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CIES DISCUSSION PAPER 0505

How Significant and Effective has Foreign Aid to Indonesia been?

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This paper is based on a policy working paper prepared for the United Nations Support Facility for Indonesian Recovery (UNSFIR), a joint project of UNDP and the Government of Indonesia. The paper benefited enormously from inputs received from a wide range of public officials and donor community as well as from Dr. Satish Mishra, Chief Economist/Head of UNSFIR, Bona Siahaan, Senior Project Coordinator, UNSFIR. However, none of these individuals or organisations they are affiliated with is responsible for views expressed herein.

Abstract

With the improvement of relationship with the western countries after the demise of the old order regime of President Soekarno, Indonesia received a large volume of foreign aid that played a crucial role in the recovery of the economy. Indonesia remained a significant recipient of foreign aid through out the 1970s and 1980s, especially during the balance of payments crises. In addition to smoothing out balance of payments problems and providing budgetary supports, aid played an important catalyst for policy reforms that are believed to have contributed to the spectacular success of the Indonesian economy. However, no systematic study has been done so far on the effectiveness of foreign aid in Indonesia. This issue has become critical in the wake of the financial crisis of the late 1990s which turned Indonesia a heavily aid-dependent country as well as the renewed world wide debate on aid effectiveness. This paper, thus, attempts to examine the historical significance and effectiveness of aid flows to Indonesia. It finds that aid did contribute positively to economic growth, but made the government lazy in terms of domestic resource mobilisation. As a result, despite significance progress, Indonesia remained aid-dependent.

Key words: Foreign aid, economic growth, balance of payments, government fiscal behaviour.

JEL classifications: F35, F34, O53

I. Introduction

As the aid flow is becoming more stringent and tied to policy reforms amidst growing or at best stagnant world poverty, the debate about the effectiveness of foreign aid has once again returned to the centre stage of development strategy.[1] After a brief period of disillusion in the late 1960s and early 1970s about the effectiveness of aid, there was a renewed hope that countries could be moved out of poverty through the allocation of aid. This saw a rise in net aid flows to developing countries in real terms until the early 1990s (White 2004, pp 235-36). However, disillusion about aid effectiveness again set-in since the mid 1990s with little signs of world poverty disappearing (Hudson, 2004). This has led to a decline in net aid flows both in real terms and as a percentage of donor countries' GNP.[2]

Nonetheless aid is still regarded as essential for economic development and poverty reduction, especially for meeting the multilaterally agreed millennium development goals (MDGs). The need for increased aid flows has been highlighted at the March 2002 UN Summit on Finance and Development in Monterrey and the September 2002 UN Summit on Sustainable World Development in Johannesburg. Stern (2003, p. 14)) has argued that meeting the challenges of the MDGs would depend on "scaling up" the international community's development efforts, which means not only increasing the quantities of aid, but also "more importantly changing qualitatively from the past modes of doing business". Stern has also outlined the ways in which the World Bank and other donors are targeting and managing aid for improving efficiency or effectiveness of aid money. In short, donors have increasingly become more selective in allocation of aid to those countries with records of "good" policies and are

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[1] The voluminous literature on aid effectiveness has failed to produce any consensus. See Tarp (ed.) (2000) for a comprehensive survey of aid-effectiveness literature. Also see Symposia in *Annual World Bank Conference on Development Economics 2003, Economic Journal*, vol. 114 (June, 2004), and *International Review of Economics & Finance*, vol. 13 (2004) for most recent and comprehensive discussions of issues pertaining to aid effectiveness and aid allocations.

[2] By 1992 developing countries were receiving $62.7 billion a year from the main donors, reflecting a steady rise in aid flows during the last three decades. By 1997 the flow declined to $48 billion a year (White, 2004).

attaching conditions on policy reforms and improving governance. Donors are now asking for a more detailed strategy for poverty reduction before agreeing to increased economic assistance.[3]

However, recent work on aid effectiveness raised concerns about the manner in (and criteria by) which the reduced volume of aid is being allocated (Obedokun, 2004, p. 229). Easterly (2003, p. 38) has expressed doubts about the effectiveness of selectivity in aid allocation. He has characterised the imposition of conditions as “no more than a wistful hope, rather than a policy with consequences” in circumstances where “a nation will selectively receive aid if it is a ‘good performer’ – unless it is a bad performer, in which case it will receive aid from the ‘bad performer’ fund.” Easterly (2003) has also argued that donors are as much responsible for the past failure of aid as recipients. According to him, donors are judged by the amount money spent and hence are driven by the desire to “move money”.[4] This creates potential moral hazard and incentive problems for both donors and recipients. He has, therefore, emphasised the need for independent evaluations of aid-funded projects as recommended by the Meltzler Commission (2000).

Following the increase in aid-dependence (both in terms of volume and number of donors) in the wake of recent economic crisis, Indonesia has become almost a test case for the issues pertaining to aid effectiveness, and both policy makers and donors have devoted increased attention to aid effectiveness. However, the discussions have remained focused mainly on microeconomic aspects of management such as coordination, fiduciary standards and absorptive capacity. Broader macroeconomic issues such as the relationship between aid and national efforts in mobilising domestic resources, or the relationship between official and private capital flows are hardly mentioned.[5] The discussion of other broader issues such as country ownership of policy reforms and project designs (broadly described as national development strategy) has remained confined to a small number of academics and civil society organisations, and has often led to more emotions than substance. The Indonesian discussion is somewhat influenced by its

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[3]This reduction in aid flows is generally referred to “donor or aid fatigue”. One of the reasons for this is increased awareness among the donor country citizens about corruption, human rights abuses and overall development failures in recipient countries. The citizens of donor countries now demand better value for their tax-funded foreign aid. More importantly, with the end of the Cold War, donor country governments are also reluctant to “bank role” so-called friendly regimes and ignore their corruption and human rights abuses.

[4] According to Easterly, Judith Tendler’s observation as far back in 1975 that “A donor organization’s sense of mission … relates not necessarily to economic development but to the commitment of resources, the moving of money…” remains valid even today.

[5] This is evidenced from the agenda of CGI.

historical experience with foreign economic assistance and the lack of any comprehensive study of the contribution of aid to country's development. In the words of Hill (1996, p. 81),

> *It is surprising … that there has been no serious academic study of one of the world's largest and most successful aid programs over the past quarter-century, examining in detail the impact of the various aid programs and projects, and assessing the importance of expatriate economic policy advice from the World Bank, the Harvard group, and other organizations.*

The cosy relationship between the Soeharto Government and the donor community, and the revelation of wide spread corruption in the regime in the wake of economic crisis led at least part of civil society to believe that aid helped maintain a corrupt regime. Therefore, the use of aid has come under increased scrutiny in the era of "reformasi".[6] As mentioned earlier, donor governments, too, have come under increased pressure from their own electorates to improve aid efficiency. Thus, there is a search for improved and innovative ways of managing foreign aid. Partnership among donors, the government and civil society is one such method of delivering aid; and donors have attached conditions related to governance and poverty reduction.

In the context of the above, this paper provides a historical perspective on aid flows to Indonesia and reflects on some post-crisis issues. The paper is organised as follows. Section II provides a brief historical account of aid flows to Indonesia since 1970. It includes discussions of the size and significance, sources and terms and rationale for foreign assistance. Section III examines the pre-crisis contributions of foreign aid to economic development of Indonesia. Section IV highlights some post-crisis issues. The most immediate and pressing post-crisis issue is external debt and its effects on the state budget. The concluding section highlights the importance of reducing aid dependence and reflects on some possible options.

II. Historical Significance

The early 1960s saw the very acrimonious exit of foreign donors as President Soekarno asked the donors to go to hell with their aid (Hill, 1996, p. 79). In sharp contrast, the New Order regime that replaced President Soekarno's Government, welcomed foreign economic assistance. In fact, the New Order marked a clear break with the Old Order in terms of foreign relations. While President Soekarno was fraternalising with the communist countries, the New Order firmly allied

[6] See the statement by INFID to the 11th CGI meeting held in Jakarta, Nov. 2001.

itself with the West in the Cold War, and the western countries rewarded Indonesia with a massive aid package. Foreign economic assistance was crucial in lifting the economy from its disastrous collapse that marked the end of the Old Order, and was always called upon in times of economic difficulties. The donors enjoyed a most congenial relationship with the Government of President Soeharto to the extent that Indonesia received a large "Trade Adjustment Loan" from the World Bank in 1987 without any conditionality attached. [7]

However, the inclusion of some structural reform measures in the conditionality of the International Monetary Fund (IMF) following the latest economic crisis contributed to a strained of the relationship with the crumbling New Order regime and subsequent governments since its demise.[8] Although the relationship improved markedly since the installation of President Soekarnoputri's Government, senior ministers continued to debate about the use and effectiveness of foreign aid.[9] The government finally decided not to seek a renewal of the IMF program at the conclusion of the present one in December 2003.

Significance of aid

A number of indicators are used to assess the significance of foreign assistance to Indonesia. The most common indicator is the ratio of foreign aid to GDP. It can be taken as a rough and ready indicator of the importance of foreign aid in an economy. As can be seen from Figure 1, foreign aid flows to Indonesia relate very closely to the times of economic difficulties. Gross aid flows declined steadily to less than 2% of GDP as the economy began to show signs of improvement in the early 1970s. It dropped to about 1.5% of GDP in 1977, but since then continued to rise until

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[7] See Mosely, et al eds. (1991, p. 105). One of the Indonesian technocrats describe the relationship as:

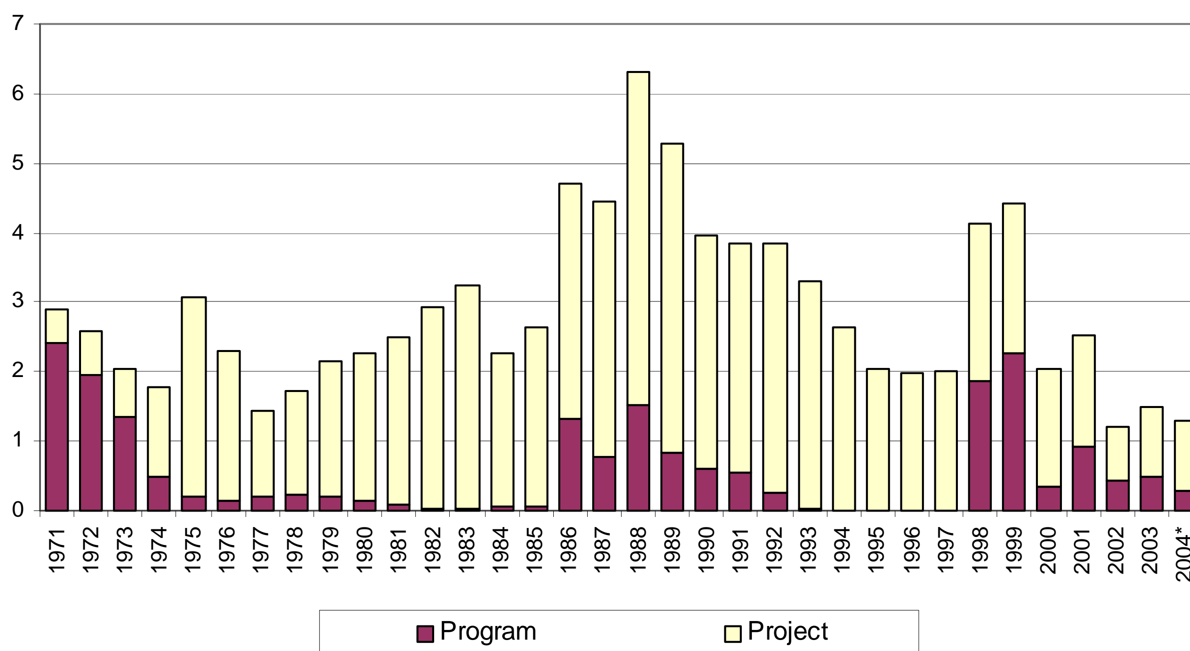
[The] relationship with the IMF and the Bank had been friendly from the beginning in 1967…The relationship between the IMF and World Bank at one hand, and the "economic technocrats" on the other hand, was also based on a sympathetic understanding and trust between the Widjojo group at the Indonesian end, and personalities such as Bernie Bell (World Bank) at the other… There was something unique in the chemistry between the different personalities in the game that is difficult to explain and rationalize … These remarkable relations with the Bank and Fund remain even today. (Sadli, 1989).

