environment; (b) improving the supply of serviced land; (c) strengthening housing finance systems, addressing risks, accessing long-term funding, mitigating liquidity risks and improving credit quality; (d) rationalizing the roles and strengthening the capacities of various government agencies; and (e) providing housing assistance through transparent, well-targeted, on-budget programs.

42. **Urban Services.** A dozen years before the sweeping decentralization, central authorities shifted responsibility for most urban services—water, waste water, solid waste, urban roads, drainage, *Kampung* Improvement Program (KIP) and market infrastructure—to district-level governments. In practice, that deconcentration still left central agencies in their pivotal roles. By law, local governments are now the principal agents for the delivery of urban services. However, few are prepared to carry out their duties fully, starting with the replacement of traditional, top-down, supply-driven planning and operations with public participation in a bottom-up, customer-oriented approach.

43. The physical and financial dimensions of the challenges are staggering. About 33 per cent of Indonesian households were connected to piped water supply in 1999. Modern sewerage networks reach

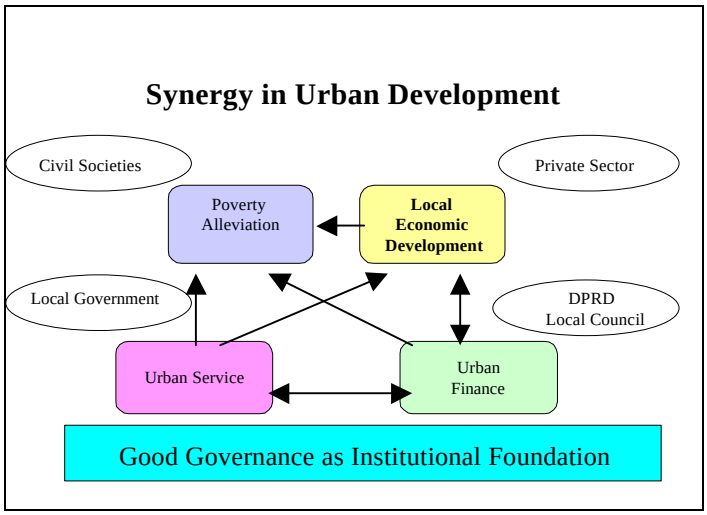
little more than one percent of all urban households. The financing requirements for urban infrastructure are also large; for example, water supply and sewerage investments for the next ten years are estimated at between $10-20 billion. Surface and ground water pollution, as well as water-logging have created major urban environmental problems. Inadequate drainage, poor land management, disorderly development and environmental destruction add up to mismanaged watersheds and frequent floods. The nascent, yet growing, private sector participation in infrastructure was halted by the *Krismon*. With decentralization, new challenges have emerged of weak local government capacities, low standards of service delivery and potential capture by local elites.

44. There is a need to develop a comprehensive and integrated approach for efficient urban services. Until the investment momentum is restored to maintain the current stock and address the backlog, economic development and social well-being in Indonesia's cities are at risk. What applies to infrastructure is relevant for human development services too. Decentralization has given city governments the opportunity, through local planning, to improve the coverage, efficiency and quality of education and health services; to explore the appropriate mix of public, private and non-governmental providers; and to increase local participation in managing and monitoring these services.

Approach for Sustainable Urban Development in Indonesia

45. **Guiding Principles.** Two overarching principles guide complex urban issues in Indonesia: (a) a comprehensive and synergistic approach to the urban sector; and (b) meeting the challenges posed by decentralization.

Approaching the urban sector comprehensively and synergistically: The Urban Sector Review focused on five key strategic areas: governance, urban finance, poverty alleviation, local economic development and urban service delivery. The dynamic interplay of these five dimensions, interpreted in the urban spatial setting, is the key to a comprehensive understanding of cities as "living organisms" that evolve dynamically. Indonesian cities confront extraordinary challenges ranging from economic stagnation and poor services to rising urban poverty and weak capacities. Sustainable urban development becomes more probable when a strategic synergy pulls together all the areas mentioned above. Good governance, exemplified by capacity, transparency, accountability and participation, provides synergy, and thus becomes the indispensable foundation for dynamic and sustainable urban growth.



Meeting the *Challenges of Decentralization:* Decentralization will inevitably create winners and losers, with cities that provide good governance and efficient management likely to attract more resources and have greater growth. Adapting to the changes wrought by decentralization will require the following: (a) demand-driven, in line with the national agenda on decentralization and democratization; (b) competitive selection of cities based on strong ownership; (c) cross-sectoral and thematic approach to urban issues, rather than narrowly defined urban infrastructure investments; (d) institutionally and financially sustainable and replicable interventions; (e) programmatic involvement rather than stand-alone investment projects; (f) right institutional and incentive framework to induce local governments to embrace reforms; and (g) expanded learning and innovation to deepen understanding of complex urban issues, to learn from both national and global experience.

46. **Good Governance as an Institutional Foundation.** Successful cities are built on a solid foundation of *good governance*. Its elements include capacity, transparency, accountability and participation.

47. In cultivating good urban governance, Indonesian cities face significant, institutional and human resource gaps in capacity. These gaps embrace all categories of personnel in urban development—mayors, DPRD members, local government officials and civil society groups. Among those to be assisted, DPRD members are particularly important because of their role in local policy formulation, decision making and oversight. With regard to municipal staff, a fundamental change in the institutional and incentive framework is necessary to promote better performance. Introduction of professional city managers and merit-based compensation system are two important steps in that direction. GOI and its local governments need support, taking into account the existing National Capacity Building Framework for Decentralization.

48. The GOI and local governments, together with civil society groups, need to develop institutional and regulatory mechanisms to secure effective citizen participation, transparency of administration and accountability of city officials. Direct election of mayors and city councils would significantly enhance the accountability of city hall. Tackling corruption will require two parallel approaches. First, it is important to enhance the fiduciary responsibility and ensure adequate safeguards. National level regulations requiring competitive procurement procedures and sound financial management systems should be adopted and applied at the local level. To enable this, technical assistance and training should be provided to local government officials to introduce new procurement procedures and financial management system. Second, it is critical to change the underlying incentives that foster corruption. Civil service reforms that reward merit and private sector participation in provision of urban services (under a transparent regulatory framework) are medium-term remedies to be pursued.

49. The 400-odd autonomous local governments and 30 provincial governments require effective vertical and horizontal coordination mechanisms. To enable these regulatory reforms, operational systems and procedures, and training of personnel are required. Decentralization regulations that are still unclear, need to be further defined to eliminate unnecessary confusion and conflict, and to support inter-governmental regional coordination among different levels of governments. At the operational level, innovative use of Information and Communications Technologies (ICTs) can promote good governance, by facilitating information flows between the center and local governments, supporting regional cooperation, strengthening capacity building, developing transparent information sharing with civil societies and by disseminating knowledge and experience among the cities inside and outside Indonesia.

50. **Alleviating Urban Poverty.** Although local governments are expected to play a bigger role in poverty alleviation, most have inadequate financial and institutional capacity to assume these responsibilities. At the outset, they have insufficient information and data on the poor, making it difficult

to target programs and to monitor progress. In addition, most poverty alleviation programs, typically those financed by GOI and donors, are on a project-to-project basis. Sustainability is uncertain once the projects end. Finally, community involvement and support of intermediaries should be integral to urban poverty reduction efforts.

51. An essential first step is to obtain accurate information on urban poverty. Local governments need to design poverty alleviation programs that target the right population, reflect the real needs of the poor, set specific and measurable poverty reduction goals, and monitor progress. Support should be provided to the cities to develop capacity in collecting data and information on the urban poor, analyzing them and developing effective poverty alleviation strategies and programs.

52. Cities will need to rely on a more systematic and homegrown approach for successful poverty reduction, one that does not depend heavily on GOI's budgetary support or donor funding. Poverty alleviation activities should be mainstreamed within local government budgets. As the first step toward this goal, local governments should formulate city poverty reduction strategies (CPRS) as integral parts of comprehensive and participatory City Development Strategies (CDSs).

53. The needs of the urban poor in financially non-viable cities or even in non-reforming cities cannot be neglected. The poor should not be penalized for the weak fiscal position or poor governance of the cities where they live. Evidently, the financial terms and conditions, and the modalities of channeling the funds in the case of non-viable cities or non-reforming cities should be different from those applied to reform-oriented and financially viable ones. Typically, this may require provision of subsidies targeted to the poor in the form of matching grants, an approach aligned with the GOI policy on special grant mechanisms such as the DAK.

54. To effectively reach the poor, local officials will need to understand community priorities and become accountable to residents. This, in turn, will require communities to be organized, able to aggregate and prioritize their needs and articulate these to the government. The capacity for carrying out these tasks is weak at the local government and at the community level. Therefore, it becomes important to empower the poor by transferring resources directly to them to provide social, financial and physical services at the community level, and to enable communities to determine their own priorities. This can be further strengthened by promoting partnerships between local governments and communities through intermediaries like NGOs. As a part of this approach, micro-financing schemes for income generation, incorporating worldwide best practices, should be strongly supported.

55. Well-functioning land and housing markets are important to the poor. Current land regulations are not usually well-disposed to the poor because they hold only customary rights to land. GOI and the local governments need support to advance the titling efforts that began in 1995, extending these to urban areas. Improving housing conditions is a priority for poor households, second only to the education of their children. In parallel with urban land reforms, it is imperative to implement a comprehensive housing sector reform program, aimed primarily at low-to-lower-middle income households in the informal sector, with no official title and no access to formal mortgage financing.

56. The premium on urban space arises from the economic and social value of urban land. Efficient use of urban land has the potential to transform urban areas into dynamic human and economic agglomerations. This is missing from Indonesian cities. Policy deficiencies, institutional shortcomings, financing limitations and human capacities constrain urban land and housing markets. Clarifying institutional frameworks, modernizing the land registration system and reforming land tax policies are bound to be time consuming and politically inexpedient in the short run. Reviewing outdated regulations

and strengthening district land offices is a good starting point. A transparent and time-bound program for divesting excess government land into open markets is also important.

57. **Promoting Local Economic Development (LED)**. Local economic development is an idea whose time has come, as a means to make cities economically and financially sustainable, and to reduce poverty. Although decentralization gives cities the political impetus and legal framework to promote local economic growth, most local governments lack comprehensive local economic development strategies or plans.

58. For example, cities can stimulate their local economies by effectively utilizing urban land in their domains through innovative land management programs. They could, for instance, develop idle land in partnership with the private sector and with the active participation of communities, to create a win-win situation.

59. More generally, since LED is still an emerging issue for most cities, it is important to fill in the gaps on how local governments respond to economic and business demands, given decentralization. Such knowledge would help policies, strategies and actions that help reduce corruption, rent seeking and other deleterious practices that hinder local businesses, provide better producer–market linkages; and enable LED-friendly government-business to interface. Supporting this should be an overarching framework of efficient infrastructure.

60. **Developing Sustainable Urban Finance Mechanisms**. In spite of the ever-increasing demand for urban infrastructure investments and poverty alleviation programs, Indonesia has yet to develop sustainable urban financing mechanisms, a task that will require reforms at the central and local levels.

61. At the central level, GOI should establish clear policies for fiscal transfers and local taxation. While DAU needs to be refined to reduce regional disparities and to match expenditure needs with revenue capacity of local governments, policies on DAK and other special grant mechanisms to support national priority areas—for example capacity building, poverty alleviation or environmental management, should be spelled out. Technical assistance, currently being provided to GOI, to formulate relevant policies and undertake required reforms, is expected to bear fruit in the coming months and years.

62. It is imperative that the cities generate greater resources by themselves through local taxation, cost recovery, borrowing, and public-private partnerships. At the national level, in support of cities, GOI needs to formulate clear policies for local government borrowing and develop a lending mechanism for assisting local governments. At present, it intends to do so by improving the existing on-lending mechanisms, rather than by developing an entirely new arms-length institution. Given the weak financial position of most local governments, the central government needs to maintain its direct budgetary channel and develop a financial intermediary with access to the financial markets over the long term.

63. Sustainable urban financing depends greatly on the fiscal health of local governments. To reduce their reliance on central fiscal transfers, local governments should expedite efforts to increase their financial capacities by expanding their tax bases, improving tax collection and user charges, rationalizing expenditures, promoting public-private partnerships in service provision and utilizing urban land as an important resource. Expanding local tax bases through GOI's fiscal reform property taxes; improving cost recovery for services, such as water supply and solid waste management; and promoting local economic development through public-private partnerships in land development, are some definitive steps in this regard. It is also important to check any further creation of fiscally non-viable local governments, and to consider merging fiscally non-viable local governments with stronger ones, to strengthen their aggregate fiscal capacity and to improve efficiency though economies of scale.

64. **Improving Urban Service Delivery**. Despite grave deficiencies in providing basic services to their inhabitants, financial constraints on both central and local governments make any progress in increasing coverage of urban services unlikely in the short-term. Given that cities and the central government are unable to finance all of their required infrastructure investments on their own, they will need to mobilize substantial resources from the private sector. This requires creating an institutional and regulatory environment that would attract sustainable private investment in infrastructure, by reforming laws and regulations, and by introducing cost-reflective pricing.

65. System improvements to optimize the utilization of existing assets, increase the efficiency and quality of services, and enhance their demand-responsiveness should certainly take precedence before new investments. This is particularly relevant for utility agencies like the water companies (PDAMs), which often face problems of over-designed capacity combined with large-scale unaccounted-for-water (UFW). Further, new capital investment programs should fully consider the impact of capacity expansions on future operation and maintenance (O&M) budgets.

Outlook: Cautious Optimism

66. Indonesia's decentralization is underway but far from complete. Its future will depend in part on the country's macro-economic and fiscal stability, and in part on the energy and resourcefulness of local authorities. Any threat to macro-economic stability seriously affects local governments' revenues, obliging them to reduce development spending. The consequences of that will affect the poor in the cities more than anywhere else.

67. At the city level, local bureaucrats need to adopt bottom-up participatory approaches involving multiple stakeholders. Lack of experience of DPRD members and civil society, the human checks and balances in the democratic system, add to the challenge. Additional risks arise from weak institutional capacities, combined with the absence of mature control systems to check corruption and rent seeking at the local level. Finally, cities may not be able to generate enough resources for financing required investments. If these risks materialize and the cities cannot respond quickly to the demands of their citizens, the momentum for democracy and civil society participation may fade away.

68. These risks, though, need not become a reality. The Urban Sector Review team observed that cities, on their own, are taking steps to meet their new roles and emerging responsibilities, in different ways. Although decentralization and democratization are relatively new concepts in Indonesia, there is already a growing awareness about democratic governance and a greater intolerance for corruption. In a climate of distrust for old-style public administration, decentralization has accelerated changes in the political landscape. Although confusion and uncertainty abound, the current movement towards the establishment of democratic and autonomous city governance seems irreversible. Part of the World Bank's mission will be to work together with the central government and the regions as well as their stakeholders to insure that measures in addressing urban challenges mentioned earlier translate into progress in enhancing local governance, improving urban services, strengthening the local economy and reducing urban poverty.

I. THE SETTING FOR CHANGE

Background

Introduction

1.1 In the wake of a profound economic and financial crisis of 1997 (the *Krismon*) and a period of dramatic political contention, Indonesia, the world's fourth most populous country, finds itself in the midst of two major transformations. One, the devolution of authority and resources from the center to local jurisdictions, is a matter of political choice. The second, the steady migration of individuals from the countryside to the cities, is a matter of many hundreds of thousands, even millions, of individual decisions. Decentralization and urbanization, however, intersect and overlap. They are working together to change the country's society and economy in profound ways.

1.2 The Urban Sector Review examines the trends, the progress and the problems of that multi-faceted transformation. It focuses on urbanization in the context of the transfer of power and responsibility and the associated growth of democratic local institutions in the country's 30 provinces and 416 districts, including 50 cities with populations of 100,000 populations or more. The review addresses urban sector issues both in their spatial and administrative contexts; typically, cities and towns extend beyond administrative jurisdictions of urban local governments in Indonesia. It concludes with the identification of strategic frameworks, policy drivers and immediate actions that will make Indonesia's cities strong engines of economic growth, effective providers of services and environments of opportunity for the poor.

Population Trends

1.3 The estimated population of Indonesia–some 13,667 islands occupying around 1,919,440 sq km and containing more than 300 ethnic groups–is about 210 million people, 60 percent of whom live on the island of Java. Of the total population, the urban share[1]at the end of 1999 comprised 82.5 million, or 39.8 percent (SIMA tables, World Bank), and around 40.34 percent in 2000 (United Nations, 1996). While the average yearly population growth between 1990 and 1999 was about 1.6 percent, the urban population grew almost three times as fast, about 4.4 percent, during the decade. Like many developing countries, Indonesia is steadily urbanizing; out of its projected total population of 275.6 million people in 2025, 167.4 million will be urban residents. That forecast signifies a dramatic demographic shift from an urban population of less than 20 percent in 1975 to over 60 percent 50 years later.

Table 1.1: Urban Demography Patterns

	1971	1976	1981	1986	1991	1996	1999
Population growth (annual %)	2.4	2.5	2	1.8	1.8	1.6	1.6
Urban population (millions)	21.1	27.1	34.8	44.8	57.3	72.3	82.5
Urban population (% of total)	17.6	20	23	27	31.6	36.7	39.8
Urban population growth (annual %)	5.1	5.3	5.5	5.2	5	4.6	4.3
Source: SIMA tables, World Bank 2002							

[1] BPS defines a village as urban on the basis of population density, the proportion of the population engaged in non-agricultural occupations and the number of urban facilities.

Urbanization

1.4 In terms of distribution, slightly more than half of the total urban population lives in 90 municipalities with autonomous status (*kotas*) and the remainder in the urban areas of 326 rural districts (*kabupatens*). Urbanization rates vary significantly across Indonesia with 65 percent of the 120 million Javanese considered urbanized, compared to 18 percent of the inhabitants of Lampung province on the island of Sumatra. Throughout Indonesia, eight major cities – five of them on Java - hold more than a million people each and, collectively, about 12 percent of the country's total population. Jakarta (9.2 million), the capital, is the center of a megalopolis (Jabotabek) with a population of more than 20 million. It is followed in size by Surabaya (2.7 million), Bandung (2.4 million), Medan (1.9 million), Semarang (1.4 million), Palembang (1.4 million), Tangerang (1.2 million) and Ujung Pandang (1.1 million).

1.5 This urban expansion comes from three sources: natural growth, rural-urban migration and the transformation of rural areas to urban centers. Although natural growth accounts for less than half of the increase (about 45 per cent) during 1990-1999, information on migration patterns and the change of rural areas into urban centers is scant. The inter-census survey (BPS, 1995) indicates that about 7.2 per cent of the total population migrated during the five-year period since the 1990 census, with most migrants (about 61 per cent) moving to urban areas. Of the latter, 34 percent came from other urban areas (intra-urban mobility), and the remaining 27 percent, from rural ones. This suggests that net rural-urban migration may account for about 25-30 percent of urban population growth, with the remaining 30-35 percent of urban growth due to rural-urban transformation of settlements. (ADB, 2000a).

Urban-Rural Ties

1.6 The demographic movements that are changing the face of Indonesia occur against a background of significant social, economic and political linkages between urban areas and their rural hinterlands, both at macro and local levels. At the macro level, the linkages – some stronger than others – take the form of circular/seasonal migration, remittance of food provision and administrative connections eased or hampered based on the condition of transportation infrastructure, market and transit/storage facilities, and market information.

1.7 These conditions vary in different parts of rural Indonesia. As a whole, the rural economy has low levels of growth in non-farm employment and is dominated by urban capital. The urban informal sector provides marginal income opportunities to rural migrants (Sudarmo, 1997: p. 230). The SUPAS (1995) study on migration and urbanization found that 55 percent of rural-urban migrants cited improved access to key services and opportunities (education and employment) as the main reason for moving. A further 41 percent gave family matters as their main reason for moving from rural to urban areas (Supas cited in ADB, 2000). Many urban residents retain strong linkages to their village of origin. While financial flows between urban and rural areas have been typically on a person-to-person basis, rather than at an institutional level, in the area of information, flows have widened in an extraordinary fashion with the pervasive influence of television among all income groups, even in remote villages. However, information to help rural producers better access urban markets is still not available.

1.8 The 1997 crisis, moreover, clearly demonstrated that the fickleness of the urban economy can be balanced by a more stable rural economy, as the changes in sectoral GRDP shares, unemployment and poverty rates and even reverse migration between urban and rural areas illustrated. In general, there is a sense that rural-urban interactions have increased everywhere in the last two decades, helping to raise levels of welfare, albeit without necessarily narrowing urban-rural or regional disparities in income. It is important to understand this urban-rural linkage in terms of assessing the roles of secondary cities as buffers and as support to metropolitan cities, such as Jakarta.

1.9 To narrow that gap, the government will need to respond more energetically in terms of policies, investments and information. While local-level empowerment as a result of decentralization and democratization represents a very significant step in this direction, the pace of urbanization confronts urban areas with growing and changing demands that require important responses in planning for the provision of infrastructure, basic services and housing in urban areas. That manifold challenge and related ones are the subject of this review.

Recent Developments

1.10 **Political and economic events.**[2] With an average growth rate of 7.1 percent between 1985 and 1995, a real GDP growth of 7.8 percent in 1996, a reduction of poverty from almost 60 percent to around 11 percent of the population between the 1960s and 1990s, and an overall improvement in general living standards, Indonesia was once regarded as a "model of development." The *Krismon* changed all that and much more! In the aftermath of the Asian economic and financial crisis of 1997, the country experienced a period of dramatic depression. The value of its currency fell by over 80 percent; inflation peaked at 80 percent; and poverty more than doubled. The recent political history of Indonesia has been equally dramatic. After 31 years as president, General Suharto was forced out of office in May 1998, succeeded by his Vice-President, B. J. Habibie. That interregnum ended with Indonesia's first free and open elections in June 1999, leading to the presidency of a moderate religious leader, Abdurrahman Wahid, emerging from a multiparty post-election negotiation process and overtaking Megawati Sukarnoputri, who became Vice-President.

1.11 In its first year, the Wahid government restored democratic freedoms and civil rights and tackled the difficult issue of the role of the military in politics. The new parliament ceded independence to East Timor in November 1999 and the government opened a dialog with a number of regions pressing for greater autonomy. A major program of decentralization, initiated during the time of the Habibie Government and designed to reverse the extreme centralization of power in Jakarta, took root during this period. Steps toward regional autonomy also made local governments increasingly active with local legislatures becoming more vigilant in overseeing their executive branches. Despite such welcome changes, the transition was beset with tensions and uncertainty. Wahid's tenuous relationship with Parliament affected the government's ability to maintain reform. The new freedom also brought to the surface long suppressed ethnic divisions, a deterioration in law and order, and communal violence, particularly in Maluku. Secessionist movements became increasingly active in Aceh and Irian Jaya. Tensions mounted as local aspirations for self-rule were met by the determination of the central government and military to maintain Indonesia's territorial integrity. These issues absorbed most of the new government's energy, leaving policymakers little time for serious policy and strategy work to lift the country from the depths of the crisis of 1997.

1.12 The Wahid government struggled to live up to expectations of ushering in a new era of political and economic transparency and reform. The President's impeachment on July 23, 2001, brought Megawati Sukarnoputri into office as Indonesia's fourth president in a little over three years. Her months in office since then have seen a marked improvement in political and economic stability; however, she faces a daunting list of challenges from separatism to economic stagnation.

1.13 In addition to facing the same pressures as her presidential predecessors did, Sukarnoputri must oversee the far-reaching decentralization program initiated earlier. Expected to have major implications

[2] The commentary on recent political and economic events is drawn from the Economist Intelligence Unit, World Bank country reports and a number of other sources.

in every sphere of governance, decentralization is a strong political imperative to counter the centrifugal forces within the country. It also makes good economic sense, as Indonesia was unusually centralized for a country of its size and diversity. But if managed badly, the transition to a decentralized Indonesia could not only impair macroeconomic stability, but also seriously affect the delivery of government services and the success of poverty reduction efforts.

1.14 **Recovering from crisis**. In a single year, 1997, Indonesia saw its economy swing from rapid growth to even more rapid contraction, the stock exchange lost approximately 70 percent of its value, urban unemployment climbed to unprecedented levels and the country was engulfed in social unrest and political violence, threatening its very fabric. Few countries in recent history, let alone one the size of Indonesia, have suffered such a dramatic reversal of fortune within such a short span of time.[3]

1.15 The impact of the crisis was severe in all sectors of the economy. As a result of the crisis, GDP growth slowed to 4.7 percent per year in 1997, then contracted by 13.1 percent in 1998, the worst performance since record keeping began. Declines in output occurred everywhere except in agriculture, which managed full-year growth of 0.8 percent in 1998; and electricity, gas and water grew by 1.9 percent. The worst affected sectors were construction - down by 36.4 percent, trade, financial, real estate and business services - down by 26.6 percent, and hotels and restaurants - down by 18 percent.

1.16 In 1999, the economy returned to growth, but only just, expanding by 0.8 percent. The next year brought the appearance of recovery, a 4.8 percent annual expansion, with all sectors recording positive growth. Robust external trade was a major factor behind the 9.4 percent annual growth in transport and communications and the 6.2 percent growth in manufacturing. Although construction grew by 6.7 percent, the sector is still 30 percent smaller than it was in 1997. Foreign reserves have also steadily climbed from US$16.6 bn. by the end of March 1998, to around US$29 bn. by August, 2001; since the resumption of IMF lending, the Rupiah has rapidly appreciated; and inflation fell to an annual average of 2 percent. However, the sharp deterioration in the global economy following the terrorist attacks in the United States posed fresh challenges to the new leadership. The economy was already set for lower growth in the succeeding years, along with greater pressures on the Rupiah and stubborn inflationary tendencies.

Decentralization: The "Big Bang"

1.17 Indonesia is now undertaking what may be one of history's most sweeping and rapid decentralization efforts, powered by the regional political strength that emerged following the collapse of the highly centralized and authoritarian Suharto regime. Despite its diversity and size, Indonesia has a centralized administrative and fiscal system. In fiscal 1999, for example, the central government collected 94 percent of general government revenue and about 60 percent of sub-national spending was financed by central transfers[5]. This system weakened links between local demands and decisions on local public services, undermined local accountability, and produced ad hoc allocation of fiscal resources across regions.

1.18 In the past, resentment arose from the central government's control of revenue earned from natural resources in outlying provinces and its insensitivity to regional differences; this resentment led to strong calls for devolution of power. Since the early 1970s, several proposals have been made for fiscal decentralization (MacAndrews, 1986; Leigland, 1993; Azis and Schroeder, 2001), but the key elements were never implemented. Triggered by the *Krismon* and the subsequent political upheavals, Indonesia is

[3] The World Bank. Indonesia in Crisis, 1998.
[4] World Bank. Indonesia: The Imperative to Reform, 2001.
[5] "Indonesia's decentralization after crisis," PREM Notes Number 43, September 2000.

now taking huge steps forward in political and fiscal decentralization. The government responded to the heightened and more strident calls for decentralization when the Parliament hastily adopted two laws in April, 1999 to set January 1, 2001 as the starting date for a drastic, "big bang" decentralization. The basic elements of decentralization are[6]:

- **Law 22/1999 on Regional Governance** specifies the political and administrative responsibilities of the central, provincial and local governments within a decentralized structure.

- **Law 25/1999 on Fiscal Balance** provides the legal foundation for fiscal decentralization, delineating the new division of revenue sources and intergovernmental transfers.

These laws cover all major aspects of fiscal and administrative decentralization. Based on them, an exceptionally broad range of functions was shifted at the start of 2001 from the center to local governments–largely bypassing the provinces and their centrally-appointed governors. Under the laws, all public service delivery functions except defense, foreign affairs, monetary and fiscal policies, trade affairs, and legal systems have devolved to sub-sovereign governments. Cities and rural districts (*kotas* and *kabupatens*) became responsible for most public services–for example, health, education and infrastructure–; the provinces act as coordinators. Any task unspecified in the law resides with the local government.

1.19 The transfer of thousands of central agency offices with over 2 million employees accompanied this constitutional shift. *Kotas* and *kabupatens* are now controlled by freely elected local councils that select their mayors and hold local administrations accountable for performance. With these changes, the sub-national share of government spending almost doubled in a single year to over 30 percent; some 60 percent of the development budget was expected to be managed at sub-national levels[7]. Most important, block grants of general allocation funds, called DAU, became the principal mechanism for fiscal transfers to local governments, signaling an end to central control over local budgets and financial decision-making. These grants will, by law, amount to at least 25 percent of total central government revenue after tax sharing; 10 percent goes to provinces and 90 percent to districts. DAU is based on formulas aimed at equalizing the fiscal capacities of sub-national governments to meet their spending needs. The central government will also share revenues from natural resources—onshore gas, onshore oil, forestry and fisheries, and other sources with sub-national governments. In addition, the Minister of Finance has granted 20 percent of personal income tax revenue to provinces, though this provision is not in the legislation.[8]

1.20 The new laws and the resultant changes reflect the political reality that ordinary Indonesians want a greater role in managing their affairs. The changes offer great opportunities for such participation, but they hold major risks as well. Several issues remain unresolved in the decentralization process. Among the most pressing outstanding issues are:

- Law 22/1999 does not define local government functions. To do this, supporting regulations are critical to clarify the division of functions, sub-functions, activities and responsibilities among levels of government, as well as the devolution of projects, personnel, assets and other resources. The Law on Regional Governance is too general in assigning spending responsibilities and therefore threatens effective service delivery.

---

[6] A more detailed discussion of decentralization follows in Chapter 2.
[7] Ahmad and Hofman. Indonesia: Decentralization – Opportunities and Risks, March 2000.
[8] "Indonesia's decentralization after crisis," PREM Notes Number 43, September 2000.

- Equally unclear is the specification of what local governments are obliged to undertake. While the law itemizes the obligatory "sectors" of local governments, it does not specify what the functions of the local government are in those sectors. Furthermore, the description of "sectors" is far from a level of operational detail that local governments need.
- Decentralizing most services to local governments on such short notice may be overtaxing their capacities. Representatives to local legislatures often lack the knowledge and experience to provide valuable policy guidance and be effective overseers.
- Law 34/2001 has empowered the local governments to create their own new taxes subject to certain criteria and rate limits decided by the central government. However, the supervision of this law is difficult for the central government, leading to a proliferation of new taxes at the local level, many of which are not rational or optimal.

1.21 While many of these issues are likely to be addressed in the coming months and years, as decentralization grows into a political, administrative and economic reality, Indonesia faces the challenge of insuring that the transition occurs in a stable and coherent manner, and the opportunity of unleashing the economic and human potential of its dispersed regions for greater growth and less poverty. Those challenges and opportunities, as they confront cities and towns of the country, are the subject of the rest of this report. Chapter II examines the processes and problems of decentralization as they relate to local governments; Chapter III addresses urban poverty, service delivery, urban land and housing, local economic development and urban environmental issues; Chapter IV reviews the Bank and non-Bank operations in urban areas; and finally, Chapter V identifies key thrust areas and essential policy drivers that will enable Indonesian cities to grow more efficiently and equitably.

II. DECENTRALIZATION AND LOCAL GOVERNANCE

Introduction

2.1 Indonesia's "big-bang" decentralization is a dynamic and constantly evolving phenomenon, with macroeconomic and fiscal implications, as well as having impacts on political and social life, and the urbanization process. This review certainly does not purport to be the last word on the process of political, administrative and fiscal decentralization now underway in the center, the provinces and local governments.

2.2 Indonesia is divided into provinces and local governments in two categories: city districts (*kota)* and rural districts (*kabupaten*). Within them are sub-districts or (*kecamatan),* which are smaller administrative government units; these sub-districts are further divided into villages. Villages in rural areas, called *desa,* are referred to as *kelurahan* in urban areas.

Decentralization: The Policy and Regulatory Framework

Background

2.3 Since its independence, Indonesia has had a highly centralized but multi-tiered unitary state, with the central government at the top of the hierarchy. Provincial governments belong in the second tier and local governments the third tier. Apart from historical factors that led to the establishment of a unitary state, a centralized authority was considered necessary to unify the fourth most populous country in the world. Concomitant with this centralization of power, Indonesia also had one of the most centralized tax systems in the world (Ma, 1996: p.29), making the system of transfers from the central to regional governments the determining factor in local fiscal capacity (Silver, Azis and Schroeder, 2001). Revenues of the central government constituted almost 90 percent of all revenues; lower level governments, both rural and urban, depended on central government grants for almost 60 percent of their spending. The central government, including the 'deconcentrated' central departments at provincial, district and village levels, controlled over 80 percent of all government expenditures (Alm and Bahl, 2001).

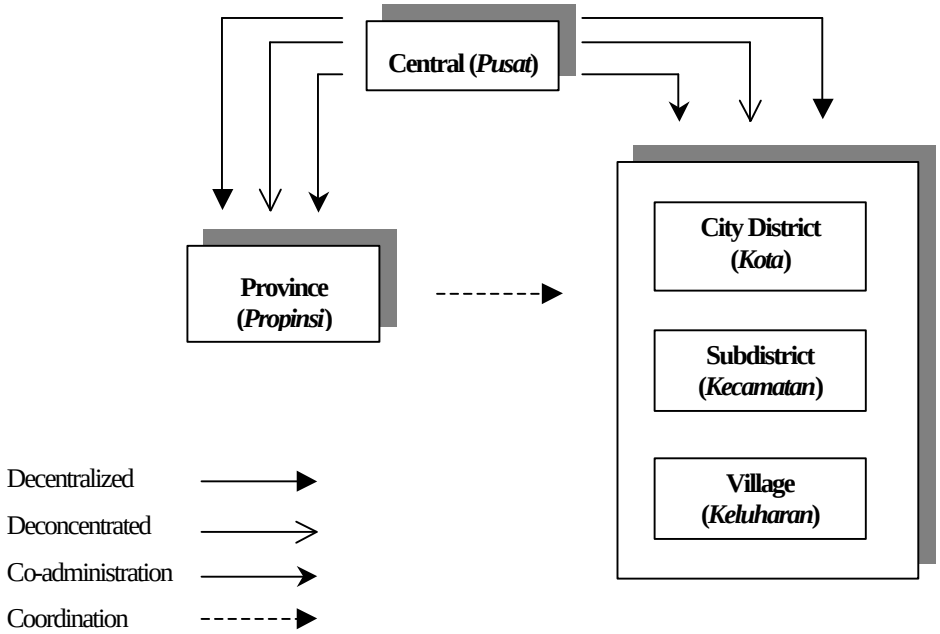
2.4 Law 22/1999 on Regional Governance and Law 25/1999 on Fiscal Balance between the Central Government and the Regions (provinces and local governments) changed the organization of and relationship between central, provincial and local governments in Indonesia in several fundamental ways. Both laws are founded on the principles of democracy, community participation and empowerment, equity and justice, recognition of the potential and diversity within regions, and the need to strengthen local legislatures. When fully implemented, the two laws will transform intergovernmental relations in Indonesia. In tandem with increasing democratization at the provincial and local levels, the laws have the potential to increase significantly the accountability of local governments and move government closer to the people.

The Regional Governance Law

2.5 Law 22/1999 on Regional Governance eliminates the hierarchical relationship between the provincial and local governments. The local governments, previously known as *kotamadya* and *kabupaten* (city and rural districts), have become fully autonomous, with *walikota* and *bupati* (the mayors and rural district heads), selected by elected local assemblies, called the *Dewan Perwakilan Rakyat Daerah* (DPRD). Departing from the past practice of reporting to Provincial Governors, these heads now report to the local assembly, making them responsible to the local electorates. In the new system, the provinces have no hierarchical relationship with local governments; they have a

coordinating role, and perform that the local governments cannot yet undertake perform. In contrast, the provinces retain their hierarchical relationship with the central government and continue to have status as self-directed regions and administrative regions under the President.

Figure 2.1: Hierarchy of Government Structure (Urban Areas)



Source: SMERU, 2001/others

2.6 Law 22/1999 assigns all government functions, except defense, judiciary, national planning, finance, and others it specifies to the district (Chapter 4, Article 7). The law spells out the functions that the district must perform and cannot hand back to the province, including education, health care, and local infrastructure. This arrangement has been amplified by Government Regulation 25/2000 (PP 25/2000), specifying the remaining roles of the center and the province, while treating the roles of the district by default (Chu, Nehru et. al., 2000).

2.7 Although over the years, more and more functions moved to the local level, they were primarily filled by 'deconcentrated' central government agencies; in effect, local government's role was marginal. After the passage of Law 22/1999, this practice was discontinued. With some exceptions, the relevant central government agencies, including their staff and assets, have merged at the regional level with their respective local counterparts.

