A Budget Dilemma in an Indonesian City

A riot of banners lined the main thoroughfare into the central business district of Kota Fajar, partially obscuring the flimsy ramshackle huts erected along the road. Fluttering in the morning breeze, the images on the banners looked like they were waving at Arianto as he drove to work. It seemed not too long ago that the local elections were held, but the campaigning was ramping up again. The general sentiment was that it would be a tight race at the polls this year for the mayor who was facing a strong contender. It did not help that the mayor had done little to improve the city's infrastructure during his five years in power. The city's roads were potholed and congested, pedestrian sidewalks were crumbling and unsafe, its waste management facilities were overwhelmed and much-needed social housing projects had stalled.

A sudden and insistent car honk sounding from behind his car startled Arianto. The traffic was bumper-to-bumper as vehicles coming from the suburbs around the city centre merged with those disgorged from the neighbouring port city of Pasirmerah. It was especially frustrating in the morning when heavy vehicles like freight trucks and buses were out in full force, reducing Arianto's morning commute to a crawl. Driving to work would be a much better experience, Arianto thought, if the proposed flyover in the south of Kota Fajar could go ahead.

As the Head of the Finance and Asset Management Section (*Bagian Keuangan dan Manajemen Aset* or BKMA) of Kota Fajar, Arianto was familiar with the proposal to construct a 750-metre flyover above the existing arterial roads leading into the city centre. It would help divert traffic coming in from Pasirmerah and unclog some of the arterial roads. Although it was conceptualised two years ago, the flyover project had been left languishing. Arianto was aware that Edi, Director of Kota Fajar's Department of Transportation (*Dinas Perhubungan* or DP) had been telling the mayor that the construction of a flyover was sorely needed. In fact, the DP had conducted a six-month preliminary study analysing various alternatives before identifying the flyover as the most cost-effective option. The report also quantified the expected economic benefits generated from the time and transport cost savings, as well as the health benefits associated with reduced air pollution from fewer idling engines. Although Edi had briefed the mayor on the report's findings, Arianto knew the project had received scant attention from the mayor. The catch was that the project came with a hefty price tag of US$9.5 million (IDR135 billion) and would take at least three years to build, beyond the current tenure of the incumbent mayor. Moreover, the city would also have to worry about coughing up additional budget for recurring costs to operate and maintain the flyover.

Indonesia's infrastructure gap and the Kota Fajar flyover

Indonesia's infrastructure gap, especially the lack of good roads and transport corridors throughout the archipelago, had long stymied economic growth. Under Indonesia's "big bang" decentralization reforms in the late 1990s, power and responsibility devolved from the central government in Jakarta to more than 500 local governments in regencies (*kapubten*) and municipalities (*kota*) which were now directly elected. Local governments were tasked with developing, operating and maintaining urban infrastructure such as urban roads, municipal services and social services, through local government agencies with funding from the central government. The functions and local branch offices of central line ministries were incorporated into local governments.

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There had been high hopes when the new Indonesian president was elected three years ago. Infrastructure development was a key pillar of his economic platform, and the president's tweets often featured photos of him at construction sites. But Arianto remembered that the stark figures cited in news reports gave him pause. The central government had promised an infrastructure splurge of US$327 billion on projects like roads, bridges, airports, seaports, railways and power stations across the country.[1] Indeed, the construction of many infrastructure projects were moving ahead and this year's budget called for the building of 856 km of new roads across the archipelago.[2] In reality however, only US$15 billion, or less than 5% of the funding needed, was coming from the state budget.[3] Even with state-owned companies chipping in, the central government was hoping that private investors would stump up the bulk of the funding needed, while expecting local governments to share the fiscal burden.

