STUDY OF ISSUE MUNICIPAL BOND AS AN ALTERNATIVE SOURCE OF FUNDING FOR REGIONAL DEVELOPMENT

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ABSTRACT

From many research result related to regional finance, showed that Central Java province had APBD revenue was high enough which is reached the number above Rp2 trillion in two last budgets. In year 2006, from that number, 77.1 % derived from local own revenue. It means that only 22.9% Central Java revenue comes from intergovernmental transfer. Meanwhile, by 2008 Central Java needs Rp97.29\textsuperscript{1} trillion of capital investment for infrastructure development. This number reach by government is estimated [by] only 30%, thus more or less 70% (Rp68.108 trillion) requirement of defrayal for development can be fulfilled from other source. From the data hence fiscal capacity owned by Central Java Province still in such a way limited. For the period in 2004 - 2006 regional own revenue experienced the rise in average 25.66% and the rise contribution to total regional revenue in general reached 26.76% per year.

As alternative solution to finance development projects, local government tried to get the source of funding through the publication of the regional bond. This research paper tried elaborates and analyses issue of area bond as one of alternative of source of development funding for local government in Central Java.

\textsuperscript{1} Bisnis Indonesia,
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CHAPTER 1
Introduction

1.1 Background of the Research

After knocked over economic crisis in 1997, the Indonesia economic growth in 2001 was still low at 3.3 %, represented a slowing performance from 4.8 % growth recorded in 2000. Following increased of 4.10 percent during 2003 compared with 2002. And economic growth reached 4, 97 % at 2006. At the third quarter of 2007 Central Statistic Bureau of Indonesia recorded that the economy grew a faster-than-expected 6.5%.

Many problems faced by the local governments, the most important immediate economic problem are fiscal sustainability to finance regional economic development. This problem also emerges as a consequence of the issuance of the Law No.22 in 1999 concerning Local Government and Law No. 25 in 1999 concerning Fiscal Balance between The Central Governments and The Regional Governments was completed with Law No. 32 in 2004 and Law No.33 in 2004, were hoped for the local governments had the authority that was wider to develop the potential and resources in order to increase welfare of the community.

Year 2001 is the corner stone of fiscal decentralization and regional autonomy in Indonesia. One of many target goals of decentralization is reducing finance allocation disparity and equalizing development among the region. This phenomenon will make a chance for local governments to suffice their local need and development. Starting this year, Kabupaten (Regency) and Kota (Municipality) have essentially become responsible for all public service that the provincial and central government do not deliver, such as public works, health, education and culture, communications, agriculture, environment and labor. Fiscal decentralization should ideally be able to improve the capacity of the Local Governments to carry out their tasks and responsibilities properly. It does not only refer to the capacity to manage expenditures, but essentially also refer to their authority to raise owned revenues.
It also faced by Central Java Province. Almost all of the public service was fulfilled by local taxes and intergovernmental transfer (balancing fund) from central government. Table 2 shows that the composition of revenue highly dominated by balancing fund, namely general allocation fund. Although the share of balancing fund decreasing from year 2000 to 2006 but the amount is still increasing from Rp.369,220.05 million in year 2000 to Rp.808,406.00 million in 2006. It indicate that Central Java Province still depend on Central Government Balancing Fund to fulfill fiscal needs. According to Central Java Regional Revenue and Expenditure Budget (APBD), total expenditure of Central Java Province decreasing 40.17% from Rp.902,121,850,000.00 in year 2000 (before implemented decentralize fiscal) to Rp.1,508,024,900,000.00 in year 2001. Province make available as much as 24.34% of the public need at Regional Revenue and Expenditure Budget, the rest is for routine activity. This expenditure 34.89% is earned by actual own revenue (PAD), the other come from intergovernmental transfer in year 2001.

The contribution of local own revenue is small to finance total expenditure. On the other hand, to increase economic activity and providing the public service, regional authority needs some extra money which comes from not only base on local own revenue but also other finance resource. Local government need to explore new mechanisms and arrangements for meeting the cost of such investment. Table 1 below show the revenue structure of Central Java Province and Table 2 Balancing Fund of Central Java Province:

Table 1.1 Realization fo Central Java Revenue
(In billion rupiah)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Own</td>
<td>240.00</td>
<td>320.59</td>
<td>832.20</td>
<td>1,244.50</td>
<td>1,449.90</td>
<td>1,867.50</td>
<td>2,492.70</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balancing</td>
<td>369.05</td>
<td>877.11</td>
<td>717.51</td>
<td>985.96</td>
<td>789.69</td>
<td>807.66</td>
<td>808.00</td>
</tr>
<tr>
<td>Fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>00</td>
<td>00</td>
<td>194.20</td>
<td>00</td>
<td>229.00</td>
<td>229.00</td>
<td>229.00</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>610.05</td>
<td>1,197.70</td>
<td>1,745.96</td>
<td>2,230.49</td>
<td>2,467.59</td>
<td>2,097.16</td>
<td>3,530.70</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 1. Realization of Central Java Balancing Fund
(In billion rupiah)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Tax Sharing</td>
<td>39.46</td>
<td>112.24</td>
<td>149.78</td>
<td>199.25</td>
<td>232.05</td>
<td>254.50</td>
<td>256.00</td>
</tr>
<tr>
<td>2) Natural Resources Sharing</td>
<td>10.19</td>
<td>7.12</td>
<td>7.73</td>
<td>4.39</td>
<td>3.64</td>
<td>2.16</td>
<td>2.00</td>
</tr>
<tr>
<td>3) General Allocation Fund</td>
<td>317.40</td>
<td>755.75</td>
<td>560.00</td>
<td>781.35</td>
<td>553.00</td>
<td>549.00</td>
<td>549.00</td>
</tr>
<tr>
<td>Total Balancing Fund (1+2+3)</td>
<td>369.05</td>
<td>877.11</td>
<td>717.51</td>
<td>985.99</td>
<td>789.69</td>
<td>807.66</td>
<td>808.00</td>
</tr>
<tr>
<td>Total Revenue (see table 1)</td>
<td>610.05</td>
<td>1,197.7</td>
<td>1,745.96</td>
<td>2,230.49</td>
<td>2,467.59</td>
<td>2,097.16</td>
<td>3,530.70</td>
</tr>
<tr>
<td>Share (%) of total balancing fund to total revenue</td>
<td>60.51</td>
<td>73.23</td>
<td>41.14</td>
<td>44.18</td>
<td>31.97</td>
<td>24.73</td>
<td>22.9</td>
</tr>
</tbody>
</table>

Source: Calculated based on the Data of Ministry of Finance of Republic Indonesia (2000-2006)

Since the local government is permitted to seek more local taxes, there is also the fear that the local government will allow investors to exploit natural resources more intensively and extensively. It could create and exacerbate the environmental problems in the areas. Issued municipal bonds and borrowing are other possible local government sources of finance.

In recent years there is a suggestion to issue local government bonds as another way of local government to sustain financial sources. Governor of Central Java suggested must dig up the possibility of issue regional bond (municipal bond) for funding the regional government. The idea actually not the new matter because of being based on Law of Republic Indonesia No. 25/1999 that already amendment became Law of Republic Indonesia No. 33/2004 which the local government was enabled to issue bond.

After local government allowed seeking fund through the bond market, Finance Minister Republic of Indonesia, Sri Mulyani Indrawati warned local officials to only use the proceeds for economically feasible projects, and to familiarize themselves with the capital market regulations beforehand. "I'd be pleased if local governments came up with economically viable infrastructure projects. And if they have the financial capacity to execute them, I'll have my staff provide them with the technical assistance," Mulyani said during a public discussion Thursday on the regulations governing the issuance of municipal bonds. Mulyani, however, stressed that bonds could only be issued for the financing of economically feasible capital projects, adding that local governments were
prohibited from using bond proceeds to cover routine spending, such as the payment of wages (The Jakarta Post, June, 2007).

According to Law of Republic Indonesia No.32/2004 concerning Local Government and Law of Republic Indonesia No.33/2004 concerning Fiscal Balance between Central and local Government, local government can finance their infrastructure which come from regional own revenue (regional tax, retribution, proceeds from the management of regional assets set aside for the purpose) through the regional revenue. The regional loan could come from domestic or foreign. The domestic loan could be earned from central government, bank, finance company, non bank financial institution, community and the other source. Law No 33/2004 cites some alternative solution of funding for regional development through issue of municipal bond. Here, the law allowed regional government to issue municipal bond could become alternative to funding regional development.

1.2. Problem Identification

The government of Indonesia drops of its responsibility to local institution which are cities and regency administration. It implies that local government has to start thinking of how they can optimize their service delivery on limited revenue source. Intergovernmental transfer from central government may just manage to finance regular expenditure for, road maintenance, garbage collection. As cities develop they require huge sums to build road network and sometimes flyover to ease traffic bottleneck and provide other necessary infrastructure like railroad, airport. All these require capital to invest in new roads, station parking plot, housing project.

In this era of decentralization, municipalities have to be innovative in order to meet their financing. The regional government was prosecuted to be able to look for the alternative source of funding in reaching purpose of serve community as good as possibly. The pool tax revenue loss should be replaced by income generating projects. Vibrant capital markets lower the return investor require that keeps cost capital low, the liquidity of such investments is the main incentive for investor. For local government, it enables to raise money to finance the necessary infrastructure to develop public service,
without relying on the central government.

‘One mechanism that is being increasingly adopted in number of countries is the municipal bond’. (Ian Blore, Nick Devas and Richard Slater, 2004). Municipal bonds are debt obligations that are issued to raise funds for public infrastructure and services such as water supply, road, housing and other public facilities. A bond may issue directly by organization or through a financial intermediary.

There is some potential advantage that is possibly obtained from publishing municipal bond to local government for raising capital as many investors willing to lend money through the bond mechanism. Local government can also access fund from foreigner to financing infrastructure project that need longer financing source. Municipal bonds also could exempt from tax, this make attractive to investor. Good governance is important in issuing municipal bond. Local authorities need have competence in order to handling financing matters. This means that local government must be transparent and accountable. Applying good governance in local government activity will increase their credibility. It will be create healthy competition among regional government to show their good financial capability.

On the other hand, from the negative side, it is possibly to make risk. Municipal bond is relatively riskier than other investments instrument. Since no guarantee from central government is provided. If the local government mismanages its finance in serious manner, there is possibility to make a default without any financial resource to repay the principal. Hence, higher returns must be offered to investor. Other disadvantages that possibly emerged, not least the very substantial costs of establishing and operating a market for municipal bond, cost which are agreed on to municipal government. Countries with a fairly well established and regulated capital market are likely to be able to adopt this method of capital financing. It is not appropriate mechanism for many of weaker municipalities with poor financial management, nor for countries where local government is relatively weak or poorly managed.

1.3. Research Questions.

The main question for this research is:
What are the advantages and disadvantages to municipal bond financing of local and regional development?

After explore the main question, than next following question is:

- It is feasible to issuing municipal bond for local government as alternative financing source of local and regional development?