2.8 In a departure from the past, where the roles of the legislature and the executive were almost indistinguishable at the local level, the Regional Governance Law separates the legislature—DPRD—from the executive. Regions are now empowered to legislate and enact regulations without the consent of the central government. However, the Law provides for intervention by the central government to nullify legislation that is not in the 'national interest;' regional governments, in turn, have the right to judicial appeal of these decisions by the central government.

2.9 The Law allows local governments to borrow from capital markets; however, direct foreign borrowing is not permitted. Local governments have to present detailed revenues and expenditures in their budgets (APBD). The Law also supports efforts by local governments to establish inter-regional

cooperation in the delivery of services and obliges them to involve local communities and stakeholders in the decision-making process.

The Fiscal Balance Law

2.10 Law 25/1999, which addresses fiscal balance between the central government and the regions, aims to provide the resources to finance the devolved tasks by assigning revenue sources and broad expenditure functions to the provinces and districts. Its main objectives are to utilize and improve regional economic abilities; to create a regional financing system that is just, proportionate, rational, transparent, participatory, accountable and correct and to achieve fiscal balance between the center and regions.

2.11 To implement decentralization, this Law establishes the sources of regional revenues as original regional revenues, balance funds, regional loans, and other legal revenues (Chapter III, Article 3). The Law provides for (a) sharing property and natural-resource revenues (land and buildings, property transfers, forestry, mining, fisheries, gas, and oil), (b) the creation of a General Allocation Fund (GAF) called *Dana Alokasi Umum* (DAU), and (c) the creation of a Special Allocation Fund (SAF) called *Dana Alokasi Khusus* (DAK).

2.12 Routine transfers of the past, called the Subsidy *Daerah Otonom* (SDO) and used to pay the salaries of local civil servants, have been eliminated; so have general development transfers known as block *Instruksi* President, or block *Inpres*. Instead, these two have been combined into the general allocation fund—DAU. Total amount of the DAU is 25 percent of central government revenues after tax sharing;[1] distribution among local governments is determined by appropriate revenue-sharing formulas. The 25 percent is a minimum share for the regions, but for FY01-03 it is the actual share approved by Parliament. DAU comes from the central government‘s annual budget (APBN). The formula for transfer under DAU is based on the relationship between local needs and local capacities (see section on Local Government Financing). The special allocation fund, DAK, which originates from the APBN, is allocated to the regions to promote and finance national priority programs, such as poverty alleviation, reforestation, and capacity building, based on specific regional requirements.

2.13 This Law also introduces revenue sharing among provincial and district governments, assigning each level of government its share of revenues from taxes on land and buildings, the transfer of land and buildings, forestry, mining, fisheries, oil and gas. Other sources of local government revenue, such as own-source revenues and charges (PAD), profits from government enterprises or borrowings, remain unchanged; the same is true for revenues from specific *Inpres* grants for development projects, such as schools and health facilities.

2.14 Further, this Law states that the regions may borrow from domestic sources to finance part of their budget and from foreign resources through the central government under certain conditions. Regions are allowed to make long-term loans to finance the development of “facilities constituting regional assets that may produce revenues for repayment of loans and provide benefits to the community,” as well as short-term loans for “regulating the cash flow in line with managing the regional treasury.” These regional loans require the approval of DPRD; their repayment constitutes one of the priorities of APBDs. In the event the regions fail to meet their obligations for payment of regional loans from the central government, the Law empowers the central government to offset such

[1] While Law 25 does not specify whether 25 percent is before or after revenue sharing, PP 104 defines it as net of revenue sharing. PP 104’s interpretation is that it should be based on actuals (Decentralizing Indonesia: A Regional Public Expenditure Review, World Bank, 2003).

obligations by intercepting the DAU allocations to the regions. The directive on local borrowing contains supporting regulations.

Other Laws and Regulations

2.15 The Regional Governance and Fiscal Balance Laws lay down the foundations for a decentralized inter-governmental political, administrative and fiscal structure in Indonesia. These laws are supported by revisions of existing laws/regulations and the creation of new ones. A summary of the most relevant laws/regulations to date, follows.

2.16 The Regional Governance Law is supported by Regulation 25/2000 regarding the authority and functions of the central government and the provinces as autonomous regions. It assigns specific service responsibilities to the central and provincial levels, with local governments responsible for "everything else."

2.17 The most relevant legislation on regional taxes is Law 34/2001 which expands on the Fiscal Balance Law and revises Law 18/1997, to provide The legal framework for all regional government taxation and charges. It makes a number of significant changes to local taxing and charging authority, and to the allocation of tax bases across provinces and local governments. Most important, the Law empowers local governments to create their own new taxes subject to limits on tax rates by the central government for purposes of nationwide conformity. Local governments must also meet certain criteria for DPRD approval. In addition, the Law insists that any local government regulation (PERDA) creating a new tax must be presented to local citizens before it can be enacted. Finally, the Law requires local governments to submit the "new tax PERDA" to the central government for review after DPRD ratification. The central government retains the power to revoke any new tax that contravenes the public interest and/or contradicts laws of a higher order.

2.18 Regulation No. 104/2000, which concerns "Fund of Balance" funds originating from APBN and allocated to the regions to finance decentralization, sets forth formulas used to distribute central government transfers to the regions: general allocation funds; special allocation funds; and shared revenues from land and building taxes, fees for acquisition of rights to land and buildings, and revenue from natural resources.

2.19 Regulation No. 105/2000 on regional financial management and accountability lays down principles for preparing local government budgets, procurement of goods and services, and standards of financial management for local officials. The regulation aims to ensure transparency and accountability. As an anti-corruption safeguard, the regulation requires local officials to ensure that the goods and services they procure are necessary for public policy. This regulation does not, however, establish related verification procedures, and its auditing provisions are vague.

2.20 The draft government Regulation on Local Government Financial Management encourages full cost recovery for services, wherever appropriate. To clarify the link between inputs and expected outputs, it also specifies that local governments will use performance-oriented budgeting for budgeting and reporting financial performance. Regulation No. 11/2001 obligates the regions to submit information about their finances, including regional borrowings, to the central government and it specifies the format and periodicity. It also defines measures of recourse that the central government can invoke in the event the regions fail to submit the needed information.

2.21 Regulation No. 106/2000 on deconcentrated tasks deals with the central government's spending on development. Almost all these resources come from development projects funded by foreign donors and co-financed in part by the central government. The latter will retain control over

these development funds and sub-contract projects to the regions as it sees fit. The central government did not consult with local governments on this issue, and many local officials found the news an unpleasant surprise.

2.22 Regulation No. 107/2000 sets limits on local borrowing; the regions may receive long-term loans for financing infrastructure, designated as a regional asset and capable of generating revenues to repay the loans. The projects must also provide benefits to the public. The maximum available limit for short-term regional loans is one-sixth of the amount of APBD funds from the current year. Total debt can never exceed 70 percent of the previous year's APBD general revenues; the ratio of revenues to debt service payments in a given year is limited to 2.5:1. Further, Ministerial Decree KMK35/2003 clarifies the rules for on lending to the regions. Local governments may borrow from foreign sources only with the approval of the central government.

2.23 The draft Regulation on Urban Management and Governance requires urban governments to involve and consult the public in planning, implementation and monitoring. A key feature of this regulation is the convening of an Urban Forum (Forum *Kota*) for stakeholders' participation.

2.24 The draft law on Regional Government-owned Enterprises (RUU BUMD) empowers local governments to establish, dissolve or restructure BUMDs without the approval of the central government. It also vests them with full authority to select from various existing organizational forms—*dinas*, UPTD, unit *swadanas*, BUMD, BP—to provide for services without prior approval of the central government.

2.25 Regulation No. 20/2001 on Fostering and Supervision of Local Governance ensures that local governments function in accordance with the plans and stipulations of existing laws and regulations. The regulation authorizes the central government to delegate the supervision of *kotas/kabupatens* to the provincial governor as the central government's regional representative. The 'fostering' referred to in the regulation pertains to guidance, training, directives and supervision of local government.

Policy and Process: Highlights and Emerging Issues

2.26 Decentralization can improve the lives of the people of Indonesia, especially its poor, by increasing their voice in decision-making and improving their access to government. Consequently, public expectations are high for a more accountable and transparent government at the central and regional levels. As the process is still evolving, many issues are emerging. Some of them may be part of the learning process and resolved over time. What is critical to progress is that the government, civil society and donors monitor developments and keep the dialogue going.

- The assignment of significant new expenditure responsibilities to provincial and especially to *kota/kabupaten* governments has the potential to achieve gains in efficiency as a result of aligning service delivery with local needs and affordability. Other potential gains include greater revenue mobilization because citizens may be more willing to pay local taxes for public services and local governments may be more familiar with and thus better able to tap local tax bases.

- Debate continues over whether the powers should be concentrated at the provincial or local level. The debate hinges on economies of scale, spill-over and the capacity of local governments to deliver certain services. Higher levels of government may be reluctant to devolve power or skeptical about local government's capabilities, nevertheless, the debate is a serious one and some issues are pending.

- There have been conflicts and/or contradiction between Laws 22/1999 and 25/1999 and subsequent regulations. For example, Presidential Decree No. 10, "Implementation of Regional Autonomy in the Land Sector," postpones the transfer of land administration to local governments. It contradicts Article 11 of Law 22/1999, which cedes responsibility for land matters to local governments.

- The end of the hierarchical relationship between the provinces and the local governments has led local governments to position themselves as direct subordinates to the central government. As a result, provincial and district assemblies have issued conflicting and/or confusing local legislation and regulations on the same subject. There is a need for a clear set of guidelines outlining the relationship between various layers of government on functions, such as land, transport, communications, statistics, and family planning.

- A key issue highlighted by many teams monitoring decentralization is the lack of sufficient and up-to-date knowledge about legislation and regulations by local government officials. "Socialization exercises" by the central government have not been adequate in disseminating information and building local awareness about the policy and regulatory framework.

- Because the scope and responsibilities of local government remains unclear, despite Law 22/1999 and PP 25/2000, there has been occasional frictions between the center and the regions about their responsibilities and accountability. Such clashes have led to calls for a "non-binding positive list" of local government functions.

- Revenue and expenditure assignments need to be aligned at the *kota* level. The new laws support decentralization of expenditures, not revenue. This issue is discussed in detail in the section on Local Government Financing.

- In line with the central government's laws and regulations, the provinces and local governments are required to pass their own laws and regulations. However, their capacity to do so in a meaningful manner, given certain time constraints, is uncertain. The regions will require support from the central government to fulfill this responsibility.

Institutional Framework Governing Urban Affairs

Centralization to Deconcentration: Pre-Decentralization Period[2]

2.27 Prior to decentralization, five ministries (and their agencies) were involved in urban affairs at the national level. The coordination between them was handled mostly by specific task forces set up for this purpose. Central government agencies maintained their "deconcentrated" offices at the provincial (*Kanwils*) and local levels (*Kandeps*). The arrangements at the provincial level mirrored those at the national level, with provincial-level planning agencies (*Bappedas*) and autonomous "decentralized" departments (*dinas*) responsible for delivering services. Local governments maintained *dinas* in their own jurisdictions. The intent was to decentralize delivery of services

[2] For a discussion of the institutional framework for urban and local governments in the pre-decentralization period, refer to Annex 2.

based on UU No. 5/1974 and PP 14/1987. However, because local governments had limited capacity, central agencies continued to play an important, although diminishing, role over the years in the financing, planning, construction and operation of key urban services, up to the commencement of decentralization.

Autonomy and Responsibility: Post-decentralization Period

2.28 In the post-decentralization period, the institutional framework for urban and local government affairs changed. At the central level, the Ministry of Public Works (MOPW) and the State Ministry for Housing consolidated and was replaced by the new Ministry for Human Settlements and Regional Infrastructure (*Kimpraswil*), with Directorate Generals (DGs) for (a) Spatial Planning and Regional Development, (b) Urban and Rural Development, and (c) Infrastructure and Settlements Development. At the Ministry of Home Affairs (MOHA), after a brief period of existence as a separate state ministry, the Directorate General for Governance and Regional Autonomy (PUOD) consolidated in August 2000 with the MOHA and Regional Autonomy (MOHARA); it was renamed the DG for Local Governance (DG-PUMDA) with a Directorate for Local Government Revenues and Financial Management. In January 2001, a new DG for local autonomy (DG-OTDA) was formed with a concomitant reduction in the functions of PUMDA. Meanwhile, the DG-BANGDA (local development) was renamed DG-BINA BANGDA, offering institutional support for local development. The Ministry of Finance (MOF) continues to dominate national priorities; within it, a DG for local government finance has operated since January 2001. Although changes in the tasks and functions of *Bappenas* have been minor, the agency's role in carrying out projects was cut back.

2.29 While many alternatives are in place, a formal inter-agency coordination mechanism in the post-decentralization period has yet to emerge. Alternatives specified under government regulations are: (a) Urban Forum, an ad-hoc forum that meets periodically to discuss national urban policy issues with the DG-UD, *Kimpraswil*, as the secretariat. This body is not restricted to government departments, but has representatives from the private sector, academia and NGOs; (b) the National Spatial Coordination Board (BKTRN), recently revitalized, as the Coordinating Minister for Economic Affairs as the Chair and the Minister for Human Settlements and Regional Infrastructure as the Deputy-chair; (c) a new National Board for Policy and Supervision of Housing and Human Settlements Development (BKPRN) at the ministerial level, chaired by the Minister for Human Settlements and Regional Infrastructure; and (d) the Regional Autonomy Advisory Council (DPOD), an interdepartmental body provided for under Law 22/1999 (ADB, 2001).

2.30 With decentralization, elected DPRDs and their *Walikotas/Bupatis* have greater autonomy and more direct responsibilities than ever before. As the executive head of the local government, the *Walikota/Bupati* is accountable to the DPRD. The DPRD is authorized to approve local government budgets and plans. At the provincial and district levels, the deconcentrated *Kanwils* and *Kandeps* , have transferred their personnel and assets to the provincial and local governments, respectively. Although local governments had been gaining increasing responsibility for delivery of urban services in the immediate pre-decentralization period, the key changes since have put new methods and approaches to local governance and service delivery into place. Among them are the new urban stakeholder forums at the local level and the authority local governments now possess to improve urban services by restructuring (even dissolving) existing organizations (*dinas, swadanas, badan pengolas* and BUMDs), or by recruiting private firms to do the work. With that has come the expectation of prioritizing and aligning local budgets with local needs.

2.31 Although autonomous in principle, in practice, government services in many regions are still being carried out by two kinds of government agencies: the "autonomous agencies" (*instansi*

otonom) and "vertical agencies" (*instansi vertikal*). *Instansi otonom* refers to government offices previously under the regional government (province or local governments) and funded from the APBD, such as *dinas*, boards, regional secretariats (*Sekretariat Daerah, Setda*), technical units (Unit *Pelaksana Teknis*, UPT). *Instansi vertikal* applies to those government offices previously under the central government and funded by the APBN. The APBD operated within a particular province, district or municipality. These included the *Kanwils, Kandeps*, and technical units of the central government.

2.32 Restructuring the institutional framework of local government was an essential step in preparing for decentralization. As of this writing, a total of 239 provincial-level *Kanwils*, 3,933 district-level *Kandeps*, and 16,180 UPTs by the central government have been handed over to the provinces and local governments, (GTZ, March 2001). The amalgamation of some offices by the central government has resulted in the formation of technical offices and autonomous agencies. This has led to an excess number of work units in many local governments.

2.33 Members of the DPRDs are not directly elected. Voters choose political parties, not candidates themselves. The parties then select their members for the local parliament. The parliament, in turn, elects the head of the district or municipal government. These elected *bupatis* and vice-*bupatis* recruit staff from the local bureaucracy.

2.34 Although chosen indirectly, the members elected to the 1999-2004 local DPRDs are recognized as the most legitimate representatives from local communities since the 1955 election. The executive and the legislature work together as partners and equals at the municipal level. Open public debates flourish. Citizens enjoy greater freedom than ever in exerting their influence on the legislators and the executive. Community representatives express their views and demand that local assemblies recognize their aspirations. Nevertheless, barriers still prevent interest groups and community organizations from fully participating in public policy.

2.35 More than 2.1 million civil servants—over half of them school teachers—were transferred to provincial and local governments on January 1, 2001 without incident. Assets went with them and financial allocations occurred as planned. This transfer represented more of a change in status than a physical transfer; most government officials were already based in the regions. However, their impact on the organizational structure, finances and work culture of urban local governments has been profound. The concerns that have come about due to this massive change will be a major challenge to local governments in the coming months.

Emerging Institutional Challenges: Capacity Building, Streamlining and Accountability

2.36 Many cities are adjusting to the changes wrought by decentralization. For cities with a track record of good governance, decentralization has brought new opportunities; for example, Balikpapan and Blitar are reaching out to lower levels of administration—the *kelurahan* and *kecamatan*. Others, like Kupang and Bandung, are trying to deal with increasingly vocal local constituencies. Some cities have not been touched by the changes at all.

2.37 A key institutional challenge facing urban local governments in the post-decentralization period is insufficient technical and professional staff in the local legislatures. The voices of the people are often not being channeled effectively through local-level representatives because of their limited preparedness. Many of them, for instance, lack formal education and political experience. The level of policy awareness and the quality of political debate is poor. Local governments have an urgent need to build capacities in planning, engineering, budgeting, accounting, financial and project management. Capacity building needs to be mainstreamed so that regions can employ resources

based on their specific needs. A National Framework for Capacity Building to Support Decentralization has been produced as a reference by the GOI with donor support, for use as a reference for initiatives supporting decentralization.

2.38 The new shift in accountability remains incomplete; the "big bang" decentralization may have left behind an inadequate set of checks and balances, one that does not take into account the wide range of capacities (Smoke 2000; Kaiser and Hofman, 2002). In many cases, it is not clear whether local constituencies reflect the "real" public will or the elite interests. Although local governments are accountable to the local legislature, widespread reports of money politics (*politik uang*) raise concerns about the accountability of legislators themselves (Usman, 2001). Fiduciary oversight is weak, leading to increased opportunities for corruption and nepotism. In this environment, rent-seeking has flourished (Hofman and Kaiser, 2002) to the point that some local legislatures have voted themselves disproportionately large salary increases.

2.39 In the transfer of personnel from the center to the regions, a number of problems have emerged. For example, there have been discrepancies between the number of employees counted by local governments and figures released by the National Agency of Civil Service Administration (BKN); BKN has reported a higher number of employees in several provinces. If such reports are accurate, there are questions about the extent of these discrepancies and whether they were inadvertent mistakes. However, there is suspicion that recording incorrect data was deliberate, aimed at claiming the salaries of these non-existent personnel. "Phantom" personnel are only one of many problems that need to be addressed by the central and local governments as they implement decentralization.

2.40 At present there are more employees than public-service positions with a preponderance of non-technical staff over technical staff. The number of city government personnel has increased notably and it varies from city to city. *Cities Speak* cites the following examples: Palembang's personnel increased 4.8 times after decentralization, Kendari—3.6 times and Balikpapan—2.77 times. In terms of sheer numbers, Bandung alone added around 10,000 personnel. The general characteristics of the transfer are two-fold: school teachers account for over half the increase; those with relatively higher educational backgrounds have transferred, resulting in an increase in higher-echelon civil servants at the local level.

Table 2.1: Number of Civil Servants Before and After Decentralization

		Bandung	Palembang	Balikpapan	Kupang	Kendari	Blitar
No. of Civil Servants	Before	15,770	3,410	1,900	2,680	1,550	2,230
	After	25,880	16,380	5,270	5,110	5,600	5,720
1/ All figures from *Cities Speak* field surveys.							

2.41 Many local governments are trying to streamline their structure. Although Law 22 gives the regions the right to "hire and fire" their civil servants, no large-scale redundancies have yet taken place. Moreover, the central government still determines civil service wages to a large extent. In addition, job classifications and accompanying qualification standards are being developed by the National Civil Service Agency (BKN), which wants to see these standards applied locally. Sector ministries, such as health and education, are developing similar standards for teachers, doctors, and other technical personnel. Some of these measures ensure certain minimum national-level standards, particularly during the transition period. Over the long-term, however, they may limit the ability of local governments to restructure and streamline local administration to suit their needs and resources.

2.42 Along with this structural problem, there is also a bias among local government officials toward filling important positions with *putra daerah* or "sons of the region." Local governments tend to exclude regionally-based central government officials when drafting the structure of government bodies. This causes anxiety among incumbent civil servants that have moved to the regions. These employees, including teachers, are concerned that the change in status has limited their inter-regional mobility. At the same time, as local staff feel threatened by the "invasion" of better-qualified central personnel; some are seeking advanced training to enable them to hold onto their positions.

2.43 In general, local governments have yet to undertake self-assessment studies to determine priorities in restructuring the local civil service. In the short- to medium-term, excess staffing, identifying the mix of skills suited to local needs, staff movement across offices and regions, remuneration, career and skills development, and performance appraisal will continue to occupy local governments.

2.44 Although Forum *Kota* requires public participation, its structures and mechanisms are still being sorted out. Interim bodies exist in many cities; their influence on municipal decision-making varies from city to city, as documented in the *Cities Speak* survey. Some cities have been innovative in cultivating a culture of dialog among citizens, legislators and administrators. The Talk Show in Kendari is a case in point (see box below).

Table 2.2: Types and Sponsors of Urban Forums

City	Type
Bandung	• NGO-initiated "Sawarung" • CDS-facilitated "Forum Tatar Bandung"
Palembang	• "Dewan Kota" formed by radical activists • publicity by city government using radio, newspaper, suggestion box • Bureau of Community Empowerment by city government
Balikpapan	• Urban Forum with wide participation of stakeholders
Kupang	• Ad hoc consultation meetings
Kendari	• Urban Forum with wide participation of stakeholders • Radio talk show between city officials and citizens • NGO-initiated radio program regularly discussing public budget
Blitar	• Traditional form of mutual help • City-level urban forum called FKMK • Community-level LPMK (sub district community empowerment board)

Box 2.1: Kendari Radio Talk Show

The radio talk show is an effort on the part of the City of Kendari to promote transparency in the functions of the local government. The objectives of the talk show are: (1) to open communication among city stakeholders; (2) to socialize the development policies and programs; (3) to broadcast community aspirations, address citizens' needs, and monitor government officials in implementing development programs; and (4) to foster equality among citizens.

The first interactive radio talk show was produced by the RRI (Radio of the Republic Indonesia) and was followed by the establishment of "Transangga," a private broadcast entity. The latter was managed by a local NGO with a particular interest in highlighting transparency in local budgeting. Resource persons come from the government, NGOs, the community or informal sector, and academia.

In the early stages, citizens used the radio talk show to air their complaints, opinions and critiques on government programs and government performance. But gradually, the people learned to have constructive discussions, offering suggestions to officials in the government and the development sector to resolve problems. Usually, both the local government and parliamentary officers respond quickly to these recommendations.

Local Government Financing

Background

2.45 As noted earlier, for a country of its size and structure, Indonesia has had a highly centralized fiscal system. In 1990-91, central government transfers financed about 70 percent of local government expenditures. The share of direct central government expenditures out of total government expenditures was around 76 percent, with another eight percent transferred to local governments. By approving local government budgets, Jakarta exercised control over the remaining 16 percent (World Bank, 1994). Centralized public sector decision-making reduced accountability, impeded the development of public infrastructure, imposed high economic costs and hindered the development of local institutions (Bastin and Smoke, 1992; World Bank, 1994). Against this background, the Law on Fiscal Balance and the Law on Regional Autonomy, in conjunction with subsequent regulations, changed the entire framework of inter-governmental fiscal relations and the pattern of local government financing. Together, they ushered in an era of greater autonomy, stability and efficiency of public expenditures at the local level.

Local Government Financing: Pre-Decentralization Period[3]

2.46 Prior to fiscal decentralization, the finances of local governments in Indonesia were dominated by transfers from higher levels of government—general subsidies, specific grants and tax sharing from the central and provincial governments. Summary expenditures for local governments fell under two headings: current expenditures—mainly salaries and other recurring expenditures—and development expenditures for new projects. In general, local governments had low per-capita budgets, weak mobilization of local resources, poor cost recovery, and limited access to market loans for capital investments.

Table 2.3: Revenue and Expenditures of Local Governments in Indonesia (Pre-Decentralization Period)

Items	**Percentage of Total Revenues** (percentage breakdown of actual)	
	1997/1998	**1998/1999**
Revenue		
Previous year's surplus	3.0 %	2.8 %
Local Government's own revenue	13.0 %	11.0 %
Shared tax receipts	15.1 %	13.1 %
SDO Subsidies and INPRES Grants	68.0 %	71.9 %
Development Revenue	0.9 %	1.0 %
	Percentage Of Total Expenditures	
Expenditures		
Current expenditures	56.0 %	68.0 %
Development Expenditures	44.0 %	32.0 %
BPS: Financial Statistics of Second-Level Government 1997/98, 1998/99; ADB, 2001.		

[3] Refer to Annex 3 for an explanation of local government finances in the pre-decentralization period.

A Time of Change and Learning: Post-Decentralization Period

2.47 The broad policy and institutional framework governing inter-governmental fiscal relations and local government financing have undergone major changes following the enactment of Law 25/1999 on Fiscal Balance and subsequent regulations. These changes relate to revenue and expenditure assignments, inter-governmental transfers, local government borrowing and responsibility for provision of services.

2.48 **Expenditures and revenue assignments.** On the expenditure side, Law 22/1999 assigns responsibility for the judicial system, religious affairs, national defense and security, macroeconomic planning, fiscal and monetary affairs, standardization and international relationships to the central government. All other duties are to be handled by local governments. The Law also contains a positive list of services that local governments have to perform: public works, health, education, trade and industry, investment, environment, agriculture, cooperatives, and labor. This mandate was further clarified by PP 25/2000, which detailed assignments by sectors in the central and provincial governments. The list presumes that all responsibilities allocated fall to the district and municipal governments. Inter-governmental transfers, local governments' own-revenues from various sources, such as local taxes, local charges, locally-owned enterprise profit, and local government borrowing constitute the revenue base.

2.49 **Inter-governmental transfers.** The regulatory framework for intergovernmental transfers is provided by Law 25/1999[4] and PP 104/2000. The regulations cover the three major types of transfers: general-purpose grants (DAU), specific-purpose grants (DAK and others) and revenue sharing (SDA). The objectives of the new intergovernmental fiscal regime are to correct vertical and horizontal fiscal imbalances, address problem of externalities and promote national priorities.

2.50 SDOs, routine transfers to pay the salaries of local civil servants, have been eliminated with general development transfers—the *Inpres* block grant. These two transfers have been consolidated into a general allocation fund called the DAU. The DAU is split between local governments and the provinces on a 90:10 basis. The allocation is based on a formula which considers the fiscal needs of local governments and provinces based on population, area, geography and income and fiscal capacity. The latter is measured by industry, natural resources, human resources and GRDP. The degree of transparency and the level of local discretion implicit in the grant is greater than under the previous *Inpres*.

2.51 DAU, which accounted for 71 percent of total *kota* (urban district) revenues in 2001 and covered about three-quarters of district government's expenditures, is the most important decentralization-era transfer mechanism for equalization between the center and the regions. (Hofman, Kadjadmik and Kaiser, 2002). In 2001, the total DAU for all regions amounted to Rp. 60.5 trillion or 75 percent of the total balancing fund. DAU 2001 was based on historical considerations to ensure that local governments did not get less than in the past. It was also to accommodate additional civil servants and responsibilities arising from decentralization. DAU 2002 was allocated in three components: lump sum, balancing fund and fiscal capacity formula. In the medium-term, DAU is expected to provide a stable source of local financing, given that allocations are pegged on the central government's gross domestic revenues. In the short-term, though, those revenues have not stabilized, leading to concerns that not all local governments will receive comparable development benefits from DAU due to concerns about the instability of central government revenues in the given macroeconomic environment.

---

[4] Main points of Law 25/99 are summarized in Annex 4.

2.52 The center-region balancing fund includes a new special allocation grant—DAK—to be allocated from APBN. DAK will serve as a channel for promoting national priorities, such as poverty alleviation, capacity building and for matching them with regional needs. The programs will have to meet ministerial-level criteria. DAK is evolving with no objective assessment for determining final regional allocations. In 2001, the share of DAK amounted to 2.8 percent of *kota* revenues.

2.53 For shared revenues, the two summary categories are tax revenues, mostly from land and property transactions, and non-tax revenues, primarily from natural resources. The regulations on revenue sharing specify the portion that the central government retains and the shares distributed to provincial and local governments. For revenues from natural resources, the regulations describe the criteria for local government distributions, that is, whether amounts are returned to a "place of origin" or spread across all places within a province. The distribution ratios include:

(a) Land and property tax: 10 percent for the central government, the distribution to local governments will be decided by a decree of MOF; 90 percent for the regions—16.2 percent for the provinces, 64.8 percent for local governments and 9 percent for the cost of collection to the state and regions;

(b) Tax on acquisition of land and building rights: 20 percent for the central government to be redistributed in the same portion to local governments throughout Indonesia, and 80 percent for regions-16 percent for the provinces and 64 percent for local governments;

(c) Forestry, public mining and fishery: 20 percent for the central government; 80 percent for the regions. There is a detailed formula for distribution among the provinces and local governments, based on source and non-source.

2.54 Revenues from tax sharing and non-tax sharing totaled around 6.5 percent and 6.2 percent, respectively, of total *kota* revenues for 2001. Concerns have been expressed that the present regime for transferring shared revenues, particularly those from oil and gas, may widen regional disparities between resource-rich jurisdictions and less-endowed local governments. In addition, sharing land and property taxes may undercut the potential for local accountability. Discontent is rising; resource-rich provinces and regions are demanding a greater say in revenue sharing based on resources.

2.55 **Own-revenues.** Local governments' own-revenues (PAD) are derived from taxes (*pajak*), levies (*retribusi)*, local-government-owned enterprises (BUMDs) and other revenues. Among *kotas*, the share of PAD in 2001 was estimated at 9.7 percent of total revenues (with taxes at 5.1 percent and levies at 3.9 percent). The Fiscal Balance Law and Law 34/2000 provide a legal framework for all provincial and local government taxes and levies, including the allocation of tax bases across provinces and local governments. Local governments are empowered to create their own new taxes upon satisfying certain "good tax" criteria. These criteria include: (a) the tax objects must be located in the particular local government and possess relatively low mobility across its boundaries; (b) the tax does not contradict public interests; (c) the tax does not constitute a national or provincial tax; (d) the tax has sufficient revenue potential; (e) implementation of the tax will not negatively impact the local economy; (f) the tax is fair to local residents; and (g) the tax safeguards environmental conservation. Local authorities have the power to set local tax rates to maximize revenue or to make their regions competitive for potential investors. However, Law 34/2000 sets a maximum rate for each local tax.

2.56 Local taxation powers are meant to provide local governments with the fiscal instruments they need to expand their own revenue base. Enacting new taxes requires consultation with local citizens and approval by local DPRDs, as well as the assent of the central government. However, two major problems have been identified at this stage: lack of a major, localized tax base, such as

property tax and the proliferation of nuisance taxes. At the local level, there are roughly seven local taxes. Only a few contribute significantly to total local revenue. In major urban areas, hotel, restaurant, entertainment and advertising taxes are among major sources of revenue.

2.57 Well-functioning sub-national governments are able to access some tax bases more readily than the central government (for example, certain user charges, rudimentary sales taxes and property taxes). In many countries around the world, the property tax is one of the most widely used municipal tax instruments. Generally, local governments have the greatest comparative advantage in property tax administration, especially in identifying the tax roll and in collecting it. In Indonesia, however, revenues from land and property taxes continue to flow to the central government before being redistributed to the provinces and regions. While its administration has been relatively efficient, this practice has deprived *kotas* of a stable source of revenue that belongs to them. The fee for collecting taxes, for which the central government receives 9 percent of revenues, and the central tax administration's fear of massive job reallocation to the regions are the main reasons why the tax is not yet decentralized. Devolving the authority to set property tax rates, within certain centrally set limits, is considered feasible and desirable.

2.58 A proliferation of nuisance taxes was a problem in the first year of fiscal decentralization. Intent on raising their own-revenues, many local governments are resorting to "nuisance taxes and levies." Examples of such local charges are "mandatory" charity, cattle ID fees, public road fees, "export" fees, and production fees. These taxes and levies often exceed local government's taxing authority; they also have distortionary effect on regional and national trade and the economy.

2.59 **Local government borrowing.** Although the demand for urban investment financing is significant in Indonesia, no systematic and sustainable financing mechanism meets this demand. Urban investments are lumpy and require long-term financing, characteristics that make for a mismatch with limited municipal revenues. GOI's loan financing through Subsidiary Loan Agreements (SLA) and the RDA function poorly, if at all. The arrears rate of SLA and RDA was about 42 percent; total arrears were Rp.843,269 million, as of December 1999. RDA is still operating, but its emphasis is cleaning up its current loan portfolio. RDA depends on central government budget support for its lending, but MOF has been less than eager to support RDA lately. The 2001 national budget had no allocations for RDA. GOI policy on the continued functioning of RDA is unclear (Lewis, 2001 a; Varley, 2001). In the absence of RDA, SLA is the only channel left for lending to local governments.

2.60 Regional government borrowing is regulated by Law 25/1999, PPs 107/1999 and 109/2000. Within the context of the broad policy framework set out by the Fiscal Balance Law, various regulations outline the appropriate sources and types of regional government borrowing, the purpose of borrowing restrictions, and sanctions for default. Long-term borrowing is restricted to financing infrastructure that "generates revenues." PP 107/2000 sets limits on local borrowing, stipulating that local governments cannot finance more than one-sixth of a year's expenditures with borrowed funds, that total debt can never exceed 75 percent of the previous year's revenues, and that the ratio of revenues to debt service payments in a given year must be at least 2.5:1. Local governments can borrow from foreign sources only with central government approval.

2.61 Ministerial Decree KMK 35/2003 defines the on-lending terms and conditions of foreign loans for local governments. Foreign loans are to be passed on to the sub-national governments as sub-loans for cost recoverable or revenue-generating projects, and as grants for non-cost recoverable or non-revenue generating projects. The sub-loans will carry the same maturity and grace period as the original loan to GOI. All the costs (interest rates and commitment fees, including GOI's foreign exchange management cost) will be passed on to the local governments. For non-cost recoverable

projects, grant financing depends on the fiscal capacity of each local government (at 30 percent, 60 percent and 90 percent of the project costs for fiscally strong, medium and weak local governments, respectively). Appraisal of sub-projects and decisions on loan or grant approval will be made by a team from MOF and Bappenas in consultation with the relevant technical ministry.

2.62 While this Ministerial Decree has clarified a large part of the on-lending terms and conditions, two areas need GOI's further reflection. First, the decree does not propose any new institutional framework for loan/grant decision making and sustainable local government financing. While the appraisal criteria for the sub-loan and sub-grant projects is rational, the project appraisal system is not free of potential risks of political interference. The appraisal team of central bureaucrats could create considerable delay in decision making. Furthermore, the institutional framework defined in the decree is silent on the sustainability of local government financing. To address this the GOI should consider developing a professionally managed and financially sustainable intermediary for local governments. The second concern is that the current decree does not allow fiscally strong local governments to borrow for non-cost recoverable projects. While GOI's desire to limit sub-loans to cost recoverable projects is understandable, there is no clear rationale to explain why credit-worthy local governments cannot borrow for non-cost recoverable projects. Given GOI's weak fiscal position and the demand for grant financing, under the current rules, there is every possibility that local governments will be discouraged from borrowing for essential, but non-revenue generating activities. That would reduce investment in priority areas, such as poverty alleviation or environmental management. The legal structures required for a local government bond market will not be in place for some time, but the government is already taking steps to create it. Local short-term borrowing to cover cash flow is happening in several regions.

2.63 The rationale for enabling access to credit for local governments is strong. Typically, central governments are constrained by political considerations and bureaucratic inertia, aside from the moral hazards associated with a central government loan. The markets and market mechanisms are the best long-term strategy for sustainable local government borrowing. However, the key issue here is how many local governments are creditworthy and attract the interest of private investors. Some may lack the resources to generate sufficient revenues to borrow, while others with a revenue base may be poorly managed or have weak capacities (ADB, May 2001). A key lesson, based on experience the world over, is simple: not all local governments can borrow; only those that can establish their creditworthiness should be allowed to do so. The role of GOI in the coming years will be to formulate the long-term policy and regulatory framework for regional government borrowing, set up mechanisms for assessing the creditworthiness of local governments, assist them in improving their financial management standards and capacities, enable markets to function and local governments to move to a fully market-based borrowing system. In the interim, central government involvement will be required in local government financing. The central government will also have to establish clear institutional frameworks for its own grant and loan mechanisms and set out transparent mechanisms for allocating these, including an interest rate policy on government on-lending. For local governments, the critical issue will be to have, as efficient as possible, a channel for mediation between the central and local governments, and policies that will, over time, enhance their creditworthiness (tax policies, financial management and reporting policies, work-out procedures).