[8] See Boediono (2001) for a comparison of the implementation of Fund-supported program under three regimes – President Soeharto, President Habibie and President Wahid. Boediono has summarised President Soeharto's feeling in the following words: "His dissatisfaction toward the program deepened as he increasingly felt pressured to accept conditionality that was repugnant to him. We can only speculate, but it is quite possible that things might have turned out differently had the conditionality (particularly in the first two LOIs) been confined to the one that was really critical for handling the emerging crisis…". Also see Sadli (2002).

[9] For example, the Minister for State Development and National Planning, Pak Kwik openly called for an end to the IMF program, in particular not to renew it at its expiry in December 2003. See the statement by the Minister to the Interim CGI in June 2002.

1988, peaking at roughly 6.5% of GDP. The sharp rise in aid in 1988 was due to problems caused by the drop in oil and gas revenues from a peak of nearly 65% of total government revenue in 1981 to about 30% in 1988-89. Since then official aid flows continued to decline as private capital inflows surged in the early 1990s.

Figure 1: Aid Flows as Percentage of GDP, 1971-2004



Note: *2004, Budget figure
Source: Financial Notes (Nota Keuangan), Ministry of Finance (MOF), various years. The data exclude capital transaction with the IMF

Of course the situation has changed markedly since the economic crisis of 1997-98. Gross foreign aid flows rose from 2% in 1996-97 to about 4.5% of GDP1999. This figure does not include the loan received from the IMF. The IMF loan is not regarded as "development assistance", and is provided as a short- to medium- term support for balance of payments. It is not recorded in the state budget, but goes to the Bank Indonesia (BI) as a supplementary fund to be used when BI's foreign exchange reserves fall short of meeting the balance of payments needs. If the IMF fund is included in the total foreign assistance then the aid-GDP ratio will stand at around 10%. Thus, the economic crisis and the consequent ballooning of government debts have turned Indonesia into one of the most aid-dependent countries in the region (Table 1). In 1998-1999, its aid/GDP ratio exceeded that of Bangladesh and Sri Lanka, and is now

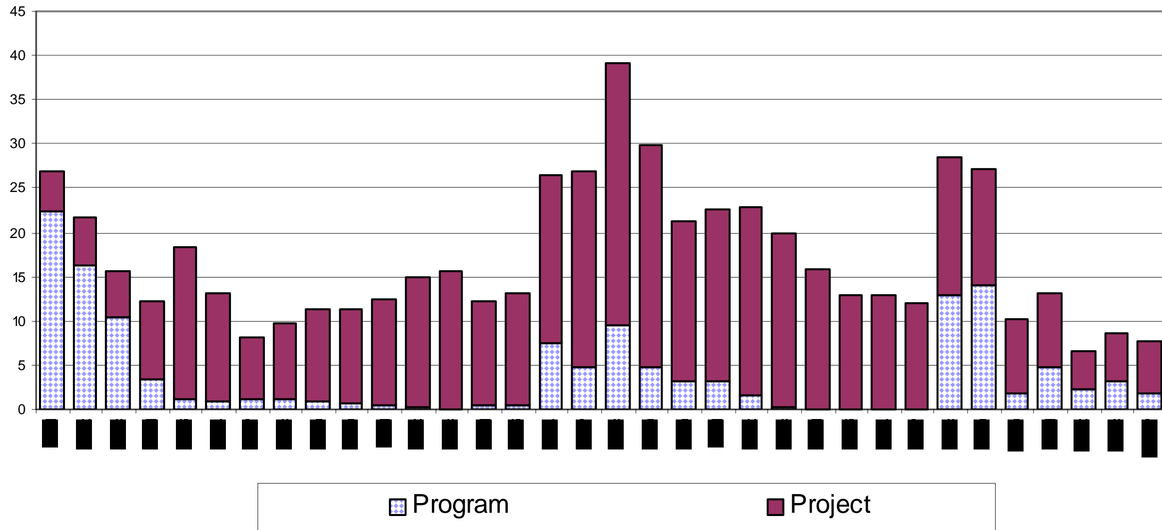
classified as a severely indebted country by the World Bank. However, unlike in the past, the aid/GDP ratio fell sharply once the economy is stabilised. As a matter of fact, it now stands at less than one percent, a figure much less than what it was in the early 1990s.

Table 1: Official Flows From All Sources to Selected Countries (%GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Indonesia	2.68	3.09	2.75	1.89	1.3	0.93	-0.08	0.51	3.44	2.96	1.63	0.90
Thailand	0.62	0.58	0.12	0.76	0.47	0.51	0.41	4.13	1.23	2.06	0.86	0.21
Philippines	3.47	3.13	4.02	3.1	1.24	-0.13	0.63	0.67	0.67	0.48	0.23	0.20
Viet Nam	1.66	2.38	5.22	1.18	4.53	3.06	2.5	3.13	5.6	4.55	4.63	4.55
Bangladesh	6.27	6.27	5.67	4.16	5.22	3.27	3.57	2.62	2.88	2.75	2.53	2.58
Pakistan	4.4	4.69	3.8	3.46	3.3	2.43	2.71	1.95	2.07	2.1	1.2	3.48
Sri Lanka	7.98	9.7	4.78	5.58	4.6	4.75	4.45	3.82	4.05	2.54	2.37	2.28

Figure 2 presents another measure of aid dependence. The trend of foreign aid as a percentage of government revenue is almost identical to that of aid-GDP ratio (Figure 1). After a steady decline since 1988 from nearly 39% of government revenue to close to 12% in 1997, foreign aid rose to about 28% of government revenue in 1998. Aid-revenue ratio now stands at about the pre-crisis level.

Figure 2: Aid as Percentage of Domestic Revenue, 1971-2004

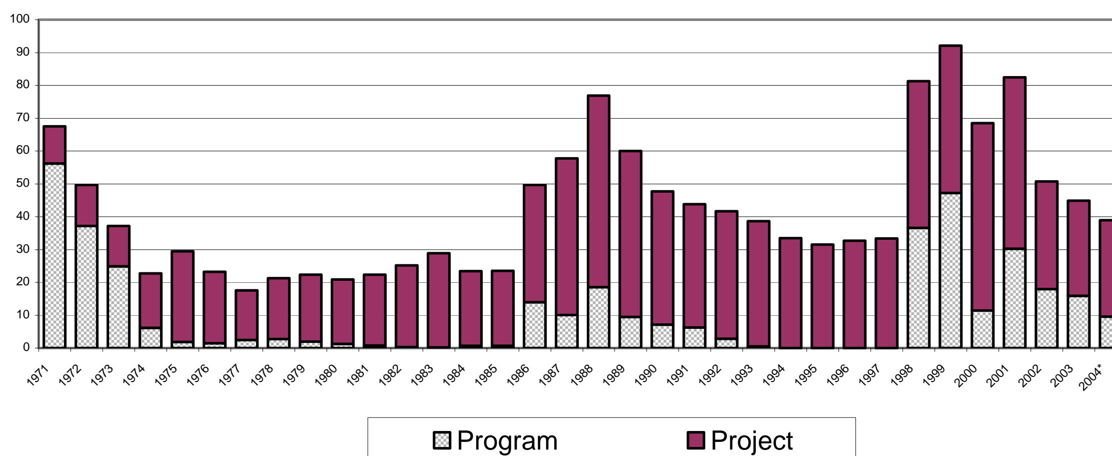


Note: *2004, Budget figure
Source: Financial Notes (Nota Keuangan), MOF, various years.

Perhaps the most telling indicator of the significance of foreign aid is its share in total development expenditure. As can be seen from Figure 3, foreign aid financed nearly 70% of total development expenditure in 1971, dropping to about 22% in 1974. It fluctuated between 20 and 30% during the period 1975 – 1985. The contribution of foreign aid to development expenditure rose to about 78% in 1988 when aid flows peaked at 6.5% of GDP. But after the crisis during 1998 and 2001, over 80% of development expenditure was financed through foreign aid. Thus, Indonesia's present scale of aid-dependence resembles that of late 1969 at the start of the New Order regime.[10]

[10] Nearly 80% of development budget of 1969/70 fiscal year was financed through foreign aid. See Hill (1996, Figure 4.3, p. 46).

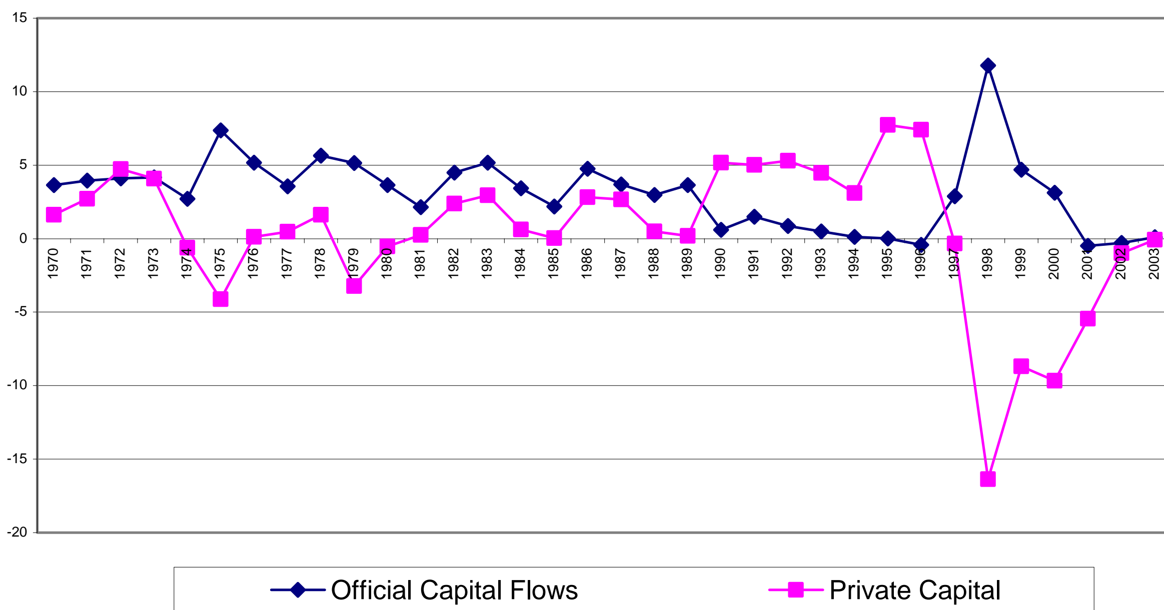
Figure 3: AID as Percentage of Development Expenditure, 1971-2004



Note: *2004, Budget figure
Source: Financial Notes, MOF, various years.

