REALIZING AN EFFECTIVE MECHANISM OF INFRASTRUCTURE DEVELOPMENT

Fauziah Zen

This policy brief is the result of an activity entitled "Economic Policymaking in Indonesia' which is jointly conducted by Centre for Strategic and International Studies (CSIS) and Economic Research Institute for ASEAN and East Asia (ERIA). This activity is a contribution from research community that is expected to assist the government in formulating more effective economic policies in the future. In this activity, CSIS and ERIA invited 16 economists with specific fields of expertise from some leading research institutions to conduct in-depth discussions on seven strategic issues facing Indonesian economy (infrastructure development, competitiveness, investment climate, food policy, services sector policy, fiscal policy, and social protection policy), which is then summarized into policy briefs covering each of the topics.

Dissemination of the findings and recommendations produced by this activity is conducted through several channels. First, this activity has made efforts to engage the relevant government officials through some Focus Group Discussions (FGD), the publication of High Level Policy Notes, and hearings with some strategic policymakers with regard to each of the strategic issues mentioned above. Secondly, this activity also conducts widespread public disseminations through Public Seminars on each of the strategic issues, along with publications of the Policy Briefs and supporting multimedia that can be accessed online through www.paradigmaekonomi.org.

INFRASTRUCTURE DEFICIT; SOME KEY ISSUES

Infrastructure plays a crucial role in the socio-economic development of a country. Infrastructure is needed as a means of connecting, input, and output from a wide range of socio-economic activities. Infrastructural conditions and development in Indonesia is a central topic, especially considering the presence of an infrastructure deficit.

Infrastructure requires large financing. Since the state budget cannot cover all infrastructure financing needs, discussions among policymakers usually revolve around the issue of financing. However, in the implementation, construction's financing is not the only factor at play to ensure infrastructure projects are successfully carried out.

This policy brief will cover three main issues;

1. The role of private sector
2. Funding
3. Land Provision

ROLE OF PRIVATE SECTOR

The government wants the private sector to play a bigger role in infrastructure development. According to the state budget, it is estimated that the government can only fund 20% of the total infrastructure needs, so it requires a significant contribution from the Indonesian state-owned enterprises and private partnership, which is also called Private-Public Partnerships (PPP). This is already a common practice, and if properly managed will create benefits beyond the obvious reception of financing sources. Private companies will provide innovation and efficiency, as they strive through competition with one another. Sharing the burden to the private sector can somewhat help the government to concentrate on infrastructure projects that are considered to be purely public domain.

These private companies have the right to seek infrastructure projects with high margins as well as those projects with government support schemes that will help them generate more profits. Participation from the private sector can also reduce the burden on the public sector and improve the efficiency of the infrastructure facilities services.

However, there are two potential challenges. The first is the division of both benefits and risks shared between between public and private parties. Risks should be born by a party who is potentially responsible for the generation of such risk, and can best internalize such risk. The government should be responsible for the political risks. If the government does not want to bear responsibility for these risks, then the private sector will not participate in similar projects. The delay in the "*Kereta Cepat Jakarta Bandung*" project was somewhat caused by news that the government is pushing the responsibility of funding the massive project to the private sector, which clearly gave negative signal to investors.

Secondly, there is a loophole in the strategy of attracting private investors. The decision to appoint Indonesian state owned enterprises to build various strategic infrastructure projects did provide benefits to the country, specifically when it comes to speeding up the process and keeping the profits domestically. However, if the majority of prospective projects are assigned to SOEs, then the projects offered to the private and non-SOEs are usually unattractive; these projects typically require rigid incentive structures to make them feasible.

In addition, assigning SOEs a greater role will entail greater state budget and at the same time crowd out the private sector. Rather, more opportunities should have been provided to the private sector, as it strategically contributes to the job creation and fair competition climate.

WHEN CAN PPP PROJECTS ATTRACT SERIOUS INVESTORS?

Investors of the PPP projects do not lack the funds to build them; they have the competence and the mechanism to collect these funds from equity and loans. But why are investors disinterested in submitting proposals for numerous PPP projects being offered?

At least there are three deciding factors:

1. The types of infrastructure project that has been offered by the government towards private sector lacks financial feasibility. If the private sector offers a proposal, the government will likely consider their cost or selling price to be too high. Usually such projects are risky, and more likely to be those bringing more social justification rather than financial/economic justification. In economic jargon, these goods are considered to be public goods. This may create a dilemma when the government assigns SOEs and equips them with massive injection of funds to carry out the favorite/desirable projects, while private sector is only left with "undesirable" projects.
2. The projects are not offered in a proper manner, thus failing to convince investors about their potential returns. To get a fairly good estimate of the potential benefits, risks and costs, investors must be willing to spend considerable financial and time resources.
3. The project itself does not provide certainty when it comes to (i) the government's commitment towards the implementation of the project, and (ii) the bidding or auction of all the planned projects in a certain period (for example within the next 2-3 years). For potential investors, this commencement date of bidding process is important as participating in auctions requires lots of efforts, resources, and funds. They need to devise an investment strategy as it is not financially feasible to participate in all project tenders. Offering infrastructure projects with a clear timetable will help potential investors to concentrate on projects they consider the most attractive or profitable.