2.64 **Regional Financial Information System**. PP 11/2001 outlines the type of information requested of regional governments. It specifies who in the central government is to receive it (MOF and MOHARA), the purposes of the information, and the sanctions for not providing it. The MOF will use the information to develop a Regional Finance Information System (SIKD). PP 105/2000, whose focus is on management and accountability in regional finance, aims to ensure transparency and accountability. It contains guidelines for drawing up local government budgets, the procurement

of goods and services and standards for financial management. Yet there is criticism that its auditing provisions are vague. As an anti-corruption safeguard, the regulation requires local officials to ensure that the goods and services they procure are necessary for the implementation of public policy. It does not, however, establish procedures to verify that.

Box 2.2: Lending to Municipalities: Experience of Other Countries

Many countries around the world, including the advanced market economies, have established institutions that specialize in municipal lending. The GOI will need to develop a system that conforms to its own needs, to the circumstances of its municipalities and of its domestic credit markets. The GOI could consider a number of institutional mechanisms in formulating its approach.

- Columbia and the Czech Republic have set up second-tier institutions that facilitate lending by commercial banks to local governments. These institutions rediscount loans made by commercial banks to local governments, providing liquidity to the banks and allowing them to make loans of longer tenure than would have been possible otherwise.

- Certain European countries, including the Netherlands, Norway, Denmark, Finland and Sweden, have established municipal financial institutions that are, at least in part, owned by borrowing municipalities. These institutions follow a "credit union" style of banking. They are all highly rated by credit agencies and float bonds to fund their lending activities.

- In Tamil Nadu, India, a publicly owned municipal development fund was restructured by bringing in private investors and private sector management. Although the Government remains a majority equity holder, the fund is managed by a private fund manager that has its equity in the fund. The restructured fund was able to successfully float a bond on the domestic capital market to complement resources provided by a World Bank loan.In Parana, Brazil, a non-profit private sector corporation has a contract to operate a publicly-owned municipal fund.

2.65 **Post-decentralization Status of Local Government Finances**. Post-Decentralization local government revenue sources fall under five summary heads: (a) central government transfers (DAU, DAK, and others); (b) own-revenues (PAD); (c) carry-overs; (d) borrowings; and (e) other revenues (e.g., transfers from provinces to districts). The major local government expenditure headings are a) routine expenditures—civil service salaries, purchases of goods, travel expenditures, loan interest payments; (b) unforeseen expenditures; (c) assistance to the regions under its charge; (d) reserve funds; and (e) development expenditures.

2.66 In terms of revenue patterns, local governments continue to rely heavily on central transfers. In 2001, on average, all local governments depended on central government transfers for 90 percent of their total revenues roughly 84 percent and 92 percent, respectively, for *kotas* and *kabupatens*. DAU was responsible for around 80 percent of total revenues, a substantial increase from 47 percent in 2000. Where cities could generate higher shares of own-revenues (PAD), shared taxes and other revenue sources, they projected a lower level of dependence (71 percent) on DAU than regencies (81 percent). As before decentralization, borrowing constituted a negligible share of local government finances.

Table 2.4: Local Government Revenues: 2000 and 2001

	FY 2000*			FY2001			
	Local governments	*Kota*	*Kabupaten*	Local governments	*Kota*	*Kabupaten*	
Revenues	241,635 (322,180)	259,948 (346,597)	236,647 (315,529)	574,249	609,086	564,272	Per capita Rp.
				(17.65)**	(13.86)**	(18.74)**	% RGDP
Carry-over	4.4	5.1	4.2	2.0	2.1	1.9	(%)
Local revenues (PAD)	7.9	13.4	6.4	5.6	9.7	4.5	(%)
Taxes	*3.5*	*6.8*	*2.7*	*2.4*	*5.1*	*1.6*	(%)
Levies	*3.0*	*5.3*	*2.4*	*2.3*	*3.9*	*1.9*	(%)
Transfers	87.1	80.9	88.8	89.9	83.9	91.7	(%)
Tax Sharing	9.7	11.0	9.3	4.9	6.5	4.5	(%)
Non-Tax Sharing	1.9	1.1	2.2	6.8	6.2	6.5	(%)
DAU	46.6	40.1	48.4	79.0	70.9	81.3	(%)
DAK	27.3	27.5	27.2	1.3	2.8	0.9	(%)
Contingency	1.3	1.2	1.3	-*	0.1*	-*	(%)
Borrowings	0.6	0.6	0.6	0.4	1.1	0.2	(%)
Other Revenues	0.0	0.0	0.0	2.0	3.1	1.7	(%)

Source: Decentralizing Indonesia: A Regional Public Expenditure Review (Preliminary Note) 2002 World Bank.

(*) FY 2000 is for nine months. Bracketed per capita figures are annualized. Shares are averages of individual local government figures, based on 313 observations in 2000 and 273 observations in 2001(out of 336. For 2000, the DAU line items refer to SDO transfers; DAK channel refers to *Inpres*. FY 2001 planned budgets do not include DAU contingency payments. Total 2001 DAU Contingency payments to the districts were about 2.6 percent of total local government revenues (Rp2.1 trillion on top of Rp 78.9 trillion budgeted). The data suggest that 37 districts in the sample, of which 26 were *kabupaten*, engaged in some form of borrowing in 2000, totaling Rp 756 billion.

(**) RGDP figures are from BPS but refer to 1999 and they overstate actual shares based on current prices.

2.67 Overall, routine expenditures by local governments have risen since decentralization from approximately 65 percent in 2000 to 67 percent in 2001. The trend is particularly pronounced for *kotas;* routine expenditures as a share of total expenditures have gone up from roughly 62 percent to 71 percent. Wages constitute the largest share of routine expenditures. For *kotas*, the wage bill as a share of total expenditures rose from 41 percent to 46 percent as a direct outcome of the transfer of central government personnel. Equally important, the share of development expenditures for *kotas* declined from 38 percent to 29 percent between 2000 and 2001. While local governments have a transparent and relatively stable revenue source in DAU, devolution has thrust more expenditures on them than in the past. Cities must strengthen the own-revenues base and refine inter-governmental transfers. When that happens, there should be a distinction between *kotas* and *kabupatens* in their revenue-expenditures and the potential for different types of local governments to generate their own revenues. This will be key to developing incentives for efficient and sustainable local government finances.

2.68 Decentralization had a visible impact on the revenue-expenditure patterns of the six cities studied under *Cities Speak*.

On the revenue side, key findings are:

- A 2 to 4 times increase in total revenues;
- Central government's revenue transfers (grants from central/provincial governments before decentralization were more or less equivalent to the DAU after decentralization) remained at 80-90 percent of total revenues;
- Tax/non-tax revenue share for Balikpapan and Palembang, both rich in natural resources, is considerable due to decentralization; and
- Cities' PAD decreased to less than 10 percent of total revenues, except for Bandung which remained at18 percent.

Table 2.5: Local Government Expenditures: 2000 and 2001

	FY 2000*			FY2001			
	Local Governments	*Kota*	*Kabupaten*	Local Governments	*Kota*	*Kabupaten*	
Expenditures	244,158 (325,544)	295,951 (394,601)	230,052 (306,736)	573,178	604,999	564,108	Per capita Rp.
Routine	139,139 (185,621)	143,326 (179,101)	137,999 (183,998)	350,561	412,116	331,171	Per capita Rp.
Development	104,216 (138,955)	152,625 (203,499)	91,191 (121,588)	222,449	192,883	230,795	Per capita Rp.
Routine (of total)	64.86	61.50	65.78	66.89	70.87	68.70	(%)
Wages	46.52	40.93	51.49	46.21	45.93	49.78	(%)
Development (of total)	35.14	38.50	34.22	31.60	29.13	32.31	(%)
Economic (as % of development)	12.42	9.95	13.10	12.95	11.40	13.39	(%)
Infrastructure	39.44	34.53	40.78	39.16	31.57	41.34	(%)
Social	27.88	35.14	25.91	26.06	29.79	24.99	(%)
Government	13.93	15.64	13.46	16.31	18.65	15.64	(%)
Other	6.01	4.75	6.35	4.76	6.89	4.15	(%)

Source Notes: Decentralizing Indonesia: A Regional Public Expenditure Review (Preliminary Note) 2002 World Bank.
FY 2000 is for nine months. Bracketed per capita values are annualized. Shares are averages of individual local government figures, based on 313 observations in 2000 and 273 observations in 2001 (out of 336). Development aggregate categories are based on 21 sector classifications used in standard budget reporting.

On the expenditure side, the impacts were:

- A sharp increase in routine expenditures, to about 65-80 percent of total expenditures, due to the transfer of central government personnel (except in Kendari) and higher-ranking employees;
- In general, the development expenditure budget increased, but its share of total expenditures decreased, except in two cities. Bandung allocated 34 percent and Balikpapan maintained more or less the same 34 percent share. Other cities allocated much less for development expenditures (19 percent in Palembang, 21 percent in Kupang, 20 percent in Kendari, and 20 percent in Blitar);[5] and
- Non-salary routine expenditures showed more or less the same pattern as development expenditures.

2.69 The assignment of new expenditure responsibilities to provincial and local governments may herald new efficiency gain in the provision of services and strengthen revenue mobilization. Yet, the new laws provide for expenditures and not enough for decentralization of revenue. At this stage, the

[5] Many city governments explained that city finances were much more scarce than this analysis indicates. It was often reported in the meetings that due to a large number of personnel, the city suffers from a serious reduction in the number of development programs being carried out.

reforms do not give local authorities any significant new revenue-raising powers. Local governments can propose new taxes under certain circumstances if they get the approval of the central government. They also have limited autonomy to determine rates and bases. To establish a link between costs incurred, at least at the margin, and services demanded by citizens, it is important for local governments to be able to make some real choices using appropriate tax instruments. This linkage is crucial, since, at least in principle, it makes the citizens aware of the connection between the taxes that they pay and the services that they receive. This linkage also establishes accountability on the part of local government officials. However, such modest local control is missing from the decentralization reforms.

2.70 This shortcoming is partly explained by the lack of a clear vision of what the country is trying to accomplish through decentralization. As Alm and Bahl have noted, on the international level, there is not one ideal structure for fiscal decentralization. (Alm and Bahl, 2001). In Indonesia, the laws defining expenditures and revenues have been written in an uncoordinated manner by different groups within the government. Lack of an overall policy has created a mismatch between revenue and expenditure functions of local governments, leading to a situation where many governments have more expenditure responsibilities than revenue sources, thus setting the stage for soft budget constraints. A negative consequence of this has been the increase in local nuisance taxes.

Accountability, Participation and Financial Management

2.71 One offshoot of fiscal decentralization has been a significant reduction in vertical accountability. Among various local government revenue sources, only the DAK is subject to monitoring and evaluation by the central government. Other revenues are accounted for and audited by the local government. The state internal auditor no longer audits local governments; instead, every local government has its own internal auditor.

2.72 Since decentralization, horizontal accountability plays an important role in monitoring and evaluation. The DPRDs are vested with the right and responsibility to monitor and evaluate local government budgeting and implementation; they must also approve the proposed budget before it becomes effective. During the fiscal year, the local government must submit quarterly reports to the DPRD on budget implementation, cash-flow and balance sheet.

2.73 Participatory planning and budgeting are lacking because of poor communication between the government and its communities. Most cities follow a combination of top-down and bottom-up approaches to budgeting a practice corroborated during the *Cities Speak* studies. Public disclosure of local budgets is limited; typically, the community gets information about the budget from DPRD members, the media, and NGOs. There are concerns about the capacity of DPRDs to act as watchdogs for budgeting and implementation. It should not be a surprise if corruption, nepotism and negligence continue to haunt Indonesia. There are exceptions, such as Balikpapan or Kendari, where consultations exist between the city and its citizens; planning and budgeting are well established, dating back many years.

Table 2.6: Characteristics of the Planning and Budgeting Process: *Cities Speak* case studies

	Basic Process	Characteristics
Bandung	▪ combination of top down and bottom up; ▪ communities can state priority projects; ▪ criteria for prioritizing and selecting projects are underway	▪ gradual shift toward increasing involvement at the grass-roots level which remains difficult ▪ only a small portion approved ▪ much of the budget implements a little of each program to satisfy many; inability to phase out low-priority activities
Palembang	▪ similar to Bandung	▪ similar to Bandung
Balikpapan	▪ unlike other cities using *balanced budget, deficit budget* system is in place ▪ combination of top-down and bottom-up approach	▪ big budget allows the city to implement innovative programs for the city and the poor; interactive process is institutionalized and better balanced
Kupang	▪ still very much top-down	▪ national standards are in place ▪ civil society participation is under consideration
Kendari	▪ new development planning process is practiced with more bottom-up approach ▪ criteria established by the local development planning board are effective	▪ liberal environment for dialogue among stakeholders ▪ criteria reflect limited local financing and discourage inordinate expectations by citizens and agencies
Blitar	▪ method practiced before decentralization is still used[1/]	▪ communities are consulted and forum is open, but the general public has little influence on decision making

1/ "Guidance in planning and implementing local development" based on MOHA Regulation No. 9/1982.
Source: *Cities Speak* surveys, 2002.

2.74 Empowerment by communities remains the best bet to achieve public accountability and to improve horizontal accountability by local governments. It is up to the DPRDs to initiate public involvement and put pressure on local governments to respect community opinion. The budget process and its implementation must be transparent and accessible to all interested parties. Along these lines, there have been calls for performance budgeting, as mandated by government regulations for a fair evaluation of local-level public finances.

2.75 Fiscal transparency is essential for accountability and for monitoring the performance of local governments. Moreover, it is a key safeguard against corruption. However, in their present form, the Regional Governance Law and the Fiscal Balance Law have overlapping, and sometimes conflicting, approaches to fiscal reporting and financial management. The Regional Governance Law, which takes a hands-off approach, has broad guidelines for regional financial management and reporting, while the Fiscal Balance Law prescribes that central government should design and implement a regional government financial management system. Both approaches appear untenable. GOI will need to clarify responsibilities for financial management—the roles of the center, provinces and regions, and the mechanisms for establishing cooperation. The financial reporting required from regional governments—internally to the central government and externally to the voters—should be sufficient to allow the center to compile government statistics and to enable the public to evaluate regional government performance. The center has a task in analyzing and publishing comparisons among regions—not only in financial matters, but also what regions do with the money they spend.

Local Government Finance: Emerging Issues

2.76 In summary, the current intergovernmental fiscal system has several strong features that should be maintained: (a) it funded most of the expenditures by the regions during a difficult transition; (b) it introduced the notion of expenditures requirements and revenue capacity in the equalization grant; (c) it provides the foundation for local governments to raise their own-revenues

through local taxation, a potential means of enhancing accountability; (d) there is an information system to monitor regional finances.

Box 2.3: Participatory budgeting in Brazil: the Porto Alegre model

Porto Alegre, the largest industrial city in Rio Grande do Sul, has approximately 1.3 million inhabitants. Its local economy is worth roughly US$7 billion. The city has consistently enjoyed one of the highest living standards and per capita incomes among Brazilian cities; it has a reputation for hosting a progressive civil society led by intellectuals and labor unions experienced in mobilizing people to participate in public life. The year-long participatory budgeting cycle of Porto Alegre has attracted considerable attention. The budget cycle, which starts in March-April, proceeds according to the following schedule:

- March: Informal citizen gatherings to collect demands; no interference from executive (mayor's office).
- April: First regional plenary held between the citizens and the mayor's office to account for previous year's projects, discuss new proposals and elect delegates to the second round.
- April to June: Intermediary meetings for delegates to learn technical criteria and discuss needs and priorities in each region; informal preparatory meetings held with citizens and civic associations who rank their demands. The executive aggregates these based on two criteria: (i) how much access a region has had to a service, and (ii) its population.
- June: Second plenary held when Councilors are elected and regional priorities voted.
- July: 44 Councilors installed in the Council of Participatory Budgeting (COP)-two from each of the 16 regions, two from each of the five themes plus two other reps.
- July to September: Council meets for at least two hours a week to discuss criteria, constituents' demands, allocation of resources as proposed by the mayor's office, etc.
- September: New budget approved by the COP and sent to the legislature for debate and endorsement.
- September to December: COP follows the debate in the Chamber, and lobbies, while working separately on a Specific sectoral investment plan for different regions; rules are set for the following year's meetings.

Key outcomes: Since 1989, the Workers Party, which initiated Participatory Budgeting, has won three consecutive municipal elections in Porto Alegre. An influential business journal has nominated Porto Alegre as the Brazilian city with the 'best quality of life' for the fourth year in a row since 1989. The city has witnessed spectacular achievements in recent years; credit should go to the participatory budget process. Between 1989 and 1996, the number of households with access to water services rose from 80 percent to 98 percent; the percentage of the population served by the municipal sewage system rose from 46 percent to 85 percent; the number of children enrolled in public schools doubled; in poorer neighborhoods, 30 kilometers of roads have been paved every year since 1989. Because transparency affected attitudes toward paying taxes, revenue increased by nearly 50 percent (budget resources for investment only went up from US$ 54m in 1992 to US$ 70m in 1996). Over 80 Brazilian cities are now following the Porto Alegre 'model' of participatory budgeting. The neighboring city of Viama, ceased operating independently to become a region within Porte Alegre.

Source: http://www.worldbank.org/participation/web/webfiles/cepemcase1.htm

2.77 The abolition of discretionary grants and the establishment of DAU as a transparent and secure fiscal transfer mechanism is expected to provide some stability to local government finances. It will increase the number of local governments eligible for loans; even small local governments will have a reliable flow of revenues.

2.78 The intergovernmental fiscal system, however, needs to be improved, a process that can only be done incrementally. To take the next steps in a progressive fiscal decentralization program, GOI will need to address a number of important issues:

- Correcting any mismatch between revenues assigned to local governments and their expenditures. The starting point for this is an analysis of the expenditure budget for sub-

national governments and the adequacy of the 25 percent revenue transfer through DAU.

- Reviewing and refining intergovernmental fiscal transfers by: (a) making DAU more equitable by phasing out transitional allocations; (b) developing a transparent and consistent treatment of natural resource revenues in revenue sharing; (c) introducing a transparent and selective system of specific grants to promote the financing of national priorities at the local level. A larger DAK could be financed by gradual reduction of the center's own development spending on regional functions.
- Rationalizing and strengthening the framework and capacity for local-level taxation to enhance the share of local revenue relative to total revenues. First, increasing local taxing power by including "pure local tax" in local tax assignment and restricting local taxes to a closed list over which the regions have tax rate autonomy, within centrally-set limits. Additionally, such steps could include a local surcharge on certain national taxes and selective business taxes. Second, intensifying local tax collection with improved data and information systems and law enforcement, rather than adding new taxes and fees that disrupt the economy. Third, prohibiting or removing all types of new local charges that violate existing laws and regulations.
- The current mechanisms for loan financing operate poorly. Enhancing the framework for regional borrowing to ensure that regions borrow responsibly is needed; so too are measures to establish the required regulatory and institutional frameworks for developing institutions and instruments to lend to urban local governments.
- Including in Law 25/99 national requirements for financial management, procurement, accounting and audit at the regional level.
- Reviewing the results of the intergovernmental fiscal system regularly by setting up a system for monitoring and evaluating local finances and credit systems.

Changing the Face of Urban Local Governance

2.79 Indonesia's decentralization has been a "big bang" indeed. Regional spending rose from an estimated 17 percent of government spending in 2000 to over 30 percent in 2001 (5.5 percent of GDP); two-thirds of the central government's civil servants were reassigned; 239 provincial-level offices of the central government, 3,933 local-level offices, more than 16,0000 service facilities—schools, hospitals, health centers—were transferred to regional governments across the country. A brand new inter-governmental fiscal system is in place—all of this without major disruption to government services. Out of a civil service of 3.9 million, some 2.8 million are now classified as regional. Over time, the regional share of spending is expected to rise to 45-50 percent, making Indonesia one of the most decentralized countries in the world. As GOI implements the decentralization program in four different phases—initiation in 2001, installation during 2002-2003 period, consolidation 2004-2007 and stabilization 2007 onward—it is clear that both central and local governments will require assistance in several areas to make its outcomes fruitful and sustainable. That will depend on the success of effective governance and poverty reduction at the local level.

III. URBANIZATION: RISING PRESSURES, UNCERTAIN RESPONSES

Addressing Urban Poverty in Indonesia

Introduction

3.1 To the traveler, the most visible face of urban poverty in Indonesia is the condition of the millions of poor people living in slums in Jakarta. The abject conditions of slum dwellers amply demonstrate the serious socio-economic, political and environmental implications of the phenomenon of urban poverty. Marginal groups, such as the slum dwellers in Jakarta, and others suffer from material poverty due to insufficient income for food and shelter. They also suffer from poverty of security and well-being arising from violence, inadequate health systems and poor social safety nets; a lack of access to adequate water supply, sanitation and transportation; poor access to information and education, which creates a poverty of awareness; social poverty due to marginalization and exclusion; and poverty of their own identity due to the stress of migration and imposition of alien values upon local cultures. If poverty was defined in such terms, it would encompass a large share of Indonesians--urban and rural.

Urban Poverty: Historic Trends and Current Status

3.2 **Historic trends**. From the 1960s up to the 1990s until the economic crisis, Indonesia made rapid strides in reducing "material poverty." The economic and financial crisis of 1997 changed that dramatically. Based on the head count index, poverty increased from 11.4 percent in 1995 to 15.7 percent the following year, then jumped to 27.1 percent in 1999 at the peak of the crisis.

Table 3.1: Indonesia's Spectacular Success in Reducing Poverty

Poverty indicators	**1975**	**1995**	**1996**	**1997**
Poverty (head count index; %)	64.3	11.4	15.7	27.1
Life expectancy at birth (years)	47.9	63.7	63.2	65.5
Infant mortality (per 1000 births)	118	51	56.0	46.0
Primary school enrolment (net %)	75.6	95	94.8	92.7
Source: Constructing a new strategy for poverty reduction, World Bank, 2001				

3.3 In the 1960s, Indonesia was a very poor country. The per capita income of Indonesia was well below that of neighboring Southeast Asian economies. The real per capita GDP (in 1983 Rupiah) was about the same in 1965-67 as in 1911-13 (Booth, 2000). More than two thirds of the population lived in material poverty. Following stabilization policies carried out by Suharto between 1966-69 to combat the steep recession of 1965, the economy took to a path of reduced inflation and sustained economic growth, setting a trend for long-term poverty reduction. However, these policies contributed to income disparities which were contentious; in urban areas, the Gini coefficient[1] of household incomes in 1968-69 was approximately 0.4 in Jakarta, Mandano and Yogyakarta, and slightly lower in Bandung, Surabaya and many other large towns outside Java.

[1] An aggregate measure of the degree to which the distribution of income across a population can be considered equal.

3.4 At the beginning of the 1970s, high oil prices had important consequences for economic growth, poverty reduction and income distribution in Indonesia. The growth of non-agricultural sectors created employment and fueled greater migration to urban areas. Between 1970-76, poverty declined in urban areas. [2,] Although inequalities in income rose in urban and rural areas, by the late 1970s, the poverty rate was falling. However, because the population was growing faster in urban areas, the numbers under the official poverty line fell more rapidly in rural areas. Between 1976-81, the average annual decline in the numbers below the BPS poverty line was 5.6 percent.

3.5 In the early 1980's, following a decline in oil revenues, the GOI initiated a series of economic reforms and austerity measures. In spite of lower growth rates in GDP and cuts in government spending, the poverty rate continued to decline for much of that decade. In addition, the incidence of relative poverty[3] declined in both urban and rural areas; the change in income disparities was marginal. The government continued its reforms during the late-1980s, ushering in a period of sustained growth that lasted till 1996-97. The share of the population living in poverty continued to decline, although not as dramatically as in the period of 1976-87. During this period, there was also an increase in relative poverty in both urban and rural areas and greater inequalities among the former. The Gini coefficients rose from 0.32 to 0.36 between 1987-96. What was striking was that beginning in the mid-1970's, poverty declined in Indonesia, regardless of changes in macroeconomic policies.

Table 3.2: Headcount Measure of Poverty

Year	**Poverty Line** (Rp/capita/month)	**Population Below Poverty Line** (million)			**Population Below Poverty Line** (percentages)		
	Urban	Urban	Rural	Urban+Rural	Urban	Rural	Urban+Rural
1970					53.6	38.7	
1976	4,522	10.0	44.2	54.2	38.8	40.4	40.1
1980	6,831	9.5	32.8	42.3	29.0	28.4	28.6
1987	17,381	9.7	20.3	30.0	20.1	16.1	17.4
1990	20,614	9.4	17.8	27.2	16.8	14.3	15.1
1993	27,905	8.7	17.2	25.9	13.5	13.8	13.7
1996	38,246	7.2	15.3	22.5	9.7	12.3	11.3
1996 a/	42,032	9.6	24.9	34.5	13.6	19.9	17.7
1998 b/	96,959	17.6	31.9	49.5	21.9	25.7	24.2
1999 c/	92,409	15.7	32.7	48.4	19.5	26.1	23.5
Notes							
a/ Susenas of February based on the 1998 standard which is adjusted to account for the shift in consumption pattern of the respective year.							
b/ Based on Susenas of December 1998							
c/ Based on Susenas of February (regular) 1999							
Source: Central Bureau of Statistics							

3.6 **The crisis of 1997 and its impact on urban poverty**. In 1996, the government's estimate of the absolute poor was around seven million in urban areas or approximately 10 percent of the population and a little over 15 million in rural areas, representing approximately 12 percent of the

[2] Interestingly, in rural areas the incidence of poverty increased during this period.
[3] Relative poverty is defined as the proportion of the population spending less than 50 percent of its average per capita consumption expenditure.

population. However, a significant percentage of the population remained just above the poverty line. As a result of the crisis, poverty levels increased substantially, especially in urban areas, with the island of Java suffering the most. The urban population living below the poverty line increased significantly from around 7.2 million (9.7 percent) to 17.6 million (22 percent) of the total population by 1998. Using the (new) SUSENAS (1998) definition of the poverty line, BPS estimated that in 1996 the percentage of the population below the poverty line was 13.6 per cent in urban areas, rising to 21.9 percent in December 1998, with a marginal decline to 19.5 percent in February 1999. Additionally, SMERU estimates that a much larger percentage of people, in fact, nearly half of the entire population, remains vulnerable to poverty and struggles to avoid falling into a poverty trap[4]. It is also clear that poverty is an increasingly urban issue, considering the rapid growth of the urban population—an annual rate of 4.4 percent during 1990-99.

3.7 **Prior to 1997,** Indonesia's success raised the prospects for sustained progress in poverty reduction. The *Krismon* changed all that. The impact of the crisis was severe across all sectors of the economy as well as socio-economic and political arenas. In 1998, the crisis had a disproportionate impact on the urban economy (especially in the largest cities) with urban-based GDP declining by 18 percent versus 13 percent for the economy as a whole. (ADB, 2001). Decline in output occurred across all major sectors, except agriculture; the worst affected were predominantly urban. There were massive layoffs from urban industries that closed or went bankrupt; many construction projects in urban areas came to a halt. Unemployment increased to unprecedented levels, particularly in the formal sector and in urban areas.

3.8 The impact was felt most by the urban poor. Layoffs abruptly pushed thousands of urban low-income workers out of the formal sector, into the informal sector. Many poor residents unable to make a living in urban areas returned to their villages, adding to the pressure there. High unemployment, exacerbated by a high inflation rate in 1998, reduced the purchasing power of the poor to record lows. As a result, poor households had to reduce the quality and quantity of their food intake; access to the most basic social services, such as health and education, was compromised. Between 1997-98, urban households reduced real spending on food by 28 percent (compared to 8 percent for rural households). While the incidence of poverty rose countrywide from February 1996 to February 1999, the relative increase was much higher in urban areas than in rural areas; urban poverty rose by 126 percent, almost double the increase in rural areas. Similarly, poverty indices, such as headcount, the gap in poverty and its severity increased by 152 percent, 184 percent, and 202 percent, respectively, between 1996-99, well over twice the increases seen for rural (EAP Urban Poverty Study, World Bank, 2001). The crisis also had an impact on inequalities in income. Reversing the trend from 1993 to 1996, there was an improvement in the distribution of income, according to national Gini coefficients from 1996 to 1998, suggesting that the *Krismon* may have had more of a negative impact on the incomes of high- and middle-income households than on low-income households (ADB, 1999; BPS, 1998).

Vulnerability: the Multi-dimensional Nature of Urban Poverty

3.9 The political upheavals that followed the crisis are well known. High urban unemployment, particularly among the youth, aggravated social tensions between urban communities and disenfranchised large sections of the urban population. It also brought to light vulnerability to poverty. The headcount index of poverty, used to define the "poor" herein, is only one measure of poverty and does not reflect its multi-dimensional nature. Across the country, poor people identify inadequate assets, unreliable livelihoods, indebtedness, and environmental and seasonal stresses as sources of insecurity. Poor infrastructure and governance compound the exposure. Women are doubly insecure

[4] This dimension of poverty is discussed in the next section under Vulnerability.

due to entrenched gender inequities. The leading sources of vulnerability vary by region (Mukherjee, N, 2001; p.184).

3.10 The level of vulnerability reflects the degree of risk a household facing a given variability in its expenditures will see these expenditures fall below the poverty line. For Indonesia, the World Bank has defined a household vulnerable to poverty if the level of risk of poverty is above 0.5 (World Bank, 2001). Vulnerability also includes susceptibility to health risks, natural disasters, crime, social exclusion, and by variations in access to basic services and facilities, such as the judiciary, police, health education, water supply and sanitation facilities. The Indonesian crisis highlighted the high degree of vulnerability of a large share of the population because of shocks in their external environment. In fact, SMERU suggested that nearly half of the population is vulnerable to poverty; the odds are even that they may face an episode of poverty every three years (Pritchett et al, 2000). Unfortunately, little data is available to grasp the magnitude of this problem, especially in the urban areas of Indonesia.

The Government's Response

3.11 In the short term, the government's priority was to overcome the immediate and direct effects of the crisis and to create an environment conducive to long-term recovery. The government responded in four key areas: (a) providing food security, (b) supplementing the purchasing power of poor households by creating employment; (c) preserving access of the poor to critical social services, such as health and education, (d) sustaining local economic activity through regional block grants and the extension of credit. These were addressed by establishing new initiatives called the Social Safety Net (JPS) program.[5]

3.12 The programs covering food security and social protection were intended to prevent further deterioration in the quality of human life. The food security program aimed to provide poor households with subsidized rice. The education component of the social protection program provided block grants for: the operation and maintenance of as much as 60 percent of primary and secondary schools, targeting those in poorer regions; scholarships to keep children from poorer households in school; and block grants to universities. The health program made available essential health services for the poor, while another social welfare component addressed the protection of street and other neglected children. The productive employment generation component was intended to promote job creation and income in urban areas throughout Indonesia. It supported infrastructure development and provided employment opportunities for urban poor with at least three months of employment annually for each person. Additionally, a program called Special Initiative for Women Unemployment was developed in some provinces for women workers who had been laid off. In the post-crisis period, many cities and regions continue to depend on centrally-funded poverty programs. JPS programs are still the main vehicle for poverty alleviation in the six cities surveyed under *Cities Speak*.

3.13 Many JPS programs and components were not well regarded by the purported beneficiaries.[6.] The most frequent charges against them were lack of coordination, poor targeting, favoritism and lack of transparency in the delivery of programs. For instance, one complaint was the school scholarship program mainly benefited either families who were better off or those with connections; many eligible beneficiaries had scant information about the program.

3.14 The Ministry of Settlements and Regional Infrastructure implemented an Urban Poverty Project (UPP 1) in the densely populated areas of Java, the region which fared the worst during the

---

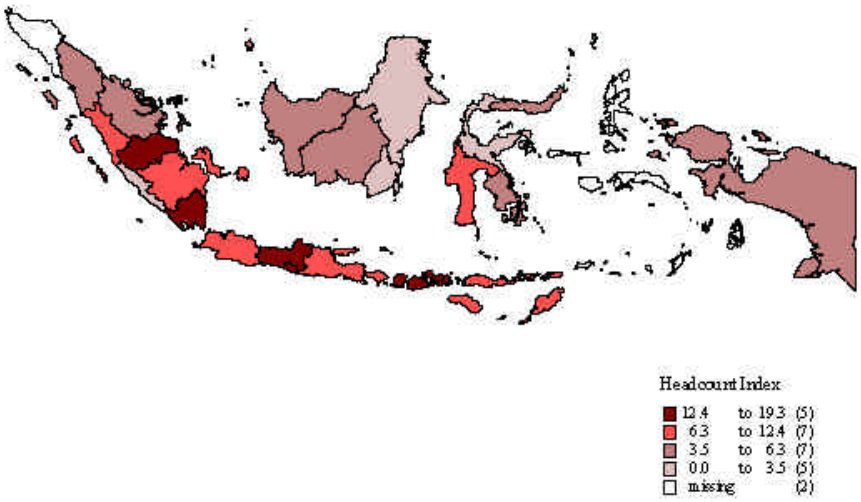
[5] see Sumarto, S et. al. and Marc Jacquand, 1999.
Source: Indonesia: Imperative to reform, World Bank 2001.

economic crisis. Funds went directly to community organizations (BKMs) to assist them in the crisis; the community organizations decided how to use the funds. Most BKMs opted to establish a revolving fund, providing credits to groups of people for developing micro-enterprises (industries and services). A small percentage of the funds provided for basic infrastructure. The programs were planned and implemented by the community organizations themselves with minimal intervention from the local government. Many locally recruited facilitators assisted the communities in organizing themselves into representative organizations, electing leaders and implementing programs. The main objective was to improve basic infrastructure in poor urban neighborhoods and promote sustainable income generation for urban poor through a bottom-up approach.

Current Status

3.15 Economic recovery and macroeconomic stability have helped to substantially reduce poverty. Preliminary estimates on the basis of SUSENAS 2000 suggest the urban poverty has declined from its peak of almost 22 percent in 1998 to roughly seven percent in 2000, with a Gini of 0.328 in 1999. While still higher than the best pre-crisis lows, urban poverty is now at a level comparable to that of 1996. Calculations using the international standard poverty lines of US$1 and US$2 a day per capita (at 1993 PPP prices) and the *Cities Speak* findings yield much the same conclusion. However, the current reduction in poverty is based on headcount and does not take into account the broader, multi-dimensional nature of poverty. When the concept of poverty is expanded to include vulnerability, access to health, education, basic infrastructure, and a chance to participate in social and political life as equals, then the number of people considered poor increases considerably (Indonesia: Imperative to Reform, World Bank, 2001).

Figure 3.1: Profile of Urban Poverty by Area for Year 2000



Source: Imperative to Reform, World Bank., 2001

Table 3.3: Latest Estimates of Indonesia's Poverty Rate
(Headcount index; percentage of population)

	National poverty line			Other poverty lines	
	Urban	Rural	Total	**US$ 1/day**	**US$2/day**
1996	7.2	20.5	15.7	7.8	50.5
1999	16.3	34.1	27.1	12.0	65.1
2000	7.3	20.7	15.2	7.8	57.1
Note: The US$ 1 and US$ 2 a day poverty lines are at 1993 PP prices and are the standard poverty lines used to compare poverty across countries. They are applied to Indonesia.					
Source: Indonesia: Imperative to Reform; World Bank, 2001. World Bank staff estimates based on SUSENAS data. These estimates differ from others because of different estimation methodologies.					

Conditions of Urban Poor[7]

3.16 The rights of the urban poor to land, housing, basic urban infrastructure and services, income opportunities and credit, social capital formation, empowerment and participation in civil society basic security and justice are highly compromised in their everyday lives. To better understand the factors leading to their vulnerability, the following sections examine the living conditions of the urban poor in Indonesia. Much of this section derives from a number of recent World Bank studies on poverty in Indonesia. Among them are: Urban Poverty in the East Asia Region: A preliminary desk review with particular focus on Indonesia, the Philippines and Vietnam (2001); Indonesia: Imperative to Reform (2001); Indonesia: Constructing a New Strategy for Poverty Reduction, (2001); People, Poverty and Livelihoods: Links for Sustainable Poverty Reduction in Indonesia, (2002); Voices of the Poor: From Many Lands (2002); and supported by empirical evidence from the *Cities Speak* studies.