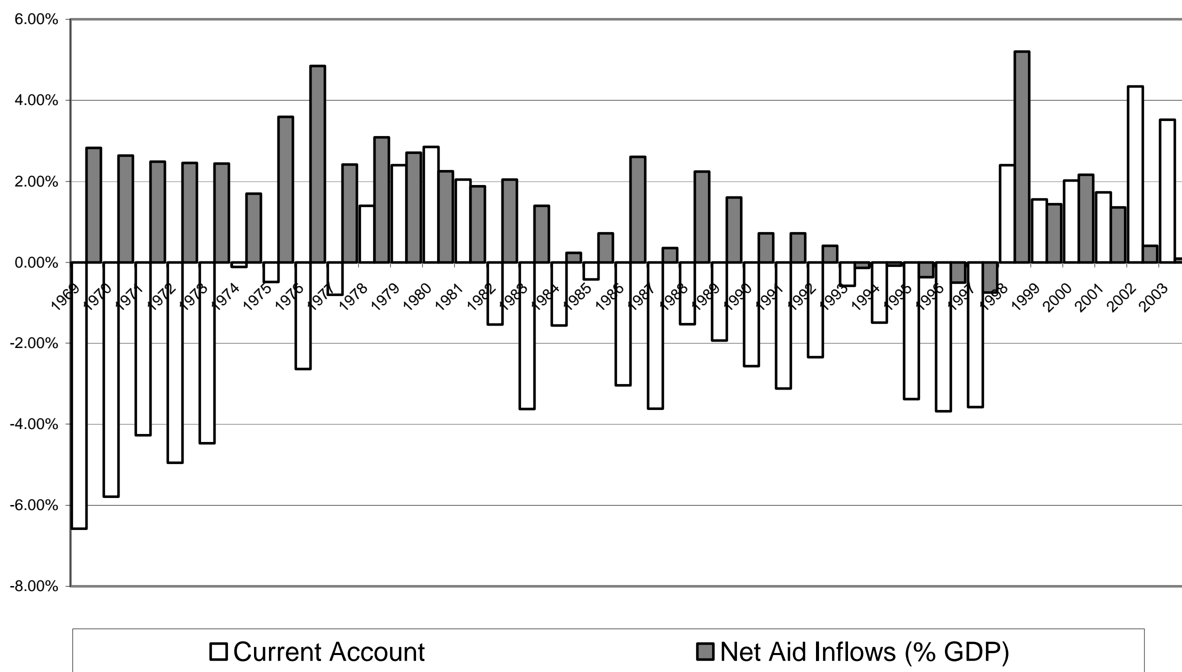
Finally, the importance of aid flows can be assessed from the point of view of financing current account deficits. As can be seen from Figure 4, until late 1980s, ODA was the main source of external financing. Compared with net private flows, ODA have also been more stable. Net private capital flows were negative in 1975 and 1979, and never exceeded 3% of GDP until 1989. Except for four years (1982, 1983, 1986, 1987), net foreign private capital flows were very marginal (not exceeding 1% of GDP). Only since 1990, private flows exceeded official flows, but the situation has reversed after the crisis. The ODA had to match the outflow of private capital that triggered the crisis.

Figure 4a: Net Official & Private Capital Inflow (% of GDP), 1970-2003



Note: Official = ODA + IMF, Private = FDI + Short-term
Source: International Financial Statistics, IMF database (CD-ROM)

Figure 4b: Current Account Deficit and Net Aid Flows (% of GDP), 1970-2003



Sources and Sectoral Distribution

Indonesia has received official development assistance from thirteen multilateral agencies and twenty countries in the past. The World Bank and the Asian Development Bank (ADB) are the two major multi-lateral donors. Among the bilateral donors, Japan is by far the largest, accounting for nearly 70% of total bilateral pledge. The IMF is not a donor agency and hence is not a member of CGI, although its programs have implications for other donors, and the over all aid flows.

As can be seen from Table 2, sectoral distribution of aid in Indonesia changed over time. In FY 1990/1993, the five largest aid recipients were mining, transportation, agriculture, education and national defence sectors. In FY 1996/1997, just before the crisis the main recipients were mining, transport, irrigation, telecommunications and education sectors. Note that public investment in mining, transport and telecommunication often requires imported capital goods. It is not surprising that much of project aid was allocated to those sectors. After the crisis the aid share of the mining and energy sector declined from around 20% to less than 10%. But the share of education, health and social welfare sector increased significantly and that helped cushion the poor to some extent from the adverse impacts of the crisis. The share of regional development, too, increased markedly. This shows the importance the donors are giving to the decentralisation process that Indonesia undertook following the crisis.

There have also been significant increases in aid allocated to the national defence since 2003. Its share of aid doubled from about 7.6% in 2001 15.5% in 2003 and rose to 23.7% in 2004. This reflects the growing importance the donor countries are giving to Indonesia due to security factors that arose after the September 11, 2001 event. On the other hand, despite concerns about governance and needed legal and civil service and political reforms, the relevant sectors (law, state apparatus and politics) continue to receive an insignificant share of aid. The lack of fund may have contributed to the slow progress in reforms in these areas.

Table 2: Sectoral Distribution of Project Aid (%)

Sector	1990/ 1991	1995/ 1996	1996/ 1997	1998/ 1999	1999/ 2000	2000	2001	2002	2003	2004*
Industrial	4.34	2.75	2.41	2.03	1.30	0.37	6.26	6.46	3.57	3.72
Agriculture, Forestry, Fishery	15.62	3.72	3.79	4.33	4.41	10.34	7.50	6.11	5.78	5.44
Irrigation	5.27	9.93	8.68	8.78	6.87	8.57	8.45	8.31	12.03	10.00
Manpower	0.47	0.32	0.22	0.62	0.26	0.00	0.38	0.09	0.13	0.06
Trade, Finance, and Cooperative	3.82	3.23	1.77	2.63	0.98	1.01	0.51	0.01	0	0.23
Transport, Meteorology, Geophysics	14.08	17.65	20.48	19.59	19.32	15.75	14.15	19.95	19.98	21.06
Mining and Energy	18.83	25.71	25.47	20.82	19.45	8.36	8.16	11.53	9.15	6.73
Telecommunication, Post and Tourism	2.30	7.89	7.64	4.75	2.78	4.17	4.61	6.07	0.79	0.66
Regional Dev. & Transmigration	3.20	4.45	2.31	4.74	11.80	6.94	11.96	11.35	10.06	8.95
Environment and Spatial Planning	1.45	2.04	2.36	1.72	1.18	2.77	2.35	1.57	0.65	1.67
Education, Culture, Youth, and Sport	11.80	6.39	7.36	9.03	11.88	17.32	18.28	12.35	11.86	7.74
Population and Family Welfare	0.53	0.41	0.40	1.19	1.17	1.29	0.16	0.26	0.38	0.46
Social Welfare, Health and Women	0.20	1.63	2.21	4.06	6.26	9.42	7.77	4.42	4.71	5.84
Housing and Settlement	6.09	5.00	5.87	6.18	5.02	3.10	0.95	1.14	2.17	1.02
Religion	0.01	0.37	0.61	0.70	1.05	0.03	0.02	0.00	0	0
Science and Technology	2.89	1.79	1.60	2.13	1.11	1.99	0.92	0.69	0.79	0.71
Law	0.00	0.07	0.11	0.04	0.03	0.00	0.00	0.16	0.44	0.34
State apparatus	0.03	1.03	1.25	1.45	1.58	1.26	1.66	1.63	1.78	1.55
Politics, international relations, information	0.36	0.57	0.35	1.01	0.15	0.00	0.15	0.21	0.26	0.11
National Defence	8.71	5.04	5.10	4.21	3.41	7.31	5.75	7.68	15.48	23.69
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

*Budget figures

Source: *Financial Notes* (Nota Keuangan), various editions.

Composition and Terms

Foreign aid is classified as technical assistance (TA), grants and official development assistance (ODA). ODA is basically a loan and it can be on a concessional or commercial basis. For nearly two decades prior to the crisis, Indonesia did not receive development assistance from the International Development Association (IDA), the World Bank (WB) facility for highly concessional loans to low income countries. Only after the economic crisis, the WB approved $26.5 million IDA credit to Indonesia to mitigate the effects of the crisis. Indonesia has also become eligible for IDA loans for poverty reduction programs.

Table 3 gives a summary of average terms of aid to Indonesia. A point to note is a steady hardening of average loan terms. Between 1970 and 1997, the average interest rate more than doubled, and the maturity years and the grace period nearly halved. The grant element in 1997 was only 22.7% compared to more than 60% in 1970. This reflects Indonesia's graduation from a poor aid dependent country to an emerging economy with an increased ability to borrow on commercial terms. The average loan terms have eased very marginally after the 1997-98 economic crisis, but nowhere near what Indonesia enjoyed in 1970.

Table 3: Average Terms of Aid, 1970-1999

Terms	1970	1980	1990	1995	1997	1999
Interest (%)	2.4	5.4	5.6	5.1	6.3	3.8
Maturity (years)	35.9	25.5	23.1	21.3	19.5	16.7
Grace period (years)	9.5	7.3	6.6	5.8	4.9	5.1
Grant element (%)	62.9	36.2	32.8	33.3	22.7	38.1

Source**:** World Bank (2001), *Global Development Finance*

The ODA is divided into project and program aid. Project aid is used to finance physical and institutional infrastructure. One of the features that need to be noted here is the dominance of program aid during bad economic times. Program aid is related to policy reforms and the Bretton Woods institutions (the International Monetary Fund and the World Bank) are the main sources of such aid. This aid provides primarily balance of

payments and budgetary supports. As can be seen from Figure 1, program aid was 2.5% of GDP, and only a tiny 0.5% of GDP was project aid in 1971. The proportion of program aid declined to a negligible level between 1975 and 1985. The balance of payments crisis precipitated by the sharp decline in oil price in 1982 led to the return of program aid with Indonesia entering into the IMF/World Bank structural adjustment programs. In 1983 the IMF approved SDR260 million under Compensatory Financing Facility (CFF). Indonesia received SDR463 million from the IMF in 1987 under the CFF to compensate for the decline in exports. In the same year, Indonesia obtained $300 million from the World Bank under the Trade Adjustment Program Loan.

Following the economic crisis of 1997-98, program aid has once again become an important component of multi-lateral assistance. Tables 4 (a-b) list the IMF and World Bank stabilisation and adjustment loans. However, the distinction between program and project loans has become blurred in the present circumstance. Compared with no conditionality in the case of the WB Trade Adjustment Loans in 1987, now all program loans are tied to a long list of conditions – both own and linked to the IMF program. This has an effect on the release of funds, and to some extent it defeats the original idea behind program loans which are supposed to be quick disbursing as opposed to project loans.[11]

Table 4a: The IMF Stabilisation Loans to Indonesia

Program Type	Date of Approval	Expiry	Amount Approved	Amount Drawn (Disbursement ratio %)
Stand-by	March 1972	1973	USD14 million	
CFF	August 1983		SDR360 million	
CFF	May 7, 1987			SDR463 million
Stand-by	November 5, 1997	August 25, 1998	SDR8.34 billion	SDR3.67 billion (44.0%)
EFF	August 25, 1998	February 4, 2000	SDR5.38 billion	SDR3.79 billion (70.6%)
EFF	February 4, 2000	December 31, 2003	SDR3.64 billion	SDR1.99 billion (54.6%)

Source: IMF website (www.imf.org)

[11] In 1998, the Fund postponed loan disbursement three times: March, May and November. This automatically affected the disbursement of loans from the WB, ADB and some bilateral lenders.

Table 4b: The World Bank Adjustment Loans to Indonesia

Type	Date of Approval	Amount Approved
Trade Policy Adjustment	1987	USD 300 million
Policy Reform Support	1999, 2000	USD 1.5 billion
Social Safety Net Adjustment	1999	USD 600 million
Water Resources Sector Adjustment	1999	USD 300 million

Source: BAPPENAS, 2001

Crisis and the IMF Support Facility

The first IMF program in Indonesia, a three-year stand-by arrangement (SBA), was signed on 5 November 1997 against the background of intense pressures on the exchange rate. The main objectives of the program were to restore market confidence, orderly adjustment of the current account, limit the unavoidable decline in growth and contain the inflationary pressure of exchange rate depreciation. Adjustments in fiscal and monetary policy as well as structural measures were deemed necessary to achieve these objectives. The Fund was committed to disburse emergency loans of about SDR 8.3 billion, but only SDR 3.7 billion was actually disbursed (Table 4a).

Against the background of deteriorating economic conditions and major banking crisis, the Indonesian authorities signed the first Extended Fund Facility (EFF). The shift from SBA to EFF was a sign that the Fund and the Indonesian government recognised that the crisis would not end very soon. The first EFF was expected to expire in February 2000, and it involved an SDR 5.3 billion. The program imposed structural measures which emphasised on bank and corporate restructuring on top of the usual fiscal and monetary measures.

As the end of the crisis was hardly seen, the second EFF was signed in February 2000 to end in December 2003. This involved an SDR 3.6 billion loan commitment from the Fund. In addition to bank restructuring, the EFF also introduced new measures (decentralisation) and strengthened measures on privatisation and legal reforms.