In the case of the proposed flyover in Kota Fajar, the need to ease congestion was clear. Kota Fajar was the premier manufacturing and distribution hub in the region, but the largest seaport was in Pasirmerah. A steady stream of freight trucks and buses plied between the two cities each day. By some estimates, about 10,000 people also commuted to Kota Fajar each day to work in its business district and surrounding industrial estates. A patchy public transport system had spurred the heady growth of private vehicles, which increased by 10% last year. Meanwhile, the expansion of the Pasirmerah port was due to be completed next year, and freight traffic would likely increase. Each year that the flyover project was delayed meant that traffic congestion worsened and dragged down productivity. There were also adverse health impacts of air pollution from vehicles stuck in traffic. The DP report estimated that almost 3% of the city's GDP was lost to congestion. Kota Fajar could ill-afford such self-inflicted wounds on the economy at a time when the external economic climate was expected to deteriorate.

Local government budgeting

The major stumbling block to the proposed flyover was that the central government was only prepared to foot up to 50% of the cost, leaving the Kota Fajar government to stump up the rest. While the central government had experience implementing regional toll roads through concessions to the private sector, such projects were regulated by the Toll Road Regulatory Authority (*Badan Pengatur Jalan Tol* or BPJT) and subjected to stringent criteria, such as demonstrating clear financial viability. It would be next to impossible for an urban flyover with little potential for financial returns to qualify as a toll road for private sector investment. In the face of such funding gaps for capital expenditure, the city had limited options—the government could divert funding from other areas, or try to raise funds from other sources. However the city was already near the top of its debt ceiling and could hardly shoulder another large loan for a transport project of this scale.

Local governments in Indonesia were largely dependent on transfers from the central government, which could account for over 90% of their budgets. Such inter-governmental transfers comprised shared tax revenues, shared non-tax revenues such as from natural resources, general purpose allocations and special-purpose allocations. With the presidential elections looming next year, the incumbent central government was expected to spend more generously on national initiatives like social development and energy subsidies, leaving even less funding for infrastructure development in municipalities and regencies. On the other hand, local government revenue raising was largely limited to the levying of certain taxes and government charges. While well-run local government-owned enterprises could contribute to local coffers, but they were often more likely to harbour hidden subsidises and drain local budgets. Assets sales, which some local governments

[1] Karlis Salna, "Indonesia needs $157 billion for Infrastructure Plan", *Bloomberg*, January 26, 2018.
[2] "Indonesia's leader, Jokowi, is splurging on infrastructure—The hard-hat president", *The Economist*, May 5, 2018.
[3] Salna, "Indonesia needs $157 billion".

elsewhere resorted to as a means of raising revenue, were one-off and thus unsustainable revenue sources. Moreover, Indonesia cities tended to have few viable assets suitable for sale to the private sector.

The ability of local governments to borrow for infrastructure development was also curtailed. At the central and local government levels, Indonesia's national fiscal rules capped annual budget deficits at 3% and accumulated debt at 60% of national and regional GDP respectively.[4] Local governments also faced additional restrictions in borrowing, such as limiting debt to 75% of the previous year's budget revenues and prohibition against borrowing internationally.[5] In practice, borrowing by local governments for infrastructure building was limited and largely took the form of loans provided by the central government, which included on-lending from multilateral institutions like the World Bank. In any case, most local governments lacked the capability, transparency and creditworthiness to secure financing from other permitted sources such as domestic financial institutions.

However, mayors had wide discretion over the work plan for the city and allocation of the local budget (*Anggaran Pendapatan dan Belanja Daerah* or APBD) across various expenditures, although the budget had to be passed by the local legislature (*Dewan Perwakilan Rakyat Daerah* or DPRD).[6] Local governments could opt to plug funding shortfalls in infrastructure development by drawing from allocations for other expenditures, such as government administration, which was often one of the largest expenditures for local governments. Instead, the Kota Fajar government had chosen to put a number of proposed infrastructure projects, including the flyover, on the backburner.