3.17 **Access to land and housing**. The pressures created by distorted urban land markets and high land values cause the urban poor to suffer. Indonesia's complex system of land rights provides for as many as seven different types of rights to the same parcel of land, ranging from "ownership" (*hak milik*) to short-term, limited-use rights (*hak guna sementara*). This chain has owners, lessees, sub-lessees, sharers, often tied in a complex arrangement, with a number of certificates issued for each house. The cost of obtaining the certificates is simply too high. Legally, this makes the urban poor "squatters." Given the complexity of and endemic corruption in land administration, where only a share of urban land is documented, the poor are disenfranchised from any meaningful participation in the formal land markets. Yet, the very same complexities in land tenure also allow the urban poor to enjoy a reasonable degree of de facto security.

3.18 Most poor households hold only customary rights to land without any official title. It is easy for the government to displace them and appropriate their land without adequate compensation or access to grievance mechanisms. Land conflicts are growing more frequently typically when large projects displace the poor with inadequate compensation. The lack of institutional mechanisms for the adjudication or resolution of disputes has created long-standing feelings of distrust and hostility toward the government and private developers by poor communities. Sometimes these tensions spill over. It is not uncommon to find newspaper accounts of displaced *kampung* residents forcibly

[7] Refer to the EAP Urban Poverty Study for detailed figures on the urban poor and land, education, health, employment and access to services.

occupying vacant government land, golf courses or incomplete residential developments, especially, when many developers became insolvent during the economic crisis. Lack of tenure security also inhibits poor households from investing in home improvements, thereby improving their living environment.

Box 3.1: Clean-up Drive Against the Poor

In the final years of the Suharto government evictions increased tremendously. Rampant land speculation and construction of infrastructure suddenly dropped to near zero during the *reformasi*. Since 1999, however, a campaign began to rid the city of informal sector workers such as pedicabs, street hawkers, beggars and others. The Jakarta regional government introduced a new decree on the so-called PMKS Operation, eradicating those who bear social welfare problems; *Yustisi* Operation, Socialization, and Technical -Assistance Operation. The goal was to eradicate beggars, street vendors, homeless children, prostitutes, pedicab drivers and to check ID cards, fight against drugs and firecrackers.

This year the government began evicting slum communities. The main reasons given were the city's campaign to make Jakarta a city without slums and to implement government projects such as flood control. (As in other countries, the project blamed the urban poor for the city's flooding and wanted to remove them from so-called danger areas).

Source: Urban Poor Consortium website (http://www.urbanpoor.or.id/index.htm).

3.19 Land titles reduce threats to the poor, increase their asset base and access to credit, and encourage the production of housing stock. Since 1994, the National Land Agency (BPN) has issued over two million land certificates to the poor on Java. Expanding this program countrywide will require an account of more traditional communal land ownership patterns (ADB, 2001). Indonesia needs fundamental legal and institutional reforms to administer land. Decentralization offers an opportunity for fundamental reform, but it needs to avoid the risk of simply decentralizing the previously corrupt and inequitable system.

3.20 Housing for the urban poor represents not merely shelter, but also an asset, a workplace and a source of rental income. But in many cities in developing countries, including Indonesia, poor households have few choices. They are forced to choose between locational advantages: access to work and the lack of tenure security with their attendant unsafe environmental conditions, risking their health, earnings and security. The cost of such housing can be substantial, especially when the associated expenses (poor infrastructure, absence of public transport, exposure to pollution, etc.) are taken into account. More often, the poor construct shelter in vacant urban land areas and upgrade them incrementally—adding a room is one example—as their economic situation improves. These houses are passed down from parents to children. When provided with basic infrastructure, many *kampungs* slowly upgrade to regular settlements.

3.21 The share of the population at all deciles owning their own homes is greater; renting/leasing occurs much less frequently in rural than urban areas. The share of the urban poor in "free housing" (most likely squatters) is 6.4 percent. Many of the 77 percent of the urban poor who own their own housing and the 14 percent who rent or lease may lack secure tenure. The share of the lowest expenditure decile in free housing, nine percent, is highest in settlements of 500,000-1 million. Roughly 34 percent of the urban poor have floor space of less than 40 square meters, compared to approximately 29 percent of the rural poor. The difference in dwelling size between the urban rich and poor is not significant, but the difference in quality across urban income groups is notable. For example, nine percent of the poorest decile have bamboo walls, compared to 0.7 percent of the richest.

3.22 **Labor and human capital assets**. Although urban households are, on average, better educated than rural, urban areas show sharper differences in educational levels between the rich and

the poor. The proportion of individuals not completing primary school education is almost four times higher among the urban poor than among the urban rich, compared to only a two-fold difference in rural areas. School participation and literacy are highest in Jakarta and lowest in rural areas, but they do not uniformly drop as the size of the settlement declines. In fact, illiteracy is more prevalent among the lowest decile in several of the city size categories than in rural areas.

3.23 **Health status**. Normally, urban dwellers have greater access to health facilities. However, their health outcomes may not be better because of poor nutrition, environmental stresses, sanitation and unsafe behaviors. Averages on the reported availability of facilities or services can also mask effective access and quality, especially for the urban poor. Often health care and health outcomes within the poorest urban areas are no more favorable, and sometimes much worse, than those in rural areas. Frequently the poor find the services at government primary care facilities deficient; they are reluctant to use hospitals and other higher order health facilities because the expense deepens their debt. Compared to the rest of the population, typically slum dwellers have shorter life expectancies, a higher incidence of infant and maternal mortality, and health problems like diarrhea/dysentery, malnutrition and mental illnesses, compared to rest of the population. Added to this litany of issues, the HIV epidemic in Indonesia is growing rapidly among urban intravenous drug users and commercial sex workers. Many of them are poor.

3.24 **Employment status and types of work**. Unemployment was reported higher in urban areas than in rural areas. But, as the East Asia Poverty Study points out (p. 42): "employment status alone is neither a predictor of income, nor a useful poverty targeting criterion." According to the surveys, employment status is not indicative of the actual situation in urban areas, especially those who worked in the informal sector during the *Krismon* of 1997. The urban poor report consistently higher rates of "not working" than the non-poor. The same pattern continues across all settlements, regardless of size. The share of women claiming to not work is twice that of men in all settlements—which was curious, considering that female-headed households were not particularly poor, according to the studies. Although women who claim to be unemployed are less prevalent, it is possible that the type of work they do is not recognized. It is also possible that many of the relatively well-off female-headed households are migrants with jobs in new manufacturing industries (ibid).

3.25 The unemployment rate tends to increase for the poor (and non-poor) with a corresponding increase in settlement size. For example, 12.6 percent of poor males and 10 percent of poor females claim to be unemployed in cities with a population of over two million, such as Jakarta, compared to 8.5 and 6.7 percent, respectively, in urban areas below a population of 250,000. Based on national labor surveys, estimates of underemployment indicated an increase in the numbers and percentage of workers, particularly in manufacturing, that were on the job less than fulltime, during and after the crisis; this trend may have pushed some marginal earners to seek work in the informal sector and to fall below the poverty line. Among poor households, individuals work long hours, a reflection of underemployment. In times of crisis, they mobilize more family members, especially secondary school children. In the post-crisis period, unemployment was estimated to have risen to 15 million out of a labor force of 90 million; underemployment was estimated at 45 percent (up from the pre-crisis estimates of 35 percent.

Access to Basic Urban Services

3.26 The urban poor are inadequately covered by most basic environmental infrastructure services, such as clean water, sanitation, storm drainage, and access roads. While the effects of the economic crisis on environmental infrastructure has yet to be fully understood, preliminary findings indicate that the poor were particularly affected by lack of government funds for both, maintenance of existing infrastructure and urgently needed new investments.

3.27 According to an Indonesian survey on living standards, a higher share of urban households has access to tap water than rural households (46.6 percent vs. 11 percent); they are also less likely to use unprotected water sources. Approximately 42 percent of the urban poor purchase water, compared to 15 percent of the rural population. Approximately 55 percent of poor urban households rely on "private" drinking water facilities, specifically in-house or yard taps; these figures are much higher than in comparable rural areas but they were expected. Less evident is the inequalities in sources of drinking water between urban rich and poor across rural income groups. For example, while twice as many poor as rich drink from unprotected water sources in rural areas, the urban poor are five times more likely than the rich to drink from unprotected wells and to rely on public drinking water facilities. The situation is worse in the largest cities. In Jakarta, the poor are even more likely than the rich to purchase water from alternative sources, such as street peddlers and neighborhood standpipes. These supplies are less healthy and more expensive than water distributed through house connections (Crane, 1994). Sector failures have had a widespread impact on all groups, especially the city's poor.

3.28 The EAP poverty study notes that, across Indonesia toilet facilities—private or shared—do not vary greatly between rural and urban with one exception. Public facilities in urban areas are used almost exclusively by the poorest households. Squatter toilets are the preferred option by 60 percent of the urban poor; dry latrines are next (16 percent of the poorest vs. 2 percent of the rich, in urban areas). The study also shows that safe waste disposal, using septic tanks, are twice as available in urban as in rural areas (73 vs. 32 percent). The urban bottom third relies on open fields, ground holes or water bodies; about 40 percent use these discharge methods, thus risking contamination of the surface and groundwater in dense urban areas. In Jakarta, for example, 30 percent of the poor discharge their waste directly into bodies of water. In Greater Jakarta, the water source for 30 percent of households surveyed was within six meters of a source of contamination, such as a sewage discharge outlet.[8]

Insecurity and Urban Poverty

3.29 Poverty is also characterized as a state of insecurity and exposure to risks—personal, communal and financial—that can undermine the asset base of the poor as well as their ability to cope. Poor urban communities are vulnerable to threats from their immediate environment. A major source of insecurity for informal settlement communities is a lack of recognized tenure and the resulting risk of extortion and/or eviction. Such losses are traumatic since households lose their homes, belongings, as well as social networks and connections (see box on **Clean Up Against the Poor**). Typically, many poor communities reside on marginal land—flood-prone land, on hillsides, or near factories—that are vulnerable to disasters. The high density of informal settlements and the temporary materials used to make them are susceptible to fire. The results can be catastrophic, involving loss of assets and loss of life. The haphazard layout of such neighborhoods, without storm drainage or access roads, also renders emergency evacuation difficult, raising the human toll of natural disasters and industrial accidents.

3.30 In urban areas, personal insecurity stems from health problems, traffic risks and crime. Poor urban communities are exposed to violence, extortion and harassment. Women are particularly vulnerable to the above as well as domestic abuses. Slum dwellers contend with negative stereotypes which exacerbate the exclusion and marginalization of the urban poor.

3.31 An urban population, especially the poor, depends on a cash income and expenditure economy; therefore, they are sensitive to swings in the economy. Micro credit programs can be an important safety net in low and middle-income countries. In the Voices of the Poor interviews, NGO and private

[8] BPS. Environmental Statistics of Indonesia, BPS Catalogue 2202, Jakarta. Cited in ADB Urban Chapter p. 12.

credit programs received favorable reviews from many poor households (p.199). Typically, the poor rely on informal supplementary sources of income, especially when times are difficult. Moneylenders and pawnshops are often described as necessary evils, the only source of loans for poor families in urgent need of money. These moneylenders charge exorbitant rates, in excess of 30 percent per month, leaving many households in debt (ibid, p.200). Based on household interviews in Jakarta, mutual financial support among families, communities and informal credit groups may also decrease during crisis periods. Often private transfers constitute a more important safety net than public programs. In a sample of Indonesian communities surveyed, of the 44 percent of respondents who reported receiving cash transfers, 20 percent obtained them from the government and NGOs, compared to 80 percent from family and friends.[9]

Empowerment, Social Capital and Urban Poverty

3.32 The urban poor feel excluded and powerless. They rely heavily on their own social organizations and networks and on informal means to satisfy many of their needs. While this resourcefulness may be positive in many ways, it also reflects government's failure to recognize the needs of the urban poor and to treat them fairly.

3.33 **Relations with government**. According to a Consultations with the Poor study of both rural and urban populations in Indonesia, respondents rated institutions, such as government, religious, private commercial, and NGOs, for their effectiveness and ability to engender trust. No government services or programs and no NGOs appeared among the top five institutions that the urban poor selected for their effectiveness, trustworthiness, and openness to community influence. The poor frequently stress that programs aimed at poverty reduction fail to reach them because they lack the capacity to influence government officials or to hold them accountable. Corruption is widely perceived as a major impediment to the people's ability to obtain government services and benefits fairly and efficiently. In areas of Jakarta, local corruption interfered with an emergency rice subsidization program funded by the World Food Program at the height of the financial crisis. Fortunately, residents mobilized a boycott which corrected the problem. [10]

3.34 Good governance, especially at the local level, is a vital ingredient to any sustainable poverty reduction strategy. Other support measures and mechanisms, while essential, can be most effective while operating with a local government that cares for its poor. The case of Balikpapan is an example of that synergy.

3.35 **Social networks among the urban poor**. For the urban poor, social interactions and relationships are more significant than their dealings with government or other institutions. These social networks usually consist of relatives, friends and neighbors. They are an asset for coping with shock and an important source of mobility, and are central to improving the living standards of the poor. Formal or informal groups are also essential for the poor to bargain for access to public services. This is particularly true in large cities like Jakarta or Bandung. In short, they serve as a shield and safety net for the urban poor. Among such groups/networks, neighborhood associations (RW/RT) and formal religious organizations command a high degree of trust among the poor. Although such networks may be effective when it comes to collective action, they can also be a source of political violence and a means of excluding other disadvantaged groups.

---

[9] Reyes et al., 1999, cited in Craig et al., 2001, from EAP Poverty Study, 2001.
[10] Craig et al., p. 40 cited in EAP Urban Poverty Study.

Box 3.2: Governance and Poverty Alleviation in Balikpapan

Good governance in Balikpapan took time. Although the city is relatively wealthy and its city managers are capable, Balikpapan learned by trial and error over a period of decades. Commitment to sustainable urban development by mayors, city administrations, and its citizens, has shaped Balilkpapan. The city management encourages "grass roots" initiatives. Management at the district and sub-district levels ensures that assistance reaches the targeted groups. Decentralization has brought about many unique programs:

Poverty Mapping and Database: The city conducted a survey to map the poor and built a database of poor households. Based on this database, the city has set a goal of reducing the number of poor households in 5 years.

"Nine carry one": The city enjoined that poor households, who represented 10 percent of those surveyed, will be supported by the remaining 90 percent who are not poor. ID cards were issued for the poor to access basic health services and social benefits, including scholarships, micro credit, etc.

ID cards for the poor: The card specifies the holder's occupation, such as street vendor, to stimulate upward mobility and create a desire to escape from the social stigma associated with certain jobs. The intention is to empower the poor to draw on their own self- esteem instead of depending on charity.

Micro credit for income generation: the city offers Interest- free micro-credits to help the poor generate income. Once borrowers establish credit records, the city encourages them to graduate from this scheme to commercial loan programs offered by an Islamic Bank.

Education grant and medical services for the poor: Balikpapan requires compulsory education for 12 years instead of nine as in most Indonesian cities. Education grants are available to poor households. In addition, the city ensures access to basic health services for the poor.

Source: *Cities Speak* surveys

Gender Dimension of Urban Poverty

3.36 In many developing countries and countries that have strong gender biases, women are often underprivileged. Indonesia is no exception. Gender relations are inequitable and make women vulnerability to poverty. Despite having a gender-neutral Constitution, throughout their lives, poor women in Indonesia are doubly disadvantaged by their economic status and gender. Over the past 10 years, there have been advances in improving the condition of women. Yet poor women continue to be deprived and vulnerable on a number of counts: traditional customs and mores; discriminatory labor practices and work environments; inequitable wage structures; greater susceptibility to health problems; harassment, rape and other forms of physical violence; domestic abuse, social stigmas about divorce and female-headed households. Although women contribute to the major livelihoods of poor households-- equally or even more than men -- their roles are not recognized by government agencies, extension services or development programs. Poor women do not shape projects; gender analyses are not considered an essential part of project planning. [11]

[11] World Bank. People, Poverty and Livelihoods: Links for Sustainable Poverty Reduction in Indonesia, 2002

Table 3.4: Gender Differences in Perceptions of Root Causes of Poverty in a Poor Urban Community

According to men	According to women
Cannot find work - little education and no contacts for KKN (corruption, collusion, nepotism). Forced to remain indebted to money lenders *Krismon* (financial crisis in the country).	Too much competition from other food vendors, often the only skill women have. Afraid or too late to adopt family planning methods – too many children. Dirty, unhealthy physical and social environment leads to young men gambling, drinking and crime.
Source: World Bank, People, Poverty and Livelihoods: Links for Sustainable Poverty Reduction in Indonesia, 2002: p.25.	

Decentralization and Poverty

3.37 Ongoing decentralization provides new opportunities and poses new challenges for the alleviation of poverty. The following have ramifications for developing an urban poverty reduction strategy[12]:

- The devolution of political, fiscal and administrative authority includes the devolution of authority for designing appropriate poverty-reduction policies and programs.

- Fiscal decentralization has had a significant impact on patterns of budget allocations for poverty reduction. With a corresponding decline in central government resources for poverty reduction, the regions now have discretion in framing their budget allocations for the same in their APBDs.

- Decentralization has given latitude to the regions in policy decision making. In principle, this augurs well for sustained poverty reduction policies and programs.

- Laws and regulations governing decentralization emphasize community participation in program planning and implementation. Although these laws have not provided for or laid out mechanisms for communities to monitor and evaluate specific programs, at a minimum, they provide the regulatory framework for facilitating participation.

- A distinct advantage of decentralization is that it strengthens local initiatives. Many regions went through a participatory planning and budgeting process; regional heads had to submit their *Renstras*, which specify the local government's goals. Budget watchdogs have sprung up in large numbers in the regions (World Bank, 2001).

3.38 On the other hand, the difficulties of monitoring public expenditures and outcomes on key services when a large part of government spending is decentralized, is a challenge. Another cause for concern is the low and uneven capacity of the country's civil service. Moreover, the uneven distribution of fiscal resources is likely to have consequences for uneven service delivery. The responsibilities added to local governments have reduced their development expenditures which impacts the poor the most. There is no guarantee that in the new environment, regional governments

[12] The MOHA has presented a policy note on a decentralization policy or poverty reduction to the CGI in November 2001.

will focus on poverty reduction. Instead, there is an inherent danger that regional elites may capture local institutions for their own purposes and divert resources away from pro-poor activities. Regional governments may be disinclined to devote significant resources to activities that may yield benefits outside their region. In the six cities studied, all of them said they would address urban poverty; in fact, only one of them substantially did. The exception was Balikpapan, which allocated Rp. 20 billion or five percent of its 2002 budget for poverty alleviation programs.

Essentials of an Urban Poverty Alleviation Strategy

3.39 For the most part, poor families and individuals will escape poverty and reduce their vulnerability as a result of their own efforts. The response of poor households and communities to the problems and crises in their environment depends on the assets—labor, human capital, and social capital—they can mobilize.

3.40 **Resumption of growth to create an environment for poverty reduction.** A thriving economy with stable macroeconomic and financial fundamentals—rising real wages, expanding employment and limited inflation—is insurance for reducing poverty. Equally important, these gains must be across the board and not reserved for the elite. For growth to be effective in poverty reduction, the poor must have equitable access to, and fair returns on assets and products. Public policies for labor, capital (finance, savings), land and natural resources must meet the needs of the poor.

3.41 **Decentralization for improving *pro-poor* governance.** Decentralization bodes well for changing the day-to-day relationships between the poor and the government and for making government more accessible. The notions of "quality" and "access" should be at the heart of new local government policies and programs for the poor. Vital ingredients for a decentralized governance agenda for poverty reduction include:

- free flow of information to create awareness about policies/programs that directly impact the poor and putting in place mechanisms for the poor to access information that matter to them;

- a voice for the poor to empower them to shape the policies and programs that affect their lives and ensure efficient and effective implementation of public service delivery; and

- transparency and accountability in decision making, accompanied by a gradual shift from meeting physical targets to achieving specific outcomes. It is also important to visibly "appear" transparent and fair, as much as "be" transparent and fair, to elevate the confidence of the poor in the rule of law and the ability of the government to uphold it.

3.42 **Investing in the poor by way of poverty-focused public expenditures.** Allocations of public expenditures that maintain fiscal balance and enable decentralization while benefiting the poor should be a key element of economic policy, both at national and local levels. Additionally, there needs to be:

- better ways of measuring poverty and strengthening the capacity of city governments to track it ;

- the ability to analyze the impact of poverty on public expenditures across and within sectors, to monitor their effectiveness, and to strengthen the capacity of urban local governments to undertake these actions;

- to make subsidies more effective, especially in the extension of credit and provision of services;

- to make fiscal decentralization pro-poor by reflecting poverty priorities in DAU design, focusing DAK allocations to address poverty and to allow city governments to borrow for poverty programs (conditional to meeting other borrowing criteria).

3.43 **Developing safety nets for the poorest**. While much of poverty reduction in urban areas will be accomplished by individuals, families and communities themselves, there will be pockets of poverty and groups of people that require special attention and assistance, such as the chronically poor, the physically or socially excluded, orphans, widows and so forth. Additionally, during crisis episodes, many poor families may need extra help. Special programs, like the JPS program, are required to assist the most vulnerable. However, the success of such programs will lie in their adopting the following principles:

- locally driven, rather than by the central government, although resources can come from anywhere;

- limited to specific groups and/or time periods, aimed at the basics—food, health care, shelter, etc.; and

- government resources, but with targeting and implementation left to NGOs/CBOs.

3.44 **Access to secure land and affordable housing.** Detailed strategies on making land and housing markets more accessible to the poor are discussed in the section on land and housing. Needless to say, land reforms will cover titling and registration processes, land information systems, urban land use planning and management, and land supply mechanisms. Housing programs must focus on removing unwanted (KPR) subsidies and replacing them with targeted housing assistance to meet the specific needs of different segments of urban poor; strengthening KIP and other community programs for the poor; and down-market expansion of housing finance.

3.45 **Infrastructure provision for mobility, access and environmental well being.** Current levels of access and quality of infrastructure for poor urban communities needs improvement, based on the following principles:

- strengthen municipal capacities and develop feasible financing options for municipalities to sustain services. That includes reducing waste, making users pay for services, using subsidies judiciously to target the poor and developing partnerships with NGOs/CBOs;

- reduce current anti-poor bias in urban infrastructure policies. This is particularly relevant in the transport sector where public transport and non-motorized modes should be a priority instead of in urban transport planning instead of private modes;

- planning, design and implementation driven by community needs and capacities, especially for those services delivered at the community level (water supply, sanitation, SWM, drainage); and

- community-based provision of local infrastructure, aided by appropriate design standards and technology. This can be supported by enhancing the community's role in operations and maintenance.

3.46 **Opportunities for economic empowerment through access to credit and capital.** Recovering from the ill effects of the *Krismon*, Indonesia should regain and strengthen its tradition of leadership in making financial services available to the poor. The essential steps toward a strengthened micro-finance sector that can better serve the poor are: providing a regulatory framework and

developing institutional oversight; eliminating interest rate subsidies and making other government subsidies rational, direct and targeted; strengthening micro- finance institutions rather than merely expanding the sector; reducing costs and improving efficiency of operations; and improving access with information.

3.47 **Strengthened human capital through better education and health.** Improvements to the physical environment and opportunities for economic empowerment work best when integrated with investment in human capital and efforts to strengthen social support systems. Many Bank-assisted urban programs for the poor have been relatively weak. The guiding principles that apply to reaching the poor are relevant here as well:

- the design should be based on proven, effective interventions which take account of local aspirations, needs and capacities;
- use government resources and frameworks for planning and standard setting where they exist, but targeting and implementation are best left to NGOs/CBOs; and
- targets and monitoring should not be based on numbers alone, but include specific outcomes and clear mechanisms.

3.48 **The Rule of Law and an accessible judicial system for safety, security and justice.** An accessible judicial system will strengthen the capacity of the poor to participate in urban markets on a fair footing and reduce the socio-economic tensions enveloping many urban areas. The poor need to be made aware of their constitutionally-guaranteed rights and legal remedies. Inexpensive and accessible legal advice is vital. NGOs and relevant voluntary organizations have an important role to play here. Additionally, the police and the judiciary need to be specially sensitized to the needs of the poor. Respect for human rights should be essential to law enforcement training; human rights violations affect the poor the most. These advances will not come easily; they will require a change of attitude, state resources, and sustained political will. On a positive note, decentralization offers a great opportunity to move in the right direction.

3.49 **Gender dimension is essential to a sustainable poverty alleviation strategy.** The needs of women require that attention be paid to poverty policies, program planning, design and implementation. Ensuring meaningful participation by women means moving beyond current efforts in urban areas.

Urban Land and Housing

Introduction: Urban Land Markets in Indonesia

3.50 Urban land use is primarily determined by competition, the availability of land, ownership patterns, public policy and the regulatory environment. Interactions between these variables determine price and create a dynamic and efficient land market. Indonesia lacks a well-functioning land market. As a result, urban development and housing have been stifled, so too economic development.

3.51 The revival of economic growth in the country and its likely impact on urbanization, urban productivity and economy is expected to place a heavy demand on land, housing and infrastructure. A combination of outdated policies and regulations, questionable government practices in urban land administration and development, poor institutional capacity, outdated land registration systems and limited structures for long-term loan financing have limited the supply of land that can be developed; all of these factors have had a negative impact on all segments of the population. Although these problems are hardly unique, urban growth and the concomitant demand for urban land, rigidities in

land supply, weak land administration etc., and others, such as titling and development permit systems distinct in Indonesia.

Constraints on the Functioning of Urban Land Markets

3.52 **Outdated and incomplete regulatory framework**. The foundation of all current land law in Indonesia is Law 5/1960, the Basic Agrarian Law (UUPA or BAL), which derives from formal and *adat* (customary) law. This law replaced the pre-1960 dual system of land rights based on the Dutch Civil Code and the unwritten *adat* law. Under the BAL, land is controlled by the State for achieving "prosperity of the Indonesian people, Indonesian socialism, and *adat* philosophy" (Wallace, 2001; Behuria, 1994). Land use is administered through bureaucratic discretionary processes, replete with confusing and contradictory regulations. The scope of BAL covers the rights to land, water and space; registration; and penal provisions. BAL has a complex system of land rights offering varying degrees of tenure. The most important of these are the *Hak Milik* (right of ownership – closest to freehold tenure), *Hak Guna Bangunan* (HGB, right to build), *Hak Pakai* (right of use) and *Hak Pengelolaan* (right of management). Upon registration, the holder receives a certificate (*sertifikat*) as evidence of the title.[13]

3.53 Under the *adat* law, ownership and holdings are not surveyed, registered or titled, but based on community acceptance of boundaries and claims. Although BAL recognizes the primacy of *adat* land law, the insistence on documentation has stopped formal recognition of a large share of land holdings. It has also given the bureaucracy latitude in allocation of land rights with few mechanisms for fair resolution of tenure disputes. Corruption is endemic. The rights of private landholders are not adequately defined, whereas regulations defining the State's land rights are extensive and discretionary. Contrary to the requirement of Law 20/1961 on the Revocation of Rights on Land, land expropriation procedures are not in place and unfair bargaining practices force out private landholders. Appeals are rarely successful and confidence in the court's impartiality have been eroded.

3.54 The principles governing BAL are not capable of addressing the complexities of a modern urban land market system. Forty years after the legislation was passed, many of the laws, decrees, and regulations needed to define land rights specified in the BAL have not been enacted. Regulations are not in place because there is no clear land policy to support. Existing legislation, regulations and directives—over 2000—are outdated and need simplification. Under the BAL, formal ownership of land is very difficult. Only specific types of corporations can possess a *hak milik* title. Residential land is commonly held under a short-term lease. In Jakarta, for example, the term is 25 years with an HGB with the resulting insecurity, financial hardship and opportunities for rent seeking. Developed land is customarily sold without any formal title, thereby limiting access to formal sources of financing. The law also severely limits land transfers, for example, to foreign nationals or corporations—Indonesian or foreign. Until 1998, communal rights of traditional societies (*hak ulayat*) were ignored.

3.55 This situation makes for a complex and unclear tenure and titling system. Yet, this ambiguity has allowed lower income groups to have a degree of tenure security -- less than outright freehold --, which would otherwise have been unattainable.

3.56 **Poorly-developed and inefficient land registration system**. Less than 10 percent of the country is recorded by cadastral maps. Roughly 20 percent of the nation's estimated 70 million land parcels are registered. The main reasons for this low percentage are a complex and overlapping pattern

[13] Not all tenure ships require registration. For example, rural smallholders have unregistered *hak milik* rights, evidenced by tax receipts and/or letters from local officials.

of land tenure, a large number of parcels, a rapid increase in the number of parcels, weak institutional capacity by the agencies, absence of documentation, long-term disputes and unclear procedures for adjudication. The land registration system is complex, paper-intensive and manual. Registration fees are excessive, among the highest in the world. The number of unregistered land transactions is massive. Even where titling is complete, the number of registrations of transactions subsequent to titling are few and threaten the integrity of land records. Over two-thirds of land registration is improperly or incompletely documented and lacks geo-referencing. The sharing of data between institutions is fragmented and limited. Furthermore, there is no clear policy or law regarding issues of copyright, privacy, public access to information, custodianship, legal liability, insurance risks and information standards[14].

3.57 The weak land registration system has had a negative impact on the urban economy. Land purchasers and vendors face a high transaction risk because of unclear land title; as a result, land prices are higher to account for the risk. It also prevents land from being used as collateral; the risk of disputed titles must be borne by mortgage bankers. The complex titling procedures, along with corruption, have fueled the high cost of land development, spurring prices higher. Unclear land titles, unreliable and inaccessible land records and non-recognition of informal but valid land tenures discourage private investment, thwart housing development, lead to litigious overload and social conflict, particularly during turbulent times which Indonesia has seen in recent years.

3.58 Since the early 1990s, GOI has developed a reliable land registration system and established an efficient land market. In 1992, GOI announced a 25-year program to title and register all non-forest land parcels. A World Bank and AusAID-supported Land Administration Project (LAP) began in 1995. By the end of October 1999, LAP had supported the National Land Agency (BPN) by issuing more than 1.2 million titles in Java. It has also made progress in developing a land registration system, improving the efficiency of BPN and its Land Offices (LOs), increasing the reliability and accessibility of the land register, improving the customer service efficiency of titling and administration in 38 participating Los. It has also assisted land policy, legal, and institutional studies, which have influenced changes in land administration. The project has gained strong stakeholder support and has proved highly beneficial, particularly among poor landholders.

3.59 **Weak Land Administration**. Land administration is deficient in several ways. There are three main agencies responsible for land administration and management at the national level: the Ministry of Forests, BPN and the Bappenas. The Ministry of Forests controls forest land, which amounts to about 70 percent of the total land in Indonesia. Much of it is not forested. Boundaries are unclear and the registration of private land rights in these areas is difficult. There has been a lack of consensus regarding the administration of this land. Until 1999, non-forest land—about 30 percent of the national land surface, including much of the urban land—was administered by BPN, a central agency reporting directly to the President and controlling a network of some 300 district LOs. The agency has been characterized as over-centralized, secretive and unresponsive to landholders; it has been used by the prevailing political and bureaucratic establishment for personal and political gains. Bappenas has maintained responsibility for overall land policy although its role in land administration has been marginal.

3.60 Procuring a location permit, submitting a land rights application, granting land title and obtaining a registration receipt, is time consuming. In the late 1980's, a full title took approximately 32 months; turnaround has not improved since then. Information on land markets, land administration and land use are often not readily accessible to the general public. This has inhibited the private sector,

[14] From Land Administration Project PID and other project documents.

particularly small operators, from participating in urban land development. The lack of transparency makes it ripe for corruption. The urban poor suffer the most.

3.61 **Formal and informal land development**. The informal land development process occurs in three ways: occasional sale of large single plots by individual landowners; the large-scale purchase of land and informal subdivision of sites by entrepreneurs; and the development of large holdings into informal rental housing. Historically, informal subdivision has been the most important, especially for urban Indonesia. The process is long and incremental, with sub-dividers buying land from intermediaries on an installment basis, subdividing it, preparing site plans with rights of way for utilities, and selling them to prospective buyers. Typically, individual lot owners obtain a *hak girik* title. Although in theory this title conveys the same rights as a *hak milik* title, many formal sector lenders are reluctant to accept it as collateral. Illegal occupation of land has been tolerated by officials. De facto tenure security enjoyed by many urban poor communities, which are part of the *Kampung* Improvement Program, is an example.

3.62 Formal land markets are dominated by developers who have to obtain a location permit (*Izin Lokasi*) from a *bupati* or *walikota*. These permits comply with government policies and local development plans; additionally, they may contain special provisions or conditions. Based on the permit, the developer pays the landowners and the landowner releases his/her rights to the State. The developer then obtains formal approval from the *Bappeda* for the site plans, divides the land into sites and registers individual plots. These titles are then sold to buyers.

3.63 **Land Markets and the Supply of Land.**[15] The System deficiencies are distorting land markets and impeding the supply of affordable urban land. Developers incur significant costs as a result of delays which have a negative impact on poor households. This also encourages sellers and buyers to evade the formal process, which in turn affects the urban poor, who become further removed from potential access to government subsidies and other benefits. Delays also discourage much needed private investments in land and housing development. The complexities and dense administrative requirements have encouraged rent seeking by officials. In the end, most, if not all, of these costs are passed on to the consumer. As a result, much of the land around large cities is not part of the formal supply process, thus leading to significantly higher land prices. An HOMI study estimates that the price of a low-cost house could drop as much as 15 percent if the supply of land increased over a five-year period.

3.64 Land is also held out by a number of agencies. Major holders of idle land include the Bank Restructuring Agency (IBRA), large developers, small developers (part of land banks), central government agencies, some local governments, and a few large manufacturing enterprises. The peculiarities of location permits warrant special mention. The permits are mistakenly seen as conferring exclusive rights of acquisition to the developer holding the location permit, making it difficult for the owner to sell the land to other interested buyers. Often, large developers choke off supply by holding on to land without actually acquiring it for which they have permits. Permits have time limits of one to three years, after which they can be revoked; however, this is rare. Developers cannot hold on to large tracts of land under a single location permit. As a result, huge areas of urban land throughout Indonesia are restricted by this practice.

3.65 The financial crisis also had an impact on land markets. Many banks had their assets taken over by the IBRA. The extent of these holdings were valued at approximately $16 billion at late-2001 prices. IBRA's policy on divesting this land in the open market is unknown.

---

[15] Refer to the World Bank. Study of Housing Markets in Indonesia (HOMI), 2001 for a discussion on the land development process.

3.66 **A New Challenge: Decentralization of Land Administration**. Lately, the GOI realizes that a fundamental overhaul of land policy, regulation, and institutions is overdue. Because of LAP and PP 24/1997, there has been some relaxation of evidentiary requirements for registration.

3.67 Under the Regional Governance Law, the primary responsibility for routine land administration has devolved to local government. BPN's role has been reduced to monitoring standards, training, and provision of some services. The responsibility for land policy appears to have transferred from Bappenas to MOHA/BPN. Despite the law, the changes have yet to take place; in the interim, the previous system is still operating. The relative responsibilities of BPN and the districts have yet to be defined. This law is also silent on the role of the community.

3.68 Land reform is long-term and will require sustained political commitment at the highest levels of government, consensus and capacity building. Decentralization adds new challenges. Major concerns persist about the intent, commitment and capacity of the government to undertake fundamental sector reforms. It appears unlikely that BPN, which has been instructed to submit a decentralization action plan, has neither the leadership nor capacity to envision comprehensive changes, especially in the policy and regulatory areas.

3.69 District administrations have a mixed record. In the absence of clear policies, regulations, transparency requirements and enforcement, they may not perform better than BPN. Many district LOs have limited institutional capacities and financial resources. Cash-strapped local governments may not choose to provide LOs with the necessary resources. Revenues accrued from land taxes will be passed to the central government before reverting back to them. Without a skills upgrade, inconsistencies among LOs are likely to affect land titling, records management and survey reliability, thus compromising tenure security and the potential advantages of decentralization. This would be compounded if a plurality of tenure systems was introduced to LOs to accommodate *adat* diversity.

3.70 Many central government agencies retain powers that can influence land administration and/or override regional decisions in areas such as development planning, land use, and natural resource policy. It is important to protect the regions against any attempts to centralize land administration. Devolution provides an opportunity for wide-ranging stakeholder consultations to build consensus for sustainable reforms.

3.71 **Urban Land Use Planning and Management**. Urban land use planning is benign at best. Law 24/1992 and PP 47/1997 on National Spatial Planning form the foundation for urban spatial planning in Indonesia. The National Spatial Development Plan is translated into a Regional Spatial Development Plan, a City or District Development Plan and detailed partial and technical plans. The main offshoots are Sector Master Plans which translate long-term views into long and medium-term infrastructure projects (ADB, 2001: p.41). These plans are not integrated with local economic planning or the budget; they are not prepared after public consultations and are perceived as being inflexible and corrupt, resulting in low commitment to their implementation by the public.