There has been considerable confusion about the purpose of and need for loan from the IMF. The IMF money is commonly perceived as a form of "bail out", and therefore expendable for any use. The other view is that it provides no economic purpose because it can only be used to support balance of payments when the central bank runs out of foreign reserves. The term bailout became very popular in Indonesian public policy debate after the Fund announced the first rescue package in November 1997 which also included financial commitments not only from the Fund but also from the World Bank, the ADB, Singapore, the USA, Japan, Australia, China, Hong Kong, and Malaysia. The financial scheme totalled to USD 43 billion and grouped into two lines; USD 23 billion in the first line and USD 20 billion in the second line (Table 5). The second line help would be issued only after the first line was fully exhausted. In reality, the second line was never been utilised.

Table 5: International Financial Rescue Package for Indonesia

Contributors	Amount (USD billions)
First Line	**23.0**
IMF	10.0
World Bank	4.5
Asian Development Bank	3.5
Government of Indonesia	5.0
Second Line	**20.0**
Singapore	5.0
United States of America	3.0
Japan	5.0
Australia	2.0
China	3.0
Malaysia	1.0
Hong Kong	1.0

However, this scheme should not be seen as a bailout from the Fund. The money from the Fund cannot be used other than for balance of payment purposes. In fact, it has not been used for any purpose at all because Indonesia's net foreign reserves was and is at a very healthy level. Unlike Korea and Thailand, which had virtually run out of usable reserves when their programs were negotiated, Indonesia asked IMF assistance when its

usable reserves was about USD 24 billion.[12] When the crisis broke out, the net reserve was equivalent to 6.8 months of imports, just about the same as the current level. Additionally from theoretical point of view, foreign exchange reserves are needed for open market operations. Under a floating exchange rate regime that Indonesia currently has, the central bank does not need to intervene in the exchange market on a regular basis.[13] Therefore, the additional reserves were not necessary, and practically speaking, Indonesia was capable of returning all IMF loans before the termination of the program.

While Indonesia did not need to use the IMF money, it still ended up bearing the cost. For example, in 2002 Indonesia paid USD2.3 billion to the IMF, consisting of USD1.8 billion in principal and USD500 million in interest payment (Ramli 2002, p. 13). On average the cost of this *idle* fund (fees and interest) was about 3.5 percent.[14] Table 6 presents a breakdown of repayments to the IMF.

Table 6: Disbursement and Repayment of IMF Loans (SDR)

Year	Disbursements	Repayments	Interest
2002	825,720,000	1,375,920,000	153,322,440
2001	309,650,000	1,375,920,000	369,498,855
2000	851,150,000	0	398,846,600
1999	1,011,000,000	0	267,539,445
1998	4,254,348,000	0	133,963,634
1997	2,201,472,000	0	0

Furthermore, program loans from the World Bank and the Asian Development Bank can be obtained without IMF involvement. This means that commitment from other donors can be made without tying it to IMF conditionality.[15] The reason for the inclusion of other donors commitment in the first rescue package was to prop up market

[12] See Rajan and Sugema (1999) for Indonesia, Thailand and Korea for a comparison of foreign reserves.
[13] However, foreign reserves are still needed to contain speculative attacks.
[14] SBA and EFF apply variable interest rates. Even if the money can be used to buy international securities, there will be some degree of risk that has to be costed. The margin between interest rate on international securities and the cost of IMF loan may not be so attractive. Two separate conversations with BI high rank officials provide opposing views. One official said that the margin is slightly negative while the other suggested a slightly positive margin. In addition, with the world economy is heading a downturn, the margin would not be attractive (not possible to get a high return). On top of that, additional loan may complicate the task of fund management unit of the central bank.
[15] In practice, a Fund program is virtually a *sine qua non* for countries wishing to negotiate a SAL from the World Bank (Cassen and Associates, 1987)

confidence by showing that, collectively, donors stood ready to help Indonesia financially with a large amount of money (USD 43 billion). But this was not effective at all – instead of building confidence, it might have ruined it. A large amount of financial scheme might have created a perception that the problems that Indonesia faced were actually worse than the market expected.[16] Thus, the effectiveness of the IMF rescue package and conditionality of its program generated passionate debates among Indonesian policy makers and practitioners.[17] Some of these issues will be discussed later in a separate section.

III. Aid Effectiveness

Most empirical studies on aid effectiveness relate to the contribution of aid to economic growth. This follows from the fundamental rationale for foreign aid derived from the two-gap model that developing countries lack either sufficient domestic savings or sufficient foreign exchange needed for boosting their economic growth. Aid helps fill these gaps. The voluminous literature has failed to produce any consensus and part of the problem lies in the fact aid is only one factor and a host of other institutional and behaviourial factors are responsible for economic growth.[18] Yet it is useful to begin with a look at the aid-growth relationship. However, the assessment of aid effectiveness should be examined from other perspective beyond the simple aid-growth relationship.[19] They include contributions to: (a) policy reforms, (b) macroeconomic stability by supporting budget and current account deficits, and (c) development and social sector

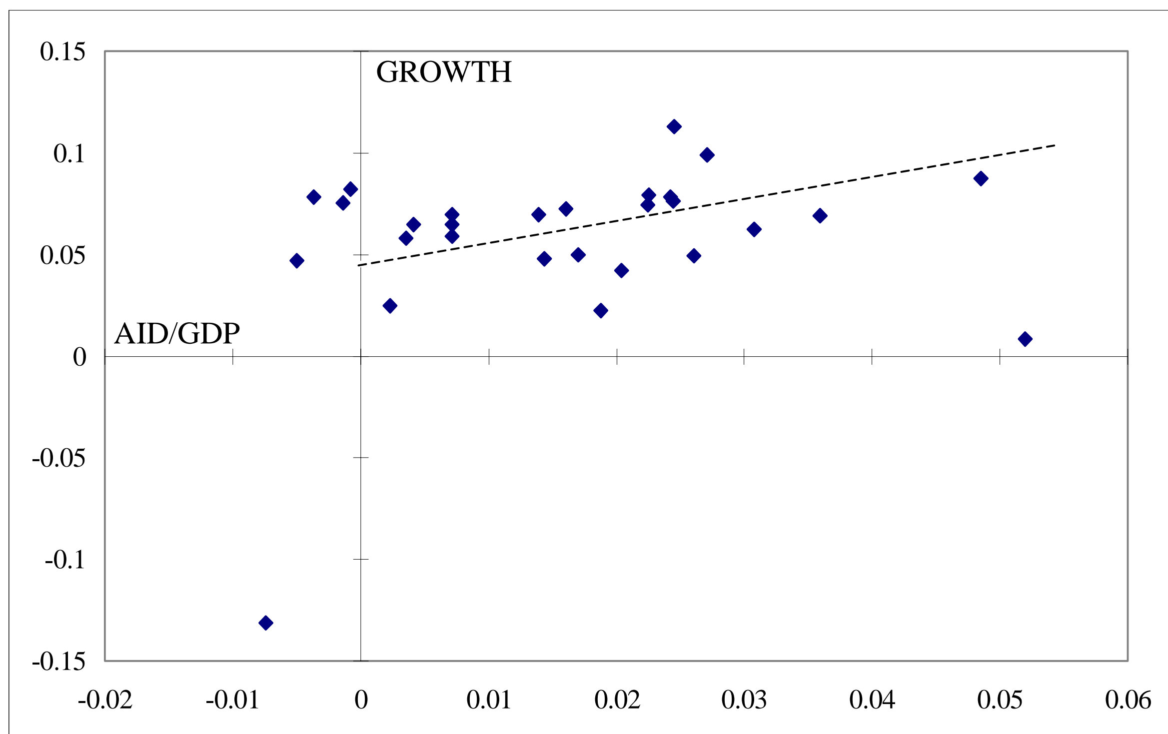
[16] The other problem is strengthened and cross conditionality which will be discussed in the next section.
[17] See Ramli (2002) for the arguments against the IMF involvement and its adverse consequences.
[18] This point has been summarised in the first most comprehensive study of aid effectiveness by Cassen and Associates (1986, p. 31) as "Aid is but one resource of many, and its effectiveness depends on many factors not all of them economic or aid-related". The World Bank has arrived at the same conclusion more than a decade later. "The complexity of social and economic change means that the impact of aid cannot be separated easily from other factors. Developing countries themselves bear most of the burdens of development, and rightly claim credit when development succeeds… Levels of development assistance are small relative to… the scale of the challenge at hand. Development aid totalled about $54 billion in 2000; this was … only a small fraction of total investment (nearly $1.5 trillion)". (World Bank, 2002, pp. ix, xv).
[19] For the conceptual framework of this analysis, see White (1996). Case studies based on this conceptual framework are contained in White and Dijkstra (eds.)(2003).

expenditure. The discussion will also reflect on the issue of tied aid and the link between aid and corruption.

Aid and Growth

Figure 5 shows some positive relationship between aid flows and economic growth in Indonesia. The correlation coefficient being 0.25, the relationship does not appear to be very strong, implying that aid flows to Indonesia has not been highly effective.

Figure 5: GDP Growth Rate and Aid/GDP Ratio (1972-1999)



However, it is widely believed that foreign assistance played a significant role in Indonesia's success in terms of sustaining rapid growth for nearly three decades. Starting as an IDA recipient in the late 1960s, Indonesia graduated to an IBRD client and the bulk of its foreign financing since the early 1990s until the crisis was from commercial sources. As a matter of fact, Indonesia's graduation from one of the poorest countries to a second-tier newly industrializing economy in less than three decades is in itself a remarkable achievement matched by only a handful of East and Southeast Asian

countries. The relatively low inequality of income and asset distribution in the late 1960s also meant a rapid decline in poverty (as measured by head-count ratio of poverty) for every percentage point increase in the growth rate (Mishra, 1997).

Aid and Policy Reforms

One of the commonly cited reasons for the successes of Indonesia is policy reforms in the 1970s and 1980s as part of IMF/World Bank adjustment programs. Indonesia liberalised its capital account completely in the early 1970s and its foreign investment policy was hailed as a model for others. Later in the 1980s, Indonesia initiated major deregulation of financial sector and trade liberalisation. As mentioned earlier, the 1987 World Bank's Trade Adjustment Loan was approved entirely on the basis of reforms already made. Technical assistance, especially from the Harvard Institute for International Development (HIID), played an important role in the design and implementation of financial deregulation in the 1980s, and earlier in the late 1960s.

The critics, however, have raised a number of issues. First, the soundness of technical advice on deregulation of financial sector and capital account opening has come under questioning after the devastating financial crisis in Asia and elsewhere. Cole and Slade (1999), two leading proponents, have openly confessed in hindsight the mistakes of overzealous financial sector deregulation which amounted to almost complete *Laissez-faire* in the absence of strengthened prudential regulations. It was also possible that technical reports coming from different agencies had conflicting advices, as they were likely to reflect different interests of various donors. Hill (1996, p. 81) observed, 'Indonesia may even suffered from a surfeit of expatriate policy advisers and a seemingly endless flow of consultancy reports'. More importantly, there seems to be a crowding out effect of easy availability of foreign consultancy reports to the extent they have diminished the local research capabilities.

Secondly, there have always been policy reversals. For example, by about 1973 the government began reintroducing restrictions on foreign investment which were intensified in early 1974. Foreign investment policy was liberalised once again only in 1992 when 100% foreign ownership was permitted. With the oil price boom Indonesia also moved back to more capital-intensive industrial policy supported by high protection.