1.4. Methodology

1.4.1. Study Areas

This study will be limited on district in Central Java Province. This is necessitated by time and information constraints. However, the province geographically has the area of 32,548.20 km²; approximately a quarter of the total land area of Java. Its population is 31,820,000 (2005), making it the third most-populous province in Indonesia after West Java and East Java, and constituting approximately one quarter of the island's population. This province is divided in 29 regencies and 6 cities.

1.4.2. Methods of Analysis

Descriptive statistic applied to analyse comparison from various alternative of regional infrastructure financing, to see how far eligibility of municipal bond as source of regional development fund, compared to another alternative financing.

1.4.3. Scope and Limitation

The focus of the study is the municipal bond, especially the advantages and disadvantages of issuing municipal bond as an alternative of local government financing resource and the feasibility of issuing municipal bond. Study will limited to a single province Central Java. This case study use Central Java as an object study represented as region that has good fiscal capability. This could be recognized from its own revenue which is contributed 89% in year 2005 and 70.5% in year 2006 to total revenue.

1.4.4. Data Sources and Method of Collection

This research mostly used a documentary approach by using secondary data (reports, policy documents, previous studies). Those consist of:

The structure of Local Government Finances.

Regulations concerning the fiscal decentralization policy, such as the laws and government regulation about local government, loan, municipal bond, and the other related fiscal policy.

Regional conditions, e.g. fiscal capacity and fiscal need, Local Government administrative condition.

The data was accessed by website of the Directorate General of Fiscal Balance (DJPK) and Indonesia Capital Market and Financial Institution Supervisory Agency (Bapepam-LK). Law and regulations data was accessed by the State Secretary and Home Affairs Ministry. Data about regional conditions, e.g. economic and regional development were accessed by Central Bureau Statistic (BPS) and Dipenda in the study areas.). In addition, some data were obtained by some literatures and the previous researches.

1.4.4. Organization of the Paper

The outline of the paper divided into 5 chapters. The second chapter provides literature reviews about municipal bond. The third chapter examines the background, discussion about law of bond market and the structure of municipal finance. The fourth chapter examines the analytical, critically the possibility of the establishment of bond market in the local areas (a case in Central Java Province). Finally the last chapter is conclusion and policy recommendation consisting of the major findings, conclusion and facilitating bond financing by local government as reflection of policy recommendation.
CHAPTER 2
Literature Review

2.1. Introduction

Our case study revolves around the financing source of local government. One of many alternative sources that can meet local government fiscal need is issuance municipal bond. Therefore this chapter will explore about advantages and disadvantages of issuing municipal bond for local government as a source of regional development financing. This chapter will also explore about implementation of municipal bond in City of Johannesburg (South Africa).

2.2. Financing Option Consider to Infrastructure Finance

Fiscal decentralization is anxious with various issues related to the intergovernmental fiscal framework and local public finance. Important areas include local government taxation, intergovernmental transfers, local government borrowing, and accumulation of sub-national reserves. Many source of financing option scheme in order to support this issue for local government in Indonesia as explain follow:

a. Borrowing from donor through Ministry of Finance

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2 Information for this section is adapted largely from a report by Decentralization Support Facility Programme publication related to fiscal decentralization in Indonesia.
Features: time consuming and bureaucratic process, may take 3-4 years to arrange, must finance up 30% of project cost, from own resource. Extended maturity and cost of finance is attractive.

**b. Borrowing from bank**

![Diagram of Borrowing from bank]

Features: More expensive and unfavourable debt service profile than Donor/Ministry of Finance, much faster negotiation and closure than loan/sub loan option

**c. Issuing Municipal Bond**

![Diagram of Issuing Municipal Bond]

Features: full faith and credit offering, favourable debt service profile, have unique characteristic completely free of federal taxes.
2.3. **Reason to Issuing Municipal Bond**

Municipal securities are debt obligations issued by states, cities, counties, and other governmental entities to raise money to build schools, highways, hospitals, and sewage systems, as well as many other projects for the public good. An important distinguishing characteristic of the municipal securities market is the exemption of interest on municipal bonds from federal income taxes.

Local government or municipal have a responsibility to provide for the needs of their community. But the needs increase oftentimes and there is not enough money in local government budget to pay these needs which usually obtained from local taxes. In other hand, central government also has limited general allocation fund to share for local government. Like government of Republic of Indonesia which has very huge area. Divided into 33 province, 349 regency and 91 cities, central government can not suffice all requirement of local government infrastructure.

Especially for large project such us construction of a bridges, traditional and modern market, highway, public school, hospital, airport, stadium, and public transportation, required extra money to finance these projects. For these reason, local government raise the necessity capital to finance the public project by issuing municipal bond. Local government get fresh money from public and capital will increase so they can complete their project. The face value or principal and interest of the bond are paid overtime by the revenue which takes from these projects. Local government which has good infrastructure will attract investor to come and invest their money. Economic activity will increase and economic will growth.

For Indonesia stock market investor, municipal bond is new investment instrument, after central government bond, corporation bond, pension fund, and also insurance. Because of tax exempt, municipal bond can be an attractive securities investment. More than anything else, if later municipal bond offers interesting basic yield, investor would enthusiasm to buy this bond. This phenomenon will make Indonesian bond market more interesting.

Municipal bond which published in domestic market can make community closer to their government. They can control what governments do for them in order to increase
their welfare with the certain project. Published municipal bond will bring consequence that investor will claim transparency, accountability, and always watch local government performance in managing their development fund. Including all issue of processing this bond. As consequence, process of issuing municipal bond will create health competition among the regional government to be trustworthy local government.

2.4. Experience of Issuing Municipal Bond in City of Johannesburg (CoJ), South Africa

2.4.1. Background

‘By the mid-1990s the City of Johannesburg was close to bankruptcy. Infrastructure was deteriorating, and this city of 4 million residents had a capital budget of less than $50 million. But a visionary municipal management team was put into place, and it promptly began corporatizing utilities, selling off commercial enterprises, and contracting out services. The city had many of its operating problems largely under control by 2003, but it needed huge amounts of capital investment’. (Jason Ngobeni, 2008, p 1).

Capital expenditure decreased from over R1.2 billion in 1997 to less than R220 million in 2000 (Peter Honey, Financial Mail, 2005). ‘There was an R8 billion capital expenditure backlog over and above annual spending requirements. This means that, for example, bulk electricity infrastructure, surfacing of roads and provision of water could not receive the investment required to maintain or extent service’ (Palmer Development Group 2005). To avoid the fail of public service, the city was bailed out by national treasury with a R525 million grant in 2002. The financial crisis and low performance of treasury resulted low confidence of investor in the city.

2.4.2. The reason

The reasons of CoJ to issuing municipal bonds are:

- Diversification and expand of funding source
- To reduce the average cost of borrowing
- To make more closely funding maturity profile to the asset life profile
- To initiate the bond market and bring competitive pricing
- Estimate the city backlog capital expenditure R8 billion, required capital support

2.4.3. Institutional and policy framework (Roland Hunter, 2004)
Regulator
- National treasury: making fiscal policy, intergovernmental fiscal relation
- South African Reserve Bank: has responsibility to make monetary policy
- Financial reserve Board: provide regulation according to non banking financial sector

Lenders:
- Commercial bank
- Development Bank of South Africa (DBSA)
- Infrastructure Finance Corporation (IFC)

Exchange: Bond Exchange of South Africa (BESA) as facilitator of bond trading

Debt Issuer Association: as private association of issuer

Policy parameter:
- no government guarantee,
- municipalities may not borrowing from overseas

2.4.4. The type of bonds
There are two types of bonds that the city considered: institutional and retail bond. An institutional bond is made available to large institution such as bank, insurance, mutual fund and specific investment institution. While, retail bond is made available for small group or provide to citizens of city.

The City of Johannesburg successfully launched 4 Institutional bonds totaling R3.9 billion listed on Bond Exchange of South Africa (BESA) as summarized follow:

<table>
<thead>
<tr>
<th>Bond Code</th>
<th>COJ01</th>
<th>COJ02</th>
<th>COJ03</th>
<th>COJ04</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenure</td>
<td>R1 billion</td>
<td>R1 billion</td>
<td>R700million</td>
<td>R1.2billion</td>
</tr>
<tr>
<td>Maturity date</td>
<td>6 years</td>
<td>12 years</td>
<td>8 years</td>
<td>12 years</td>
</tr>
<tr>
<td>Comparison bond</td>
<td>R153</td>
<td>R157</td>
<td>R157</td>
<td>R203</td>
</tr>
<tr>
<td>Spread</td>
<td>96 bps</td>
<td>120bps</td>
<td>100bps</td>
<td>115bps</td>
</tr>
<tr>
<td>Coupon</td>
<td>11.95</td>
<td>11.90</td>
<td>9.70</td>
<td>9.00</td>
</tr>
</tbody>
</table>

Source: Jason Ngobeni, 2007

2.4.5. The result of bond issuance
COJ01 is the first bond that issued by the city was R1billion without a guarantee. This city success to issue with oversubscription and received 18 bids totaling ZAR1.48 billion (1.5 times oversubscribed). At the clearing price, the issue was oversubscribed 1.3 times. With the numbers of investors are 14.
COJ02 was 40% partially guaranteed. International Finance Corporation (IFC) guaranteed by 20% and The Development Bank of South Africa (DBSA) at the same portion, 20%. The city received 16 bids totaling ZAR2.3 billion (2.3 times oversubscribed). And at the clearing price, the issue was oversubscribed 1.5 times. For the second bond the city gained seven additional investors.

The COJ03 clearing price was 154 points above the R157 government bond. The bond coupon is 11.90 with the nominal R 700 million. This bond issued under the Medium Term Note Program.

2.4.6. The impact for CoJ

These bonds were extremely received by the market; it was proofed by 1.5 times oversubscribed on COJ01 and 2.3 times for COJ02. An important impact from issuing bonds process has been creates platform further municipal bond issue for other municipalities. Another impact, investor now has a good knowledge of credit risk related to municipal bond by looking from the bond performance. Further good impact is improved the bonds in secondary market. And in long term issuing municipal bond can be a model for capital fund raising in South of Africa.

Issuing municipal bond also has impact on capital expenditure. The capital expenditure increase by 52% from R0.95 billion in 1995/6 to 1.98 in 2004/5 shown in table 2.2 below.

Source: Roland Hunter Presentation to IADF Conference, 2004
The effort of issuing municipal bond is concentrated on using capital raised to reduce the backlog of infrastructure. ‘The CoJ is now investing extensively in meeting service need, 40% of the capital budget in the last year went to repairing and replacing electricity infrastructure, in attempt to reduce power outages and improve bulk infrastructure’ (Palmer Development Group, 2050).

2.5. The Advantages and Disadvantages of Municipal Bond

Local government can be borrowed money to increase their capital within country, from banks or from local capital market. The advantage of using local capital markets is that there is no risk that emerges from currency devaluation. The money is leant and repaid in local currency. The other advantage is that external lenders can not impose, especially by development bank. (David Hall, 2004).

Another advantage of municipal bonds is exempt from federal income tax. Bonds also exempt from local tax if the bonds are issued in their local area. (Esme Faerber, 1999).