Priority Areas for Reforming Urban Land Administration and Management

3.72 Sustainable and efficient urban development requires an efficient land market. In a country like Indonesia, that will require accommodating both the complexities of *adat* and the needs of a modern urban economy. A comprehensive agenda on land policy, law and administration has to be developed to ensure that local governments can assume their responsibilities in land administration and management.

Policy and Regulatory Reforms for Creating Efficient Urban Land Markets

3.73 The foundation for an efficient, equitable and growth-oriented urban land market lies in the enunciation of a clear national land policy with attention to customary tenure, land assembly, due process and institutional analysis. Such a land policy should form the basis for drafting a Basic Land Law that can address issues of land rights, registration and titling, private participation and tenure security for the poor. There is also a need for many pieces of land legislation to be rewritten and a review of the forestry, mining, energy, and related laws and regulations affecting land tenure and use.

3.74 Regulatory reforms are required in land titling and registration to simplify it , reduce costs and delays, lower risks in transactions and improve access to formal financing. For example, the HOMI study recommended that developers be given the right of *hak milik* title in conjunction with a location permit with conditions specified in the permit. This will reduce the time and the costs associated with registration by 25-33 percent and around 40 percent, respectively. Provisions under current law allow corporations to acquire *hak milik* for "furthering social and economic interest of the community" can be extended to housing developers; housing is in the community interest.

3.75 Further, public participation and consensus building will be critical in reforming all aspects of land administration, reviewing policy and regulatory changes and building a case for new land laws; pilot projects to test the legislative and regulatory changes are welcome and necessary.

Land Titling and Registration to Upgrade Efficiency and Equity in Land Administration

3.76 Improving land titling and registration will require simplifying the current processes, expanding registration nationwide, reducing delays, increasing transparency in registration and providing incentives for individuals to register. Steps include:

(a) simplification of standardized forms of title evidence;

(b) simplification of standardized forms of Deed of Mortgage and Sales Purchase Deed;

(c) computerization of titling and registration; and

(d) enforcement of registration.

3.77 Titling and registration reforms will have to consider a range of land certification options, depending on whether the land is rural, urban, or *adat*. A national campaign for registering parcels on a transaction basis remains high on the agenda. A campaign will include systematic registration in areas where little registration has occurred, sporadic registration of remaining parcels where a large percentage of parcels has already been registered; and derivative registration to deal with registered parcels. This process should be accompanied by an updated cadastral map and awareness programs for the community about the benefits of subsequent registration. Concurrently, local-level LOs will need training to handle the increased land records and services to the community.

Improving Land Supply

3.78 Reforms in the regulatory environment, along with improvements in titling and registration, are bound to have a catalytic effect on land markets.

(a) reviewing land holdings by government agencies against their institutional needs and divesting excess land into open markets;

(b) developing a clear policy and action plan for transparent divestiture of IBRA land; and

(c) having local governments take a greater role and strengthening their capacities in land administration, planning of urban land for development, and provision of serviced land through a proactive infrastructure policy.

Decentralization and Institutional Reform in Land Administration

3.79 A clear program is necessary for transferring responsibilities from the deconcentrated BPN *dinas* to the local governments. The LOs will require support to function autonomously. Technical, financial and administrative capacities as well as customer relations and service within LOs have to be substantially upgraded to manage cadasters, to administer registration and titling to maintain local-level databases, to address land disputes at the first level, to undertake routine assessments of social impact, to carry out awareness campaigns among constituents, and so forth.

3.80 The role of BPN has changed, not diminished. The agency should continue to have a vital role in national-level land policy formulation, implementation and inter-agency coordination, upgrading land administration procedures, setting uniform (minimum) standards, developing national-level land databases and a land registry networked to the district LOs, assisting in quality management and providing training and implementation assistance to LOs. This will require restructuring BPN, strengthening its technical and managerial capacities, developing appropriate IT strategies and support structures with adequate equipment support.

Introduction: An Overview of the Urban Housing Sector in Indonesia

3.81 Compared to its neighbors, the housing and housing finance sectors in Indonesia are under-performing. Housing investment in Indonesia is approximately 1.5 percent of GDP compared to two to eight percent in other countries. Similarly, mortgage financing in Indonesia equaled only 3.1 percent of GDP, compared to 23 percent in Malaysia and 13 percent in Thailand. Housing is an important economic sector, contributing to job creation and creation of household wealth. It can also be a powerful tool for equity and social well-being (Hoek-Smit and Iskandar, 2001). Yet, these attributes have not been sufficiently recognized.

3.82 Three key characteristics highlight housing in Indonesia: one, the country has a high proportion of homeowners; two, only a small percentage has a proper title to land or a building permit for the house; three, an overwhelming majority of households produce their own housing. Details of households by tenure status and by method of purchase are in Annex 5.

Functioning of the Housing Market

3.83 Current housing policies and programs have not been helpful in promoting efficiency expansion. The sector is recovering from the devastating effects of *Krismon*. Market-produced non-subsidized housing units for low- and moderate-income groups has declined. Despite interest rate subsidies and other governmental interventions in the market, only about 40 percent of the population can afford a 21 sq.m. low-cost house. Demand for high and moderate-income housing remains low, with reports of oversupply in some segments. New construction is depressed; interest rates are high; mortgage and construction finance are limited. Among the characteristics of the housing market are

low income and finance affordability, insufficient serviced land available for housing, a fragmented GOI policy , limited mortgage financing and a culture of self-help and incremental construction.

3.84 **Demand Estimation**. A detailed estimate of urban housing needs is not available due to a lack of comprehensive and reliable data. However, based on government assessments,[16] and recent studies by the World Bank and the ADB, approximately 735,000 new housing units in urban areas and 420,000 replacement units are needed annually. A ballpark distribution of annual needs across various income groups indicates that around 812,000 units—new and replacement—are needed annually for the lower 70 percent of the urban population (refer to Annex 5 for a distribution table of urban housing needs across income groups). The yearly capacity of housing production, supported by the government-subsidized Home Ownership Credit (KPR) program, is around 120,500 units (Noudehou, 2002). Traditionally, the demand for new housing has represented about 60 percent of the total demand. The remainder has been for the replacement of decaying units—18 percent, units to relieve over-crowding and replace non-upgradeable units—7 percent, and upgrading—15 percent. In terms of quality, 55 percent of the total housing stock was considered unacceptable in 1988. Overcrowded units represent 6 percent of stock, with roughly 20 percent of urban households having only 7 sq. m. space per member (Struyk et. al., 1990).

3.85 **Low Affordability**. Household incomes are low relative to land and housing costs. Outside Jakarta, the median household expenditure is approximately Rp.800,000 to Rp.900,000[17]. With mortgage interest rates at a high, 60-65 percent of households cannot afford even the lowest priced, unsubsidized house. Unsubsidized mortgage lending is available only for the top 25 percent of urban households. Lenders are reluctant to make loans for houses below Rp.50 million. In the absence of other forms of credit, moderate and low income households have to depend on personal savings and loans from informal sources.

3.86 **Supply Mechanisms**. Indonesia has two systems of housing delivery: the first is the 'informal' and the main vehicle for housing supply; the second is the formal housing system, which has almost ceased to function following *Krismon*. The key features of the two systems are summed up below[18]:

3.87 An informal delivery system is responsible for 80 percent of supply, serving a whole range of incomes, particularly at the lower end. It is based on household-based financing with no direct assistance from the government. The emphasis is on the expansion and improvement of existing dwelling units. Much of the housing produced this way is characterized by relatively secure house tenure but less secure land tenure that is substandard in quality and inadequate infrastructure. The formal delivery system meets about 20 percent of the demand, much of it for moderate and high-income households. It has benefited from direct government support through subsidized interest mortgage loans provided by *Bank Tabungan Negara* (BTN), the state-owned housing and savings bank. The emphasis is on production of new single-family units that meet official standards, with generally adequate infrastructure. House and land tenure security is greater under this system.

3.88 The informal or popular housing system has been reasonably efficient and relatively responsive to market demand. Despite a number of constraints, among them government regulations, requiring high standard, financing limitations, tenure and title issues, the informal sector has come to meet the shelter requirements of a majority of Indonesians. The formal housing delivery system has a government stream and a private stream, providing high-priced and/or heavily subsidized products, largely for middle- and higher-income groups. Both streams were badly affected by the crisis. Even

---

[16] Repelita VI, Year 2000 as cited in Noudehou, Alain. A housing micro finance program for Indonesia, 2002.
[17] Depending on the CPI inflation ratio applied.
[18] World Bank. Performance Audit of Housing Sector Loan, 1995, and other documents.

with subsidized mortgage loans, the high cost of development under the formal system has rendered it unaffordable to most low-income households.

3.89 **Housing Providers**[19]. Key players are the private sector (formal and informal), the government (central and local) and NGOs. Their role and influence in the markets varies. The crisis of 1997 had an impact on all housing providers.

3.90 The private sector is the largest housing provider. It has been constrained by problems of acquiring and titling land, high interest rates for construction credit (25-28 percent), weak capital structure among developers, lack of take-out finance, costly regulatory framework – actual fees and KKN, limited availability of serviced land and impractical standards. The economic downturn, along with social and political unrest during the *Krismon*, added to these challenges. The sale of new houses by the private sector in all market segments declined dramatically, from 209,800 units in 1996 to 55,200 units in 1998. Roughly 80 percent of the approximately 2,500 property developers in Indonesia subsequently became technically bankrupt. There is reason to believe the market has bottomed out; sales increased again to about 95,000 units in 1999 and 2000. The bulk of them were in the RS and RSS categories.[20]

3.91 The key central government players in housing are the Ministry of Settlements, the Regional Infrastructure (MSRI) and the National Urban Development Corporation or *Perum Perumnas* (*Perumnas* for short).[21] MSRI is not a housing provider in the strict sense, but is implementing several shelter programs, including the community-based initiatives for housing and local development project (CoBILD). *Perumnas*, the principal government agency for housing production, has built an average of 17,500 housing units annually in urban areas. From its earlier focus on costly public sector housing for government employees and the military, the agency has constructed four to eight-story apartment blocks for low-income groups. As part of this program, many *kampungs* in poor condition were demolished and replaced. The crisis had an adverse impact on *Perumnas*. The agency's fortunes went from a modest profit in 1997 to a loss of almost one-third of its accumulated equity and reserves the following year. In the post-crisis period, the agency was projected to turn a profit once again. *Perumnas* was restructured and its management changed in 1999; the agency is now focusing on building small plots of affordable houses (KASIBA/LISIBA sites-and-services schemes) and decentralizing to be more responsive to local needs.

3.92 Local governments have played a key, if somewhat limited, role in housing. The housing section of the local government—*Dinas Perumahan*—drafts local housing policy, plans for site identification and housing, monitors and evaluates implementation, and assists in land acquisition where state land is used or in cases of compulsory acquisition. It also manages housing owned by local government, allocates public housing and sets up tenant management groups, and supervises compliance with housing construction standards. With decentralization, local governments have the potential to be a key player in housing. To live up to this role, the *Dinas Perumahan* will need to improve its capacities, facilitate land development for housing with proactive infrastructure policies, elicit public participation and be sensitive to the needs of client groups, provide professional and unbiased assessment of projects, and ensure efficient processing of approvals.

3.93 Although a number of NGOs and CBOs have upgraded activities under KIP, few supply urban housing *per se* on a sustained and long-term basis. Rather they have done micro financing, housing

---

[19] From Lindfield, Michael. Indonesia: Housing finance for urban poor, 2001 and ADB. Urban Sector Study, 2001

[20] RS or *rumah sederhana* housing refers to 50 sq. m. low-cost housing units on 150 sq. m. plots and RSS or *rumah sangat sederhana* refers to 21 sq. m. core houses on 54 sq. m. plots.

[21] Other key agencies-Bappenas and national and provincial boards for policy and supervision of housing and human settlements (BKP4N) play key roles in policy formulation and coordination activities.

relocation and direct house construction. Many local NGOs have the support of other international NGOs or local religious groups. Lindfield and Lanyon (2000) have noted that their performance has varied.

3.94 **Fragmented GOI policy and institutional framework for housing**. The cornerstone of the GOI housing policy has been the KPR interest rate subsidy for loans for specific types of houses. Lenders receive subsidized liquidity credit from Bank Indonesia (BI) for part of the loan amount, and on-lend at fixed, below-market interest rates to qualifying households. The interest rates charged to borrowers and the proportion of liquidity credit to lenders varies by the cost of the unit. Developers, public and private, seek qualifying customers to whom they pre-sell houses. They receive mortgage financing directly from the bank and construct prototype houses at set prices. The system remained unchanged for at least 20 years until the 1997 crisis. It is now acknowledged as being untenable due to:

- the unsustainable subsidy costs of the system that kept increasing with rising interest rates;
- its negative influence on market expansion and innovation; competition with subsidized loans and houses was impossible. Although KPR was meant to increase the role of the private sector in moderate-income housing, it succeeded in doing so only for an allocated number of subsidized housing; and
- its negative impact on urban development, because it encouraged developers to build low-cost units on cheap land far away from infrastructure.

3.95 GOI has been irregular in supporting KIP, IUIDP, PPMK and other effective community-based housing approaches with an appropriate policy framework, adequate resources and sustained institutional commitment. The lack of consistent housing policies, combined with a high cost regulatory environment, are among the constraints faced by housing markets. On the institutional side, there are many departments and agencies dealing with land, housing (including finance) and residential infrastructure, whose policies and actions are not integrated. There are a multitude of housing, housing finance, residential infrastructure and urban poverty projects, with fundamentally different or overlapping types of subsidies. Against this background, the World Bank supported the HOMI project in the preparation of a national housing policy, taking into account relevant government policies, the lessons learned from *Krismon* and the changes wrought by decentralization.

3.96 **Affordable housing: the rule of 1-3-6.** The “1-3-6 rule” in housing requires private sector developers to build low and middle standard housing in the ratio of 6 units of “simple” housing and 3 units of “mid-standard” housing for every unit of “luxury” housing. This rule applies to housing developments in excess of 100 luxury units and is normally specified in location permits. First introduced in 1974 to promote social integration and to persuade private developers to build housing for low- and middle-income groups, the 1-3-6 rule has been a failure for various reasons. With many loopholes and scant enforcement, developers have bypassed, or worse yet , ignored the rule. In contrast, some years back, REI members as a whole reportedly developed low-cost housing in approximately the same ratio, responding to market opportunities, including interest rate incentives, rather than merely in compliance with the regulation.

Decentralization and Urban Housing

3.97 Under the new paradigm for urban development, the onus has shifted to urban local governments to support housing development. However, the outcomes of decentralization for the housing sector are by no means clear. There are concerns that housing, in particular housing for low-

income households, will not be an investment priority for local governments. Indeed, housing is not considered an important political issue. Local governments often lack housing-related planning, financing and implementation capabilities as well as a clear understanding of market operations, particularly in dealing with the private sector. It is also possible that they will take a highly interventionist role in the housing markets rather than an enabling one. National-level housing institutions and instruments that affect local housing systems need considerable strengthening from the government.

Housing Finance

3.98 The housing finance sector in Indonesia is small for a country of its size and potential. Only about 30 percent of households can afford an RSS house with a formal mortgage loan. Over 85 percent of the housing financing has been provided by the state housing bank, BTN. The government has also supported other housing finance institutions in providing mortgage-based credit for housing. The sector was badly affected by the *Krismon.* Many financial institutions failed during this period. Some of them, including BTN, were subsequently recapitulated while many others had their good loans sold by the bank restructuring agency, IBRA. The key strengths and weaknesses of Indonesia's housing finance system are:

Strengths

- There is an active main stream banking sector, with commercially and highly competitive private and public banks jockeying for position in providing consumer and mortgage financing. Such competition is vital to efficiency;

- Following the *Krismon*, there was improved oversight, regulation, and supervision by BI, with consolidated supervisory initiatives in the pipeline;

- Presence of well-developed organizations and institutions, such as PERBANAS, REI, APERSI, and appraisal associations, which support real estate functions overall; and

- An extensive network of regional banks, micro-finance institutions, co-ops, credit unions, and rural banks exists to extend housing finance to moderate income households.

Weaknesses

- A significant gap exists in the availability of housing financing to a large group of bankable households. Mainstream banks are generally reluctant to offer smaller loans, thus limiting themselves to roughly the upper 10 percent of urban households.[22] Current micro-finance loan instruments are not suitable for construction of new housing. This is a needless limitation, given the potential offered by the low and moderate income lending network;

- The expansion of the housing finance market has been inhibited by a housing subsidy policy that is detrimental to down-market growth. The KPR/RSS system reaches only a fraction of the eligible households; it has also stifled housing innovation and expansion of commercially-based mortgage lending. Additionally, the "one size fits all" approach in lending instruments and products have limited the ability of banks to move down-market.

---

[22] The HOMI report Effective Demand for Low Cost Housing (World Bank, 2001) has information on income and affordability.

- The risks inherent in the current conduct of housing financing are excessive, resulting in higher loan prices as well as limitations on the growth of the sector. Banks have risk-averse policies following the *Krismon*. Both credit risk and legal risk stem from lack of automation, information from credit bureaus, and ineffective foreclosure policies, thus inhibiting the development of an investment-quality portfolio.

- No system of access to long-term funding from the capital markets is in place. Bond markets are relatively under-developed; only eight percent of housing finance has been funded from bonds. As banks and mortgage lending recover from *Krismon*, access to long-term funds will become increasingly important.

3.99 The housing finance situation in the country should improve as the financial sector recovers and economic growth picks up over the medium term. However, the long-term viability of a broad-based and effective formal housing finance system will depend on progress in several important areas: expanding the reach of the housing finance sector; addressing credit risk, legal and administrative risks; accessing long-term funding and mitigating liquidity risks. These reforms can be done only over the medium to longer term; they will require concerted GOI effort backed by external technical expertise and support.

3.100 Potential exists for expanding access to credit to a large number of bankable households across income groups. This will require alternative mortgage products, such as indexed adjustable rate mortgages, balloon loans and non-mortgage based credit and other new tools, including new approaches to underwriting, shorter-term financing, repeat loans and credit enhancement tools like mortgage default insurance. An expanded group of financial institutions, including regional banks, selected state and private banks, a wide range of micro finance institutions, cooperatives, and so forth, need to make housing loans. The current KRP/RSS subsidy regime will have to be replaced with a more market-oriented housing assistance and subsidy program with different approaches for different income segments. This is essential to promote greater housing innovation and to better match the demand with supply in the moderate and low-income segments.

3.101 To improve risk management, bring greater efficiency and transparency in the mortgage process, enhance long-term funding and improve credit quality, new institutions and instruments are required. They include establishing credit bureaus, secondary mortgage facilities, mortgage-default insurance and a liquidity guarantee fund; bringing standardization and automation to credit institutions; setting up credit-scoring systems and mortgage portfolio databases; and improving foreclosure procedures.

Enabling Housing Markets to Work

3.102 A preliminary vision for a new national housing policy has been outlined in the Bank-supported HOMI studies (2001). The following merits attention:

- **Creating a stable and transparent regulatory and political environment** for facilitating devolution of responsibilities, encouraging private investments in housing development and improving linkages to the financial sector and supporting low-income housing.

  (a) Amendments to the1992 Housing Law to bring it in line with changes brought by decentralization.
  (b) Change the housing decrees required to implement the new programs.
  (c) Developing a national housing policy and multi-year policy goals and objectives.

- **Improving the supply of serviced land to reduce land costs for housing.** Some of the key measures for this were discussed in the section on Land. Additionally, sites-and-services programs (KASIBA/LISIBA); urban renewal initiatives supporting housing, and upgrading of *kampungs* should also be undertaken, as appropriate.

- **Strengthening housing finance systems** by expanding the reach of the housing finance down-market; addressing credit, legal and administrative risks; accessing long-term funding; mitigating liquidity risks and improving credit quality.

  (a) Reform institutional frameworks and expand the group of financial institutions that make housing loans;
  (b) Replace current subsidies with better targeted, more flexible and market-friendly housing assistance programs;
  (c) Put in place new institutions and instruments—credit bureaus, mortgage default insurance—for better risk management and strengthen regulatory oversight;
  (d) Develop secondary-mortgage facilities, strengthen capital markets and enhance access to funds from markets for housing institutions; and
  (e) Strengthen community-based housing finance institutions and micro-financing networks.

- **Providing housing assistance** through programs that are transparent, well-targeted, on-budget, administered in an efficient and effective manner, and tailored to meet the varied needs of lower-income households in differing circumstances.

  (a) Assistance to moderate-income households to access housing finance through mortgage insurance support for saving on down payments and reducing default risks;
  (b) Flexible, upfront subsidy for low-income households who would not qualify for a mortgage loan even with mortgage insurance; and
  (c) Specific assistance to low-income communities for shelter and service upgrades.

- **Rationalizing the roles of various levels of government and government agencies**, strengthening the capacities of relevant sector institutions and coordinating institutional actions and investments.

  (a) Clarification of the roles and functions of national, provincial and local governments; statutory bodies such as BTN and *Perumnas*; and housing-related functions of the inter-ministerial committee and different ministries as well as setting up coordination functions;
  (b) Separation of policy and regulatory functions from implementation, and assignment of specific institutional responsibilities for each of these;
  (c) Create a housing information system (in conjunction/integrated with a system on urban) to collect, process and analyze data.
  (d) Strengthen the central government's role in policy and regulation, coordination, oversight and supervision, setting national standards and conducting housing research;
  (e) Build housing capacity for local governments, NGOs and other housing providers with guidelines and training to improve their skills in planning, financing and implementation, governance and community participation.

Provision of Urban Services

3.103 Over the years Indonesia has made some improvements in expanding its urban infrastructure. Yet, against the backdrop of other notable national achievements in poverty reduction and sustained economic growth, the improvements in urban services are not impressive. Some of the blame may be attributed to a national framework which vacillated between a strong central government and frequent attempts at decentralizing services. The scope of urban services by local governments has expanded from water and transport to education and health services, the prevention and management of social problems, including crime and ethnic conflict and natural disasters, such as earthquakes and floods.

Decentralization and Urban Services

3.104 Following the landmark legislation on decentralization, the framework for the provision of urban services has undergone a significant change. Law 22/1999 and supporting regulation PP No. 25/2000 replace Law 5/1974. Together, they set out the institutional framework for urban service planning, construction, provision and maintenance. Law 25/1999 also addresses municipal financing. Local governments have provided most urban infrastructure services for the past few years. A paradigm shift will not affect their current institutional roles or the kind of services provided. Rather, new approaches to urban governance and management, public participation and municipal financing engendered by these laws will have major ramifications on their approach, methods, and oversight.

3.105 The decentralization legislation and regulations have thrust local governments into the role of agent for the delivery of urban services. The Regional Governance Law obliges urban local governments to change long-standing practices of top-down, supply-driven planning and instead adopt a bottom-up, customer-oriented approach. The provision of services, it is presumed, will follow local priorities and the capacity of citizens to afford such services. The Mayors are now answerable to local citizens; the DPRDs are expected to be watchdogs in ensuring that the real needs of city dwellers are met. In addition, if empowered and allowed to function regularly, the *Forum Kota* may serve as a larger citizen watchdog group.

3.106 Replacement of various *Inpres* grants by the DAU and DAK, the newly assigned powers of local taxation and cost recovery, and new rules for local government borrowing, financial management and performance-oriented budgeting should help *kota/kabupaten* governments find necessary resources and ensure financial sustainability to finance urban services. These governments will have difficult decisions regarding the allocation of funds between competing sectors and within each sector. This state of affairs can promote strategic prioritization and encourage greater efficiency. Decentralization also empowers local governments to make appropriate decisions regarding the organization of service delivery units and to seek appropriate forms of service delivery, such as private sector driven or the community.

3.107 At the national level, the role of the central government has undergone a fundamental change. Setting quantitative targets for urban services, as was common in past *Repelitas*, has become more difficult, perhaps not even desirable. Central government guidelines on standards of service are no longer mandatory, but advisory. For the purpose of supporting improvements/expansion in services because of these local programs, capacity building, monitoring local program development and implementation from the center assume greater importance.

3.108 The upbeat aspects of decentralization pale when viewed against the constraints local urban governments have in meeting the rising expectations of the public. The limited capacities of *kota/kabupaten* governments have been highlighted in previous sections. This may impact service standards in the short-term and infrastructure expansion in the longer term, unless capacity building,

customized to specific local needs, is addressed as a national priority. The financing requirements for urban infrastructure are large. For example, to raise the level of urban coverage to 65 percent and serve the urban poor, water supply and sewerage investments for the next ten years are estimated at anywhere between $10-20 billion. Yet, there are no institutional mechanisms to access funding of this magnitude. (see Chapter II on Local Government Financing).

3.109 Concerns about minimum standards have nagged policy planners, especially those skeptics of decentralization who are worried about services falling below acceptable levels. The government committed itself to the introduction of "negative" incentives for urban service delivery, i.e., the technical specification of minimum delivery standards, combined with possible penalties for non-achievement. It is not clear if this commitment has been translated into a specific proposal. Nevertheless, the central government will have a continuing role in ensuring minimum standards are met. This will also require a review of existing standards as a reality check and revised standards for all local governments with possible incentive-disincentive measures for adhering to them. The prospect of uneven progress in increasing the coverage and quality of basic urban services has also raised the question of establishing some incentive grants (say, matching grants for the achievement of specific service targets). The case for special matching grants, desirable from a national perspective is worthy of attention.

3.110 Other threats to decentralized, equitable and affordable services include the prospect of local elite capture, greater opportunities for KKN in the absence of sufficient checks and balances, such as fiduciary and audit standards; reduced coverage for the urban poor and other vulnerable groups.

The State of Urban Services[23]

3.111 Most Indonesian cities face the challenge of a deficiency of urban services. For example, in 1999, only 33 percent of households were connected to a piped water supply; less than one percent of all urban households was connected to waterborne sewerage systems. Surface and ground water pollution, excessive groundwater extraction have contributed to major urban environmental problems in the cities. No consolidated information on urban drainage or flood control coverage is available, but limited information indicates the gap is growing in these areas too. Solid waste management coverage is relatively high, if uneven, throughout urban Indonesia. But final disposal sites are insufficient in number and quality. Urban transportation displays significant gaps, despite major road improvements and expansion in the 1980s-90s. Traffic congestion is a big problem in major cities and public transport is unreliable. Development of all of these services came to a halt with the *Krismon*.

3.112 **Water Supply.** In the absence of piped water, many urban households rely on ground water; they use private/individual or public wells and "informal" sources. Most of the new residential estates in urban areas use individual wells. Often, the reliability and quality of this water is questionable. Public wells are common in low-income and slum areas and in publicly provided washing-cum-toilet (MCK) facilities. Water vendors play a significant role in providing water in areas with limited water sources or poor PDAM connections.

3.113 In line with PP 14/1987, the delivery of water to the urban population has been conducted by financially autonomous municipal water companies called PDAMs. There are around 290 such companies all over Indonesia. PDAMs develop and manage water supply systems; they serve urban consumers with affordable water. Although their focus has been on day-to-day operations, PDAMs have participated in planning, project preparation and implementation as well as direct negotiations with the private sector. PDAMs have been assisted by DG *Cipta Karya* in developing water supply

[23] Much of the data for this section came from recent ADB reports on urban sector.

projects in its five directorates. Most PDAMs are small (less than 10,000 connections), have high unaccounted- for water levels, limited revenues, high staff ratios, low tariffs and complex tariff structures.

3.114 Before the crisis, GOI's strategy was to strengthen the management and organization of the PDAMs. Financing for this came through subsidiary loan agreements (SLAs) between the MOF and the PDAM. Under this arrangement, MOF assumed the credit risk, and national-level agencies provided technical assistance for planning, construction and management of water supply facilities to the PDAMs. Local governments which owned the PDAMs were responsible for setting tariffs and seeking dividend contributions from PDAMs. This arrangement has been severely disrupted since 1997. Local governments found it politically impossible to raise tariffs anywhere near the rate of inflation, while continuing to take dividend payments. As a result, the PDAMs have been unable to service the loans as specified in the SLAs. As of March 31, 2000, approximately 221 out of 290 PDAMs had 412 loans outstanding with MOF;, 63 percent of these accounts were in arrears. In response, a PDAM Rescue TA program was launched with Bank assistance to benchmark the performance of water utilities and offer technical assistance to PDAMs interested in debt restructuring and restoring commercial viability through a financial recovery action program (FRAP).

3.115 The requirements of water supply and sewerage investments for the next 10 years are estimated at between $10 billion and $20 billion for raising the level of urban coverage to 65 percent and serving the urban poor. There are no institutional mechanisms available to enable local governments to access funding for required investments. The availability of public financing of water supply and sanitation infrastructure has become severely constrained while water tariffs have been unable to keep pace with the increased cost of production. Consequently, most PDAMs are starved of investments as well as unable to generate the requisite cash flow to service their past debts to MOF.

3.116 General problems facing the sector are:

- lack of safe water;
- unreliable services, even among those with piped water, the service is often limited to a couple of hours a day;
- residents have to rely on privately-invested wells, arrange for contracts with water vendors and purchase costly bottled water to mitigate the risks of unreliable supply;
- inefficient management of water utilities. The general standards of efficiency are low in the PDAMs. Tariff-setting is usually based on political considerations rather than on the basis of operational efficiency and economic cost recovery. Further, efforts at sharing water resources with neighboring urban centers through the formation of regional water utilities that could generate economies of scale have been difficult to promote;
- in adequate engagement of local governments as guarantors of PDAM performance and loans. The prior arrangements, which involved direct supervision by GOI agencies and the signing of SLAs with MOF, had effectively reduced the role and responsibility of local governments. Although the latter played a critical part in tariff setting, they had no incentive to monitor and encourage PDAMs toward improved performance;
- the above conditions lead to an unfavorable climate for investment. There have been several efforts to promote public-private partnership in the water supply sector, but success has been limited due to the problematic financial performance of many PDAMs.

Other Urban Services

3.117 **Sewerage:** Only seven cities (see Table 3.5) in Indonesia have some form of modern sewerage system. Their total combined reach is limited to just over one million urban residents or one percent of all urban households. The first urban sewer networks were built during colonial times in

several medium- size cities: Bandung, Cirebon, Surakarta and Yogyakarta during the first half of the twentieth century. During the last two decades, GOI has expanded some of these older systems and developed sewerage systems in three other cities: Jakarta, Medan and Tangerang. Sewerage service in the above seven cities covers an average of less than 10 percent of the population. In some parts of the cities, the treatment facilities operated poorly (ADB, 2000). Most urban dwellers continue to rely on on-site sanitation rather than a sewer network to dispose of human waste. Traditional sewerage programs have been unsuccessful due to their limited focus on physical targets and a lack of understanding for the demand for sewerage services in urban areas. There is very little community awareness and participation in the provision and maintenance of sewerage systems. Lessons learned from schemes, such as the community-based sewerage program in Malang, reveal that a demand for sewerage exists, but it takes time. Access to information is important to community participation.

Table 3.5: Number of Sewerage Connections, Population and Area Served

City	No. of Connections ('000)	Population Served ('000)	Population Served (%)	Area Served (%)
Bandung	90.0	450.0	20.0[2]	17.0
Cirebon	18.8	90.0	32.0	9.7
Jakarta	2.3	220.0	2.8	2.8
Medan	7.4	49.0	2.3	1.9
Surakarta[1]	8.0	70.0	13.0	26.0
Tangerang	9.8	46.0	4.0	---[4]
Yogyakarta[3]	10.1	85.0	10.0	6.0

[1] When completed
[2] Including indirect connections
[3] Greater Yogyakarta population/area
[4] Negligible

Box 3.3: The cost of Inadequate Sanitation in Indonesian Cities

Indonesia has one of the lowest rates of urban sewerage coverage in Asia. This causes widespread contamination of surface and ground waters all across the country. As a result, there have been repeated local epidemics of gastrointestinal infections, and a high incidence of typhoid. Economic losses attributed to inadequate sewerage are conservatively estimated at US $4.7 billion per year and 2.4% of 1997 GDP—roughly equivalent to US $12/household/month (ADB, 1999). Low coverage is partly a result of the GOI policy, which assigns the responsibility for sanitation to households. This policy—which is a result of poor past performance of large centralized sewer systems—has inhibited the evolution of effective local governmental institutions for planning,, implementing and operating sewer systems. Currently 73 percent of urban households have on-site sanitation, using septic tanks. The partially treated, or untreated, effluent from these facilities flows into soil, open drains, or directly into water bodies. Proper disposal of human waste, either sewage or sullage, is rare. Given the scale of the problem, interest in neighborhood or community-based sewer systems is increasing.

Excerpted from: Shareen Joshi, "Urban Poverty in East Asia", Draft literature review-background paper, Yale University, May 2001 cited in EAP Poverty Study.

3.118 **Solid Waste Management**. In comparison to other urban services, solid waste disposal in urban areas has been high, although there is still room for improvement. The proportion of solid waste collected in several big cities in Indonesia varied from 57 percent to 94 percent of the total volume of daily solid waste. However, final disposal sites are poorly managed. For metropolitan cities on the island of Java, such as DKI Jakarta, Bandung, Yogyakarta and Surabaya, disposed garbage varied between 84 percent and 95 percent of the total generated. Similar performance was also reported in major cities in the provinces of Kalimantan, Sulawesi, and Nusa Tenggara.

3.119 Key issues in SWM in Indonesia are (a) the inability of urban local governments to handle solid waste; (b) poor technical capacities of municipal staff to deal with SWM, leading to poor reliability and quality of service and poorly operated landfill sites; (c) limited availability and increasing difficulty in obtaining landfill sites; (d) unsanitary and environmentally hazardous disposal methods; (e) low direct cost recovery; (f) limited private sector participation. These issues hamper further expansion of coverage and sustainability of services. Sector strategies for consideration include: (a) efficient and environmentally-sound landfill practices with better waste disposal mechanisms; (b) strategic alliances between neighboring urban local governments for efficiency and economies of scale in SWM facilities; (c) capacity building of local governments and awareness building in communities; (d) sustainable cost recovery; and (e) private sector participation, community-based SWM, where applicable.

3.120 **Drainage**. There is very little information on urban drainage systems. The *Susenas* data does not disaggregate drainage conditions along rural-urban lines, but rather province by province. Provision of drainage, measured by proportion of households covered, has decreased significantly from 1995 to 1998; the overall proportion of households without drainage system in Indonesia increased from 16.8 percent in 1995 to 37.2 percent in 1998.

3.121 **Urban Transport.** At the end of 1996, Indonesia had 385,800 kms. of roads; approximately 31,600 km were in urban areas under local responsibility. The hierarchy of roads, based on government level responsibility for maintenance, comprises state (national) roads, provincial roads, regency roads and municipal roads. Urban roads generally comprise sections from all four categories. Most of the state and provincial roads, which comprise mostly inter-city roads, are asphalt covered.

3.122 Several big road projects were undertaken over the last decade until the 1997 crisis. These included many toll road developments involving public-private partnerships (PPP) with significant local private investment. These projects were mainly undertaken around the metropolitan cities in Java, such as Jakarta, Ciawi, Bogor Cikampek, Karawang Surabaya and Malang. Most of these projects were implemented under build-operate-transfer (BOT) arrangements. Despite rapid infrastructure developments in the big cities, traffic congestion continues to hamper large cities like Jakarta, Bandung, Medan, Surabaya, and many satellite towns like Bogor, Bekasi, and Tangerang.

3.123 Public transport is commonly used, despite poor public transport facilities. Public transport includes buses, mini buses, taxis, motorcycles and bicycles. Private modes in urban areas have increased rapidly, despite the 1997 crisis. Imported cars are on the increase following the liberalization of motor vehicle import rules. Vehicular pollution is a serious problem in the largest cities, such as Jakarta and Bandung and a rapidly emerging one among the next level of cities.

3.124 **Power Supply**. Electricity production has traditionally been provided by the State-owned electricity company (PLN). In urban areas, coverage is relatively high. In 1998 the proportion of urban households having a PLN connection for lighting was about 96 percent, an increase of about nine percent from 1992. Over the last decade, electricity production has increased from 29,431,000 mWh in 1988 to 74,922,000 mWh in 1998. Estimated production in 1999 was roughly 83,033,000 mWh. About 75 percent of electricity produced was sold in 1988. In 1998, that figure had increased to 87.2 percent and to 88.6 percent in 1999. These increases suggest a gradual increase in efficiency levels. Despite greater coverage, increased revenues and better utilization, PLN is in a serious financial crisis as a result of huge foreign exchange losses because of the currency depreciation. The shortage of power supply is becoming a major problem in the cities in the islands other than Java, reducing quality of life as well as their economic competitiveness.

