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Indonesia needs rules know-how
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The aftermath of the 1997 Asian financial crisis has led to a dramatic deterioration in Indonesia's infrastructure, to the point that it's a serious impediment to attracting desperately needed investment to the country.

Rectifying this could be a top priority for Australia's greatly increased assistance program, but it would require a lot of legwork to be effective.

What should be done?

Before the crisis, Indonesia had 30 years of high growth, which left it with better infrastructure than Thailand, China or Taiwan (as ranked by the *Global Competitiveness Report*). Public-private partnerships, both with domestic investors and foreigners, were an important element.

Since 1997, slow growth and a budget burdened by debt payments have left Indonesia lagging badly behind other Asian countries. Infrastructure spending has fallen from 7 per cent of gross domestic product to 3 per cent, while private investment in infrastructure has fallen by 90 per cent.

Spending needs to be doubled to between 5 and 6 per cent of GDP to provide a minimal level of service.

Forty-three per cent of the population is not connected to the electricity grid, and those who are suffer regular "brownouts". Only 4 per cent have access to landline telephones. Mobile phones have filled the gap to some extent (even here, Indonesia ranks 9th in the Association of South-East Asian Nations), but this is not the answer for internet and data access.

The January infrastructure summit in Jakarta identified more than 90 projects, valued at more than $US22 billion ($29 billion). You can argue about the figures (and with the specification of the projects), but it's not necessary to do a major survey to know the general and widespread deficiencies of infrastructure: casual observation is enough.

The inefficiency that this brings to everyday life is obvious. Anyone who has sat in Jakarta's notorious traffic jams knows the issues and knows there is no solution until the public transport infrastructure is radically upgraded.

Less obvious is the disincentive it gives to investment, raising the required hurdle rate of return and raising the cost of projects, which have to supply their own inefficient small-scale private infrastructure, such as diesel generators. If a company has to deal with inadequate and unreliable water, ports, telecommunications and electricity, it can't offer adequate incentives to investors.

Such is the size of the task that it can't all be funded by the government, or even by domestic private investors: foreign funds are needed.

It is not just a matter of leveraging the projects to expand the funding (although this is the central issue), but also of drawing on the operational experience of the private sector. These

big projects will always have their complex risks, but can be managed better if they can be defined more precisely and spread more widely.

Infrastructure is, in many ways, a "natural fit" for foreign investors. These projects are steady cash-earners, offer a physical asset as security and often have an assured and predictable market. Why are they not attractive?

One problem is the recent history of public-private projects in the country. Both sides (Indonesian and foreign) feel scarred by earlier experience when many projects were cancelled at the height of the crisis. There were serious and costly contract disputes with some foreign private infrastructure providers. To get foreign participation now will require a clear break from the past.

Those projects that have been put to tender so far have attracted little interest.

One major Australian player in this sector — a world-leader in the funding of infrastructure — has indicated that it is not interested in Indonesia at this stage because the legal structure is not strong enough.

A recent study initiated by the European Commission warns potential investors of the difficulties of projects that are heavily controlled by state-owned enterprises, such as toll roads, terminals, ports and water-supply projects, calling these "high-risk investments".

The Indonesian government has acknowledged the issues — hence the Jakarta infrastructure summit. A ministerial co-ordinating committee has been formed, and Australia, for its part, is appointing an adviser on these issues.

This seems to be an opportunity for Australia to demonstrate its relevance to Indonesia's problems. Infrastructure is a difficult area to get the institutions right. The sums of money involved are huge and the returns take a long time, so there needs to be long-term certainty about the enforceability of repayment.

There are physical assets to secure the projects, but the property rights to the physical assets are always going to be under pressure. If you own a water supply system or a gas pipeline, the customers will be constantly bringing pressure to bear to prevent price increases (even legitimate ones).

The projects often provide a "community service", which adds to the pricing-setting difficulties. Many are, in some important senses, monopolies, so it is legitimate to protect the users against price gouging. But what is the right balance to strike between the owner and the users? Should the owner of a facility, such as a telephone line or a gas pipeline, be forced to offer its use to competitors, and if so, on what terms?

Many of these projects form part of wider infrastructure, often owned by the government (think of toll roads, which are fed by the un-tolled road system). What should the owner of the toll road pay for this benefit?

Many of these projects impinge on community property rights, and the special power of the government is needed to push through the enabling measures (think of land rights). What should the owner pay in exchange for this special advantage? Above all, what is the best way of sharing the risks between government and investor, in a way that maximises the social return on the project?

This is just a fraction of the complex issues that need to be sorted out if privately-funded infrastructure is to work well (that is, fairly and efficiently) for all parties.

Markets only work well if they are embedded in appropriate institutions — that is, sets of rules. In Australia, we have developed these institutions to a high degree — often developed the hard way by making mistakes and ending up with unworkable projects that gave unconscionably high returns to the owners. We learned, too, of the dangers of "privatising the profits and socialising the losses".

We have lots of experience of federal-state jurisdictional disputes, which may not be exactly the same as Indonesia's problems with Jakarta-regional turf-disputes, but have the same flavour.

Is there an opportunity, now, to add weight to the current infrastructure initiatives in Indonesia (a second summit is planned for next year) to develop what might come to be called the "Jakarta Rules"?

Like the Paris Club covering official debt relief, and the London Rules for private sector debt relief, these would be a prescriptive and proscriptive set of rules and understandings that would govern foreign infrastructure investment. They would set down the broad parameters of finance, the regulatory framework (including a framework of price regulation for monopolies), set out dispute resolution processes, governance arrangements for tendering and operational issues, and perhaps provide model contracts or templates for agreements.

Above all, the endorsement of all the governments that take part not only gives the rules the legitimacy to ensure they are implemented and enforced, but keeps all the foreign parties on an equal footing.

The World Bank, with its deep experience in infrastructure projects of this type, could be a key participant and signatory.

What's in this for Indonesia? Reducing investor uncertainty means two things: more investment and cheaper funding costs. It would involve, incidentally, the creation of an "oil spot" of superior bureaucratic governance, which might over time spread into other areas of the bureaucracy, currently seen as a stumbling block for investors.

What's in it for Australia? Other than putting in place new commercial and bureaucratic relationships that are the ballast for the overall relationship, these sorts of rules ameliorate the disadvantage Australian businesses face when operating in an environment where unethical behaviour is common. We want institutions that put a premium on ethical behaviour, because we can operate at our best in such an environment.

But above all, it may be the most effective way of dispensing a significant part of the tsunami aid money. Half of the $1 billion commitment has been earmarked for infrastructure, but the intention is to use the conventional channel of government-to-government projects.

A set of Jakarta Rules would not only create the opportunity to leverage this to an amount commensurate with the pressing infrastructure needs, but would, if successful, have a wider impact on governance.

The impact on income distribution suggests this should be high priority: the poor are always the greatest losers from infrastructure inadequacies, so this directly addresses one of the principal aims of our assistance policy.

The challenge is formidable, but the rewards would be great.

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