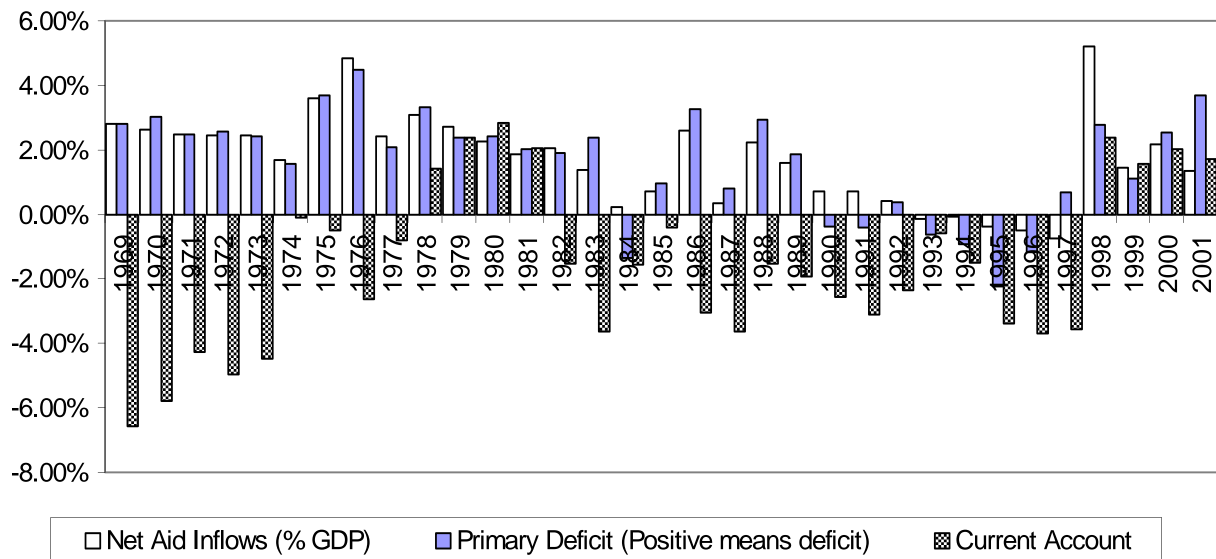
These policies were halted after the collapse of oil price and subsequent fiscal and balance of payments problems in the early 1980s, only to be restarted with more vigour in the early 1990s when emphasis shifted toward prestige high-tech industrial activities. These policy reversals indicate that Indonesia was less than committed to reforms. Indonesia agreed to these structural reform agenda under duress. This observation is consistent with the international literature that doubts the ability of donors to influence policy reforms. This raises question about the effectiveness of conditionality based lending linked to policy reforms – an issue which has become contentious in recent times involving the IMF program at the wake of economic crisis.

Aid and Macroeconomic Stability – Balance of Payments and Budget Support

In the 1970s and 1980s, current account deficits largely reflected the size of government budget deficits (Figure 5).[20] Budget deficits were mostly financed with foreign borrowings. Over the period 1982-1996, deficits in services and net transfers were the source of current account deficits, while trade balances were always positive. Thus, the current account deficits reflected payments on foreign services and interest on foreign debts, rather than trade deficits. As the bulk of foreign debts were government's, in the ultimate analysis, accumulated past budget deficits were responsible for the persistent current account deficit during the later period.

[20] Montes (2001)

Figure 5: Budget Deficit, Current Account and Net Aid flows (% of GDP), 1969-2001



In the 1990s, the way current account deficits were financed shifted from official to private sources, with private capital flows dominating total capital inflows. However, the increase in foreign direct investment (FDI) was not enough to cover the growing current account deficits. Besides, FDI was also partly responsible for the increase in capital goods imports, despite its positive impacts on exports. Thus, the country became increasingly dependent on short-term portfolio capital inflows.

Indeed filling the fiscal gap was the clearest objective of the Indonesian government in obtaining loans. As can be seen from Figure 5, the fluctuations in aid flows almost mirrored the size of government budget deficits. Econometric tests show that foreign aid is demand driven, and budget deficits cause foreign aid.[21] As noted earlier, aid flows constituted a substantial part of government revenue (Figure 2). As a matter of fact, due to the certainty or “implicit” guarantee of aid flows, aid was regarded as revenue. There were a number of reasons that made aid financing attractive.

First, the domestic taxation system was very rudimentary especially before 1985. There was no serious effort to modernise the old tax system - some inherited from the Dutch colonial era - and to ensure tax compliance. The collection process was slow and corrupt. It was only after a significant decline in oil revenue in the early 1980s that the

[21] UNSFIR (2002) prepared by Sugema.

government took some initiatives for tax reform aimed at producing a more efficient and buoyant tax system. A decade of continuing low oil prices ensured that these reforms were actually implemented.[22]

Second, financing the deficit through the commercial domestic market was difficult in an underdeveloped financial market.[23] The domestic bond market was very thin and therefore could not be relied on for deficit financing. Before the crisis, the size of the market was only about IDR 6 trillion. After the crisis, although the government has issued bonds amounting to IDR 660 trillion as a result of bank bailout, only about 10% is actively traded in the market.

Third, even if the domestic bond market is relatively sizeable, aid financing is still more attractive when the government wants to avoid crowding out effects of budget deficit. The deficit can directly reduce private investment through the increase in the domestic interest rate. However, the adverse impact of aid financing on the private sector may not be fully contained when it leads to a real exchange rate appreciation.[24]

Fourth, aid can also avoid inflationary financing of budget deficits by means of printing money. This was indeed the main success story of aid and technical assistance to Indonesia in late 1960s and 1970s. The run away inflation during the mid 1960s was successfully scrapped in just a few years. ODA has been instrumental for non-inflationary financing. In sharp contrast to the Old Order, the New Order Government of President Soeharto adopted a "balance budget" principle which prohibited the government from borrowing from the central bank. The government could adhere to this non-inflationary financing method for development expenditure due to sustained ODA flows. Thus, ODA helped avoid crowding out of domestic private investment, and adverse effects of budget deficit on exports due to inflation induced real appreciation. On the other hand, ODA may have helped crowd-in private investment or increase its productivity through complementarities between public, social and infrastructure investment and private investment.

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[22] Hill (1996) and Gillis (1985). The results of these reforms have been impressive. In 1984, non-oil domestic revenue contributed to about 30% of total government revenue. In 1996, just before the crisis, the share increased to 68%.

[23] Domestic bond market may be very thin like in Indonesia. Although the government has issued bonds amounted to IDR 660 trillion, only IDR 35 trillion is actively traded in the market. Hence, it would be difficult for the government to "recycle" the bonds.

[24] Gray and Woo (2000).

Fifth, obtaining concessionary loans from bilateral and multilateral donors can reduce financial cost. Government projects are typically less commercially oriented than that of private, and therefore it is more reasonable to seek funds with the actual cost below the market rate. The financial terms from non-commercial sources are generally favourable; lower interest rate and longer repayment period. For instance, in 1999, the average interest rate of official creditors was only about 3.8% per annum, with average maturity about 16.7 years, grace period of about 5.2 years, and the grant element of the total aid was about 38.1% (Table 3). However, these favourable financial terms have to be compensated by non-financial conditionality such as donor determined procurement, earmarking, and policy reform. Thus, effectively the government may lose its policy independence.

Sixth, in a crisis situation, aid could play a more significant role in preserving fiscal sustainability and sustaining growth. When the economy enters a down turn, tax revenues also fall. The need to stimulate growth can be facilitated by creating an aid financed fiscal deficit. By doing so, the cut in public expenditure which tends to propagate the crisis can be avoided.

Indeed ODA financed nearly 80% of development expenditure in the difficult times of the late 1960s and the early 1970s. Foreign assistance also came to ease out the balance of payments problems such as in the mid 1980s after the collapse of oil price. Lensik and Morrissey (2000) show that impact of aid on growth rise significantly if external shocks are taken into account. Lensink and Morrissey (2000) show that the impact of aid on economic growth is primarily determined by the stability of the aid flows, and not by the level or size of aid *per se*. As noted earlier (and shown in Figure 4), ODA flows to Indonesia have been very steady and displayed very little volatility, when episodes of external shocks are taken into account. The stability of ODA flows allowed the government to plan its development expenditure and execute it. Hill (1996, pp 79-80) has summarised the contribution of ODA in the following words:

> *The stability of foreign aid flows, in contrast to volatility of private flows,… has been a recurring feature of the New Order… The stability of official flows underlies a crucial contribution of foreign aid… In a close relationship with donors, aid flows are more consistent, they provide a basis on which governments may plan longer-term investment projects and they enable nations to endure difficult economic periods and to enact policy reforms less painfully than would be the case in the absence.*

However, Hill (1996, p. 47) also noted, '…notwithstanding the gradual decline in the importance of aid after 1988, Indonesia has not yet achieved one of its major fiscal objectives, that of reduced dependence on foreign aid. The annual "IGGI [since 1992 CGI]" … remains important.'

It is generally believed that an easy availability of ODA support for the state budget contributed to a lazy fiscal regime of the government.[25] As mentioned earlier, Indonesia's net aid flows mirrored government's budget deficit (Figure 5). Simulations that both program and project aid induces increases in routine expenditure and declines in non-oil tax revenue.[26] Project aid is always directed to finance development expenditure, and therefore the increase in routine expenditure suggests that project aid is fungible. The availability of aid to finance development expenditure frees some part of government resources which then can be used to increase routine expenditure. Moreover, the fact that aid has a negative impact on non-oil tax revenue suggests that the government put less effort to collect tax because the creditors stand ready to fill the gap between government revenue and expenditure.

Aid and Development Expenditure

As depicted in Figure 3, aid has been a major source of development finance. This is especially so during periods of economic crisis. For example, aid financed around 70%, 80% and 90% of the development budget in the early 1970s, the mid 1980s and the late 1990s when the Indonesian economy went through internal and external shocks. The average contribution of aid to development finance was around 28% during 1971-1985, and it rose to 48% during 1986-1996 and stands at around 67% since the economic crisis in 1997-98. Thus, Indonesia has become progressively more dependent on aid for development expenditure.

Until the early 1990s, agriculture, forestry, fishery and mining sectors received nearly one-third of foreign aid. Although the rice sector was protected, one can conclude that during this period aid has generally benefited the tradable sector. Furthermore, the

[25] The oil price boom in the 1970s has also played a role; see Hill (1996, p. 81).
[26] See simulation results in the Appendix. Details are in UNSFIR (2002). The methodology followed is that of McGillivray (2002).

transport sector continued to receive close to 20% of ODA, which also aided the development of the tradable sector. Thus, aid perhaps was not "immiserising".[27]

However, social sectors health, education, and public housing received 2% to 6% of aid money. Therefore, if expenditure on tertiary health and higher education sectors were excluded, the aid share of basic health and basic education which are regarded as pro-poor would be much less. Thus, ODA's impact on poverty over and above what may have trickled-down through its impact on growth could not have been significant.

There is also a growing body of literature which points out that if the objective of aid is primarily poverty reduction in line with the reorientation of development focus since the 1970s, then growth is not the only way to achieve it. For example, Ramirez et al (1997) show that countries that focus on growth alone have poor performance with respect to both growth and human development indicators. On the other hand, countries which emphasise investments in human development also reap benefits of higher growth. Based on cross-country evidence Mosley et al (2004) find a significant relationship between poverty (head-count ratio) reduction and pro poor public expenditure.[28] They also report significant impact of health spending on infant mortality. Thus, they advocate greater donor leverage on recipient countries for pro poor public expenditure. Furthermore, aid that contributes to the reduction in inequality (via pro poor expenditure) is likely to achieve a larger reduction in poverty for each percentage point increase in the growth rate.

Nonetheless, aid helped maintain essential social expenditure at times of economic crisis. For example, during the recent crisis, aid funded almost the entire social sector budget. Actual government spending excluding foreign assistance declined in real terms, from 10% in 1997/98 to 23% in 1998/99, but real health expenditure could be maintained due to 17% in increase in donor assistance in real terms in 1999/2000.

[27] Yano and Nugent (1999) have shown both theoretically and empirically that if aid goes to finance the expansion of non-tradble and/or import-competing (protected) sectors, "transfer paradox" may arise and the net welfare may decline. They found evidence of "immiserisation" effect of aid in Congo, Uganda, Bangladesh and Nepal.

[28] Pro poor expenditure includes agriculture, housing, education, water and sanitation, and social security.

Impact of Tied Aid

Tying of aid flows to procurement remains a prominent feature of many donors. According to an estimate by BAPPENAS, almost 75% of aid goes back to donors in the forms of purchases of goods and services (consultancy). As can be seen from Table 7, on average close to 80% of aid money goes back to bilateral donor countries. The proportion is around 60% for the ADB. Aid tying raises the issue of who gets the most benefit from aid flows.