3.125 **Telecommunications**. The state-owned monopoly telecommunication company (TELKOM) has historically provided telecommunication service to urban and rural areas. In 1997, the number of

telephone subscribers in Indonesia was about 4.8 million. In the mid-1990s, there was some diversification with the entry of private operators—INDOSAT, mainly for international connection; and RATELINDO, servicing greater Jakarta only. Additionally, cellular telephones are becoming increasingly common and fashionable in larger urban areas. Cellular services are privately run. There are three providers: TELKOMSEL, managed by TELKOM; INDOSAT, with its SATELINDO; covering almost all the regions. Cellular telephone services also use satellites, which broaden the service area and improve the quality of the connection. Indonesia's internet use per capita is one of the lowest among ASEAN countries.

3.126 **Flood Control.** Many Indonesian cities are vulnerable to frequent floods. Floods are the result of several factors in addition to Mother Nature. These factors include inadequate capacity of local rivers and their tributaries, poor urban drainage, inadequate operation and maintenance of drainage, the absence of land management, disorderly urban development and environmental destruction of the surrounding water basins, informal settlements along the river banks as a result of failure in land and housing policy, poor solid waste management, weak institutional capacity of local administrations to forecast and minimize the impact of natural disasters, and lack of coordination among several regional and local governments. Few cities have comprehensive watershed management programs or comprehensive flood control strategies. Flood control systems in most cities tend to be designed and implemented incrementally, for example, building dikes along the river banks and forming river channels. They often focus on physical infrastructure and pay little attention to land management, operation and maintenance of drainage systems, stream monitoring and warning systems. There have been few attempts at integrated urban flood control by local governments. Supported by donor agencies, several large cities have attempted to develop comprehensive integrated flood control. Two recent examples of integrated flood control systems in Indonesia are the comprehensive river water management plan in Jabotabek and a study on river flow and flood control in the Medan River Basin, conducted as part of the ADB-assisted Medan Urban Development Project 2.

Private-Sector Participation (PSP) in Urban Infrastructure

3.127 By the second half of 1997, Indonesia had committed to long-term power purchase agreements with 26 independent power producers (IPP) and awarded concessions for numerous toll road, telecom, water supply, and other projects, most of them unsolicited. Three years later, over $20 billion in investment commitments had been secured for private infrastructure projects, primarily electricity, telecom, and transport. In the urban sector, PSP concentrated on toll roads in Jakarta and water supply concessions in the Jabotabek area and other cities. However, the procedures by which private partners were appointed were generally opaque. A majority of the projects were unsolicited or awarded to consortia with "politically connected" local partners. Private infrastructure projects, particularly those with foreign financing, were quickly impacted as the crisis hit and the Rupiah plunged. In September 1997, *Keppres* 39 of 1997 decreed that many major infrastructure schemes and projects—including some private projects for which contracts had already been signed—were to be postponed or reviewed. Numerous others were unable to reach financial closure or were halted as their financing sources dried up. Affordability concerns and mounting social pressures caused the government to abandon automatic tariff adjustments in the power and telecom sectors and to defer other proposed tariff increases; these steps affected the commercial viability of private projects already underway or close to completion. In the urban sector, the greatest need and potential for PSP is in the water sector; of critical importance is a transparent regulatory framework for fixing tariff levels, service standards and coverage.

Box 3.4: February 2002 Flooding in Jakarta : Give disaster management a chance

The Meteorology and Geophysics Agency (BMG) had predicted massive flooding in early January to hit Jakarta in about two weeks. Linda, a housewife (33) living in Bukit Duri, South Jakarta: " My house is flooded whenever there is rain, so I'm 'trained' for flood." "There will be another big flood?" she asked. "I thought it will be the usual flood like every rainy season," she said. Apparently, many people were not prepared for the torrential rains that followed, saying they were unaware of any potential flood disaster. "They never prepared us for flood and didn't assist us during the flooding – perhaps because they think that it's our risk for living at the riverside," she remarked.

Hidayat (42) lives in the same neighborhood as Linda. Almost everything he had was lost during the floods that hit the capital in early February 2002. "This is all because we received wrong information on the expected water height in the Ciliwung River. Information we received was that we might expect a water depth of about 1.5 meters." When the flood came, the water rose three to four meters. "The flood came so fast we didn't have time to save our belongings," the father of three children said. All our clothes, books, cooking stoves and utensils were swept away by the rushing water." Musminah (45) who was trapped in the upper floor of her house said: "We were here for eight hours waiting for some help to come." Apparently there was enough time to prevent damage due to flooding and to reduce the loss of life.

An opinion poll by the weekly magazine Tempo concluded "the flooding revealed a communal sense of caring and sharing. The Jakarta people, who are often considered individualistic, proved to have a high sense of solidarity with their fellow residents." Further " the people proved to be more efficient in distributing aid than government officials", "The have-nots now have less."

Floods are a perfectly natural phenomenon and cannot be eradicated. Dealing with floods requires more than engineering, there are political, institutional and social aspects as well. Keywords are coordination and management, decision-making and anticipation. Many flood problems are the outcome of poor land-use practices, ill-conceived development projects, lack of rules and guidelines, and the absence of consistent law enforcement.

The citizens are key stakeholders. They should be informed of the consequences of flood. and made aware of the risks and how to minimize them through disaster management. Risk reduction is a strategy to protect the lives and livelihoods of the most vulnerable, the urban poor. A combination of structural and non-structural flood mitigation measures are called for and have worked in other parts of the world. Otherwise, Indonesia may drown in an ocean of muddy water, silt, garbage and debt.

Source: Newspaper reports on floods in Jakarta, 2000.

Local Economic Development

Overview

3.128 Crucial to economic development in Indonesia, cities create employment and contribute about 70 percent to non-oil GDP. Both national and rural poverty reduction depend on their efficiency. Growth rates higher in cities than the national average, greater access to information, a key resource, and infrastructure elucidate this point. Decentralization has given local governments a basis for addressing their local economies; to that end, laws and regulations offer direction on economic development to local governments. For example, the PROPEDA formulated economic strategies. Local governments have agencies and institutions with economically explicitly functions and development budget line items to support economic projects. However, most local governments have been slow to react to these legal, institutional and financial opportunities.

The Institutional Setting and Strategic Direction of LED

3.129 Scant information is available on the strategic direction of local economic development in Indonesian cities. This section is based on *Cities Speak* case studies. Most of the six cities do not address economic development. Neither has the PROPEDA developed appropriate LED strategies. Strategies that do exist have been ad hoc, without adequate consideration for economic realities and business demands. There has been some attempt to link economic strategies with immediate internal economic realities but no attempt to examine the linkages between an area's economy and its region, with other cities, the rural hinterland, the national economy or global needs. It is therefore not demand responsive. There is often little connection between strategy and programs. The informal economy is a concern of all cities, there is no evidence of incorporating it into an overall strategy by any of them.

3.130 Innovative projects and programs do exist, but they often do not further any strategic objective. The programs have a narrow focus and approach LED in a passive way. Collaboration between business, a key player in LED, and local government is poor despite the existence of local Chambers of Commerce, and collaboration on other fronts. There are also agencies and budgets for economic development. Business demands center on governance issues, such as corruption and taxation, and on poor infrastructure, especially power, water supply and telecommunications. IT has not been well developed in Indonesia, compared to other ASEAN countries because of poor telecommunications infrastructure, a fact which few local governments seem to overlook (World Development Indicator 2000).

Steps Toward a Comprehensive LED Strategy

3.131 Indonesian cities want to improve their local economies, but they lack the necessary know how. LED is new to GOI and local governments. The first step is to understand supply and demand at the local level, to create "matches" between local government and local businesses. It is also critical to understand how regional governments can promote local economic development among provincial and local governments (both *kota* and *kabupaten*) and between urban and rural areas. Such an analysis would help GOI and local governments develop comprehensive LED strategies and supporting programs.

3.132 A more detailed review of the local economic development issues is in Annex 6.

Urban Environmental Issues

Introduction

3.133 The rapid population expansion and economic growth over the last few decades has resulted in rising pollution and environmental degradation following the *Krismon*. Environmental regulations were largely disregarded during this period. While rapid expansion of industry has resulted in greater economic growth, employment, rising wages and increasing exports, the concentration of industrial waste in urban areas poses a serious and growing threat to the health and welfare of Indonesia's urban citizens.[24] Without a doubt, the urban poor are the most vulnerable to the ill effects of such environmental hazards. An analysis of the pollution data suggests that the air in Indonesia is under threat, resulting in increased health problems and a loss of productivity; meanwhile, poor water quality and sanitation contribute to high rates of waterborne diseases. Poor solid and hazardous waste

[24] Indonesia Environment and Development: Challenges for the Future, World Bank, 1994.

management is leading to land, air and water degradation.[25] Urban population pressures are fast consuming prime agricultural land, open spaces, wetlands and other ecologically sensitive regions, and threatening the cultural and aesthetic value of urban living.

Air Pollution and Air Quality

3.134 Urban population pressures, along with the increased concentration of industry and automobiles have resulted in severe air pollution, imposing significant economic costs by impacting health and threatening long-term productivity. In the early 1990s, UNEP ranked Jakarta as the third most polluted mega city in the world, after Mexico City and Bangkok. The main pollutants are lead, particulates, CO, NOX, HC, SO2, and CO2. Vehicular air pollution is considered a key source of localized urban air pollution. The use of leaded gasoline has been a major concern with cities like Jakarta showing a significant increase in atmospheric lead pollution in recent years. Other sources of air pollution include biomass burning, fuel consumption from domestic and street vendors' cooking, solid waste burning (municipal incinerators and open burning), and construction. Indoor air pollution is also significant. Acid rain is increasing. For example, the average pH of rainfall in a sample of 10 Indonesian cities showed a change from 5.5 in 1996 to 4.8 in 1998, with the highest acid levels found in DKI Jakarta, Surabaya and Bandung. Despite advances in general health, air pollution is increasingly becoming a health hazard in cities. Cases of respiratory ailments in Jakarta are high, compared to other Asian cities. Respiratory inflammations account for 12.6 percent of all deaths in Jakarta, more than double the rate for all of Indonesia.

3.135 Efforts to manage and improve air quality have been hampered by poor regulations, weak enforcement, capacity and a lack of reliable information. For the first time, in 1999, GOI established a comprehensive network of ambient air quality monitoring stations in 10 cities; in addition, the government is also undertaking programs like the Blue Sky Program and the Clean Air Program for improving air quality in cities.

Water Quality and Water Pollution

3.136 Although Indonesia has an adequate water supply[26], there are growing concerns about the quality of water, access and unsustainable usage patterns. Access to safe water in Indonesia is limited and its availability will decrease as levels of pollution rise. Domestic sewage, industrial effluents, agricultural runoff, and untreated solid and dry waste are polluting surface and groundwater in Indonesia. Improper storage and use of industrial/agricultural chemicals exacerbate the problem.

3.137 Indonesia has one of the lowest rates of sewerage and sanitation coverage in Asia. The number of people connected to the piped water system is low. Much of the existing water, sewerage, wastewater infrastructure is in poor condition. The maintenance of sewerage systems is limited and/or neglected in most cities. This has caused widespread contamination of surface and groundwater.[27] Water from most PDAMs is not potable. It is difficult to remove pollutants at a reasonable cost from bodies of water, using existing treatment plants. As a result, Indonesia has experienced repeated epidemics of gastrointestinal infections and the highest incidence of typhoid in Asia. The quantity and quality of groundwater has been adversely affected by poor aquifer recharge, leading to saline intrusion; over-exploitation; pollution from domestic sewage, factory wastes and agricultural runoff; and the lack of a proper pricing policy. Evidence suggests the burden of pollution falls disproportionately on the urban poor. Throughout urban Indonesia, household piped-water connections

---

[25] Indonesia Environment Monitor, World Bank, 2002.
[26] Indonesia has about 6 percent of the world's freshwater resources, equivalent to around 2530 km^3 of annual renewable water resources (World Bank, 2002).
[27] Indonesia Urban Water Supply Sector Policy Framework: World Bank, 1997.

correlate to household income. As groundwater becomes increasingly polluted and, in some areas, saline, households without access to piped water systems have no choice except to buy drinking water from private vendors at relatively high prices --often as much as fifty times more per unit of water than households connected to the network.

3.138 Much industrial expansion has taken place without sufficient attention to the environment, leading to serious environmental degradation, particularly in the urban areas of Java. Data from 1994 concerning discharge from large industries revealed that industrial pollution in Java constitutes 25 to 50 percent of the total pollution load in terms of Biological Oxygen Demand (BOD)[28.] Industrial effluents, such as phenol, detergents and nitrate, have been observed in shallow aquifers in the Jabotabek area.

3.139 Major obstacles to improving water quality include weak and inconsistent enforcement of existing laws and regulations, failure to implement the 1995 effluent discharge permit program, lack of standard operating procedures for hospitals and other institutions to handle wastewater, and lack of sufficient data to determine pollution levels. With decentralization, *kotas* and *kabupatens* are entitled to plan and manage environmental services, including construction and operation of central wastewater treatment facilities. It is too early to assess the impact of this on the management of water quality programs.

Solid and Hazardous Waste

3.140 The level of waste generation in urban areas has been increasing over the past five years; its dispersion is a growing threat to the quality of water, air and land. This threat is compounded by the lack of environmentally-sound waste disposal and treatment facilities. Most of urban solid waste originates from a wide range of residential, industrial, agricultural, institutional, municipal and commercial sources. Much of this waste is highly organic, up to 75 percent of municipal waste and recyclable.

3.141 Indiscriminate dumping of waste in urban areas contaminates surface and groundwater supplies. In urban areas, solid waste clogs drains, creating floods during the rainy season and stagnant water for the breeding of insects. Uncontrolled/improper burning of waste contributes significantly to urban air pollution. Greenhouse gases are generated from the decomposition of organic wastes in landfills, while untreated leachate pollute the surrounding soil and water bodies. Health and safety issues also arise from improper solid waste management. Co-disposal of hazardous and medical wastes with municipal wastes poses a serious health threat. Human fecal matter is commonly found in municipal waste. Insects and rodents attracted to the waste spread diseases such as cholera and dengue fever. Use of water polluted by solid waste for bathing, food, irrigation and drinking can also expose individuals to diseases and other contaminants. Waste workers are poorly protected from direct contact and injury. Dust stemming from disposal and open burning of waste also contribute to health problems.[29]

3.142 Solid waste collection efficiencies throughout the country are low, estimated at 50 percent, with some large towns having a higher collection rate. The poorer areas of the cities as well as many rural areas are generally under-served or not served at all. Treatment methods include composting, anaerobic digestion, incineration and sanitary land-fills. Around 90 percent of the waste is disposed through illegal open dumping with no environmental safeguards. Controlled dumps and sanitary landfills are few. Roughly 85 percent of small cities and 53 percent of medium-sized cities dispose of

---

[28] BOD is the amount of oxygen consumed in the biological process that breaks down organic matter in water. The greater the BOD, the greater the degree of organic pollution.
[29] What a Waste: Solid Waste Management in Asia: World Bank, 1999.

their waste in open dumps. Only a small portion of solid waste is recycled, mostly by the informal private sector.

3.143 Additionally, there is a threat from hazardous waste, generated by a wide range of industrial, commercial and agricultural activities. These take the form of solids, liquids or sludge and can pose both acute and chronic public health and environmental risks. Every year approximately 2.2 million tons of hazardous waste are generated in West Java and DKI Jakarta alone. In regions with high concentrations of home industries, such as Bali, which have no official waste disposal methods, the possibility of contaminating water bodies with toxic and inorganic waste is a concern.

A Way Forward

3.144 Growing congestion and pollution in the major cities of Indonesia are bound to affect the quality of life and their ability to compete. It may also lead to community resistance in urban areas to uncontrolled pollution and pressure to slow industrial expansion, especially in those areas where future growth is most likely to occur. The key challenge is to define a strategy for the management of urban areas that accommodates their growth while protecting the environment. It will also require more effective policies and incentives for environmentally responsible behavior by firms, households and individuals, and for enhanced institutional capacities for urban environmental planning and management. This is easier said than done. What's at stake? The health and welfare of Indonesia's urban population, the country's growth and the efficiency of its cities. At the *kota/kabupaten* levels, priorities are:

- Improving the availability of safe water through a major expansion of the piped water supply, better O&M of existing infrastructure and appropriate pricing policies.

- Significant improvement in sewerage and sanitation coverage and better O&M of existing systems to reduce fecal contamination of urban water supplies and groundwater resources.

- Improvements in both the collection and disposal of urban solid waste, especially in the larger cities, with long-term strategic planning and greater involvement by the private sector.

- Better traffic planning and management for reducing vehicular air pollution through a combination of critical investments, improved traffic management and engineering, more effective land-use planning, higher technical standards for motor vehicles, introduction of cleaner fuels, expansion of public transport systems, and more effective policies for demand-side management.

- Controlling industrial pollution through strategic planning; a framework for waste/pollution reduction and efficiencies; strengthening institutional capacities for monitoring and enforcement, especially at the local level; encouraging clean technologies and waste minimization initiatives; improving information networks and access to such information by the public; and developing and implementing plans for controlling and reducing the use of toxic and hazardous wastes.

- Improving efficiency in land allocation for controlling urban sprawl and putting land to the highest and best use; improving legal and institutional frameworks and procedures for space planning and prior review of potential environmental impact on urban projects; addressing inefficiencies in infrastructure; preserving and strengthening local culture and community networks; building community awareness; and protecting regional and local watersheds, open spaces, urban forests and other critical urban ecosystems.

IV. REVIEW OF URBAN SECTOR OPERATIONS

Overview of Past Development Assistance

4.1 The urban sector in Indonesia has received support from the World Bank, the Asian Development Bank (ADB), UNCHS/UNDP, and several bilateral donors. The two distinct strands in urban lending in the past three decades have been support for the *Kampung* Improvement Program (KIP) and the Integrated Urban Infrastructure Development Program (IUIDP). Between 1972 and 2000, the lead agencies in investment support have been the ADB and the World Bank. ADB assisted 27 investment projects in the urban and water sector between 1972 and 2000, 17 of them were IUIDP projects. Since 1975, the World Bank has supported 24 urban investment projects, covering urban infrastructure and services, urban transport, housing slum upgrading, urban environment, cultural heritage management and so forth. In the last decade the basis for much of this assistance has been support for IUIDP. Under this rubric, more than US$1 billion in donor-supported investments took place in urban Indonesia during this period. Prior to the IUIDP, the most discernible trend in urban investments was in the 1970s and 80s, to support KIP, an ambitious and innovative program to improve living conditions in the *kampungs* of Indonesia.

4.2 Donor support has gone to other projects too. For example, in 1987, the ADB extended the Urban Sector Loan, which comprises urban sector budgetary support, as well as technical assistance for implementing an urban policy action plan. In 1989, USAID did likewise under its (now defunct) Housing Guarantee Program. Many donor-supported projects in urban upgrading, housing, water supply and sanitation emphasized participation as an underlying building block. The Community-Based Initiatives for Housing and Local Development (CoBILD) Program and the Implementation of the Enabling Strategy for Shelter Development, both funded by the government of the Netherlands through UNDP/UNCHS, and the *Kecamatan* Development Program (KDP) funded by the World Bank, are other examples. The alleviation of urban poverty has remained high on the donor urban agenda. Apart from the KIP investments were the UNDP-supported Urban Poverty Alleviation Program and the Urban Poverty Projects of the World Bank (see later). This is in addition to other regional and global initiatives dealing with the urban poor, such as the UNDP/World Bank/UNCHS-sponsored Urban Management Program (UMP), the UNDP/UNCHS-sponsored Sustainable Cities Program (SCP), the NGO-based Megacities Project, the UNDP's Asia Pacific 2000 and the Urban Governance Initiative (TUGI) Regional Programs. After the World Bank-assisted housing sector loan, this sector has not attracted much donor financial support since 1986 except for odd housing/sites-and-services schemes in some of the early IUIDP investments. The aim of the USAID-supported Private Participation in Urban Services (PURSE) Project was to encourage the private sector to deliver urban services and to spur local economic development through the establishment of public-private partnerships (ADB, 2000, p. 33, 34).

4.3 Among analytical and sector work undertaken by the World Bank, the most recent comprehensive sector review dates to 1984: the Urban Services Sector Report (World Bank, 1984). This report, together with the Indonesia: Sector Policy Action Plan (World Bank, 1988), provided the framework for the IUIDP. Later, an informal sector report (Indonesia: Urban Public Infrastructure Services, 1993) analyzed key urban subsectors. In hindsight, given the rapidly evolving socio-economic environment in Indonesia, the Bank should have undertaken urban sector work more often. In 1998, the Bank issued a comprehensive water-sector strategy. However, its impact on reforms was limited; the real stakeholders (cities and their citizens) had little influence in policy deliberations and formation. With more empowered stakeholders, the Bank's AAA work is expected to have a greater impact on sector reforms. Furthermore, since 2001, the Bank has helped nine cities implement City Development Strategies (CDS) with financial assistance from the Cities Alliance. CDS focuses on the local economic development and poverty reduction issues. Although implementation is still at an early sage, the program

is expected to contribute significantly to the decentralization and democratization process within these cities.

4.4 In the post-decentralization era, attention has centered on the ongoing decentralization program. Most major development agencies have assisted GOI with implementation. The World Bank and ADB support this effort with investment loans and technical assistance; UNDP, bilaterals like the GTZ, the Netherlands, DfID, USAID and others are providing much needed grant support for developing the necessary frameworks, institutions and capacities for a sustainable transition.

The Story of Two Programs

Enhancing the Quality of Life in Urban Indonesia: the *Kampung* Improvement Program (KIP)

4.5 Between 1970-88, the World Bank supported four projects to improve housing and basic infrastructure in low income, densely-populated *kampungs* of Indonesia. These projects, Urban I-IV, emerged during a period of rapid rural-urban migration of Indonesia's poor; they led to an increasing demand for basic infrastructure. KIP became the primary vehicle for doing so. Many of them were successful, especially in improving basic infrastructure in the *kampungs.* In addition to making substantial environmental and institutional gains, they also improved the lives of residents in surrounding areas. Beginning in the 1970s, the economic transformation that the country underwent also contributed to a reduction in poverty and notable improvements in family planning, health care and education.

4.6 **Outcomes of KIP**. During its three distinct operational phases—KIP I (1969-79), KIP II (1979-89), and KIP III (1989-99)—the program has evolved from its initial focus on physical improvements, (KIP I and II) to a three-pronged approach—Tribina—integrating social, economic and physical development (KIP III).

4.7 **Housing and Infrastructure**. The projects brought improvements in housing and infrastructure to low-income areas at low cost. They led to improved housing, footpaths, lighting, education and health facilities. One of the projects' most important outcomes was its spillover effect; the KIP served as a prototype for investments and improvements in other areas, although improvements to KIP *kampungs* came more rapidly.

4.8 **Urban Environment**. Thanks to the program, the majority of residents in KIP *kampungs* now have piped water in their homes as well as their own closet toilets with septic tanks. This is a great improvement, at least for Jakarta, where most houses flushed their sanitary waste into open ditches along the roadside. Improved drainage under KIP helped reduce flooding; in this, there are notable differences between KIP and non-KIP *kampungs*. Efforts to improve solid-waste management had mixed results, with the largest differences not found between KIP and non-KIP *kampungs* but between cities. Among the KIP's weak points were: the improved infrastructure was not always effectively integrated with the trunk infrastructure; inadequate operation and maintenance was another.

4.9 **Land/House Values**. KIP residents have enjoyed land values higher than those in non-KIP *kampungs*. However, with rapidly-emerging real-estate markets, new construction has supplanted existing *kampungs*, raising questions as to whether KIP investments were worthwhile. The potential capital gains from KIP investments were estimated to yield an estimated 31 percent rate of return (ERR) over a 15-year period. Even if redevelopment reduced a project's life to five years, the estimated ERRs were still 12 percent. Thus, most investments benefited the residents, even if many of the improved *kampungs* subsequently made way for new developments. Yet, many *kampung* residents were not able to recoup the real value of their land and houses due to their poor business savvy and weak claims on tenure. They also

lacked skills to manage their new fortunes. Clearly, the government has a monitoring role to play to ensure that the rights of *kampung* residents are recognized and their wellbeing is safeguarded.

4.10 **Institutional Development**. The projects had impacts on institutional development because they created new agencies and strengthened capabilities of existing agencies. A new government agency, *Perum Perumnas*, was established to manage low-cost housing development. Also, BTN introduced Indonesia's first mortgage- lending operation. Another important outcome was to keep institutional development issues, such as cost recovery and decentralization, on the urban sector reform agenda. The cost of *kampung* upgrades was recovered indirectly through citywide property taxes, those of sites and services directly from purchasers of plots; both had disappointing results. The performance of the special KIP units that were established within the local administration of each project city was mixed. Some institutional improvements, particularly in cost accounting and auditing, were mainstreamed within the more dynamic local administrations. Specific functions, such as project implementation, devolved to local authorities. The follow-on urban projects supported by the Bank also became instruments for implementing the government's decentralization agenda.

4.11 **Community Voice and Urban Stability**. A large share of *kampung* residents participated in the planning and implementation of the KIP. The level of participation determined the perceived benefits of the program. Consultations generally led to participation and participation generally resulted in greater satisfaction with KIP outcomes. Furthermore, community consultation and participation in the early stages of project preparation and design helped instill a sense of ownership among the beneficiaries. KIP also contributed to residential stability, perhaps due to its rapid and extensive coverage. Although some had feared otherwise, project improvements did not induce any major gentrification in the improved areas.

4.12 **KIP is Unique Worldwide**. When KIP first began in Jakarta and Surabaya in 1969, it was a breakthrough in large-scale slum improvement. Prior to KIP, the prevailing view was that all unplanned development and informal settlements were to be treated as a disease that had to be eradicated through planned relocation or redevelopment. Before KIP started, more than 60 percent of the settlements in Jakarta lacked the most basic infrastructure. The KIP concept was a direct response to a looming political, social, environmental and public health crisis because of the city's limited resources. The decision to launch KIP was both brave and innovative for its time. Departing from the centralized and top-down system of the 1960s, it introduced a bottom-up, democratic approach, encouraging public consultation and participation. The policy has benefited millions of urban poor and raised public health in general. In its 30 years, KIP has improved 18,000 hectares of *kampungs*, reaching more than seven million people, giving them a sense of hope, self- esteem and belief in a better future. The success of the KIP has found acceptance among most cities in Indonesia as well as global acclaim.

4.13 For a program of its size and scope, KIP had its share of shortcomings. Among the most critical are: (a) limited attention to criteria for selection of sites and project components; (b) lack of involvement in the titling of land; (c) poor selection and training of facilitators; (d) the need to create a balance between local, small-scale improvements and community-level infrastructure; (e) poor attention to O&M; and (f) integrating upgraded slums into the urban community and infrastructure. However, to its credit, the program has incorporated lessons learned from its operations. Also, in sum, the benefits of the program far outweigh its flaws.

The Integrated Urban Infrastructure Development Program (IUIDP)

4.14 During the mid-1980's, in line with the central government's desire to decentralize, there was growing concern that a more comprehensive approach was necessary to meet urban services. That was the impetus behind a citywide basic infrastructure planning and programming mechanism, known as the IUIDP. This approach brought together all sectors of public works (water supply, urban roads, drainage, solid waste management, sanitation, market area upgrading and KIP) in one program. The objective was to strengthen the capacities of level II local governments and institutions to plan, program, build, operate and maintain city-level urban infrastructure and services, based on local priorities, a responsibility previously vested in MOPW. It also sought to improve efficiency and avoid duplication in the construction of urban infrastructure. GOI also wanted to create greater self-reliance among urban local governments in the delivery of services, to increase local government revenue generation capabilities, to enhance local government human resource and institutional capabilities, and to integrate the country's traditional town planning with programming of capital investment projects, mobilization of funds, and implementation of projects.

4.15 One of a kind, the IUIDP drew a great deal of attention and soon became the centerpiece of national decentralization (Devas and Rakodi, 1993; UNCHS, 1997; World Bank, 2001). Over 75 percent of local governments adopted it and it became the basis for donor-supported urban programs throughout Indonesia. The East Java & Bali and the Sulawesi/Irian Jaya Urban Development Projects were the first two major Bank-assisted projects in the IUIDP series. Since then, the Bank has supported roughly four IUIDP-style projects all over urban Indonesia. In the Jakarta metropolitan area alone, the Bank supported three urban development projects under the rubric of the IUIDP. These projects—JUDP I, II, III—addressed urban transport, water supply and sanitation, flood control and drainage, solid waste management, KIP, and, to a lesser extent, urban spatial management and infrastructure maintenance. Together, the projects laid down the foundation for metropolitan development.

4.16 The achievements of the IUIDP projects are many, especially in reducing infrastructure backlogs and improving municipal service delivery. The value of the IUIDP for most local governments was to introduce the much more ambitious decentralization of services now underway in Indonesia. Most local governments have created inventories of their infrastructure assets, improved personnel capacities, however limited, and increased potential revenue. They have also prepared development strategies, feasibility studies, and most important, gained experience in managing integrated development programs.

4.17 Nevertheless, the IUIDP has many critics. Among the arguments against it are that the IUIDP has been less-than-successful in its primary objective of strengthening local capacities. It has remained an extension of central government. Local governments have not been motivated to find funds for repaying the loans under the program and they continue to treat the IUIDP process separately from their traditional budgeting and infrastructure activities. The limited-term political mandate of the mayors and the local councils, who were the logical focal point of the program, had a bearing on sustained support for long-term investments in water supply and sanitation and the reform of financial and administrative policies that underpin them. The capacity building of local governments is far from complete and the bureaucracy continues to depend on consultants. There has been little motivation to internalize IUIDP experiences within local governments and other local urban entities.

4.18 From the World Bank perspective, the challenge of preparing and implementing such disparate projects has been considerable. In the mid-1990s the Bank recognized that the IUIDP paradigm was not resulting in the desired creation of local government capacities nor in sector reforms. For example, water investments were a sizable portion of the IUIDP investments; the intent was to form viable PDAMs for operating and maintaining local-level systems. However, this objective was not served; PDAMs have neither acquired the sustainable capacity required to operate and maintain systems nor raised service

coverage and quality. The program has also been criticized for focusing on discrete local investments, rather than on policy reform and the financing of investments requiring effective implementation of policy reforms at the local level.

Overall Lessons Learned

4.19 Based on a review of implementation completion reports and performance audits of Bank-supported urban projects as well as similar reviews undertaken by other agencies like the ADB, we learned what has succeeded in the urban sector and what has not. While such a review can be lengthy and its findings extensive, this section focuses on the pertinent few, crucial in the framing of any future sector-assistance strategy.

4.20 The failure of past projects to bring about necessary sector reforms prompts a recommendation that the focus of future sector assistance should be in creating appropriate sector legislation, regulation, and policies. Such a policy-based assistance strategy would improve the development impact of future lending and reach the smaller municipalities that need it most. The institutional development impact of many recent urban projects reviewed by OED have either been unsatisfactory or modest at best. With some exceptions, the projects did not fare much better in their outcomes or sustainability.[1] These results remain a challenge to urban lending. Decentralization poses additional challenges. With gaps between the institutional capabilities of the central, provincial and local governments support for local government capacity building should continue. Future projects should improve the ability of local governments to deliver sustainable municipal services rather than simply adding new infrastructure.

4.21 It is also important to identify winners, such as the Second Sulawesi UDP. Although managerial improvements are difficult to achieve and measure in comparison to infrastructure development, they are possible and have occurred in local governments with strong leadership. A publicly reviewed City Development Strategy that cities themselves prepare and maintain should be a prerequisite of any long-term partnership with the Bank.

4.22 Based on JUD projects and the findings of an OED evaluation of KIP, stakeholder involvement, local institutional ownership and sustained dialog are essential for long-term project sustainability. In addition, decentralization has given a new thrust and meaning to good governance, transparency and accountability and participation of civil society in urban management. As part of a total assistance package, efforts supporting decentralization should essentially encompass these dimensions of urban sustainability.

4.23 Within the Bank and other development institutions, a focus on outcomes and output indicators is critical, especially in the more nebulous and broadly-conceived activities such as "poverty alleviation." For community-driven development (CDD) type projects, there should be frank discussion of the objectives and how they will be monitored. CDD projects should adopt a less prescriptive approach and focus more on sharing. In CDD and urban poverty projects, there is latitude to expand the role of women beyond the typical micro-credit activities.

4.24 With water supply and sanitation, the lending paradigm of IUIDP projects has delayed vital sector reforms. The lack of credible tariff regulation has been a stumbling block in improving sector efficiency and attracting private sector operators. One recommendation is that future Bank sector assistance would be more effective and sustainable if it were provided by stand-alone water and sanitation

[1] One exception is the WSSLIC project; its outcomes were rated satisfactory, its institutional development impact substantial and sustainability likely.

projects, with a focus on financial and institutional reform. Since local governments are PDAMs shareholders and bear responsibility for water tariff setting, it is essential that *Walikotas/Bupatis* and DPRDs fully support reform. The successful lessons of greater community involvement under the (rural) Water Supply and Sanitation in Low-Income Communities (WSSLIC) project are applicable to urban water supply and sanitation projects in Indonesia.

4.25 Donor coordination in the sector, essential as it is, has proven to be difficult time and again. It has worked best in the presence of an established policy and program framework such as the IUIDP, which the donor agencies subscribed to and supported in different geographic regions. Decentralization throws new challenges to an already difficult and complex environment. Over and above the donor coordination meetings under the CGI auspices, the Inter-ministerial Core Group of the Urban Forum or a similar mechanism should ensure that urban assistance is well-coordinated and fits well with the national development agenda as well as sector priorities. Donor agencies have been flexible in reviewing their current portfolios to better adjust their assistance for coping with the needs of decentralization and *krismon*. This 'nimbleness' is welcome and should be extended to all future program planning in the urban sector.

4.26 Procedural issues like land acquisition, resettlement implementation, procurement management, and coordination arrangements continue to vex. For example, land acquisition problems contributed to the failure of the Surabaya UDP in a major way. One suggestion is that the Bank take up the issue of land acquisition with GOI and develop a common agreement and framework.

A New Paradigm of Urban Lending: UPP and USDRP

4.27 Responding to the evolving challenges in the urban sector, especially those posed by rising urban poverty which occurred during the *krismon* as well as the extraordinary demands of decentralized urban local governance and local government financing, the Bank's urban assistance is taking an interesting new turn. Two new projects exemplify this: the Urban Poverty Project 2 and Urban Sector Development Reform Project. Both projects represent a fundamental change in the Bank's lending assistance.

4.28 **Urban Poverty Project 2 (UPP 2).** UPP 2, aims to (a) establish or support representative and accountable community-based organizations (CBOs) at the *kelurahan* level to provide services to the urban poor and increase their voice in decision making; (b) make local government more responsive to the needs of the poor through increased cooperation with the CBOs; and (c) improve financial, social and infrastructure services for the urban poor. The project will achieve these objectives by (a) building community capacity for the formation and institutionalization of elected CBOs that are accountable to communities; (b) providing grants to communities directly and transparently through the CBOs to finance poverty alleviation activities; and (c) enhancing the capacity of local governments to partner with community organizations through the establishment of a Poverty Alleviation Partnership Grant. UPP 2 is a follow up to UPP 1 which supported the development of community organizations at the kelurahan level and provided block grants to them for poverty-alleviation activities. UPP 1 targeted urban centers, mostly in the northern part of Java, one of the worst areas affected by the economic downturn. The first phase of the project is complete; it has met and significantly surpassed its original objectives. There is a high sense of ownership among community members; approximately 1,200 community organizations have been supported; more than 500,000 people have received small loans for small businesses through the project in its first phase. Infrastructure developed through the project has attracted high community contributions; services are maintained by the community and relatively little leakage has been reported. UPP1 sought to bypass all local government structures and chose to strengthen the capacity of communities to organize themselves into elected community organizations (BKMs), to receive resources and decide on their allocation. UPP2 will take the process a step further by involving local governments in an active way.

4.29 **Urban Sector Development Reform Program (USDRP)**. This program is being developed as a direct and dynamic response to the change wrought by the ongoing decentralization. The proposed program will support a three-phase Adaptable Program Loan (APL) over a 10 year period, to enhance urban services to improve the quality of life of people in participating municipalities in the country. USDRP will assist municipalities to (a) engage in reforms to improve their governance and capacity for delivery of services; and (b) implement priority investments identified through a participatory planning process. USDRP will also assist the national government to (a) improve on-lending mechanism for local government borrowing; (b) develop a Municipal Reform Grant Facility to provide matching grants to promote reforms and capacity development at a local level; and (c) establish a City Performance Rating System to evaluate municipal performance. The proposed APL will take an incremental and phased approach to accommodate the dynamic nature of the decentralization process along with its associated uncertainty and risks. APL I will support reforms and priority investments in about 10 municipalities as well as the preparation of APL II. At the local level, APL II will assist approximately 20 municipalities. At the national level, it will support improvement of on-lending mechanisms, municipal credit facility, municipal reform grant facility and a city performance-rating system. APL III will support an additional 20 municipalities, along with 30 from the previous phases and help institutionalize and strengthen the national level municipal instruments.