Michael Pettis explains that ‘Local term bond market has several economic benefits as follow:

1. First, it allows a more efficient allocation of savings as it matches the borrowers and savers directly. Hence it reduces the role of banks in the investment process, and reduces the amount of political interference in the allocation of credit since banks are subject to regulators such as the central bank.

2. Second, local bond markets allow borrowers to use capital that is tailored to their assets and operations. Such tailoring may occur in many ways, the most important of which concerns maturity. Banks typically like to lend fairly short because their funding sources are very short, but projects are not necessarily short term. That is why maturity mismatches have traditionally been one of the biggest sources of domestic market problems.

3. Third, economic benefit of long-term local bond markets is that they provide retail and institutional investors with several high-quality and liquid domestic saving vehicles. Bonds have investment funds and pension funds. Many of the characteristic that allow savers to choose their risk and maturity, and to develop
4. Fourth, local government bond markets create monetary policy instruments. Government bonds also provide a pricing benchmark for the corporate sector. In fact, a corporate bond market should probably not be considered until there is a government bond market, since the government is the only borrower big enough to develop a very liquid market.’ (Michael Pettis, 2000, p 49).

Beside advantages, there are also disadvantages which resulted from issuing municipal bond. Esme Faerber mentions some disadvantages of municipal bond as follow:

1. Liquidity
   The liquidity of municipal bonds compare with government securities are less liquid and less marketable. There are some difficulties for investor to sell municipal bond in small number with the trading issues of bond are less actively in secondary market.

2. Loosing provision
   Municipal bonds have call provisions for their coupon. Investor must be sensitive with call provision. They could lose part of their investment if the issue is called at a lower price than the purchase price. It can happen when the investors buy a tax exempt bond trading at a premium.

3. Default risk is of increasing concern owing to a number of defaults in the past and the increasing number of financially troubled cities.

4. Volatility
   The price of municipal bond can fluctuate any time with the changes in interest rates. The price will more volatile in the longer maturity of the issue.

5. The spreads of dealer can be quite wide and can vary considerably among dealers. It will result too much mark-ups for investor.

2.5.1. The advantages and disadvantages of CoJ Municipal Bond

The Advantages

Start from year 2003, there is debate in Johannesburg city whether bond financing or bond loans was a better way to meet the CoJ’s infrastructure financing need. The question emerge whether advantages and disadvantages of issuing municipal bond to
raise capital financing. According to Jason Ngobeni, the advantages of issuing municipal bond for JoC are:

- **Raising Capital Size.**
  The capital which is resulted from issuing municipal bond mostly can be larger than bank loan. It depends on enthusiasm of the community. It also depends on local authority’s trustworthiness and financial management performance. (See graph 2.1, performance of city financial improved between 1996/1997 and 2004)

- **Interest Rate.**
  ‘The interest rate of municipal bonds depends on the creditworthiness of the issuer and the effectiveness of marketing the issue of underwriter and investors. The interest rate reflects a premium over the rate on the most risk-free bond of the same maturity, typically some form of national treasury debt. Most important, interest rate on bonds can be lower than those on bank loans. That potential seemed to exist in South Africa’. (Jason Ngobeni, 2008, p 2)

- **Maturities**
  The tenure of municipal bond usually has longer maturity than bank loans. It means that the debt service costs are spread over in longer period. This scheme make easier to pay. If the purpose of issuing bond for financing infrastructure project, the extending of repayment period also makes good public policy sense. The scheme of repayment matches the life of the assets which is built with liability that must be paid back. Meaning that by longer maturities of bonds, the users of infrastructures contribute to repay through tax or charges.

- **Collateral requirement**
  Traditional bank loans usually need matching collateral requirement. It makes difference with bond. This requirement will increase their true cost for municipality. Almost 20% of every $1 borrowed would have to be investing with the lender. They must return on the account which is usually below market rates in South Africa.

**The disadvantages**

Furthermore, there are also disadvantages of issuing municipal bond for CoJ. According to Jason Ngobeni the disadvantages of issuing municipal bond are:
o **Issuance cost**

At first time of issuing bond, the cost can absorb higher cost than loans. There are many cost that must be paid including cost for advisory, underwriter fees and process of due diligence for disclosure requirement on issuing bond. Most of the cost that resulted from issuing bond can be paid from proceed of the issue. This will not cause problem for the issuer cash flow.

o **Credit issue and interest cost**

Municipal bond can be more expensive than commercial loans if investors recognize quality credit of bond is underprivileged. Most investor in South Africa perceived municipal bond as a risky investment in 2003. CoJ should work hard in order to make the bond more attractive there from market interest to buy municipal bond. CoJ must pay attention to credit enhancement including financial guarantee which will reduce interest costs.

o **Market limitation**

The condition of South African Capital market in early 1900s was unstable. Interest rate relative very high, investor did not know very well about the market, there are only few financial intermediaries that had bond experience. The role of rating agencies is very rare to use. No secondary market for bonds, so it will make investor difficult to sell bond before maturity.

o **Amortization of Payment**

Usually municipalities prefer to use amortizing bank loans to finance their program. But South African investors and underwriters mainly prefer to bullet bonds because of their simplicity. Municipalities can repay their interest and principal in each year. While bullet bonds require accurate financial planning to make sure that they can be repaid when the bond mature.

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3 A noncallable is regular coupon paying debt instrument with a single repayment of principal on the maturity date. Sometimes it referred to as a virgin bond.
2.6. Feasibility and Prerequisites for a municipal bond market to function

‘There are prerequisites for a municipal bond market to function. The first is the existence of an active and well functioning capital market that can be accessed by local government. Even where capital markets exist there is often legislation that prevents local government from accessing such market. Thus legal or regulatory changes may be required before this mechanism can be used. Secondly, a bond market cannot function without sufficient institutional mechanism for credit rating through effective credit rating agencies. Such agencies may not exist in all countries and where they do exist, they may not have the necessary experience to assess local government borrowers. Thirdly, local government need to have sufficient capacity and credit-worthiness to issue bonds. In most developing countries local government revenues are weak and there is heavy reliance on central and state transfer. At the same time poor financial management system and practices result in low revenue mobilisation and and poor accounting and expenditure control’. (Blore, Nick Devas and Richard Slater, 2004, p150)

Jason Ngobeni explains that there are pre-condition that must comply by local government for successful issue municipal bond. Firstly, local government sounded public policies, fiscal policies, low interest rates, strong currency. Secondly internal treasury must have ability to manage the bond issue. Thirdly, local authority must have good long-term strategy & planning e.g. economic development strategy and long term capital development plans. Fourthly, the local authorities must provide stable leadership and management due to politician, the problem of the city and plan to deal with them.

One of the models that could be used by us to apply municipal bond in the emerging economies countries is the US model. To attracting issuer and investor, the policy maker in this country have begun to identify the basic strength within country. Table 2.2 showed the strength in which they have been achieved in the US market.
Table 2.2 Framework for assessing municipal bond market development

<table>
<thead>
<tr>
<th>Supply/Demand</th>
<th>Essential market strengths</th>
<th>US market characteristic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demand for municipal bonds: Investor Attraction</td>
<td>o Investor familiarity and confidence</td>
<td>o 200 years of legal procedural development, with history of market success and failures</td>
</tr>
<tr>
<td></td>
<td>o Ability to trade securities</td>
<td>o Active secondary market</td>
</tr>
<tr>
<td></td>
<td>Freedom to invest</td>
<td>o Absence of government control</td>
</tr>
<tr>
<td></td>
<td>o Acceptable investment return</td>
<td>o Tax exemption for interest income</td>
</tr>
<tr>
<td></td>
<td>o Strong credit quality</td>
<td>o Tax supported debt</td>
</tr>
<tr>
<td></td>
<td>o Information regarding risk</td>
<td>o Revenue back debt</td>
</tr>
<tr>
<td></td>
<td>o Assistance in interpreting information</td>
<td>o Separate corporate issuers, Standardised legal and financial data (rating agencies, bond insurance, mutual)</td>
</tr>
<tr>
<td>Supply of Municipal Bond: Issuer attraction</td>
<td>o Tolerable borrowing costs</td>
<td>o Low interest rate and issuance costs</td>
</tr>
<tr>
<td></td>
<td>o Long term debt amortisation</td>
<td>o Extended maturities</td>
</tr>
<tr>
<td></td>
<td>o Assistance for small borrowers</td>
<td>o Bond banks, pooled borrowing, etc</td>
</tr>
<tr>
<td></td>
<td>o Facilitative formal oversight</td>
<td>o Responsible self regulation</td>
</tr>
</tbody>
</table>

Source: James Leigland, Rosalind H. Thomas, 1999, p734
CHAPTER 3

Background

3.1. Introduction

Our case study revolves around the financing source of local government. One of many alternative sources that can meet local government fiscal need is issuance municipal bond. Therefore this chapter will explore about public finance and rule of municipal bond in Indonesia capital market.

3.2. The Source of Financing

According to Jack M. Ruhl in his article that was quoted by Nicholas G. Apostolou and D. Larry Crumbley in Handbook of Government Accounting and Finance, there are three funding methods that used by the regional government to build the infrastructure: traditional or conventional financing, creative financing, and public-private financing arrangement.

a. Traditional financing

Three methods that use in this case:

(1) Pay as you go financing, this funding did not require regional government to publish promissory note. Funding for the capital expenses came from the tax income in the proceeding year. The benefit from this funding the regional government can avoid interest rate loan payment and formation fund payment in the future.

(2) Short term financing, is funding by published debt in 12 month period or less.

(3) Tax exempt bond financing.

b. Creative financing

The creative financing types are:

(1) Tax increment financing, applied by government as main supporting to defray development in damage region which affected by disaster.
(2) Lease, is legal agreement, which confers a right on one person (lessee), in this case government, to use property another person (lessor) in certain period time.

(3) Public enterprise.
   Public company provides public facility which finance by published bond. Consumer will pay principal and interest payment who uses the public facility.

(4) Short-term financing, by published tax-exempt commercial paper and variable or flexible rate notes.

(5) Creative long-term financing: zero coupon bonds (zeros), put option bonds, credit enhancements.

c. Privatization

   Privatization is a form of cooperation between public sectors and private sector where government delivers authority and providing responsibility of public service to private company, like City Park, fire company and road/street service.

   Davey in “Financing Regional Government”, 1983, p.17 mentioned five sources of funding by regional authorities which can carry out to fit their needs. ‘The five sources are:

   a. Central Government Allocation
      Is allocation from central government budget-appropriation from revenue accruing in the first instance to national government – are significant and often predominant sources of funding for regional authorities. They are frequently described as “transfer” and take several forms; grants; tax sharing; loans.

   b. Taxation
      Regional authorities may derive revenue from taxation in three ways. First sharing of taxes levied and collected by central government, second regional authorities may impose a surcharge on tax levied and collected by central government, third source of tax revenue is the levies which regional authorities collect and retain themselves.

   c. Charging
Are paid directly by those who consume a service and are normally appropriated to meeting all or part of its cost (rent for local authority house, irrigation charges, entertainment fees are cases point)

d. Borrowing
Loan is a channel of central government finance. Regional authorities in different countries borrow also from a variety of other source, including international and foreign agencies, centrally operated credit funds, commercial banks and other financial institution.

e. Enterprise
Regional authorities may generate revenue from the operation of commercial or productive enterprise as a source of net income’

3.3. Fiscal Decentralization in Indonesia.
The source of funding in APBD (Regional Revenue and Expenditure Budget) generally very limited to provided the cost of regional development investment. According to Law No 33/2004, regional government was given by the authority to make use their own revenue supported by intergovernmental transfer. Further, regional government was given by the authority to collect the tax/regional retribution, accepted revenue sharing and grant or as know as balancing fund.