The budgeting process of local governments could also be susceptible to unsavoury influences. Just a year ago, the Corruption Eradication Commission (*Komisi Pemberantasan Korupsi* or KPK) investigated several legislators in the neighbouring city of Pasirmerah for allegedly taking bribes from the mayor to approve the local budget. That year's budget was apparently rife with "ghost budgets" amounting to US$3.3 million (IDR 50 billion). These were unplanned budget items that evaded official budget approval processes, but were included in the final budget passed. Such "ghost budgets" often reflected hidden compromises between the legislative and executive branches, or were "rewards" to certain legislators for supporting initiatives of the executive. Even in a country where people had come to see corruption as endemic, the scale of the bribery made national news and was talked about for days after.

This year, the budgeting season was taking place close to the local elections in Kota Fajar. This meant more-than-usual clamouring among various parties for a slice of the city's funds. As the coordinator for the municipal budget, Arianto had a bird's eye view of the budgeting process. He already had spent some weeks in discussions with various local government units to understand their respective targets, work plans and budget needs for the coming financial year. These were in turn supposed to be aligned with the city's medium term development plan. Arianto had the unenviable task of putting together a coherent municipal budget proposal within the financial resources available to the city. More importantly, budget allocations among the various government units had to be moderated to achieve the best outcomes for the city as guided by the mayor. The budget would then be submitted to the DPRD. Besides the flyover project, one

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[4] Anwar Nasution, "Government Decentralization Program in Indonesia", ADBI Working Paper Series No. 601, Asian Development Bank Institute, October, 2016, https://www.adb.org/sites/default/files/publication/201116/adbi-wp601.pdf

[5] "Indonesia", OECD, October, 2016, https://www.oecd.org/regional/regional-policy/profile-Indonesia.pdf

[6] World Bank, Spending for Development: Making the Most of Indonesia's New Opportunities; Indonesia Public Expenditure Review 2007 (Washington, D.C: World Bank, 2008).

other initiative—a new social assistance programme that was the mayor's brainchild—stood out in this year's budget.

A new social assistance programme

The mayor had been publicising his new social assistance programme at a number of recent public events. Arianto had heard details about the new initiative in his budget discussions with Mina who was in charge of Kota Fajar's Social Welfare Section (*Bagian Kesejahteraan Sosial* or BKS). Mina had been in charge of the social welfare portfolio for several years and had weathered her fair share of election cycles and mayors. She explained that the new Program for Hope (*Program untuk Harapan* or PUH) that the mayor was rolling out, would significantly expand the number of households eligible for cash handouts.

The PUH would build on the nation-wide Family Hope Program[7] (*Program Keluarga Harapan or PKH*) from which Kota Fajar has already been receiving assistance for some years. While the PKH gave out cash grants to about 5% of the poorest households, the mayor planned to reach out to a much larger group and raise the amount of social assistance provided to each household through his new programme. Mina added that the mayor wanted US$8 million (IDR113 billion) to be earmarked in this year's budget for the PUH. This would make the scheme one of the single largest expenditures for the city. Besides being channelled to cash disbursements, the budget for the PUH would also go towards funding the construction of several new social assistance offices to be manned by additional staff hired to roll out the new programme.

Arianto could hardly disagree with the need for a wider social welfare net. Although poverty rates had declined nationally, the ranks of the urban poor in Kota Fajar were swelling as more rural families moved to the city in search of better prospects. Many were living in at the edges of society in precariously built squatter settlements, while trying to eke out a day-to-day living. Nevertheless, Arianto had also seen reports in the local newspapers that were critical about the PUH. Some commentators had pointed out that the PUH's eligibility criteria for families receiving cash grants was far less stringent than the national PKH. In fact, some of the beneficiaries could be considered rather well-off. Unlike the PKH which required households to achieve certain beneficial outcomes such as requiring parents to ensure that their children get basic health checks or go to school regularly, the PUH appeared to expect little in return from its beneficiaries. One newspaper article put it bluntly, "It seems that the PUH is basically designed to give away cash for free to anyone who shows up at the Social Welfare office. The benefits of building more social assistance offices is also unclear. But with the local elections coming up soon, the launch of the programme is particularly well-timed."