V. FRAMEWORKS FOR SUSTAINABLE URBAN GROWTH IN INDONESIA

Concluding the Urban Sector Review, this chapter presents a strategic framework for sustainable urban growth and outlines a reform agenda that will support such a framework, bringing to bear the local-level impacts of the ongoing decentralization and democratization program and lessons learned from the economic and financial crisis of 1997.

Government of Indonesia's Urban Development Policy

5.1 Law No. 25/2000 on National Development Program (*Program Pembangunan Nasional* or PROPENAS) lays down the macro policy that provides direction to urban development in the country. PROPENAS focuses on key themes of democratization, good governance and economic recovery, and emphasizes increasing accountability and public participation in decision making through more democratic elections and participation in decisions regarding resource allocation. On urban development, PROPENAS provides the following guidelines: (a) establish and operate institutional structures that can meet the demands of cities; (b) increase private sector investment in urban development; (c) form Urban Forums for city planning and development; (d) increase community institutions/organizations at the urban level; (e) reduce urban crime and urban poverty; (f) encourage small and medium enterprises; (g) base functional reorganization on strategic, historic, and traditional values; and (h) improve infrastructure networks and services and establish effective connections between collection and distribution points.

5.2 While these guidelines are too broad and ad hoc to provide a comprehensive and integrated framework for GOI's urban sector strategy, GOI policy makers have elaborated on them in subsequent discussions and presentations on the direction of the country's urban development. At the second *Cities Speak* workshop, representatives of *Kimpraswil* and *Bappenas* offered the following strategies on urban development:

Kimpraswil's Views

- In the past, foreign loans were the primary source of funding for urban projects. Today, however, Indonesia's fiscal constraints, particularly its accumulated foreign debt, require GOI and local governments to drastically change their approach to urban development.

- The old 'urban infrastructure-based approach' should give way to an emphasis on 'urban local economic development.' This shift in strategy is based on the belief that only an empowered, economically and financially viable urban community can sustain the cost of providing urban infrastructure and services.

- Sub-sectors of urban development—local economic development, poverty alleviation, urban infrastructure and services, environmental management, urban governance, and urban finance — should be viewed comprehensively within the context of an "integrated urban development framework."

- The totality of available urban resources, not merely financial resources, should be analyzed in formulating an urban development strategy. Land and human resources are two particularly valuable assets; their proper development and management are critical to sustainable urban development in Indonesia.

Bappenas's Views

- Cities are beset with a complex array of problems. Sound planning that involves stakeholders and produces detailed urban programs is a key factor in solving the multi-dimensional challenges of urban development.

- In the aftermath of the *Krismon*, urban poverty has become a crucial issue. Decentralization shifts the initiative on poverty alleviation to local governments. Local economic development, which exploits local potential for positive growth, may support poverty alleviation if such development is fostered by policies and regulations conducive for small and medium enterprises (SMEs). Urban poverty alleviation programs should be developed in the context of rural-urban linkages.

- In the past, the internalization of IUIDP experiences by local governments was limited. The central government led the initiative although 'space' for local government initiatives also existed. The past record for this particular approach to urban development was not flattering; it primarily benefited big investors instead of the urban poor.

- It is important to improve inter-regional cooperation and rural-urban synergies to develop sustainable and livable cities.

- An overall evaluation of existing urban and municipal financing programs is necessary. In general, *kotas* and *kabupatens* spend most of their revenues on routine expenditures. Improving the private-community partnerships (PCP) is an alternative way to mobilize greater domestic financial resources.

- Local economic development depends on how local governments can mobilize their sources and potential, such as human and natural resources, capital and institutional support. Laws and regulations related to the local business environment are crucial to local economic development.

- The essence of the decentralization policy is to improve the delivery of public services. Community-based development is a good alternative to the top-down public sector approach.

Guiding Principles and Approach

5.3 Two overarching principles should help Indonesia rise to its challenges in the urban sector: (a) a comprehensive and synergistic approach to urban issues; and (b) meeting the challenges posed by decentralization.

Approaching Urban Development Comprehensively and Synergistically

5.4 The analysis of Indonesia's urban sector focused on five key dimensions: governance, urban finance, poverty alleviation, local economic development and the provision of urban services. The dynamic interplay of these five dimensions, interpreted in an urban spatial setting, is the key to a comprehensive understanding of cities as "living organisms"[1] that evolve.

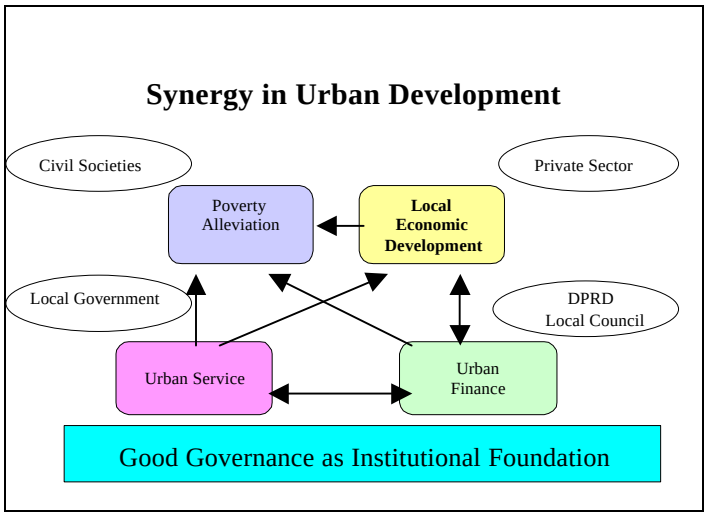
[1] World Bank. A Strategic View of Urban and Local Government Issues: Implications for the Bank, 1999.

5.5 In an idealized and over-simplified model of city growth: (a) good governance will lead to sound financial management and the provision of high quality urban services; (b) investors, drawn by that progress, will stimulate local economic development and improve the general quality of life for everyone, including the poor; (c) local economic development will bolster municipal finances and help alleviate poverty through job creation; and (d) a stronger fiscal position will further improve urban services and keep the development cycle moving forward. Enabling such a positive development cycle will be effective interaction among the different and varied urban stakeholders—local governments, DPRDs, the private sector and civil society.

5.6 In reality, the situation is not so simple. Each city faces a different set of problems and has different assets. The challenge varies by city. Some, like Blitar, face economic stagnation despite good governance and relatively good urban services because city residents are migrating to larger urban centers. Others, like Bandung, which have dynamic levels of economic activity, do not necessarily provide good urban services. They are also besieged with problems of large-scale urban poverty and weak social capital.

5.7 As they confront these extraordinary challenges, ranging from economic stagnation and poor services to rising urban poverty and weak financial resources, Indonesian cities need a driving force or a strategic synergy that pulls all the key dimensions of urban growth into action. Good governance, exemplified by capacity, transparency, accountability and participation, provides such synergy; it is the indispensable foundation for dynamic and sustainable urban growth.

Figure 5.1



Challenges of Decentralization

5.8 Decentralization will inevitably create winners and losers among the 400 plus local governments in Indonesia; those that offer good governance and efficient management are likely to attract more resources and grow faster. Adapting to the changes wrought by decentralization and rising to the opportunity it presents requires the following approach:

Competitive selection of cities based on strong ownership. Given limited resources, support should be extended to cities that demonstrate a strong ownership of reform and a track record for implementing them. Resources should be allocated in a competitive manner, based on transparent selection criteria. This selective approach, supporting only reform-oriented cities, has the potential to encourage other cities to embrace a reform agenda.

Sustainability and replicability. Projects and programs that are institutionally and financially sustainable after their completion and with underlying concepts that are replicable elsewhere have the greatest outreach and impact. Support in the urban sector should be provided to projects and programs that will leave not only physical assets but also sustainable and replicable institutional and financial systems.

Cross-sectoral and thematic approach. The complexity of the urban agenda requires cities to increasingly engage in cross-sectoral and thematic issues, for example, decentralization, poverty alleviation or LED, rather than narrowly-defined urban infrastructure investments. This requires comprehensive program planning, well-integrated institutional and financial frameworks and full participation by civil society.

Programmatic interventions. The complex and evolving demands of cities are better managed through a programmatic approach, as opposed to conventional stand-alone sectoral investment projects. Some sectors, such as water, sewerage and urban environment, which are rooted in complex policy setting and substantial externality, require long-term and phased intervention.

Addressing institutional and incentive frameworks. Successful urban reforms will depend on developing the right institutional and incentive framework for local governments to improve their performance. These frameworks are as diversified as the urban agenda itself but most definitely include: (a) civil service reforms, offering the right incentives for improved performance by local civil servants; (b) access to loan and grant financing for required urban investments; (c) a transparent and objective city performance rating system to compare performance levels across cities; and (d) dynamic linkages between performance ratings and access to financial resources.

Expanding knowledge and innovation. The multi-faceted nature of the urban challenge entails innovative approaches and answers. This requires investing greater resources in research and development for new approaches and developing knowledge networks among cities, bringing 'state-of-the-art' from within and outside Indonesia.

Response to the Challenge: Furthering Change in Cities

5.9 In molding a response to the emerging challenges in the Urban Sector, this study concludes by proposing a framework for sustainable urban development in Indonesia, based on the approaches outlined in the previous section. The proposed framework integrates five strategic areas—good governance; urban poverty alleviation; local economic development; urban finance; and urban service delivery—that embody the multi-faceted nature of the urban sector into a comprehensive reform agenda. The framework identifies the highest priorities in each of these areas; it proposes essential policy drivers and regulatory reforms, and outlines fundamental institutional structures and financing mechanisms. The focus is very much on *what can be done* and *who should do it;* the parts add up to a comprehensive vision of a vibrant urban sector that will lead the economic engines of growth.

Enhancing Good Governance

5.10 Successful cities are built on a solid foundation of good governance. Its elements include capacity, transparency, accountability and participation. In developing good governance, the most pressing requirements are to fill the substantial gaps in capacity at the local level arising from decentralization; to develop institutional and regulatory mechanisms for securing effective citizen participation, transparency of administration and accountability of city officials; to address all-pervading corruption in government; and to develop mechanisms for inter-governmental and regional coordination and cooperation.

5.11 **Developing the Capacity that Decentralization Requires.** In cultivating good urban governance, Indonesia faces significant, institutional and human resource gaps in capacity at the local level, which have been aggravated by decentralization. These gaps in capacity embrace all categories of personnel involved in urban development—mayors, DPRD members, local government officials and civil society groups. As an integral part of City Development Strategy (CDS), the cities could identify their needs for institutional development and capacity building. Among those to be assisted, DPRD members are particularly important because of their key role in local-level policy formulation, decision-making and oversight. With regard to municipal staff, over and above conventional capacity-building approaches, a fundamental change in the institutional and incentive framework is needed to promote better performance. For example, rationalizing the size of their work force, recruiting professionals from an open labor market, and introducing professional city managers and a merit-based compensation system represent a few steps in the right direction. Taking into account the existing National Capacity Building Framework for Decentralization, the GOI and its local governments need support for filling in these gaps.

5.12 **Enhancing Participation, Transparency and Accountability.** The GOI and local governments, together with civil society groups, need to develop institutional and regulatory mechanisms to secure effective citizen participation, transparency of administration and accountability of city officials. Direct election of mayors and city councils can significantly enhance the accountability of city hall. Access to relevant information by the citizenry can open doors of transparency. Law 22/1999 and subsequent regulations provide the cover for establishing local Urban Forums, a venue to involve urban stakeholders in municipal planning and management. However, institutional and regulatory arrangements for setting up Urban Forums are not well articulated. Major issues to be clarified are: (a) selecting representatives to the Urban Forms; (b) institutionalizing and integrating Urban Forums in local government planning and budgeting; and (c) balancing cities' strategic priorities with communities' day-to-day demands for improved urban services.[2] Although the law stipulates access to information, few citizens have ready access; others are unaware of their right to information. As a starting point, local governments should issue a disclosure policy statement spelling out information available to the public and describe how to obtain it. Transparent and objective monitoring and evaluation of local governments' performance should assist in measuring progress and hold local government officials accountable for their performance.

5.13 **Fighting Corruption**. Corruption is among the most serious impediments to development and alleviation of poverty. Weak institutional capacity, coupled with an absence of mature controls, contributes to greater corruption and rent seeking at the local level. Fighting corruption requires a two-step parallel process. The first is to enhance fiduciary responsibilities and ensure adequate safeguards. National-level regulations, requiring competitive procurement procedures and sound financial management systems, should be adopted and applied at the local level. To bring this about, local government officials should receive technical assistance and training. A parallel and equally critical second approach is to change the underlying incentive structure that fosters corruption. Other initiatives to reduce the risk of corruption include enhancing participation by civil society in project design and supervision, civil service reforms that reward merit and reduce personal incentive to engage in corruption, and participation by the private sector in the provision of urban services.

5.14 **Clarifying Decentralization Law.** Law 22/1999, too general in assigning spending responsibilities, creates confusion about the division of responsibilities among different levels of government. With some urgency, the GOI should define the obligatory "sectors" of local governments and the "functions" of the local government within these sectors. It should also take steps to widely

[2] Larger cities face greater challenges in getting their citizens to participate. In some sense, there is a need for decentralization *within* the cities to enable people's voices to be heard. Some cities, such as Balikpapan and Blitar allocate a certain percentage of their annual development budget to lower level sub-districts as block grants; these grants permit the views of neighborhoods to be reflected in public expenditures at the sub-district level.

disseminate information on decentralization-related legislative and regulatory issues to all local governments. In all of these, MOHA and other line Ministries will require considerable support in the coming months and years.

5.15 **Improving Regional Coordination.** Decentralization has created 30 provincial governments and 416 autonomous local governments to date, but without effective vertical and horizontal coordination among them. As urban areas expand beyond municipal administrative boundaries, effective metropolitan-wide management is crucial. Typically, local economic development, natural resources and environmental management and large-scale infrastructure investments will need strategic collaboration among local and provincial governments. In addition, provincial governments should provide much-needed regional coordination, acting as facilitators to promote collaboration rather than seeking to impose top-down views. To formulate effective operational strategies for regional collaboration, it will be important to analyze the regulatory, institutional and financial linkages between provincial governments and local governments in light of the actual regional demand for investments. Such an analysis should identify specific measures to support the development of a regional infrastructure within the local economy.

5.16 **Information & Communications Technology for Local Governance and Economic Development.** For a country of its size—three time zones and more than 13,000 islands—Indonesia has poorly developed information and communications technologies and networks (ICTs). For example, per-capita Internet use in Indonesia is among the lowest in the ASEAN region. By themselves, ICTs can be powerful facilitators of development. This factor alone justifies a strategic approach to build up their capacities. Furthermore, ongoing decentralization offers a powerful incentive to explore the use of ICTs to support effective communication between the center and its regions to monitor progress on decentralization, to scrutinize the performance of local governments and to promote inter-governmental coordination; and among the regions—to promote inter-regional coordination, to share information and to improve regional planning. Most important, ICTs can help local governments integrate planning with budgeting and implementation; they can help promote local economic development; make critical information accessible to citizens, and ultimately enhance transparency and improve administration by providing cost-effective solutions for capacity building, training and knowledge management. Despite obvious benefits, a comprehensive and strategic plan linking information technologies and communication systems' development with the strengthening of local governments and their economies is still missing. The development of such a plan and associated programs should be viewed as a national imperative by GOI and a regional priority by provincial and urban local governments.

Alleviating Urban Poverty

5.17 In the near- and medium-term, urbanization may increase the absolute numbers of urban poor in part because of the migration of the rural poor. Roughly 50 percent of the current urban population is either poor or vulnerable to poverty. The urban poor are marginalized and vulnerable with limited access to land, housing and basic services. They also suffer from great economic, financial, social and physical insecurity. Devolution has left local governments with greater responsibilities in the alleviation of poverty. However, local governments have limited understanding of the multi-dimensional nature of urban poverty, which makes it difficult for them to develop well-targeted poverty alleviation programs and to monitor their progress. Moreover, most of them have inadequate financial and institutional capacity to assume these additional responsibilities. Thus, most poverty alleviation programs are financed primarily by GOI and its donors; implementation is on a project basis. Sustainability is doubtful once projects and budget support end.

5.18 **Deepening Understanding of Urban Poverty.** Cities need reliable information and data on urban poverty—its multi-dimensional nature, numbers, locations, household composition, land and housing conditions, employment, education levels, access to urban services and social integration, etc. The numbers of urban poor vary greatly depending on statistics.[3] Such information is essential for local governments to design poverty alleviation programs that target the right population, reflect the real needs of the poor, set specific and measurable poverty reduction goals, and monitor progress in achieving them. Cities need support—institutional, financial and technical—to develop the required capacities for collecting information on the urban poor, analyzing the data and translating it into effective poverty alleviation strategies and programs. Such support, customized to the needs of individual cities, should come from the GOI, provincial governments, donors, NGOs and other civil society institutions. From the *kota* side, local governments should put in place the necessary institutional mechanisms to measure, analyze, and better understand urban poverty and the urban poor.

5.19 **Mainstreaming Poverty Reduction Efforts.** Thus far**,** most poverty alleviation activities have come out of the GOI budget that includes donors' grants and loans. For a successful reduction in poverty, cities will need to rely on a more systematic and homegrown approach, one that does not heavily depend on GOI's budgetary support or donor funding. Poverty alleviation activities should be mainstreamed within APBDs—the local governments' annual budgets. As a first step toward this goal, local governments should formulate city poverty reduction strategies (CPRS) as an integral part of their comprehensive and participatory City Development Strategies. Although cities are expected to play the primary role in reducing poverty, the cities have limited capacities and experience in these endeavors. As a result, continued GOI support for strategy formulation and implementation is critical for most cities, at least for the foreseeable future. While certain (targeted) central programs should continue, especially to address pockets of hardcore poverty, the design, implementation and management of these programs should progress to local governments. The central government will continue to have a vital role in the monitoring and evaluation of poverty reduction efforts nationwide.

5.20 **Addressing Poverty in Financially Non-Viable Cities.** In spite of fiscal equalization measures undertaken through DAU, regional disparities exist and are not expected to disappear in the near future. A demand-driven and competitive selection process means that reform-oriented cities with strong commitment and good management may get a larger share of resources. However, the needs of the urban poor living in financially non-viable cities or in non-reforming cities cannot be neglected. The poor should not be penalized for the weak fiscal position or poor governance of the cities in which they live. Nevertheless, financial terms and conditions and the modalities for channeling funds to non-viable cities or non-reforming cities should be different from those applied to reform-oriented and financially viable ones. Typically, this may require subsidies in the form of matching grants targeted to the poor, an approach which is in line with the GOI policy on special grants, such as the DAK. It is important to help the GOI define appropriate policies on DAK for promoting a national agenda on poverty alleviation.

5.21 **Empowering the Poor through Community-driven Development.** To effectively reach the poor, local officials will need to understand community priorities and become accountable to residents. Communities, in turn, will need to be organized, able to aggregate and prioritize their needs and articulate them to the government. Currently, the capacity for carrying out these tasks is weak at the local government and the community levels. Therefore, it is important to empower the poor by transferring resources directly to them, enabling them to determine their own priorities; in tandem with that, local governments need to build their own capacities to work with poor communities. To this end, community-driven development (CDD) should be promoted and strengthened by partnerships between local

[3] For instance, the incidence of urban poverty in Kupang is 7.6 percent, according to the Central Bureau of Statistics (BPS); it is 54 percent, according to the National Family Planning Coordinating Board (BKKBN). The BKKBN definition includes not only nutrition but also debated factors such as housing conditions, etc.

governments and communities (through their CBOs). NGOs have an important role in helping local governments and CBOs develop partnerships. As a part of the CDD approach, micro-financing schemes for income generation should be strongly supported. The design of such schemes should look worldwide for best practices in micro-financing credit as well as lay out clear graduation strategies.

5.22 **Supporting Land Administration Reform and Housing Sector Reforms.** Well-functioning land and housing markets are important to the poor. In general, land regulations are not disposed to the poor. Usually the poor hold only customary rights to land, leaving them with no official titles and no access to formal mortgage financing. GOI and the local governments need support to advance the titling efforts that began in 1995 as part of a major land administration reform project with support from the World Bank and AusAID. This project resulted in the issuance of more than 1.2 million titles. Improving housing conditions is a priority for poor households, second only to the education of their children. In parallel with urban land reforms, it is imperative to implement comprehensive housing sector reforms, aimed primarily at low-to-lower-middle income households. The latter account for around 70 percent of total households and live in informal settlements. In doing so, Indonesia can benefit from building on past gains, by adding tenure security and community mortgage programs to KIP and other successful programs to improve the living conditions of the urban poor.

5.23 Efficient use of urban land has the potential to transform urban areas into dynamic human and economic agglomerations, an element which is missing from Indonesian cities. Deficiencies in policy, institutional shortcomings, financing limitations and human capacities constrain urban land and housing markets. Clarifying institutional frameworks, modernizing the land registration system and reforming land tax policies are bound to be time consuming and politically inexpedient in the short run. To address these deficiencies, a national land policy and law should be developed, based on public discussions and consensus; special attention should be paid to customary tenure, land assembly and due process, and institutional arrangements. While this will require enormous investments of both time and political will, reviewing outdated regulations and strengthening district land offices can be a good starting point. Add to this a transparent and time-limited program for divesting excess government land into open markets. In doing so, GOI will embark upon an ambitious agenda to revitalize urban areas and assist the urban poor in Indonesia.

Promoting Local Economic Development (LED)

5.24 LED is an idea whose time has come; it is a means to make cities economically and financially sustainable and to help them reduce poverty. Moreover, cities are vital engines of economic growth with an impact on national economic growth. Nationally, Kimpraswil considers LED critical for sustainable urban development, but has not outlined guidelines or strategies to assist local governments. Although decentralization gives *kotas* the political impetus and the legal framework to promote local economic growth, most local governments lack comprehensive LED strategies or plans.

5.25 **Urban Revitalization through Efficient Land Management.** The weak financial position of *kotas*, especially their limited revenue streams and increasing expenditure demands, makes it difficult for them to generate sufficient resources for large-scale infrastructure investments or poverty alleviation programs. However, many *kotas* (and provincial governments) possess large amounts of idle urban land, often in prime locations. Using the regulatory authority vested in them—master plans, zoning and development permits and so forth—*kotas* can stimulate their local economies by effectively utilizing the urban land in their domains through innovative land management programs. They could, for instance, develop idle land in partnership with the private sector and with the active participation of communities. As they seek to bolster their resources and expand their economic potential, *kotas* need to explore such latent opportunities.

5.26 **Developing Comprehensive LED Strategies.** Because LED is still an emerging issue for most cities, it is critical to fill in the current knowledge gaps on how local governments are responding to economic and business demands since decentralization, and how they could respond to such demands in future. Such knowledge would help policies, strategies and actions that help reduce corruption, rent seeking and other deleterious practices that hinder local businesses; provide better producer–market linkages; and enable LED-friendly government-business interface.

Developing a Sustainable Urban Financing Mechanism

5.27 Despite an increased demand for urban infrastructure investments and poverty alleviation programs, Indonesia has yet to develop sustainable urban finance mechanisms, a process that will require reforms at both central and local levels. Among the key issues at the central level are the need to establish clear and transparent policies for inter-governmental fiscal transfer, local taxation and local borrowing; and institutional structures for city performance rating, local government lending, and capital markets development. *Kotas* lack the necessary resources to finance all their spending needs; they also need to bolster their own-revenues; improve transparency, accountability and efficiency of their public expenditures; and strengthen budgeting, accounting, procurement and auditing processes.

5.28 **Policies for Fiscal Transfers and Local Taxation.** At the central level, GOI should urgently establish transparent policies for fiscal transfers and local taxation. More specifically, DAU needs to be refined to reduce regional disparities and to match expenditures of local governments with revenue capacity. GOI needs to monitor and review the actual implementation of current DAU transfers in order to refine its allocation criteria. Improvement of DAU should be complemented with clear policies on special grant mechanisms, especially DAK, as a means of supporting national priority areas—for example capacity building, poverty alleviation or environmental management. Technical assistance, currently being provided to GOI, to formulate relevant policies and undertake required reforms, is expected to bear fruit in the coming months and years. Furthermore, GOI needs to review and reform Law 34/2001 and other regulations pertaining to local taxation. Specifically, it needs to consider adding a significant local tax to strengthen the *Kota* tax base, grant local governments greater autonomy in rate setting, and monitor more closely "nuisance" taxes and other local taxes that contravene national regulations. With regard to property taxes, it will be worthwhile to provide local governments progressively greater autonomy in rate setting within certain centrally specified limits and for the central government to continue to administer these taxes.

5.29 **Developing Policies and Institutional Mechanisms for Local Borrowing.** It is imperative that the cities generate greater resources for themselves. This will come through local taxation, borrowing, cost recovery and public-private partnerships. Local borrowing and grant mechanisms fall under GOI's regional fiscal policy; it also affects the implementation of donor-funded projects in all sector operations by local governments. At the national level, the GOI needs to formulate clear policies in support of cities. That includes reviewing Law 25/1999 and Regulations 107/1999 and 109/2000 for local government borrowing and developing appropriate institutional mechanisms for assisting local governments. At present, GOI intends to do so by improving the existing on-lending mechanisms—SLA—rather than by developing a new arms-length institution to manage this. The GOI should also ensure that the entity assigned to manage the loan and grant funds is professional and insulated from political interference. Given the weak financial position of most local governments, the central government will need to maintain its direct budgetary channel, while simultaneously developing a financial intermediary with access to the financial markets over the long term.

5.30 **Supporting Local Government Fiscal Reforms.** Developing a sustainable urban finance mechanism depends greatly on the financial health of local governments. To reduce their reliance on central fiscal transfers, local governments should expedite efforts to increase their financial capacities by

expanding their tax bases, improving tax collection and user charges, rationalizing expenditures, promoting public-private partnerships in the provision of urban services and utilizing urban land as an important resource. Some positive steps include: expanding local tax bases through GOI's fiscal reform—property taxes being a promising area for such action; streamlining municipal administration; restructuring financially distressed PDAMs and other municipal service entities; improving cost recovery for services, such as water supply and solid waste management; and promoting local economic development through public-private partnerships in land development. Concurrently, it is important to keep in check the creation of fiscally non-viable local governments and to consider merging fiscally non-viable local governments with stronger ones for the purposes of aggregate fiscal capacity.

Improving the Provision of Urban Services

5.31 Most Indonesian cities face tremendous backlogs on the provision of urban services, often to the extent of affecting economic development, environmental health and the country's social well being. The *Krismon* halted many investments in major urban services. Given the financial constraints facing the central and local governments, it is unlikely to expect an expansion of coverage in the near term. In addition, the efficiency, quality and reliability of existing services; the management of current infrastructure assets; and the recovery of costs for services provided, leave much to be desired. With devolution, local government has become directly responsible for service provision, without having the requisite institutional and technical capacity to undertake these new responsibilities.

Key Elements of the Proposed Approach

5.32 **Improving Asset Management.** The following should take precedence before new investments are considered: system improvements to optimize the utilization of existing assets, increase the efficiency and quality of services, and enhance their demand-responsiveness. This is particularly relevant for utility agencies like the PDAMs, which often face problems of over-designed capacity combined with large-scale unaccounted-for-water (UFW). Further, new capital investment programs should fully consider the impact of capacity expansions on future operation and maintenance (O&M) budgets. This issue should be addressed as part of municipal financial reform agenda, as well.

5.33 **Promoting Public-Private Partnerships.** Given that cities are unable to finance all of their required infrastructure investments on their own, they will need to mobilize substantial resources from the private sector. This requires creating an institutional and regulatory environment that attracts sustainable private investment in infrastructure, reforming laws and regulations; introducing cost-reflective pricing; and putting in place transparent procedures and processes in disinvestments and/or privatization. Such reforms also contribute to improving public sector accountability and delivery of better public services for the poor. For example, adopting transparent competition among private suppliers of public services will help address one of the most visible aspects of corruption. Increased competition should help improve quality and efficiency and lower prices in areas dominated by inefficientpublic sector entities. Likewise, the introduction of negative concessions, supported by output-based aid, will help improve access to public services at the lowest cost. In general, efficient private participation should relieve the fiscal burden on local governments and free up public resources for priority programs.

5.34 **Sector Reforms and Investments in Water, Sanitation and Environmental Management**. Given the complex policy issues and substantial externality involved, the water, sewerage and urban environment sectors require long-term and strategic support, typically in the form of Adaptable Lending Programs. Investment loans in these programs are in exchange with the phased adoption of certain sector policy and institutional reforms and tied to time-bound triggers.

Outlook: Cautious Optimism

5.35 Indonesia's decentralization is well underway but very far from complete. Its future will depend partly on the country's macro-economic and fiscal stability and partly on the energy and resourcefulness of local authorities. The latter are trying to cope with a flood of demands that threaten to overwhelm them. Any threat to macro-economic stability would seriously affect local governments' revenues, obliging them to reduce development spending. That will have the greatest consequences for the urban poor.

5.36 At the city level, local bureaucrats need to shift from their old ways and adopt bottom-up participatory approaches involving multiple stakeholders. Lack of experience by DPRD members and civil society, the human checks and balances in the democratic system add to the challenge. Additional risks arise from weak institutional capacities and an absence of mature control systems to check corruption and rent seeking at the local level. Finally, cities may not be able to generate adequate resources for financing required investments. If these risks materialize and the cities cannot respond quickly to the express demands of their citizens, the momentum for democracy and participation in civil society may fade away.

5.37 These risks, though, need not become a reality. The Urban Sector Review team observed that cities, on their own, have already taken steps to meet their new roles and emerging responsibilities in different ways. Although decentralization and democratization are relatively new concepts in Indonesia, there is a growing awareness of democratic governance and a greater intolerance of corruption. In a climate of distrust for old-style public administration, prevalent in many sectors of Indonesian society, decentralization laws have accelerated changes in the political landscape. Although confusion and uncertainty abound, the current movement toward the establishment of democratic and autonomous city governance appears irreversible. Part of the World Bank's mission will be to work together with the central government and the regions as well as their stakeholders to insure that measures in addressing urban challenges analyzed in the Urban Sector Review translate into progress in enhancing local governance, improving urban services, strengthening the local economy and reducing urban poverty.

Annex 1

SELECTED SOCIAL INDICATORS

Indicator	Latest Period	Previous Period	Indicator	Latest Period	Previous Period
Poverty Rate (%)	Feb-99	Feb-96	**Literacy Rate (%)**	1999	1998
National	27.1	15.7	National	88.4	87.9
Urban	16.3	7.2	Urban	94.0	94.8
Rural	34.1	20.5	Rural	84.5	83.9
Inequality (Gini Coefficient)	Feb-99	Feb-96	**School Dropout (%)**	1999	1998
National	0.32	0.36	Primary School	1.4	1.6
Urban	0.33	0.37	Junior High School	2.2	2.6
Rural	0.25	0.28	Senior High School	2.6	2.9
Mortality Rate	1999	1996	**Health Facilities**	1998	1996
Infant Mortality Rate	46.0	56.0	Community Health Centers:		
Child Mortality Rate (< 5 yr old)	65.5	70.4	Total number	36,307	35,425
			Per 100,000 population	17.8	17.8
Nutritional status: children < 5	Dec-98	Feb-95	**Hospitals**		
Good (%)	61.1	63.9	Total number	1,112	1,074
Medium (%)	21.2	23.0	Number of beds	123,168	120,038
Bad (%)	16.6	13.1	Beds per 10,000 populations	60.3	60.5
			Medical doctor per 100,000	11.0	10.7
School Enrollment (%)	1999	1998			
7-12 yrs old:			**Labor Force Participation**	1999	1998
National	95.3	95.2	National	67.2	66.9
Urban	97.5	97.6	Urban	61.2	59.6
Rural	94.2	94.1	Rural	71.6	71.9
13-15 yrs old:					
National	79.0	77.2	**Hourly Real Wages (1998 Rp)**	1999	1998
Urban	88.0	88.6	Agriculture	1,157	1,210
Rural	73.6	70.6	Mining	2,910	3,483
16-18 yrs old:			Manufacturing	1,514	1,370
National	51.1	49.3	Utilities	3,057	2,577
Urban	68.8	67.7	Construction	1,627	1,433
Rural	38.0	36.2	Trade	1,595	1,449
			Transportation	1,947	1,758
			Finance	3,407	2,939
			Services	2,522	2,033

Source: World Bank. SIMA tables

Annex 2

CENTRALIZATION TO DECONCENTRATION: PRE-DECENTRALIZATION INSTITUTIONAL FRAMEWORK GOVERNING URBAN AFFAIRS

1. Prior to decentralization, five ministries were involved at the national level in urban affairs: (a) the Ministry of Public Works (MOPW), mainly through its Directorate-General (DG) of Human Settlements (*Cipta Karya*); (b) the Ministry of Home Affairs (MOHA), through its DG of General Governance and Regional Autonomy (PUOD), and its DG of Local Development (BANGDA); (c) the Ministry of Finance (MOF), through the Center/Board for Analysis of National Finances (BAKN) which has a division dealing with local government finance, the DG of Financial Institutions, which supervises the national savings/housing bank (BTN), the Regional Development Account (RDA) which is the major window for local government borrowing, the DG of Taxation which has a division dealing with property tax (PBB), and the DG of Budget; (d) the national development planning board (*Bappenas*) which had a department for regional development, within which there was a division dealing with urban and housing issues; and (e) land and housing issues were dealt by the National Land Administration Agency (BPN) and the National Urban Development Corporation (*Perumnas*) respectively, under the State Ministry for Housing (Suselo and Sundungdolok, 2000 and ADB, 2000).

2. Coordination among various ministries and agencies was handled mostly by specific task forces set up for that purpose. Thus, there was the Institute for Urban Policy Analysis (IUPA), formed in the MOF for coordination, succeeded by the Coordination Team for Urban Development (TKPP). The latter coordinated overall urban policy issues and major urban programs, including donor-supported ones; and a National Spatial Coordination Board (BKTRN) for coordination of spatial issues.

3. At the provincial level, the arrangements largely mirrored those at the national level. The provinces had their own planning agency (*Bappedas*) and autonomous 'decentralized' departments (*dinas*) at the provincial level for delivering various services. Additionally, the central government ministries and agencies maintained 'deconcentrated" provincial offices (*kanwils*). At the local level, *kotas* and *kabupatens* had their own *dinas*, along with some deconcentrated central government offices at the local level (*kandeps*).

4. The intent to decentralize service provision to the district level was evident from the UU No. 5/1974 on Local Government Administration. Yet, the provision of urban services was undertaken by central ministries such as the MOPW, that planned and implemented urban infrastructure facilities through DIPs and transferred these facilities, on their completion, to respective local governments for operation and maintenance. Many such projects were neither based on local priorities, nor matched the technical or financial capacities of local governments to own and operate the services. Following this, the PP No. 14/1987 dictated the transfer of most urban services: water, waste water, solid waste, urban roads, market infrastructure and KIP, previously under the MOPW, to the district level. However, due to the weak institutional capacity of most local governments, central ministries continued to play important but diminishing roles.

5. With the introduction of the Integrated Urban Infrastructure Development Program (IUIDP) as the primary vehicle for financing of urban infrastructure, there were greater efforts to build capacities of local governments. During this period, APBN funds were increasingly moved from DIPs to fund local governments directly through INPRES mechanisms. New service delivery mechanisms were introduced to complement the *dinas* at the local level. These included technical

implementation units (*unit pelakasa teknis daerah* or UPTD), self-financed service units (unit *swadana*), operational management units (*badan pengola* or BP) and municipal-owned enterprises (*badan usaha milik daerah* or BUMD), to introduce greater operational autonomy and financial sustainability. However, in practice, local governments were compelled to adopt certain organizational structures, such as in the establishment of local government-owned autonomous water enterprises (PDAMs) and to seek and also seek the approval of higher levels of government for organizational restructuring. These constraints limited their operational and financial autonomy.

Annex 3

LOCAL GOVERNMENT FINANCING: PRE-DECENTRALIZATION PERIOD

1. The finances of local governments in Indonesia, in the period prior to fiscal decentralization, was dominated by transfers from higher levels of government-general subsidies, specific grants and tax sharing from central and provincial governments. Local governments were characterized by low per-capita budgets, weak local resource mobilization, poor cost recovery on services, limited access to and use of market loans for capital investments.