Moreover, regional government was also given by the authority to carry out the regional financing by issued loan. This loan could take in the short-term and long term. Short term loan released to overcome difficulty of local government cash flow and the long-term loan is to finance the regional infrastructure. The source of local government financing covers:

---

4 The system of intergovernmental transfers in Indonesia comprises three basic types of schemes: revenue sharing, a general purpose grant (DAU), and grants for specific purposes (DAK).
5 Balancing Fund means a fund sourced from APBN (National Revenue and Expenditure Budget) allocated to a region to finance the need of the region in implementation of Decentralization.
1. Regional Own Revenue, called PAD, means locally-raised revenue of a region collected based on a Perda in implementation of Decentralization.

2. Balancing fund means a fund sourced from APBN (National Revenue and Expenditure Budget) allocated to a region to finance the need of the region in implementation of Decentralization. Balancing fund consists of: Revenue Sharing Fund (DBH), General Allocation Fund (DAU), and Special Allocation Fund (DAK).

3. Regional Loan means a transaction to enable a region to receive money or benefits of monetary value from a third party with the obligation on the part of the region to repay the loan.

The source of financing that comes from PAD, DAU and DAK did not yet give quite significant contribution in order to finance regional development. This condition could be seen in the regency or municipal where the source of revenue 86% came from balancing fund and only 7% from PAD (Usui and Alisjahbana, 2003). General allocation fund is still dominant for regency or municipal to overcome their regional budget. Around 45% of regency and municipal in Indonesia, still draping more than 80% funding of APBD from DAU to finance their regional budget. There is only around 4% of regency and municipal which its DAU contributed more or less to 10% to APBD. (Bambang Brodjonegoro, 2003).

Ironically, most acceptances were utilized to pay the routine need like official salary, so the allocation for development financing is relatively small. Almost in each region the portion of salary expenses reached 60 percent to 80 percent, whereas the

---

6 Revenue Sharing Fund (DBH=Dana Bagi Hasil) is sourced from taxes and natural resources.
7 General Allocation Fund, called DAU (Dana Alokasi Umum), means a fund sourced from APBN allocated to bring equality in the financial capacity among the regions to finance the need of the regions in implementation of Decentralization.
8 Special Allocation Fund, called DAK (Dana Alokasi Khusus), means a fund sourced from revenue in APBN allocated to a certain region with the aim of helping funding special activities of the region in accordance with national priorities.
9 Total number of province in Indonesia are 33, divided into 370 regency and 95 city/municipal.
portion of the expenses for development not more than 25 percent (H Djoko Sudantoko SSos MM, Taufik Hidayat, SE., MSi, 2005).

For the region that was classified as rich in nature resources, the alternative to increase funding for regional development perhaps did not become a problem, because they could use revenue sharing fund from natural resources (BHSDA), especially for oil and natural gas as well as results of fisheries. However for areas that were classified as barely adequate or backward in nature resources, the alternative source of funding for development will be carried out through methods that not populist. For example, improvement of source of funding through PAD by intensifying local tax and retribution as arranged in Law 34/2000 exactly potency pursues investment local government, even not closed possibility would many companies which will close and exit from the area.

That is way; scheme BHSDA seems to less can be pledged for funding regional government because there is only one percent regency/municipal in Indonesia which has BHSDA more than 50% in APBD. The other hand, there is around percent regional government in Indonesia which have BHSDA more than 30% in APBD. Equally, more than 80% of local government is not possibly relies on receiving from natural resources.

By seeing the phenomenon, it can be concluded that the amount of dependency of local government to central government still big to counter balancing fund. It gives meaning that decentralization happened present is not decentralizing source and receiving authority, but decentralization depend on transfer of balancing fund from central government to local government.

Local government can not provide basic facilities with so small development budget. In other word, it caused stagnation in process of regional development. Municipalities have to be innovative in order to meet their financing needs. In consequence, it needs thought of alternative of regional development funding by digging fund outside source of receiving which there have. One of the benefits from region autonomy was to be given the freedom to the regional government to carry out their finance. Including the freedom to arrange and determine the source of regional budget funding through the region loan.
Municipal bond still unexplored as a mechanism of financing capital project of municipalities in Indonesia. The need of municipal bond as source of funding for regional development in any case there are three things (Ardi Hamzah, 2005). First, regional government has been very urgent to look for alternative sources of funding apart from PAD and balancing fund. Second, many of the securities companies and investment banking aggressively approached the regional government to offer various funding schemes. Third the discourse of municipal bond has aroused the interest of several investors, both domestic and foreign for the development of regional infrastructure.

3.4. The Nature of Bond

“A bond is a debt security. When you purchase a bond, you are lending money to a government, municipality, corporation, federal agency, or other entity known as the issuer”. 10 Bonds are debt and are issued for a period of more than one year. When an investor buys bonds, he or she is lending money. ‘The seller of the bond agrees to repay the principal amount of the loan at a specified time. Interest-bearing bonds pay interest periodically’.

Generally, there are two type of regional government bond that is the General obligation bonds and revenue bonds. The General obligation bonds are bonds that guaranteed be based on full Faith and credit of an issuer with taxing power. While revenue bonds are bonds that published by regional government for a certain project where the fulfillment of the obligation that emerged from the regional bond was paid from the income of the project, so as the full Faith and credit of an issuer with taxing power are not pledged.

10 http://www.sec.gov/answers/bonds.htm
11 http://www.investinginbonds.com/learnmoreasp/bond
Bond Classification

We can classify bond as many type. **First**, classified by issuer side: (1). Corporate bond are bonds that was published by the company, State Owned Company or private enterprise's company, (2) Government Bonds are bonds that was published by central government, here including Municipal bond, are bonds that was published by the regional government to finance projects that were linked with the interests of the public (public utility).

**Second**, classified by interest payment system : (1) zero coupon bond are bonds that do not pay interest periodically. However when zero coupon mature the investor will receive the lump sum equal to the initial investment and imputed interest, (2) coupon bond are bonds with the coupon that could be cashed in periodically in accordance with the provisions of the issuer. (3) fixed coupon bond are bonds which has fix amount of coupon rate from the time of initial issued until maturity date. Fix coupon bond will be paid at specific period of time, (4) Floating coupon bond are bonds Bond which has coupon rate that is usually keep on adjusting to the reference rate in the market, such as weighted average of interest rate of average time deposit (ATD) in the biggest government bank or private bank, (5) mixed rate bond are bonds Bond has a fix coupon rate only for certain period of time (e.g. 1- 3 year) then it will be floating follow the market rate.

**Third**, classified by changing right/option: (1) convertible bond are bonds that give the right to the holder to convert this bond in several share belonging to the issuer, (2) exchangeable bond: are bonds that give the right to the holder of the bond to exchange the share of the company in several shares of the affiliation company belonging to the issuer.

**Fourth**, classified by aspect of the guarantee or collateral: (1) secured bond are bonds that was guaranteed with the certain wealth from the issuer or with other guaranteed from the third party. In this group including: guaranteed bonds, mortgage bonds and collateral trust bonds. (2) Unsecured bonds are bonds that not guarantee with the certain wealth but it was guaranteed generally with issuer’s wealth.
Fifth, classified by the aspect of the value: (1) are bonds that usual traded in one nominal, one billion rupiah per one lot. (2) Retail bond are bonds that traded in small value unit, both corporate or government bond.

3.5. Briefly Indonesia’s Bond Sector

3.5.1. Corporate Bond Market

- The profile of Indonesia’s corporate bond

<table>
<thead>
<tr>
<th>Summary of Indonesian IDR Corporate Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer</td>
</tr>
<tr>
<td>Types</td>
</tr>
<tr>
<td>Time to maturity</td>
</tr>
<tr>
<td>Coupon payment</td>
</tr>
<tr>
<td>Coupon Structure</td>
</tr>
<tr>
<td>Settlement</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Listing</td>
</tr>
<tr>
<td>Trading</td>
</tr>
<tr>
<td>Outstanding amount</td>
</tr>
</tbody>
</table>

Corporation bond market, although the volume is smaller compared to government bond market, but still grows. Both corporate and government bond is listed on the Indonesia Stock Exchange (IDX). From 1989 until 2007 both bonds was listed on Surabaya Stock Exchange. The Surabaya Stock Exchange started in 1989 as a region stock exchange to support the main exchange, Jakarta Stock Exchange. Approximately there are 95% of bonds issued in Surabaya Stock Exchange. Later on 30th November 2007 Surabaya Stock Exchange merged with Jakarta Stock Exchange. And the name was change to be Indonesia Stock Exchange. It currently lists 175 issuer of corporate bonds in Indonesia Stock Exchange with the total of outstanding is IDR 84,553.03
billion\textsuperscript{12}. The following chart shows the movement of outstanding corporate bonds from 2000 to 2007.

Graph 3.1 Outstanding Corporate Bond 2000-2007

- The Issuer

In the end of 2007 there are 175 companies as issuer, most Indonesian corporate bond are concentrated on finance and trade service and investment. The third rank is basic industry and chemical. The following table shows Indonesia corporate bond sector as of December 2007.

Table 3.1 Corporate Bond by Sector

<table>
<thead>
<tr>
<th>Amount of Issuer</th>
<th>%</th>
<th>Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>2.67</td>
<td>Agriculture</td>
</tr>
<tr>
<td>1</td>
<td>1.12</td>
<td>Mining</td>
</tr>
<tr>
<td>20</td>
<td>5.93</td>
<td>Basic Industry and Chemical</td>
</tr>
<tr>
<td>9</td>
<td>2.26</td>
<td>Miscellaneous Industry</td>
</tr>
<tr>
<td>11</td>
<td>8.83</td>
<td>Consumer Good Industry</td>
</tr>
<tr>
<td>19</td>
<td>5.17</td>
<td>Property, Real Estate</td>
</tr>
<tr>
<td>13</td>
<td>23.65</td>
<td>Infrastructure and Utilities Transportation</td>
</tr>
<tr>
<td>68</td>
<td>43.74</td>
<td>Finance</td>
</tr>
<tr>
<td>27</td>
<td>6.63</td>
<td>Trade Service and Investment</td>
</tr>
</tbody>
</table>

\textsuperscript{12} Source from Capital Market Supervisory Agency, December 2007
The ownership composition of corporate bond

Pension and mutual funds is the largest holder of Indonesia corporate bond. The state owned pension firms Jamsostek under Ministry of Labor (with Rp50 trillion of asset, in April 2007) and Taspen under Ministry of Finance (with Rp20.5 Trillion asset in 2005) are the largest pension and social securities fund in Indonesia. Both of firms are the largest corporate bond holder. As a whole, the composition of corporate bond ownership explains by table 3.2 as follow:

Table 3.2 Investor Diversity of Indonesia’s Corporate Bond

<table>
<thead>
<tr>
<th>Bond holder</th>
<th>(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Investor</td>
<td>4.59</td>
</tr>
<tr>
<td>Local Investor</td>
<td>95.41</td>
</tr>
<tr>
<td>Insurance</td>
<td>19.68</td>
</tr>
<tr>
<td>Investment Fund</td>
<td>17.70</td>
</tr>
<tr>
<td>Pension Fund</td>
<td>26.86</td>
</tr>
<tr>
<td>Finance companies</td>
<td>21.99</td>
</tr>
<tr>
<td>Others</td>
<td>9.18</td>
</tr>
</tbody>
</table>

3.5.2. Government Bond Market

The summary below explains briefly about the profile of Indonesia IDR government bond:

- The profile of IDR Government Bond

<table>
<thead>
<tr>
<th>Summary of Indonesian IDR Government Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer</td>
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<tr>
<td>Types</td>
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<tr>
<td></td>
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<tr>
<td></td>
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<tr>
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</tr>
<tr>
<td>Trading</td>
</tr>
<tr>
<td>Outstanding amount</td>
</tr>
</tbody>
</table>
Seen from the summary above, all type of government bonds were issued by central government. There had regulation which is supported local government to release municipal bond. The local government opportunity to issue municipal bond was wide opened, but until now did not yet have one of local governments issued municipal bond as part of source of local government finance.