Table 7: Tied Aid (% of total)

Creditors	Foreign Utilisation (%)	Local Utilisation (%)
JBIC	80.45	19.55
ADB	61.93	38.07
World Bank	35.04	64.96
Austria	92.81	7.19
Netherlands	87.42	12.58
Denmark	90.55	9.45
Germany	97.31	2.69
South Korea	82.88	17.12

Source: BAPPENAS

Aid and Corruption

Given a reasonably high domestic savings ratio (close to 30% of GDP), Indonesia's high dependence on external finance (both ODA and private) remains an enigma. Comparison of this savings ratio with Indonesia's historical growth trend would result a very high incremental capital-output ratio (around 5 for a growth rate of approximately 6%), implying a massive inefficiency of capital. Besides low productivity, this could be due to misuse of investment fund. Indeed, corruption has been identified as major drain on both public and aid money.

The predominance of project aid, especially in the infrastructure sector (e.g. transport, mining and energy) has perhaps made corruption easier as they involve large procurements.[29] Additionally, most grants were not recorded systematically and did not require budgetary appropriation. Donors dealt directly with the executing agencies or line ministries who did not normally report to the ministry of finance. This suited donors as they could minimise bureaucratic controls and pursue their own objectives. But it also meant a lack of instruments for proper monitoring leading to a lack of accountability

[29] See Mauro (2002) for arguments linking corruption and infrastructure projects.

which facilitated corruption. Furthermore, there is a widely held perception that the cosy relationship between donors and the New Order regime hid major failures of assistance programs in Indonesia. The willingness of donors to lend, and generally positive remarks by donor agencies about the Indonesian economy concealed the problems associated with the lack of participation by civil society, accountability and corrupt use of money.[30] Thus, aid was instrumental in "helping bad government survive" and "created more problems than it solved". This perception is fuelled by the continued refusal by the GOI and donors to audit the past use of loans as demanded by some civil society organisations.

In sum, although Indonesia received significant donor supports since the late 1960s, there remains considerable doubt about the impact of foreign aid. The flow of foreign aid and its certainty have contributed to macroeconomic stability, and to the extent macroeconomic stability contributed to economic growth and poverty reduction, foreign aid played a very useful role. But at the same time the certainty of aid flows may have made the government lazy in terms of building a sound domestic resource base. Thus, Indonesia still remains heavily dependent on official development assistance. Foreign assistance has been crucial in maintaining public social sector expenditure at times of economic crises, but the allocation of foreign aid to pro-poor sectors, such as public health, basic education and public housing has been low compared with the amount allocated to infrastructure projects. The dominance of infrastructure in aid allocation and almost unconditional aid flows regardless of poor governance and institutions may have contributed to the unprecedented rise in corruption to place Indonesia at the bottom of the list of most corrupt countries in Asia.

IV. Post Crisis Issues – the Burden of External Debt

The most debilitating post-crisis issue is the burden of external debt and its impact on the state budget. The public external debt increased from USD 54 billion in 1997 to about USD 80 billion in 2003 (Figure 6a). The external public debt as a percentage of GDP has been steadily declining since its peak of about 50% in 1987 to about 26% in 1996. It

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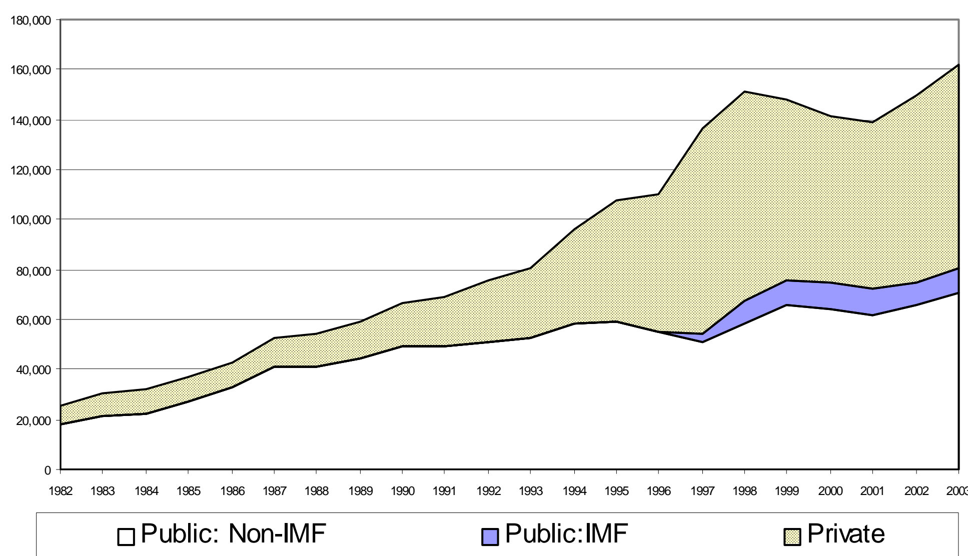
[30] For example, World Bank (1993) categorised Indonesia as one of the highly dynamic economies of East Asia. There was no hint of corrupt government-business relations despite by then they were well known (see for example, MacIntyre (1993, 1995). In fact, the surge in private capital into Indonesia followed the positive assessment of Indonesia as an emerging economy.

jumped to about 45% in 1997 at the wake of the crisis and continued to rise to reach about 55% of GDP in 2000-2001. The public external debt is now around 39% of GDP (Figure 6b). The overall external debt remains at over 60% of GDP which is more than twice the projected size in the medium term economic framework (Propenas 2000-2004).

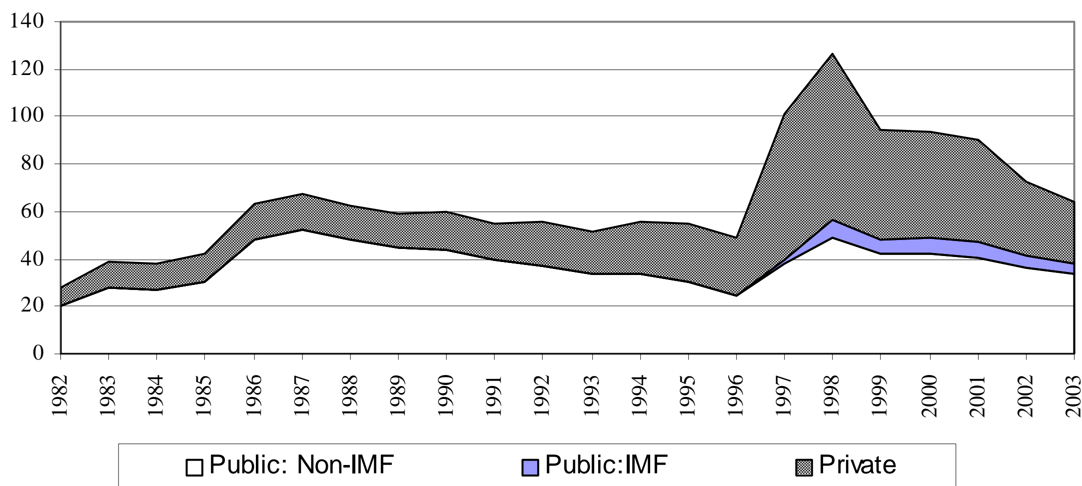
More than a half of the increase mainly reflected the net borrowing from the IMF which was about USD 10 billion in 2001. Without the loan from the Fund, the public external debt should be about USD 67 billion. As noted earlier, the IMF money was kept at the BI to be used should the central bank run out its foreign exchange reserves. But as the BI has enough net reserves (around 6 month of imports), the money has never been used. Moreover, it has not added to the net reserves and thus there is a view that the government has been unnecessarily increasing its indebtedness.

Figure 6a: Trend in foreign debt (USD million), 1982-2003



Source: Financial Notes, MOF, various years

Figure 6b: External Debt (% of GDP), 1982-2003



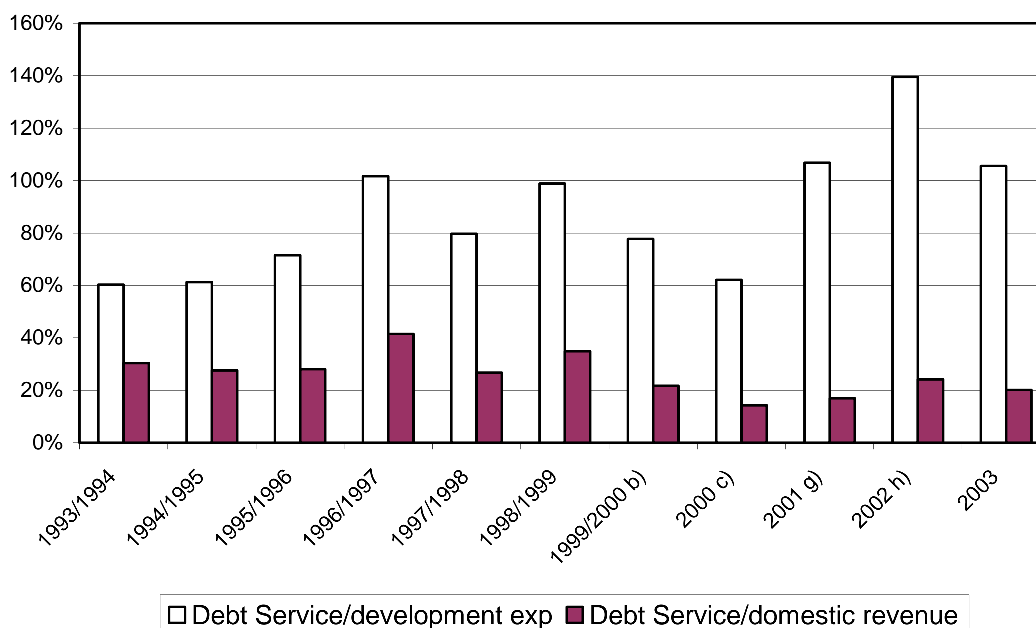
Source: Financial Notes, MOF, various years

Debt Servicing and Development Expenditure

External dependence and debt burden is not an entirely new phenomenon for Indonesia. As can be seen from Figure 7, over 40% of domestic revenue was spent in servicing external debt even in 1995/96 prior to the crisis. This happened as debt incurred in the mid-1980s fell due. As noted earlier, foreign aid financed nearly 80% of development expenditure in 1988 (Figure 3). This proportion was on the decline until the crisis, and gross aid flows as a proportion of development expenditure increased dramatically from close to 40% in 1997 to nearly 120% in 2002.[31] Yet more is spent on external debt servicing than on development. The ratio of external debt service (excluding the servicing of IMF loans) to development expenditure stood at 140% in 2002. If the servicing of IMF loans were taken into account, this figure would be much higher.[32] Thus, debt servicing is putting a huge pressure on the capacity of the state to finance social expenditure.

[31] This reflects the impact of Paris Club debt rescheduling. The ratio excludes the IMF loan as it cannot be used for supporting the state budget.
[32] The IMF money can be invested in the commercial market. Views on the net profitability of such investment differ. One official reported net negative return, and another small positive margin. Given the administrative cost of fund management, perhaps the small positive margin is not worth the risk involved in such investment.