Table A. 3.1: Revenues and Expenditures of Local Governments in Indonesia

Items	**Percentage Of Total Revenue** (percentage breakdown of actual)	
	1997/1998	**1998/1999**
Revenue		
Previous year's surplus	3.0 %	2.8 %
Local Government's own revenue	13.0 %	11.0 %
Shared tax receipts	15.1 %	13.1 %
SDO Subsidies and INPRES Grants	68.0 %	71.9 %
Development Revenue	0.9 %	1.0 %
	Percentage Of Total Expenditure	
Expenditures		
Current expenditures	56.0 %	68.0 %
Development Expenditures	44.0 %	32.0 %
Source: BPS. Financial Statistics of Second Level Government 1997/98, 1998/99; ADB, 2001.		

Summary expenditure classifications for local governments were under two headings: current expenditures, mainly salaries and other recurrent expenditures and development expenditures for new projects.

2. The UU No. 5/1974 titled, "Elucidation of Basic Principles of Administration in Regions," provides the legal framework for regional autonomy and administration. The law stipulated 19 local government functions, including public health, local public works, housing traffic management/transportation, tourism and local enterprises. Yet, regulations to implement this legislation were slow to come. For much of the 1990s, central government involvement in local functions was pervasive (World Bank, 1994: p. 18-20; Devas, 1989 etc.). For example, in the provision of urban water supply, central government assumed responsibilities for the planning and construction of the required infrastructure facilities while local governments were entrusted with their operation and maintenance through their water utility companies - PDAMs. The structure of expenditure assignment meant that decision-making was highly centralized. Even purely local functions were sometimes assigned to the Center; accountability of the public sector was highly impaired. Efficiency and equity in the provision of services were not ensured. Private sector investments were crowded out.

3. Major local government revenue sources in this period were: central transfers; provincial transfers; local own-revenues; project support, including donor support; and carry-overs. Of these,

central transfers of various kinds constituted the largest portion by far, totaling around 70 percent of all local government revenues. The central government's unitary system limited local taxes and local taxation with revenues of the Center constituting almost 90 percent of all revenues. Most productive direct and indirect taxes were assigned to the Center, with not even supplementary (piggyback) taxes levied by local governments on the tax bases administered by the Center. Personal and corporate income taxes, major indirect taxes - the VAT, excises and duties on foreign trade, property tax, natural resource royalties for petroleum, mining and forests were centrally administered. These property taxes and royalties from natural resources were shared with local governments. While sub-national governments could levy a multiplicity of taxes, most of them were insignificant and unproductive. At the district level, about 85 percent of their own-revenues came from six taxes: hotels and restaurants; street lights; entertainment; advertisement; business registration, and slaughterhouse. The high degree of tax centralization was one major reason for the inability of local governments to self-finance a sizeable share of their spending. Besides, separation of taxing and spending responsibilities at the local level also led to problems of accountability and efficiency.

4. Although user charges constituted a notable proportion of local government's own-revenues, roughly 52 percent at the district level in 1991-92, utilization of these charges remained well below potential. At the district level, fees and charges covered less than 10 percent of the outlay on public services. Heavy dependence on central government transfers created weak incentives for local level cost recovery. Most public services charged less than the cost of providing the services. For example, whereas the average tariff for all PDAMs was estimated at Rp. 277 per cubic meter, the average tariff to cover costs was estimated at around Rp. 460 per cubic meter (World Bank, 1993). Many of the public services were characterized by heavy subsidies intended to benefit the poor, but poorly targeted. Additionally, the requirement to seek approval of higher levels of government for tariff adjustments acted as a major disincentive for timely tariff revisions.

Table A. 3.2: Average Revenue Distribution Across Selected Municipalities

Local government	**Year**	**Central/total revenue** (% of total)	**Primary local revenue source**	**User fees** (% of total)	**Property tax** (% of total)
Large municipalities	1994/95	52.9	PADL	14.8	12.7
	1990/91	52.6	PADL	15.2	9.7
Medium municipalities	1994/95	64.5	PADL	8.5	9.9
	1990/91	57.4	PADL	10.8	9.0
Small municipalities	1994/95	72.5	PBB	3.7	11.5
	1990/91	77.8	PADL	4.0	3.8
Source: Silver, Azis and Schroeder, 2001.					

5. From 1970 to 1998, central government transfers to local governments consisted of two kinds of grants: block grants for general purpose local spending subject to general central guidelines; and specific grants for uses specified by the Center and subject to detailed central guidelines and controls. The former included several types of INPRES block transfers, while the latter included SDOs--a transfer that covered virtually all local government personnel expenditures and INPRES sectoral transfers for specific development expenditures. Over the years, consistent with a policy of gradual decentralization, the share of block grants in total transfers increased (from 16 percent in 1986-87 to 20 percent in 1993-94). The specific purpose grants financed a very significant share of local government expenditures under various categories. For example, in 1990-91, the SDO grants financed around 92 percent of total operating expenditures of local governments, while the primary school grants financed around 90 percent of expenditures for primary education. These grants and

other revenue sharing mechanisms were used by the central government with the intent of resolving disparities between increasingly decentralized service responsibilities and low levels of local resource mobilization.

6. While the economic rationale for the particular intergovernmental transfer system included aspects of inter-jurisdictional spillovers (correcting inefficiencies), fiscal gap (vertical & horizontal fiscal imbalances) and maintaining minimum service standards, this often created conditions for perverse incentives. Typically, this system encouraged local governments to raise their local wage bill for a greater share of SDO allocations, which, in turn, led the central government to retain control over local government hiring. Silver and others have noted there was contradiction between the increasing level of block grants and the continuing pressure to use more and more targeted transfers for national development objectives (Silver, Azis and Schroeder, 2001). The result was less local discretion at the municipal level.

7. Loan finance played only a small part of the financing development expenditures of local governments. Local government borrowing capacities were generally quite weak and incentives to borrow were limited. Most of the borrowings were from the central government, including the on-lending of donor loans, much of it to finance water supply (60 percent), markets (15 percent), drainage, solid waste and sewerage projects. Market borrowings through loans or bonds were negligible. This, in part, reflected the poor state of local revenues and financial management capacities of the governments. Some improvement to the inter-governmental borrowing framework was made with the establishment of the Regional Development Account (RDA) in 1988, a revolving fund which consolidated into one channel a number of disparate central loan schemes, subject to uniform terms and rules of access. However, RDA's implementation was disappointing.

8. Attendant to the issues of a distorted inter-governmental fiscal system were the weak capacities of local governments in matters of municipal financial management: planning, budgeting, accounting, monitoring and auditing. The absence of a local level financial management system, limited public participation in the planning and budgeting process, inconsistencies between revenue and expenditure assignments, lack of proper accounting and bookkeeping systems, deficient monitoring, inspection and auditing, and poor capacities of local government staff doused all hopes for a sustainable system of local government financing in the pre-decentralization era.

Annex 4

REVENUE SHARING UNDER FISCAL BALANCE LAW

1. The main points of Law 25/99 (based on the English translations of Draft Law 25/99, its Clarification, Government Regulation No.104/2000 of Nov.10,2000 on Equilibrium Funds, posted at the GTZ's web-site).

2. APBD and APBN: Law 25/99 first defines two budget sources, APBD for the Regions' tasks to be undertaken by the Regions and APBN for the Central Government's tasks to be undertaken by the province or by the regencies/municipals or villages. (Article 2)

3. Sources of Regional Revenues: Law 25/99 defines four sources of regional revenues. They are: (a) Original Regional Revenues; (b) Balance Funds; (c) Regional Loans; and (d) Other Legal Revenues. The definitions and allocations of these revenues are defined as follows (Articles 3 –15):

(a) **Original Regional Revenues** are revenues obtained by the Regions from sources in their own areas that are levied according to the Regional Regulations in accordance with the prevailing legislative regulations). The Original Regional Revenues consists of (Articles 4 and 5):

(i) Result of Regional taxes (to be further regulated by law).

(ii) Result of Regional redistributions (to be further defined by law, by amendment of law 18 Year 1997 regarding Regional Taxes and Regional Redistribution).

(iii) Result of Regional-owned enterprises and processing results of other Regional wealth, set aside (to be regulated by the prevailing legislation); and

(iv) Other legal original Regional revenues (Other legitimate revenues, among others, grants, Emergency Funds, and other revenues that are in accordance with the prevailing legislative regulations.)

(b) Balance Funds consist of (i) Regional Shares; (ii) General Allocation Fund (GAF); and (iii) Special Allocation Fund (SAF). They are defined as follows (Articles 6-10):

(i) Regional Shares from the revenues of (Article 6):

(a) land & property tax (10% for the Central Government, the distribution of which to regencies/municipals will be decided by a decree of MOF; and 90% for the Regions-16.2% province, 64.8% for regencies/municipals, 9% for cost of collection transferred to the state and regional cash);

(b) tax on acquisition of land & building rights (20% for the Central Government which will be distributed in the same portion to

regencies/municipals throughout Indonesia and 80% for the Regions-16% province and 64% for regencies/municipals); and

(c) forestry, public mining and fishery: 20% for the Central Government and 80% for Regions to be distributed as follows:

Forestry - distribution of 80% for Regions: (i) 80% of the Contributions of Rights on Forestry concession revenues (16% for Province and 64% for Regency/Municipal); (ii) 80% of the Commissions on Forestry royalties/commission revenues (16% for the Province, 32% producing Regency/Municipal, and 32% for other Regencies/Municipals in the Province).

Mining - distribution of 80% for the Regions: (i) 80% of the permanent contributions (Land Rent) revenues (16% for the Province and 64% for the producing Regencies/Municipals); (ii) 80% of the exploration and exploitation (Royalties) revenues (16% for the Province, 32% for the producing Regencies/Municipals, and 32% for other regencies/municipals in the province).

Fishery - distribution of 80% for the Regions: 80% of the Fishery Business Retributions and the Fisheries Business Retributions shall be divided evenly among all of the Regencies / Municipals in Indonesia.

Oil mining: 85% for the Central Government and 15% for Regions (3% for the Province, 6% for the Producing Regency/Municipal, 6% for other Regencies/Municipals in the Province), on a net tax basis.

Natural gas: 70% for the Central Government and 30% for the Regions (6% for the Province, 12% for the Producing Regency/Municipals, 12% for other Regencies/Municipals in the Province), on a net tax basis.

(ii) General Allocation Funds (GAF) (Article 6): GAF should be at least 25% of domestic revenues, of which 10% is for province and 90% is for Regencies/Municipals (proportion to be adjusted subject to change by any authority between Province and Regency/Municipal). Allocation for each province, Regency/Municipal will be calculated according to the formula, considering inhabitants, surface area, geographical conditions, level of income, particularly low the income population.

(iii) Special Allocation Funds (SAF) (Article 8): Special Allocation Funds (SAF) can be allocated from the State Budget to the certain region to assist special needs (the unpredicted needs using the public allocation formula; and/or. the committed needs or the national priority needs, depending on the available budget from the state budget. The Special Allocation Funds also include reforestation fund (40% for the producer area as the Special Allocation Funds and 60% is for the Central Government). With the exception of Reforestation, the region that receives the special fund, referred to in para. (2) is provided an additional fund from the Regional Budget which is appropriate to the region's potential.

(c) **Regional Loans** (Articles 11-15): Law 25/99 allows the Regions to borrow domestically (from the Central Government, commercial institutions, the capital market by issuing bonds) and externally through the Central Government. Draft regulations allow for short-term (less than 1 year) borrowing for cash flow management purposes and long-term borrowing to finance capital expenditures) provided that the tenures are not longer than the economic life of such infrastructure (Articles 11).

The Regional loans require approval of DPRD (Regional People's Consultative Council) In its decision, DPRD should consider the ability of the Regions to fulfill their. Each loan agreement shall be announced in the Regional Gazette. (Article 12).

Regions are not allowed to borrow exceeding the limit of Regional Loans (the definition to be provided by regulation). Regions are not allowed to provide guarantees. Violation of these provisions will be sanctioned according to the prevailing legislation (Article 13).

Debt service constitutes one of the priorities in the expenditures of APBD. In the event the Regions default, the Central Government may offset said obligation with the Central Allocation Funding to the Regions. (Article 14).

Although draft regulations provide the borrowing eligibility criteria, there is ambiguity regarding the borrowing limit in terms of a macro-economic ceiling, and borrowing of local enterprises and on-lending terms of the loan from Central Government to the local governments. There is a risk that the Regions expect the Central Government's bail out as (i) repayment of debt is only one of the high priorities; and (ii) the Government's intercept is not automatic in the case of default. The Ministry of Finance has not yet decided on the terms and conditions for on-lending of external loans. Regarding foreign loans from aid agencies, the MOF has decided that GOI will provide the proceeds of external loans as a grant to local governments in FY2001.

(d) Other Legal Revenues are other legitimate revenues, among others, grants, Emergency Funds, and other revenues that are in accordance with the prevailing legislative regulations.

(e) Emergency Funds, a part of APBN, will provide grants to the Regions (Article 16).

Annex 5

URBAN LAND AND HOUSING CHARACTERISTICS

Reliable numbers on the share of households with titles is disputable. BPS statistics indicate that a large share of households possess land titles. However, HOMI surveys, while limited to a small number of cities and to a modest number of households, especially lower-income households, suggest a different picture. First, the proportion of population with titles varies dramatically from city to city, from 90 percent in Denpasar to 15.4 percent in Mataram. In general, around 30 to 40 percent of households surveyed had some type of title.

Table A. 5.1: Percentage of households by land title (1998)

	Property right	Right to build	Right to use	Other & unknown	Total
Urban	83.4	7.0	3.9	5.8	100
Rural	88.1	1.2	4.7	6.0	100
Total	86.6	3.1	4.4	5.9	100
Source: Noudehou, Alain. A housing micro-finance program for Indonesia. (2001)					

Table A. 5.2: Households by Tenure Status (percentage; 1998)

Urban/rural	Own	Rent/lease	Official	Other	Total
Urban	71.0	22.9	3.5	2.7	100
Rural	91.2	5.2	1.6	2.0	100
National	83.7	11.8	2.3	2.3	100

Table A. 5.3: Households by method of purchase (percentage; 1998)

Urban/rural	Developer	Self-build	Purchase from individual	Purchase second-hand	Other	Total
Urban	5.8	73.3	1.9	7.7	11.3	100
Rural	0.9	83.5	0.7	3.4	11.5	100
National	2.49	80.2	1.1	4.8	11.4	100
Source: BPS data cited in HOMI study (World Bank, 2001)						

Table A. 5.4: Distribution of urban housing needs across income groups (2001)

Monthly income levels	Urban population share (%)	New housing needs (nos.)	Replacement/rehabilitation needs (nos.)
Below Rp. 391,200	10	73,500	42,500
Rp. 391,200-664,300	20	147,000	85,000
Rp. 664,300-948,700	20	147,000	85,000
Rp. 948,700-1,455,800	20	147,000	85,000
Rp. 1,455,800-2,777,200	20	147,000	85,000
Above Rp. 2,777,200	10	73,500	85,000
Total	**100**	**735,000**	**425,000**
Source: Noudehou, Alain. A housing micro-finance program for Indonesia (2001).			

Annex 6

REVIEW OF LOCAL ECONOMIC DEVELOPMENT IN INDONESIA

Introduction

1. Local economic development is a strategic response by local actors to economic demands and the concomitant needs of businesses. LED advocates the creation of a demand-driven economic strategy by local actors, including businesses, communities and local government; the concomitant formulation of programs to achieve such aims; institutional restructuring or creation; and financial investment by the private sector or budgetary reallocation by the public sector. An evaluation of local economic development must assess the responsiveness of the economic strategy, projects, programs, institutions and investment to economic demands, business needs and city competitive and comparative advantages and the concomitant impact that this has on economic outcomes, such as economic growth, employment and reduction in poverty.

2. This paper is less ambitious, due to the relative youth of the LED practices in Indonesia. Several central ministries are beginning to prioritize local economic development as a function of local government. However, no national support mechanisms are in place and strategic LED practice by local government is almost non-existent. Secondary information on LED, its practice (including methods, inputs and approaches) and its impact on outcomes, such as employment and economic growth, is scarce. A detailed analysis of LED was beyond the scope of this Urban Sector Review.

3. Instead, this paper provides an introduction to an approach and particular issues of importance in developing LED in Indonesia[1]. It begins by examining the general economic performance of Indonesian cities to ascertain if LED is an appropriate response. It continues by analyzing national incentives for city engagement in LED on the assumption that a national regulatory framework for LED is key to the practice of LED in cities. Finally, it evaluates city LED practices. It does so by examining the institutional and budgetary opportunities for practicing LED, the extent to which LED strategies are included in the mandated strategic planning processes, such as the Propeda's, and programs and projects that support economic activities.

Summary of Findings

4. Indonesians cities require LED. They are key contributors to national GDP and employment. However, since the crisis of 1997, they have experienced a declining growth rate and increasing unemployment. National and local institutional incentives also support a climate for LED. Decentralization advocates some legal responsibility to local areas to address economic issues. The PROPEDA process allows for strategic LED planning. Local level institutional and budgetary support is also available for LED.

5. However, these institutional mechanisms do not translate into traditional local economic development. Most local governments fail to use the planning processes to formulate LED

[1] The Urban Competitiveness Study currently underway will provide a more in-depth understanding of the practice of LED in Indonesia.

strategies. LED application is ad hoc. Although institutions, programs and budgetary mechanisms for economic development do exist, they are often unresponsive to economic and business needs. Thus, there is a disconnect between the supply of services and business's demands. Although businesses emphasize corruption, predatory taxation, and poor infrastructure as key constraints, most local government programs fail to address these issues. Finally, there is no strategic link between the local economy, the regional economy, the national economy and the international economy.

Indonesia's Cities in the National Economic Context

6. Indonesian cities contribute about 70 percent to non-oil GDP. The trend in city growth rates mimics that of national growth. For example, among the *Cities Speak* case studies, all cities experienced growth rates until 1998 and the onset of the crisis (apart from Kendari where growth was positive in 1998 but negative in 1999). However, all cities (except Bandung) grew at a rate faster than the national growth rates between 1996 and 2000. Indonesia's economic future is tied to the economic development of its urban areas.

Table A. 6.1: Economic Growth Rates

Year	National	Kupang	Blitar	Kendari	Balikpapan	Palembang	Bandung
1996	8.1	11.0	5.5	n.a.	13.1	-	9.3
1997	1.74	5.2	3.2	14.49	2.4	5.4	4.5
1998	-13.61	-5.7	-3.8	12.95	-0.6	-11.5	-19.7
1999	3.4	6.8	0.7	-8.62	0.2	4.6	2.8
2000	5.3		3.3	3.02	4.4		n.a.
Growth	-0.37	17.3	8.9	21.84	19.5	1.5	-3.1

National Institutional Incentives for Local Economic Development

7. Indonesia's decentralization has created opportunities for local governments to determine their futures. Before decentralization, local governments role in the local economy was minimal. This changed with the introduction of Law 22/1999. Industry and trade are among the 11 obligatory functions transferred to local governments.[2] Law 25/2000 on the National Development Program (*Program Pembanguan Nasional/Propenas*)[3] gives further direction to economic development. Guidelines relevant to economic development include:

[2] Article 11 of Law22/99 states 'Governance field that must be performed by Regency Regions and Municipal Regions shall include public works, health, education and culture, agriculture, communication, industry and trade, capital investment, environment, land, co-operative and manpower affairs.'

[3] URDI. 2002. Urban Sector Review, Annex3: Review of National Urban Policy. P3-4.

- to increase private sector investment in contributing to urban development (processes);
- to increase small and medium size enterprises; and
- to increase the network system and infrastructure services and connecting facilities between collection and distribution points.

National direction on local economic policy is present.

The Institutional and Budgetary Space for Local Economic Development

8. The practice of local economic development requires institutions to implement economic programs and activities. It also requires budgetary allocations to support such programs. Most Indonesian local governments do have both the institutional and budgetary[4] space for practicing local economic development. However, this is currently unfocused as strategic economic development planning is absent.

Institutions for Economic Development

9. Local governments have line departments, and thus, concomitant routine expenditures to fulfill transferred economic functions. The institutional structure and the types of line departments vary, depending on economic structure. Most common agencies are a labor agency (4/6 kotas), a tourism agency (5/6 kotas), an industrial and trade agency (6/6 kotas), and a market agency (6/6 kotas). However, the functions of these *dinas* remain unclear. It is thus difficult to assess the relevance of the institutional structure or its program to the economic and business needs of cities.

Development Expenditures for Local Economic Development

10. City development expenditure budgets reflect economic development allocations[5]. The six cities in the case study spend about 8 percent of their development budgets on visibly-economic sectors, including industry, agriculture and forestry, trade and local business development, mining and energy, tourism and local communication. This varies from city to city. Some cities also have a specific line item for economic development (e.g. Bandung is Rp 6.6 billion). However, it is unclear as to exactly how this is spent[6]. It is also unclear if this spending is the most effective use of resources for promoting LED.

---

[4] Indonesian local government budgets are reported as 'routine' expenditures which are similar to 'operating' expenditures; 'development' expenditures are similar to capital expenditures.

[5] Interestingly, Indonesia's local government development expenditures are reported in categories that include economic sectors. Other categories, apart from those listed in Table 2.2 include education, population, welfare, local development and settlement, environment, population and family planning, health and social welfare, religion, science and technology, law, government apparatus, politics, information and communication, security, and transportation.

[6] In several other cities, economic development expenditures may include infrastructure if that infrastructure traverses an economic area, such as a downtown or an industrial zone.

Table A. 6.2: Sectoral Development Expenditures as a Percentage of Total Expenditures

Sector	Average 6 Cities	Pelembang	Bandung	Blitar	Balik papan	Kendari	Kupang
Industry	0.27	0.2	0.47	0.34	0.2	0.21	0.2
Agriculture and Forestry	1.65	2.77	2.12	1.53	1.26	1.15	1.03
Water Resources and Irrigation	0.68	0	3.68	0.19	0	0.14	0.09
Labor Force	0.19	0.43	0.27	0.14	0.29	0	0
Trade, Local Business Dev	5.01	5.08	4.23	3.22	4.86	1.93	10.71
Mining and Energy	0.75	1.06	0	1.12	0	0.85	1.46
Tourism and Local Telecom	0.45	0.12	0.37	1.61	0.2	0.19	0.24
TOTAL	**9**	**9.66**	**11.14**	**8.15**	**6.81**	**4.47**	**13.73**

Thus, the basis for the practice of effective LED is present. However, in practice this has not occurred. There is a lack of follow through in strategy, programs and responding to business and economic needs.

Assessing Economic Structure, Strategic Direction and Projects

Strategic Direction

11. Indonesia does not lack planning. Planning processes are mandated for the *Propeda*[7], *Regional Renstra*[8], *Repetada*[9]. The *Propeda*, which is the five-year strategic plan, provides the best opportunity for Strategic LED Planning. Most cities have not capitalized on the opportunity provided by the PROPEDA to institute strategic economic development. For example, four out of the six *Cities Speak* cities have implemented economic development in an ad-hoc manner as part of a broader strategic planning process. This economic development strategy varies from broad statements of public private sector partnership to specific objectives, such as becoming more investor friendly (see Table 6.3).

[7] Development policies to suit local needs and capacities, in compliance with national law, incl. *Propenas.*
[8] Strategic plan of regional agencies, defining visions, missions and programs. Programs cover control functions, service functions and development.
[9] Each region will develop an annual development plan based on the renstra and review of evolving needs.

12. Even where the city strategy reflects economic development objectives, chosen projects and approaches were often not relevant to economic and business demands. Links between the demands of the economy, the demands of business and the concomitant supply of projects was lacking in all of the local areas except Balikpapan (see Table 2.3).

13. Under the circumstances, it is not surprising that none of the local governments had given any strategic thought to the role of the city within the regional context, the national context or the ASEAN context. Consequently, regional cooperation between cites or between cities and their rural hinterlands, linkages with national organizations and concomitant investment promotion were absent from the strategies and programs in the case study cities.

Table A. 6.3: Assessment of Strategy and Programs

City	Economic Structure and Business Needs	Strategy	Projects	Comments
Bandung	(i) Textiles - 70 percent of Indonesia's Textiles come from Bandung. (ii) Trade – largest GRDP contributor.	No economic strategy	Better investment climate	No direct efforts to support textiles.
Palembang	(i) Manufacturing largest contributor; (ii) trade restaurant and hotel is second largest; (iii) Regional Center; (iv) insufficient power; (v) poor road network; (vi) large informal sector	Addressing SME sector	The two issues identified are (i) addressing co-operative and SMEs; and (ii) markets for fruits and vegetables	SME and informal sector strengthening are relevant. Approach fails to capitalize on strategic industry, natural resources and regional center role. Fails to address infrastructure.
Balikpapan	(i) Manufacturing is key; (ii) Mining is important; (iii) Balikpapan crucial service center; (iv) infrastructure problematic	Participatory vision and strategy. Strategic economic objective – 'ensuring city maintains its comparative advantage as a service center.'	'One roof system' co-ordinates economic agencies. Industrial Estate	Balikpapan is more advanced in economic development planning. However, it should concentrate on improving infrastructure.
Kupang	(i) Trade, hotel and restaurant – largest GRDP contributor; (ii) Transport and communication is second; (iii) Infrastructure incl. water, power, sewerage and solid waste is problematic.	Local Spatial Plan exists. Economic goals appear as increasing exports.	(i) industrial zone specializing in cement export; (ii) improving function of the harbor and airport to increase exports; (iii) investor friendly environment and (iv) tourism	Export orientation appears misplaced. Port and airport for imports. Industrial focus appears misplaced - manufacturing contributes only 5.5 percent to GRDP. No focus on infrastructure.
Kendari	(i) Agriculture largest GRDP; (ii) trade, second; (iii) infrastructure (water, power, sewerage, solid waste poor).	RENSTRA – 'encourage the private sector to speed up economic growth.'	(i) improvement of infrastructure and utilities; (ii) focus on SMEs; (iii) investor friendly - one roof permits	Programs match problems. Improvement of infrastructure - a direct response to business needs.
Blitar	(i) Trade largest sector; (ii) Manufacturing second; (iii) PDAM and sewerage are problematic.	No strategic economic plan. Surprisingly, has economic forum.	(i) Kelurahan grant for infrastructure .(ii) Co-op support; (iii) micro finance partnership with banks.	Economic programs linked with poverty reduction.

Projects and Programs

14 LED programs can be classified on a spectrum from facilitation to proactive. They can also have an 'internal' orientation where the local government improves the way it does business

or an ‘external’ orientation where the local government targets an external audience (see figure below). In general terms, facilitatory programs are simpler than those requiring a proactive approach. The choice of the type of program is, however, dependent on the needs of the economy and businesses in the local governments area of jurisdiction and on the resources available to that local government.

Figure A. 6.1: Strategic Plan

Strategic Plan			
Immediate →			**Future**
Internal Facilitation	**External Facilitation**	**Internal Proactive**	**External Proactive**
• Business licenses • Zoning regulations • Economic Area Management • Infrastructure	• SME Service Centers • Market Construction and management Chamber of Commerce	• Marketing/Image Making in general • Develop your own land • Procurement Policy	• Cluster Development • LG as Developer • Active Targeted Marketing of economic sectors

15. Most of LED interventions in Indonesia focus on *internal* and *external facilitatory* programs. The most common *internal facilitatory* activity is the formation of ‘one roof permit’ systems, which allow for easier access to business licenses. The one roof system has been implemented in many cities in Indonesia, including Bandung, Palembang, Kendari and Balikpapan, which were among the case study cities. However, the practice appears to differ from city to city. In Bandung it is used to coordinate the issuing of 14 permits. In Balikpapan it coordinates different agencies involved in economic development, including the Investment Board, the Industry Promotion and Trade Office, and the Sasamba Special Development Zone. However, this is merely a reorganization of institutional processes and does not involve a review of actual licenses and regulations.

16. Except for Kendari, the link between infrastructure and economic development is not strong. Thus, although infrastructure deficiencies are a constraint to private sector development, they rarely feature in economic development plans and programs. However, the link between public works and unemployment is clear. Bandung and Blitar have both instituted public works for temporary job creation in Bandung and Blitar. Blitar has been most innovative in this regard. It has also allocated Rp 580 m for the formation of work co-operatives and gives block grants to *kelurahan* to engage in labor-intensive provision of infrastructure. *External passive* approaches focus on SME’s, the provision of micro credit and some training, and the development of markets. Provision of micro-credit has occurred in Palembang, Bandung, Blitar, and Kendari. Blitar provides the most innovative example; it has provided Rp 3 billion deposited in three local banks for on-lending to SME’s. In Bandung, the local Chamber of Commerce provides training for SME’s. More active approaches such as investor promotion are lacking. Finally, where entrepreneurial active approaches are present (although these are rare and occur only in the case of Kupang), they are not necessarily strategically focused.

17. The informal economy is an issue for all cities. However, there is no evidence of a strategic approach to the informal economy by most Indonesian cities, including those reviewed under *Cities Speak*. Instead, most cities view the informal economy as a "nuisance." For example, in Palembang, the Council focuses on removing the informal sector. Balikpapan uses a more innovative approach. The city has devised ways to 'share public spaces' with the hawkers to lessen the nuisance factor and ensure that hawkers have space for operating. This has led to private sector sponsorship of the spaces.

Business Opinion and the Business Environment

18. The existence of an institutional structure, expenditure (development and routine) allocations and programs for economic development has had a limited effect on changing businesses opinion of local government, or indeed, improving the local business environment. This is exacerbated by a lack of collaboration between the local government and the business community. The lack of collaboration is surprising, as all local governments under examination had made an effort to reach out to community groups. However, only Blitar has made a specific effort to reach out to the business community. As a result, the business community appears to regard the local government as irrelevant.

Table A. 6.4 : Public Participation

	Kupang	**Blitar**	**Kendari**	**Balikpapan**	**Palembang**	**Bandung**
Forum/Participation	Yes	Yes	Yes	Yes	Yes	Yes
Business Inclusion	Yes	Yes	Unknown	Yes	Unknown	Not effective

Businesses tend to concentrate complaints on corruption, additional tax burdens and lack of infrastructure. These issues are not addressed as part of economic development strategies for the cities affected.

19. Poorly functioning infrastructure is problematic for local business in all cities under *Cities Speak*. However, only Kendari has addressed the issue in response to business needs. This includes:

- Palembang has insufficient, poor and unstable power supply, poor road networks from the hinterland.
- Kupang's water supply is problematic. Power supply and solid waste management are erratic. Telecommunications is unreliable.
- In Kendari, electricity and water supply are poor. This has led directly to investor withdrawal.
- Balikpapan has erratic power supply.
- In Blitar sewerage and water supply are the biggest concerns.

20. Local businesses are greatly affected by corruption. This includes land and property, the provision of urban services and in procurement and tendering. Land-related corruption relates to

five areas: (a) land compensation; (b) land usage and spatial planning, (c) buying and selling property; (id) property development and building regulations; (e) property tax.[10] Corruption in urban services falls into the class of petty corruption, such as bribes for access to services.[11] However, none of the cities indicated that they had instituted programs to address this. Business needs from local government now is on more basic issues of infrastructure provision, good governance, including taxation, regulatory changes and decrease in corruption, rather than for more complicated cluster strategies or even investment promotion and marketing.

Conclusions

21. Economic data on cities reveal that they are crucial to the broader economic development of Indonesia. Their growth rate is at a higher pace than the national average, greater access to information (which is a key resource), and more developed infrastructure (in comparison to rural areas) elucidate this point. Indonesian cities have the institutional basis for addressing their local economies. Decentralization gives local governments greater control. Several laws and regulations give explicit direction to local governments on economic development; the PROPEDA planning process creates the space for the formulation of economic strategies. Local governments have local agencies and other institutions with an economically explicit function. The development budget has particular line items that can support economic projects. However, local governments have been slow to react to these legal, institutional and financial advantages.

22. The cities under study do not address economic development strategically. The PROPEDA is not used to develop strategy. Even when strategy is developed, it is deficient in several ways. First, it is developed in an ad-hoc manner. Second, it is developed without adequate consideration for economic realities and business demands. There is some attempt to link the economic strategy with immediate internal economic realities but no attempt to examine linkages between the area's economy and its region, other cities and the rural hinterland, the national economy and international competitive needs. It is therefore not demand responsive. Third, there is often little follow-through between strategy and projects and programs.

23. Innovative projects and programs exist. However, first, as elucidated above they often do not further any strategic objective. Second, they, like existing strategies, are not demand responsive.

24. Collaboration between business (a key player in LED) and local government is poor. This is in spite of the existence of some form of civil society collaboration mechanism in almost all cities under study and the presence of local Chambers of Commerce. It is also in spite of the presence of agencies and budget allocation for economic development. Business demands center on governance issues, including corruption and taxation and on poor infrastructure, in particular power supply and water supply. However, telecommunications is also problematic. Poor telecommunications infrastructure accounts for the fact that IT has not been well developed in Indonesia, compared to other ASEAN countries. Indonesia's Internet use per capita is one of the lowest in East Asia (World Development Indicator 2000). Few local governments directly address these issues as part of their economic development thinking.

The basis for Indonesian cities to adopt LED in improving their local economies is positive. However, currently, they lack the motivation and know-how to address it.

---

[10] Woodhouse, A. Unpublished draft. Urban Corruption in Indonesia.
[11] ibid.

REFERENCES

1. Ahmad, Ehtisham and Bert Hofman. Indonesia: Decentralization-opportunities and risks, Washington DC: World Bank, March 2000.

2. Alm, James and Roy W. Bahl. "Managing Across Levels of Government" in Sudarshan Gooptu, editor. Indonesia, public spending in a time of change. Washington DC: World Bank, 2000.

3. Alm, James, Robert H. Aten and Roy W. Bahl. "Can Indonesia decentralize successfully? Plans, problems and prospects" in Bulletin Of Indonesian Economic Studies (Australia); Vol. 37 No. 1:83-102, April 2001.

4. Akita, Takahiro and Rizal Affandi Lukman. 'Spatial patterns of expenditure inequalities in Indonesia: 1987, 1990 and 1993" in Bulletin of Indonesia Economic Studies (Australia); Vol. 35, No. 2, August 1999.

5. Asian Development Bank (ADB). Indonesia Urban Sector Study, Manila: ADB, 2000.

6. Asra, Abu. "Urban-rural differences in costs of living and their impact on poverty measures" in Bulletin of Indonesia Economic Studies (Australia); Vol. 37, No. 3, December 1999.

7. Azis, Iwan J. "Simulating economy-wide models to capture the transition from financial crisis to social crisis" in Annals Of Regional Science : An International Journal Of Urban, Regional And Environmental Research And Policy (U.S.); 34, No. 2:251-78, 2000.

8. Beard, Victoria A. "Rethinking urban poverty: a look inside the Indonesian household" in Third World Planning Review (U.K.); 22, No. 4:361-78, November 2000.

9. Bahl, Roy W. and Johannes F. Linn. Urban public finance in developing countries, Oxford; New York: Published for the World Bank by Oxford University Press, 1992.

10. Behuria, Sutanu. Some Aspects of Land Administration in Indonesia: Implications for Bank Operations, Manila: ADB, 1994.

11. Bird, Richard M. and Michael Smart. "Intergovernmental Fiscal Transfers: Some Lessons from International Experience" March (revision), paper prepared for Symposium on Intergovernmental Transfers in Asian Countries: Issues and Practices, Asian Tax and Public Policy Program, Tokyo: Hitosubashi University, February 2001.

12. Brodjonegoro, Bambang and Shinji Asanuma. "Regional autonomy and fiscal decentralization in democratic Indonesia" in Hitotsubashi Journal Of Economics (Japan); 41, No.2:111-22, December 2000.

13. Booth, Anne. "Poverty and Inequality in Soeharto Era: An Assessment", Bulletin of Indonesian Economic Studies, Australia; 36 No. 1:73-104, April 2000.

14. Booth, Anne. "Regional Disparities and inter-governmental fiscal relations in Indonesia," in Fragmented Asia: Regional Integration and National Disintegration in Pacific Asia. Ian G. Cook, Marcus A. Doel and Rex Li, eds. Aldershot: Avebury, 1996.

15. Crane, R. “Water markets, market reform and the urban poor: results from Jakarta, Indonesia”, World Development, Vol. 22 No.1, 1994.

16. Dimitriou, Harry T. “Integrated approach to urban infrastructure development : a review of the Indonesian experience” in Cities (U.K.); 8:193-208 August 1991.

17. Douglass, Mike. “A regional network strategy for reciprocal rural-urban linkages: an agenda for policy research with reference to Indonesia” in Third World Planning Review (U.K.); 20:1-33, February 1998.

18. Economist Intelligence Unit for country reports.

19. GTZ and USAID. Capacity Building Needs Assessments for Local Governments and Legislatures: Report on Urban Services, 2001.EN.REFLIST