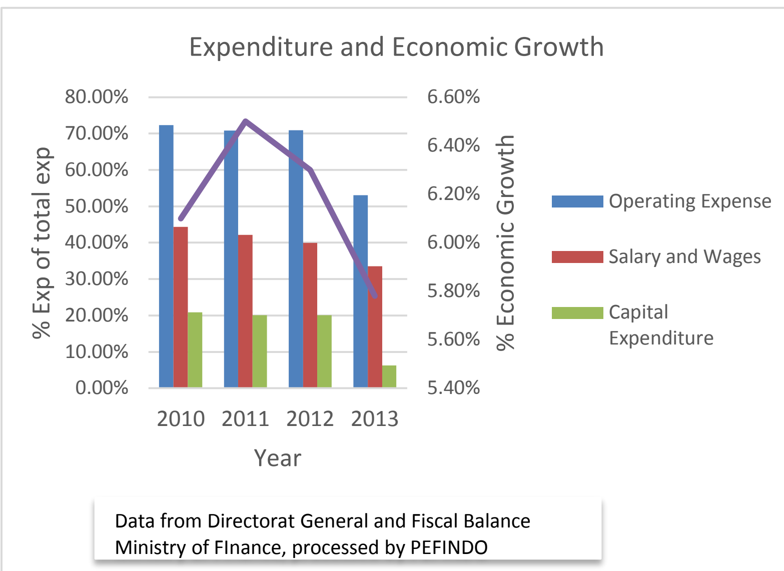
Municipal Bond and Economic Development

Analyst: Endi Roswendi

To maintain sustainable economic growth, PEFINDO views that Indonesia's regional governments need to invest significantly in better infrastructure projects. The regional governments should realize that infrastructure development has significant contribution to the regional economic growth. Accessibility and quality of regional infrastructure will have positive impact to the overall regional economy. The business sector needs to be more efficient and has access to the market for their products. For the residence, better infrastructure will increase productivity. The World Bank report shows that infrastructure development effects both directly and indirectly to the economy. Spurring fund to the infrastructure development will boost economic growth, for example by providing jobs for the people and businesses to the industry. Furthermore, infrastructure development will promote efficiency in production. Unfortunately, the capacity of Indonesia's regional governments to build and develop infrastructures is very limited. For the last four years from 2010 to 2013, total capital investment from all regional governments in Indonesia only reached around 22% of the total expenditure, while the portion for operational expenses, particularly salaries, accounted for 50% of total expenditure.
Out of the total allocated capital investment, only less than 10% was allocated to build or repair the road, irrigation and other infrastructure network. The minimal allocation for capital investment is feared to slow down current positive economic growth in the near to medium term.



The government has acknowledged that the under-developed infrastructure contributed to the Indonesia's economic deterioration. With the absence of new initiatives to improve the country's infrastructure, Indonesia's economy, in our view, could eventually falter. According to the data from BAPPENAS (National Development Planning Board), Indonesia will need roughly IDR6,000 trillion of funding to build infrastructure across the regions for the period of 2015 to 2020. The Indonesian government can hardly self-finance all the projects. To overcome these financial obstacles, several efforts have been undertaken by the government to accelerate the infrastructure development, including promoting public private partnership. Since 2005, The Ministry of Finance has encouraged sub national government to explore other financing source for regional development, but execution is yet to be realized.

Looking at the gap between actual capital investment and total investment needed to develop regional infrastructures, it is challenging for the regional governments to meet BAPPENAS expectation, especially when expenditure allocation for wages is still significant at the level of above 40% out of total regional expenditures.

Municipal Bond as alternative financing

Unlike the central government that has routinely been issuing bonds with the objective to close the fiscal gap, sub national governments still hesitate to explore municipal bond as an alternative financing. As of May 16 of 2014, total outstanding national government securities have reached IDR 1,769 trillion. The regional government should review the source of fund for their development. Even though Indonesia's local governments are really in dire need to get financing supply for their infrastructure projects, not even one regional government stepped forward and has committed to issue municipal bond.

For most developed countries, municipal bond has been long utilized by their sub-national governments to finance their infrastructure projects ranging from education, hospital, water and sewer, seaport, housing to highway construction. In the United States (US), The Municipal Securities Rulemaking Board (MSRB) predicted that the approximately US$ 3.7 trillion worth of municipal bond has been used to finance public infrastructure projects. Municipal bond so far is believed to provide low cost and efficient way for cities and counties, mostly in the US, to finance their infrastructure projects.

Municipal bond is not only an efficient source of funding, but also provides better assurance for investors. If we look at the data default rate of municipal bond, based on the data from Municipal Bonds in United States, the 10 year cumulative default rate on A or AA rated was only 0.03%, meaning that out of 10,000 municipal bond issued, only 3 defaulted. Compared to corporate bond that could reach 2.05% for the same period.

The municipal bonds should also be viewed as a type of business venture or partnership between the government, both local and central, and private businesses. The government needs supply of funding to build its infrastructures. Private businesses, in return, need better infrastructure facilities to smoothen their businesses. Providing better infrastructure will not only providing better public service to businesses, but also to their people and this will stimulate regional economy. For investors, municipal bond is viewed not only as an investment alternative but also as a way for investors to involve in regional development. To entice both investor and entity in issuing municipal bond, tax regulation should also be adjusted. Currently, there is no specific regulation for the coupon from municipal bond. Municipal bond coupon will still be imposed with 15% to 20% of taxes in accordance to Government Regulation No. 6 of 2009. In such developed countries as the United States, coupon from the municipal bond is tax free and this policy is expected to encourage both regional government and investor to grow the municipal bond market.

In term of financial management accountability, municipal bond can promote good corporate governance as the local government is required to be more transparent to the public and investors. Local government needs to have ability to manage its loan with more prudent to ensure that the fund is channeled into right projects. Detailed assessment to the ability of local government to manage its financial is very critical to assure the market that all the funds generated from municipal bond are well managed, monitored, and accountable.