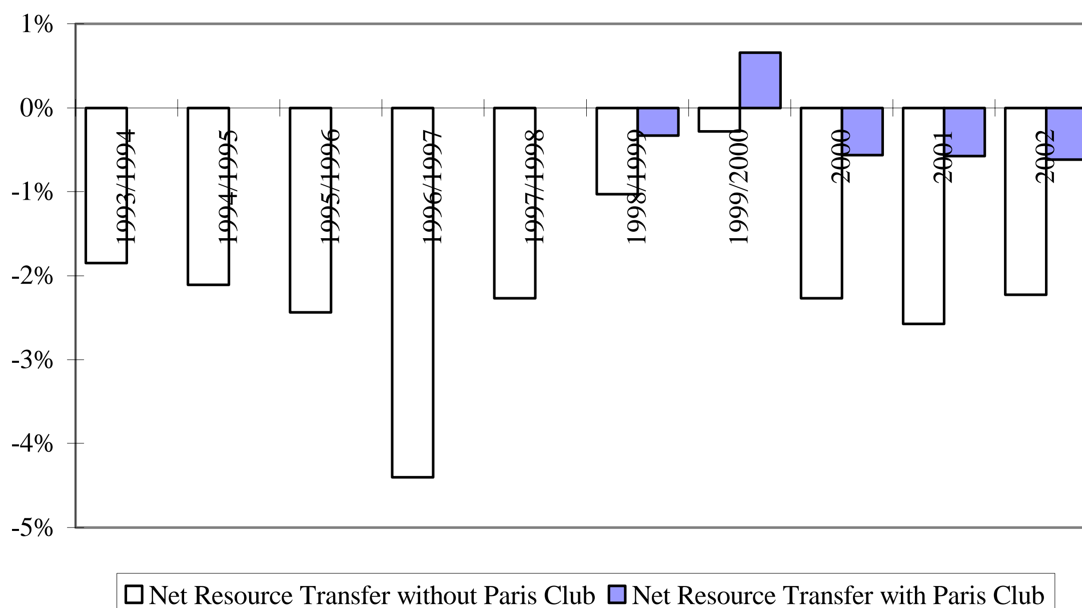
Figure 7: Public Foreign Debt Service (% of development expenditure), 1993 -2003



Source: Financial Notes, MOF, various years

Historically, external debt servicing as a proportion of development expenditure has been higher than the proportion of aid financed development expenditure (Figures 3 & 7). The question is then, has aid really helped Indonesia in alleviating fiscal constraint? The ratio of net resource transfer to GDP perhaps provides the answer. Before the crisis, the ratio was about minus 2.1% on average. During the crisis it has dropped to about minus 0.3% on average (see Figure 8). Thus in general it can be said that aid has reduced the fiscal burden during this period, although the burden was not fully eliminated. The only positive figure was only in FY 1998/1999 where the gross aid inflow exceeded the debt service, making the net resource transfer positive, and aid was particularly helpful to Indonesia.

Figure 8: Net Resource Transfer (% of GDP)



Source: Financial Notes, MOF, various years

As the gross aid flow did not fully offset the debt service except in one fiscal year, the adjustment on social expenditure had to be severe. In the pre-crisis period the average development expenditure was about 7.9% of GDP. In the post crisis period, the development expenditure had to be cut significantly and by FY 2002 it was only 3.1% of GDP. In the 2003 budget statement this expenditure is planed for a further reduction to only about 2.8%. Because development expenditure is particularly important in stimulating private investment and sustaining economic growth, with this level of public investment the growth prospect of the country could be jeopardised.

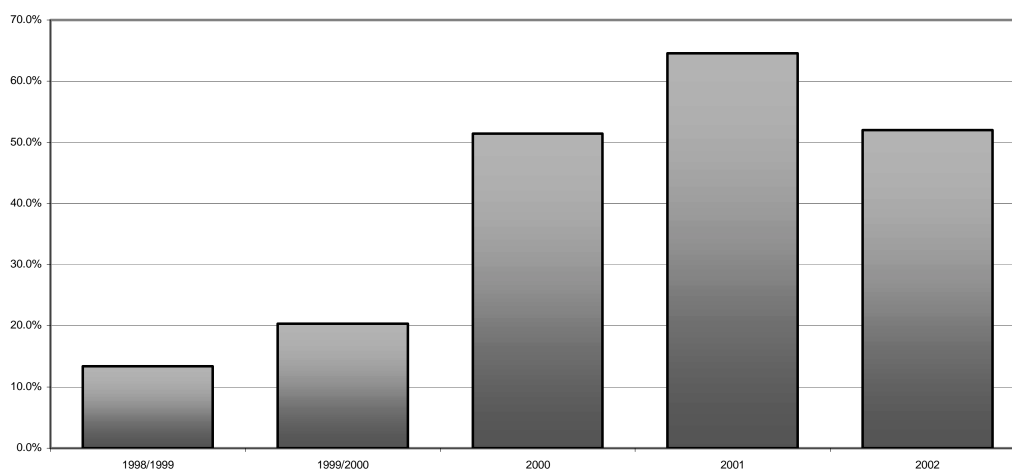
The Paris Club Debt Scheduling

In order to reduce fiscal pressure, the creditors through the Paris Club (PC) provide rescheduling of public foreign debt. So far three PC schemes have been granted to Indonesia. The PC-I, signed in September 1998, rescheduled USD 4.5 billion public debt that fell due between August 1998 and March 2000. ODA loans (USD 3 billion) were rescheduled up to 20 years with 5 years grace period. For non-ODA loans (USD 1.5 billion), the rescheduling would take up to 11 years with 3 years grace period. A more

generous rescheduling was given through the PC-II, signed in April 2000. This time the total amount of principal rescheduled was about USD 5.8 billion – the principal due between April 2000 and March 2002. In addition, PC-III rescheduled USD 5.4 billion of principal and interest that is due between April 2002 and December 2003.

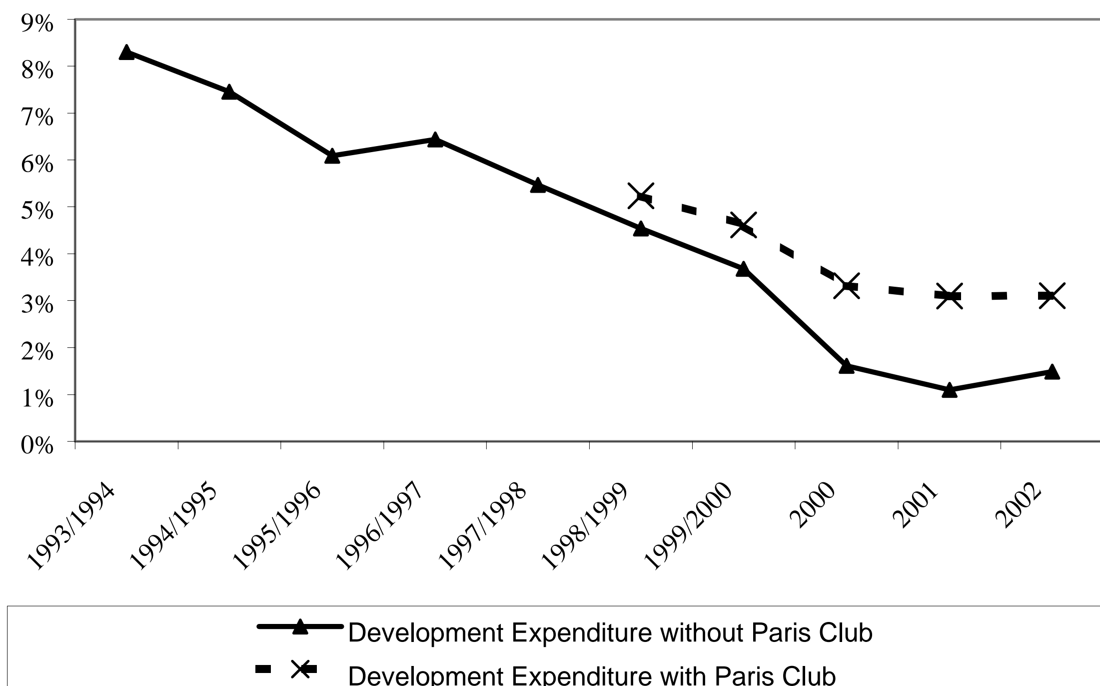
Figures 9a-b present the impact of PC scheduling. As can be seen from Figure 9a, the amount of rescheduled debt represented close to 65% and 54% of development expenditure in 2001 and 2002, respectively. Assuming that revenue saved from the PC rescheduling is used for development expenditure, Figure 9b shows that the development expenditure during 2000-2002 would rise close to 4% of GDP. This is nearly double the amount without the PC rescheduling.

Figure 9a: Fiscal Impact of Paris Club (Rescheduled Debt / Development Expenditure %)



Source: Financial Notes, MOF, various years

Figure 9b: Development Expenditure with and without Paris Club (% GDP)



Source: Financial Notes, MOF, various years

However, the PC rescheduling is only a temporary relief; it does not resolve future fiscal risk. For instance, in 2004 the total debt service for both domestic and foreign debt (both principal and interest) is estimated to be 58% larger than that of 2002 if exchange rate is assumed constant at IDR 9000 per USD.[33] In fact, 2004 will be the peak of public debt servicing and Paris Club III will end by December 2003. Thus, the uncertainty regarding fiscal sustainability remains unresolved.

V. Concluding Remarks

Aid is only one source of financing. Its impact on growth and poverty remains a subject of considerable debate. The assessment made nearly two decades ago by Cassen and Associates that its effectiveness depends on many factors, not all related to economic has been echoed recently by Easterly (2003, pp. 39-40) in the following words:

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[33] See UNSFIR (2002) for simulation results on fiscal sustainability. Also see Nasution (2002).

> *How to achieve a beneficial aggregate impact of foreign aid remains a puzzle. Aid agencies should set more modest objectives than expecting aid to "launch the take-off into self-sustained growth". Aid agencies have misspent much effort looking for the Next Big Idea that would enable aid to buy growth. Poor nations include an incredible variety of institutions, cultures and histories …. The idea of aggregating all this diversity into a "developing world" that will "take-off" with foreign aid is a heroic simplification.… The macroeconomic evidence does not support these claims [of aid helping take-off]. There is no Next Big Idea that will make the small amount of foreign aid the catalyst for economic growth of the world's poor nations… The goal of having the high-income people making some kind of transfer to very poor people remains a worthy one, despite the disappointment of the past. But the appropriate goal of foreign aid is neither to move as much money as politically possible, nor to foster societywide transformation from poverty to wealth. The goal is simply to benefit some poor people some of the time.*

The above assessment is by and large true for Indonesia. Aid helped Indonesia get over the crises and prevent humanitarian disasters. But Indonesia's past growth and transformation owe much more to its domestic savings efforts than to foreign aid. Any discussion of foreign aid must keep this perspective in mind, and a gradual reduction of aid dependence must be the ultimate objective of a country.

The issue of aid effectiveness in Indonesia has assumed urgency since the crisis. However, the Indonesian discussion of aid effectiveness hardly involved broader macroeconomic issues such as the relationships between aid and economic growth, between aid and investment. In particular, the question why Indonesia remained highly aid dependent despite its very high domestic savings rate was never examined. Nor there was any examination of welfare implications of sectoral aid allocation and the impact of different modes of aid delivery on aid effectiveness. The focus of discussion is primarily on management of aid. That is, improving fiduciary standards, coordination (among government agencies, among donors and between donors and the government), and absorption capacity. Policy reforms, particularly with regard to governance and privatisation, are also high on the agenda. As a matter of fact, fiduciary standards and governance are equally important for domestically generated public funds. Thus, raising productivity and curbing corruption will go a long way in reducing Indonesia's dependence on external finance.

The consequences of its high aid dependence were becoming obvious even before the crisis. The debt-servicing requirement was eroding a significant amount of state budget putting pressure on social expenditure. For example, as much was spent on debt

servicing as development expenditure in 1996. And the 2002 budget allocated 40% more for debt servicing than for development expenditure. This is despite some temporary respite from the Paris Club rescheduling. Fiscal sustainability will become a serious issue in 2 to 3 years time. Thus, Indonesia has to deal with immediate question of fiscal sustainability arising from increased debt-burden. In the long run, it must find ways of reducing its overall dependence on aid.

The government's post-IMF economic framework paper aims to address the issue of debt burden and fiscal sustainability by cutting expenditure, in particular reducing or removing subsidies. It also has measures to raise privatisation proceeds and other revenues. Measures for raising tax revenue included adjustments of tax brackets, coverage of VAT and administrative restructuring. These have resulted in the increased in tax-GDP ratio from around 10% to about 13%. There is a prevailing view that tax is distortionary, and it would not be effective as there is wide-spread evasion and corruption. However, this view can be challenged in view of very low tax-GDP ratio in Indonesia compared to ASEAN standards. This ratio in comparable ASEAN countries (Thailand, the Philippines and Malaysia) ranges between 12%-19%. Indonesia's tax effort should be increased to that of Malaysia.

However, the post-IMF package does not give any explicit consideration to equity issues arising from increased tax efforts. Increased tax coverage should not hurt the poor and the vulnerable, especially when subsidies are being cut. Therefore, the target for increasing the rate should be luxurious goods like automobiles, and other goods that are consumed by the rich. This is justified on distributional grounds as they are indirectly subsidised through bank restructuring and recapitalisation. Moreover, it is also possible to increase the tax base. The rate of value added tax is currently 10%, but the total revenue from this tax is only 4.5%. Thus the gap is about 5.5%, which also means that 55% of goods is not taxed.