- Ownership of IDR Tradable Government Securities (%)

Banks are still dominant as the ownership of government bonds. Foreign investors (offshore) share tends to increase. The composition of government ownership shows in the next table.

Table 3.3 Composition of IDR Government Bond Ownership (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>72.02%</td>
<td>72.44%</td>
<td>64.27%</td>
<td>56.84%</td>
<td>57.27%</td>
</tr>
<tr>
<td>State Banks - Recap</td>
<td>39.78%</td>
<td>38.64%</td>
<td>36.48%</td>
<td>32.63%</td>
<td></td>
</tr>
<tr>
<td>Private Banks Recap</td>
<td>23.83%</td>
<td>21.35%</td>
<td>19.29%</td>
<td>16.64%</td>
<td></td>
</tr>
<tr>
<td>Non Recap Banks</td>
<td>8.12%</td>
<td>11.45%</td>
<td>7.83%</td>
<td>6.77%</td>
<td></td>
</tr>
<tr>
<td>Regional Banks</td>
<td>0.30%</td>
<td>0.99%</td>
<td>0.66%</td>
<td>0.79%</td>
<td></td>
</tr>
<tr>
<td>Bank Indonesia (CB)</td>
<td>2.63%</td>
<td>1.8%</td>
<td>2.98%</td>
<td>3.11%</td>
<td></td>
</tr>
<tr>
<td>NON Banks</td>
<td>27.98%</td>
<td>24.93%</td>
<td>33.93%</td>
<td>40.19%</td>
<td>39.62%</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>13.52%</td>
<td>2.28%</td>
<td>5.12%</td>
<td>5.44%</td>
<td>5.65%</td>
</tr>
<tr>
<td>Insurance Company</td>
<td>6.78%</td>
<td>8.08%</td>
<td>8.37%</td>
<td>8.14%</td>
<td>8.15%</td>
</tr>
<tr>
<td>Foreign Holder</td>
<td>2.69%</td>
<td>7.78%</td>
<td>13.12%</td>
<td>18.62%</td>
<td>17.83%</td>
</tr>
<tr>
<td>Pension Fund</td>
<td>4.11%</td>
<td>5.51%</td>
<td>5.51%</td>
<td>5.20%</td>
<td>5.19%</td>
</tr>
<tr>
<td>Securities Company</td>
<td>0.11%</td>
<td>0.24%</td>
<td>0.24%</td>
<td>0.13%</td>
<td>0.15%</td>
</tr>
<tr>
<td>Others</td>
<td>0.77%</td>
<td>1.58%</td>
<td>1.58%</td>
<td>2.65%</td>
<td>2.65%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Total in Trillion IDR</td>
<td>399.30</td>
<td>399.84</td>
<td>418.75</td>
<td>448.42</td>
<td>448.42</td>
</tr>
</tbody>
</table>

Source: Indonesia Debt Management, Ministry of Finance

Note:
- Foreign Holders (offshore) are non-resident Private Banking, Fund/Asset Management, Securities Co, Insurance, Pension Fund, etc.
- Others are Corporate, Individuals, Foundations, etc.
- Private Banks – Recap and Non Recap Banks include foreign banks Source: Ministry of Finance branches and subsidiaries
• Outstanding IDR Government Bonds 2000-2007

The trend of outstanding IDR government bond increasing from 2000 to 2007. The purpose of issued government bond is to finance the deficit state budget which was resulted by economic crisis in year 2007.

The next chart explains about the movement of IDR government outstanding in year 2000-2007.

Graph 3.2 Outstanding Government Bond 2000-2007

3.6. Law of Municipal Bond in Indonesia

3.6.1. Basis Law

On this chapter we will concentrate on highlight of the law that augments the issue of municipal bond. Rule number 33/2004 concerning Fiscal Balance between Central Government and Local Government chapter 5 paragraph (1) cites “Regional Incomes in consists of Regional Revenue and Financing. Financing referred to in paragraph (1) derives from:

a. Remaining balance in the regional budget

b. Regional loan

c. Regional reserve fund, and
d. Proceeds from sales of regional assets set aside for the purpose

The chapter above followed by chapter 51 paragraph (1) mentions: Regional Loan shall be sourced from:

a. The Government
b. Other regional governments
c. banks/financial institutions
d. Non-bank financial institutions, and
e. The public

Regional Loan source from the public referred in chapter 51 paragraph (1) letter e in the form of Regional Bond shall be obtained through the capital market. The regional government may issue Regional Bond in Rupiah currency on the domestic capital market. Proceeds from the sales of Regional Bond shall be used to finance investments in the public sector which generates income and brings benefits to the public. As mentioned in chapter 2 the long term loan has some requirement, such as:

- The balance of the existing loan plus the amount of the loan to be drawn shall not exceed 75% of total revenue in APBD (Regional Revenue and Expenditure Budget), of the previous year,
- Debts Coverage Service Ratio $\geq 2.5$
- It is not in arrears in repayment of loan from the Government. The other important matter that must be paid attention The Central Government does not guarantee Regional Bond. Issuance of Regional Bond by the regional government is subject to the Regional Head obtaining a prior approval from Regional House of Representatives (DPRD) and the Government and shall be established by Regional Regulation (Perda).
- The cumulative maximum limit referred to in paragraph (1) shall not exceed 60% (sixty percent) of the Gross Domestic Products of the year concerned.

The above law quotes are useful in two ways, with respect to revenue. First the trustworthy source of revenue can be pledge to allow local government to borrow through the issue of bonds. Second empower the local government to start project that are bound to deal with issues affecting their community. In Central Java there are
number of issue that are affecting people that can easily be addressed by bond issue, such as building toll road to improve connection one to another city, organized low cost housing as an alternative to the slum area in order to get better standard of living, building public hospital, increasing airport service facility.

It is legally possible for local government to borrow money especially in case where the purposes are to improve the local government revenue performance and to be used to finance investment in the public sector which generates income and brings benefits to the public. Related to high light which is mentioned above, Law No 33/2005 chapter 66 mention that Regional finances shall be managed in an orderly, efficient, economical, effective transparent, and responsible manner in accordance with the prevailing laws and regulations with due regard to fairness, propriety and benefit to the public. It gives sign that the wish for borrow money from public will force local government to be aware of accountability in their wish to get good ratings on their bond that reduce the cost of obtaining funds.

3.6.2. Accounting Regulation and Borrowing

Accountability of local government finance is governed by Government Rule Number 58/2005 concerning Local Governments Financial Management. In chapter 5 that guides the management authority of local government finance, it is stated that the financial transactions of local government and a lower board shall be managed by the head of office as a chief finance officer. Subject to the provisions of the Rule and these Regulations under the general supervision and guidance of the accounting officer of the own board. The accounting officer is the chief executive that ensures appointment of qualified and competent staff among other duties: In the exercise of his or her duties the chief finance officer, the accountant shall prepare monthly financial statements, balance sheet, cash flow and realization of budget in each board and make sure that such reports are made available to members of the standing committee responsible for finance within ten days after the end of each month. This report is reviewed by the standing finance committee before reported to the local parliament as representative of local society.
Compliance to the implementation of accountability is annually monitored by Financial and Development Supervisory Board (BPK). This board shall guarantee that local governments and the relevant officers of local governments comply with the regulations. It is clear that the law on financial management and the terms for audit is obvious, if well followed then the fears of fraud and loss can be eliminated. This is particularly useful to lenders that may be worried about the financial behavior of local governments.

In section V Article 5 and 6 Law Number 33/2005, local government revenue derive from local tax, retribution/local charging, proceeds from the management of regional assets set aside for the purpose, and other legal own revenue (PAD). It imply that local government have several revenue that may make them credit worthy if the collection of their revenue is good.

In section VIII part 7 articles 51, 57, 58; the provision for local government borrowing is provided clearly and it is an interesting part as far as protection for investor is concerned. I state it below with some remark specific to bond:

- Local government revenue can derive from regional loan which shall be obtaining from public in the form of municipal bond through the capital market.
- The regional government may issue Regional Bond in Rupiah currency on the domestic capital market
- Long term loan referred to Regional Loan for a period of more than one budget year with the obligation to repay the loan, including principal, interests and charges, in full in the following budget years in accordance with the terms and conditions of the loan.
- Income from investments in the public sector shall be used to pay the principal and interests of the municipal bond with the balance paid to the Regional Treasury
- Issuance of municipal bond by the regional government is subject to the Regional Head obtaining a prior approval from Local Parliament (DPRD) and the Government (executive).
Local parliament (DPRD) approval to the issuance of Municipal Bond referred shall include provisions on payment of principal and interests arising from the issuance of municipal bond.

The regional government shall pay the principal and interests on every Regional Bond on maturity.

Funds to pay principal and interests shall be provided in Local Government Budget (APBD) annually until the end of the obligations.

After municipal bond was published, the regional government had an obligation to make a report with reference of the use of the fund and the payment of principal and interest of municipal bond periodically to the Finance Minister. This report was made by the Head of local government or the official that was indicated. This report must be submitted to Finance Minister every 3 month.

Director General Fiscal Balance on behalf of Minister of Finance will carry out the evaluation regarding the publication of the municipal bond, the use of fund that come from municipal bond, the achievement of the implementation of the activity, as well as the realization of principal and interest of municipal bond. If there is fraud, then Director General Fiscal Balance could give the recommendation to Bapepam to suspend the publication of municipal bond in the capital market.

The law is clear on the issuance and repayment of bond. It can be said that most worried about risk default are addressed by the law. Most importantly local government can issue bond legally to finance public project.

3.6.3. The Role of Capital Market Supervisory Agency (Bapepam)

Capital Market Supervisory Agency hereinafter referred to as Bapepam acts as the regulator of the capital market industry in Indonesia. Bapepam has duty to provide guidance, regulation, and day-to-day supervision of the capital market. It is a legal administrative agency of the government under the Ministry of Finance. It derives authority from the Capital Market law Number 8/1995.