Clear directions from the mayor

The mayor had summoned Arianto to his office a week ago to give a progress update on the draft municipal budget. The mayor seemed to be in a good mood that day; he had few objections to the various work plans and budgets proposals. Arianto decided to take the opportunity to promote the DP's flyover proposal. Given that infrastructure projects were often seen as vote-winners, Arianto thought the mayor might finally make the flyover a priority this year.

The mayor quickly interrupted Arianto. He intoned that there were many demands on the city's budget and it was obviously not possible to fulfil all of them. The country's feeble economic performance in the last few years had not helped. The number of poor families who were just scrapping by in the city was growing. The

[7] The PKH is Indonesia's conditional cash transfer programme first piloted in 2007. It pays benefits to mothers and aims to reduce poverty and inequality through increased access to, and consumption of basic services particularly in health and education. For example, the PKH only disburses cash after verifying a mother's attendance at pre- and post-natal check-ups, or after verifying that a household's school-aged children have good school attendance records.

mayor had seen the situation himself during his inspections of the city. The welfare of the people, he continued, would have to come first and the Kota Fajar government was placing priority on expanding its social assistance to the poor through the PUH. Moreover, this was aligned with the focus of the central government to inject more funds into national social assistance programmes.

The mayor added that he was well aware of the benefits that the flyover project would bring, and he too wanted to improve the city's transport infrastructure. But at this point, it was more important to support vulnerable families. Projects like the flyover would have to be put off unless other ways of funding it could be devised. As he rose from his seat to signal the end of the meeting, the mayor made his point clear—this was simply the reality of running the local government on the small budget disbursed by the central government. Arianto's job was to ensure that funds were forthcoming for the PUH.

Another push for the flyover

Two days earlier, Edi was in Arianto's office for further discussions on the DP's department budget. While Edi had been busy reaching out to his counterparts in the central government to try to negotiate for more funding for the proposed flyover, all he had received so far were vague promises to review the proposal. In a bid to make the flyover proposal more palatable to the mayor, Edi was now suggesting to shrink the capacity of the flyover. Although this was not optimal from the perspective of transport planning, it would shave 15% off the construction cost. Edi had also heard rumours that the cost of steel—a major component in the flyover construction—was primed to rise sharply in the second half of next year and construction costs were likely to go up. This would only make the project look even less financially palatable next year.

Furrowing his brow, Edi made his parting shot, "Even if we cut the cost for the flyover, we can't count on the central government to provide more money, so we still need funding to come from somewhere." After a slight paused, he continued, "I know this being election year, the mayor has certain plans to boost his popularity… so it's tough on you, but I also know you get why this flyover is so important. If we don't start building it soon, it might never happen." As he was leaving Arianto's office, Edi added, "This election seems wide open… no one knows what will happen."

A looming deadline

Having finally navigated his way through the morning crush, Arianto was glad for the respite of his office. However his secretary had urgent news to relay as soon as he stepped into the office. The mayor's assistant had just called to say that the mayor wanted to bring forward the inter-department budget meeting and the mayor wanted to see the municipal budget paper before four o'clock today. Arianto was caught by surprise. The budget paper was originally supposed to have been submitted to the mayor two days later. Arianto wondered about the reason was for the urgency. Although he had already spent some time mulling over the budget, hoping to find some way to fund both the PUH and the flyover, he was now running out of time. He knew that the numbers had to look just right on the budget paper. He quickly switched on his computer.

Discussion

1. What were the constraints and opportunities that Arianto was facing?
2. As Arianto's Assistant Head, you were approached by Arianto for your opinion. What would you tell him?
3. If Arianto decided to make one final attempt to persuade the mayor, what arguments would you bring to help your boss convince the mayor?