Crisis is an extraordinary circumstance and therefore sometime an extraordinary measure is justified. Malaysia and Chile introduced a drastic capital control. During the Second World War some European countries imposed a special levy called war levy. Recent examples include Germany's "solidarity surcharge" to help the re-unification cost of former East Germany. It was initially imposed at 7.5% on all income and corporate

taxes, and since 1998 is charged at 5.5%. An advantage of such a levy is that it is temporary, and hence in unlikely to cause much distortion or disincentive. Furthermore, the fact that it is raised for specific purpose, there is a greater incentive to pay by the public. The fear of adverse investor reactions to such drastic measures is unfounded. Rather, as the experience of Malaysia shows, investors may respond favourably as they regard this as a national resolve to solve the problem and restore stability.

Thus, it may be worth considering for Indonesia something like a "crisis levy" as an extraordinary tax scheme. This levy may be attached to various asset holdings like upper class property and luxury cars, or to specific commodities like cinema, tobacco and liquor (alcohol), and shopping in big shopping malls in metropolitan centres where majority of shoppers are well-to-do people. This levy is not only socially justifiable, but also will increase the awareness about the seriousness of the problem.

As mentioned earlier, one of the indicators of success is to be able to graduate from dependence on ODA to private sources of finance. In the case of Indonesia, it took more than 2 decades (1968-1991) for private capital flows to exceed ODA in a stable manner after its major economic crisis in the 1960s. How long will it take now?

Six years after the onset of the crisis, private capital has not been returning to Indonesia yet. The return of private capital would reduce the pressure on balance of payments and thus lessen the need for program loans. However, it is not known with certainty when foreign investors will come back, although the size of capital outflow from Indonesia has tended to decline. It may be interesting to note the experience in other regions. After the 1995 tequila crisis, foreign investors came back to Mexico in just one year. However, it took 7 to 8 years after the 1980s Latin American debt crisis. Certainly careful analysis regarding the timing is needed, especially for policy design to stimulate early re-entry.

Different types of capital flows respond differently to domestic policies. While FDI reacts positively to improved fiscal stances, short-term capital may react in an opposite way. There are occasions where portfolio capital inflows are induced by large fiscal deficits coupled by a relatively tight monetary policy. In other words, a higher domestic interest rate is instrumental for short-term capital flows. On the other hand,

improvements in the longer-term economic prospects and certainty in policies are more important in explaining FDI inflows.

Distinguishing the determinants of long and short-term capital movements is a very important issue. Foreign direct investment is more responsive to changes in economic and political fundamentals, rather than to short-term arbitrage conditions. The factors influencing FDI includes prospects of domestic demands (domestic market oriented FDI), competition and trade policies, investment climates, political developments, quality of human capital, wage and labour policies, and tax incentives.

In this respect, it is perhaps time to reflect on the entire policy framework and the relationship between ODA with associated conditionality and private capital flows. Many observers have pointed out likely adverse effect of a long list of structural adjustment programs. A number of factors may contribute to a negative relationship between the nature of structural adjustment programs and investor confidence. First, a long and difficult list of structural adjustment may signal the existence of severe problems. Second, a long list of donor conditions may reflect lack of confidence or trust in the government. Third, the longer and complex are the conditions, more difficult they are to implement. Thus, implementation failures reinforce the initial lack of trust and/or confidence in government with adverse implications for investor confidence. This assessment is perfectly in line with Indonesia’s own experience in the mid-1980s when the economy was in a serious balance of payments and fiscal crisis. The World Bank’s Trade Adjustment Loan was provided without any conditionality. Perhaps this public display of confidence in the government by the Bank was instrumental in surge of private capital inflows in the early 1990s.

Both the government and donors also should not remain ideologically tied to the principal of a balanced budget and a very low inflation target. The experience of countries around the region shows that at times of depressed domestic and international demand, government should pursue expansionary policies with carefully targeted credit expansion programs for SMEs and agricultural sector. This mix of policies does not necessarily lead to an unsustainable position. Rather, it helps crowd in private investment and accelerate growth needed for employment creation and debt reduction.

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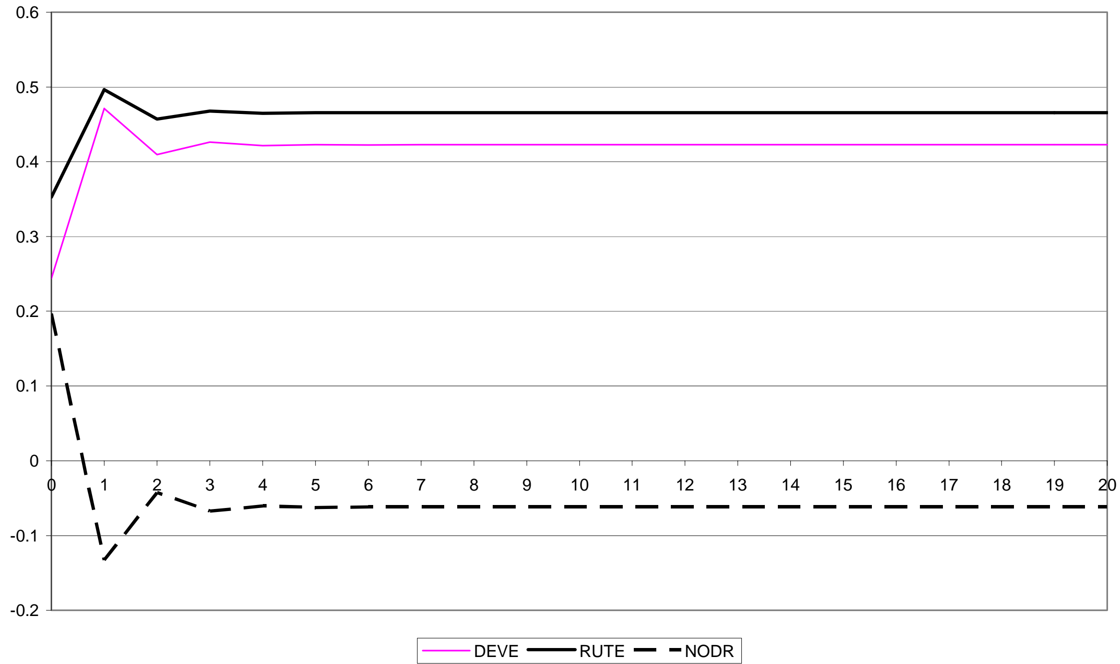
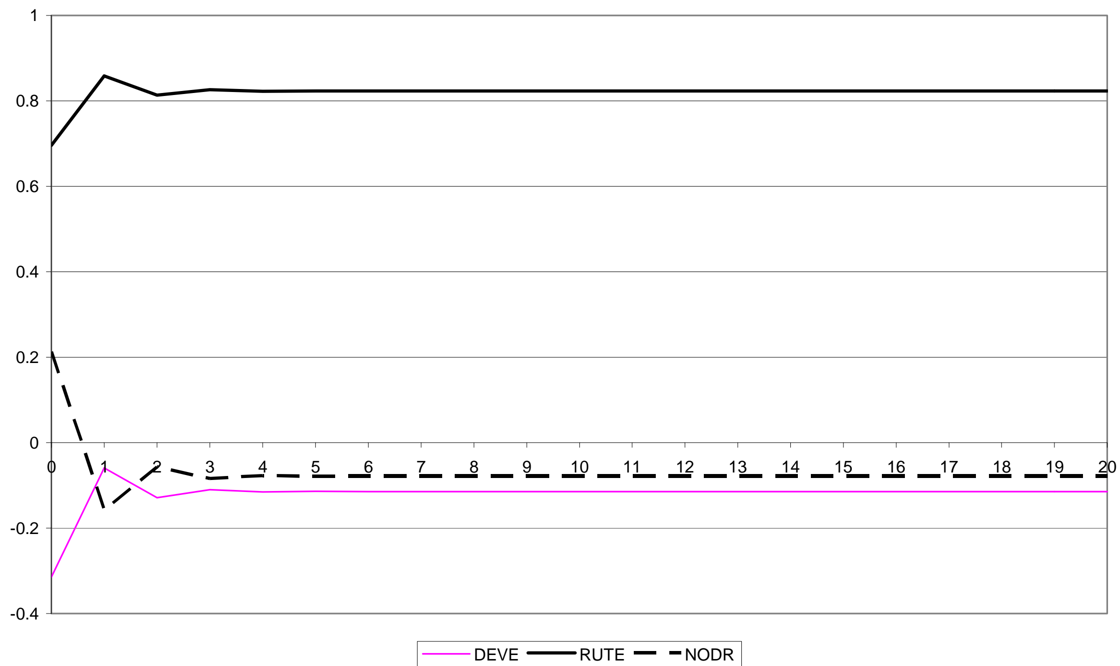
Appendices

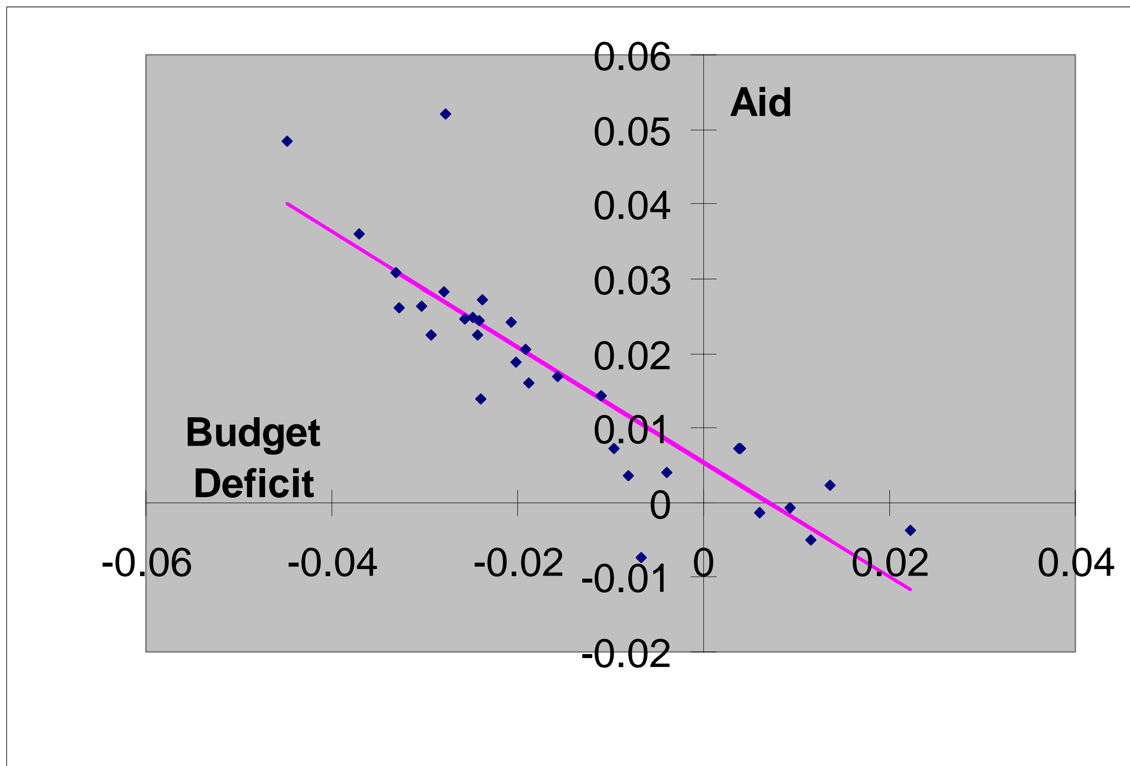
Appendix 1: Fiscal response to Aid flows

Effect of one standard deviation shock of PROJECT AID on development and routine expenditure and non-oil revenue



Effects of one standard deviation shock of PROGRAM AID on development and routine expenditures and non-oil revenues




0.06
Aid
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0.04
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0.02
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Budget
Deficit
0
-0.06
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