In providing the guidance, regulation and supervision, Bapepam shall act with the purpose of ensuring that the Capital Market is orderly, fair, and efficient and that the interests of investors and the public are protected. It is empowered to supervise
Indonesia Stock Exchange, all capital market supporting institution and to protect the interest of investor. If any municipality will issue bonds then all aspect of agreement have to convince and approved by Bapepam in the interest of reducing default risk. The process of issued municipal bond follows the same process and provisions with corporate bond.

3.7. Public Offering of Municipal Bond in Indonesia Capital Market

"To go public companies/issuer have to make internal and documents preparation in accordance to the requirements needed for going public, and fulfill all the requirements stated by the Indonesia Capital Market Supervisory Agency (Bapepam). Public offering or go public is the activity of stock or other marketable securities offering by an issuer (firm or government) to the public based on the procedures arranged in the capital market law and its implementation rules” (Indonesia Stock Exchange). The only Issuers that may conduct a Public Offering are those that have submitted a Registration Statement to BAPEPAM with respect to the sale or offering of Securities to the public, and then only after such Registration Statement has become effective.\(^{13}\)

The process of issuance of municipal bond covered several steps, that is: preparations, registration-statement submitting, evaluating by Bapepam, shares offering, and listing in the stock exchange.

**Preparation phase**

Preparations phase had several important activities that must be carried out by the issuer, including discussions with Local Parliament (DPRD) that furthermore was presented in the regional regulation (Perda) about issuance of municipal bond. The Perda must be mentioned several things, that is: purpose of issued bond, bond type, project or activity which will be financed, bond face value, principal payment obligations and bond interest, duration (time line), etc. After approval, the issuer must select the underwriter, market institution, supporting professions that consist of:
− Underwriter is a party who has most involvement is assisting the issuer for the agenda of go public. The activities that done by underwriter are: prepare various document, prospectus, and giving guarantee for issuing process.
− Public accountant has responsibility to audit and check the financial statement of issuer.
− Appraisal company for appraising the fix asset owned by issuer and determines proper value of the fixed asset
− Law consultant for giving legal opinion
− Notary for making amendment of the company basic’s budget and various agreement for the agenda of public offering

Registration-statement submitting (Letter of Intent)

Letter of Intent (LoI) is a statement of issuer (local government) to issue bond through capital market. The next step, issuer will complete the registration by giving supporting documentations to Bapepam.

Evaluation by Bapepam

In this step, Bapepam carried out the evaluation that was related to the completeness of the emissions document which was made by the issuer, compatibility of document material that was sent with the current provisions, the capacity of issuer to meet the main condition for public offering, and the other aspect that aimed to protect the interests of the bond holder (the investor).

Shares/bond offering

This is the main step, because the issuer offers its bonds to public for first time. Investor can buy the bond through seller agents who has been referred. For offering period is usually at least three trading days. Not all desire of investor fulfilled in this step. For instance, 200 million bonds offered in the market, while the amount of bonds

1) Indonesia Capital Market Law Number 8/1995
that investor to buy is 250 million shares. If the investor could not buy at the primary market, they can buy in the secondary market after listed in the stock exchange.

**Shares/Bond Listing in the exchange**

After selling the bonds in the primary market, the bonds are listed in the exchange. In Indonesia, the bond can be listed at the Indonesia Stock exchange. The next chart shows about the process of issued municipal bond start from preparation at local government level through public offering at capital market.
Chart. 3.1. Activity Related to Public Offering of Municipal Bond

Source: Ministry of Finance of Republic Indonesia
3.8. Good Governance Principle

Logical consequence that comes from issuance of municipal bond is claimed transparency and accountability by investor to local government as an issuer. Investor would always watch local government performance in managing their development fund which is got from public offering. Process of issuing municipal bond must follow the good governance principle which is applied in capital market that is Transparency, Accountability, Responsibility, Independency and Fairness. Consequently, local government officials should undertake the concept of good governance during the process of issuing municipal bond.

Transparency

Transparency and disclosure play important role to maintain credit worthiness of investor. This principle is very important feature for the new paradigm of local government's finance management. In the process of public offering, local government as issuer is obliged to deliver registration statement that consists of document covering disclosure, accountancy and legal aspect. This statement was exposed the background of company, purpose and scope of financial report, picture of company’s activity, industry’s risk. This statement also mention some component of finance report that consist of balance sheet, loss and profit, change of equity, cash flow, and the note on finance report. The aim of this guide was to increase the quality of transparency. Most all of documents including prospectus can be access by investor. Thereby investor can analyze the company performance, ownership and management before they make a decision to invest.

After issuers go public hence they are obliged to submit report to Bapepam, namely periodic and incident report. Periodic report covers financial statement either yearly (rule VIII.G.2) or semi annual (rule X.K.2) and report on the use of funds received from public offering (Rule X.K.4). While incident report cover “Disclosure of Information that Must Immediately be Made Public “(Rule X.K.1), and “Disclosure of Information by Issuers or Public Companies Regarding Bankruptcy” (Rule X.K.5). Transparency and disclosure principle emphasize all information which is published to public must be compiled, audited and presented appropriate to Indonesia accounting standard. These standards are harmonized with the International Accounting Standards. All information related
to the condition of local government finance can be accessed accurately and right on time by public. This thing will bring impact to increase performance of local government. In addition, the rules related to issuing municipal bond are:

- Bapepam Rule Number VIII.G15 concerning Guidelines for Drafting Comfort Letters for Municipal Bond Public Offering.
- Bapepam Rule Number VIII.G16 concerning Guidelines for Drafting Head of Local Government’ Accounting Statement for Municipal Bond Offering.
- Bapepam Rule Number IXC.12 concerning Form and Content of A Registration Statement for Municipal Bond Public Offering
- Bapepam Rule Number IXC.13 concerning Guidelines Concerning the Form and Content of a Prospectus for Municipal Bond Public Offering.
- Bapepam Rule Number IXC.14 concerning Guidelines Concerning the Form and Content of a Summary Prospectus for a Public Offering.

**Responsibility**

Responsibility principle means that local government has responsibility to make a report their finance management to stakeholder. According to Finance Minister Regulation PMK/147/2006 concerning Issue Procedure, Responsibility and Municipal Bond Publication explain that head of local government is obliged to make report of fund that obtained from municipal bond, this responsibility covers:

- Description about municipal bond portfolio.
- Municipal bond transaction report in capital market including public offering, amortization, repurchase, exchanges, payment of coupon and other cost, and other activity related to municipal bond management.
- The realisation of municipal bond strategy and policy including control of risk.
Head of local government reported their responsibility to local parliament, as part of local government annual budget report which is usually reported at the end of year financial statement.

**Independency**

Regarding the aspect of independency, the head of local government obedient to accounting standard in managing local government finance. The policy of government accountancy must be measured, recorded and reported openly, fair and could be accounted for to public through local parliament. The head of local governments as well as their apparatus has independency in managing economic resource in accordance to accounting standard.

**Fairness**

Fairness is the principle to protect the rights of bondholders, as well as guarantee the investor's commitment. The rights of the bondholders shall be protected and, for that reason, bondholders shall be able to exercise their rights through reliance upon appropriate procedures that have been adopted by the Company. This right comprise of:

- Received information that was relevant about the company periodically and regularly.
- Giving their voice on general meeting of bondholders.
- Received company's profit

With the existence of openness information to the public, then each government that did public offering in the capital market must be managed in accordance with the principle good corporate governance. So this process will increase competitiveness among local government in order to be trustworthy local government.

**3.9. Source of Local Government Revenue and the Constraints**

**3.9.1 Local Tax**

Tax as source of national income, has functions to finance state disbursements. Tax play a role in financing the development, without the existence of the tax, then the requirement fund for development will be difficult to meet because most national incomes come from tax that is approximately 67.52%.
From table 3.4, we can get information that the contribution of tax to form national income is very significant in amount. It is around 61% to 71% and the rest come from non tax. Table 3.4 shows the contribution of tax and non tax to total national income FY 2000-2007.

Table 3.4 Indonesia National Income from Tax and Non Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax</th>
<th>%</th>
<th>Non Tax</th>
<th>%</th>
<th>Total</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>125.95</td>
<td>61.60</td>
<td>89.42</td>
<td>38.40</td>
<td>205.33</td>
<td>100</td>
</tr>
<tr>
<td>2001</td>
<td>185.54</td>
<td>61.70</td>
<td>115.05</td>
<td>38.30</td>
<td>300.59</td>
<td>100</td>
</tr>
<tr>
<td>2002</td>
<td>210.08</td>
<td>70.40</td>
<td>88.44</td>
<td>29.60</td>
<td>298.52</td>
<td>100</td>
</tr>
<tr>
<td>2003</td>
<td>242.04</td>
<td>71.00</td>
<td>98.88</td>
<td>29.00</td>
<td>340.92</td>
<td>100</td>
</tr>
<tr>
<td>2004</td>
<td>280.55</td>
<td>69.60</td>
<td>122.54</td>
<td>30.40</td>
<td>403.10</td>
<td>100</td>
</tr>
<tr>
<td>2005</td>
<td>347.03</td>
<td>70.30</td>
<td>146.88</td>
<td>29.70</td>
<td>493.91</td>
<td>100</td>
</tr>
<tr>
<td>2006</td>
<td>409.20</td>
<td>64.30</td>
<td>226.95</td>
<td>35.70</td>
<td>636.15</td>
<td>100</td>
</tr>
<tr>
<td>2007</td>
<td>492.01</td>
<td>71.28</td>
<td>198.25</td>
<td>28.70</td>
<td>690.26</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

While regional tax was arranged due to Regional Regulation. Regional tax is very essential to put in local government infrastructure development. Table 3.5 explains about composition of Central Java Own Revenue. Seen form that table, it indicate that local tax still dominate to form total revenue. Local tax contributed 55% to total revenue and 85.91% to local own revenue in year 2004. FY 2005 local tax allocate 56.59% to total revenue and 80.14% to local own revenue. And FY 2006 local tax present 60.77% to total revenue and 85.52% to local own revenue. From explanation above could be concluded that the regional tax really played a role in contributing local government revenue.