FUNDING SUSTAINABLE PROJECTS

The project financing consists of two main stages: (i) construction costs or financing the project and (ii) the cost of operation and maintenance. In PPP, both of these stages have different schemes, but they are highly related to one another. For example, when the government refused to subsidize the cost of train tickets for MRT Jakarta, the other alternative is to participate in the cost of construction through Viability Gap Funding (VGF). By lowering initial construction costs, tickets can be sold at more affordable prices (without subsidies) in the operational phase. If the government does not want to subsidize the price of the ticket and does not want to give VGF, then the operator will not be able to sell tickets at the price requested by the government.

Presidential Regulation No 38/2015 provided a more progressive approach. Yet, there are still uncertainties with regard to: **a) procedure to determine the**

procurement scheme. KPBU projects are determined by the Person in Charge of Cooperation Project (PJPK) based on the compatibility with the planning and Value-for-Money (VfM) analysis. However, there is no requirement to create a comparison between traditional scheme with KPBU scheme, for instance with Public Sector Comparator (PSC) method or any other method. As a result, in some cases KPBU may not be the best possible scheme for a particular project, relative to other schemes. **b) State-Owned or Regionally-Owned Enterprises (BUMN or BUMD) could act as Person in Charge for Cooperation Project (PJPK) (public sector), and as Business Entity (private sector).** This may create uncertainties if not immediately addressed by the implementing regulation; **c) institutional aspect has yet to be decisively addressed:** what is the role of KPPI, will there be any sort of PPP Center, how to deal with PPP Centers that are found in both Ministry of Finance and Bappenas, and how is its implementation in the regions?

Construction funding is a combination of equity, loans and sponsorship. While operation and maintenance funds can be a combination of user fees, subsidies, and concessions of related businesses. In Japan, train operators receive concession management of commercial land at some stations to cover the cost of trains that cannot be covered from ticket sales alone.

Determinant variables of these two schemes, financing and funding, are seriously affected by a couple of factors. The rule of thumb of these factors is as follows:

1. The value of the project's benefits and beneficiaries should be commensurate with the amount of fiscal support given.
2. The need to avoid the burdens of future liabilities due to current decisions arising from short-term decisions regarding debt, guarantees, and subsidies.
3. The fit between types of goods (public, semi-public or private goods) with a choice of financing and funding schemes.
4. Estimate the externalities, both positive and negative and schemes to compensate.

In reality, decisions based on political considerations cannot be avoided entirely, and there may be a proper room or justification for it. However, it should not entirely crowd out or overrule decisions made based on considerations of socio-economic benefit and national development goals. Affirmative actions could still exist while retaining a rational ground of socio-economic benefit.

LAND PROVISION

Land acquisition is a recurring problem and is protracted in the many infrastructure projects in Indonesia; indeed many projects are delayed for years. Delays clearly increase the cost of the project, as there will be a rise in prices for construction materials, disruption of supply and the payment of corporate overhead. There is also the possibility that the technology will be obsolete or depreciate by then. All of these factors affect the feasibility of the selling price of the service. In short, a project overrun will increase total cost, consequently increasing the selling price of products.

In Malaysia, the citizens have the right to protest public land acquisition with regards to its technical issues. For instance, these include determining the location or the area of land and property. In addition, the landowner's maximum term of land acquisition is 1.5 years. The landowner cannot refuse to sell their land if requested by the government for public interest. Furthermore, the market

price of land can be seen from the past historical prices. The purpose is to avoid speculative attacks that might raise land prices far above the reasonable price at the time of the initial announcement of the planned purchase of land for the project. Land acquisition is certainly a major hurdle for PPP projects, because construction delays will reduce the advantage of this scheme and increase the total cost.

RECOMMENDATIONS

1. A healthy division of infrastructure projects for SOEs and private sector should consider the following aspects: a rational portion for either SOEs or private sector, encourage SOEs to engage in fair competition, the need for new technology and innovation, and the variations/distinctiveness of sectors and regions.
2. Create a more effective, efficient, and simple institutional setup for the implementation of KPBU, formulate a standard for implementing VfM to compare the option of KPBU scheme with other schemes, and arrange the proper mechanism for SOEs/ROEs to act as Business Entity in KPBU projects.
3. Offer projects in a more proper and serious manner. This requires regular funds (Project Development Facility), which is used to conduct preparations to produce a project document that meets international standards, and provides a strong argument about the scheme the government wants. Thus the government needs to be strongly informed in the negotiation process with the private sector, with regard to the scheme, prices, and fiscal support.
4. The government should be a leader in project execution of the PPP scheme, because the government must be able to count and determine the type and amount of support, be it fiscal or non-fiscal, as well as risks. This has to be done in order to optimize to ensure that the role of public vs. private balance.
5. A significant breakthrough to overcome the problem of land acquisition is needed. This can be done through various restrictions on the number and filing lawsuits for determination of compensation from the government. For example, one proposal is having a maximum of 1.5 years since the establishment of the compensation price approved by the government. Furthermore, there is also a need to logically derive the reference price market; this can done based on historical prices of up to two years before the establishment of the project, with the prices of last two years estimated based on the benchmark of inflation. Rising property prices, in the short term should not count in the calculations. Lastly, there is a need to define an additional percentage of the property value as compensation for non-material. For instance a 15% of the price of land too meet high demands of the landlord and the market value of the land.