Table 3.5 Composition of Realization

<table>
<thead>
<tr>
<th>No</th>
<th>Description</th>
<th>2004</th>
<th></th>
<th>2005</th>
<th></th>
<th>2006</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Rp.Trillion</td>
<td>%</td>
<td>Rp.Billion</td>
<td>%</td>
<td>Rp.Billion</td>
<td>%</td>
</tr>
<tr>
<td>1</td>
<td>Total Revenue</td>
<td>2.88</td>
<td>100.00</td>
<td>3.52</td>
<td>100.00</td>
<td>3.58</td>
<td>100.00</td>
</tr>
<tr>
<td>1.1</td>
<td>Local Own Revenue</td>
<td>1.86</td>
<td>64.69</td>
<td>2.49</td>
<td>70.62</td>
<td>2.54</td>
<td>71.08</td>
</tr>
<tr>
<td>1.1.1</td>
<td>Local Tax</td>
<td>1.60</td>
<td>55.55%</td>
<td>1.99</td>
<td>56.53%</td>
<td>2.18</td>
<td>60.89%</td>
</tr>
<tr>
<td>1.1.2</td>
<td>Local User Charges</td>
<td>0.14</td>
<td>4.86%</td>
<td>0.19</td>
<td>5.39%</td>
<td>0.20</td>
<td>5.58%</td>
</tr>
<tr>
<td>1.2.3</td>
<td>Share of profits from local enterprises</td>
<td>0.01</td>
<td>0.20</td>
<td></td>
<td></td>
<td>0.09</td>
<td></td>
</tr>
<tr>
<td>1.1.5</td>
<td>Others</td>
<td>0.10</td>
<td>0.09</td>
<td></td>
<td></td>
<td>0.07</td>
<td></td>
</tr>
<tr>
<td>1.2</td>
<td>Intergovernmental transfer</td>
<td>0.78</td>
<td>27.36</td>
<td>0.80</td>
<td>22.89</td>
<td>0.80</td>
<td>22.54</td>
</tr>
<tr>
<td>1.3</td>
<td>Other Legal Revenue</td>
<td>0.22</td>
<td>7.95</td>
<td>0.22</td>
<td>6.49</td>
<td>0.22</td>
<td>6.39</td>
</tr>
</tbody>
</table>

Source: Directorate General Fiscal Balance, Ministry of Finance

* Share to total revenue

50
Presently there are four provincial taxes and seven regency/city taxes. Table 3.6 shows structure of provincial and municipal own revenue.

**Table 3.6. Structure of Provincial Government Revenues**

<table>
<thead>
<tr>
<th>Provincial Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Own Revenue (PAD)</td>
</tr>
<tr>
<td>- Local Tax</td>
</tr>
<tr>
<td>1. Motor Vehicle Tax</td>
</tr>
<tr>
<td>2. Motor Vehicle Transfer TAX</td>
</tr>
<tr>
<td>3. Fuel Excise Tax</td>
</tr>
<tr>
<td>4. Ground water extraction and use tax</td>
</tr>
<tr>
<td>- User Charging (retribution) or fees</td>
</tr>
<tr>
<td>- Share of profits from provincial enterprises</td>
</tr>
<tr>
<td>- Others legal own revenue</td>
</tr>
<tr>
<td>Revenue allocated by central government</td>
</tr>
<tr>
<td>- Share tax</td>
</tr>
<tr>
<td>- General Allocation Fund</td>
</tr>
<tr>
<td>- Specific Allocation Fund</td>
</tr>
<tr>
<td>- Foreign aid/loans</td>
</tr>
<tr>
<td>Other Revenue</td>
</tr>
<tr>
<td>Grant from central government</td>
</tr>
<tr>
<td>Emergency aid</td>
</tr>
</tbody>
</table>

**Table 3.7 Structure of Municipal Revenues**

<table>
<thead>
<tr>
<th>Municipal Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Own Revenue (PAD)</td>
</tr>
<tr>
<td>- Local Tax</td>
</tr>
<tr>
<td>1. Hotel Tax</td>
</tr>
<tr>
<td>2. Restaurant Tax</td>
</tr>
<tr>
<td>3. Entertainment Tax</td>
</tr>
<tr>
<td>4. Advertising Tax</td>
</tr>
<tr>
<td>5. Street Lighting Tax</td>
</tr>
<tr>
<td>6. Parking Tax</td>
</tr>
<tr>
<td>7. Business Registration Tax</td>
</tr>
<tr>
<td>- local User Charging (retribution) or fees, including building permit fee</td>
</tr>
<tr>
<td>- Share of profits from local enterprises</td>
</tr>
<tr>
<td>- Others local own revenue</td>
</tr>
<tr>
<td>Revenue allocated by central government</td>
</tr>
<tr>
<td>- Share tax/non tax from province</td>
</tr>
<tr>
<td>- General Allocation Fund</td>
</tr>
<tr>
<td>- Specific Allocation Fund</td>
</tr>
<tr>
<td>- Financial aid from province</td>
</tr>
<tr>
<td>Other Revenue</td>
</tr>
<tr>
<td>Grant from central province</td>
</tr>
<tr>
<td>Emergency aid</td>
</tr>
</tbody>
</table>
In addition, regional governments have the right to impose new taxes as long as these taxes comply with general “good tax” principles; these are in line with international good practices. Law 33/2004 prohibits local governments from establishing own revenue sources that impose high costs on the economy or restrict the mobility of people and goods and services across (internal) borders or constrain (international) imports and exports.

The Regional Government's excessive creativity and was not controlled in collecting the regional tax and fee, will cause negative impact. Finally this policy will affect damage for their community and business activity. It will lead inefficient taxes and charges with small revenue potential that in turn caused high cost economics. These taxes tend to contribute to economic distortions.

3.9.2. General Allocation Fund

The General Allocation Fund (DAU) is the major source of local government revenues. The DAU is the primary source of local government budgets, accounted on average for roughly 80% of total revenue at regency/city level and 30% at provincial level. The dependence on transfers has increased post-decentralization, even as the share of the DAU in total national revenues decreased from 23.16 percent in FY 2002 to 22.86 percent in FY 2006. This does not imply that aggregate regional revenues have fallen but suggests a shift away from DAU to other revenue sources, mainly to shared revenues and taxes. Nevertheless the DAU grant is still one of the largest items in the national budget. It should be noted that in 2006 the DAU actually increased by 64.11%, as a result of more realistic budgeting. Graph 3.3 shows General Allocation Fund FY 2002-2007.
The basic allocation covers the personnel expenditures of local governments. Total amount of General Allocation Fund (DAU) shall be at least 26% percent of Net Domestic Revenue as established in National Budget (APBN). DAU for a region shall be allocated based on fiscal gap and basic allocation. The formulation of DAU as follow:

\[
DAU = \text{Fiscal Gap} + \text{Basic Allocation}
\]

\[
\text{Fiscal Gap} = \text{Fiscal Needs} - \text{Fiscal Capacity}
\]

\[
\text{Basic Allocation} = \text{Total Salaries of civil Servant}
\]

The fiscal gap component is estimated as the difference between fiscal needs and fiscal capacity. The proxy variables used for the calculation of fiscal needs are proportional population size, area, construction price index, GRDP per capita, and Human Development Index. The variables of fiscal capacity are actual own source revenue and shared taxes and natural resources revenues. According to Law Number 33/2004, regions with a fiscal gap equalling zero will only receive the basic allocation; regions with a fiscal gap less than zero will only receive the basic allocation less the fiscal gap; regions with a negative fiscal gap that is more than or equal to the basic allocation will receive no DAU.

The DAU formula has some features that might cause distortions in revenue and expenditure decisions. On the revenue side, in FY 2006, actual own
revenues was used in determining fiscal capacity. Should this practice continue it might cause regional government to lower their revenue collection efforts, since higher own revenues will lead to lower DAU allocations. The wage component of the DAU allocation creates adverse incentives for regional government to increase (or at least not decrease) public employment and shift costs to higher levels of government. This feature in the grant allocation will discourage necessary efforts to right-size the regional civil service and will reduce capital expenditure to suboptimal levels.

3.9.3. Special Allocation Fund

Special Allocation Fund (DAK) shall be allocated to certain region to finance special activities being the affairs of the region. Meant by certain region is a region meeting the criteria established annually to receive DAK allocation. In this way, not all regions will receive DAK allocation. The general criteria for the DAK are based on a formula that takes into account a proxy for capital funds available in a given district. In addition, coastal areas, conflict areas, less developed regions and regions that experience floods and other natural disasters receive DAK grants. The DAK could play a vital role in financing investments in infrastructure in poorer regions. Currently the allocation process of the DAK funds remains at risk to political interference, by regional governments, sector of departments and the budgeting commission of parliament.

3.9.4. Share Tax

Revenue sharing is allocated to local governments in order to address the problems of imbalances between central and local governments. Some major taxes remain at the central level, such as Personal Income Tax (PIT), VAT, and property tax. Until recently property tax is still administered at the central level. However, almost all the money obtained from property tax collection is allocated to local governments through revenue sharing.

Law Number 33/2004 identifies shared revenue from geothermal mining and slightly increased the regional share of oil and natural gas revenues. Regional governments will receive an extra 0.5% of both oil and gas revenues in 2009 which are increased regional expenditures on primary education (84.5% of oil revenues will accrue to the central budget and 3% to province, 6% to originating
local government and the rest 6% to other local government. For gas revenues, 69.5% will go to the centre and 30.5% to the regions.). Most of the revenues from these two resources are returned to the originating regional jurisdictions. In addition municipal/city governments receive shares of the four provincial taxes (motor vehicle tax, motor vehicle transfer tax, fuel excise tax, ground water extraction and use tax). However; the contributions of these taxes to overall regional revenues are relatively small.

For the region that was classified as rich in nature resources, the alternative to increase funding for regional development perhaps did not become a problem, because they could use revenue sharing fund from natural resources, especially for oil and natural gas as well as results of fisheries. However for areas that were classified as barely adequate or backward in nature resources, the alternative source of funding for development will be carried out through methods that not populist.
Chapter 4
Analytical Case Study

As mentioned in chapter 2, Law Number 33/2004 mandate the source of local government revenue consist of Regional Own Revenue, called PAD; intergovernmental transfer (balancing fund); regional loan and other legitimate revenues. This chapter will explore advantages and disadvantages and feasibility of issuing municipal bond as alternative source of financing for local government in Central Java.

4.1. Advantages of municipal bond issue for Central Java Province

4.1.1. Raising funds from municipal bond.

In local government which fiscal revenue is unstable, surpluses may happen in certain year and deficits in others. Sudden spending demand might not be covered by fiscal revenue for that year, bond financing is an alternative way to meet unexpected spending demand (ADB Report, 2003). In conformity with the principle of matching costs with benefits, because some benefits will last a long time. This project can be expected to repay through taxes.

Table 4.1 Central Java Revenue and Expenditure
Estimation Budget

<table>
<thead>
<tr>
<th></th>
<th>Year 2006 (Rp Trillion)</th>
<th>Year 2005 (Rp Trillion)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own Revenue</td>
<td>2.56</td>
<td>2.11</td>
</tr>
<tr>
<td>- Local Tax</td>
<td>2.10</td>
<td>1.66</td>
</tr>
<tr>
<td>- User Charge</td>
<td>0.25</td>
<td>0.18</td>
</tr>
<tr>
<td>- Proceeds from the management of regional assets set aside for the purpose</td>
<td>0.09</td>
<td>0.20</td>
</tr>
<tr>
<td>- Other</td>
<td>0.10</td>
<td>0.06</td>
</tr>
<tr>
<td>Intergovernmental Transfer</td>
<td>1.18</td>
<td>0.78</td>
</tr>
<tr>
<td>Other legal income</td>
<td>0</td>
<td>0.22</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>3.74</td>
<td>3.12</td>
</tr>
<tr>
<td><strong>Expenditure</strong></td>
<td>4.00</td>
<td>3.19</td>
</tr>
<tr>
<td><strong>Deficit</strong></td>
<td>0.25</td>
<td>0.06</td>
</tr>
</tbody>
</table>

Source: Central Java Province Financial Statement 2005-2006
Central Java budget in year 2005 and 2006 experienced deficit budget. Local Government needed 0.06 trillion in year 2005 and 0.25 trillion years 2006. While at the same period, local tax contributed 56.53% and 60.89% to total revenue. Although local tax revenue increasing every year, regional government could not persistently depend on local tax to finance local development. Because to much impose and was not controlled in collecting the regional tax and fee, possibly will cause negative impact which lead inefficient taxes and charges with small revenue potential that in turn caused high cost economics, dampen local consumption and investment. These taxes tend to contribute to economic distortions. Central Java should try to look for alternative of finance source. The possibility to raising funds is through the issuing of municipal bond.

According to Law 33/2004 local government can issue loan with the balance of the existing loan plus the amount of the loan to be drawn shall not exceed 75% of total revenue in APBD of the previous year. The second condition is that the ratio of financial capacity of the regional government to repay the loan (DCSR) shall be ≥ 2.5. Due to that law, Central Java be permitted to issue municipal bond not exceed a number of 1.58 trillions (75% from APBD of previous) to overcome deficit budget in year 2006. For example Central Java will issue bond in year 2006 as 0.25 trillion with maturity date 5 years and coupon 11%. The illustration of DCSR calculation can be described from the data below:

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own Revenue (PAD)</td>
<td>2.11 trillion</td>
</tr>
<tr>
<td>Intergovernmental transfer (DAU)</td>
<td>0.78 trillion</td>
</tr>
<tr>
<td>Revenue Sharing Fund (DBH)</td>
<td>0.23 trillion</td>
</tr>
<tr>
<td>Reforestation Sharing Fund (DBHDR)</td>
<td>0</td>
</tr>
<tr>
<td>Obligation Expenses</td>
<td>0.69 trillion</td>
</tr>
<tr>
<td>Principal</td>
<td>0.25 trillion</td>
</tr>
<tr>
<td>Interest</td>
<td>0.125 trillion</td>
</tr>
<tr>
<td>Charges(^\text{14})</td>
<td>0.008 trillion</td>
</tr>
</tbody>
</table>

\(^{14}\) Guidance of issuing municipal bond, Ministry of Finance, 2007:Underwriter charges approximately 1.5% and issuance charges 1.7% from total amount of bond issuance
DCSR = \frac{(PAD + DAU + (DBH - DBHDR) - Obligation expense)}{Principal + Interest + Charges} \geq 2.5

= \frac{[2.12 + 0.78 + (0.23 - 0)] - 0.69}{0.25 + 0.125 + 0.008}

= \frac{2.44}{0.38}

= 6.4 \geq 2.5

From the DCSR calculation above, it is feasible for central java to issue municipal bond in order to overcome the budget deficit in year 2006. This bonds published by regional government for a certain project where the fulfilment of the obligation that emerged from the regional bond was paid from the income of the project as mention in law 54/2005 concerning local government loan.

4.1.2. Cost efficiency

Central Java government can collect fund with cost of fund is relative low to trigger and races development by issuing municipal bond. The developed projects can be used to enhance the revenues of municipalities; the desire to borrow from the public will force local governments to be mindful of their accountability in a desire to get good ratings on their bonds that reduce the cost of obtaining funds. Raising fund by issuing municipal bond through capital market could become alternative to the accumulation of the fund apart from the banking system. Bond issue can offer important advantage than bank loan. One of the fascinations of capital market was the existence of cost efficiency to receive money. It can be explained as follow:

Source of funding from bank loan:
Deposit Interest Rate: 11-13% per year
Loan Interest Rate: 18-19% per year
\{\text{Spread 5 - 8%}\}

Source of funding from issuing municipal bond:
Coupon of municipal bond: 12% per year
Issuing charges: 3-4% per year
\{15-16 \text{ % per year}\}
For Central Java government, better gathered fund from issuing municipal bond than bank loan. Because issuance bond cost was cheaper (15%-16%) per year compared to bank loan (18-19%)

4.1.3. Autonomy of policy making

Another advantage that will be received by Central Java from issuing municipal bond is local decision making and control. The planning, approval, and execution of the project financing are essentially between the debt management unit and the local government chief on the one hand. And bond holder on the other hand, without any intervention from higher level government or another institutional financial agent such as development bank.

4.2. The potential disadvantages of municipal bond issue for Central Java

4.2.1. Possibility of Insolvent

One of the possibly disadvantage issuing municipal bond for Central Java is insolvent. Despite bond issuer guaranteed to pay coupon and principal that has been determined, the government could bankrupt. If it is happened, the bond holders will more be given priority to distribution of assets. A project financed by Regional Bond, including regional property attached to the project, may be pledged as security for the municipal bond. The indicator of bond issuer capacity to meet their promised could be seen from the value rating of municipal bond. The implementation of issuing municipal bond depended on the level of local government credit rating that will be determined by rating agency. In Indonesia, the independent rating company was Pefindo (Pemeringkat Efek Indonesia). Each local government which will issue municipal bond need to obtain credit rating, include Central Java. Until now, Central Java did not yet have credit rating, because never issuing bond. Another indicator bond issuer capacity is local government financial statements, which must be audited at least with result unqualified opinion. For two last years, Central Java got unqualified opinion appraisal from BPK. By this requirement, Central Java enables to issue municipal. But still need good credit rating with the range between idAAA idBBB to be categorized that a bond safe from default risk. Or bond with this ranking can be
told as investment-grade bond. (Pefindo, 2008). So, central Java must be concern with this requirement before issuing municipal bond.

4.2.2. Volatility of Capital Market

The fluctuation in capital market between stocks, cash fund (saving deposit), and bond graph as of rhythm with level of interest rate and time journey. If interest rate went up, hence market investor tends to chooses saving deposit as investment choice so that saving deposit in banking will leap. However, if interest rate downdraft, hence investment choice of investor will change over to bond so reaching lowest point and then returns will change over to stock. Indonesia capital market experiences growth fast. In range of time 10 years out of 1991 to 2007 the capitalization value increase more than 40 times even more. At 1991, number of stocks and bond in Indonesia capital market only Rp.11, 2 trillion, but by 2007 amounts is reaching Rp.484 trillion.

Although Indonesian bond market is small compare with regional (East Asia) bond markets but still growing, with a total capitalization of about Rp399.0 trillion for government bond and 84.5 trillion of corporate bonds in year 2007. The volatility of bond trade in capital market made local government must paid attention before issue bond. Central Java debt Management Unit must have bond analyst in order to observe the vagaries of bond market.

The lesson that we get from explanation concerning advantages and disadvantages of issuing municipal bond is that Central Java needed matured consideration before decided to issue municipal bond as an alternative source of local government financing. Firstly, although minimum requirement to issue loan is fulfilled by Central Java however it requires further research related to cost efficiency, because no experience of issuing bond by local government in Indonesia. Presently there is only local own companies that has been issued bond in Central Java. Secondly, possibility insolvent that will be experienced by Central Java. This could happen because Central Java not yet has credit rating that could be used to measure the credibility finance management of a local government. From several explanations about advantages and disadvantages above, it is feasible for Central Java to issuing bond, but without neglecting two
considerations which I have mentioned that is concerned to further study of cost efficiency and the existence of credit rating of Central Java.

4.3. Feasibility to Developing Local Bond Financing 
Investor and Bond Issuance

The Government of Indonesia has a high savings rate of 25–30% of GDP. In year 2007, total individual savings reached Rp.424.19 trillion. However, investment channels are limited and many people consider the capital market risky, prefer to bank savings and government bonds, which have lower risks and less volatile earnings. Bonds held by institutional (such as bank, non bank, pension fund) including corporate and government bond amount to about Rp484 trillion, and with individual savings of over Rp.424.19 trillion, the bond market seems to have great potential. Local government bonds held by individuals can stop money from hidden idle in banks and facilitate of saving money in bank into investments through bond in capital market.

Institutional investment funds, insurance funds, social security funds, commercial banks, have huge demand and purchasing power for local government bonds. Because they want to spread risks and create opportunities to reach stable returns, these institutional investors and individuals will be the main investor of local government bonds.

Settlement system and Government experience

The government of Indonesia has gained experience in issuing government, corporate, and financial institutional bonds during last ten years. It is familiar with bond fluctuation, structure, variety, duration, and interest rates. Local government bond issuance will be successful if supported and guaranteed by the systematic integration of various kinds of bonds (long, medium, and short term, general and revenue) and by the market participants (institutional investors and professionals) skilled in issuing and circulating bonds.

The securities trading network, however, Fixed Income Trading System (FITS) is a trading system for bond listed in Indonesia Stock Exchange including, inter bank bond trading market, and over-the-counter trading system, will provide substructures for possible local government bond circulation. Intermediary agencies (investment banks, credit-rating agencies, accounting and auditing firms,
and law firms) are developing rapidly. Their profession can provide services in issuing, underwriting, rating, and circulating local government bonds and supervise debt management unit.
Chapter 5
Conclusion and Recommendation

5.1. Conclusion

Is it possible to issue bond as a part of finance source for local government? The rule regulation supports local government to issue municipal bond. So it is legally possible for Central Java to issue municipal bond. Central Java shall borrow money through capital market. The balance of the existing loan plus the amount of the loan to be drawn shall not exceed 75%f (seventy five percent) of total revenue in Local Government Budget (APBD ) of the previous year. And the ratio of financial capacity of the regional government to repay the loan (DCSR) shall be \( \geq 2.5 \). From the sample calculation in chapter 4, Central Java can issued municipal bond to overcome deficit budget in year 2006 not exceed the amount of 1.58 trillion. DCSR of Central Java shown number 6.4 higher than 2.5, this mean Central Java has ability to repay their long term loan.

Municipal bond can be an alternative of source of revenue for Central Java to develop infrastructure, compared to other funding issued municipal bond has some excellent:

- The government could attract fresh money from public in a big amount and relatively short time. Raising revenues on capital markets through municipal bonds is often a more efficient way to finance capital expenditures than financing them through taxes or transfers or bank loan.
- The existence of transparency and accountability of local government financial management which is claimed from process of issuance municipal bond will make the community believed to invest their capital on local government's project.

5.2. Recommendation

- Clearly it must be legally possible for the municipality, include Central Java to issue a bond. The term and size depend on the ability of the municipality to pay back, and the general rule is that the term of the loan should not exceed the useful economic life of the project.
- Revenue bonds are used to finance local government project which will create revenue directly, such as: toll road, airport, hospital, public transportation, clean water, telecommunication in one hand. In another hand this public project will generate multiplier effect in economic activity.

- Issued municipal bond only can be done by certain local government, especially for local government that has rich financial. Only local government has ability to pay for the interest and principal periodical at due date and high fiscal capability which can publish municipal bond.

- Government of Indonesia needs to provide a system of credit rating for local government in order to maintain and control their fiscal management credibility, especially for issuing bond. Credit rating. Presently credit rating only to access central government and corporate bonds.

- Central Java government requires increasing their experience on human resource capability regarding to capital market, including the procedure of municipal bond. Issuance.
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